SMALL BUSINESS WHITE PAPER

POLICY OPTIONS FOR AUSTRALIA

IPA INSTITUTE OF PUBLIC ACCOUNTANTS®

BACKGROUND TO THE INSTITUTE OF PUBLIC ACCOUNTANTS AND THE IPA DEAKIN UNIVERSITY SME RESEARCH PARTNERSHIP

The Institute of Public Accountants (IPA) is one of the three legally recognised professional accounting bodies in Australia. The IPA was established in 1923 and has grown rapidly in recent years to represent more than 35,000 members and students in Australia and in more than 80 countries. The IPA has offices around Australia and in London, Beijing, Shanghai, Guangzhou, Kuala Lumpur and Hong Kong. It has a range of partnerships with other global accounting bodies. The IPA is a full member of the International Federation of Accountants and has over 6,000 individual accounting practices in its network, generating in excess of $2.1 billion in accounting services fees annually. The IPA's unique proposition is that it is for small business; providing personal, practical and valued services to its members and their clients/employers. More than 75 per cent of IPA members work directly in or with small business every day. The IPA has a proud record of innovation and was recognised in 2012 by BRW as one of Australia's top 20 most innovative companies.

In 2013, the IPA partnered with Deakin University to form the IPA Deakin University SME Research Partnership, a first in Australia. The goal of the partnership is to bring together practitioner insights with cutting edge SME academic research to provide substantive policy input. This Australian Small Business White Paper builds upon the solid work plan that has delivered a range of SME policy events and publications to date.

The IPA Deakin SME Research Partnership comprises:

Chair Andrew Conway FIPA
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Professor Peter Carey
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FOREWORD

The Institute of Public Accountants (IPA), together with the IPA-Deakin University SME Research Partnership, is very pleased to present what is a first for the Australian small business sector; an industry-led Small Business White Paper. We have developed this paper to extend a new, robust and credible voice for small business, backed by rigorous research, practitioner insights and industry views.

The insights and inputs we have collated from key stakeholders and from over 500 small business people will play a key role in small business advocacy. Whilst we must be realistic in relation to what can be achieved by this initiative, the IPA is committed to facilitating an ongoing discourse to ensure that when small business speaks, it does so with the support of industry and evidence, and on a platform that aims to boost productivity of our small businesses.

The IPA has a long-standing and direct affiliation with small business. Our 35,000 members and students across Australia and in over 80 countries around the world have a primary focus on small business. In fact, more than 75 per cent of our members work with the small business sector. Because small businesses trust their public accountants, we are uniquely placed to bring their insights to the public policy debate.

The relative importance of small business as a driver of Australia's productivity is increasing rapidly. Following the release of the Australian Treasury publication *Australia's Productivity Challenge*, it is abundantly clear that with the changing composition of Australia's growth in income per capita, the need to foster greater productivity in the SME sector is critical. This must involve a foundational policy recalibration. The economic policy setting for the nation and addressing the longer term structural challenges facing Australia are crucial to charting a sustainable future for small business. To this end, it is vital to start with re-setting the policy debate. In recent times, there have been disparate and confused messages coming from different SME segments of the Australian economy, which in turn have led to conflicting and confusing policy discourse. Given their most trusted adviser status for small businesses (CCH 2012), Australia's public accountants are, in our view, uniquely well placed to consolidate the varying issues, to reconcile some of the conflicting views and to provide well-resourced, considered policy input.

As Chair of the IPA Deakin University SME Research Partnership, I would like to thank the partnership team. Specifically I would like to thank Professors Peter Carey, Julie Clarke, Philip Clarke, George Tanewski George Tanewski and Vincent Bicudo de Castro from Deakin University and Professors Marc Cowling (Brighton Business School), Gordon Murray (University of Exeter) and Paul Nightingale (University of Sussex) for their academic contributions to the White Paper, while Ms Vicki Stylianou and Mr Tony Greco FIPA and Mr Wayne Debernardi are acknowledged for their invaluable practitioner input.

Professor Andrew Conway FIPA
Chief Executive Officer & Chair IPA Deakin University
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EXECUTIVE SUMMARY

The principal purpose of this Small Business White Paper is to present policy options for Australia to deal with a looming economic crisis which has the potential to rival or even surpass the recession of the early 1990s.

After more than two decades of prosperity driven by booming prices for mineral exports, Australia now faces the real prospect of a sustained fall in living standards. A deteriorating federal budget and higher unemployment are obvious symptoms of our predicament. But at the core of the nation's economic problem is its failure to lift business productivity for much of the past 15 years – which is to say that Australia's businesses collectively are barely more efficient than they were at the start of this century. The mining boom, while it lasted, was an adequate cover for the economy's failings. Now that the boom appears to be over, Australia's underlying economic vulnerabilities have been exposed and remedial action is needed. While much of the public and media focus tends to be on big business, it is clear that lifting productivity in the small and medium-sized business sectors will hold the key to our chances of avoiding recession, and directing Australia into a new era of prosperity.

The challenge cannot be over-stated. Prolonged stagnation in the productivity performance of small and medium-sized businesses is borne out in an alarming series of statistics and survey data from the Australian Bureau of Statistics, which have been analysed in detail for the first time in this White Paper. Among the survey findings are that:

- Australian firms have been going backwards since 2007 on seven key indicators – product differentiation, profits, productivity, exporting, outsourcing, training and IT expenditure.
- Only 1 in 7 businesses consider innovation is important.
- Only 1 in 8 businesses have an international market presence.
- Many medium-sized, well established firms with the potential to expand into international markets consider only the national market as their end goal.

A key objective of this paper is to bring about a foundational policy recalibration, away from discussion about the federal budget, and towards a focus on the small business sector and how it can assist in lifting Australia's national productivity. Small business is a huge component of the economy, accounting for nearly one-half of private sector employment and one third of private sector industry value added. It will be critical in helping to revitalise Australia's productivity.

There is a large body of research and evidence indicating that governments and small business need to focus on three key elements or 'pillars' – human capital (people), financial capital (investment) and technological change (innovation) – to achieve the end goal of building a more productive and dynamic small business sector. And to achieve the best outcomes, the three pillars must work in combination. It is only when firms have a strong pool of skilled and talented people that it makes sense to invest in new technology, plant, machinery or research and development. This has clear implications for government policy: it will require well-targeted and co-ordinated responses across the various departments that deal with these issues.

This paper contains a number of key policy recommendations, focusing particularly on the key pillars required for a more productive and dynamic small business sector.

Recommendation 1 – State-backed loan guarantee scheme: To increase the availability of much-needed affordable loan finance to the small business sector, the Federal Government should introduce a state-backed loan guarantee scheme. Australia is currently one of the only countries in the developed world without such a scheme. The scheme would provide a limited state-backed guarantee to encourage banks and other commercial lenders to increase loan finance available to small business. The White Paper identifies a number of specific problems that smaller firms have in accessing finance from commercial banks, particularly younger start-up firms. Our evidence suggests that, by international standards, the cost of debt for Australian small businesses is high. Hence, there is a strong case for designing and implementing a loan guarantee program 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, loan guarantee programs can deliver value for taxpayers through their support of employment growth, productivity, innovation and exporting.

In addition, the Federal Government should:

1. Pilot a general SME guarantee scheme exclusively for capital investment projects, with a maximum loan of A$100,000, a maximum term of 5 years, a guarantee level of 65 per cent and an interest premium of 3.5 percentage points over the retail bank loan rate.
2. Pilot an exporting SME guarantee scheme exclusively for international market development projects, with a maximum loan of A$200,000, a maximum term of 10 years, a guarantee level of 75 per cent and an interest premium of 2.5 percentage points over the retail bank loan rate.

Recommendation 2 – Venture capital: The Federal Government should introduce a publicly supported venture capital (VC) fund to ensure that risk capital is made available to high potential young firms. The White Paper highlights the funding problems faced by young firms in uncertain technological or new knowledge environments, particularly because of their unattractiveness to bank lenders. It is a lost opportunity to the economy when innovative firms with a high commercial potential are constrained by the absence of external finance. Accordingly, governments with a strong commitment to economic growth via research and development (R&D) investment and innovation must find a means to ensure that early-stage VC finance remains available to high-potential, young firms. Specifically, we recommend:

- The establishment of a pilot scheme to pool public funds with private sector VC firms exclusively for capital investment projects for small and medium-sized enterprises developing new R&D products or services. The scheme would involve a maximum public exposure of AUD$2 million on an equal basis with private sector VC firms.

Recommendation 3 – Innovation policy: Australia needs a rethink of public policy to realise the massive potential for innovation in the SME sector and, by extension, to achieve increased national productivity and economic prosperity. There is very little cooperative behaviour between Australian businesses, which creates a barrier to the spread of existing innovations to a wider cross-section of firms. This represents a significant lost opportunity to the economy.

To promote increased innovation across the Australian SME sector, we propose:

- More government support for R&D by small and medium-sized firms.
- Better linkages between cutting-edge research universities and industry.
- Government support for firms to adapt existing technologies and innovation.
- Measures to help the spread of existing innovations to a broader range of firms.
- Encouragement to firms to adopt 'continuous improvement' methods to embed incremental innovation, as this will generate large productivity improvements quickly.
- In addition, the focus of public policy towards entrepreneurs should shift from quantity to quality, with resources directed towards a smaller percentage of firms that have the potential to grow. To these ends, we recommend that the Federal Government should:
- Provide tax breaks for companies acquiring new technologies not developed in-house.
- Develop a 'matching' service to promote the development of collaborative relationships between multinational corporations and Australian businesses both domestically and abroad.
- Provide a tax allowance for companies investing in intellectual property protection (through patents, copyright, trademarks, design rights etc.) in-house.
- Provide a tax allowance for companies that generate licensing income from in-house new technologies.

Recommendation 4 – Revamp education and training: To address the significant skills deficit in the economy, governments (federal and state) need to reform the education system to increase and improve the nation's stock of skilled, knowledge-based workers. Our research shows that 1 in 6 small businesses face a skills deficit, and 391,000 businesses are constrained in their efforts to innovate by a lack of skilled labour – imposing a significant drag on the economy. Deficiencies are most apparent in trades, but many businesses also report shortages of finance professionals, marketing professionals and IT professionals. Our results suggest that governments should consider the inclusion of business training at all levels of the education system, from early school years through to further and higher education. Specifically, we recommend that:

- Entrepreneurship programs should be integrated into the National Curriculum at all levels of secondary school.
- STEM (science, technology, engineering and maths) subjects should be promoted and financially supported for all secondary school students.
- Small and medium-sized enterprises employing STEM graduates should receive a training and development allowance for the first year of their employment.

Recommendation 5 – Government regulation: Despite the efforts of governments to reduce bureaucratic red tape, many small and medium-sized businesses continue to be hobbled by poorly designed, poorly targeted or excessively enforced government regulations. Ultimately, of course, there can be no total victory in the war on red tape; some regulation will always be necessary in a civilised society. But governments must remain vigilant in the fight against excessive regulation, in all its forms. To this end, we recommend that:

(i) A European Union-style 'think small business first' approach to the design and implementation of regulations be adopted by governments in Australia, which have historically focused too much on the 'big end of town' when approaching regulation.

(ii) Regulations should be made more effective by identifying the minimum required to meet regulatory objectives.

(iii) Governments and regulators should improve regulator culture. This can be achieved by:

- Promoting a 'risk-based' approach to enforcement of regulations, focusing mainly on enterprises considered to present the greatest risks to society from non-compliance.
- Enforcing regulations in a proportionate way.
- Placing more emphasis on education of small businesses on how to do the right thing, rather than enforcement and punishment of those who transgress.

Recommendation 6 – Fair Work laws and competition policy: The Fair Work laws are a source of major confusion and expense for many businesses. More clarity is needed, specifically, over the issue of classifying people as either independent contractors or employees. Accordingly, the Government should simplify the industrial relations system for small business owners by:

- Reviewing the award system to make it more flexible for small businesses to suit the current economic conditions and to ensure that Australian small businesses remain globally competitive.
- Legislating to give more clarity to businesses on the distinction between people being engaged as independent contractors or employees.

The unconscionable conduct and unfair contract terms provisions of the Australian Consumer Law do not adequately protect SMEs from becoming victims of price gouging or price squeezes. This White Paper recommends that:

- The Australian Consumer Law be amended to make it clear that it is unconscionable conduct for a firm to use its superior bargaining power to force a customer (or supplier) to accept an unfair price, and to make void a contractual term specifying an unfair price.
- Section 46 of the Australian Consumer Law be amended to strengthen the prohibition on firms from using their market power to substantially lessen competition, and to remove the 'take advantage' element from the existing prohibition in Section 46(1).

Recommendation 7 – Taxation: To encourage growth, productivity and employment, Australia needs tax policies designed to drive business activity and entrepreneurship. The May 2015 federal budget initiatives to cut the company tax rate for small businesses, and to provide an income tax discount for business owners who do not use a company structure, are welcome steps in the right direction. Importantly, the changes are an acknowledgement by the Government of the disproportionately high burden of compliance that small businesses bear from regulation, relative to larger businesses. But the changes do not go far enough. Immediate and more substantial tax incentives must be offered to entrepreneurs and innovators.

Recommendation 8 – Exporting: The Australian Government should prepare an overarching trade policy strategy that identifies impediments to trade and investment and available opportunities for liberalisation, and that includes a priority list of trading partners. Within the strategy, special attention should be given to small business and SMEs and the particular problems and impediments that they face in developing export markets for their goods and services.

In the coming decade, we will have to become significantly more reliant on local businesses producing goods and services faster, smarter and cheaper than rivals.

CHAPTER 1:
THE IMPORTANCE OF SMALL BUSINESS AND PRODUCTIVITY

Introduction

Australia has enjoyed an unprecedented period of sustained economic growth in recent decades. Gross national income has risen steadily at rates seldom seen since federation. And it is no secret that our national prosperity and rising living standards have been underpinned by a boost in on our terms of trade brought on by bullish demand for our minerals, particularly from a booming China.

Now that the minerals boom has ended, however, the outlook for Australia is much gloomier. The federal Treasury has forecast that the composition of our growth in income per capita will change dramatically in the next decade, and that we will no longer be able to rely on our terms of trade to boost our prosperity.

How, as a nation, can we respond to this? From where will we source our next phase of growth? According to the best brains in Treasury and industry, the economic 'stop-gap' to this game-changing turn of events must be productivity in small business. In the coming decade, we will have to become significantly more reliant on local businesses producing goods and services faster, smarter and cheaper than rivals.

The change cannot come soon enough. For much of the early part of this century, Australia's productivity performance has been lagging compared with other developed nations, as well as with our own performance in the later decades of the 20th century. Despite a welcome lift in our labour productivity performance in three years to the end of 2013-14, the most recent update from the Productivity Commission (July 2015) confirms a continuation of weakness on the broad measure of multifactor productivity. The Commission reported that multifactor productivity increased by just 0.4 per cent in 2013-14, and some industries recorded negative figures. Measured over the period 2007-08 to 2013-14, annual multifactor productivity growth in the market sector remains negative (at -0.1 per cent). As noted by Productivity Commission Chairman Peter Harris in the July 2015 update, Australia's productivity performance has remained ''well below what is required to maintain our historical growth in living standards''.

The authors of this paper believe that reliance on productivity to maintain our national income levels requires a seismic shift in government policy. Small businesses are the engine room of the economy, and must rise in prominence as a source of fundamental economic reform.

What is productivity and why does it matter? The New Zealand Productivity Commission has a succinct definition: Productivity is about how well people combine resources to produce goods and services. For countries, it is about creating more from available resources – such as raw materials, labour, skills, capital equipment, land, intellectual property, managerial capability and financial capital. With the right choices, higher production, higher value and higher incomes can be achieved for every hour worked.

Generally, productivity matters because the higher the productivity of a country, the higher the living standards that it can achieve and the more options it has to choose from to improve well-being. Well-being can be increased by things like quality healthcare and education; excellent roads and other infrastructure; safer communities; stronger support for people who need it; and improved environmental standards. High productivity societies are characterised by smart choices about savings and investment versus current consumption; dynamic and competitive markets; openness to trade and to international connectedness; high awareness of external influences; rapid uptake and smart application of new technologies, products and processes; and increasing demand for highly skilled and creative people. These are the successful societies that attract and retain people, ideas and capital.

So how do you unleash the potential of small businesses to produce goods or provide services that are faster, smarter and cheaper?

Faster

We don't just need to look at the cost of regulation (which of course is important), but we must recognise that one of the greatest finite resources that small business owners have is time. We should be prioritising the unnecessary regulations that cost businesses time and remove them. This time can be reinvested into businesses to enable them to grow and enhance productivity by boosting output.

Smarter

Immediate concessions should be granted to small businesses to enhance their R&D capabilities, with a specific focus on deployment of technology to improve production processes, streamline operations and leverage data. Consideration should also be given to direct assistance to ensure small businesses are positioned to capitalise on social media commerce.

Cheaper

Consideration should be given to provision of tax concessions to small businesses that undertake innovative practices, deliver a productivity dividend or develop an innovative strategy to employ and up-skill new or existing employees. This will lower the input costs and provide a greater productivity yield. The Government should be setting a lofty goal of turning Australia into the best place to start and operate a small business in the world. This means a preferential taxation system, long term investment in technology, simpler industrial relations and, importantly, a focus not just on barriers to entry, but on barriers to exit.

The downward trend in productivity is statistical proof that it has been getting tougher for small businesses due to rising input costs driven by the cost of the small business supply chain. Whilst it may be difficult in the short term to address many of the input costs (with the exception of taxation reform), reductions in regulatory time, increased incentives to use technology and enhanced competition protections would greatly assist in boosting output and, in turn, our nation's productivity.

This economic backdrop will provide considerable context to this landmark White Paper. Identifying the policy settings and parameters to facilitate productivity in small business will be a key contributor to ensuring Australia's longer term prosperity is secured.

Our vision with this White Paper is to harness the support of governments and the small business sector so that they can both contribute to a sustained increase in Australia's productivity. We see the role of government as a facilitator and promoter that aims to create an increasingly dynamic small business sector that can generate jobs, create and sustain innovation, and be internationally competitive. To do this we need to understand the characteristics of Australia's small businesses – their current capabilities, their latent potential, the factors critical to achieving successful outcomes and the factors that are constraining small businesses.

A role for government

The key role for government is, first, to identify market failures or gaps in these key business performance areas and, second, to design appropriate policy responses. To achieve this, we first need to build an evidence base that will help us understand the nature and extent of the market failures and gaps for small businesses, and how these failures and gaps constrain small businesses from achieving better outcomes. Only then can we design and target effective policy action.

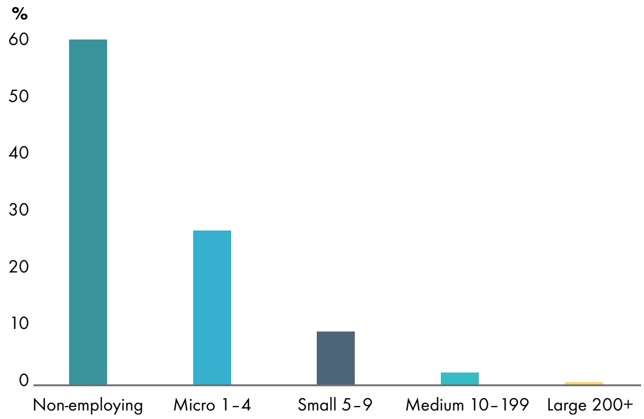
The importance of small business in the economy

This White Paper draws upon multiple data sources to map the characteristics of Australia's small businesses. Chief among our sources is a unique dataset obtained from the Australian Bureau of Statistics – the 'Business Longitudinal Database (BLD) Confidentialised Unit Record File (CURF)' for the financial years 2006-07 to 2010-11. The dataset contains the most recent information available in this form and is analysed in detail for the first time in this White Paper. It has provided us with invaluable – and in some instances quite worrying – trend information related to the small business sector of the economy.[1]

The ABS (2001) defines a micro-business as having fewer than 5 employees. A small business is defined as having 5–19 employees and a medium-sized business has 20–200 employees.

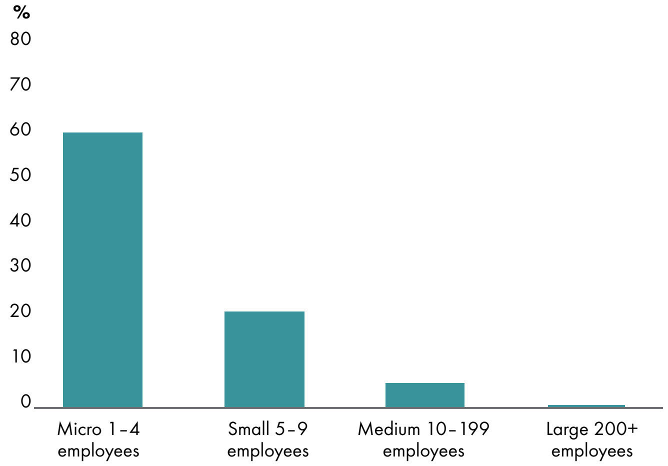
In June 2013, there were 2.08 million actively trading businesses in Australia (ABS, 2014). Of these, 1,264,298 (60.8 per cent) had no employees, 563,412 (27.1 per cent) employed fewer than 5 people, 197,412 (9.5 per cent) employed between 5 and 19 people, 50,946 (2.4 per cent) employed between 20 and 199 people, and 3,598 (0.17 per cent) employed more than 200 people.

Figure 1: The size distribution of non-employing and employing businesses actively trading in Australia, June 2013



1 The dataset is based on a sample of 3075 businesses classified by industry and size, and surveyed over five reference periods from 2006-07 to 2010-11. The dataset excludes large businesses (with 200 or more employees) and industries dominated by government enterprises, finance and insurance companies, or those classified as not-for-profit. As the survey is designed to measure micro drivers of small and medium-size business performance over time, we examine a sub-set sample of small businesses across a number of characteristics highlighted in this report.

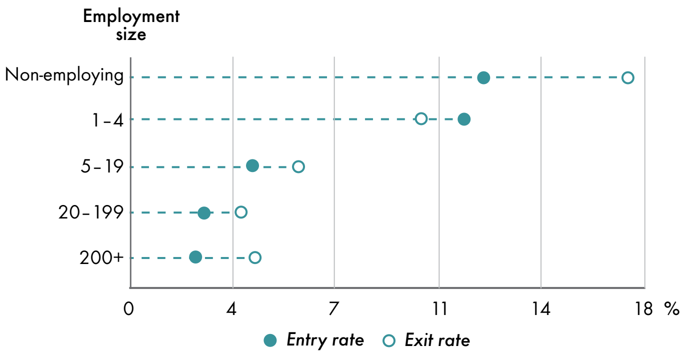
Figure 2: The size distribution of employing businesses actively trading in Australia, June 2013



While there was modest growth in the number of businesses actively trading over the period 2009-2013, new firm entry rates declined from 16.7 per cent to 11.2 per cent, and exit rates rose from 13.1 per cent to 14.1 per cent. Of the stock of firms that were trading in 2009-10, 62.9 per cent were still operating in June 2013. For new firms that entered in 2009-10, only 47.5 per cent were still in operation 3 years later.

Figure 3: Entry and exit rates by firm size

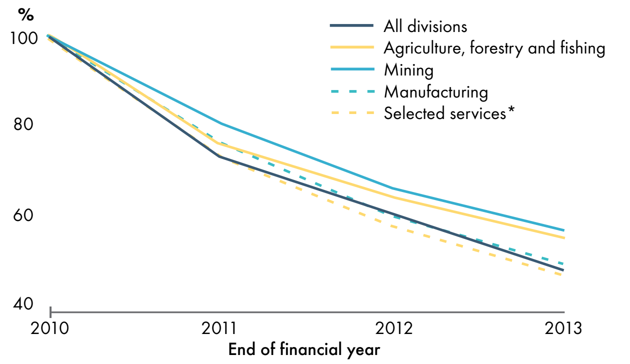
Entries and exits by employment size range as a percentage of business counts at the start of the financial year 2012–13



Source: ABS Catalogue Number 8165.0 (ABS, 2014)

Figure 4: Survival rates of newly established firms, 2009–10

Survival of entries by ANZSIC Division as a percentage of business entries during financial year 2009–10



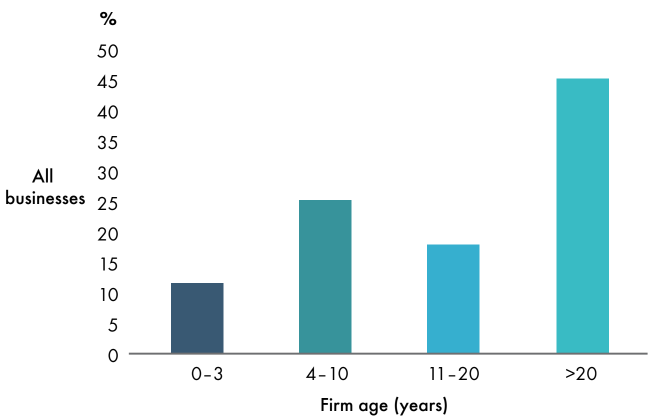
*Comprised of wholesale trade; retail trade; accommodation and food services; information media and telecommunications; financial and insurance services; rental, hiring and real estate services; professional, scientific and technical services; administrative and support services; public administration and safety; education and training; health care and social assistance; arts and recreation services.

Source: ABS Catalogue Number 8165.0 (ABS, 2014)

The construction sector had the highest number of individual businesses of any industry (328,486) in 2013. But the highest number of new entrants in 2012-13 were in accommodation and food services (13.6 per cent) and public administration and safety (12.4 per cent). The highest exit rates were in administrative and support services (18.6 per cent) and public administration and safety (18.2 per cent).

Over long periods, the size distribution of this changing stock of firms is fairly static. Figure 5 highlights that a large proportion of the business stock (63.1 per cent) comprises well-established firms that have been trading for longer than 11 years.

Figure 5: The age distribution of Australian businesses

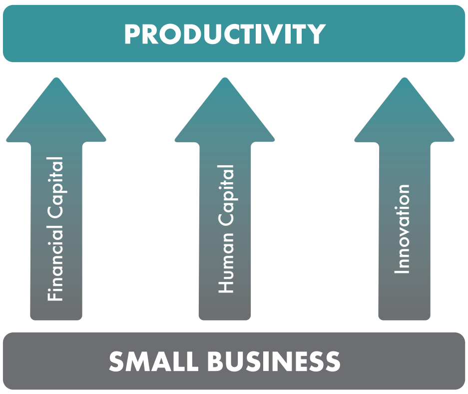


Source: ABS Catalogue Number 8165.0 (ABS, 2014)

The 3 pillars of productivity

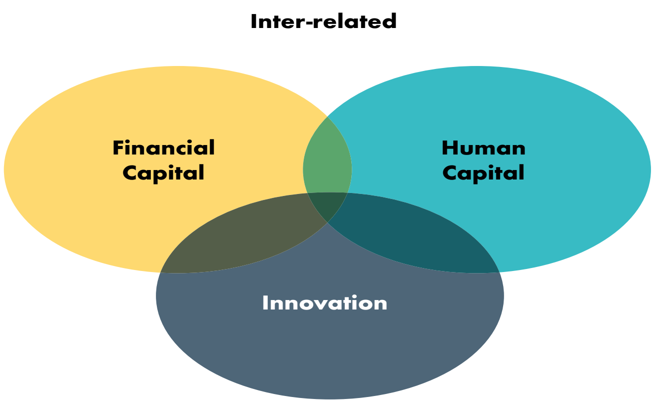
Figure 6 graphically displays the 3 key elements (pillars) on which we believe government and small business need to focus if Australia is to build a more productive and dynamic small business sector. Drawn from the economic theory of the production function, the 3 pillars are human capital (people), financial capital (investment) and technological change (innovation).

Figure 6: The 3 pillars of productivity



All 3 pillars have been found to be critical – both individually and collectively – to productivity and economic growth since the formal development of a theory of the production function by Charles Cobb and Paul Douglas in 1928, and the later work on economic growth by Robert Solow and Trevor Swan in 1956, which related economic growth to increases in labour, capital, and technical progress. More recent developments, such as endogenous growth theory[2], emphasise the important role of producing new technologies and human capital. Wider applications of these models relate economic growth to openness, competition, change and innovation.

Figure 7: The inter-relatedness of the 3 pillars

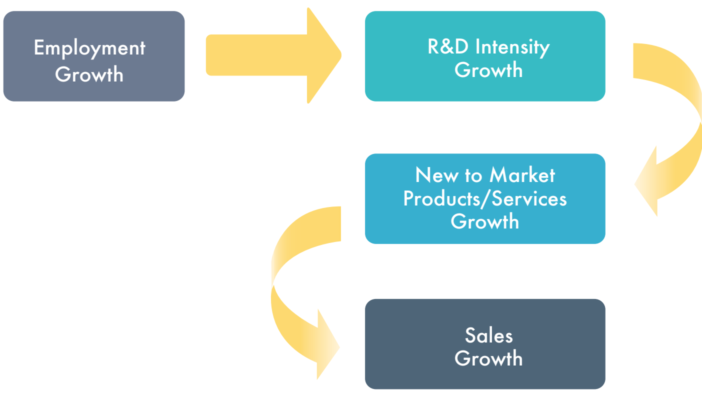


2 Romer (1994)

While it is clear that focusing on any one of the 3 pillars is preferable to doing nothing in terms of productivity growth, there is strong evidence of a high degree of complementarity between the pillars. Even within each pillar there are likely to be internal complementarities. For example, Milgrom and Roberts (1993) argued that while product or process innovation will ultimately lead to higher profit, undertaking both simultaneously, or in close sequence, will lead to higher profit than simply adding the two together.

Moreover, a 2014 study empirically showed that there is a set of causal and sequential building blocks that must be in place to secure long-term growth from innovation at the firm level. Importantly, even if a firm has all these building blocks, they only work in a unique sequence.

Figure 8: Growth through innovation: The sequential building blocks

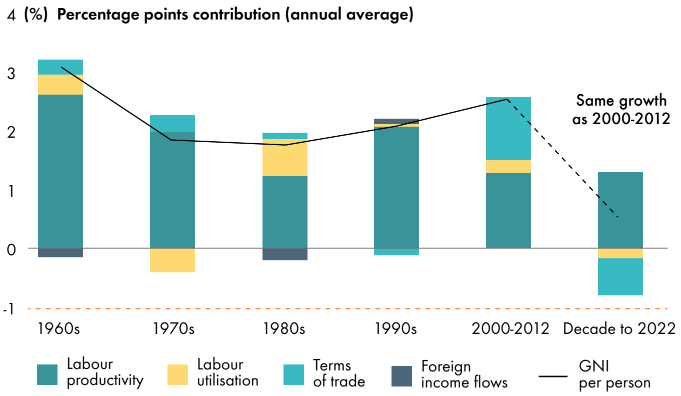


Source: Coad et al. (2014)

Here, the first sequential building block involves expanding the human capital available to the firm. For technology firms, this explicitly means having people with Science, Technology, Engineering and Maths (STEM) graduate capability. But the general point holds for all firms. People take time to integrate into a new employment setting. It is only when the firm has a strong pool of human capital (skilled and talented people) that it makes sense to invest in physical assets (such as new technologies, plant or machinery) or commit more expenditure to R&D. New investment expenditure without the human capability required to fully exploit it will lead to improved, but sub-optimal, outcomes.

This does present some potential problems for government and policy makers seeking to support small businesses as the three sequential building blocks cut across ministries and departments. The first block, which refers to labour force skills, would typically be associated with the Education Department on the supply side, and the Employment Department on the demand side. The second block relates essentially to investment, and would cut across the Treasury and Business Departments. The final building block would typically be associated with the Innovation and Science Department in the case of technology firms, and Business Department in the case of low-tech firms.
So when governments can identify and justify intervening in markets relevant to the growth and development of the small business sector, the responses must be co-ordinated across relevant departments. In particular, the rate at which small businesses can absorb new workers and new capital expenditure in a productive combination must be carefully considered.

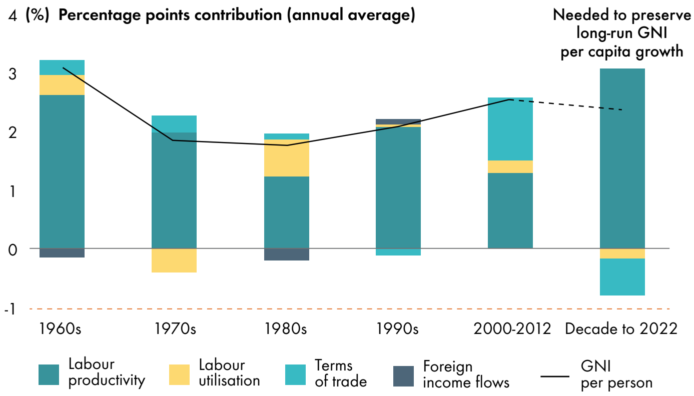
Figure 9: Contributions to growth in average incomes – same LP growth as last 'decade'



1.3% labour productivity growth and no contribution from foreign income flows assumed to 2022

Source: Peter Harris, Chairman, Productivity Commission, 29 May 2014.

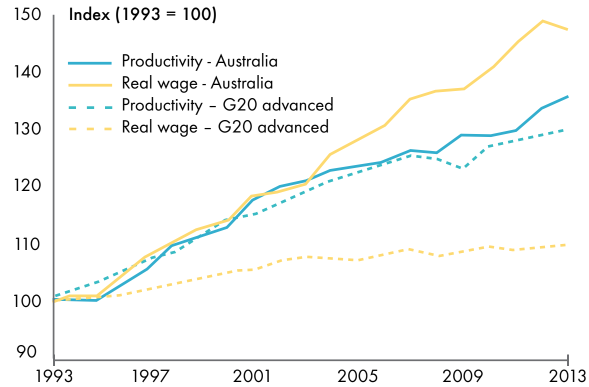
Figure 10: Contributions to growth in average incomes – needed for long-run GNI growth



No contribution from foreign income flows assumed to 2022.
Long-run GNI growth of 2.3% a year.

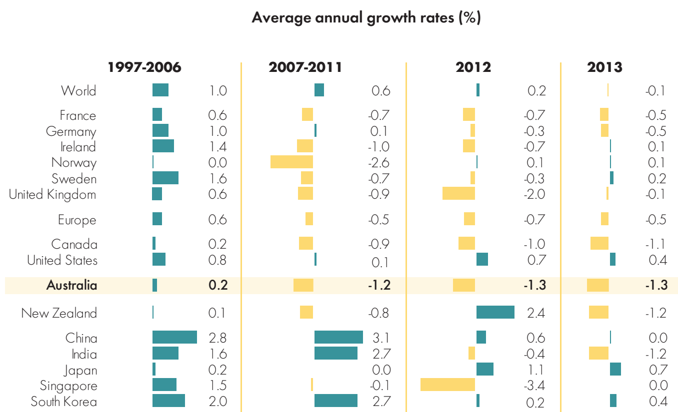
Source: Peter Harris, Chairman, Productivity Commission, 29 May 2014.

Figure 11: Labour productivity and real wages – Australia and G20



Source: Peter Harris, Chairman, Productivity Commission, 29 May 2014.

Figure 12: Multifactor productivity growth in selected countries and regions



Source: Peter Harris, Chairman, Productivity Commission, 29 May 2014.

It would appear that the national market is the end goal for many medium-sized firms – including those with the potential to expand offshore – and this represents a missed opportunity for Australia.

CHAPTER 2:
CREATING A DYNAMIC SMALL BUSINESS SECTOR

Headline findings

The stock of businesses

- Around 10 per cent of businesses at any point in time are young firms.
- Six in 10 businesses are very well-established and unlikely to fail.
- One half of all new firm entrants do not survive their first three years in business.

Strategic issues

- Businesses are under increasing cost pressures.
- Fewer than 50 per cent of businesses explicitly focus on financial measures.
- Innovation is only important for one in seven businesses.
- While the focus of attention has largely been on the mining industry and property market boom, our evidence suggests that the strongest sectors of the economy going forward – the ones most able to deliver productivity growth and exports – will be the wholesale industry (comprising businesses mainly engaged in the resale of new or used goods to businesses or to institutional users) and the communications industry.

Performance

- Since 2007, the general trend across a wide range of measures related to productivity and growth in Australia has been downwards.
- A lack of investment in skills development and IT in the past few years could have negative competitive and productivity effects in future years.
- The relative lack of expenditure on training and IT suggests that the retail, hotels and catering, transport and real estate sectors of the economy are likely to find it more difficult to achieve productivity gains.

Competition, markets and customers

- Only one in eight businesses have an international market presence.
- The national market is the end goal for many medium-sized, well established Australian firms that have the potential to expand into international markets. This may represent a missed opportunity for Australia.
- There is little evidence that well-established firms extend the geographic reach of their operations over time.
- Many businesses are overly dependent upon a small number of key customers.
- One in seven businesses are at severe risk of failure due to the narrow nature of their customer base.
- Compared to large firms, medium-sized firms face more competitive pressure in markets, and this has made them more efficient and focused on achieving cost reductions and productivity gains.

Introduction

While it is a widely held view that entrepreneurs are largely motivated by the desire to maximise profits, empirical evidence suggests that there are many non-pecuniary motives for running one's own business[3]. Hence, it might be more appropriate to consider the entrepreneur as someone who seeks to satisfy a minimum income threshold, while also deriving utility from independence and control over personal working time and arrangements[4]. These considerations hold even for established entrepreneurs. This is why Professor Andrew Henley, in a 2004 longitudinal study of UK self-employment, found that there was a very high level of state dependence in self-employment compared to waged employment. That is to say that once an individual starts their own business, their preferred option is to remain in charge of that business even when it is not generating enough income – unless they are forced out of the market. Yet this feature of entrepreneurs can also be harnessed by policy makers if it can be shown that government initiatives to support small businesses have the potential to improve their long-term capacity to survive.

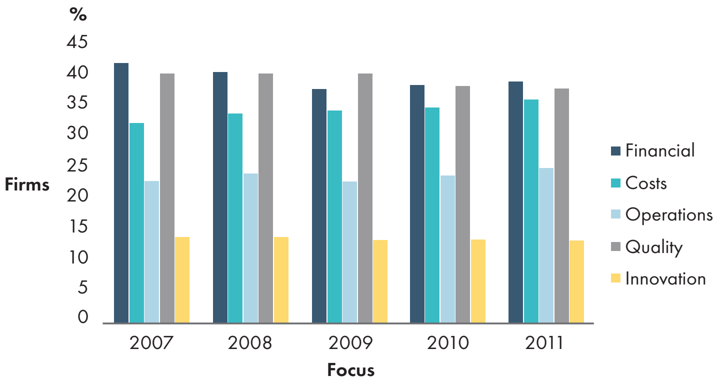
3 Taylor (1996)

4 Eisenhauer (1995); Taylor (1996); Cowling and Mitchell (1997); Douglas and Shepherd (2000); Evans and Shepherd (2002)

Strategic focus

The accompanying graph shows that fewer than half of all Australian businesses place major strategic importance on financial measures, and this proportion diminished from 2007 to fewer than one in four by 2011. However, there has been an increasing strategic focus on costs over time, which suggests that profit margins may have been under pressure. Quality is an important strategic focus, but its importance has diminished over time. Innovation is only of major importance to one in seven Australian businesses. Operational measures, often an indicator of micro level productivity, have been increasing in importance over time, but are still only a major focus for one in four businesses.

Figure 13: Firm strategic focus



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

This evidence suggests that:

a) Australian businesses are under more pressure now to reduce costs in order to sustain profit margins, and ultimately entrepreneurs' incomes, and

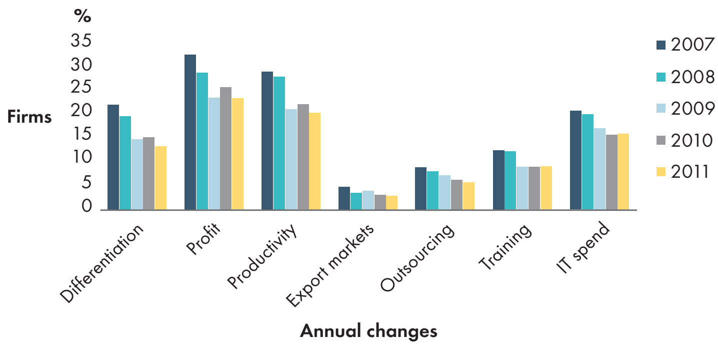
b) There is significant scope for businesses to re-align their strategic planning in order to better reflect the immediate economic environment they face and be better prepared to upgrade their capabilities for the future. Indeed, this scenario creates a potential important role for key business advisers such as accountants (on financial measures and cost reduction), operations management advisers (on operations and quality), and technology advisers in supporting firms to upgrade their innovative capabilities.

There is also an important industry-specific aspect to strategic focuses. We find that firms operating in the wholesale, retail and communications sectors are more focused on financial performance measures than firms in other sectors of the economy. Operational level performance is important in manufacturing, wholesale, transport and communications. Innovation as a strategic focus is far more prevalent among manufacturers, wholesalers and communications firms. Taken as a whole, there is a strong association between international market presence and firms having a strategic focus on financial performance, operational performance and innovation. This is clear in the wholesale and communications sectors in Australia, and to a lesser degree in manufacturing. While the focus of attention has largely been on the mining industry and property market boom, our evidence suggests that the sectors of the economy most likely to deliver productivity growth in coming years will be the wholesale and communications industries.

Business performance dynamics

The remarkable feature of the ABS business longitudinal data is that across seven quite different key indicators, the trend since 2007 has been downwards. Fewer and fewer Australian businesses have observed increases in product or service differentiation, profits, productivity, export markets, outsourcing, training, or IT expenditure.

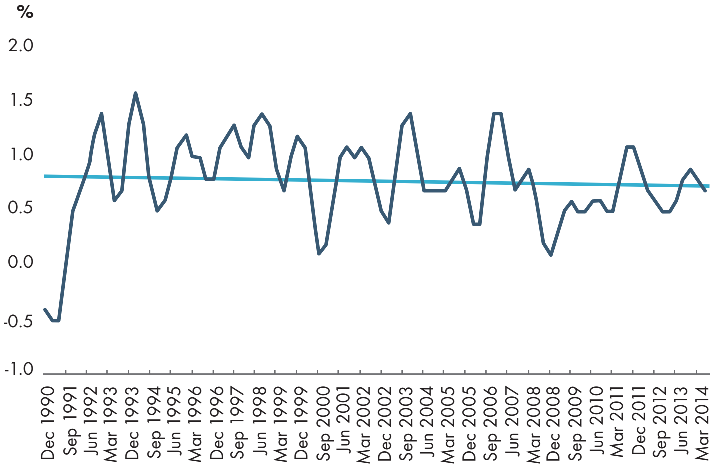
Figure 14: Year to year increases on key measures



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

Fewer than one in four businesses in 2011 were able to increase their profits, and only one in five increased productivity. Many firms have cut their expenditure on training and on investment in human capital, IT and other technology. Fewer firms were able to expand internationally, indicating a lack of global competitiveness. These movements across a broad range of indicators would imply that the emerging productivity problem in Australia is likely to remain an issue for businesses into the future.

Figure 15: Quarterly GDP growth and trend



Source: ABS Catalogue Number 5206.0 (ABS, 2014)

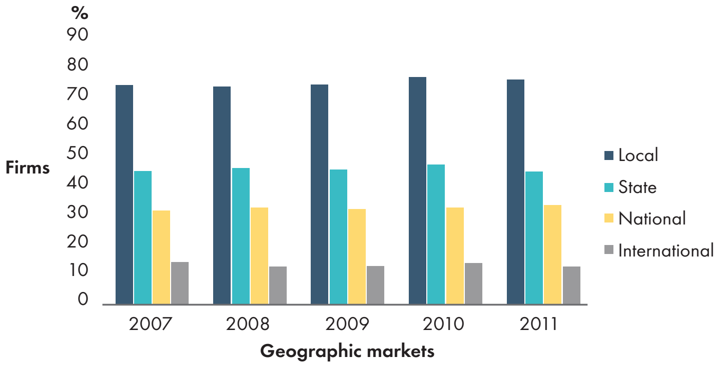
Despite the Australian economy's remarkable resilience in the face of the Global Financial Crisis (GFC) of 2008–09, the overall long-run trend in GDP growth since 1990 has been downwards, from 0.8 per cent per quarter to 0.75 per cent. This problem is exacerbated by a struggling small business sector that is finding it difficult to differentiate its products and services, facing falling sales, and becoming less productive. Equally, the general decrease in commitment to enhancing skills through training and investing in IT means that many small firms will become less competitive in the future.

Firms with 5–20 employees are having particular problems with sales and productivity; they are the least likely to be experiencing growth in sales or productivity, even compared to smaller (1–5 employee) firms. But looking forward, the fact that increases in skills training and IT expenditure are positively associated with firm size suggests that small businesses will be the least well placed to remain competitive.

There are important sector differences in performance too. Agricultural, mining and transport industry firms were comparatively less likely to deliver sales growth. And the poorest productivity performances were found in agriculture, transport and real estate. Looking forward, the relative lack of expenditure on training and IT suggests that the retail, hotels and catering, transport and real estate sectors of the economy are likely to find it more difficult to achieve productivity gains.

Markets and competition

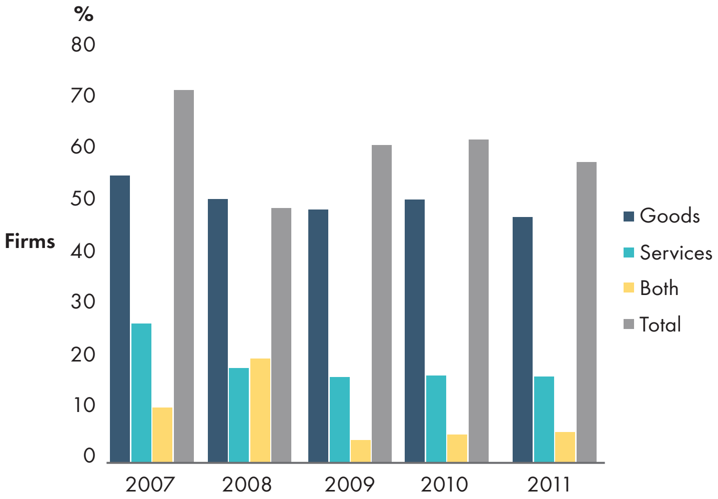
Figure 16: Geographic market reach



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

About 75 per cent of Australian businesses trade only in local markets. Conversely, only one in eight Australian businesses has any international market presence – and the number of businesses with an international presence fell by 31.4 per cent between 2007 and 2011. A more detailed analysis shows that medium-sized firms (20-plus employees) are 18.5 per cent more likely to have an international presence than firms with fewer than six employees, and are 10.1 per cent less likely to operate in local markets. Further, there is no relationship between a firm's age and its geographic market reach – which is perhaps counter-intuitive, as one might expect that experience in business and the capacity to have developed wider and extended networks may assist international market expansion.

Figure 17: Exporting of goods and services

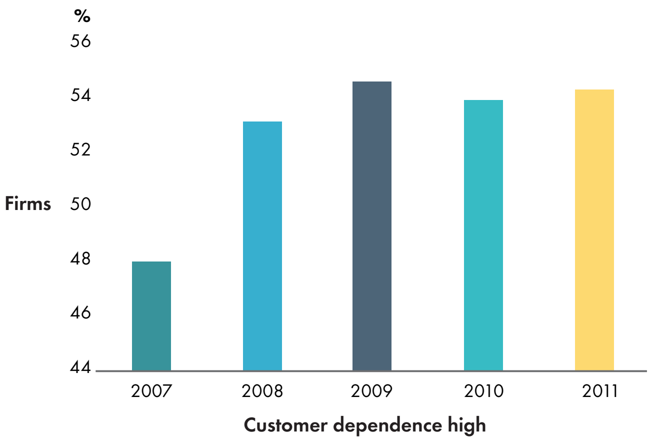


Source: ABS Business Longitudinal Database 2006-07 to 2010-11

Figure 17 highlights the fact that the export of goods, as distinct from services, dominates overall exporting activity. Only 4 per cent of businesses export services, and the general trend in services exporting has been down since 2008. This is despite a global shift towards trade in knowledge-based services, which presents a clear opportunity for Australian businesses.

While there are many structural reasons why it is comparatively more difficult for Australian businesses to internationalise, it would appear that the national market is the end goal for many medium-sized firms – including those with the potential to expand offshore – and this represents a missed opportunity for Australia.

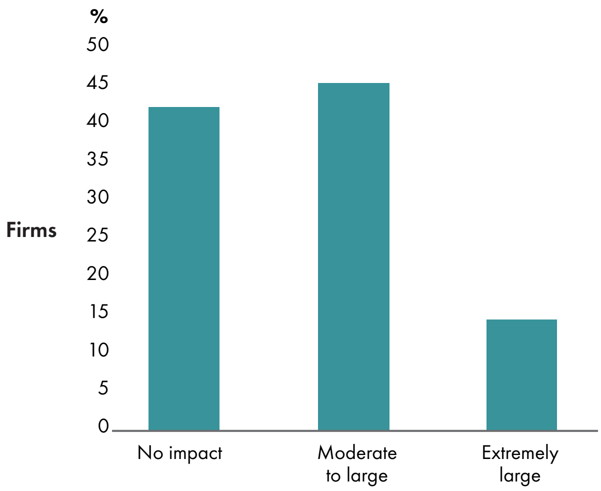
Figure 18: Level of customer dependence



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

The ABS data also reveals that more than half of all Australian businesses are heavily reliant on a small number of key customers, and that this close dependence has increased since 2007 (Figure 18). For four in ten businesses, losing one key customer would have little or no impact on them, but for 44.37 per cent it would have a moderate to large impact, and for 14.19 per cent of businesses the effects would be extremely large (Figure 19). This implies that building and maintaining key customer relationships are critical to the future success of around six in ten Australian businesses. A failure to do so, or unanticipated exogenous factors that alter these relationships, would put many businesses under severe pressure. In this sense, one in seven businesses are at severe risk of failure due to their dependence on a few key customers.

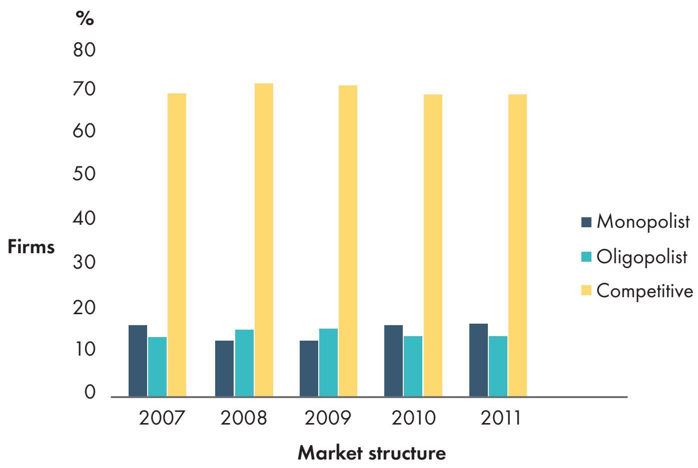
Figure 19: Implications of losing one key customer



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

Since Australian businesses largely trade only in local markets and are heavily reliant on a small number of key customers, from a short-term policy perspective there is a clear case to be made for the proposition that entrepreneurial businesses that create a market niche – or a new market – through the development of new products and services, should be able to capture the returns. But in the long run, society is best served by competition to ensure that resources flow to the firms that can use them most efficiently. Competition acts as a catalyst for productivity increases, which in turn drives economic growth.

Figure 20: Market structure



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

Figure 20 shows that seven out of every ten Australian businesses operate in competitive markets characterised by the presence of similar firms offering similar products or services. This compares to around one in seven that compete against a small number of firms, and one in six that have a monopoly position in their core markets. Smaller businesses can drive competition, which raises productivity and in turn stimulates economic growth. The concept of 'creative destruction' – a term coined by Austrian-American economist Joseph Schumpeter in 1942 – is an important feature of competitive markets that are 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.

One of the unique features of the business landscape in Australia is the positive relationship between firm size and the degree of market-based competition they face; larger firms tend to face more competitive pressure than smaller firms. This could help explain why relatively few smaller firms have achieved productivity gains in recent years. It may also be a pointer to future problems if the economic environment becomes more competitive. In contrast, the medium-firm sector, which faces more dynamic competition, appears to be leaner and generally more productive.

Barriers to business

A good indicator of where government might consider focusing attention comes from businesses themselves: what they report about the barriers they face to ongoing survival and development. The most significant barrier identified by businesses in the ABS business longitudinal data relates to environmental regulation, with 158,000 businesses nominating it as a concern over the 2007–2011 period. The next most important barriers nominated by businesses relate to the general state of the economy, and cost pressures brought about by an increasingly competitive business environment. Labour market issues, particularly skill shortages, rank as the third most important general barrier. The availability of funding from capital markets was the fourth most important concern, with 180,000 businesses citing it as an issue. In contrast, despite the high profile of regulations and 'red tape' as a political issue, regulatory barriers were a relatively minor concern for the vast majority of Australian businesses.

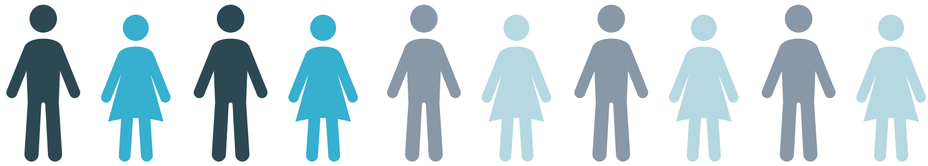
Figure 21: Barriers faced by business

Source: ABS Business Longitudinal Database 2006-07 to 2010-11

The evidence on barriers largely corroborates our other evidence; that the most important barriers reflect the overall decline in the economic environment, more competitive pressures and the struggle that many businesses are facing to increase their productivity and remain competitive. The fact that labour and capital markets are key issues for many businesses suggests that the 3 pillars approach is well grounded.

CREATING A DYNAMIC SMALL BUSINESS ENVIRONMENT

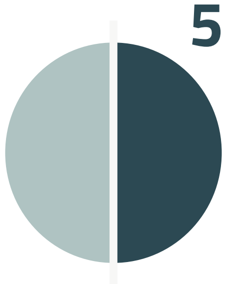
THE STOCK OF BUSINESSES



Six in 10 businesses are very well-established and unlikely to fail

10%

Around 10 per cent of businesses **at any point in time are** young firms



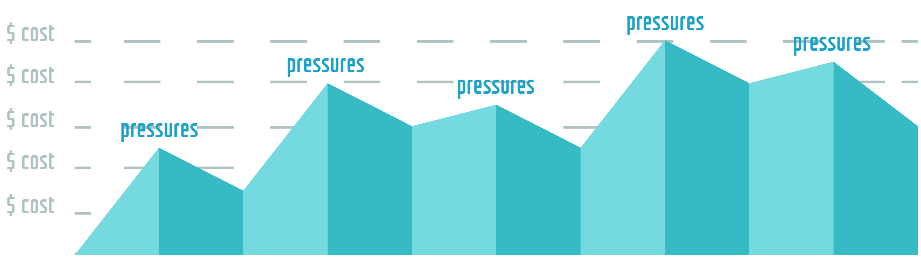
50%

One half of all new firm entrants do not survive their first three years in business

STRATEGIC ISSUES

50%

Fewer than 50 per cent of businesses explicitly focus on financial measures



Businesses are under increasing cost pressures

1/7 Innovation is only important for one in seven businesses

"Irrespective of your profit situation and track record, the banks regard you as a high risk business. For that reason if you want to grow, it's difficult to get finance."

Bob Richards, NT barramundi farmer (Case study: Page 27)

CHAPTER 3:
FINANCIAL MARKETS AND ACCESS TO DEBT CAPITAL

THE CASE FOR A LOAN GUARANTEE SCHEME

Headline findings

- Tens of thousands of Australian small businesses face major constraints in accessing loan finance.
- Loan costs in Australia are high by international standards, and lending practices by Australia's commercial banks are cautious – which potentially results in funding being withheld from many viable businesses.
- The inability of many small businesses to obtain adequate loan finance to fulfil their potential is ultimately a lost opportunity for the national economy in terms of new ideas, new jobs and growth.
- The mismatch between demand and supply of loan finance for small businesses *might* indicate some level of market failure that warrants intervention by the state.
- Australia is one of the only countries in the developed world without a government-funded loan guarantee scheme for the small business sector. It is recommended that such a scheme be introduced in Australia on a modest scale for a trial period.
- External equity, rather than loan finance, is of particular relevance for high growth/high potential young businesses whose current revenue cannot sustain guaranteed payment of loan interest, thereby ruling out debt finance.

Introduction

The subject of financial constraints or credit rationing has been the focus of a considerable body of theoretical work[5]. Research has generally assumed that information-based problems discourage banks from advancing as much credit as entrepreneurs with potentially viable investment opportunities demand, even when they are willing to pay more for these loans[6]. But information asymmetry between lenders and borrowers may not necessarily lead to under-investment. On the contrary, under certain assumptions, the unobservable quality of entrepreneurs may result in investment exceeding the optimal level[7]. On the other hand, informed financiers screening commercially unattractive firms out of the loan market may actually be exhibiting rational behaviour and indicating an efficient market. Conceptualising the small business finance problem from both supply and demand sides would produce a more systemic framework for developing future entrepreneurial policy.

In line with classic credit rationing theories, when loans are not forthcoming to entrepreneurs with viable investment opportunities, then lending is at a sub-optimal level and banks suffer from lower profit, some of which could be used for future lending. On the demand side, when entrepreneurs with viable investment opportunities do not access loans that they would have received, then there is a sub-optimal level of investment from the entrepreneurial sector, and this can result in lower returns to entrepreneurial ability (human capital) at the micro level and lower rates of innovation, fewer jobs created, and generally lower levels of economic growth.

In the context of this White Paper, what happens in the market for small business finance when an economy is showing signs of a productivity slowdown is of great importance. US research[8] has shown that the credit cycle and the business cycle act in opposite ways as far as loan supply is concerned. The researchers concluded that credit standards imposed on prospective borrowers are more informative about future lending than are interest rates on loans – that is, loans are rationed via changes in credit standards, not loan rates. Other researchers[9] have argued that the way that banks allocate loan funds is the main cause of credit rationing for small firms, as investment generally flows to industries (not explicitly firms) with the greatest profit potential.

5 Berger and Udell (1992); Cowling (2010); Goldfeld (1966); Jaffee (1971); King (1986); Slovin and Slushka (1983); Sofianos et al., (1990).
6 This is classic Stiglitz and Weiss (1981) explanation of credit rationing.
7 De Meza and Webb (1987, 2000).
8 By Lown and Morgan (2006).
9 Hanousek and Filer (2004).

Hence, there appears to be a gap in our knowledge of what really happens to SME lending from the demand side (as well as the supply side) when there are signs of a slowdown in productivity growth. This is important because loan applications are not costless; financial information has to be collated, along with a formalised investment-focused business plan with cash-flows forecast and revenue projections. These costs are likely to vary substantially between entrepreneurs, with relatively inexperienced entrepreneurs incurring the highest application costs. Thus, we focus on the demand for credit from entrepreneurs and how this is affected by dynamics on the supply side of the credit market. This is outside the more traditional focus of credit rationing theories, which primarily focus on the lenders' (suppliers of credit) inability to accurately assess entrepreneurs' risk due to information problems.

Rationale, practices and effectiveness of government support initiatives

The rationales for public intervention to improve the ability of SMEs to access private financing are twofold[10]. First, the spill-over hypothesis argues that SMEs are able to 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 rationale for government intervention is the existence of market failures, such as the presence of asymmetric information in terms of adverse selection and moral hazard[11]. Hence, the availability of risk capital for small and highly innovative companies, young enterprises, and firms located in depressed areas has been a key policy issue for government in order to promote not only the growth of these SMEs, but also the whole economy.

Given the difficulties that SMEs face in accessing debt capital, and given the commonly existing credit rationing in the small firm loan market[12], (partial) credit guarantee schemes are the most widely used and long-standing public policy supporting mechanism worldwide. The objective of most such schemes is to provide loan security to SMEs that would not otherwise be able to obtain debt finance through conventional means.

Well established examples of these schemes include the SBA 7(a) loan program in the United States, founded in 1953; the Canadian core guarantee program (CSBFP), founded in 1961; and the UK Small Firm Loan Guarantee program, founded in 1981. A World Bank survey in 2008 identified loan guarantee programs in a total of 46 different countries including France, Germany, Sweden, India, Korea, Indonesia and Macedonia. Australia is unique in the developed world in having no guarantee scheme.

10 Lerner (1999).

11 Hyytinen and Väänänen (2006).

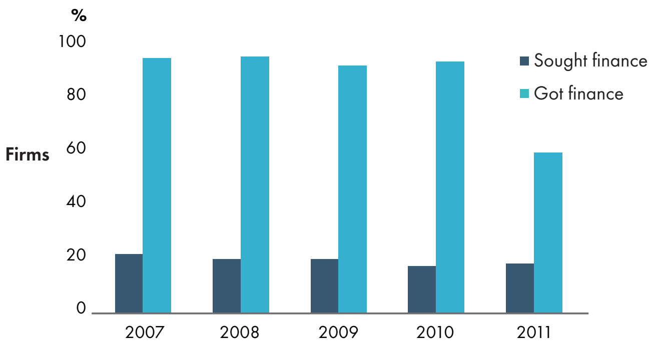
12 Cowling and Mitchell (2003); Honaghan (2008); Klapper et al. (2006); Riding (1998).

In the United Kingdom, the SFLG program was the Government's primary debt finance instrument over three decades until it was replaced by the Enterprise Finance Guarantee (EFG) program in 2009. The EFG was introduced as a response to the GFC in order to improve the availability of capital to a wider range of businesses, and a recent evaluation found positive effects[13]. Generally speaking, empirical evidence from the scheme suggests that the rationale for public intervention is justified[14] in the sense that it has allowed certain types of small firm borrowers to access bank funding and/or it has improved supported firms' performance.

Smaller business and financial markets in Australia

At any point in time, only one in five Australian businesses (or around 400,000 businesses per annum) will be seeking external funding. In line with evidence from other developed economies[15], the dominant (or preferred) source of external finance is bank lending.

Figure 22: External finance demand and supply dynamics



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

On average, only between 7 per cent and 8 per cent of businesses seeking external finance are unable to secure funding. This is typical for developed economies in periods of economic growth. There is a distortion in the ABS Business Longitudinal Database figures for 2011, however, as a much larger number of businesses sought equity finance, which has a significantly lower success rate than debt finance. So, on average, 28,000 Australian businesses per annum face a binding finance constraint, while 118,000 face some access to finance issues.

13 Allinson, Robson and Stone (2013).

14 Cowling and Mitchell (2003; Cowling and Siepel (2013).

15 Cowling, Liu and Ledger (2012).

The important public policy question is whether or not these constrained businesses are of poor quality and, hence, are 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.

There are three potential outcomes for talented entrepreneurs where banks have high collateral requirements.

- Only talented entrepreneurs with full collateral apply for loans and get separating contracts (i.e., the price of a loan reflects the specific risk of that firm or project).
- Talented entrepreneurs with not enough collateral get pooling contracts (i.e., high quality borrowers in the banks' portfolio effectively subsidise lower quality borrowers whose loan price does not fully reflect their relative risk).
- Talented entrepreneurs with no collateral get rationed.

It is this latter outcome that represents a market failure that requires public policy intervention to prevent an overall loss of economic welfare.

Critical indicators of the need for loan guarantee programs

The critical indicators that policy makers might consider when assessing the specific need for policy intervention in the form of loan guarantee type programs are:

- A highly concentrated banking sector (few large banks)
- Less 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 is narrow (indicating rationing is favoured over risk-adjusted lending)
- Substantial diversity in the relative quality of lending institutions.

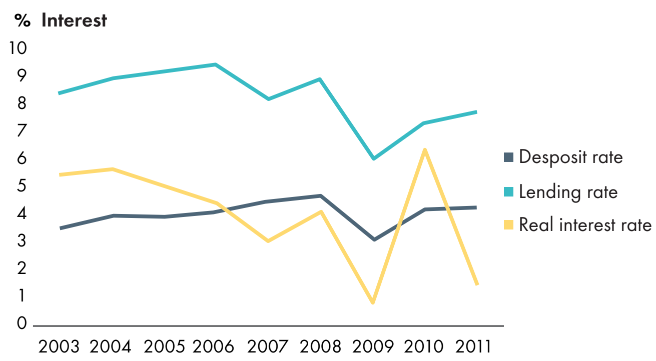
The case for an Australian loan guarantee scheme

The evidence is broadly supportive of the use of financial engineering instruments to correct for collateral issues in debt markets (potential borrowers with insufficient collateral) and, to a lesser degree, lack of a track record. Loan 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 loan guarantee schemes the potential to have disproportionately high and positive effects in countries and regions where (a) collateral based lending is the norm, and (b) a significant proportion of the entrepreneurial population is not asset rich. As a tool for promoting local economic development, loan guarantee schemes have been shown to be relatively successful.

Small businesses and the credit market in Australia

With interest rate margins on bank loans in the 2 per cent to 3 per cent range (which is in line with those in many developed economies) the key determinants of the total cost of credit are commercial banks' lending rates and the default rate on non-performing loans. Figure 23 shows Australian deposit and lending rates from 2003-2011.

Figure 23: Australian lending and deposit rates

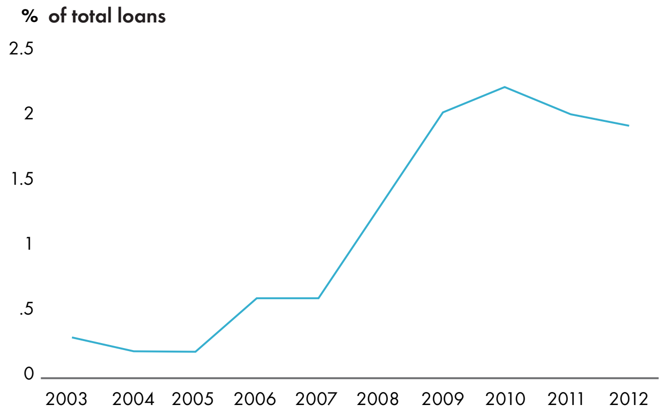


Source: Derived from Reserve Bank of Australia (RBA) Data

The deposit rate is subject to much less temporal variation than the lending rate, and the spread between the two is large. By comparable international standards, the cost of debt is high, which is consistent with the highly profitable nature of the large lending banks in Australia. The trend in real interest rates (the difference between the inflation rate and nominal interest rates) has generally been downward, with the notable exception of the upwards spike in 2010.

The second key element of the cost of debt finance is the rate at which banks issue loans that are non-performing – i.e., not fully repaid. What is immediately apparent is that the general incidence of non-performing loans is low by international standards. But the trend in the rate of non-performing loans has been upwards. Overall, this suggests that Australian banks are cautious in their general lending policies and that risk-adjusted lending (where lending rates vary according to the risk profile of the borrower) is not the norm.

Figure 24: Non-performing bank loans



Source: Derived from Reserve Bank of Australia (RBA) Data

To a degree, these three pieces of evidence – high costs of debt, low interest margins and cautious lending – are consistent with credit rationing theories. 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.

Designing a loan guarantee program

One of the key success factors of loan 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 on prospective borrowers (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 still not suffer from excessively high default rates. The core parameters of a loan guarantee program are:

- The level of the 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.

These parameters are easily understood by most people who have ever taken out a personal or business loan and/or insurance. So loan guarantee schemes benefit from being simple to create and administer, 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 can often be high.

As a guideline, the typical range across these core parameters for established loan guarantee schemes are as follows: guarantee 65 per cent to 85 per cent; interest rate premium 0.5 per cent to 2.5 per cent; loan size, minimum A$8,000, maximum A$500,000; loan term one to ten years; arrangement fee, 0.25 per cent to 3.0 per cent of the total loan value.

Recommendations

State-backed loan guarantee scheme

To increase the availability of much-needed affordable loan finance to the small business sector, the Federal Government should introduce a state-backed loan guarantee scheme. The scheme would provide a limited State-backed guarantee to encourage banks and other commercial lenders to increase loan finance available to smaller and younger start-up firms that face difficulty financing new investment opportunities through normal commercial channels. When appropriately designed and administered, such a scheme could deliver value for taxpayers through its support of employment growth, productivity, innovation and exporting.

In addition, the Government should:

1. Pilot a general SME guarantee scheme exclusively for capital investment projects, with a maximum loan of A$100,000, a maximum term of 5 years, a guarantee level of 65 per cent and an interest premium of 3.5 percentage points over the retail bank loan rate.
2. Pilot an exporting SME guarantee scheme exclusively for international market development projects, with a maximum loan of A$200,000, a maximum term of 10 years, a guarantee level of 75 per cent and an interest premium of 2.5 percentage points over the retail bank loan rate.

CASE STUDY: BOB RICHARDS, HUMPTY DOO BARRAMUNDI

THE ISSUE: OBTAINING FINANCE FOR EXPANSION

Humpty Doo Barramundi, a family-owned business based in the Northern Territory, is doing pretty well by some measures. From humble beginnings in 1993, it now turns over about $8.5 million a year producing farmed barramundi that ends up on dinner plates around the country.

"What's disappointing," says managing director, Bob Richards, "is that the business could be much bigger than it is today but for one major obstacle: the difficulty of obtaining loan finance."

Australian banks are notoriously conservative when it comes to assessing business risk, and aquaculture is seen as a risky business, according to Mr Richards. "They [banks] don't place collateral value on our stock [fish] because it can die," he says.

"Irrespective of your profit situation and track record, the banks regard you as a high-risk business. For that reason if you want to grow, it's difficult to get finance."

He has considered external equity as an alternative source of funds, but he is wary of this option after seeing other family-run operations cede control to interfering shareholders. "Once people have skin in the game, they want to put their hands on the steering wheel. And that can create problems," he says.

The lack of finance leaves Mr Richards and partner Julie Tyson, with whom he runs the business, stuck on a restricted growth trajectory at a time when they believe the business needs to expand more to achieve the economies of scale necessary to stay ahead of the competition.

"Now it's beyond our means to do anything other than organic growth, reinvesting profit," he laments.

THE FEDERAL GOVERNMENT SHOULD

PILOT

a general SME guarantee scheme exclusively for capital investment projects

WITH

a maximum loan of A$100,000, a maximum term of 5 years, a guarantee level of 65%

INTEREST

premium of 3.5 percentage points over the retail bank loan rate

PILOT

an exporting SME guarantee scheme exclusively for international market development projects

WITH

a maximum loan of A$200,000, a maximum term of 10 years, a guarantee level of 75%

INTEREST

premium of 2.5 percentage points over the retail bank loan rate

“(In Australia) we have good scientists. But not to have the mechanism or incentive to commercialise that is just wrong.”

Ingmar Wahlqvist, venture capital fund manager (Case study: Page 41)

CHAPTER 4:
FINANCIAL MARKETS AND ACCESS TO EQUITY CAPITAL

VENTURE CAPITAL, BUSINESS ANGELS AND CROWD FUNDING

Headline findings

- Venture capital (VC) is a valuable but 'niche' source of capital for a small cohort of an economy's highest potential young firms. Such firms are commonly involved in 'new knowledge' industries, particularly the early commercial application of new technologies.
- The persistently unattractive returns to a majority of investors in VC as an 'asset class' since 2000 has meant that institutional investors have reduced their interest in and commitment to VC funds.
- A small minority of VC managers have produced the majority of best performing funds over several years, and access to such funds by new investors is severely limited. This has further reduced the attractiveness of VC to investors.
- Given the declining supply of VC finance from the private sector, governments have seen a need to either support or substitute for private VC equity to ensure that risk capital is made available for high potential young firms.
- Increasingly, government support for VC is provided in concert with the private VC industry through 'hybrid' funds (including public and private investors).
- The majority of publicly supported VC programs have produced poor returns to private investors. However, such schemes can still have positive benefits to government when a full cost-benefit analysis is undertaken[16].
- There is some international evidence that government-supported VC programs have become increasingly effectively focused and managed over time. Evidence supports this positive trend in the UK, Finland, Denmark and New Zealand.
- 'Business angels' can be an alternative to VC. In reality, business angels are increasingly investing as networks and are emulating their VC counterparts. Business angels are increasingly assuming the first and earliest investments and are also co-investing with VC funds, particularly (but not exclusively) in the UK and the USA.
- Crowd funding has recently come into the funding escalator at the earliest stages of external equity and debt provision. This market is still very immature.

Venture capital and alternative sources of equity finance

It is important to use the terms VC and private equity (PE) consistently and accurately. The European Venture Capital Association uses the following definitions:

Venture capital relates to seed, start-up and early-growth activities. Seed activity and much of start-up activity concerns newly formed enterprises that are not yet selling a product or service. Venture capitalists are only interested in supporting firms with high potential and very ambitious growth plans, and which are often located in novel or innovative markets with very high international sales potential. VC usually involves *new* money into *new* (or at least relatively young) enterprises. A majority of the firms supported are unlikely to become commercially successful. If a VC fund makes positive returns, it is usually the result of a small minority of portfolio companies creating exceptional value. While some VC funds may make very attractive returns when portfolio companies are finally sold or floated, this activity is both very risky and highly uncertain. In recent years, disappointing financial returns to venture capital industries world-wide have resulted in many institutional equity investors abandoning VC investments for later-stage, less risky and more profitable PE deals.

16 See Murray & Cowling's 2009 evaluation of the Australian IIF program.

Private equity relates to later-stage investments in companies with established products or services, and which have already generated revenue. They may not be making a profit, or sufficient profit. These companies may need additional capital to grow or expand to their full commercial potential and value. The most popular PE activity is the management buy-out (MBO), which is a form of corporate restructuring by professional investors. Since the collapse of the technology bubble in 2000, PE has attracted considerably larger funds and generated significantly better and more stable returns for investors compared to VC. Given that fees are often based on a proportion of funds under management, managing larger PE funds has also been far more profitable for the general partners managing these funds than VC. The potential of a share in the capital gain of the investment portfolio ('the carry') is also more attractive in PE. Importantly, PE funds are also able to accommodate much larger investments by institutional funds, while still allowing these investors to maintain portfolio diversification given the much greater value of both deals and PE funds under management.

The above two categories of risk capital are examples of external finance provided by *professional* investors to both new and established firms. The investment managers, also referred to as 'general partners', are essentially intermediaries and are allocating the funds under management received from institutional investors who in turn are running pension funds, insurance companies, etc. These venture focused activities are highly regulated.

While venture capitalists receive a great deal of publicity, the probability of a new or young firm receiving VC finance is almost vanishingly small. In the UK, the percentage of firms that received VC funding in 2012 was 0.5. The recent unattractiveness of VC returns to investors has served to reduce the supply of VC finance.

The unavailability of VC to the great majority of growing young firms has meant that both businesses and governments have sought to find alternative, substitute finance channels. In this context, the growth of an established and recognised 'business angel' community in several countries – notably the USA and the UK – has become a source of considerable interest. In both countries, the aggregate finance raised for young firms by business angels is considerably larger than that raised from the formal VC industry. Additionally, a much larger number of firms are recipients of BA finance when compared to VC providers.

Business angels are defined as individuals, acting alone or in a formal or informal syndicate, who invest their own money directly in an unquoted business in which there is no family connection. After making the investment, they take an active involvement in the business – for example, as an adviser or a member of the board of directors. Three advantages of BAs when compared to VCs are often cited: (1) they are prepared to invest smaller sums of money in younger companies; (2) they are more widely dispersed geographically than VC firms; and (3) they are prepared to become actively involved as 'smart investors' in the recipient company. Increasingly, BAs are forming syndicates, which increases both their investment capacity and their ability to undertake full due diligence. As such, BA syndicates have become a credible and professional alternative to VC finance at the earlier stages of a growing enterprise.[17]

Each of the above sources of financing, while primarily equity focused, can include debt within the package of money and services provided to firms. Over time, both VC and BA providers are becoming more professionalised and more formal in their activities, behaviour and acceptance of fellow or co-investors. VC funders are much more likely to co-invest with experienced and professional BA syndicates. Indeed, as BA syndicates grow, they may well on occasions undertake several rounds of finance or total responsibility for a deal up to the exit stage without involving any VC investors[18].

In the above circumstances, there has been little or no role for amateur or informal investors to become involved in these rapidly formalising investment channels. However, this is changing dramatically with the rapid rise of 'crowd funding' or 'crowd sourcing' as a means by which the public at large can invest equity into small and medium-sized enterprises seeking money for the realisation of their business ideas. Equivalent platforms exist for individuals to make loans to enterprises or projects. This is normally termed 'peer-to-peer' lending. Critically, the substantial (and continuing) rise in peer-to-peer loan activity is a reflection of the considerable reduction in formal bank debt provision to SMEs since the Global Financial Crisis starting in 2008. While clearing banks continue to be the primary providers of debt finance to SMEs, and their lending statistics have started to rise, these alternative sources of finance raised from individuals have quickly established a foothold in the debt market. Their presence has been strongly assisted by their command of internet marketing.

17 This definition was based on the work of Mason and Harrison (2007).

18 Mason and Botelho (2014).

Crowd funding is a novel method for funding a variety of new ventures, allowing individual founders of for-profit, cultural, or social projects to request funding from many individuals, often in return for future products or equity. Crowd funding projects can range greatly in both goals and magnitude from small artistic projects to entrepreneurs seeking hundreds of thousands of dollars in seed capital as an alternative to traditional venture capital investment.

The diversity of these new platforms is a result in part of their relative immaturity as well as the fact that they have captured the imagination of many individuals who would like to support entrepreneurial activities. A recent report classified these individuals by type of funding and motivation:

Figure 25: Alternative models of crowd funding

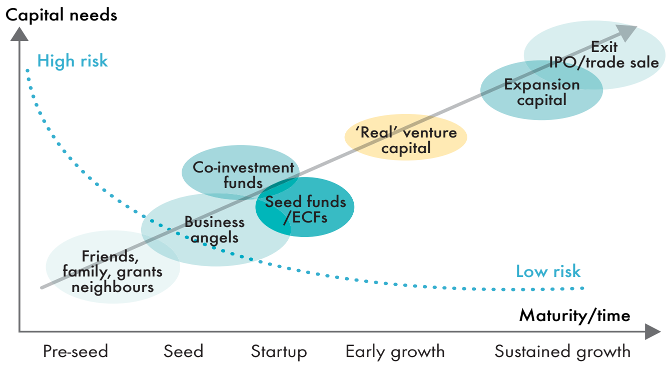
	FORM OF CONTRIBUTION	FORM OF RETURN	MOTIVATION OF FUNDER
Donation crowd funding	Donation	Intangible benefits	Intrinsic and social motivation.
Reward crowd funding	Donation/ pre-purchase	Rewards but also intangible benefits	Combination of intrinsic and social motivation, and desire for reward.
Crowd funded lending	Loan	Repayment of loan with interest. Some socially motivated lending is interest free.	Combination of intrinsic, social and financial motivation.
Equity crowd funding	Investment	Return on investment in time if the business does well. Rewards also offered sometimes. Intangible benefits another factor for many investors.	Combination of intrinsic, social and financial motivation.

Source: Pierrakis and Collins NESTA 2013

The importance of external equity

It is useful to understand the funding needs of an enterprise from its birth – and over a typical lifecycle of growth, maturity and exit – by reference to the 'funding escalator or ladder'. Over time, different types of financial products are needed at different stages of the growing enterprise's development. Both debt and equity are complementary assets, the relevance of each depending, in part, on the individual circumstances of the enterprise as well as the ambitions of its owner/entrepreneur. As will be noted below, the value of VC, or other forms of 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 ruling out debt finance. In the funding escalator, there is a role for several different forms of equity finance over time. Governments, in seeking to create a benign entrepreneurial ecosystem, will recognise the need for multiple and complementary provision of financial products including, critically, dynamic exit markets if investment cycles are to work.

Figure 26: The risk finance ladder



Source: Gill, 2014

The importance of venture capital

Despite the significant impact of VC as a source of funding for exceptional growth businesses[19], it is not a well understood phenomenon among either entrepreneurs or policy makers. As noted earlier, we use an American definition for VC that encompasses external professional investment in a new or young company to create new assets to reap substantial economic gain, which is eventually realised through an attractively priced flotation or trade sale. This type of risk financing has three distinctive features. First, because VC funding, unlike debt funding, transfers part of the ownership risk from the entrepreneur to the investor, it encourages venture capitalists to provide managerial support to entrepreneurs. The most successful and experienced VC firms have considerable managerial expertise, and the transfer of this expertise can have a major influence on the success of their portfolio firms.

Second, VC is highly selective. Because VC is a very costly form of finance with many failed or disappointing investments, VCs need to generate very high financial returns on their minority of successful investments in order to achieve economic viability. As a result, only a small number of outlier firms are likely to attract venture capitalists' attention. On average approximately 3,000 US firms, including around 500 start-ups, receive VC investment each year. Almost all these recipient firms are concentrated in a small number of high-growth industries. In 2013, for example, 3,382 firms in the US received $29.5 billion of VC investment, while 1,334 firms received first time funding of which, exceptionally, 56 per cent were seed or other early-stage investments. Software was the leading sector in 2013, receiving 37.3 per cent of the total amount in dollars. The second largest sector was biotechnology, with 15.4 per cent of total investment, followed by media and entertainment, which includes much of the social networking (9.9 per cent) and medical devices and equipment, with 7.2 per cent.[20]

Third, this mixture of high skills and high selectivity means the returns to VC fund investments are very highly skewed. The majority of all industry returns comes from the top quartile of funds.

VC finance, allied with or independent of business angel finance (and/or increasingly crowd funding), has a considerable potential to accelerate the commercial development of young, high potential firms. This is both the promise and the difficulty. External equity is a resource which demands that firms of exceptional international potential have a chance of meeting the expectations placed on them by entrepreneurs, investors and government alike. The vast majority of firms created in an advanced economy in any one year will not have this potential, and thus VC is, or should be, irrelevant. VC finance requires a ready supply of (rapid) growth businesses and we know that such businesses are the exception, with less than 5 per cent of established businesses (with ten or more employees) ever likely to succeed[21].

Sources of Australian VC activity

The Australian Private Equity and Venture Capital Association (AVCAL) annual statistics show that Australian VC invested A$516 million via 155 investments in 93 companies in 2014. While investment was 89 per cent higher than in 2013[22], the trend in terms of fund raising is more worrying, with a decline of 21 per cent to A$119.57 million. A recent Forbes Inc. article put this disappointing performance down to three reasons: immature markets, inexperienced people and bad timing.

However, it is difficult to give full credence to these reasons given that Australia's VC industry received a significant impetus as far back as the mid-1980s with the Management and Investment Company (MIC) program, and from 1997 with a ground-breaking government supported VC program, the Industry Innovation Fund (IIF). The IIF ran until 2013 and, at the time of its evaluation in 2009, it had raised A$524 million for VC funds and had invested $A291 million in 102 companies via 17 VC funds in three rounds of the program.

19 Gompers and Lerner (2001); Murray and Lott (1995).

20 It is important to appreciate that in the USA, VC and PE are quite separate industries compared, for example, to the UK industry. Thus, the NVCA does not report in detail on the MBO industry unlike the BVCA.

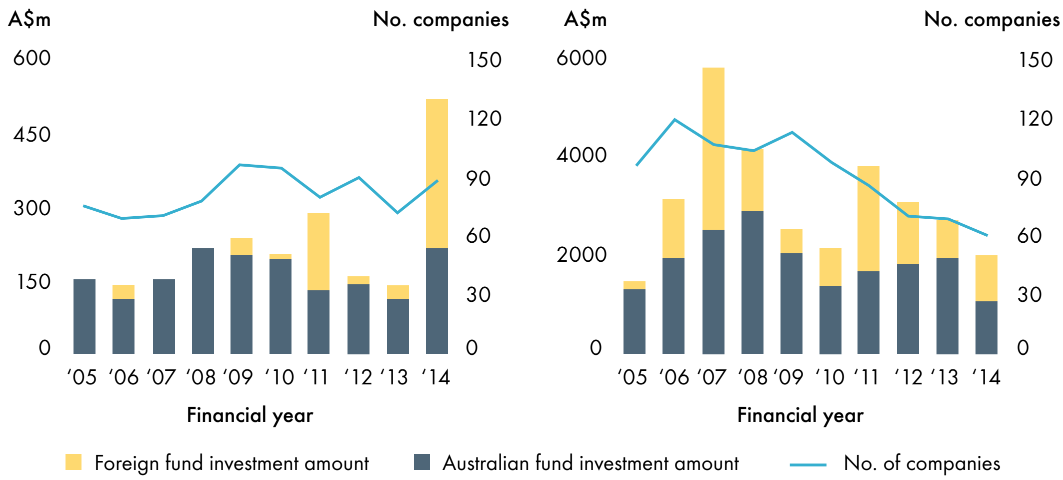
21 Birch (1979); Tereul and deWitt (2011).

22 This is primarily due to US-based Insight Venture Partners' A$266m investment in Campaign Monitor, a Sydney-based email marketing campaign developer.

Figure 27: Australian VC and PE

YEAR (FY)	VENTURE CAPITAL			PRIVATE EQUITY			TOTAL		
	AMOUNT (A$m)	NO. COMPANIES	NO. GPS	AMOUNT (A$m)	NO. COMPANIES	NO. GPS	AMOUNT (A$m)	NO. COMPANIES	NO. GPS
2005	144.68	74	17	1400.92	95	32	1545.60	169	49
2006	136.95	68	12	3128.36	118	36	3265.31	186	48
2007	150.57	69	16	5837.23	106	36	5987.80	175	52
2008	211.57	77	18	4194.40	103	40	4405.97	180	58
2009	228.61	98	18	2491.45	112	45	2720.06	210	63
2010	191.38	94	21	2155.74	97	40	2347.12	191	61
2011	280.31	79	20	3779.28	85	39	4059.59	164	59
2012	153.18	88	16	3055.58	69	33	3208.76	157	49
2013	131.39	71	18	2725.87	67	34	2857.26	138	52
2014	516.39	93	22	1957.08	64	34	2473.47	157	56

VC investments by fiscal year (AUD millions) *PE investments by fiscal year (AUD millions)*



Source: Australian Private Equity and Venture Capital Association (AVCAL, 2014)

Crowd funding has arrived

From a policymaker's perspective, two issues dominate contemporary discussion. How do we encourage a major new activity that directly addresses the financing of entrepreneurial activity? At the same time, how do we stop this new activity being a licence for con-men and grafters to prey on the vulnerable and the gullible? The Jobs Act in the US gives greater freedom for crowd funding activity. However, equity-based schemes in the UK and the USA are still regulated. According to Britain's Financial Conduct Authority, most UK legislation is out of date and is poorly adapted to deal with the challenges of crowd funding (Financial Conduct Authority (UK), 2013 ref CP13/13).

This concern and ambivalence about crowd funding is also present in Australia. At the time of writing, the Government has released the National Industry Investment and Competitiveness Agenda and it endorses the concept of crowd funding. The Government is also consulting widely with various stakeholders on how it works, including caps on the amount that can be raised and the amount an individual can contribute.

The Corporations and Markets Advisory Committee recommended that individuals should not be allowed to invest more than $10,000 in crowd-funded ventures each year, suggesting this be rationed to $2,500 across four companies. This ambiguity has resulted in one Australian company, Equitise, launching its crowd-funding service in New Zealand, where existing legislation and regulation is more conducive to its activities.

Putting a cap on individual contributions may not necessarily frustrate crowd funding, as the logic is that many small investors combine their payments to create significant sums of money. However, unlike VC or BA finance, this provision of finance remains subject to the totality of investors' contribution and investors have no role in the business. No advice can be imparted in this model. And, indeed, the investors are unlikely to have any advice to proffer.

The reality is that we are all in unknown territory with this novel, exciting and potentially scary form of entrepreneurial finance. The remainder of the decade will be a very steep learning curve as to crowd funding's strengths and weaknesses. For Pebble 'gizmos' and supporting the manufacture of 'realistic' female teen dolls that are an antidote to Barbie (see https://www.lammily.com), i.e. products that catch the public's fickle imagination, crowd sourcing has been an almost magical intervention. Whether this can translate into a credible and sustainable source of entrepreneurial finance for attractive young enterprises across the sector, product and service spectrum remains to be seen.

Why is government interested in VC?

VC as a policy instrument for promoting high-growth enterprises has almost universal appeal to governments across both the developed and developing world, regardless of political colour[23]. The reason for their enthusiasm is simple: VC, despite its well-publicised difficulties, is seen as a critical component of a modern enterprise economy. It is particularly associated with the identification and support of young new-knowledge/new-technology firms with the potential to bring about major disruptive changes to markets and their users, and thus spur innovation and economic progress[24].

23 Lerner (2009).

24 Hellmann and Puri (2000); Lerner and Khortum (2000).

Why is VC difficult?

VCs commonly support new enterprises in 'new knowledge-based' areas of science and technology where the returns to successful companies can be extraordinarily high. In order to exploit such novel and emerging opportunities, the investors and the supported entrepreneurs and managers have to operate in markets and sectors with enormous levels of uncertainty regarding the technology, and the feasibility and attractiveness of the novel products and services produced.

This uncertainty is further compounded by the frequently untested nature of the entrepreneurs and their management teams. Seasoned VC investors have even argued that they would prefer to support a first class management team with a problematic business idea rather than vice versa.[25] Thus, the experienced venture capitalist has to be skilled at both recognising opportunity and being able to nurture young enterprises, which includes coaching their founders and managers to achieve a successful, valuable commercial entity[26]. Such commercial, analytical and mentoring skills are scarce, even in the most advanced economies.

Government responses to 'thin' VC markets

An industry-wide migration of investors from early-stage VC to later stage and less risky private equity (PE) since the late 1990s[27] has reduced a critical supply of growth capital to young technology and/or 'new knowledge-based' firms. For such firms in their early days of development, bank finance – with its requirement for predictable cash flows – is not relevant or helpful. High-growth firms will also rapidly outgrow the financing of family and friends and often the limited availability of business angels (BA) finance[28] although, as previously noted, BA syndicated resources are increasing.

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 means to ensure that early-stage 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. In a world of international scoreboards in innovation and enterprise, few advanced economies wish to see VC disappear from their borders to the detriment of their highest potential firms[29].

25 Quote from US pioneer VC, Arthur Rock.

26 Sapienza (1992).

27 Cumming et al. (2009).

28 Ruhnka and Young (1987).

29 Wilson and Silva (2013).

These concerns have seen the role of government as a provider of VC grow rapidly to the extent that governments are now the biggest single investor in early-stage VC funds across Europe (EVCA, 2013). These actions are not designed to replace private VC firms permanently with public investment. Rather, they are there to 'pump prime' the supply of VC by both sharing risk and incentivising investors to re-examine and re-enter this sector of the equity market. However, this idea of acting as a catalyst in the VC market before withdrawing in favour of private actors may be more aspiration than a reality in the absence of private market substitution of the state's commitment[30].

Government has to determine the nature and degree of its intervention in the VC sector. It has to also decide on the type of involvement it wishes to make in the actual entrepreneurial process or VC cycle of enterprise investment, nurturing and exit. On an inverse scale of commitment, it can become directly involved as a venture capitalist by undertaking direct investments. Conversely, it can take one step back and recruit one or more venture managers, usually structured in a general partnership, to invest public money in young firms on its behalf. In effect, the government becomes a limited partner in one or more funds managed by its commercial agents or general partners (GPs). These funds with both public and private investors' monies are often termed 'hybrid' funds. The third common option is for the government to promote a Fund of Funds (FoF) structure whereby a range of investors are sought to create a large fund that itself invests in several VC funds, which in turn invests in portfolio companies. Again the FoF is a hybrid structure, as the government has to provide sufficient core funding – and an attractive formula for the distribution of any net investment returns - to encourage participation from the private sector.

The pros and cons of each level of intervention can be summarised as follows:

- Direct VC investment requires government to recruit or train government employees or contractors in the appropriate skill sets of early-stage VC investment. Government is unlikely to be able to offer the autonomy and personal rewards demanded by the most successful VC practitioners in the long term. Indeed, through its own programs, the government will occasionally help to train new VC managers who, once they have an attractive track record, may leave to set up their own VC funds.[31] The international trend has been away from government directly running VC activity. Critics have argued that this activity does not lie within government's remit or competency, and that investment should be delegated to commercially motivated investment professionals acting as agents of the state. However, there is a strong tradition of direct public engagement in the economy in Nordic countries, and this includes direct VC activity. Examples of this include Vaekstfonden in Denmark and the Finnish Industry Investments organisation. In much academic research literature, there is hostility to direct investment by government. The main concerns are the levels of investment competencies available and the non-commercial goals often imposed on 'nominally' profit-oriented, public VC funds. Many of these goals are social and can result in VC funds being placed in inappropriate areas, given conflicting goals (i.e. both social returns to the community and commercial returns to the investors), and run by managers with a public service background strongly out of kilter with the context of severely competitive, equity markets. More importantly, government supported VC programs can suffer from agency and moral hazard problems. All such structures, given the scale of public monies involved, require strong and informed oversight with rigorously defined and applied evaluation criteria.

30 Luukkonen et al. (2013).

31 This training of new VC managers was an explicitly planned outcome of Australia's IIF and the UK's ECF programmes.

- Publicly-supported VC funds, where the government provides a significant proportion of the funds under management, recognise the need to contract professional investors to realise the government policy goals. The government is not the sole investor; it normally requires the VC managers to attract other institutional investors to the fund. In devising such funds and appropriate incentives, governments have had to learn industry standards. Early fund structures were often poorly designed and managed, often at a direct cost to government – and potential firm clients.[32] Again, less experienced VC managers are likely to have more incentive to accept government co-financing than managers with an already established reputation and track record. VC managers' ability to attract investors will condition the size of funds they are able to raise. This in turn will influence the number and type of institutional investors that may wish to be involved with the fund.
- VC 'fund of funds' (FoF) programs allow government to take a position as a limited partner in a range of individual VC funds. It allows government to leverage highly each dollar of government commitment. It can both diversify its investments as well as create a range of VC funds with specific goals – for example, investing in a specific technology, co-investing with business angels or supporting women entrepreneurs. Investment managers like the large exposure of private institutional investors as this can limit government's opportunity to use the fund for social rather than commercial ends. However, this private interest may also constrain the opportunity of government to focus the FoFs specifically at areas of policy interest. The FoF structure also allows very large financial institutions, such as pension funds, sovereign funds or insurance companies, to be involved in the asset class without taking a large percentage of the money raised by a single VC fund. Institutional investors need sufficient finance committed in an asset class in order to have an effect on the performance of their total portfolio. But at the same time, they rarely wish to have an exposure greater than 10 per cent in any one fund. A FoF structure allows them to achieve both goals. From the government's perspective, FoF structures give policy makers considerable flexibility in engaging in entrepreneurial finance while not directly intervening in market activities or firm level investment decisions. Several countries have included FoFs among their policy interventions in VC, including the UK (High Tech Fund of Funds), Denmark (Vaekstfonden's investment fund program) and the celebrated original Yozma program in Israel in 1993. However, the largest European FoF program by far is that presently conducted by the European Investment Fund as an agency of the European Union (EIF summary details).

32 The UK's Regional VC Fund was unsuccessful in part because of the negative influence of regional specificity on the quality of deal flow.

Ten indicators of good practice in a public-private 'hybrid' VC program

Governments, international agencies such as the OECD, the World Bank and the European Commission, and academic and industry researchers have over time built up a substantial body of empirical and theoretical knowledge on the practice and performance of VC. Research has also addressed the various roles that government may effectively play in supporting entrepreneurial and innovative actions. The following list of 'good practice' guidelines (below) is compiled on the basis of a review of the academic literature.[33] Statements of good practice have also been tested and examined in conversations with leading industry practitioners across a number of countries.

The development of the 10 indicators seeks to address the nature of public investment in VC and to explore the means by which government may sensibly and effectively engage on some basis of equality with its commercially motivated VC industry agents. These indicators may likewise be similarly useful in looking at the practices and future options of a government in designing an effective VC intervention. Note that the list of ten indicators does NOT imply a ranking.

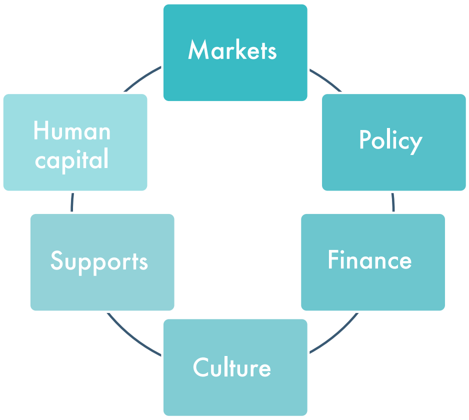
10	INDICATORS
1	Existence of an entrepreneurial ecosystem increasing the potential effectiveness of the proposed VC activity.
2	Understanding by the fund's designers of the need for a credible 'competitive advantage' in determining VC fund's deal-flow.
3	Global perspective in seeking funding and identifying investment opportunities.
4	Employment of profit seeking 'agents' as VC managers with a verifiable track record of success in the target investment sectors.
5	Aligned incentives between government and its VC agents that are attractive and 'fair' to both investors and managers.
6	Planned redundancy of program intervention over a broadly specified period including milestones.
7	Adoption of (industry-recognised) administrative and legal norms of VC activity by the VC fund.
8	Long-term perspective from government as to evaluation and impact with an agreed methodology, and data collection introduced from Day 1.
9	Public transparency of program activities, performance and evaluation reports.
10	Experimentation, learning and adaptation by program managers reflected in VC fund's focus, operations and increasing effectiveness over time.

33 Academics including Josh Lerner, Marco Da Rin, Karen Wilson, Marc Cowling, Ronald Gilson, James Brander, Gary Bruton, Markku Maula, Erkko Autio, Ari Hyytinen, Thomas Hellman, Douglas Cummings and Christian Keuschnigg.

Entrepreneurial ecosystems

In order to engender a viable and sustainable entrepreneurial ecosystem, the provision of early-stage VC finance to identify, nurture and exploit exceptional entrepreneurial opportunities should be recognised as a 'necessary but not sufficient' condition. The 'entrepreneurial ecosystem'[34] also needs to ensure the presence of a complementary range of related conditions,[35] including supportive legal structures, education, fiscal and cultural environments.

Figure 28: The entrepreneurial ecosystem



Source: Isenberg (2010), Gordon Murray and DAMVAD

It is a tell-tale sign of an inexperienced government when the considerable challenges of financing young and growing enterprises are seen as fully accommodated by the single introduction of a government co-financed VC program.

Work by the Kauffman Foundation and academics (Isenberg, 2010) shows that a VC program can only operate effectively if the environment encouraging and supporting new and growing enterprises exists and is active. Legal[36] and institutional structures[37], fiscal incentives to entrepreneurs and investors, education, the communication effects of networks and clusters, and the popular cultural view of entrepreneurs all play roles in what is increasingly and widely termed the 'entrepreneurial ecosystem'.

34 Napier and Hansen (2011); OECD (2013).
35 Lerner and Tag (2012).
36 Cumming et al. (2010); Yong et al. (2012).
37 North (1990; Busenitz et al. (2000).

Planned program redundancy

The purpose of having a publicly-supported VC fund is to improve the entrepreneurial environment, to train practitioners and users as to the advantages of risk capital, and to act as a catalyst in identifying and overcoming hurdles to successful and profitable investment. The purpose of the state's involvement is not to substitute for commercial providers of risk capital in the long term. Accordingly, over time, there should be clear evidence of a reduction in the relative commitment of public finance as a maturing market becomes colonised by fully commercial providers. Co-financing schemes should (at best) only temporarily condone public financing being greater than 50 per cent of total program funds committed. The ultimate aim of publicly-supported enterprise finance programs should remain that of a planned redundancy of state intervention.

The concept of 'pump priming' implies appropriate and *temporary* intervention. It further assumes identifying operational barriers (for example, experience, skills and networks) that can be addressed and then overcome. Yet, the reality is that for programs of sufficient size to have a material effect on the markets in which they intervene, governments are likely to become long-term participants rather than temporary visitors. This 'white knight' situation of temporary intervention, correction and then retirement of the program appears extremely rare. The most commonly cited example of a successful temporary intervention by government is the famous Yozma program (1994–1997) in which eight of the ten publicly co-financed Israeli VC funds were rapidly sold to their VC managers at a $US100m profit to the Israeli exchequer in less than three years[38]. *Yozma* is repeatedly cited, despite being 20 years old, particularly because such a successful and brief public intervention into VC is so rare.

There is a real danger that 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 public purse. Mindful of this danger, the UK's Capital for Enterprise Board was legally prevented by its statutes from becoming a cornerstone investor. CfEB could only invest *after* private investors had provided sufficient money to make the new fund a viably sized entity with CfEL's assistance. Such a prescription has the effect of ensuring that government does not colonise part of the capital market where there is no commercial interest from private and commercial interests in creating or sustaining such an activity. In the protracted absence of private investors, governments need to be very sure as to why their own intervention is justified. A 'market failure' argument may not be credible. The fact that professional investors do not choose to invest in enterprises that will not return a profit commensurate with risk and illiquidity incurred cannot *per se* be seen as a market failure.

39 Avnimelech and Teubal (2004); Erlich (2001).

Recommendations

Publicly supported venture capital fund

The Federal Government should introduce a publicly-supported VC fund to ensure that risk capital is made available to high potential young firms. Specifically, we propose:

- The establishment of a pilot scheme to pool public funds with private sector VC firms exclusively for capital investment projects for small and medium-sized enterprises developing new R&D products or services.
- The scheme would involve a maximum public exposure of AUD$2 million on an equal basis with private sector VC firms.

CASE STUDY: INGMAR WAHLQVIST, VENTURE CAPITAL FUND MANAGER

THE ISSUE: PRIVATE VENTURE CAPITAL AND THE ROLE OF GOVERNMENT

Australia is internationally renowned for its medical research, yet lamentably bad when it comes to commercialising the ground-breaking work done in our labs. We are also near the bottom of the OECD league tables when it comes to research and development by the private sector.

How can this be turned around? For one thing, we could use more people like Ingmar Wahlqvist, a Melbourne-based fund manager who specialises in high-risk venture capital and, in particular, the commercialisation of Australian medical research.

Wahlqvist, one of the investment team at Brandon Capital Partners, says Australian medical science has a competitive advantage that is sadly untapped commercially. "We punch above our weight (on research)," he says. "But traditionally we haven't put resources into translating that into products."

He cites figures showing that the Federal Government in 2011-12 spent $8.37 billion on scientific research. Yet in the preceding decade, Commonwealth spending on commercialisation of research never went above $300 million in any year. "And if you took out money spent on the car industry, it's actually half that," he says.

"Which is totally woeful. We have good scientists. But not to have the mechanism or incentive to commercialise - that is just wrong."

With the minerals boom in decline, Wahlqvist says it is crucial for policy makers to focus on new ways for Australia to sustain growth in coming decades, and he believes his industry could play a part. "I think venture capital can play an important role if we are to transition to an economy that is a bit more future proof, and not reliant on digging things from the ground."

There is much debate about the merits of taxpayer investment in private venture capital, and history is littered with unhappy tales of governments trying, and failing, to pick winners in this area. However, Wahlqvist believes his firm has a viable, if slightly unconventional financial model for co-operation between the public and private sectors.

Brandon Capital Partners was initially established with financial backing from two superannuation funds and a matching contribution from a now abolished federal scheme. The firm has also partnered with state governments on commercialisation of medical research. The states have assisted through operational support rather than investment, and control over investment decisions has rested solely with the private fund managers.

"They (governments) don't second guess our investments. Ultimately we're trying to make returns for our investors" he says, "but in the process we are creating companies, employing people, generating economic activity and providing a commercial outlet for all the terrific research being done in this country."

Given the inevitable high failure rate of high-risk, high-return investments, Wahlqvist says it is also important to spread risks over a relatively large number of investments. If only two out of ten investments succeed, it's better to start with 20 than with 10.

Wahlqvist says the states that offer support do not necessarily need to make an 'investment' return (in a narrow commercial sense) for it to be worth their while. Independent analyses of federal and state government expenditure of this type have shown there are broader returns to taxpayers in terms of economic multiplier effects, the diffusion of technology, and in opportunities created for service providers.

One of Brandon Capital Partners' success stories involves a company called Global Kinetics Corporation (GKC), which developed and now manufactures and sells a wrist-worn device that automatically records movement data to assist doctors in their diagnosis and treatment of the symptoms of movement disorders, such as Parkinson's Disease.

Another success has been Fibrotech, which developed a new treatment for fibrosis, based on research by Melbourne scientists. "We took it on and invested in it," says Wahlqvist, and then sold it to the Irish-based multinational pharmaceutical company Shire.

He says the success of the Fibrotech project helped to open the way for a more recent breakthrough: Brandon Capital Partners' raising of $200 million from four superannuation funds (a notoriously conservative sector) to invest in commercialisation of more research. "They want to invest in innovation," enthuses Wahlqvist.

The numbers might still be relatively small, but stories like this could play an important part in Australia finding a new pathway to prosperity from knowledge-based industries.

“Sometimes you can’t justify innovation spending in the initial stages of setting up a business. Help in getting started with technology is a really good thing.”

Bob Richards, Humpty Doo Barramundi (Case study: Page 49)

CHAPTER 5:
BUILDING AN INNOVATION SYSTEM

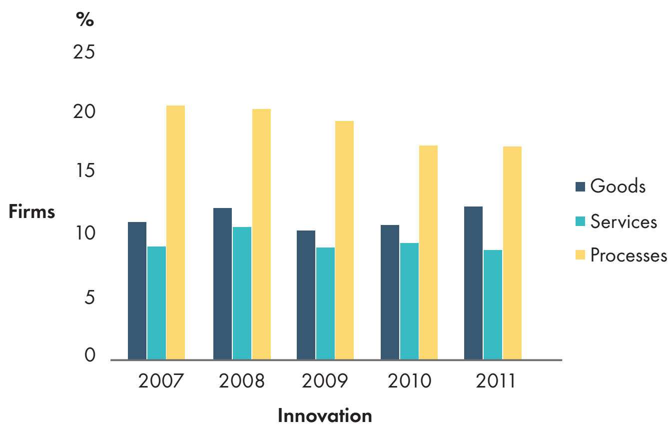
Headline findings

- Innovation is a key driver of productivity, jobs creation and economic performance.
- Around 10 per cent of Australian businesses produce innovative goods and services.
- Between 16 per cent and 21 per cent of businesses innovate in their underlying business processes.
- Capturing value and diffusing existing innovations throughout the economy are the key issues to address when designing innovation policy.
- Even if Australian SMEs are not the initial investors or innovators, they can still capture some of the value of innovations developed elsewhere.
- Innovation policy should include measures to encourage the diffusion and uptake of existing innovations to a broad range of firms, as well as encouraging new innovations per se.
- Firms that can adopt "continuous improvement" methods to embed incremental innovation can generate large productivity improvements.
- There appears to be a very low incidence of co-operative behaviour in the Australian business sector. Typically, fewer than one in ten businesses co-operate on any level, and this could be a major barrier to innovation, and to productivity growth generally.
- Large firms often find it hard to change their business models to capture value, but SMEs can change them more easily. Public policy to support innovative SMEs should increasingly take into account 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.

Introduction

Innovation is widely regarded as a key driver of productivity growth, job creation and superior economic performance. 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 R&D labs. However, only around 3 per cent of firms are high-tech, and many firms innovate outside formal R&D. Financial services firms, for example, have very low measures of R&D intensity but can be highly innovative. While not all Australian firms are innovative, Figure 29 shows that significant numbers – roughly 10 per cent – produce innovative goods and services. Many more (between 16 per cent and 21 per cent) innovate in their underlying business processes.

Figure 29: Innovation modes and prevalence



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

What is innovation?

The word innovation is often used interchangeably with invention, but they are not the same thing. Invention occurs when someone creates a new device or process for the first time, while innovation involves a commercial application of an invention. Hence, while invention is an event, innovation is a process. And because invention is only the start of this process, it may well be economically relatively small (in terms of the overall time and costs involved). Innovation is expensive because new products are normally in a very primitive state when they first emerge. As a result, a considerable amount of additional creative work is needed before they can be commercially viable, which can take many years.

Moreover, the process of innovation often continues after the product or service has been launched. If you consider the huge amount of value that has been created by the global automobile industry since Daimler and Benz came up with their initial invention in the late 19th century, the relative importance of the initial inventive step compared to the much larger and more distributed process of innovative change becomes apparent. Many more firms and nations have benefited from this process than just Daimler-Benz and Germany. Hence, even if Australian SMEs are not the initial investors or innovators, they can still capture some of the value of innovations developed elsewhere.

It is therefore misleading to make clear cut distinctions between invention, innovation and diffusion. Processes of innovation typically generate their own internal problems that require inventive solutions, and the wider diffusion of innovations typically requires ongoing innovations and inventions to adapt new products or services to their new and changing environments.

The importance of distributed, long-term processes of change means that innovation is not the same as creativity, invention, technology development or R&D. It involves a much wider range of changes in knowledge, organisational structures and processes, commercial relationships, markets and regulations. These interactions and changes are often too complex to be predicted. As a result, innovation tends to be highly uncertain and experimental. Firms may launch new products only to find that their rivals have launched better products that they did not know about. This uncertainty makes picking winners difficult, but policy makers can create the conditions for more winners to emerge and succeed. To do this requires understanding of the different types of innovation and how they might be supported to enable successful firms to flourish.

Types of innovation

Innovation processes and their outcomes are varied. It is common to distinguish between innovations that are new-to-the-world, new-to-the-country and new-to-the-firm. While most policy focuses on new-to-the-world innovations, new-to-the-country and particularly new-to-the-firm innovations are often more economically important for improving national productivity. Innovation policy should include measures to encourage the diffusion and uptake of existing innovations to a broad range of firms, as well as encouraging new innovations.

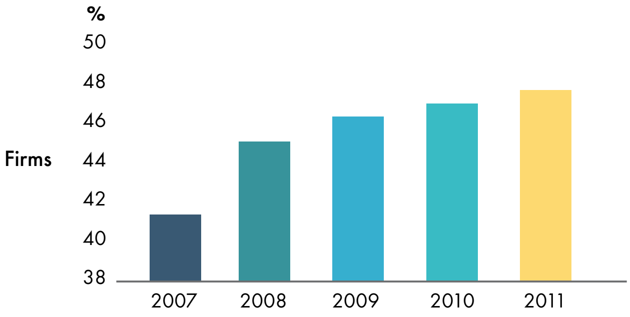
A second common distinction is between incremental innovations that involve minor changes to products and services and more disruptive radical innovations that involve new technologies and require changes to organisational processes. Academic research[39] has highlighted the economic importance of incremental innovations, and how they complement radical innovations, which typically require considerable modifications after they have been introduced. Firms that can adopt "continuous improvement" methods to embed incremental innovation can generate large productivity improvements. Toyota, for example, is considered one of the most successful and innovative firms in the world, in part because of its mastery of continuous incremental innovation.

Some innovations ('techno-economic paradigms') are so radical that they transform entire sectors and economies. The introduction of the steam engine, internal combustion engines, electricity and, most obviously today, computers and information technology, are examples of such innovations that disrupt production methods and lead to radical changes in industrial organisation, markets and regulations. As a result, there is wide ranging international policy interest in helping firms exploit new information and communications technologies (ICTs) related to web and broadband access. As Figure 30 shows, there is a gradual, but consistent increase in the percentage of Australian firms with a web presence, exploiting the growing potential of internet technologies.

These distinctions highlight the need to expand innovation policy to both encourage incremental innovation, and also to feed into broader changes in regulation and institutional adaptations to exploit the potential of economy-wide changes in technology.

39 For example, Dewar and Dutton (1986).

Figure 30: Web presence



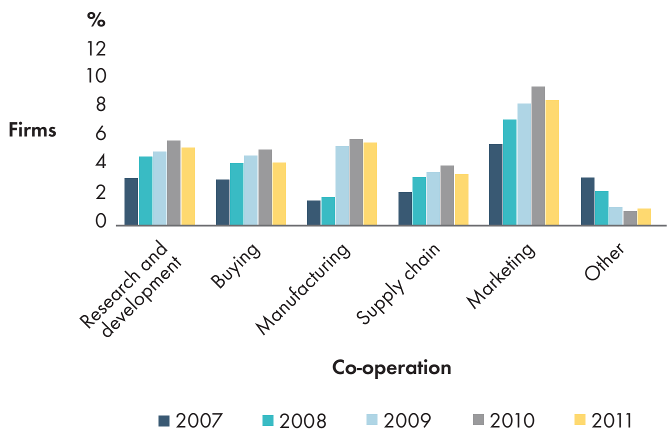
Source: ABS Business Longitudinal Database 2006–07 to 2010–11

Innovations also differ in other ways. A key distinction is between products, process, position and paradigm, or what has become known as the 4Ps[40]. Product (and related service) innovations involve changes to the commercial offerings that firms produce. Process innovation involves changes in how firms create and deliver those product and services. Position innovations, such as Haagen Daz's re-targeting ice-cream from children to adults, involve changes in where products and services are offered. Lastly, paradigm innovations involve changes in how entire products and services are understood, and therefore how they are delivered and positioned. Apple Computer's iTunes is an example of a paradigm innovation that has fundamentally transformed how music is delivered, sold and consumed. Significant changes can require combinations of different kinds of innovations. New products often require process innovations and position innovations to target new customers.

Given this diversity of types of innovations, it is not surprising that there are a variety of different sources of innovation. Some innovations are sourced from research and generated in R&D laboratories. Innovations of this kind, which are common in the pharmaceutical, chemicals and electronics sectors, typically exploit cutting-edge science to improve the performance of high value products. Process innovations, by contrast, are typically generated outside R&D laboratories and draw on engineering rather than science. Production engineering activities often source new technologies from suppliers. Lastly, customers are a core source of innovation for many firms, particularly customers who either have new requirements or who develop their own modifications.

Innovation often occurs through symbiotic relationships between networks of customers and suppliers. In surveys, customers and suppliers are typically rated as being much more important than R&D, universities or research as sources of innovative ideas. Figure 31 highlights the importance of broad ranging co-operative connections between firms, and shows they go well beyond R&D. These connections highlight the importance of building a system to support innovation that builds stocks of capability throughout the economy, allows for knowledge and resource flows, and flexibly adapts regulations and institutions to enable firms to innovate and capture the value of their innovations. But what is also clear is that there appears to be a very low incidence of co-operative behaviour in the Australian business sector, and this could be a major barrier to innovation.

Figure 31: Co-operation between firms



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

40 Tidd and Bessant (2014).

Capturing value

While the focus of most discussions of innovation is on how firms create value, an equally important element relates to how firms capture value[41]. Historical evidence shows firms and individuals that initially launch an innovation are not always the ones that profit from it. Often firms find that their competitors rapidly copy their innovations, and capture their value. EMI, for example, was the original innovator of the CAT scanner, but it was rapidly copied. EMI failed to capture its value and quickly left the market.

To capture the value of innovation, firms need what are known as 'complementary assets'. These are assets such as intellectual property rights, brands, first mover advantages, lead times, technical complexity, co- specialised technologies, production facilities, or marketing channels that allow firms to capture more of the value that their innovations generate[42].

How a firm creates and captures value defines its business model. Finding new business models can open up new opportunities for productivity improvements and the creation of additional economic value. For example, offering additional higher value services alongside current offerings can allow firms to capture more of the value that their innovations generate over their life-cycles. When Rolls-Royce moved from selling aircraft engines to providing 'power by the hour' engine maintenance services, it opened up a new stream of additional potential revenue. The importance of innovation in business models and value capture is increasingly recognised, but has not yet received the policy attention it deserves[43]. Large firms often find it hard to change their business models; SMEs can change them more easily. Public policy to support innovative SMEs increasingly takes into account value capture and business model innovation more generally. This includes ensuring that regulations help firms to capture value while balancing the benefits other firms receive from the wider diffusion of value. This is particularly important for small firms because, from a broader economic perspective, it does not really matter where the value came from.

41 Teece (1986).

42 Teece (1986).

43 Coad et al. (2014).

From Schumpeterian to post-Schumpeterian policy

The increased attention given by policy makers towards value capture reflects a move away from the older Schumpeterian tradition in the academic analysis of innovation. 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 and subsequent decline, driving 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.

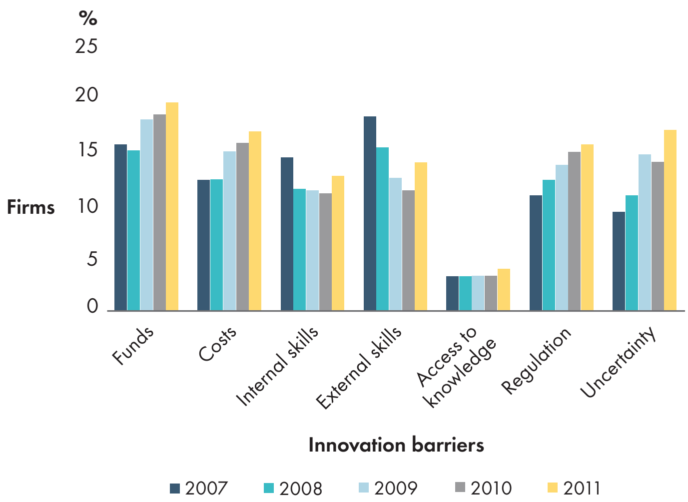
In general, however, the empirical evidence does not support this model of innovation. The problem is that Schumpeter confused innovation with invention. Because innovation is typically a long, uncertain and expensive process, innovative firms often have to have significant financial, technical and managerial resources. These get overlooked in Schumpeter's model, as he mistakenly assumes that innovation emerges in its fully formed state. This is why he suggests entrepreneurs have advantages over larger incumbent firms. However, small firms often lack the financial and technical capabilities of their larger competitors and typically find it extremely difficult to compete.

Young innovative SMEs that do manage to grow and succeed tend to be larger at start up, with more technical capabilities, more STEM graduates in the workforce and a more international, export-oriented outlook. Because innovative SMEs are often more nimble than larger firms, they play important roles in the economy in developing new innovations. However, because they lack the internal resources of larger firms, they often need to source support externally. As Figure 32 shows, firms in Australia experience a wide range of barriers to innovation, suggesting policy to support innovation needs to be flexible and broad based.

Many successful SMEs receive support from professional equity investors, such as VC funds, providing them with the managerial capabilities that they lack internally, and building the complementary assets they need to capture the value of their innovation[44]. Similarly, effective support for skill development that addresses the market failures in human capital accumulation are particularly important to smaller firms. This need for wide ranging policy measures to support innovation in Australian SMEs suggests a number of important policy implications.

44 Nightingale, et al. (2009).

Figure 32: Barriers to innovation



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

First, when thinking about innovation, it is important for policy makers to focus on diffusion, and not just on new-to-the-world innovations. For the latter, policy would focus on supporting research, and links between cutting-edge university science and engineering departments and high-tech industries. For the former, however, the key issue is diffusion and adaptation of existing technologies and innovations to multiple firms. This means getting innovations more widely distributed in the economy, with support for firms to develop their ability to search for new options, evaluate them, and successfully implement and adapt them to their specific context.

Second, policy makers need to understand that because Australia is a relatively small country, it is likely to benefit to a greater extent from access to technologies and developments from elsewhere. This doesn't mean that research is less important. Indeed investments in research have two important, broad benefits. First, they generate innovations, but secondly, and perhaps more importantly, they provide Australia with access to international networks and the ability to evaluate research conducted elsewhere. This is one reason why small, high income countries in Europe, such as Sweden, Finland, Denmark, and Switzerland, spend so much money on research. Investment in research and capturing innovations generated elsewhere are complements rather than substitutes. Investment in research contributes significantly to the development of skilled employees and this human capital enhancing part is much more important than the development of new spin-outs. As the title of a report on the economic value of research highlighted, it's "talent not technology" that is the key.

Third, given the distributed nature of innovation, which involves a wide range of organisations and extends beyond formal R&D, focusing on research without addressing these wider skill requirements is likely to create bottlenecks downstream in the innovation process. Technical skills across the workforce, and particularly interdisciplinary skills that bridge areas of expertise, are particularly important for innovation.

Fourth, for many firms a key constraint on increasing growth and productivity is the lack of scale and specialisation in the local market. Governments have a key role to play in the provision of effective communications and other infrastructures.

Fifth, the evidence on small firm industrial dynamics shows that the traditional model in which barriers to entry are high while barriers to growth are low, is flawed. Instead, we find that there are few barriers to entrepreneurial market entry, with very large and possibly excessive numbers of firms entering the market each year. However, because they find it so hard to grow, many quickly exit. This suggests the focus of public policy towards entrepreneurs should shift from increasing **quantity** to increasing **quality**. The focus should be on encouraging the growth of a smaller percentage of firms that have the potential to grow, rather than encouraging more new entrants, regardless of quality. Firms with growth potential tend to be larger at start-up, have higher educated employees, a greater export focus, and have a greater intention to grow. It has proven extremely difficult to find policy levers to support firm growth, and any policy interventions need to be well designed, subject to regular independent evaluation, and linked to a structured process of policy learning.

As discussed in the previous sections, our report highlights the important complementarities between human capital (in the form of skilled employees, often with STEM training), the allocation of internal and external resources to innovation, and the uncertain process of generating new products and services to produce profits.

The process of innovation

Despite the uncertainty and complexity of innovation, it is possible to abstract an underlying set of stages that are typically followed by innovating firms[45]. These stages are:

1. Searching for new opportunities

   This typically involves firms searching externally for new markets, technologies or delivery mechanisms that 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 have 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 that 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.

45 Tidd and Bessant (2014).

Recommendations

Innovation policy

To promote increased innovation across the Australian SME sector, we propose:

- More government support for research and development by small and medium-sized firms.
- Better linkages between cutting-edge research universities and industry.
- Government support for firms to adapt existing technologies and innovation.
- Measures to help the spread of existing innovations to a broader range of firms.
- Encouragement to firms to adopt 'continuous improvement' methods to embed incremental innovation, as this will generate large productivity improvements quickly.

In addition, the focus of public policy towards entrepreneurs should shift from quantity to quality, with resources directed towards a smaller percentage of firms that have the potential to grow. To these ends, we recommend that the Federal Government should:

- Provide tax breaks for companies acquiring new technologies not developed in-house.
- Develop a 'matching' service to promote the development of collaborative relationships between multinational corporations and Australian businesses both domestically and abroad.
- Provide a tax allowance for companies investing in intellectual property protection (through patents, copyright, trademarks, design rights etc.) in-house.
- Provide a tax allowance for companies that generate licensing income from in-house new technologies.

CASE STUDY: HUMPTY DOO BARRAMUNDI

THE ISSUE: BARRIERS TO INNOVATION

Technical innovation can be prohibitively expensive for a fledgling small business. It can also come in some strange forms. At Humpty Doo Barramundi, a Northern Territory-based aquaculture business, they have achieved major efficiencies by investing in a system that transfers fish between ponds through pipes.

"We are probably the industry leaders in pumping fish around the farm," says managing director Bob Richards. "When fish outgrow a pond, we can pump them into another pond. It doesn't harm them."

But Mr Richards says he might never have invested in this innovation except for the existence of a federal grant scheme. The pumping system and some fish grading technology was purchased with the aid of a grant worth about $160,000 – money Mr Richards says was invaluable to an innovative small business that would otherwise have been unable to find the cash.

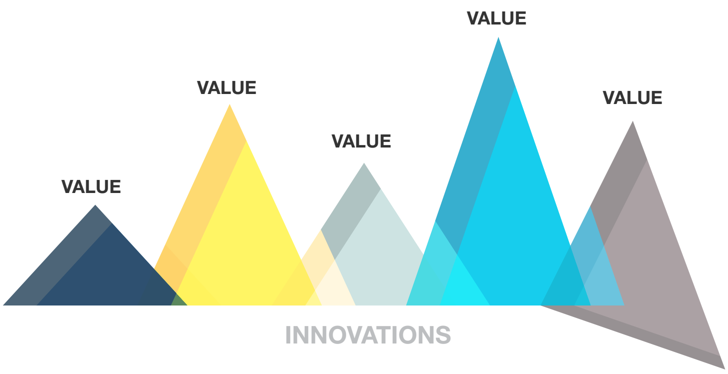
He believes many potentially innovative small businesses are held back by the absence of seed funding, and that there is a legitimate role for government to step in. "Sometimes you can't justify innovation spending in the initial stages of setting up a business," he says. "Help in getting started with technology is a really good thing."

He says taxpayers can get good value when the Government invests in businesses like his, provided applicants are carefully screened and that there is potential for broader adoption of the innovation by other businesses in the industry. "We went through a competitive process, we had to make a submission, which is a good thing," he says. "Making it too easy would lead to abuses."

"You do get a lot of cross-pollination in industry, innovation gets spread around. De-risking that first step is huge."

BUILDING AN INNOVATION SYSTEM

Around 10 per cent of Australian businesses produce innovative goods and services



Capturing value and diffusing existing innovations throughout the economy are the key issues to address when designing innovation policy

Even if Australian SMEs are not the initial investors or innovators, they can still capture some of the value of innovations developed elsewhere

16%
21%

Between 16 per cent and 21 per cent innovate in their underlying business processes

“I think business training should be for everybody, from a reasonably young age, perhaps Year 10.”

Sandra Martin, business consultant (Case study: Page 57)

CHAPTER 6:
SKILLS AND HUMAN CAPITAL

Headline findings

- When businesses have a high demand for skilled labour, but are constrained by lack of skills, there is a prima facie case for government intervention.
- The strongest argument for government intervention relates to the potential for positive spill-overs into the wider economy, as highly skilled workers move between employers and disseminate their knowledge.
- One in six businesses in Australia experience skills deficiency issues. Deficiencies are most apparent in trades, but many businesses also report shortages of finance professionals, marketing professionals and IT professionals.
- The sectors we predict are going to deliver future growth and productivity increases – communications and professional services – have a high and unmet demand for IT workers at professional and technical levels. These are sectors characterised by high knowledge intensity and a disproportionately high smaller firm presence.
- A detailed study of enterprise training in the education system provides strong support for an interventionist and broad strategy of policy development at all levels of the system.

Introduction

The ability to start and develop a sustainable business is fundamentally related to internal capacity and capabilities from top management down to the core workers[46]. For smaller businesses, which have a greater probability of being credit constrained and under-capitalised, human capital capability is more critical as they are more likely to adopt labour-intensive modes of production. To this end, the ability to successfully recruit and retain high quality workers is paramount[47]. Human capital largely determines a firm's absorptive capacity, and hence its ability to effectively deploy different types of knowledge and resources.

In the 3 pillars concept (introduced in Chapter 1), human capital is a fundamental driver of productivity in its own right. But in combination with innovation and physical capital, its economic impact through efficiency gains is even larger. A poor internal skills level is a key indicator of low productivity and high staff turnover. It also imposes additional costs by necessitating external recruitment rather than internal promotion. In contrast, high skill levels are associated with higher productivity in a direct sense, and also with a productivity-enhancing effect on other co-workers. In this chapter we present evidence relating to skills demand in the Australian business sector and identify specific skills shortages. We argue that where businesses have a high demand for skilled labour, but are constrained by lack of internal and/or external skills, then this represents a prima facie case for government intervention. On the firm side, this may relate to training of their own workforce, and in the wider economy, this may include policies relating to education and training of the wider labour force.

46 Cowling (2001).
47 BIS (2013)

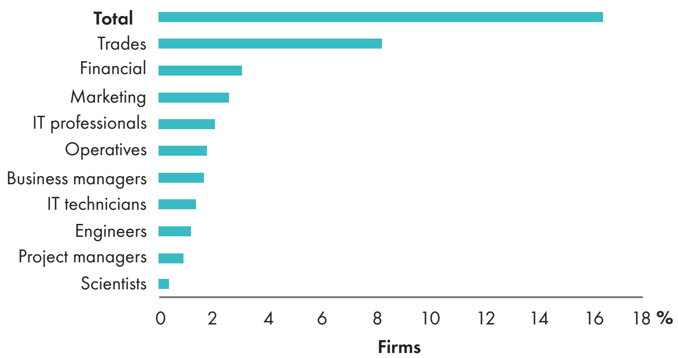
Skills demand and deficiencies

The evidence clearly shows that deployment of skilled labour increases with the size of business, with one notable exception – scientific and research staff play a more significant role among micro and smaller businesses than among larger businesses. But the general pattern suggests that the smaller the business, the fewer skills deployed. And this has negative implications for their ability to deal with unanticipated shocks.

The evidence on skills deficiencies is quite varied. Although larger businesses (those with a higher use of skilled workers) are constrained by a relative lack of engineers, IT professionals, skilled trades people, project managers and business managers, it is micro businesses that are more constrained by deficiencies in relation to scientists and research professionals, IT technicians, marketing professionals and project managers.

Figure 33 shows that one in six businesses in Australia face problems relating to skills deficiencies. While deficiencies are most apparent in trades, 64,000 businesses have an identifiable deficiency in finance professionals, 55,000 in marketing professionals, and 44,500 in IT professionals. This suggests that while the immediate labour market problem Australia faces relates to the construction boom and a lack of skilled trades people, the underlying problem might be in high value-added professional services.

Figure 33: Skills shortages



Source: ABS Business Longitudinal Database 2006-07 to 2010-11

In addition to analysing skills issues across different size classes of businesses, it is important to also consider the nature of industry sector constraints. Table 1 identifies specific industry sectors with an identifiable skills deficit.

Table 1: High skills demand and high skills deficit industry sectors

INDUSTRY SECTOR	SKILLS DEFICIENCIES
Mining	Engineers, scientists and researchers, IT technicians, project managers
Manufacturing	Trades operatives, project managers
Construction	Trades operatives, project managers
Transport	Operatives
Communications	IT professionals, IT technicians
Professional services	IT professionals, IT technicians

Source: ABS Business Longitudinal Database 2006–07 to 2010–11 (authors calculations)

It is clear that the booming sectors of the economy have a strong demand for core functional workers, and that the mining industry also has a high demand for highly skilled workers across the board. But perhaps the most critical aspect looking forward is that the sectors we predict hold the key to future growth and productivity increases – communications and professional services – have a high and unmet demand for IT workers at professional and technical levels. More importantly, these are sectors characterised by high knowledge intensity and a disproportionately high smaller firm presence.

BOOSTING SKILLS DEMAND AND SUPPLY

The key to resolving Australia's longer-term goal of creating a more dynamic and productive small business sector lies in boosting both skills supply and skills demand. In short, policy attention needs to focus on both sides of the skills market in order to create more quality jobs for more productive workers. In this sense, there is a need to:

- Co-ordinate employment, skills and economic development policy with the labour market, training and economic policy.
- Create a lifelong learning culture that delivers a workforce that is adaptable and mobile between firms and sectors, enabling resources (investment and people) to flow to those areas of the economy that have the most productive potential.
- Move out of a low skills trap, where some sectors of the economy have a low-skills equilibrium in which firms offer low-skilled jobs and operate in low-cost markets.
- Educate and train managers and entrepreneurs to stimulate demand for higher skilled jobs.

Given the importance of entrepreneurial businesses in net job generation, entrepreneurs have a major role to play. But helping the entrepreneurial sector to achieve its potential requires policy support across many areas, including business growth (initiating and managing growth) and the development of core entrepreneurship skills.

Entrepreneurs need a wide range of skills, including job-specific and functional skills such as communication, team-working, organisation and planning, as well as more general business skills. The general trend is away from jobs that require routine and manual tasks towards jobs that require problem solving and complex communications. And this requirement for high level cognitive skills is more apparent for the entrepreneurial population. A 2014 OECD report, titled *Job Creation and Local Economic Development*, states: "The 'science' of entrepreneurship is teachable but the 'art' of entrepreneurship is typically learned through practice." This is of great importance given the dominant role that knowledge capital plays in economic growth and the role of entrepreneurs as agents of change and growth.

The creation of an entrepreneurial ecosystem in which a system of support can deliver these skills to the entrepreneurial population, which in turn creates a demand for higher skilled employment, requires co-ordination across key agents including universities, economic development agencies and firms themselves.

The OECD provides a useful categorisation of the interaction of skills demand and supply for use as a skills diagnostic tool.

Table 2. Interaction of skills demand and supply

Skills Demand ↑	Skills deficit	High skills equilibrium
	Low skills equilibrium	Skills surplus
	Skills Supply →	

Source: OECD (2014) Job Creation and Local Economic Development

Here, a low-skills equilibrium is characterised by a concentration of firms using price-based competition strategies, reliant on low-skilled and standardised production. This would be a reasonable characterisation of significant parts of the domestic based service industries in Australia, particularly those segments dominated by very small firms.

MOVING OUT OF THE LOW-SKILLS EQUILIBRIUM

For the entrepreneurial population, this would require the skills and capabilities to develop and implement new market-based strategies. This, in turn, would stimulate demand for higher skilled workers. On the supply side, the Skills Australia *Better Use of Skills, Better Outcomes* report (2012) identified seven key skills-based issues that would deliver more productivity in the workplace:

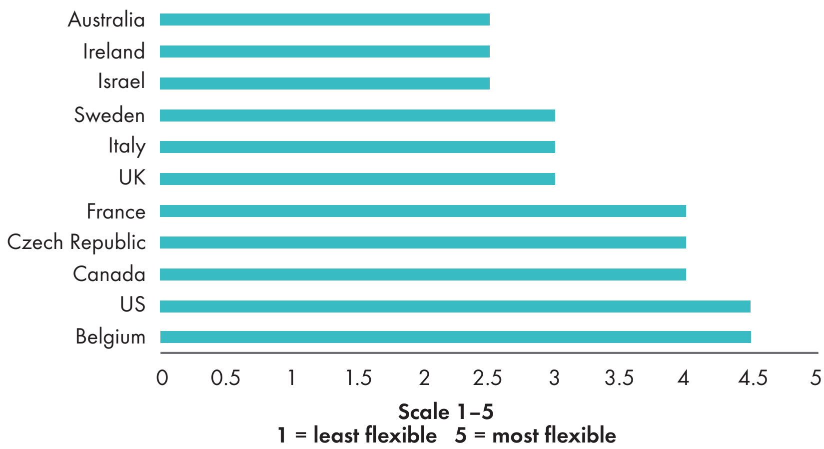
- Job redesign
- Employee participation
- Autonomy
- Job rotation
- Skills audits
- Multi-skilling
- Knowledge transfer

But, as with most government initiatives, the proposals were designed for, and in consultation with, large employers and large employee representative bodies. If implemented by a large employer, there would be a period of consultation with employee representatives, development of formal systems and processes, and lots of bureaucracy and additional costs. Many of these practices occur on an informal basis in small firms. But the evidence on the relative (lower) productivity of smaller firms compared to large suggests that these supply-side solutions are, at best, only part of a more complex solution.

What about the role of institutions in resolving skills mismatches at the firm and sector level, and where low-skills equilibriums exist?

The OECD (2014) strongly supports flexibility at the local level in designing and delivering employment policies and programs. Figure 34 suggests that Australia has a top-down, one-size-fits-all strategy in this area, which does not take into account local labour market conditions and specific skills demand and supply issues. The OECD recommends that policies and programs be adjustable at a 'local' level, but with one caveat: that flexibility requires strong 'local' leadership and capacity.

Figure 34: Flexibility in the management of employment policies and programs



CAN ENTERPRISE TRAINING IN THE EDUCATION SYSTEM PLAY A ROLE?

The role of human capital has been central to our understanding of what makes a successful entrepreneur[48]. Researchers have separated out human capital into two broad categories: formal (essentially educational qualifications and experience) and informal (developed through work and familial experiences). They have also examined whether one or the other 'types' of human capital is more helpful in pursuing an entrepreneurial career[49]. Other research has questioned whether entrepreneurship can be taught at all, or whether it is an innate characteristic[50]. Finally, the issue of whether enterprise education and training can make a difference to business outcomes has always been open to question and at present suffers from a lack of empirical testing.

While there are no definitive answers to any of these questions, the broad evidence base suggests that:

- Informal human capital is more important in the entrepreneurial sector than the waged sector[51].
- Psychological characteristics explain rather less about entrepreneurial behaviour than labour market experience and socio-demographic characteristics[52].
- Entrepreneurship has formal, managerial and decision-making elements that lend it to formalised teaching[53], and opportunity identification is at the heart of this[54].

A 2009 UK study by Professor Marc Cowling of the Brighton Business School explored (a) enterprise training in schools, (b) enterprise training in colleges and universities, (c) work experience in small business, and (d) enterprise training on a government program, and their impacts on:

- The probability of starting a new business.
- The probability of being involved in a spin-out from an existing firm.
- The probability of being an established business owner.
- An individual's willingness to start a new business in the future.

The findings were illuminating, and provide support for an interventionist and broad strategy of policy in the area of enterprise education at all levels of the education system.

The core findings were:

Business start-up

Enterprise training in college or university increased the probability of starting a business by 1.3 per cent, while enterprise support through a government program increased the probability by 1.5 per cent. These probabilities are not only statistically significant, but substantial in the context of how many people actually start new businesses each year in the UK. Of the hundreds of thousands of young people who graduate from higher education institutions each year, at present only one fifth receive enterprise training – and these people have a 1.3 per cent higher probability of starting their own business. Hence, we might conclude that an expansion of the supply of enterprise training throughout the further and higher education sector might yield a substantial increase in the number of people involved in business start-up activity. However, there may be diminishing returns if colleges and universities have cherry picked courses most likely to lead to entrepreneurial activity and careers. This question certainly appears worthy of further investigation.

48 Cowling (2000); Cressy (1996).
49 Parker (2008).
50 See Lee and Wong (2006) for an excellent review.
51 Cowling et al. (2004); Taylor (1996); Burke et al. (2000).
52 Blanchflower and Oswald (1998).
53 Cowling (2003).
54 Dana (2001).

In terms of access to government enterprise programs, the effect on business start-up probabilities is positive and significant. Among the adult population, the total exposure was just under 15 per cent, and peaked in the 1980s. But many young people today still receive government enterprise support. And this general legacy effect acts to increase the start-up probability across all age groups. This implies that a general and continued commitment to government-supported enterprise programs has paid off in terms of increasing the number of people who are currently active in starting their own business. Whether the costs of such provision are justified by the additional economic activity is an issue for policy evaluation.

Job related start-up

The next focus is on what business researchers often call intrapreneurship (entrepreneurial activity within a firm). The report finds that college or university-based enterprise training increases the probability that an individual will become involved in job related start-up activity by 0.4 per cent, and school based enterprise training by 0.3 per cent. Involvement in government enterprise programs increases this probability by 0.4 per cent. Although the scale of these effects is much smaller than for independent business start-up activity, this may reflect the relative difficulty of pursuing entrepreneurial activities within the formalised structures of firms. What it does suggest is that for individual firms, the types of people they are more likely to get engaged on these projects are those that have had access to enterprise training of all forms. This might suggest a positive dynamic generated by all forms of enterprise training, that firms themselves become more entrepreneurial or at least make use of the people with enterprising human capital.

OWNER-MANAGER OF A SMALL BUSINESS

The third measure of entrepreneurial behaviour is being an owner-manager of an existing small business. Here again, we find that receiving enterprise training through a college or university or from a government program increases the probabilities that an individual is an owner-manager of a small business by 2.3 per cent and 3.0 per cent respectively. The scale of these effects is large, and implies that exposure to enterprise training achieves its primary goal of increasing entrepreneurial activity rates.

Future start-up potential

The study found that people receiving enterprise training at college or university have a 3.2 per cent higher probability of starting a new business in the future, and that those who have received enterprise training through a government program have a 4.0 per cent higher probability. In addition, those who have had work experience in a smaller business have a 1.4 per cent higher probability. This evidence strongly suggests that exposure to enterprise training, at the minimum, raises individual awareness of entrepreneurial activity and instils a more positive attitude towards enterprise as a career option.

In summary, the results of the study suggest a generally positive relationship between enterprise training and current and future entrepreneurial activity. But this portrayal may be slightly misleading if individuals with the greatest desire, a priori, to pursue an entrepreneurial career path, select into enterprise training. Thus it becomes self-fulfilling that those who elect to get training then go on to start their own businesses.

On balance, however, it does appear that promoting enterprise in the education system, and through government-backed enterprise programs, does have the desired policy outcomes. It is also clear that gaining work experience in smaller businesses increases an individual's willingness to become an entrepreneur. But the evidence also suggests that the people most likely to pursue an entrepreneurial career also are those most likely to receive enterprise training or gain work experience in a smaller business. There are two alternative ways to view this. First, it is a good thing as it provides willing participants with new knowledge and the tools for success when they embark on an entrepreneurial career path. In effect, the provision of enterprise training and education acts as a filter to discriminate between the unwilling and unlikely and future entrepreneurs. But it may also be true that expanding enterprise training and education has diminishing returns as it becomes harder to convince the unwilling that they have an entrepreneurial future. Even so, it is not clear that we have reached the point of negative returns (where there is too much enterprise education and training for the numbers of people who might subsequently benefit). One could argue that as the peak age for starting an entrepreneurial career is typically between 35 and 45, enterprise training is a useful addition to the general human capital of any school, further education or higher education student.

While enterprise education and training appears to have a positive effect on entrepreneurial activity rates, there is another question: has it improved quality of entrepreneurs? Here the results also show some positive effects, with schools-based enterprise education and work experience being associated positively with job creation, and college/university and government-supported training associated with greater exporting capacity.

When it comes to policy, it appears that enterprise education is already well integrated into the further and higher education systems in Australia, but as yet not widely available in schools. If policy makers are minded to create a continuous ladder of enterprise education starting in schools and continuing right through to the labour market, this patchy provision needs to be addressed at the earliest level, and potentially at later stages, where large regional imbalances are evident in terms of accessing government supported enterprise training. And policy makers must decide whether they want to target resources at the 'most willing' or adopt a more inclusive agenda that would seek to change the mind-sets of the 'unwilling'.

Recommendations

Education and training

To address the significant skills deficit in the economy, governments (federal and state) need to reform the education system to increase and improve the nation's stock of skilled, knowledge-based workers. Governments should consider the inclusion of business training at all levels of the education system, from early school years through to further and higher education. Specifically, we recommend that:

- Entrepreneurship programs should be integrated into the National Curriculum at all levels of secondary school.
- STEM (science, technology, engineering and maths) subjects should be promoted and financially supported for all secondary school students.
- Small and medium-sized enterprises employing STEM graduates should receive a training and development allowance for the first year of their employment.

EDUCATION AND TRAINING

'future start-up potential'

3.2%

People receiving enterprise training at college or university have a 3.2 per cent higher probability of starting a new business in the future

4.0%

Those who have received enterprise training through a government program have a 4.0 per cent higher probability

1.4%

In addition, those who have had work experience in a smaller business have a 1.4 per cent higher probability

CASE STUDY: UNIVERSALLY SPEAKING, BUSINESS CONSULTANTS

THE ISSUE: THE NEED FOR BUSINESS EDUCATION IN AUSTRALIAN SCHOOLS

Australia may not be particularly noted for its entrepreneurial culture. But things are changing fast, according to regional NSW business consultant Natalie Shepard.

The current generation of teenagers and young adults are far more entrepreneurial than their parents and grandparents, and this could bode well for Australia as we look for new sources of growth and prosperity after the end of the minerals boom.

Unfortunately, according to Ms Shepard, Australia's school education system is woefully out of step with the needs and aspirations of the next generation of adults – and of the nation and economy generally.

"Most secondary schools are aimed very strongly towards tertiary education. Everything is heading towards university degrees. But there's a new wave of kids who are not looking to get into university," Ms Shepard says. "They have a real belief about getting out there and making money."

"They're very entrepreneurial in their thinking, they're unbelievably innovative. They have a real belief about what they can do in business. But the schools are still focusing on the same old practices, to have a good job, to go to university. This next generation thinks differently."

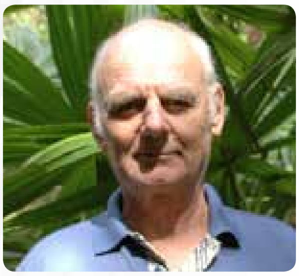
Ms Shepard's business partner, Sandra Martin, says business training and entrepreneurship should be a standard part of the school curriculum. "People who are not in business seem to have a mindset that they couldn't possibly be in business because they have no role models," Ms Martin says.

"Learning about entrepreneurship would give students a much broader range of opportunities across the board. It would equip them with the skills to do anything they choose," she says.

She cites the common statistics that show about 80 per cent of businesses fail in the first five years. "There is evidence that people either haven't done the research, they haven't matched their idea to the realities of the market," Ms Martin says.

"I think business training should be for everybody, from a reasonably young age, perhaps Year 10."

Natalie Shepard



“We’re spending something like 40 per cent of our executive time doing (regulation and compliance) stuff for the government. Some people in our industry have decided it’s too hard and have got out.”

Sean Caddy, Darwin Plant Wholesalers (Case study: Page 63)

CHAPTER 7:
REGULATION

Headline findings

- Regulation in Australia is too often written with regard only to the 'big end of town'. To correct this imbalance, we need an EU-style 'think small first' approach to the design and implementation of regulations. Regulation should be made more effective by identifying the minimum required to meet policy objectives, and how small business can deal with it.
- Governments and regulators should work on improving regulator culture. This can be achieved by promoting a 'risk-based' approach to enforcement of regulations, enforcing them in a proportionate way, and placing more emphasis on education of small businesses on how to comply, rather than punishment of those who transgress.
- Australia's Fair Work laws are complex and a source of major confusion and expense for many small businesses. A particular source of confusion and cost is the blurred distinction between independent contractors and employees.

Introduction

The impact of regulation on productivity growth has been studied by economists for many decades. While some studies[55] have found that productivity growth is negatively influenced by regulation due to effects on firms' incentives and costs, others[56] have found that regulation has no statistically significant impact on productivity growth. Notwithstanding the mixed evidence on the impact of regulation on productivity growth, it remains a serious issue for businesses as to how much productive time is diverted from their core activities to less productive activities such as fulfilling compliance obligations. In this report we focus on regulation design and implementation, regulator culture, Australia's Fair Work legislation, and competition policy that aims to create a level playing field for small businesses.

Regulation without stifling entrepreneurship

In October 2013, the Productivity Commission released its landmark report Regulator Engagement with Small Business. The report was the result of a lengthy inquiry in which the commission sought to benchmark regulator approaches to small business and make recommendations for governments to improve the delivery of regulation and reduce unnecessary compliance costs for businesses.

The Commission estimated that small businesses in Australia were subject to about 480 Commonwealth, state and territory regulators, as well as 560 local government regulators. The report reiterated established views that small businesses incur proportionately higher compliance costs compared to larger businesses, and that small businesses face great challenges in understanding and fulfilling their compliance obligations.

The first observation to make about the report is that its overall judgment of regulators and regulation in Australia is positive – perhaps unexpectedly so. Contrary to widely-held negative perceptions about the impact of regulation on small businesses, the Commission finds that many regulators in Australia are doing a good job – trying to strike a balance between society's need for regulation and the need to avoid imposing unreasonable compliance costs on businesses. The report also highlights how some regulators that might have deserved criticism in the past have been actively working to have a more positive impact.

Some corroborating evidence is provided by the ABS Business Longitudinal Database, which shows that, on average, 87 per cent of business owners between the years 2006-07 and 2010-11 did not perceive that their innovation and activities or performance were significantly hampered by government regulation or compliance. However, the data does indicate that there is a statistically significant negatively increasing perception towards government regulation or compliance over the five-year period. In 2006-07, 11 per cent of business owners stated that their innovation and activities or performance were significantly hampered by government regulation or compliance. By 2010-11 the figure had risen to 16 per cent. This demonstrates that there are still major problem areas, which Government needs to address. The report finds that many of the nation's two million-plus small businesses continue to carry unnecessary costs from their dealings with regulators.

55 For example, Denison (1979); Christainsen and Haveman (1981); Aghion and Howitt (2009).

56 Sims and Smith (1985); Conrad and Morrison (1989).

A number of insightful submissions to the Commission's inquiry highlighted real-life cases of small businesses – often family-run affairs – being hobbled, and in rare instances crippled, by regulations that are inappropriately implemented, aggressively applied or just poorly designed. Some prominent regulators were singled out for criticism, and myriad other examples were provided of regulator problems for small businesses, ranging from excessive reporting requirements to costly delays in processing licences and permits.

After careful assessment of the report's findings, we believe the Government should give priority to the following areas.

1. REGULATION DESIGN AND IMPLEMENTATION

In its submission to the Productivity Commission inquiry, the Institute of Public Accountants (IPA) advocated for an EU-style 'think small first' approach to the design and implementation of regulations. Regulations are often written with regard only to the 'big end of town' and a desire to maximise information. This can lead to over-regulation and impose significant burdens on small business. A preferred approach is to identify the minimum required to meet regulatory objectives, and how small business can deal with it. It may then be possible to upscale requirements when dealing with big business.

The report brought to light a number of examples of regulations being introduced without due consideration of potentially harsh impacts on small business. It is also important to ensure that in cutting red tape, we don't alter the policy intention but rather we make regulation more effective.

2. REGULATOR CULTURE

A large proportion of the Productivity Commission report was devoted to issues of regulator culture, and the need to improve the philosophical approaches and engagement methods of those who implement and enforce regulations. We agree with the findings on the need for governments and regulators to:

- Promote a 'risk-based' approach to enforcement of regulations. In this way, businesses considered more likely to transgress, or businesses whose transgressions would cause the highest costs to society, are supervised more closely than others. This approach encourages both an efficient allocation of regulator resources, and avoidance of unnecessary burdens on businesses that are perceived to be lower risk from a regulatory angle. Many regulators – such as the Australian Taxation Office (ATO) and various food safety agencies – already embrace a risk-based approach. But the report cited others that tend not to, such as liquor regulators and smaller regulators in general. We believe there is scope for much wider adoption of risk-based enforcement, and that governments must take an active role in promoting this.
- Enforce regulations in a proportionate way. The report and some submissions highlighted the tendency of some regulators to take disproportionately harsh measures against businesses that have fallen foul of regulations, often inadvertently. Regulators should be encouraged to use discretion in their enforcement role to ensure that small businesses are not unreasonably punished for minor infractions. The empowerment of regulators to make balanced decisions within the spirit of the law will often require cultural change among enforcement officers.
- Put more emphasis on education of small businesses on how to comply with regulations, rather than enforcement and punishment of those who transgress. In cases of minor and inadvertent infractions, enforcement officers should make the education of small business owners their first response. The response should escalate to penalties only with repeat offences. In many cases this will require specific measures by governments and/or regulators to give discretionary powers to officers. We also see an expanded role for intermediary organisations such as the IPA in educating small businesses about their obligations.
- In addition, stakeholders continually report that small business is often effectively denied access to government work, partly because of the process and the culture. It is contended that the public sector culture gets in the way and that, for example, it is less risky to appoint a large multinational than an unknown small business. Risk management within government needs to be completely reviewed. Other jurisdictions such as the US may be useful in this context.

3. CASE IN POINT: FAIR WORK REGULATIONS

Workplace relations have a significant impact on many aspects of the small business, in particular on innovation, skill formation, adaptability, and growth of many businesses in different industries (Productivity Commission, 2015, p. 2). The replacement of the Workplace Relations Amendment (WorkChoices) Act of 2005 with the Fair Work Act of 2009 has come under intense criticism from a number of commentators and major employer groups such as the Australian Chamber of Commerce and Industry (ACCI) and the Minerals Council of Australia.

A key criticism is based on the belief that the Fair Work Act has dismantled many of the Howard-era and Keating-era reforms and has made industrial relations in Australia more centralised and regulated[57]. However, the impact of these legislative changes on the small business sector is little understood.

57 Henderson (2013).

While it appears the small business sector finds it beneficial to have a well-defined award system when setting wages and conditions for their employees, small business owners seem to be challenged by the complexity of the industrial relations system. But overall, there is paucity of research on the effects of Australia' industrial relations system on the small business sector, particularly on small business performance, making it difficult to draw reliable conclusions[58].

The lack of research into the effects of Australia's industrial relations system on small business needs to be urgently addressed. It is particularly important to gain more understanding of the effects of award wage increases on small business performance and on employment dynamics in this sector. Notwithstanding, there appears to be consensus in the research literature about how confusing and complex the industrial relations laws are for many small businesses.

The Productivity Commission report included accounts from various organisations and businesses about their negative experiences with the Fair Work system. The testimony of small marketing companies about their legally expensive and frustrating experiences when being investigated by Fair Work officers was particularly compelling. The report also highlighted the ongoing problems and expenses for many small businesses in trying to deal with issues surrounding the classification of people as either independent contractors or employees.

It is clear that the Fair Work laws require urgent attention from the Federal Government. There should be legislative changes to ensure that:

- The industrial relations system is simplified for small business owners.
- Reviewing the award system to make it more flexible for small businesses to suit the current economic conditions and to ensure that Australian small businesses remain globally competitive.
- More clarity is provided on the distinction between whether people engaged by small businesses are working as independent contractors or employees.
- Other areas of confusion for small businesses over their obligations under the system are reduced or eliminated.
- The culture among Fair Work officers is changed to encourage a more educative and co-operative approach, rather than the aggressive attitudes and punitive behaviour reported in some submissions to the Inquiry.

58 Farmakis-Gamboni, Rozenbes and Yuen (2012).

4. LAYERS OF GOVERNMENT

The potential for waste, duplication and regulatory over-reach in having three layers of government cannot be over-stated. In this context it is pleasing to note that the Government has announced the Federation White Paper, to be delivered by the end of 2015. The terms of reference state that duplication and overlap between different levels of government results in waste and inefficiency. The 'Review of Current Local Government Reform Processes in Australia and New Zealand in 2013' by the Australian Centre of Excellence for Local Government also found there were nearly 30 review and reform initiatives currently underway. However, the question remains – what has been achieved in terms of actual, implemented reform?

Some work is being done around capturing and measuring case studies. Specific examples provided to the IPA include why we need to recreate certain regulations around such things as chemicals and drugs; if the United States FDA approves an item, why can't we apply a principle of mutual recognition? Another example is licensing schemes and why some, such as liquor licences, need to be renewed annually. Annual licensing should be reviewed across a range of areas to see whether they can be appropriately changed to a longer period. All of this involves greater engagement with small business.

5. OTHER AREAS OF REGULATION

We acknowledge the work of the Government and its deregulation agenda, which aims to cut red tape compliance by $1 billion per annum. The aim is to achieve this through strengthened regulatory impact analysis and quantifying compliance costs, audit of the stock of regulations, improved regulator performance and so on. The IPA and other stakeholders must hold government and its agencies to account and support and play our part in achieving this ambitious target.

Recommendations

Government regulation, Fair Work laws

To further reduce the burden of government regulation on small and medium-sized businesses, we recommend that:

- A European Union-style 'think small business first' approach to the design and implementation of regulations be adopted by Australian governments, which have historically focused too much on the 'big end of town' when it comes to regulation.
- Regulations should be made more effective by identifying the minimum required to meet regulatory objectives.
- Governments and regulators should improve regulator culture. This can be achieved by:
    - (i) Promoting a 'risk-based' approach to enforcement of regulations, focusing mainly on enterprises considered to present the greatest risks to society from non-compliance.
    - (ii) Enforcing regulations in a proportionate way.
    - (iii) Placing more emphasis on education of small businesses on how to do the right thing, rather than enforcement and punishment of those who transgress.

The Government should also simplify the industrial relations system and the Fair Work laws for small business owners by:

- Reviewing the award system to make it more flexible for small businesses to suit the current economic conditions and to ensure that Australian small businesses remain globally competitive.
- Legislating to give more clarity to businesses on the distinction between people being engaged as independent contractors or employees.

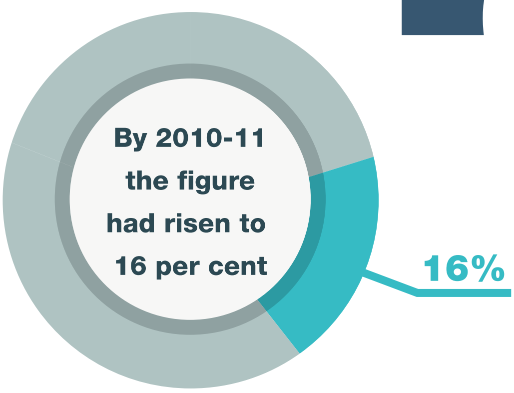
REGULATION

87% **2006-07**

On average, 87 per cent of business owners between the years 2006-07 and 2010-11 did not perceive that their innovation and activities or performance were significantly hampered by government regulation or compliance.

87% **2010-11**

In 2006-07, 11 per cent of business owners stated that their businesses' innovation and activities or performance were significantly hampered by government regulation or compliance.



However, there is a negatively increasing perception towards government regulation or compliance over the five-year period

CASE STUDY: DARWIN PLANT WHOLESALERS

THE ISSUE: DROWNING IN REGULATION

The burden of regulation falls quite unevenly across the small business sector. Some types of business operators get off relatively lightly; others feel like they're drowning in regulations.

Sean Caddy is firmly in the 'drowning' category. Mr Caddy runs Darwin Plant Wholesalers, Australia's largest tropical plant nursery, selling more than 500 species of exotic and Australian species in over 3,000 separate stock lines.

With more than 30 employees, Darwin Plant Wholesalers has to deal with the usual annoying (but necessary) regulation and compliance issues for a business of that size: workplace safety, taxation, payroll, superannuation, Fair Work laws and the like.

But the real regulatory sting for Mr Caddy and his plant nursery comes from the fact that they sell plants to interstate and overseas customers. This brings into play what must be the bane of Mr Caddy's working life: quarantine regulations.

The business has to deal with two separate quarantine agencies in Australia – the national agency AQIS as well as NT Quarantine – which between them impose major imposts in both red tape and financial costs.

Mr Caddy is particularly down on the NT agency for the fact that it will only quarantine one plant order at a time, which imposes a significant constraint on the efficiency of the business. And the cross border rules are different for every state; for sales to some states, hundreds of dollars in inspection charges are incurred for each consignment.

"You'd think there might be some sort of national standard for interstate plant trade. But every state has different rules," Mr Caddy complains.

Recently, Darwin Plant Wholesalers has been trying to build up its overseas sales, but these remain a small component of the business – in large part due to the extraordinary challenges in dealing with export regulations. "If there wasn't so much bureaucracy involved we'd probably be exporting several million dollars a year," Mr Caddy says.

"At the moment our export business wouldn't even be paying for itself because there's so much bureaucracy involved. We're hanging in there at the moment, whether we persist or not we'll see."

For example, he says the business is required by the Federal Environment Department to give an annual notification of what plants it will export in the coming year. "But we wouldn't have the faintest idea; we have to guess," he says.

"Then if we get a big order from the Middle East half way through the year, we have to say we can't fill it because it's not in our licence."

There is also significant uncertainty when it comes to how much Darwin Plant Wholesalers will need to pay in Australian export fees each year. The fees can vary by thousands of dollars across three set levels, making it difficult for the company to plan for growth based on an uncertain bottom line.

Mr Caddy says the level of regulation on the plant wholesaling business is such that "we're spending something like 40 per cent of our executive time doing stuff for the government. Some people in our industry have decided it's too hard and have got out."

Small and medium-sized businesses, as well as consumers, can be the subject of unfair contract terms and are no less deserving of protection.

CHAPTER 8:
COMPETITION POLICY

Headline findings

- The unconscionable conduct and unfair contract terms provisions of the Australian Consumer Law (ACL) do not adequately protect small businesses against being the victims of price gouging or price squeezes.
- The ACL should be amended to make it clear that it is unconscionable conduct for a firm to use its superior bargaining power to force a customer (or supplier) to accept an unfair price and to make void a contractual term specifying an unfair price.
- The current prohibition on misuse of market power, embodied in Section 46 of the Competition and Consumer Act, is deficient in addressing exploitation and anti-competitive conduct by dominant firms. In particular:

1. By focusing on a firm's purpose alone, it fails to capture conduct having the *effect* of substantially lessening competition.
2. The 'take advantage' requirement in Section 46(1) has been interpreted in such a way as to excuse conduct even where its purpose is to deliberately harm a competitor or the competitive process.

- Section 46 of the Competition and Consumer Act should be amended to extend to single firms conduct that has the effect of substantially lessening competition, and the 'take advantage' element should be removed from the existing prohibition.

1: UNFAIR CONTRACTS AND UNCONSCIONABLE CONDUCT

A comprehensive national review of competition laws and policy, the first since the Hilmer Review in 1993, has been underway since 2013. Its intention is to increase productivity and efficiency in markets, driving benefits to ease cost-of-living pressures and raise living standards for all Australians. A draft report was released in September 2014, and a final report is due in 2015.

The Institute of Public Accountants, in a submission to the review, highlighted two elements of Australia's competition laws and competition policy that are of particular concern to small and medium-sized businesses:

1. Inadequate protection from price gouging or price squeezes under the unconscionable conduct and unfair contract terms provisions of the ACL.
2. When dealing with suppliers or customers who have superior bargaining power, smaller businesses are often forced to pay, or accept, an unfair price in situations including:
   - When goods or services are in short supply as a result of a natural disaster or strike.[59]
   - When alternative supplies of goods or services are not available to a particular business – at all or within a reasonable time[60] – and advantage is taken of the urgent need.
   - 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.[61]

59 This situation has prompted the enactment of price gouging laws in many states in the United States of America. Some of these are limited to price rises following natural disasters, others are general in nature.

60 In the case of marine salvage, 19th and early 20th century courts would set aside salvage contracts if the amount charged by the towing vessel was 'inequitable, extortionate and unreasonable': see *The Port Caledonia and the Anna* [1903] P 184. There, the amount was five times what the court thought was reasonable and the vessel being rescued had agreed only because she was in danger of fouling another vessel and was in no position to bargain for more reasonable terms. A more prosaic example might be where equipment upon which the business depends is broken and an essential spare part needed for its repair is available from one supplier only.

61 This appears to lie at the heart of the action taken recently by the ACCC against Coles alleging that Coles has engaged in unconscionable conduct, and which received extensive media attention. However, it is noted that, perhaps because of the deficiency in the law about which the IPA is concerned, this action alleges in support of its unconscionability claim that Coles has engaged in misleading conduct.

- When advantage is taken of a business's inability to obtain supply elsewhere to extract an additional payment in respect of past supplies.[62]
- When advantage is taken of an existing tenant's investment in goodwill or fit-out when negotiating renewal of a lease.

Situations such as those listed above are unfair and capable of threatening a business's participation in the markets in which they operate – first to the detriment of the business, and eventually to the detriment of consumers. As the Competition Policy Review *Issues Paper* notes, this is contrary to the intent of the unconscionable conduct provisions of the ACL, which is to provide both a 'more *efficient* and *equitable basis*' for competition (emphasis added).

The best form of protection against this type of conduct is for small and medium-sized businesses to face competitive markets when they enter into acquisition or supply transactions, or for them to seek to establish countervailing market power through authorised collective bargaining. Unfortunately, when markets are not competitive, or collective bargaining is not possible or sufficiently expeditious, small and medium-sized businesses remain vulnerable.

To enable the law to respond to this situation and protect the victims of unfair pricing, the ACL should be amended to make it clear that it is unconscionable conduct for a firm to use its superior bargaining power to force a customer (or supplier) to accept an unfair price and to make void a contractual term specifying an unfair price.

Background

UNCONSCIONABLE CONDUCT AND THE AUSTRALIAN CONSUMER LAW

Section 20 of the ACL prohibits a person, in trade or commerce, from engaging in conduct that is unconscionable within the meaning of the unwritten law from time to time. Although this prohibition is broad – in particular, it is not restricted to consumer transactions and can be used on behalf of any business – it does not extend the forms of conduct that are to be regarded as unconscionable.[63] As a result, present authority suggests that it will not protect a person or business from being charged an unfair price unless this is accompanied by some other form of misconduct such as duress, undue influence, non-disclosure or sharp practice.[64]

Section 21 of the ACL creates a new, statutory prohibition of unconscionable conduct occurring in trade or commerce. Although it applies only to conduct in connection with the supply or acquisition of goods or services, 'goods' and 'services':

1. Are defined broadly in Section 4(1) of the Competition and Consumer Act. Importantly, the definition of services includes rights and interests in real or personal property.
2. Are not restricted to consumer goods or services, so that the prohibition can be invoked in relation to goods or services that are being acquired or supplied for any business purpose.

Section 21 is also not restricted to conduct directed towards consumers. As a result, it can be invoked by individuals, or corporations engaged in business. The only entities not protected are listed public companies.

Section 22 then lists a large number of matters to which a court may have regard for the purpose of determining whether the conduct of a 'supplier' or 'acquirer' was unconscionable under Section 21.

It is acknowledged that the precise scope of these provisions is unclear. It is also acknowledged that because a court can consider 'the terms of the contract'[65] and because the factors listed in Section 22 do not limit the matters to which a court may have regard, it is possible that charging or paying an unfair price for a loan could amount to unconscionable conduct. However, as the only reference to price in Section 22 is to the 'amount' for which the customer (or supplier) could have acquired or supplied elsewhere, and as the weight of previous authority is to the contrary, it is concerning that 'mere inadequacy of price is not likely to constitute unconscionability'.[66]

UNFAIR CONTRACT TERMS AND THE AUSTRALIAN CONSUMER LAW

These provisions of the ACL apply only to a 'consumer contract', the definition of which in Section 23(3) restricts them to the 'acquisition of ... goods or services ... wholly or predominantly for personal, domestic or household use or consumption.' As a result, they cannot be invoked by small or medium-sized business in respect of their contracts with dominant suppliers or customers, no matter how egregious those contracts may be.

In addition, the exclusion, via Section 26(1)(b), of 'the upfront price payable under the contract' from the terms that can be made void under Section 23 means that these provisions cannot assist a consumer whose only complaint is that they were charged an unfair contract price.

62 This is the situation that faced the milling business in *Smith v William Charlick Ltd* (1924) 38 CLR38.

63 The only difference is that equity is not restricted to conduct occurring in trade or commerce. The advantage of prohibition is that it gives victims access to the ACL's superior remedies and allows the ACCC to invoke it in the public interest.

64 7See, for example, *Smith v William Charlick Ltd* (1924) 34 CLR 38, Eric Gnapp Ltd v Petroleum Board [1949] 1 All ER 980, *Burmah Oil Co v Bank of England* The Times 4/7/1981 and *Australian Competition and Consumer Law Reporter*, para 27-320.

65 See ACL s. 21(4)(c)(i).

66 See *Australian Competition and Consumer Law Reporter*, para 27-320.

Future reform

UNCONSCIONABLE CONDUCT PROVISIONS OF THE AUSTRALIAN CONSUMER LAW

Price should be included in the list of matters in Section 22 to which a court may have regard when determining whether conduct is unconscionable, in a manner that addresses the deficiency in the existing law outlined above.

Corresponding changes should also be made to the equivalent provisions of the Australian Securities and Investments Commission Act 2001 (S. 12CC). This could be achieved, for example, by:

1. Adding a new paragraph (m) to sub-sections 22(1) and (2) such as 'the price the customer was required to pay' and 'the price the supplier was required to accept', respectively; or
2. Amending the existing sub-paragraphs 22(1)(j)(ii) and (2)(j) (ii) to read 'the terms and conditions of the contract, including the price to be paid for the goods or services'.

To be clear, it is not suggested that merely charging an 'unfair' price should make a transaction unconscionable. However, it should do so when this is combined with and results from the 'absence of a reasonable equality of bargaining power by reason of the special disability of one party to a transaction'[67] so that a finding of unconscionability is necessary to 'prevent victimisation of the weaker party by the stronger'[68].

Although it may not always be easy to determine whether the price extracted by a dominant firm was so 'unfair' as to make its conduct unconscionable, the law is not unfamiliar with addressing problems of this nature. In various jurisdictions it has, for example, been achieved in:

1. Price gouging legislation designed to protect consumers.[69]
2. Price gouging being made a competition law offence.[70]
3. Adapting the unwritten law to respond to particular instances of exploitation such as happened in the salvage cases, and cases involving expectant heirs.[71]
4. Empowering courts to reopen unjust credit contracts where the injustice results from excessive interest charges.[72]

UNFAIR CONTRACT TERMS PROVISIONS OF THE AUSTRALIAN CONSUMER LAW

Small and medium-sized businesses, as well as consumers, can be the subject of unfair contract terms, and are no less deserving of protection. This is especially so in the kinds of situations identified above. As noted earlier, as well as being unfair in the sense of preventing them from receiving an equitable share of the wealth that may be generated by the markets or supply chains in which they operate, it may threaten their ability to operate in their markets at all. For these reasons, the protection created by Part 2–3 of the ACL should be extended to small and medium-sized businesses. This can be achieved by deleting:

1. The references therein to 'consumer'.
2. Section 23(3), which defines 'consumer contract'.
3. Section 26(1)(b).

This would expand the reach of Part 2-3 so that it can apply to business-to-business contracts, not merely consumer contracts, and by making it possible for a term that 'sets the upfront price payable' to be found to be unfair.

2: MISUSE OF MARKET POWER

Given structural changes in the economy over time, how should misuse of market power be dealt with under the Competition and Consumer Act?

This was one of the key questions posed in the *Competition Policy Review Issues Paper* in April 2014, as part of Australia's first comprehensive review of competition policy in more than 20 years. At the heart of this question is a concern – highlighted by the Institute of Public Accountants in its submission to the competition inquiry – that the existing misuse of market power provision does not adequately protect small business from the predatory actions of companies with substantial market power.

67 *Kakavas v Crown Melbourne Ltd* [2013] HCA 25 per French CJ, Hayne, Crennan, Kiefel, Bell, Gageler and KeaneJJ at para 117.

68 *Ibid*

69 For an Australian example, see the (now repealed) provisions in Part VB of the *Trade Practices Act 1974* which prohibited 'price exploitation' in the wake of the introduction of the GST. This involved the concept of an 'unreasonably high' price and the matters that could be taken into account in determining whether a price was unreasonably high. As noted above, in the USA general and specific price gouging legislation exists in a majority of states and the District of Columbia.

70 European Community competition law makes charging excessive prices an offence: see *General Motors v Commission* [1976] 1 CMLR 95 and *United Brands Continental BV v Commission* [1978] 1 CMLR 429. Under the UK Competition Act 1998 charging an excessive price was found to be an offence in *Napp Pharmaceuticals Holdings Ltd v Director General of Fair Trading* [2002] CAT 1. In Australia, however, it would be a competition law offence only if it amounted to a contravention of s. 46 of the CCA.

71 See, for example, Earl of *Aylesford v Morris* [1962-73] ALL ER Rep 300 (borrowing money at an interest rate of 60 per cent). This situation is now regulated by Consumer Credit legislation: see, for example, *Consumer Credit (Victoria) Act 1995*, s. 39. For US examples under the Uniform Commercial Code s. 2-302(1) , see *Kugler v Romain* 279 A 2d 640 (1971) (charging a consumer of limited education and economic means 2.5 times a reasonable market price) and *Jones v Star Credit Corp* 198 NYS 2d 264 (1969) (charging a consumer over $1,234.80 for goods worth less than $300).

72 See the *National Credit Code*, s. 76(2)(o) (Schedule 1 to the *National Consumer Protection Act 2009)*.

The best form of protection against anti-competitive conduct is for small and medium businesses to face competitive markets when they enter into acquisition or supply transactions, or for them to seek to establish countervailing market power through authorised collective bargaining. We do not seek special protection for them from the ordinary rigours of competition. However, Australia's concentrated market structure means that many markets are not competitive and, where collective bargaining is not possible or sufficiently expeditious, small or medium-sized businesses are especially vulnerable to exploitation by firms with substantial market power.

The current prohibition on misuse of market power, embodied in Section 46 of the Competition and Consumer Act, is deficient in two key respects:

- By focusing on purpose alone, it fails to capture conduct having the *effect* of substantially lessening competition
- The 'take advantage' requirement in Section 46(1) has been interpreted in such a way as to excuse conduct even where its purpose is to deliberately harm a competitor or the competitive process.

It is for these reasons that we seek amendments to Section 46 to extend to single firms conduct that has the effect of substantially lessening competition *and* that the 'take advantage' element be removed from the existing prohibition.

Background: The objectives and operation of Section 46

Section 2 of the Competition and Consumer Act states that the purpose of the Act as a whole is 'to enhance the welfare of Australians through the promotion of competition and fair trading, and provision for consumer protection'. We submit that the object of Section 46 has never been, and should not now be, considered as limited to conduct that produces significant anti-competitive harm in a broad economic sense. That this was not the original object of the provision is apparent from its focus on the *purpose* of conduct and on harm to specific competitors or persons, irrespective of the effect of the conduct on the broader competitive process.

This was highlighted in the second reading speech accompanying amendments to the Act in 1986:[73]

> A competitive economy requires an appropriate mix of efficient businesses, both large and small... an effective provision controlling misuse of market power is most important to ensure that small businesses are given a measure of protection from the predatory actions of powerful competitors. ...

73 The 1986 amendment reduced the threshold market power test from one of market control to the current 'substantial market power' test and made clear that a court could infer requisite purpose from surrounding circumstances (s. 46(7))

Reducing competition: Purpose and effect

The current misuse of market power provision requires proof that the corporation holding substantial market power also had a prescribed exclusionary purpose. Although it is possible to infer this in appropriate cases, it is clear that the provision, as currently drafted, will not capture conduct that has the *effect* of substantially lessening competition while lacking one of the specified purposes in Section 46(1)(c).

The absence of an 'effects' test renders Section 46 inconsistent with other provisions of the Competition and Consumer Act,[74] as well as with international trends and with one of the core objectives of the Act – the promotion of competition. It is also clear that, while purpose has not proven a significant hurdle in the limited number of Section 46 cases that have been litigated, difficulties in obtaining evidence of purpose have hindered the capacity of the ACCC to bring some matters to court.[75]

Hence, Section 46 needs to be amended to capture unilateral conduct by a firm with substantial market power which has, or is likely to have, the effect of substantially lessening competition. It is further recommended that a connection between the market power and the anti-competitive effect be retained to ensure that there remains an appropriate mechanism for distinguishing between pro-competitive conduct, such as successful product innovation, and anti-competitive conduct made possible only by virtue of a party's power in the market. The addition of an 'effect' alternative without such a connection would unduly widen the provision and capture pro-competitive conduct which might incidentally impact on market competition.

Example

> Company A, which has substantial market power, invests in the development of a new widget. In doing so it believes that the new product will be so popular that it will easily win market competition. If successful, Company A's conduct is, therefore, likely to produce the effect of substantially lessening competition (by attracting significant custom from its competitors). Absent a connecting mechanism between the conduct and the market power this would be unlawful and would constitute an inappropriate impediment to pro-competitive activity.

74 For example, Sections 45 and 47 which refer to conduct having a particular 'purpose or effect'.

75 See, for example, ACCC Submission to this inquiry, page 76.

Removing the 'take advantage' requirement

The addition of an effects test in the form recommended above would ensure that unilateral conduct having an anti-competitive effect, and that reliance on market power, is captured by the legislation. However, it would not address they key limitation of the existing misuse of market power provision: the 'take advantage' element. Recent attempts to address concerns about this element through the inclusion of guidance provisions have been cosmetic only, and fail to address the real issue.[76]

We believe that conduct by corporations with substantial market power that has the purpose of (1) eliminating or substantially damaging a competitor; (2) preventing the entry of a person into a market, or (3) preventing or deterring a person from engaging in competitive conduct should be unlawful, regardless of whether it involved 'taking advantage of market power.' The level of concentration in many of Australia's markets means that conduct of this kind will frequently fail to 'substantially lessen competition' precisely *because* of the market power already held by the firms engaging in the predatory conduct. Such conduct should be prohibited, not to protect small business per se, but because it is appropriate for a law aimed at the protection of competition to prohibit conduct that has as its object the elimination of rivals and, by extension, harm to the competitive process.

The current prohibition in Section 46(1) requires that there be a connection between substantial market power and the prescribed purpose; in particular, it requires that a firm 'take advantage' of its market power. Although such a link is important when attached to an objective 'effects' test, for reasons explained above, it is not necessary or appropriate in the context of conduct having as its object the exclusion of an existing or potential competitor. The difficulties associated with this requirement in the existing provision have long been recognised, as highlighted by Alan Griffiths MP during the course of the Griffiths Review:[77]

> 'It puts a great limitation on the operation of Section 46 by insisting that the proscribed purpose alone is not sufficient; the nature of the activity also has to fall within the terms of Section 46... a corporation which has a statutory monopoly, such as Telecom... would all be capable of characterising activities as the exercise of a right given to it by statute, rather than taking advantage of the market power which it has by virtue of its position ... [130] ... The real problem with the drafting... is that it enables a corporation to engage in anti-competitive conduct which breaches the proscribed purposes provision of Section 46 but the conduct itself does not fall within the narrow definition of taking advantage of the market power'.[78]

These comments were made prior to the decision of the High Court in *Qld Wire*[79], which rejected the attempt to introduce a pejorative element into the 'take advantage' requirement and found that BHP had misused its market power in refusing to supply Y-Bar to Qld Wire. The Griffith Committee considered that that decision had resolved the 'debate about the interpretation of the take advantage provision' and that it should 'make it easier for aggrieved parties to establish a breach of Section 46.'[80] As a result, the committee recommended against a significant redrafting, preferring to leave it for the courts to resolve any further potential difficulties with the section. Unfortunately, the committee's predictions about the future of the provision proved too optimistic. Subsequent decisions, particularly those in *Rural Press*[81] and *Cement Australia*, have abandoned the neutral and holistic approach to Section 46 and the 'take advantage' element which were exemplified in *Qld Wire*. Instead, the courts in these cases have engaged in a 'complex, disaggregated form of analysis' which has rendered the provision of 'limited utility'.[82] Legislative intervention is now needed to resolve the problem caused by the 'take advantage' requirement.

We believe that the 'take advantage' element should be removed entirely from the prohibition. Despite some concerns expressed to the contrary, we do not consider that this will unduly broaden the scope of the provision. We accept that competition is often 'deliberate and ruthless' and that successful competitors will necessarily injure those who are less successful.[83] However, removing the 'take advantage' element from the existing prohibition would not capture *competitive* conduct, such as development of more efficient processes or improvements to products through innovation and investment in research and development, which may have the effect of eliminating less efficient or innovative competitors.

76 The *Trade Practices Legislation Amendment Act 2008* inserted sub-section 46(6A), which sets out a list of matters the court may have regard to when assessing whether a corporation has taken advantage of its market power.

77 'Mergers, Takeovers and Monopolies: Profiting from Competition?' (Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs) 1989

78 Hansard Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs (Reference: Mergers, takeovers and monopolies) Canberra 25 October 1988, page 129-130.

79 Queensland Wire Industries v BHP (1989) 167 CLR 177.

80 'Mergers, Takeovers and Monopolies: Profiting from Competition?' (Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs) 1989 paragraph 4.6.26

81 *Rural Press Ltd v ACCC* [2003] HCA 75

82 ACCC Submission to this inquiry, pages 79-80.

83 *Queensland Wire Industries v BHP* (1989) 167 CLR 177 (per Chief Justice Mason and Justice Wilson at para 24)

Removal of the 'take advantage' element would, however, protect against conduct that unfairly impedes normal competition; that is, conduct that has as its *object* the exclusion or deterrence of others from the market. In addition to harming competition, one competitor at a time, such conduct carries with it moral opprobrium for which purpose remains an appropriate and effective mechanism for distinguishing *predatory* conduct from normal and benign *competitive* behaviour.

If it is accepted that conduct having as its *object* the elimination, deterrence or exclusion of competitors should be prohibited, the need for a 'take advantage' link to market power is negated. Neither the anti-competitive purpose nor the effect are altered by the source of the power utilised to bring about the outcome. A firm with substantial market power may eliminate a competitor by burning down their shop or by refusing to supply them with essential materials; the former is clearly not referable to market power while the latter may be. There is no obvious reason for distinguishing between the two; the purpose and outcome remain the same.

In the event that the committee considered that a link between market power and exclusionary purpose was required to ensure pro-competitive conduct was not captured by the provision, we suggest that the 'take advantage' element be retained, but that it be *presumed* to be satisfied whenever the requisite market power and purpose have been established. This would cast the onus on the party with the market power and exclusionary purpose to prove the absence of a link between their purpose and the market power they hold.

Recommendations

Unconscionable conduct, abuse of market power

To protect small and medium-sized enterprises from becoming victims of price gouging or price squeezes, we recommend that the ACL be amended to make it clear that it is unconscionable conduct for a firm to use its superior bargaining power to force a customer (or supplier) to accept an unfair price, and to make void a contractual term specifying an unfair price.

Additionally, we recommend that Section 46 of the Consumer and Competition Act be overhauled to strengthen the prohibition on firms from using their market power to substantially lessen competition, and to remove the 'take advantage' element from the existing prohibition in Section 46(1). Specifically, we propose that:

1. Section 46(1) be repealed and replaced with the following provision:

   (1)(a) A corporation that has a substantial degree of power in a market shall not engage in conduct for the purpose of:

   (i) Eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;

   (ii) Preventing the entry of a person into that or any other market; or

   (iii) Deterring or preventing a person from engaging in competitive conduct in that or any other market.

   (1)(b) A corporation that has a substantial degree of power in a market shall not take advantage of that power in that or any other market if the effect or likely effect would be to substantially lessen competition in that or any other market.

2. Sub-section (1A) should be amended to replace references to sub-section (1)(a)(b)(c) with references to sub-section (1)(a)(i)(ii)(iii) respectively.

3. Sub-section (7), which allows purpose to be inferred, should be amended as follows:

   (7) Without in any way limiting the manner in which the purpose of a person may be established for the purposes of any other provision of this Act, a corporation may be taken to have a purpose referred to in sub-section (1)(a) notwithstanding that, after all the evidence has been considered, the existence of that purpose is ascertainable only by inference from the conduct of the corporation or of any other person or from other relevant circumstances.

The remaining sub-sections should be retained in their current form.

“Most small businesses are mum and dad sort of little operations. Anything that can enhance the ability of those families to be able to focus on running their businesses will improve economic efficiency, it will improve transparency”

Suryan Chandrasegaran, accountant (Case study: Page 78)

CHAPTER 9:
TAXATION

Headline findings

- Australia's taxation system, in combination with myriad government regulations, imposes an unreasonably heavy compliance burden on small businesses. These burdens act as a disincentive to entrepreneurial activity and employment, and ultimately represent a drag on the performance of the economy as a whole and the living standards of Australians.
- Tax cuts for small business introduced in the 2015 federal budget – combined with other concessional budget measures targeting the nation's 2 million-plus small enterprises – provide a welcome, if long overdue recognition of the disproportionate burden of regulation and compliance that the sector bears. However, the tax relief for small business does not go nearly far enough to redress the situation; it is, at best, a step in the right direction.
- The Fringe Benefits Tax (FBT) imposes the highest compliance costs on business relative to the revenue generated. A comprehensive review of the FBT legislation is required.
- The eligibility rules for small business Capital Gains Tax (CGT) concessions are overly complex and should be simplified. These concessions reward successful businesses at the end of the business cycle. Many businesses miss out using these concessions due to the fact that the business sale generates no goodwill. We are of the view that these concessions should be reviewed and redirected towards the start up and growth phase of the business to improve the chances of survival.
- Division 7A of the Income Tax Assessment Act – which is designed to stop private companies making tax-free distributions to shareholders in the form of payments, loans and debts forgiven – needs to be simplified to make it easier for companies to reinvest profits as working capital.
- An alternative to the current definition of small business would be to adopt a 'two out of three' test similar to what the Corporations Law definition has in place for small proprietary companies and the existing turnover threshold should also be increased to at least $3 million.

Introduction: A tax system that supports small business growth

A strong and vibrant small business sector is crucial to achieving sustained and healthy growth of the Australian economy – and the importance of the role of entrepreneurs in this regard cannot be over-stated.

It is sobering to note in this context that a high percentage of Australian small businesses do not have employees. There is ample anecdotal and other evidence to show that the reluctance of many small businesses to employ people is in part attributable to heavy compliance obligations associated with employment, such as PAYG, the Superannuation Guarantee Charge, FBT and workers compensation. These compliance burdens impose substantial costs of both time and money which, when combined with other non-tax regulations, create disincentives to employing staff and business growth.

In light of these effects, the authors of this White Paper believe that major and tangible changes must be made to the small business taxation environment, with particular emphasis on providing incentives to entrepreneurs and innovators. Specifically, we believe urgent government attention is required in the following areas:

1. CONCESSIONAL INCOME TAX RATE FOR SMALL BUSINESS

The level of taxation compliance and complexity facing small business has increased substantially over the last few decades. With the introduction and development of FBT, CGT, GST, the paid parental leave scheme and compulsory superannuation, the tax system has become excessively onerous, resulting in more than 95 per cent of businesses currently engaging a tax practitioner.

Large and small businesses alike face a plethora of reporting obligations. However, given that large businesses are generally better resourced to deal with reporting requirements, the cost of compliance for small business is disproportionately higher. Tax compliance is in addition to the already heavy burden faced by small business in administration and reporting relevant to workplace and OH&S laws, and the SG.

Small businesses also face higher costs than larger organisations when it comes to accessing finance.

In a welcome development, the Australian Government's May 2015 budget announced the introduction of a concessional rate of company tax for small businesses, and an income tax discount for the majority of small business owners who do not use a company structure. These initiatives amount to a long overdue recognition by the Government of the disproportionate compliance burden that small business owners carry, relative to larger businesses. The changes will go some way towards compensating smaller operators for the regressive nature of tax compliance and finance costs, while rewarding entrepreneurial activity and freeing up more after-tax income for businesses to reinvest and expand. Importantly, tax relief is what small business owners want; consultation with businesses by the Institute of Public Accountants (IPA) consistently indicates support for a lower tax rate rather than a multitude of complex, and sometimes inaccessible tax concessions.

Unfortunately, the 2015 budget tax cuts do not go nearly far enough towards redressing the relatively disadvantaged position of small businesses when it comes to compliance and finance costs. The reduction of 1.5 percentage points in the company tax rate (from 30 per cent to 28.5 per cent) for small businesses with an annual turnover of up to $2 million, and the 5 per cent tax discount (capped at $1,000 a year) for unincorporated businesses, will at best provide marginal relief. These changes are more in the realm of gestures than genuine reform.

For a more impactful approach, Australia should look at the model adopted by the Canadian province of Alberta, which has a combined federal/provincial corporate income tax rate of just 14 per cent for small business (against 25 per cent for general business). The income threshold is C$500,000. Alberta has one of the most competitive tax environments in North America, and has led all provinces in economic growth over the last 20 years, with an average GDP growth rate of 3.5 per cent (and 3.9 per cent in 2013), and unemployment in 2013 at 4.6 per cent. It has a diverse economy and 4 million people.

2. SMALL BUSINESS CGT CONCESSIONS

The small business CGT concessions are overly complex. While the rules were subject to a post-implementation review by the Board of Tax, the eligibility rules need to be simplified. Their complexity in part is due to having to deal with multiple business structures and anti-avoidance provisions. The four current and separate small business CGT concessions require taxpayers to navigate complex legislation.

A number of existing concessions such as the 50 per cent reduction and the 15 year exemption are highly concessional, and can eliminate any CGT liability when business owners exit their investment. These concessions are generally uncapped and are generous tax concessions.

These concessions reward successful businesses at the end of the business cycle. Many businesses miss out on using these concessions due to the fact that the business sale generates no goodwill. We are of the view that these concessions should be reviewed and redirected towards the start-up and growth phase of the business to improve the chances of survival. The CGT concessions provide windfall gains to successful businesses and are too focused on the end point of the business life cycle. They can also reduce incentives for the business to grow in certain circumstances.

3. FRINGE BENEFITS TAX OVERHAUL

A comprehensive review of FBT legislation is required. Since its introduction in 1996, there have been significant changes to the workplace that cannot be accommodated by the existing legislative framework. Any review of FBT must address compliance issues facing small business. FBT is an inefficient tax, intended as a disincentive, rather than a source of revenue. FBT imposes the highest compliance cost of any tax relative to the revenue generated, and there is considerable scope to reduce the compliance burden on small businesses and small not-for-profit organisations.

In particular, the FBT valuation and apportionment methodologies impose unnecessary compliance costs on small employers. Salary packaging arrangements add to administration and increase recording and reporting requirements.

In many overseas jurisdictions, fringe benefits are taxed in the hands of employees. We believe that adopting this approach in Australia would have the potential to deliver greater neutrality in the treatment of cash and non-cash remuneration, while simultaneously reducing compliance costs for all parties. Benefits that can be readily valued and assigned to an employee should be taxable in the employee's hands and reportable for transfer purposes.

The taxation of fringe benefits in the hands of employees would also alleviate the inequitable application of the top marginal tax rate to fringe benefits, which is currently applied irrespective of the income of the employee. The Henry Review supported the transfer of FBT to employees.

Other benefits incidental to an individual's employment or otherwise difficult to assign, should be taxable to the employer. This approach would provide a more neutral taxation outcome by removing the need for the current grossing-up process and would facilitate the consistent and equitable treatment of fringe benefits for means-tested taxes and transfer payments.

4. DIVISION 7A

Small businesses face significant compliance costs dealing with the unnecessarily complex Division 7A rules, which are designed to prevent private companies making tax-free distributions to shareholders in the form of payments, loans and debts forgiven. Since its introduction, Division 7A has become more and more complex and its reach has extended to capture more transactions, such as Unpaid Present Entitlements.

The rules need to be simplified to remove unnecessary red tape, and to make it easier for companies to reinvest profits as working capital. The reinvestment of profit taxed at the corporate tax rate back into an active business should be encouraged to promote entrepreneurship and productivity.

A move away from the existing prescriptive, and at times inflexible, non-commercial based rules is required to support growth and jobs by making the system simpler, reducing compliance costs and making it easier for small businesses to reinvest business income as working capital. The recent Board of Tax review of Division 7A highlighted these impediments and has recommended a series of changes which need to be fast tracked to remove these impediments.

5. LOSS CARRY-BACK REGIME

The repeal of the Minerals Resource Rent Tax (MRRT) in September 2014 came in a legislative package that also brought the unfortunate demise of a number of tax measures that were intended to be funded by the MRRT. A particularly regrettable move in this context was the repeal of the short-lived loss carry-back offset for smaller Australian companies.

Loss carry-back allows companies to offset current period losses against previously paid taxes. After their introduction by the previous federal government, the loss carry-back provisions struck the right balance between allowing losses and limiting the exposure to government revenues by placing a quantitative cap in conjunction with a two-year carry-back period. Both the Henry Review and Business Tax Working Group recommended the adoption of loss carry-back.

Australian businesses are under pressure to adapt and change their business models to overcome challenges and make the most of opportunities arising from structural changes in the economy. The tax system should therefore encourage rather than get in the way of businesses wanting to invest and innovate. Without loss carry-back, our tax system penalises investments that have some risk of failure through its treatment of losses. This penalty against risk-taking can influence the kinds of investments undertaken and how much investment occurs which can impact on productivity and employment.

Small businesses operating through a corporate structure that experience a sudden downturn would receive invaluable cash flow benefits to help them ride out any economic downturn caused by external factors such as the Global Financial Crisis. Loss carry-back could assist the survival of viable companies during similar downturns in future years.

While recognising that businesses operate through a range of legal structures, loss carry-back only helps small entities that operate using a company structure. Nonetheless, there are 760,000 small business entities that could benefit from having loss carry-back as part of our tax system. It could be the difference between a business surviving or going under in a tough year.

6. SIMPLER STRUCTURE OPTIONS FOR SMALL BUSINESS

Multiple structures are commonly needed to achieve tax outcomes that would be otherwise unavailable through a single entity. A simplified small business entity regime can significantly reduce regulation and red tape. Our current tax rules provide an incentive for small business to use complex structures. Unless we tax business income consistently regardless of structure, this incentive will remain, as tax is an important factor driving choice of structure.

Small businesses seek measures that promote asset protection, the retention of profits for working capital, lower tax rates, access to CGT discounts, succession planning and income distribution. A combination of entities is generally used to achieve these outcomes. A typical example may be a business that operates through a partnership whose interests are held by a discretionary trust with a company among the trust beneficiaries. When a small business operates through separate legal structures, the current taxation system treats the structures as taxation entities separate from their owner(s), resulting in a quantum leap in tax compliance and complexity.

In some other countries there are simple entities specifically designed for small business. In the US, for example, small businesses may be set up using a S-Corporation that offers a number of advantages such as asset protection and flow-through tax treatment.

Australia also needs a single simplified structure for small businesses. If such a structure allowed the retention of income at the corporate tax rate, it would mean most of the benefits that can currently require the use of a company and discretionary trust could be obtained more simply and at lower administrative cost.

We suggest that a separate type of entity be established specifically for small business, comprising the attributes of various existing structures. Ideally, business profits that are reinvested in a business should be taxed at a uniform corporate tax rate, as other entities are able to reinvest at least 70 cents of each dollar of profit back into the business.

As an impetus for taxpayers to use this structure, the small business concessions could be restricted to such ‘small business entities’. There could also be appropriate and simple integrity rules to ensure against misuse.

7. TRUST TAX MODERNISATION AND TRUSTEE RESOLUTIONS

Some 23 per cent of small businesses operate through a legal trust structure. Taxation of trusts has undergone a significant period of change and uncertainty as a result of judicial re-interpretation of basic trust concepts and recent legislative amendments to protect the ability of trusts to continue to stream income. A simplified taxation of trusts for non-fixed trusts carrying on a business is urgently required to modernise the rules to provide greater certainty and reduce the compliance burden.

An issue that has been causing significant compliance problems to a large number of IPA accountants servicing SMEs is trustee resolutions. Since 30 June 2012, there has been a requirement for trustees to complete trustee distribution resolutions by 30 June each year. Previously, the ATO had a long-standing practice of allowing trustees an additional two months to prepare trust distribution resolutions. This administrative practice recognised the practical difficulties faced by trustees and their advisers in making trustee resolutions prior to the end of the financial and income tax year. It should be restored.

8. ALIENATION OF PERSONAL SERVICES INCOME

The rules surrounding the 'alienation of personal services income' (PSI) were introduced in July 2000, primarily to enable taxpayers to self-assess as to whether they operate as a personal services business. Taxpayers unable to satisfy PSI rules would have their income attributed back, irrespective of whether they operated through an interposed entity.

The rules were aimed at ensuring that PSI taxation applied equally, regardless of the arrangements under which income was earned and that business deductions, income splitting and tax deferral were not available to entities not genuinely conducting a business enterprise.

While the intent of the legislation is sound, the existing framework needs to be reviewed to provide more certainty, ease compliance and reduce complexity. The PSI rules are relevant for small businesses and therefore need to be clear, understandable and conducive to the average taxpayer being able to discharge their obligations with certainty. There is too much uncertainty as to the interpretation of key elements of the law.

The use of interposed entities is often a legitimate commercial means by which contractual arrangements can be satisfied. It should not be viewed prima facie as an attempt to engage in income splitting and/or tax deferral. The use of personal services entities continues to expand in line with the growth of flexible workplace arrangements and the trend to outsourcing.

Small business has had a long-standing difficulty in drawing a distinction between employees and contractors for tax and superannuation purposes, and this has become more of a practical issue as remuneration and business structure arrangements have become more complex. The distinction is important for determining employer obligations relating to taxation, as well as workers compensation, unfair dismissal laws and entitlements.

To promote economic growth, Australia requires a tax system that is consistent, cognisant of commercial reality and encourages productivity. Accordingly, our taxation system should acknowledge the real benefits of contracting arrangements. The Henry Review called for a revision of the rules and an extension of the PSI scope to cover all entities earning a significant proportion of business income from the personal services of their owners/managers.

9. SAFE HARBOURS FOR SMALL BUSINESS

Tax laws often make little or no distinction between large and small businesses and their differing abilities and capacities to comply with the law. Greater use of administrative safe harbour practices has the capacity to significantly reduce compliance costs, particularly for smaller entities, while minimising potential revenue losses.

A good example of this is the simplified transfer pricing record keeping options. The ATO now allows certain eligible small businesses an option to minimise some of their record-keeping and compliance costs. This relieves them from the same compliance burdens that are equivalently imposed on larger entities. Another example is limiting the need for valuations when developing tax law, including short-cuts or safe harbours as an alternative to full valuations.

The ATO could develop more safe-harbour practices in respect of small business taxpayers in circumstances where the revenue at risk is disproportionate to the compliance costs incurred.

10. CONCESSIONAL SUPER CONTRIBUTIONS

We believe there is no valid reason for the restriction on making personal concessional super contributions if the member earns more than 10 per cent of his or her income from employment services or any of the services listed in sub-division 290-C of the ITAA 1997.

This prohibition is inequitable for many Australians. Small business owners who work part time to supplement their income are particularly disadvantaged.

The source of the concessional contribution should not matter; hence, this item of legislation should be repealed.

11. SMALL BUSINESS SUPERANNUATION COMPLIANCE

The Government's commitment to reducing the superannuation compliance burden on small business is welcome. It is expected that small business compliance costs will be reduced if they no longer administer superannuation payments on behalf of employees.

The introduction of the small business superannuation clearing house is a particularly welcome development, along with the recent transfer of the clearing house from the Department of Human Services to the ATO. However, we believe the system could be further enhanced to benefit small business. In particular, we believe that:

- The definition of employee for superannuation guarantee (SG) purposes should be aligned with other definitions for the purposes of determining employer obligations.
- Employers should be allowed to assess superannuation obligations for employees against a quarterly threshold, instead of the existing monthly threshold, which has not changed since the SG was introduced in 1992.
- Penalties for employers in relation to the SG system should be reformed where the failure to pay the amount within 28 days of the end of each quarter has disproportionate consequences. Further, the calculation rules can be overly complex – such as the rules about what is to be included in ordinary time earnings (OTE), wherein certain items are included and some are not.

Treasury has already begun looking at superannuation compliance for small business and the IPA has participated in the stakeholder consultations.

12. THE DEFINITION OF SMALL BUSINESS

Tax concessions targeted for small business hinge on meeting the current definition of 'small business entity'. The current $2 million turnover test makes no distinction between high margin/low turnover, and low margin/high turnover businesses, which can inappropriately produce arbitrary outcomes denying concessions in some cases and providing a windfall gain in others. An alternative to the current definition would be to adopt a 'two out of three' test similar to what the Corporations Law definition has in place for small proprietary companies. The existing turnover threshold should also be increased to at least $3 million as recommended by the Board of Tax in its 2014 report into tax impediments for small business.

Recommendations

Small business tax policy

Tax relief for small businesses in the May 2015 federal budget, though welcome, does not go nearly far enough. Wide ranging and more substantial tax incentives and relief must be offered to entrepreneurs and innovators in Australia to encourage growth, productivity and employment. To this end, we recommend:

- The **income tax rate for small businesses** should be cut further, taking a lead from the Canadian province of Alberta, which has a combined federal/provincial corporate income tax rate of just 14 per cent for small business (against 25 per cent for general business).
- The **small business capital gains tax (CGT) concessions** should be reviewed and redirected from the end point of the business life cycle towards the start-up and growth phase.
- A comprehensive review of **fringe benefits tax (FBT)** legislation should be undertaken to reduce the excessive compliance burden on small business, and to alleviate the inequitable application of the top marginal tax rate to all fringe benefits. This could be achieved in large measure by Australia moving to tax fringe benefits in the hands of employees, as occurs in many overseas jurisdictions. Fringe benefits incidental to an individual's employment or otherwise difficult to assign, should be taxable to the employer.
- **Division 7A rules**, which are designed to prevent private companies making tax-free distributions to shareholders in the form of payments, loans and debts forgiven, need to be simplified to remove unnecessary red tape, and to make it easier for companies to reinvest profits as working capital. Recent recommendations by the Board of Tax aimed at achieving this need to be fast tracked.
- The short-lived **loss carry-back offset**, which allowed smaller companies to offset current period losses against previously paid taxes before its repeal by the Coalition Government in 2014, should be reinstated to provide much-needed encouragement to investment, innovation and risk-taking in the SME sector.
- A **single legal structure for small business** should be introduced, allowing retention of income at the corporate tax rate and avoiding the need for the use of a company and discretionary trust. Ideally, business profits that are reinvested in a business should be taxed at a uniform corporate tax rate.
- A simplified **taxation of trusts** for non-fixed trusts carrying on a business should be urgently introduced to modernise the rules, provide greater certainty and reduce the compliance burden.

- The Australian Taxation Office's long-standing practice of allowing trustees an additional two months after the end of the financial year to prepare **trust distribution** resolutions should be restored, to avoid current difficulties faced by trustees and their advisers in making resolutions prior to the end of the financial and income tax year.
- The rules surrounding the **'alienation of PSI'** should to be reviewed to provide more certainty, ease compliance costs and reduce complexity.
- The Australian Taxation Office should develop more **safe-harbour practices** in respect of small business taxpayers in circumstances where the revenue at risk is disproportionate to the compliance costs incurred.
- The legislative restriction on making **personal concessional super contributions** if the member earns more than 10 per cent of his or her income from employment services or any of the services listed in sub-division 290-C of the Income Tax Assessment Act 1997 is inequitable and should be repealed.
- To further reduce the **superannuation compliance burden** on small business:

  (i) The definition of employee for SG purposes should be aligned with other definitions for the purposes of determining employer obligations.

  (ii) Employers should be allowed to assess superannuation obligations for employees against a quarterly threshold, instead of the existing monthly threshold.

  (iii) Penalties for employers in relation to the SG system should be reformed where the failure to pay the amount within 28 days of the end of each quarter has disproportionate consequences.
- The current **definition of small business** for tax purposes should be changed, using a 'two out of three' test similar to that in the Corporations Law for small proprietary companies. The existing turnover threshold should be increased to at least $3 million, as recommended by the Board of Tax in its 2014 report into tax impediments for small business.

CASE STUDY: ALBURY ACCOUNTING PTY LTD
THE ISSUE: A PROPOSAL FOR 'FAMILY TAXATION'

Among the many aspects of his work as an accountant, Albury-based Suryan Chandrasegaran advises small business clients on how to structure their tax affairs.

It therefore comes as something of a surprise to hear Mr Chandrasegaran criticise the tax laws that underpin this aspect of his work – the laws that create incentives for some small business people to set up complex business structures to minimise tax through income splitting within families.

Mr Chandrasegaran says Australia should follow the lead of some OECD countries, such as France, and introduce a system of family taxation – where tax is levied on the family unit rather than the individual – to remove the incentive for small businesses to spend time and resources creating business structures that effectively enable income splitting.

One of the problems with the existing law, he says, is its unequal application. While self-employed trades people are allowed to engage in income splitting with family members, the Tax Office has run successful test cases against other small business people, including IT professionals, who have tried to set up similar structures.

Mr Chandrasegaran says the incentive for small businesses to restructure their tax affairs results in a wasteful diversion of resources from running the business.

"It is actually an issue for small businesses," he says. "Most small businesses are mum and dad sort of little operations. Anything that can enhance the ability of those families to be able to focus on running their businesses will improve economic efficiency, it will improve transparency."

TAXATION

STREAMLINE small business

CAPITAL GAINS tax concessions

Division 7A of the Income Tax Assessment Act needs to be simplified to make it easier for companies to reinvest profits as working capital

LOWER TAX RATE

Concessional tax rate for small business

Personal service rules need to be simplified to make the distinction between employees and contractors less complex

Eligibility **rules** for small business Capital Gains Tax concessions are complex and should be **simplified**

REDUCE

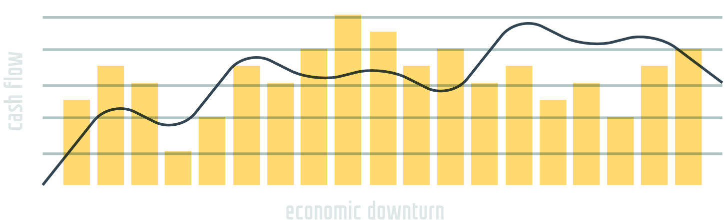
A simplified small business entity regime can significantly reduce regulation and **red tape**

Fringe benefits tax imposes the highest compliance costs on business relative to the revenue generated

REDUCE COMPLIANCE BURDEN

% 61% of Australian small businesses do not have employees

Loss carry-back could assist the survival of viable companies during downturns in future years



with invaluable cash flow benefits to help them ride out any economic downturn caused by external factors such as the global financial crisis

Reluctance of many small businesses to employ people is in part attributable to heavy compliance obligations associated with employment, such as PAYG, the Superannuation Guarantee Charge, FBT and workers compensation

"I do have clients who export, and some of them are quite savvy in that area. But for most of my small clients, just getting into that space is totally foreign to them."

Deanne Thomas, accountant (Case study: page 85)

CHAPTER 10:
EXPORTING AND TRADE: CHALLENGES FOR SMEs

Headline findings

- There is a continuing role for arrangements between governments to facilitate trade and investment; for example, by establishing consistent standards, institutional frameworks and measures to improve market openness. Bilateral Regional Trading Agreements (BRTAs) are one means by which such arrangements can be established.
- The Australian Government should prepare an overarching trade policy strategy which identifies impediments to trade and investment and available opportunities for liberalisation, and includes a priority list of trading partners. This trade policy strategy should be reviewed by Cabinet on an annual basis, and be prepared before the pursuit of any further BRTAs. A public version of the Cabinet determined strategy should be released. This strategy will assist to better coordinate and track the progress of trade policy initiatives and to ensure that efforts are devoted to areas of greatest likely return.

Within the strategy special attention should be given to small business and SMEs and the particular problems and impediments which they face in developing export markets for their goods and services.

Introduction: Turning SMEs into exporters

The world economy, including global value chains, is changing rapidly and this presents new challenges for business. The rise of China, India, and other emerging markets in Latin America, Central Asia and Africa has shifted the centre of global economic activity, while major innovations in technology and finance have changed the way business is done.

BENEFITS OF EXPORTING

There can be no doubt that exporting has numerous benefits and advantages for businesses of all sizes. It expands your business with increased sales and profits and spreads your risks; it reduces dependence on the local market; it uses excess production capacity; it provides a buffer against seasonal or cyclical demand; and it expands your skill base, management practices, marketing techniques, and ability to compete. Exporting can be an important strategic option for small business owners who want to achieve continued business growth. This will be a critical factor in the future prosperity of the Australian economy.

INTERNATIONAL EXPERIENCE

If small business and SMEs are the engine room of the Australian economy then it may be true to say that the same applies to the small business/SME sectors in other countries. In the world's largest economy, the USA, during the launch of a new initiative in 2011, "New Markets, New Jobs", Secretary of Commerce, Gary Locke, emphasized to representatives from more than 200 SMEs how important engagement with the global marketplace will be to the future economic well-being of the United States. In his speech he referred to President Barak Obama's State of the Union address where the President "said how important it was for America to win the future. He said the most important contest our nation faces is not between Democrats and Republicans, but between America and countries around the world that are competing like never before for the jobs and industries of the future."

Speaking directly to small businesses, Secretary Locke noted in his remarks that "for the American economy to produce the millions of new jobs we need in the years ahead, we need our small and medium-sized businesses to lead the way. When you succeed, the entire American economy succeeds." In fact, it is predicted that almost half of US businesses will be involved in global trade by the year 2018.

In the UK, it was reported by MarketInvoice in 2013 that SMEs have created 80 per cent of new private sector jobs over the last five years. However, it was noted that they face disproportionate barriers to exporting, particularly to countries outside of the EU.

At a meeting of the EU Federation of Small Businesses, it was noted that there are parts of the world that are growing very rapidly, and the companies that are getting into China, India, Russia, Brazil and so on are doing very well. That is where the growth of the future will come from.

It was also noted that currently, only 1 in 20 SMEs in the EU exports outside the EU. Given that China's GDP is growing at a rate of around 7–8 per cent per year, and growth in the Eurozone looks to be a distant memory, small businesses cannot afford to miss out on the opportunities that lie a little further afield.

AUSTRALIAN EXPERIENCE

Closer to home, Australia has much to gain from developments over the next 20 years. With abundant reserves of minerals, a highly skilled labour force and a flexible economy, the structure of our economy is complementary to that of the emerging economies in our region.

Australian economic engagement with Asia has increased in the last decade. Indices and aggregate statistics of trade investment and exchange of skilled people show that Australia is one of the countries taking advantage of the rise of Asia. A deeper analysis suggests, however, that this engagement has been uneven. Sectoral, regional and business size data shows that the drivers of engagement with Asia are large businesses and organisations in mining, primary sectors such as agriculture and education services. Many SMEs in other industries have been unable to seize the opportunities of Asian growth. (Centre for International Economics, 2009) It has also been suggested that countries other than China should be considered, such as Indonesia.

Two factors are fundamental to successful engagement with Asia – innovation capacity and knowledge of Asian markets. As Asian businesses and customers become more sophisticated, competition will be increasingly driven by innovation. New-to-the-world innovation is essential for competing in markets for high value-added goods and services and is also strongly linked with business use of science and engineering skills and industry research collaboration. Some Australian businesses are responding to this challenge by incorporating high value-added services as part of their offering. Encouragingly, the latest data on the percentage of innovation-active businesses reached its highest recorded value of 46.6 per cent in 2011-12. However, previous analysis has shown that most innovation is incremental in nature, comprising the adoption or modification of existing innovations with new-to-the-world innovation being only a small proportion of total innovations. This is in sharp contrast to other developed economies that have a much higher proportion of new-to-the-world business innovation and relatively high trade volumes. (Centre for International Economics, 2009).

IMPEDIMENTS TO EXPORT FOR SMALL BUSINESS

Apart from a review of innovation, it is useful to consider other impediments to exporting for small business and from there to build a framework to address these impediments. Many barriers to export have been identified in the export marketing literature; however, the general consensus appears to be that the primary barriers to export include:

- Export market attractiveness
- Foreign practices being incompatible with domestic business
- Export venture management characteristics
- Access to suitable distribution channels
- Adapting to foreign market needs
- Government policy.

Export market attractiveness as a barrier to export includes such issues as difficulty in collecting payments from foreign customers, difficulty providing after sales service, high costs associated with selling abroad, problem quoting prices with fluctuating exchange rates and high transportation costs to ship products to foreign markets. With respect to the difficulty of collecting payments from foreign customers, it is widely recognised as an export barrier because it causes cash flow problems for exporters.

A Forrester Research study found that 85 per cent of small-and-medium sized companies with an online presence said that they cannot fill orders internationally, citing shipping as the number one obstacle (Koch, 2007).

As far as the high costs of selling abroad are concerned, these costs include insurance costs, market research costs, distribution costs, etc. Considering that most small firms have problems financing their export activities, this cost factor could act as a serious export impediment for many small firms.

In a report by the United States International Trade Commission 2014, Trade Barriers that US Small and Medium-Sized Enterprises Perceive as Affecting Exports to the European Union, respondents reported that numerous EU trade barriers, particularly standards-related measures, limit SMEs' exports to the EU more than those of large exporters. They explained that while complying with standards, technical regulations, and conformity assessment procedures is costly for larger firms, it is potentially prohibitive for SMEs because many costs are fixed regardless of a firm's size or revenue. This finding can be logically applied to many smaller firms in most countries. Unless technology or innovative methods can overcome these fixed costs, then they remain a significant barrier.

Respondents in the US report also cited difficulties involving trade secrets, patenting costs, and logistics challenges, especially customs requirements, Harmonized System classifications, and the EU's value-added tax system. Trade financing in the EU was reported to be a lesser problem. Besides these cross-cutting issues, the report describes many industry-specific barriers.

Trade measures may have a disproportionate effect in diverse ways. Complying with EU standards, for instance, imposes fixed costs that do not vary with the amount traded and must be borne to enter the market, regardless of how much exports contribute to a firm's revenues. Large exporters can more easily spread fixed costs over their sales volumes than small exporters. SMEs reported that to gain access to the EU market they had to deal with a variety of non-tariff measures (NTMs)—for example, the EU regulation for chemicals, which typically requires expensive testing.

Availability of finance for small business and SMEs to export appears to be a specific barrier. It is illustrative to consider the review by the Productivity Commission (PC) into the Export Finance Insurance Corporation (EFIC), which has resulted in improvements to its operation and re-aligned its objectives. The submission by EFIC to the Financial System Inquiry is worthy of replication. "Since the Productivity Commission report, EFIC has made a significant submission to the Financial System Inquiry which argues that there are indeed inefficiencies in Australian financial markets.

"An efficient financial system is one that meets the needs of financiers, households and business. In our experience, SMEs and businesses of all sizes operating in emerging and frontier markets, cannot consistently access the finance they need to succeed."

The EFIC submission claims Australia's financial system, dominated by banks and superannuation funds, has a culture of risk aversion and a bias against lending to SMEs.

"Funding requirements of SMEs – particularly those which are innovative or growing rapidly – do not fit into the standard criteria, or the model-based lending approach adopted by banks, given the small amounts involved and the lack of security and readily available information on borrowers' abilities to perform. Australia's regulatory settings also bias banks against providing credit to SMEs.

"Australian companies looking to take advantage of opportunities in emerging and frontier markets also face financing handicaps. The international focus of Australia's banks is more limited than that of many of Australia's exporters resulting in financing shortfalls. Financial flows into emerging markets also suffer from short-termism; exposing exporters and investors to abrupt and wholesale credit withdrawals when sentiment changes.

"Australian SMEs and transactions of scale in emerging and frontier markets are likely to remain undersupplied for finance in the foreseeable future. This reflects a number of factors including: the specialised and ad hoc nature of the financing required; the strong demand for capital elsewhere; the centralised nature of Australia's financial system; and the relatively narrow business models of the major banks.

"As a commercially run government-owned export credit agency, EFIC can ensure finance is available for the benefit of exporting SMEs and those companies, both big and small, willing to take risks and expand into emerging and frontier markets. For more than 50 years, EFIC has shown that this can be done profitably and without distorting the broader financial market."

OVERCOMING IMPEDIMENTS TO EXPORT

The most successful small exporters worldwide are those that concentrate on niche markets. Australian businesses have other advantages including the Australian brand, English being the world business language and a stable and reliable system of law and governance.

PRACTICAL EXAMPLES

In the UK, where MarketInvoice cites access to finance as the greatest challenge for small firms, a policy discussion is considering the approach of localising decision making. Germany is cited as an example, where small-business lending was not affected by the global financial crisis (GFC). The banking system is targeted at improving the economy of a local community – not just delivering on shareholder profits.

Again, with respect to access to finance to facilitate export, in the US, the Export-Import (Ex-Im Bank) Bank and the US Small Business Administration offer joint working capital loan programs that provide guarantees (up to 90 per cent) to private commercial banks for small businesses to assist their entry into global markets. (However, we note that the 81 year old Ex-Im Bank is waiting for re-authorisation from Congress). Privately owned merchant finance companies have begun to finance trade by providing purchase order finance. (Morgan Stanley).

In Australia, Austrade has focussed its expertise and resources on the world's growth and emerging markets. According to Austrade, it is in markets where business is more difficult because of linguistic, cultural or regulatory barriers that Austrade finds it can add the most value to Australian businesses and education institutions. It provides direct assistance and advice, including through its network of offices. The Export Markets Development Grants scheme is administered by Austrade and provides grants to cover eligible export marketing expenses. It is designed to help small and medium-sized businesses build sustainable overseas markets.

The Government's Australia Unlimited was developed in response to global research which showed Australia's international reputation was based more on our physical attributes than our intellectual and creative ones. Australia Unlimited broadens the picture by telling the stories of talented Australians, both at home and abroad, profiling their creativity and business skills and celebrating their achievements in science, technology and the humanities.

TRADE AGREEMENTS

According to the Export Council of Australia, the field of greatest importance in trade agreements is trade facilitation issues and addressing the cost and difficulties surrounding ease of access to markets. It states that the biggest issue in the free trade agreement (FTA) discussion process is the communication of benefits to exporters. The argument that US companies get more out of the USAUS FTA is probably true because the companies are bigger and therefore able to afford consultants to evaluate the benefits.

In line with global trends, Australia has recently entered a number of BRTAs and is negotiating more. The Australian Government has sought to negotiate comprehensive agreements with substantial reductions in trade barriers. Provisions have covered lower tariffs, reducing discrimination, intellectual property, competition policy and trade facilitation.

Despite this, a 2010 research report by the PC on BRTAs found little evidence from business to indicate that bilateral agreements have provided substantial commercial benefit. This may be because the main factors influencing decisions to do business in other countries lie outside the scope of BRTAs and are not directly influenced by them.

The PC states that in the international arena, the Australian Government should continue to pursue progress in the Doha Round; and that building the case for substantive reductions in trade barriers internationally requires improvements in domestic transparency and policy analysis within each country. The PC found further that while BRTAs can reduce trade barriers and help meet other objectives, their potential impact is limited and other options often may be more cost-effective. Alternative liberalisation options should also be considered.

Australia's BRTAs typically contain provisions addressing aspects of trade in services, but these do not necessarily lead to significant reductions to services barriers in partner countries. In a number of areas, the main impediments to effective competition by Australian services providers in partners' services markets are related to regulatory and institutional issues that lie outside the scope of BRTAs.

While the incidence of preferential agreements has increased, their overall impact on multilateral liberalisation is not clear from available evidence. Greater net benefits are available through countries lowering their own trade barriers on a non-discriminatory, most-favoured-nation basis. Further analysis is required to determine whether any benefits fall disproportionately to larger businesses and if so, by what margin, and how this might be addressed during negotiations (apart from more comprehensive consultation with small business during the process).

The PC Trade & Assistance Review 2013-14 (part of an annual series) reports on recent developments in trade policy. Some of the key points highlighted are that over the past year, Australia's trade policy environment was influenced by several developments at the multilateral, plurilateral, regional and bilateral levels. The PC states that where agreement can be reached, then multilateral trade reform is the most effective way to improve national and global welfare, but it continues to be hampered by a lack of consensus among the 161 World Trade Organisation members. It is noted though that the G20 members made undertakings to reduce trade barriers and the cost of trade.

- Australia was among a number of countries that have sought to negotiate preferential trading agreements. During the last year, Australia concluded a bilateral agreement with China and bilateral agreements with Korea and Japan entered into force. Bilateral negotiations with India and Indonesia are continuing as well as two significant regional agreements – Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership.
- The PC concludes that the evolution and recent measurement of global value chains and value-added trade flows provides valuable insights for trade and assistance policy. The key policy take-outs reinforce several established policy imperatives, including:
  - multilateral trade reform is the most effective way to improve national and global welfare
  - non-discriminatory policies that seek to lower imported input costs and other business costs have the best chance of fostering firm and economic growth.

The emerging and growing potential for trade preferences to impose net costs on the community presents a compelling case for the final text of an agreement to be rigorously analysed *before* signing. Analysis undertaken for the Japan-Australia agreement reveals a wide and concerning gap compared to the PC's view of rigorous assessment. Further, evidence suggests that the complexity in FTAs may act as a barrier; and that domestic reform may be delayed or compromised by the FTA.

The 2014 report *The Impact of Free Trade Agreements on Australia: a model-based analysis* prepared by the Centre for International Economics on behalf of the Rural Industries Research and Development Corporation (an Australian government agency) shows that FTAs which include Australia lead to increases in Australian exports, production and GDP relative to what would have been the case without the FTA. The major elements that affect the size of the changes in exports brought about the FTA include the size of the trade barrier that is removed by the FTA; the importance and relative size in the trading partner's trade flows; the redistribution of resources between the products or services that are exported compared to those which attract less demand; trade liberalisation that is trade creating will increase the income of both trading partners; and consumer preferences in the importing country will also impact the flow of trade.

Recommendation

Export strategy for small business

The Federal Government should develop a new trade strategy that identifies impediments to trade and investment and available opportunities for liberalisation, including a priority list of trading partners. Special attention should be given to small and medium-sized enterprises and the particular problems and impediments that they face in developing export markets for their goods and services.

CASE STUDY: DEANNE THOMAS & CO

THE ISSUE: LOST EXPORT OPPORTUNITIES FOR SMALL BUSINESS

Melbourne accountant Deanne Thomas has no shortage of healthy small businesses in her care. But one of her enduring frustrations is how few of these clients realise their potential to become exporters.

Ms Thomas, who runs an accountancy and business consulting practice in bayside Frankston, believes many small businesses are held back by fear of the unknown, and a lack of information and education about the realities and potential benefits of offshore expansion.

"I do have clients who export, and some of them are quite savvy in that area," she says. "But for most of my small clients, just getting into that space is totally foreign to them."

This experience with her clients is not unusual for Australia. Research by the Australian Bureau of Statistics has revealed just one in eight businesses have an international market presence.

Ms Thomas believes more needs to be done at government level to promote exporting, including making businesses more aware of the possibilities and the assistance they can call on through agencies like Austrade. "A lot of people are unaware of the help that's available," she says. "They would really benefit from more education."

She also says prospective exporters would benefit from organised contact with more experienced exporters. "Businesses can help one another out to a certain extent," she says.

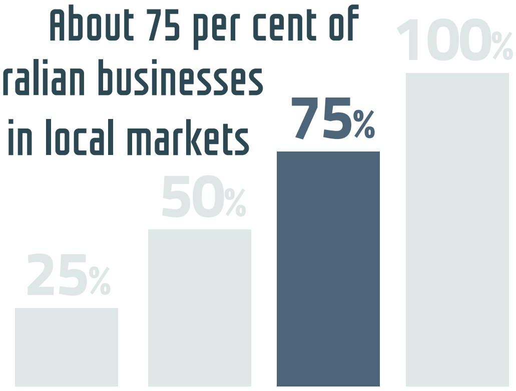
MARKETS AND COMPETITION

Conversely, only **one in eight Australian businesses** have any international market presence

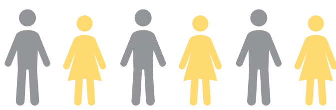
10.1%

10.1 per cent are less likely to operate in local markets

About 75 per cent of Australian businesses trade only in local markets



A more detailed analysis shows that medium-sized firms (20-plus employees) are 18.5 per cent more likely to have an international presence than firms with fewer than six employees



CHAPTER 11:
CONCLUSIONS

We have set out our agenda for the future against the backdrop of an Australian economy that has achieved unparalleled growth for two decades, but which is facing a looming productivity problem. If the problem is not resolved, Australians may face a future decline in living standards as real wages adjust to account for this lack of productivity.

Even if this does not occur, then the construction and mining booms may ultimately lead to a fragile boom and bust-style economy driven by housing equity-fuelled consumption and persistent balance of trade problems. Of equal concern is that large parts of the business sector may find it increasingly difficult to remain competitive.

But our White Paper is positive, as we see the small business sector of the Australian economy as a huge untapped resource with unlimited potential. We see a key role for government in helping small businesses to fulfil their potential to the benefit of the whole economy. This White Paper strongly supports a dual approach. For the core stock of small businesses, our view is that there are relatively easy wins to be secured with very modest levels of public support. But the potential productivity gains to the domestic side of the business economy are relatively large. We have also identified smaller parts of the business sector that have the potential to be internationally competitive, to sell output in international markets, to be highly productive, highly innovative, and to create significant new employment opportunities, particularly for highly skilled, knowledge workers. We suggest that the communications and professional services sectors are strongly placed to secure long-term growth and increases in productivity, and to develop their international market presence.

Where we have a strong and detailed evidence base, our White Paper has made very explicit policy recommendations – for example, in the area of taxation. Where more still needs to be known and understood we have set out a basic framework within which more detailed policy development might fit. On creating an innovation system, for example, we argue that more attention should be focused on diffusing knowledge and innovation regardless of its origin. At present the focus is on creating innovation at the firm level.

We view the labour market as a key area for developing a long-run strategic policy encompassing the education system *per se*, but also in terms of tackling short and long-run skills deficits both within the business sector and in terms of the wider pool of workers. The small business sector has huge potential for rebalancing itself in terms of who it employs and the way many businesses configure their operations. For developed economies, low skilled and low productivity modes of producing goods and services are no longer a viable option. Australia must harness the potential of its first class higher education system and ensure that its business sector takes advantage of the increasing talent pool. Only when the business sector has improved its absorptive capacity will the real productive potential of the small business sector be realised.

Finally, our '3 pillars' conceptual framework recognises that resolving the productivity problem requires strategic thinking in three core areas: human capital, financial capital and innovation. But more importantly, we recognise the inter-dependence between the three, and the requirement for government to think strategically across them all.

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