



INSTITUTE OF
PUBLIC
ACCOUNTANTS®

PRE-BUDGET SUBMISSION 2021-22

January 2021

Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to present our pre-Budget submission for the 2021-22 financial year. We look forward to working with the Government on its economic agenda set against the continuing COVID-19 environment.

The IPA is one of the three professional accounting bodies in Australia, representing over 40,000 accountants, business advisers, academics and students throughout Australia and in over 80 countries worldwide. The IPA Group is the largest accounting body representing the small business/SME sectors in the world.

The IPA takes an active role in the promotion of policies to assist the small business and SME sectors, reflecting the fact that approximately three-quarters of our members work in these sectors or are trusted advisers to small business and SMEs. The IPA pursues fundamental reforms which will result in boosting productivity growth and in easing the disproportionate regulatory compliance burden placed on small business.

The IPA remains strongly of the view that immediate and tangible incentives must be offered to entrepreneurs and innovators to encourage their entry into and long-term engagement with the Australian small business sector. The Federal Government should implement policies that will drive business activity and entrepreneurialism across all industry sectors. A strong and vibrant small business sector can play an active role in contributing to the economic growth of the Australian economy and help in the recovery road ahead as we eventually come out of the pandemic.

In August 2015, the IPA Deakin SME Research Centre launched the first Australian Small Business White Paper which contained numerous recommendations to boost productivity growth which is essential to maintaining Australia's overall standard of living. In September 2018 the IPA Deakin SME Research Centre launched the second Australian Small Business White Paper which continues to examine the declining state of productivity growth in Australia and makes recommendations to address this through increasing small business innovation, competition and participation. Our recommendations remain relevant and even more so, as we forge an economic agenda for our post-COVID-19 future.

Both White Papers were the result of widespread consultation with small business people, our members and a range of public and private sector stakeholders.

The IPA Deakin SME Research Centre is currently working on the third Small Business White Paper, which it expects to launch in April 2021. The third White Paper has obviously been influenced by the economic impact of the pandemic; and has hugely benefited from access to BLADE. We are pleased to be able to include content from the third White Paper in this pre-Budget submission.

The main themes and recommendations from the White Papers include:

- Productivity of small business – how can the technical efficiency of the Australian business sector be improved.
- Regulatory overload – a risk adjusted approach is needed, whilst also relying on regtech solutions, which can shift the conversation from the amount of regulation to the way we deal with it.

- Taxation of small business and SMEs – what is their overall contribution to tax collection and how to optimise the tax system, including through changes to the tax mix.
- Workplace relations – ensuring we have policies which facilitate growth-based small businesses.
- Net employment dynamics – also known as job creation and job destruction.
- Innovation policy – incremental innovation can be achieved across the economy with the message that innovation creates jobs.
- Trade policy and internationalisation – the performance of small business and SMEs needs to improve so a more meaningful contribution can be made to the economy. Trade diversification in a post-COVID world will be essential.

A copy of the full version of both the first and second White Papers, the abridged version and infographic of the second White Paper, can be found on the IPA website,

www.publicaccountants.org.au/whitepaper.

There can be little doubt that setting an economic agenda for a COVID recovery is and will be extremely challenging. We note that the Productivity Commission in its latest *Productivity Insights* No. 3/ 2020 page 7, released in November 2020 states,

In the long term, this pandemic is likely to affect productivity, but the magnitude and direction of these effects is uncertain.

On a positive note, the quick adaptability of the economy has been impressive. About 50% of the workforce had moved to working from home by September 2020, with early indications of a smooth transition (ABS 2020a). Furthermore, many firms have innovated to make their services more accessible remotely (including high end restaurants resorting to takeaway, greater use of virtual exercise classes). For large portions of the year both health and education services shifted to online or remote delivery to some extent. The increased pressure on firms to facilitate both remote work and remote delivery to consumers will likely have a long-lasting increase in the tradability of services. This could result in greater capital-intensity of services and more competitive pressures that would result in greater productivity growth.

The IPA emphasises that major reform cannot always be achieved in a short timeframe and we urge the Government to take a longer-term view based on a clear, determined and well communicated path for the Australian economy and Australian society.

In particular, the IPA is especially keen to ensure that bold tax reform becomes a priority for the Government and the IPA will continue to voice its disappointment with the stalled tax reform process. A piecemeal approach is sub-optimal and may even prove harmful to long term reform.

In addition, the IPA urges the Government to continue its effort on innovation policy despite past setbacks with communicating the benefits.

Again, we note the Productivity Commission *Productivity Insights*, page 37 states,

Nonetheless, there is considerable scope for future innovation and productivity growth in services, particularly through technology (PC 2002). Artificial intelligence, use of data and new digital platforms offer the prospect of cutting transaction costs and increasing competition, including through international trade.

But as in the past, policy will be a key determinant of success.

For example, innovation in some services industries could involve less emphasis on traditional research and development and greater reliance on new business models and new business formation as a vehicle for experimentation. Hence the quality and adaptability of regulation will be a key factor. Human capital (including the health and skills of the workforce) could become increasingly important to these labour-intensive industries, as could the mobility and flexibility of labour between locations, firms, and sectors. Supporting appropriate risk appetite and avoiding policies that either favour incumbents or act as impediments to new entrants can support this process.

The IPA believes the time has come for all Australians to stand up and put the public interest ahead of political and self-interest. The public interest will be central to the policy development and advocacy effort of the IPA well into the future.

As concluded by the Productivity Commission, page 37,

Just as COVID-19 has brought sudden, disruptive change to the economy (particularly to employment, spending patterns and the use of technology) it is likely that underlying policy settings will also be affected. Australian economic history shows that policy can either help or hinder the achievement of higher living standards. Building future prosperity will require new thinking, based on a fresh policy agenda informed by quality research, but firmly grounded in the lessons of the past.

We would be pleased to discuss our recommendations in more detail or to provide further information. Please address all further enquiries in the first instance to Vicki Stylianou (vicki.stylianou@publicaccountants.org.au).

Yours faithfully



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Small Business: Big Vision recommendations

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

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

The small business sector (as a huge component of the economy) has the potential to positively influence productivity growth. However, despite the more recent impact of COVID-19, Australian small businesses still operate in an increasingly complex global environment of increased interconnectedness, interdependence, uncertainty and change. For this reason, and others, the sector requires support to become more innovative and efficient, to employ more people and to export more.

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

- Enabling and promoting access to affordable finance to improve the longevity of small businesses
- Implementing the Harper competition reforms to enhance the competitiveness of small business
- Facilitating education and skills development for small business owner-managers
- Updating regulatory settings over time, so as not to impede private sector investment
- Resisting protectionism and facilitating increased access for small businesses to international markets
- Fine-tuning innovation policy to reward collaborative research, support innovation diffusion and expedite the commercialisation of innovative ideas, especially in the technology space
- Reforming the taxation system to increase incentives and decrease disincentives to the establishment and growth of innovative small businesses
- Undertaking workplace relations reform to ensure the framework delivers consistency and stability to small business owner-managers.

Regulatory burden: overload

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

Reducing the overall regulatory burden will relieve small business owners of onerous compliance tasks and reduce the cost of doing business. Regulatory imposts remain one of the key problems cited by small business (ie as time consuming and unnecessary requirements that impair their ability to spend more time on innovation and on growing their enterprises).

Recommendations

- The Government should continue to emphasise the need for ‘risk-based’ regulation, so individuals and entities that are at a ‘low risk’ of non-compliance are not subjected to inappropriate and unnecessary regulatory scrutiny.
- The Government should continue to contribute to and be guided by the work of the OECD in enhancing global awareness of and applying good regulatory practice.
- The Government should continue to conduct periodic reviews of regulatory agencies/bodies and statutory boards to ensure that public interest is well served.
- The Government should continue to use the Office of Best Practice Regulation (OBPR) to ensure that laws and regulations take account of the needs of small business. The government should also strengthen the use of small business Regulation Impact Statements.
- The Government should ensure that company extracts and financial Statements lodged with the regulator are made freely available. We refer to previous consultation on this proposal.
- The Government should pursue all necessary measures to implement one regime for registration and regulation of charities and not-for-profits. We refer to previous consultation on this proposal.
- The Government should consider the role of regtech (technology-based solutions applied to regulatory compliance) and facilitate the introduction, development and application of regtech solutions (especially by small business) as a means of easing the regulatory burden.
- A streamlined individual registration system should be introduced to enable consumers to access affordable and competent financial advice (see below).

Regulatory burden and financial advice

The IPA has joined with other key stakeholders to develop and advocate for a new consumer-centric regulatory framework that enables consumers and small business owners to access affordable, independent quality advice in their best interests from their choice of trusted professional adviser.

This work has included consultation with and consideration of our respective members; Government; Financial Services Reform Taskforce; Deregulation Taskforce; and Review of the Tax Practitioners Board. We have also considered alignment with the recommendations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, specifically recommendation 2.10 which refers to the establishment of a new disciplinary system for financial advisers that, inter alia, ‘provides for a single, central, disciplinary body’.

A recent survey of IPA members practicing in financial advice has found that the overwhelming impediment to consumers being able to access affordable and competent financial advice is the amount and cost of compliance. On the other hand, there is considerable and growing consumer demand which is unmet due mostly to the price gap between what consumers are willing to pay and what financial advisers must charge in order to remain in business and be able to provide the advice. This is acknowledged and detailed in the recent ASIC Consultation Paper 332. This work is ongoing

and under consultation with ASIC, which has stated that feedback for law reform will be passed on to the Government.

Further information on the proposed framework can be provided.

Regulatory burden: cost

There are two main issues which need to be addressed:

- The cost of compliance on those being regulated.
- The funding of the regulators, such as ASIC.

ASIC industry funding model

The ASIC Annual Report 2019-20 states that total revenue was \$1.56 billion, up from \$1.34 billion the previous year. This included \$544 million in supervisory cost recovery levies and fees and fines. Fees and charges in the four years up to 2019 had increased by 54%. Once again, annual expenditure exceeded the annual appropriations. In 2019-20, \$324.5 million of ASIC's total budgeted resources of \$429.6 million, that is, 75.5%, were expected to be recovered via ASIC's cost recovery levies and statutory levies (Cost Recovery Implementation Statement (CRIS) 2019-20, page 9).

Key point:

We appreciate that ASIC's revenue is remitted to the Official Public Account, however, given the revenue raising capacity of ASIC, we believe there is significant scope for ASIC to reduce fees and levies, especially in the current environment, without reducing or compromising its regulatory activities.

Fees-for-service methodology

The CRIS states that the methodology for calculating the costs for fees-for-service activities is based on the Cost Recovery Guidelines. Each of the regulatory activities are broken down into distinct outputs and the key business processes that are used to produce those outputs. The relevant costs are then identified and attributed to the outputs and processes. Costs are attributed using a weighted average hourly rate, which is based on each team involved in the business process and includes indirect costs (made up of property, IT and corporate services costs), apportioned according to average FTE staff.

Based on the worked examples on pages 150-1 of the CRIS, we note that whilst some of the work undertaken by ASIC may involve high levels of expertise, the majority seems to be either administrative, repetitive or does not require a high level of expertise given that small practices do not inherently involve high levels of sophistication. According to the annual data IPA collects for the Professional Standards Councils, including insurance claims data, most of our practitioner members have a low level of risk given the type of work and clients they have. This is the case whether they are auditors, liquidators or financial advisers.

A risk rating system is a beneficial overlay when deciding on the level of supervision and surveillance and this should be reflected in the fees and charges. It is not evident whether this is part of the ASIC CRIS methodology. If not, this would make the outcomes more equitable, even if the methodology becomes marginally more complex.

Many professional advisers have moved away from charging on the basis of hourly rates and charge according to the value and/or outcomes created for clients. ASIC could consider a similar approach for its less complex activities.

Key point:

The CRIS methodology should be refined to reflect standard market and industry practices and a risk profile of regulated entities – this would result in more equitable outcomes and a lower cost for the regulatory activities.

Indirect costs

We were unable to find a reasonable explanation in the CRIS or in other ASIC documents for ‘indirect costs’. We note comments about leases, staffing and ‘supplier’ costs. However, given that these indirect costs are relatively high, more transparency would be welcome. Most businesses are under pressure to reduce costs, from having to move to less expensive office locations, to driving efficiencies at all levels, and there is a community expectation that government will do likewise. Whilst we appreciate that ASIC has more functions and responsibilities and that more funding has been provided, we expect cost savings will be made where appropriate.

We also question why industry is being charged for ‘policy advice’ or ‘central strategy’ and we are unsure of what these are. Even being charged for ‘education’ or ‘stakeholder engagement’ seems excessive. Many regulated entities go to education institutions or their professional association for accredited/recognized education, training and information. We appreciate that some entities may benefit from education or information from ASIC, however, for many, education is costly enough without having an additional charge for something they may not be accessing. Why is industry being charged for engagement. We would expect this to be a standard regulator activity that is part of the cost of ‘doing (government) business’ and accordingly should be met by government from appropriations.

Key point:

Unless there are compelling reasons to include indirect costs in the CRIS, then we believe that all indirect costs should be removed from the funding model.

Transparency and accountability

The Cost Recovery Guidelines note under the heading of ‘accountability’ that meeting the principle of transparency and accountability involves reporting on performance for the activity on an ongoing basis. The Guidelines add that access to information about ASIC’s fees-for-service activities can help stakeholders determine whether cost-recovered activities are being implemented efficiently and effectively.

IPA agrees that transparency and accountability are critical for the successful implementation of the funding model. For this reason, more information is needed on the actual break down of the activities, the indirect costs and the linkages between the costs and performance metrics.

In addition, it would be useful to have more information in one place rather than scattered across numerous documents. We note that the CRIS contains a long list of related information (pages 205ff). Many of these are relevant to understanding the CRIS including the annual report (which includes the annual performance statement), annual corporate plan, Australian Government

Charging Framework and its Resource Management Guide 302, Cost Recovery Guidelines, Regulator Performance Framework (RPF) and ASIC's self-assessment against the RPF.

However, there are many other related documents such as numerous industry levy instruments, related legislation, ASIC Service Charter, ASIC (Fees—Complexity Criteria) Instrument 2018/578, numerous reports (eg Report 650 licensing and professional registration, Report 659 compliance review of documents, Report 654 assessing applications for relief), numerous regulatory guides, market integrity report, enforcement update report and so on.

A simplified document for users/stakeholders, perhaps on an industry/sector basis, with relevant information only, would be useful.

Key point:

Transparency and accountability would be enhanced by more clearly demonstrating linkages between costs, performance and outcomes. This should be done in one streamlined document rather than scattered among a plethora of documents.

Risk assessment – timing and certainty

We note that the risk assessment for the fee for service model is assessed in the CRIS as medium risk. The CRIS acknowledges the potential risks of the fees-for-service model include:

- the perception that the model lacks transparency about the basis of the fees;
- the fees for service may not match our actual regulatory costs;
- uncertainty about the classification of tiered fees; and
- the tiered fees could result in some entities being subject to a large increase in fees if they fall within the complex category.

It goes on to state that risks can be appropriately mitigated and managed by increasing the level of consultation and communication with stakeholders to ensure maximum transparency and understanding.

It is unreasonable for ASIC to apply estimates and expect that regulated entities can absorb huge (or any) fluctuations when they are operating in the same uncertain environment as ASIC, have their own costs to meet and cannot always pass these on to clients and customers. Many of our members charge monthly or fixed fees based on a contractual arrangement, as clients have a preference for the certainty that fixed fees provide. It is difficult for this business model to absorb the fluctuations which the ASIC fee model may impose. The need for certainty and timeliness, especially in the current pandemic environment, should not be under-estimated. No amount of 'consultation and communication' by way of mitigation is going to change this situation.

We suggest that the current approach of estimating levies in the first half of the year and then invoicing actual levies in December is inherently flawed. This would be like receiving an estimate for a house renovation and then six months later being charged a potentially much higher price and having no option but to pay it. ASIC may not be operating a business but a practical approach to regulating businesses is essential to efficient markets.

Key point:

Certainty and timeliness should be guiding principles in the structure of the ASIC funding model.

Regulatory overlap

Some of the entities subject to ASIC fees and levies are also regulated by other agencies including the Australian Taxation Office, Tax Practitioners Board, Financial Reporting Council and in the case of professional accountants, by the professional accounting bodies enforcing the Accounting Professional and Ethical Standards Board Code of Ethics. There is also the additional layer of reporting to the Professional Standards Councils. The cumulative regulatory impact should be considered.

For instance, Registered Company Auditors (RCAs) are subject to a rigorous quality assurance audit every three years by the professional accounting bodies. There is also mandatory Continuing Professional Development and a complaints, investigations and disciplinary process in place. Even though the professional accounting bodies do not have the same legislative enforcement powers as ASIC, the objectives of regulating, improving behaviour and culture, increasing professionalism (including integrity and competence) and serving the public interest are all the same. There is a high level of scrutiny of these regulated entities and they also receive education, guidance and their interests are represented by their respective professional association. This is essentially a co-regulatory model and should be taken into consideration when assessing the required level of regulatory activity.

Key point:

Fees and charges could be reduced if ASIC took regulatory overlap into consideration. For example, regulatory activities such as 'supervision and surveillance' of certain sectors, are carried out by others to a greater extent than ASIC.

Technology and efficiencies

On the ASIC website, it states: 'As technology rapidly reshapes global financial markets, services and their regulation, ASIC's strategic priority is promoting regulatory technology (regtech) adoption'.

We would expect to see ASIC leading the way in the use of regtech in its own regulatory activities, with a resulting decrease in costs, over time. We note that ASIC also mentions 'suptech' (supervisory technology); and is involved with the Innovation Hub and the regulatory sandbox. All of this should translate to reduced costs and reduced fees and charges on regulated entities.

Key point:

There should be more information provided in the CRIS on how ASIC is using technology to reduce regulatory costs, drive efficiencies and improve outcomes.

Competitive pressures

We contend that qualified accountants leaving the financial advice sector is counter-productive at a time when more Australian consumers are seeking affordable and competent financial advice from their choice of trusted adviser. The current pandemic has heightened this need, especially as we see 2.8 million Australians withdraw \$25.3 billion from their superannuation under the Government's early access to superannuation measure (APRA website, statistics current as at 12 July 2020).

We are already seeing a gradual and continuing reduction in the numbers of RCAs, SMSF auditors and liquidators. This is evidenced in the ASIC Annual Report 2018-19 (Appendix 8.4 Five-year Summary of Stakeholders key data from 2014-15 to 2018-19 on pages 264-5). In addition, according to our own data, 12% of our members surrendered their financial services license in the last 12 months.

The cost of doing business, including ASIC fees and levies, has added to the pressure on these sectors, especially the smaller practices which cannot easily continue to absorb costs and find it increasingly difficult to pass costs on to clients who are equally embattled. Many IPA members hold multiple registrations which obviously increases the cost of being in business. We believe that the cumulative cost for these, often small, practitioners should be taken into consideration.

Key point:

A proportionate levy system would be more equitable; ease anti-competitive pressures; and better serve the public interest. ASIC already collects information to facilitate this system.

RCAs and registered liquidators

We are unable to understand why liquidators are subject to higher fees and a different fee structure than other sectors such as RCAs who are charged a flat levy. We note that the total costs to be recovered by levy from 651 liquidators is \$7.760 million as opposed to \$2.569 million from 3,962 RCAs.

We are unable to reconcile the differences in indirect costs between the RCA and liquidator sectors, for instance, 'governance, central strategy and legal' is costed at \$0.281 million for RCAs and at \$0.937 million for liquidators. 'Property and corporate services' are costed at \$0.516 million for RCAs and \$0.845 million for liquidators. Given there are over six times as many RCAs as liquidators, these costs would seem disproportionate.

Mandatory legislative requirements mean that liquidators must undertake certain tasks whether they are able to recover the fees or not. We note that between July 2018 and June 2019, for companies entering liquidation: 85% had assets of less than \$100,000; 58% had less than \$10,000; almost 37% were reported as asset-less; 8.5% had assets over \$250,001; and 92% estimated the return to unsecured creditors would be \$0. (ASIC Report 645 Insolvency Statistics June 2018-June 2019). We are advised by members who practice as liquidators that up to 80% of their fees are regularly 'written-off' and that they expect this to be offset by other engagements and work.

Given that the number of liquidators is declining in an uncertain and cyclical profession, we contend that a different approach should be considered based on a lower, flat levy.

At this stage it is still too early to tell whether the recent insolvency reforms will make a difference to the costs and business model of liquidators (even with the introduction of the new category of Small Business Restructuring Practitioner).

Key point:

The methodology and fees imposed on liquidators should be reviewed in light of the structural issues facing this sector.

SMSF auditors

The other sector from which we continue to receive feedback is SMSF auditors. The impact of market concentration, offshoring, outsourcing, technology, additional regulation and scrutiny, are all taking a toll on this sector, with numbers declining. In light of this, we believe that the registration and de-registration fees should be significantly reduced. In particular, having a fee to de-register, when other sectors don't have such a fee, is unnecessarily punitive and even discriminatory according to some members who are seeking to exit the sector.

Key point:

This sector continues to face abnormal competitive pressures which should be considered by ASIC in assessing fees and charges.

Small entities

Many smaller entities are low risk and do not require and do not appear to receive much supervision, surveillance or enforcement, which make up the bulk of ASIC's costs.

Key point:

The low level of regulatory activity given to this low risk sector, does not justify the level of fees and charges.

Member feedback

We have received numerous and ongoing complaints and comments from our members about the hardships they and their clients are facing during the current pandemic. For some, this started with the recent bushfires and other natural disasters over the last summer. Many are under pressure to either waive or reduce their fees and are faced with small business clients who may not survive the economic downturn.

In this environment we are at a loss to understand the justification for a 38% increase in fees which some of our members with financial services licences have been asked to pay; and this is after a 25% increase last year. Some members have even sent their invoices to us in a state of disbelief.

Key point:

ASIC fees and levies are considered unreasonable and excessive by many IPA members.

Recommendations

- The Government should seek to reduce the cost of regulatory compliance on those who are regulated and on consumers.
- Based on all of the above discussion, a full review by Treasury of all aspects of the ASIC industry funding levy model is justified, to ensure it is genuinely transparent, sustainable and fit for purpose.
- The Government should ensure that regulators are properly funded from consolidated revenue to undertake their functions. Any contributory industry cost recovery or fee model should be fit for purpose and accurately reflect the cost of regulation.

Taxation reform – time to act

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

Over the years, successive governments had begun a process of dialogue on how to create a tax system that supports higher economic growth and living standards, improves international competitiveness and adjusts to a changing economy. In 2010 we had the release of the Henry Review into taxation followed in 2015 by the Rethink paper on tax reform. Despite these efforts, we have not seen movement on fundamental tax reform, instead we have experienced a piecemeal approach to tax policy. Simply tinkering at the edges to create 'stop gap' solutions will not address the need for fundamental reform. The tax system was already failing to address a changing pre-COVID-19 economy and was seen as holding Australia back in fulfilling its economic potential. It represents one of many important levers that the Government has at its disposal to reinvigorate a much needed growth agenda.

For a long time, tax reform has been stated as a key part of successive government's policy agenda to build jobs, growth and opportunity, yet there has been little progress to achieve these Stated aims.

There is an even greater need to reform our tax system to manage the road to a post COVID-19 recovery. While we were in a relatively good position fiscally as compared to many OECD countries, with relatively low government debt and a Commonwealth budget almost back in surplus, we have a tax system ill-equipped to manage a downturn given the reliance on personal and company tax at the Commonwealth level and property transactions at the State level. Australia has a high reliance on income taxes, including company income tax. Around 60% of the Commonwealth's tax receipts come through personal and company income taxes, nearly twice the OECD average.

Australia's experience from the GFC suggests that it will take a long time for corporate taxes to recover from the COVID-19 downturn as company losses are carried forward. This puts additional pressure on personal income taxes to carry the load.

The increase in unemployment (even with JobKeeper subsidising wages), and even further expected weakness in wages growth, suggests that personal taxes will also not provide a stable or growing base for the Commonwealth for many years.

The base and rate of our GST will also hamper the Government's ability to make up for any lost revenue from direct taxes on personal and company taxes. The percentage of consumption on which GST is payable now stands at around 47% due to exemptions on food, education and health. GST exemptions now disproportionately benefit higher income households. To enable governments to support the economy back to health requires rebuilding the tax base with efficient growth-supporting taxes.

The COVID-19 slowdown has undermined the ability of governments to raise revenue given the disruption to business and personal incomes and changed consumption and saving behaviour. With additional government expenditure to support the economy, governments will be challenged to reinvent their tax systems without stifling economic growth and will need comprehensive tax reform. The COVID-19 pandemic has now exposed an ill-equipped tax system to support the recovery process.

An effective taxation system should be premised on achieving:

- fairness – or 'equity' as between taxpayers, with respect to ensuring that taxpayers in similar positions bear tax at the same level, but also that tax is borne at a level commensurate with the taxpayer's ability to pay;
- efficiency – that is, the system should not encourage the distortion of economic decisions; and
- simplicity – the system should be relatively easy to understand and place a low administrative burden on taxpayers.

Australia's current taxation regime has arguably moved away from these ideals and can be described as inefficient, technically complex and often distortive. A tax system exhibiting the above features usually results in high levels of voluntary compliance. Australia relies on maintaining high levels of voluntary compliance which could wane over time if our tax system is not perceived as "fair".

Different layers of Federal and State taxes also increase complexity. We are riddled with a vast range of inefficient taxes imposed by the State Governments (and each subject to its own legislative regime and rules). Taxes such as stamp duty and payroll tax are distortive and will often discourage business transactions and wage growth respectively. It has been well documented that 90% of total tax revenue collected by Australian governments, was derived from only 10 of the 125 taxes paid by Australians each year. Conversely, 10% of tax revenue was contributed by the remaining 115 taxes.

Sensible, well considered, wholesale structural reform of Australia's taxation system is likely to provide an efficient way to manage Australia's road to fiscal recovery in a post COVID-19 world. Our economy is not immune to the COVID-19 driven economic impacts. The global environment is similarly impacted so we can expect pre-COVID activity to take years to recover to previous levels. The need to rebuild our own economy and the unprecedented expenditure used to fund Government stimulus packages requires a sustainable tax base. This need pre-existed the COVID-19 crisis, so it's an opportune time to be bold and unshackle the economy from the restraints imposed by our current tax settings.

In addition to the White Paper recommendations (below) we have added other matters relating to Division 7A, Compensation for Detriment Caused by Defective Administration (CDDA) scheme and the Black Economy Taskforce.

Division 7A

- The Government announced in the 2017 Federal Budget that amendments would be made to Division 7A incorporating recommendations from the 2014 Board of Taxation's final report on the 'Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936' (BOT report). The start date was to have been 1 July 2018, although the Government in its most recent Federal Budget deferred the start date again to 1 July 2020, with further deferments announced by Minister Sukkar.
- Treasury released a Consultation Paper in September 2018, to seek stakeholder views on proposed amendments to Division 7A. The consultation paper draws on but includes significant departures from the recommendations in the BOT report. If legislated in its current form, there is potential for a substantial increase in compliance costs and tax payable by business entities using trusts for business purposes.
- Some key elements of the proposed new regime outlined in the Consultation Paper include:

- New “simplified” single ten-year loans with interest charged at the Reserve Bank overdraft rate for small business (which is much higher than the current Division 7A rate).
- Not adopting the amortisation model with principal repayments at the 3, 5, 8 and 10 years as recommended by the BOT report and instead requiring annual interest and principal payments.
- Regardless of when a repayment occurs during the income year, interest will be for the full year.
- The transitioning of both 7 and 25 year loans under Division 7A into the new regime. The BOT report had recommended grandfathering (preserving) 25 year loans under the existing arrangements.
- Both existing 7 and 25 year loans will be subject to the new higher overdraft interest rate as from 1 July 2019.
- Existing 7 year loans will keep their current outstanding term when transitioned into the new regime, but existing 25 year loans must be put on new 10 year complying loan arrangements prior to the lodgment day of the company tax return for the 2021 income year.
- The removal of the concept of distributable surplus such that there is no limit to the amount that may trigger a deemed dividend under Division 7A.
- The extension of the review period for Division 7A to 14 years after the end of the income year in which the loan, payment, or debt forgiveness are triggered, or would have triggered, a deemed dividend.

Both pre-4 December 1997 loans (with the benefit of a two year grace period) and unpaid present entitlements (UPEs) arising on or after 16 December 2009 must be put on new complying ten year loans. The proposal does not address pre-16 December 2009 UPEs.

The BOT report’s recommendation for a once-and-for-all election to exclude loans from companies (including UPEs owing to companies) from the operation of Division 7A (the ‘business income election’) is not included in the proposed amendments. The Consultation Paper has taken a selective approach, removing the ability to choose to be excluded from the Division 7A regime, while introducing many of the integrity aspects.

Recommendations

- We recommend that further consultation be undertaken to revisit ways to minimise the operation of Division 7A to businesses that use corporate profits to fund business activities.
- The BOT report includes a number of recommendations designed to ease the compliance burden associated with the rules that govern distributions from private companies and to lower the cost of working capital for private businesses.

We welcome further consultation on the reform of Division 7A, and the Government’s announcement on the 30 June 2020 that the start date on amendments will now apply from income years commencing on or after the date of royal assent of the enabling legislation.

Compensation for Detriment Caused by Defective Administration

The Compensation for Detriment Caused by Defective Administration (CDDA) Scheme was established in 1995. The CDDA scheme allows Commonwealth Government agencies to pay compensation when a person or organisation has suffered detriment as a result of defective administration. The purpose of the scheme is to restore the claimant to the position they would have been in had the defective administration not occurred.

Payments made under the CDDA scheme are discretionary and the compensation is assessed against a yardstick of fairness (moral obligation), rather than a legal liability. The compensation mechanism can be interpreted broadly enough to enable agencies to pay compensation in all cases where they believe it is warranted, or narrowly enough to exclude any requests, depending on the agency's approach to compensation generally or in individual cases. There is an opportunity for agencies such as the ATO, to adopt a flexible, customer focused approach based on a broad interpretation of the powers available to them. The CDDA scheme was recently subject to a review to examine its operation and implementation by the ATO as it relates to small business. The review looked at the processes used by the ATO to consider and decide on CDDA claims.

Whilst the review made several good recommendations, it did not specifically address the need for a dedicated scheme of compensation for tax practitioners. The review noted the impact of ATO IT outages and system failures on tax professionals which has also been acknowledged by the Tax Commissioner in his Foreword to the June 2017 ATO Systems Report.

The Inspector-General of Taxation (IGT) has been very supportive of compensation for tax practitioners for ATO system failures and outages and noted the restrictive and discretionary nature of the CDDA Scheme. IGT recommended in its November 2018 Future of the Tax Profession Report, that the ATO should align its service standards for the performance of its systems with those of commercial providers, including a dedicated scheme for compensation where outages or system failures result in a loss for the user.

IGT acknowledged that tax practitioners were left without any compensation payments. Clients of tax practitioners obtain relief through lodgment deferrals and penalty waivers when ATO systems experience significant downtime. Tax practitioners suffer economic and non-economic losses. When outages occur, productivity declines which in turn leads to less billable hours and a build up of work causing other issues such as stress and reputational damage, in not being able to meet their expectations. Not all tax practitioners suffer losses equally, as it is dependent on the practice's reliance on using critical ATO IT systems in the performance of their core services.

It was noted in the CDDA review, that detriment has to take into account the impact the ATO's administration can have on taxpayers and recognise that it can have a disproportionate and very damaging impact on small business. It was also noted that the Commissioner can, within the Minister's authority, define defective administration, detriment and the application of the CDDA scheme to suit the ATO's stance. Therefore, we see this as an opportunity to revisit a dedicated compensation scheme for tax practitioners where there are major systems failures.

Recommendation

- The inadequacy of the CDDA scheme falls upon the ATO's narrow interpretation as to what constitutes "defective administration". The ATO maintains that major IT system failures are not "defective administration". It maintains that its service standards are aspirational targets

and are not a formal agreement between the ATO and the tax profession and it should not be subject to the same service standards as a commercial entity. In light of this, we recommend that the Government in conjunction with the ATO, consider the implementation of a fairer and more accessible CDDA scheme dedicated to tax practitioners as recommended by the IGT. The CDDA scheme is currently not fit for purpose in providing redress for digital reliant tax practitioners when things go badly wrong.

Black Economy Taskforce

The Black Economy Taskforce was a genuinely whole-of-government undertaking, bringing together 20 Commonwealth agencies. The Taskforce report was tabled in 2018 and had 75 recommendations most of which have been supported by the Government. Whilst the Government has made good progress in implementing some of the recommendations, we believe a new sense of urgency is required by policymakers to maintain momentum to protect the integrity of our tax system. Some of the recommendations which the Government has started scoping and require continual prioritisation to fast track their implementation are:

- ABN reforms to strengthen business identity;
- Modernise business registers; and
- Sharing economy reporting regime (we were pleased to note that the Government's 2019-20 [Mid-Year Economic and Fiscal Outlook](#) (MYEFO) included a new third party reporting regime which will require sharing economy online platforms to report identification and income information regarding participating sellers to the ATO for data matching purposes).

Recommendation

- We recommend the continual prioritisation of recommendations included in the Black Economy Taskforce report to maintain the reform agenda to protect the integrity of our tax system. The ABN reforms and modernisation of business registers are fundamental building blocks of our tax system. Whilst we understand that these reforms require significant planning and consultation, they are critical to addressing systemic weaknesses in our tax system.

White Paper recommendations

Headline findings

- Federal Treasury has stated that the impact of the US tax law changes will become evident over time. As capital markets have become increasingly global and business locations increasingly mobile, governments are using the lowering of corporate tax rates as a means of driving economic growth. The US reforms have the potential to accelerate tax competition, making Australia's current corporate tax rate increasingly uncompetitive internationally.
- Australia is yet to get closure on a comprehensive taxation debate.
- The Federal Government and the Federal Opposition remain reluctant to address the GST as a part of reform.
- Singapore offers an example for corporate tax reform designed to encourage the establishment and growth of new businesses.
- Incompatibilities remain to be addressed between payroll tax and land taxes.

- Australian schools do not appear to place sufficient emphasis on developing an understanding of the tax system.
- There is a need for a holistic review of policy objectives in relation to small business tax concessions (given the multitude of such concessions).

Recommendations

- The Federal Government should renew its commitment to a comprehensive tax reform process – a new process to draw on all the work already undertaken (including the Henry Tax Review and Tax Forum) in formulating a blueprint to prepare our economy for the challenges ahead. The Government should realign our tax system to reduce its heavy reliance on individual and corporate income tax.
- The Federal Government and Federal Opposition should explore changes to the GST.
- The Federal Government should explore the use of a parliamentary forum (such as a committee) to seek further stakeholder views on tax reform. Such an inquiry should also use the Parliamentary Budget Office to model various scenarios.
- The Federal Government should investigate the potential implications of adopting tax incentives for new businesses, such as those operating in countries such as Singapore.
- The Federal Government should explore options with the States and Territories to either remove payroll taxes or, at the very least, to ensure the laws and the way they apply are consistent in every way across the country.
- The in-house facilitation process for resolving taxation disputes should be constantly promoted and recommended by professional advisers as a potentially effective and cost-efficient means to resolving tax disputes.
- Small business tax concessions need to be consistent, with the policy objectives as defined. A holistic review of all the current concessions needs to be undertaken to ensure the suite of tax concessions work collectively to support small businesses through all stages of a business life cycle. Small business tax concessions must be benchmarked against the policy objectives to ensure they are well-targeted and remain so. The IPA Deakin SME Research Centre supports the independent self-initiated review of small business tax concessions conducted by the BOT. The consultation guideline which sets out the principles for evaluating and improving the current suite of tax concessions for small business is an appropriate basis for undertaking a holistic analysis. We await the release of the BOT report by the Government.
- That the instant asset write-off be made a permanent feature of the small business tax regime.
- A whole-of-government approach is required for small business assistance programs. Accountants are well placed to deliver such programs, as they already act as advisers to small businesses.
- The tax system should provide targeted assistance towards stress points in a business life cycle, such as the start-up phase or during a temporary setback. Most tax concessions (excluding the SBCGT concession and refundable R&D concession) are merely timing benefits that bring forward tax deductions to reduce the amount of tax payable, which is only useful if the taxpayer is in a tax paying position. If a small business is in the start-up stage or

undergoing a temporary downturn, the bringing forward of deductions may not provide essential cash flow benefits other than more carried-forward losses. Loss-carry-back for corporate entities is one way the tax system can assist taxpayers deal with a temporary setback. Non-corporate entities, while problematic, may also require similar relief to assist with the survival of viable businesses.

- To avoid incentives towards complex business structures, consideration should be given to the creation of a simplified small business entity. Our current tax rules provide an incentive for small businesses to use complex structures. Tax outcomes depend on business structures, and multiple structures are needed to achieve tax outcomes that would be otherwise unavailable through a single entity.

Full expensing of depreciating assets and small business entity pooling

Recent legislative amendments contained in Schedule 1 to the [Treasury Laws Amendment \(2020 Measures No. 6\) Act 2020](#) (the amendments) are intended to provide businesses with flexibility to choose whether to apply the new full expensing of depreciating assets (FEDA) measure on an asset-by-asset basis. However, the same flexibility is not fully available to small business entities (SBE). SBEs are required to fully expense their general small business pool balances on 30 June 2021 and cannot choose not to write off the pool balance.

New s 328-181(5) of the *Income Tax (Transitional Provisions) Act 1997 (IT(TP)A)* — inserted by the [Treasury Laws Amendment \(A Tax Plan for the COVID-19 Economic Recovery\) Act 2020](#) — requires SBEs to fully deduct the pool from 6 October 2020 to 30 June 2022 where the pool balance is more than zero. From 1 July 2022, the ordinary rule in s 328-210 of the *Income Tax Assessment Act 1997 (ITAA 1997)* reverts to require SBEs to deduct their pool balance where the amount (worked out under s 328-210(2)) is less than \$1,000.

If an SBE chooses to continue to apply Subdiv 328-D of the ITAA 1997, the entity must fully deduct the pool balance on 30 June 2021 (assuming it was not already fully deducted on 30 June 2020 because the balance, as worked out under s 328-210(2), was less than \$150,000).

There is a choice in Subdiv 328-D — to choose not to apply the subdivision for an income year — but choosing to exit the subdivision does not change the outcome.

In comparison, non-SBE taxpayers have the choice as to whether they fully expense an asset under Subdiv 40-BB of the IT(TP)A or depreciate the asset under the ordinary provisions of Div 40. Non-SBE taxpayers can also allocate low-cost assets (those costing less than \$1,000) to a low-value pool which attracts an accelerated rate of depreciation.

The practical effect of all these rules is that an SBE is required to fully deduct their pool balance on 30 June 2021, which can cause adverse tax outcomes for some SMEs. In comparison, larger businesses have the flexibility to choose not to apply full expensing on an asset-by-asset basis. This is particularly problematic for trusts that are commonly used in the SME sector. Full expensing may result in a loss being made by a trust, resulting in the trust having no distributable income. This will result in the inability of the trustee to distribute any franking credits attached to dividends received by the trust to beneficiaries, which translates to lost franking credits.

Similar issue arose when the instant asset write-off (IAW) was increased from \$30,000 to \$150,000. Broadly, s.328-210 requires a taxpayer that is claiming its depreciation deductions under Subdivision 328-D of the ITAA 1997 to claim an outright deduction where its general pool balance as at the end of 30 June 2020 is less than the IAW threshold (i.e., \$150,000 for the year ended 30 June 2020). The

change in the IAW threshold which is directly linked to outright deductions for the balance of a general pool (ie where the balance is less than the IAW threshold) can result in some anomalous outcomes that can be detrimental to taxpayers by making them worse off over time. This can happen as a result of the individual tax-free threshold and were applicable, the Low Income Tax Offset and the Low and Middle Income Tax Offset. This can negate any tax 'saving' in the 2020 income year. Understandably, taxpayers may feel disadvantaged through no fault of their own. This scenario is commonplace among many SBE taxpayers, where they had no willingness or financial capacity to acquire any depreciating assets from 12 March 2020 onwards. However, due to the lifting of the IAW threshold from \$30,000 to \$150,000, they are forced to claim a significant tax deduction in respect to their general pool balance in the 2020 income year. Without the lifting of the IAW, the deductions which would have otherwise been spread over a number of income years (which could have resulted in a better tax outcome for the taxpayer).

Recommendations

- Full expensing - The policy intent was clearly to give flexibility to all businesses. However, the translation of that policy into law has omitted its application for SBE using pooling. The law should be amended to provide SME taxpayers with the same flexibility as larger businesses, and to ensure that larger businesses are not treated more favourably than those that are SBEs.
- Increasing IAW from \$30,000 to \$150,000 - Where a taxpayer has a general pool balance less than the IWA threshold for the year ended 30 June 2020, that they have the choice to claim an outright deduction for the balance, or, alternatively, that they can continue depreciating the general pool at 30%. This would require a retrospective legislative change, which given the circumstances would be justified on the basis that it is designed to remove an unintended consequence.

Reform Small Business CGT concessions

The small business CGT concessions (SBCGT) are, arguably, the most sort after and valued small business tax concession. The SBCGT concessions are a package or suite of four different concessions which enable a small business owner to defer or reduce capital gain on a sale of active business asset. SBCGT concessions were originally intended to provide a nest egg for retirement and encourage entrepreneurial activity. However, the generosity of the concessions is matched by equally complex legislation that leads to increased compliance costs. The overall cost to the revenue is substantial and growing and changes are urgently needed to make it sustainable for the future.

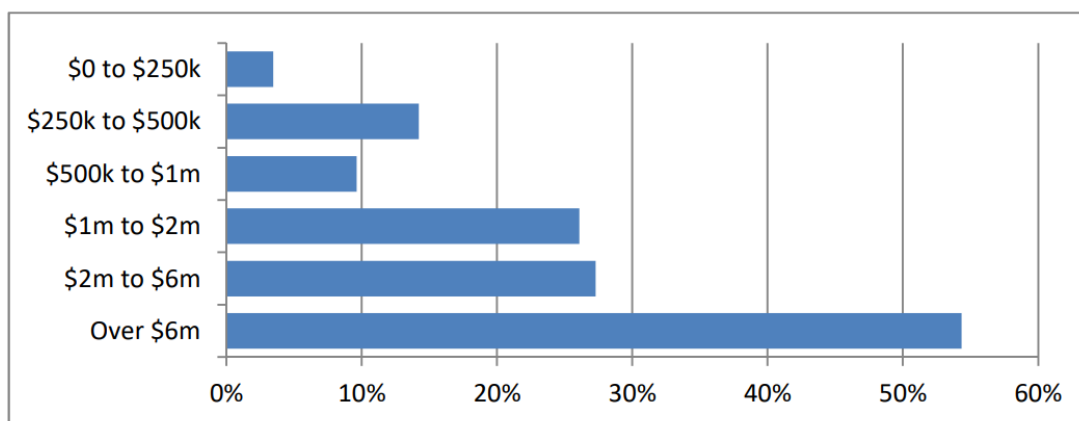
They were never intended to shelter capital gains of the magnitude we are currently experiencing. As a result, the overall benefit is not as widely distributed across the small business sector with a larger proportion of the benefits being accessed by a relatively small number of businesses. Some of the capital gains being sheltered through the small business CGT concessions are considered to be excessive compared to what the concessions were originally meant to deliver. The total dollar value of claims made under the concessions is growing at 16 %per annum over the three-year period 2013-14 to 2015-16, which is, arguably, an unsustainable rate.

In the 2015-16 income year, claims of \$1 million or more represented four %of all claims but accounted for some 38% (\$2.37 billion) of total amounts sheltered from tax by the concessions.

In the same year, there were 25 claims in relation to capital gains of between \$6 million and \$10 million and a further 15 claims, averaging \$10 million per claim. In the previous income year (2014-15) five claimants claimed concessions on capital gains of \$400 million, that is, an average of \$80 million per claim.

While all categories of claims are growing over time, claims of capital gains of \$6 million or more appear to show the highest rate of growth in recent years in terms of the number of claims and the total value (from \$180 million in 2013-14 to \$400 million in 2015-16).

Figure 5.6 - Average growth in the number of concession claims in the period 2013-14 to 2015-16



The Board of Tax in its report to Government (Review of Small Business Tax concessions) has identified a pathway for reforming the small business CGT concessions in a way that will make the system simpler, fairer and more sustainable. This is achieved by increasing the aggregated turnover threshold to \$10 million, repealing the net asset test, and collapsing three exemptions into a single capped exemption.

Recommendation

- The size of the gains that can receive preferential tax treatment doesn't align with the original policy intent and the concept of fairness and equity. We support increasing eligibility by moving the turnover threshold (from \$2 million to \$10 million) which will allow more businesses to qualify. We also support reducing complexity by removing the net asset value test (NAVt) and collapsing the 15-year exemption, active asset reduction and retirement exemption, and replacing them with one CGT exemption subject to a cap. The NAVt calculations add enormous complexity to the current rules and its removal will significantly reduce compliance costs. For this to be economically sustainable, we support the introduction of a cap for the first time, on the size of the benefits that will receive preferential tax treatment under these concessions to ensure a larger proportion of the benefit is not accessed by a relatively small number of businesses.

Expand deductibility rules around education

In the 2020-21 Budget, the Government announced that it would consult on allowing individuals to deduct education and training expenses they incur, where the expense is not related to their current employment.

We are supportive of initiatives that encourage individuals to continue upgrading their human capital skills over their working life. In an ever-changing labour market, few expect a job for life, and it will be more likely that individuals will have multiple careers over their lifetime. The increased rate of globalisation and technological change are other drivers that are contributing to the need for continued upgrading of skills.

Our current tax settings do not support or encourage the retraining and reskilling once an individual has commenced earning an income in their chosen field.

There are a number of existing support mechanism for higher education. We see this proposed measure as adding to the current support for higher education but addressing a void in the existing arrangements for individuals who are currently earning an income and may be unable to access any of the existing support initiatives. For this cohort, the existing tax arrangements represent a deterrent to reskilling. In particular, the requirement for a tax deduction is limited to expenses in gaining or producing assessable income. This limits deductions to an individual's current employment activities that either maintains or improves the specific skills required for that employment or leads to an increased income in the individual's current employment. Education expenses that do not have a sufficient connection to an individual's current employment are therefore not deductible.

We see this proposal working hand in hand with one of the other 2020-21 Federal Budget announcements; namely the exemption for FBT employer-provided education. The Government intends to exempt from FBT, employer-provided retraining and reskilling benefits to redundant, or soon to be redundant, employees where the benefit may not relate to their current employment. This allows the employer to bear the cost of retraining and reskilling without incurring FBT. Without this FBT amendment, education expenses not related to an individual's current employment would be liable for FBT. To provide equity to individuals who do have employer support for reskilling or retraining, this proposal is important to extend a similar tax concession to individuals who undertake further education costs themselves. The benefit to an individual of incurring the cost themselves will, however, be dependent on the individual's marginal tax rate.

There are wellbeing and economic benefits that quality education skills provide, which generally outweigh the cost of providing further support. There is a strong business case for providing additional support especially if it is directed to areas where there is a skills shortage.

The economy has been savaged by the financial impacts of COVID and we are supportive of initiatives that are aimed at improving our productive capacity. The recent Federal Budget has put in place sizeable tax incentives for replacing physical capital. We see this proposal in conjunction with wage subsidies such as the JobMaker Hiring Credit and Apprenticeship Wage Subsidy as providing further support to human capital. There are many skilled individuals who have been displaced and can be easily re-deployed into other less affected sectors with retraining.

The proposal also bodes well for individuals who wish to continue to work but for a number of reasons may not be able to do so (ie physical limitations, age, mental burnout), and need to reskill to remain in the workplace. There are a lot of occupations where the physical demands of the job cannot be sustained beyond a certain age, and therefore retraining offers an opportunity to extend an individual working life. This is particularly relevant if we are looking at a tsunami of baby boomers approaching retirement in the near future.

With international border restrictions, overseas immigration of skilled labour will be significantly curtailed. We need to look at ways to add to the supply side of the labour market and this proposal if, properly targeted, can contribute to adding capacity where it is needed.

Increasing the ability to claim deductions comes with a cost and therefore there needs to be integrity measures to ensure the proposal achieves good economic outcomes worthy of the tax concession.

We propose, that if this initiative is implemented, that there is a shared risk with the individual who proposes to take advantage of the concession. Quarantining half the upfront deduction until the individual earns income from an activity associated with the retraining is an appropriate model to ensure that the taxpayers does not wear the entire cost of education outlay in cases where the retraining does not result in the furtherance of a new activity.

Further, for occupations or vocations that are in short supply, we should allow the full cost to be deducted upfront. Similar in concept to the discontinued 457 visa system, an occupations list that is updated to reflect industry needs can be maintained to incentivize the supply side to target the concession to where it may be most needed. Whatever integrity measures are introduced, we need to ensure that individuals do not take advantage of the relaxation of the tax rules to engage in lifestyle or personal choices subsidised by the taxpayer.

Recommendation

- That the Government proceeds with its proposal to allow individuals to deduct education and training expenses they incur, where the expense is not related to their current employment. The expanded deductibility for education expenses should be subject to appropriate integrity measures to ensure it is targeted and achieves its policy intent.

Small Business Tax Offset (commonly referred to as unincorporated tax discount)

The unincorporated small business tax discount was intended to promote neutrality by 'levelling the playing field' between incorporated (mainly companies) and unincorporated businesses (sole traders, partnerships, trusts).

The majority of small businesses (up to 70 per cent) operate as unincorporated businesses. These businesses are not eligible to access the small business corporate tax rate. The concession in its current form provides a tax benefit of up to \$1,000 per individual taxpayer. In its present form the level of discount is too low to have a meaningful impact. Whilst the discount rate is set to increase in line with the cuts to the corporate tax rate, the \$1,000 cap remains in place meaning that most taxpayers will get to the cap amount faster and not benefit from the percentage increase.

Progressive decrease in company tax rate and mirroring increases to the unincorporated small business tax discount

Year	2019	2020	2021	2022-2027
Company tax rate	27.5 per cent	27.5 per cent	26 per cent	25 per cent
Unincorporated tax discount	8 per cent	8 per cent	13 per cent	16 per cent

Changes to the rate of the tax discount will not be accompanied by corresponding increases to the cap which will remain at \$1,000.

Recommendation

- The unincorporated tax discount should be made more targeted and prominent to small business owners by significantly increasing the cap to make it a meaningful incentive and by applying the tax discount on a 'per business' basis. At present partnership and trusts can deliver a separate benefit of up to \$1,000 to multiple individuals. The savings generated by calculating the concession in this way could be used to finance an increased cap amount.

Enhancing Research and Development tax incentives to improve Australia's SME innovation capabilities

The IPA-Deakin SME Research Centre is preparing a research report entitled "Small Business White Paper 2021: Post COVID Policy Options to Enhance Australia's Innovation Capabilities" that is to be released in April 2021, with the primary objective of outlining a number of policy recommendations related to incentives provided in the Tax Laws Amendment (Research and Development) Act 2011.

Several factors motivate this focus on Australia's R&D tax incentive (R&DTI) scheme. While the Australian federal government's proposed amendments to the R&DTI scheme announced in the October 2020 federal budget affirm the importance of innovation to future economic growth as well as development of Australia's sovereign capability, proposed amendments to the R&DTI have led to calls for greater support to Australia's smaller businesses undertaking R&D activities. More specifically, concerns have been raised about the following issues:

1. The lack of collaborative research that is being undertaken by the Australian small business sector with Australia's world-renowned research institutions;
2. There is no government or centralised entity that both specifically promotes SME innovation and provides support to SMEs planning on collaborating with other would-be industry partners and/or research institutions, thereby increasing the difficulty in finding research partners. Accordingly, industry research partners are required to navigate sometimes complex University or research centre collaboration requirements (OECD, 2014), creating significant barriers to research collaboration;
3. The current eligibility criteria for R&D activity in Australia are far too narrow as they do not include software-related research activities and development, which arguably hampers the competitiveness of Australia's software industry.

Providing greater support to Australia's smaller businesses undertaking R&D activities is crucial. R&D subsidies offered by government to the business community fundamentally tackle market failures as they primarily incentivize businesses to conduct additional R&D. These tax incentives thereby address potential underinvestment in R&D in a manner that enhances positive externalities (spillovers) to the broader Australian economy (PC, 2007; CIE, 2016; Ferris et al., 2016). However, given significant financial and other economic constraints facing small businesses in Australia, coupled with the absence of federal government policy that is specifically focused on enhancing spillovers from innovation (CIE, 2016; ISA, 2016), the SME Research Centre provides robust evidence showing that the current R&D tax incentive scheme can be optimised further to promote R&D

expenditures, particularly among small business, to enhance externalities from innovation and R&D investment.

It is well documented that the effective costs of conducting R&D are high (OECD, 2018). While limited cash reserves are a characteristic of many SMEs and start-up businesses, and SMEs are generally constrained from engaging in R&D by liquidity shortfalls, there is abundant evidence showing that inefficient or ineffective capital (and venture capital markets, specifically) constrains Australian companies financing additional R&D (Daly, 2013; CIE, 2016; Ferris et al., 2016; ISA, 2016). Accordingly, to improve the capacity of the R&DTI to support innovation and R&D expenditures among SMEs, the SME Research Centre in its Small Business White Paper 2021 outlines and discusses some of the following recommendations:

1. **Increase SME Subsidies.** Despite assertions that the R&DTI provides generous incentives for Australian SMEs (CIE, 2016; Ferris et al., 2016), the magnitude of the incentive is low compared to OECD peers. Australia ranks 14th and 23rd for the strength of incentives provided to loss-making and profitable SMEs respectively, with the benefits for loss-making SMEs deriving from the refundability of the taxation credits for SMEs, rather than the magnitude of the credits. Recent changes to the R&DTI also lower the benefit received by SMEs. Where previously tax credits were offered to SMEs at a flat rate of 43.5%, tax credits will be provided under the 2020 budget planned R&DTI at a rate of the corporate tax rate +18.5%. At inception, these credits will be of equivalent value. However, with slated corporate tax rate decreases for SMEs to come into effect in the next five years, the effective cost of engaging in R&D for these companies will increase.
2. We recommend reverting to the fixed rate incentive (at 43.5%) to remove the erosion of effective relief provided by the credit due to slated decreases in corporate taxation rates. The R&DTI is crucial to startups and other SMEs, and survey data gathered by StartupAUS (2019) suggests that much of this relief is directed towards expanding employment. Eroding the value of the taxation credit, and therefore increasing the effective cost of conducting R&D activities, reduces the incentive for companies to conduct these activities and employ local research expertise.¹ Increasing the R&DTI may also increase incentives for start-ups and other SMEs to conduct their R&D activity in Australia, rather than overseas. Many countries provide stronger incentives than Australia and provide considerably more total funding.
3. **Quarterly Offsets for SMEs.** An alternative way to provide cash for SMEs to invest in R&D is to provide more regular offsets that can be made redeemable. As highlighted in the 2011 Draft Legislation and exposure memorandum for the introduction of quarterly credits, this would be restricted to SMEs, as only SMEs can access redeemable credits under the R&DTI. The resulting bill, the Tax Laws Amendment (2013 Measures No. 4) Bill 2013, has since not been pursued by the government.
4. **Collaboration Vouchers for SMEs.** Government vouchers for innovation and R&D address several barriers to R&D collaboration. The vouchers provide direct funding to research projects, operating similar to grants addressing the limited cash resources available to SMEs and providing upfront liquidity to fund R&D, a key friction in research collaborations (CIE, 2016). For the purposes of incentivising collaboration, the vouchers provide a redeemable cash value for R&D work undertaken in collaboration with a University or publicly funded research institution. Accordingly, recipients are forced to engage with research institutions,

¹ This issue has been of considerable concern to industry groups. See, for example Atlassian (2020).

addressing cultural frictions that would otherwise prevent industry and researchers joining on projects.

5. **Collaboration Incentives for SMEs.** An alternative measure to incentivise collaboration is using indirect incentives through the taxation system. A widely considered, if not employed, approach is to provide a premium to relief rates for R&D expenses incurred while collaborating with publicly funded research institutions. The federal government's recent review of the R&DTI has provided strong support for a collaboration incentive. Ferris et al. (2016) provide strong support for such an incentive at the level of 20% of eligible expenditures. Based on evidence from the Department of Education's Review of Research Policy and Funding Arrangements (2015), they argue that the potential increases in business efficiency from collaborative research increases by a factor of three.
6. **Software and R&D.** Australia adopts a relatively strict definition of eligible R&D activity. The R&DTI requires that research activity meet the following criteria. Eligible research activities must relate to experimental activities and must resolve a question for which the outcome "cannot be known or determined in advance on the basis of current knowledge, information or experience" through the application of systematic research activities. To this extent, eligible research must be "basic" research, as opposed to applied research or experimental development (OECD Frascati Manual, 2015). Thus, research must be novel – new to the world – and therefore, resolution of the issue should provide incremental knowledge spillovers.
7. Accordingly, we recommend that the R&DTI be amended to (a) broaden the scope of eligible R&D activity to include software-related research activities; and (b) provide clear advice on the requirements for software to comply with the requirements of the R&DTI. This is both in line with calls from the industry (see Pakula, 2020) and the approach of foreign jurisdictions. Many countries use R&D taxation schemes to support software development. For example, Israel provides special taxation regimes, the United Kingdom includes many software development activities under its taxation offset, and the Netherlands provides both for deductions for wage expenses incurred in software development and provides a special taxation regime or innovation box.² These incentives aid in the development of software-based industries and promote both employment in the field. Moreover, the development of internal software improves business efficiency and can increase the competitiveness of Australian businesses.

Policy responses – a useful framework

In terms of the response to the crisis and even looking beyond to the 'road to recovery' the IPA recommends an integrated policy framework such as the one outlined below from the ILO. Whilst there is always more work to be done and measurement is problematic, we believe that the Australian Government has performed relatively adequately against this framework. The expansive response against many of the ILO pillars, including measures around insolvency, early access to superannuation, childcare support, training programs etc, have been, overall, well received, widely utilised and we believe effective.

² Other regimes with software development eligibility include Austria, Brazil, China, Malaysia, Mexico, South Africa, Spain, Russia, Turkey, and the United States (Deloitte, 2015).

The ILO refers to the four pillars of policy responses to COVID-19. These are:

1. Stimulating the economy and employment, through fiscal and monetary policy, lending financial support to specific sectors, including the health sector.
2. Supporting enterprises, jobs and incomes, including employment and retention measures (wage subsidies), financial and tax relief for businesses, extending social protections for all.
3. Protecting workers in the workplace, preventing discrimination, adapting work arrangements (eg enabling teleworking), providing health access, expanding paid leave.
4. Relying on social dialogue for solutions, including building trust and confidence, strengthening capacity and resilience of workers' and employers' organisations, strengthening the capacity of governments, strengthening labour relations and processes.

Recommendation

- The Government should consider a policy framework similar to the ILO framework above when developing policy reform for the post-COVID-19 recovery.

Wage subsidy schemes: design features

With respect to JobKeeper, we note that many countries around the world have implemented some form of wage subsidy scheme to cope with COVID-19 job losses. A country comparison was included in our submission to the Senate Select Committee on the Australian Government's response to the COVID-19 pandemic and related matters in May 2020.

There have been numerous studies and reports over the years on the effectiveness of Active Labour Market Policies (including wage subsidies). Indicative, overall, of the findings is *What Works for Active Labor Market Policies?* by Eduardo Levy Yeyati, Martín Montané and Luca Sartorio, Center for International Development, Harvard University, July 2019. Findings included:

- programs are more likely to yield positive results when GDP growth is higher and unemployment lower;
- programs aimed at building human capital, such as vocational training, independent worker assistance and wage subsidies, show significant positive impact; and
- program length, monetary incentives, individualized follow up and activity targeting are all key features in determining the effectiveness of the interventions.

Other studies have found that generous and long-lasting hiring subsidies can have more substantial positive effects in the long-term. By contrast, short-term hiring programs and subsidies are only effective if they comprise a substantial training element.

Recommendation

- The Government should have regard to the research which might provide useful indicators, considerations and features, as well as noting international comparisons, when designing policies to aid our recovery from this crisis and post-COVID-19.

Stimulus measures worth keeping – government guarantee scheme

The IPA Deakin SME Research Centre has undertaken significant research and policy development on government guarantee schemes and has been a long-time advocate. Australia was one of 47 developed countries, which until the pandemic, didn't have such a scheme to assist small businesses in accessing affordable finance and capital. One of the stimulus measures introduced has been a guarantee of 50% for business loans for small and medium sized businesses through eligible lenders. The total lending capacity will be \$40 billion (2% of GDP). We also note the support measures introduced by the banking sector, which have been very welcome for many small businesses.

Recommendation

- We urge the Government to retain a guarantee scheme post-COVID-19 and to have a coordinated program (with the Australian Business Securitisation Fund and the Australian Business Growth Fund) to genuinely assist small businesses and SMEs to access affordable finance and capital on appropriate terms and security (eg not having to mortgage the family home to secure business loans).

Supporting businesses to survive COVID-19: Small Business Viability Review program

Despite numerous support measures introduced by governments at all levels, many businesses have been unable to keep operating and have closed permanently.

However, support for many small businesses will still be required leading up to and throughout the recovery phase. This support must also test the viability of a business to determine whether it can be resurrected or alternatively assist it to exit the market in advance of insolvency and bankruptcy which can have a detrimental impact on the business owner's mental health and wellbeing. To assist in recovery measures or closures, access to professional advice is essential.

The nation's peak accounting and bookkeeping bodies have joined forces with the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) to make a united call for a Small Business Viability Review program to be included in the Federal Budget. IPA, together with CPA Australia, Chartered Accountants Australia and New Zealand (CA ANZ), Institute of Certified Bookkeepers (ICB), Council of Small Business Australia (COSBOA) and the Ombudsman are calling for a government funded subsidy to ensure small businesses can access urgently needed professional advice on their viability.

The ASBFEO recommendation has two components: the first allows for an amount of up to \$3,000 for advice from a professional (accountant) to assess the current financial position and viability; the second, includes \$2,000 for insolvency advice if the business needs to be wound up based on its non-viability.

Another example of such support to help access professional advice is Tasmania's Business Continuity Grant designed to help a business fund accounting, legal or business planning advice.

Accountants as trusted advisers have been key to the successful implementation of the Federal Government's major stimulus packages including JobKeeper and JobSeeker. They have assisted

clients to navigate and access the funding support to sustain operations during the peak of the crisis. With the Government's initiatives flowing via the tax system, accountants have been the first port of call for thousands of businesses. Even though this has been a huge increase in their workload, many IPA members have advised they are under constant pressure from clients to either waive or reduce their fees, with some work being simply unbillable. This in turn has placed significant pressure on their own survival.

It is likely that accountants will be required again to support clients through the recovery period and beyond. It is clearly noted that not all small businesses will survive the impact of the pandemic (and the extensive bushfire season in large areas of the country that preceded the pandemic). However, to provide businesses with the best opportunity to recover or to make the assessment to exit, many will require advice and guidance from their professional and trusted adviser. Whilst the new insolvency reforms will assist businesses to restructure or exit efficiently, the first stage of assessing viability has not been adequately addressed. Many small businesses simply lack the funds to seek the professional advice they need to assess their viability and their options.

Recommendation

- The Federal Government should urgently fund a grant (or other support) to enable businesses, with priority given to small businesses, impacted by COVID-19 to access professional advice to assess their financial position and determine their viability and future prospects in the recovery phase. Specifically, under the jointly proposed Small Business Viability Review program, small businesses with up to \$10 million in annual turnover would be eligible to obtain a subsidy valued up to \$5,000 to access a tailored 15-month plan from an accredited professional on how and whether to turn around their business or exit.

Further information on the proposal has been provided to Treasury in previous consultation.

Workplace relations – the need for simplicity

The small business sector is an important employer of labour and contributes significantly to the Australian economy. However, the sector is diverse. While not all small private-sector businesses employ people, 798,000 (or almost 38.0%) are employers of labour, employing 4,731,000 (or over 44.0% of all employees).

The impact of COVID-19 will make workplace laws even more critical as we face an increasing unemployment rate.

Small business owner-managers who employ labour face many challenges in managing their human resources (HR), especially if they want to grow their businesses. An important distinction to make relates to whether an owner-manager is growth-oriented. This will significantly impact how the business is likely to be managed in a sustainable way, noting that small businesses have a higher failure rate than their larger counterparts.

While the workplace relations system is sometimes seen as imposing unnecessary compliance costs on small businesses, the system provides for flexible work arrangements that are not necessarily accessed by small business owner-managers. It also provides owner-managers with key standards or benchmarks, so they can readily determine what to offer their people in terms of pay and other

terms and conditions of employment. These are readily available and easier to understand than in the past.

Businesses that rely on paying their people (minimum) award terms and conditions are less likely to succeed. Business owner-managers who do not demonstrate that they value their people are less likely to achieve such results³.

Headline findings and recommendations

- The small business sector is often perceived in the business and political media as a homogeneous group. It is, however, very diverse and a critical distinction needs to be made between growth (entrepreneurial) and non-growth-oriented owner-managers. While the latter group is numerically significant, growth-oriented entrepreneurs, in the main, do the heavy lifting when it comes to new job creation. New and small businesses are subject to vulnerabilities – that is why the survival rates are relatively low for such businesses. The longer they survive and the more they grow, the more sustainable they become. Growth-oriented businesses have the opportunity to contribute more significantly to employment growth.
- In broad terms, the workplace relations system appears to work reasonably well. Some will undoubtedly be critical, often on political or ideological grounds, while others will see merits in the current arrangements, perhaps with some changes. This is inevitable for an area that is highly contested and has seen many significant changes over time. Whenever fundamental changes have ensued, the impact has been felt at the coal-face, by employers and employees who have had to turn to third parties for assistance in interpreting and operationalise system changes. Whether the changes are worth the resulting confusion and instability (and money) is often not known for some time.
- Owner-managers of small businesses, including entrepreneurs, will benefit from a workable workplace relations framework that delivers consistency and stability. Such owner-managers are time-poor and lack resources to deal with too many ongoing changes, particularly of a significant nature. Such owner-managers, especially the entrepreneurial types, are looking for (sustainable) advantages to outdo their competition. These players will need to know how to operate optimally within the workplace relations system.
- Continued effort is required to ensure small business owner-managers understand their legal rights and responsibilities with regard to workplace relations. To achieve this:
 - Easy-to-understand regulatory material needs to be readily available. The efforts of the Fair Work Ombudsman (FWO) have been welcomed.
 - Small business owner-managers should be given the opportunity to make enquiries regarding workplace relations matters anonymously (to encourage a more accurate, timely information flow).
- Penalty rates are a highly contested area of the workplace relations landscape. They were introduced as a deterrence against the use of longer, unsociable working hours by employers, as well as to compensate employees for working such hours. Over time, consumer preferences have changed to longer trading hours in the retail and hospitality sectors. The Fair Work Commission (FWC) has addressed this issue recently and, through

³ Fox and Smeets (2011); Ichniowski and Shaw (2003); Lazear (2000).

transitional arrangements, is aligning Sunday penalty rates with existing Saturday rates. This seems to be a sensible approach as it removes inconsistencies for undertaking any weekend work.

- The main direction and operation of Federal unfair dismissal provisions appear to be fulfilling important fairness and justice standards and need to remain. We note that the Productivity Commission, in its review of the workplace relations framework, did not see any evidence to justify removing such provisions. Importantly, it concluded that unfair dismissal provisions are not playing any significant role in employers' hiring and firing decisions.
- Due to resource constraints experienced by small business owner-managers, it is important that regulators, at all levels of government, continue to address and remain vigilant to the compliance burden. Regulatory requirements need to be simplified and associated cost-burdens minimised where they are unable to be removed (such as with the wording and administration of awards and the inspectorate role of the FWO).
- While improvements to the workplace relations systems will continue to be important in addressing any anomalies and modernising outdated provisions, substantive and sustainable improvements to business productivity and competitiveness are more likely to arise from changes made at the firm level. Major differences in productivity and competitive advantage will be shaped, to a large extent, by what happens in specific workplaces and not so much by legislative or governmental changes at the national level.

Net employment dynamics of Australian SMEs

Since its inception in 2013, the IPA-Deakin SME Research Centre has been tracking the economic behaviours of small-to-medium-sized enterprises (SMEs) in Australia, analysing and highlighting the performance of these businesses in relation to financing, innovation, skills and human capital, competition, and regulation. We also consider the net employment of Australian SMEs and the relationship to size, age and innovation.

While evidence in the literature suggests that employment growth is generated by a few rapidly growing firms in a number of developed economies⁴, these high-growth firms are not necessarily small and young. More importantly, to date there is limited evidence on better understanding employment growth in Australia in relation to firm characteristics such as size, age, innovation and other firm factors.

We address the gap in the literature by focusing on these specific SME firm characteristics and their contribution to Australia's net employment between 2006-07 and 2013-14, by using the Australian Bureau of Statistics' (ABS) Business Longitudinal Data. SMEs are an important contributor to the Australian economy and are a major source of employment for Australians. SMEs often provide more employment opportunities for unskilled workers, thus they help to drive down the unemployment rate, which can have positive flow-on effects to Australian society in general by lowering the crime rate, decreasing welfare dependency, improving standards of living, and so on. Our future analysis will benefit from access to BLADE provided to Deakin University.

⁴ Henrekson and Johansson (2010).

For decades, economic policy-making and research has been influenced by the assumption that business growth is independent of firm size. More recently, however, economic research has questioned this assumption by demonstrating that small firms grow faster than larger firms and that smaller enterprises are a more important source of job creation in the economy. Indeed, a body of research on employment shows that employment growth is actually dependent on the size of the enterprise, with some empirical evidence indicating that job growth is inversely related to firm size.

Notwithstanding this inverse relationship between employment and firm size, we also note that there are significant, persistent productivity differences between different SME firm size and age classes that possibly affect both firm survival and growth. Moreover, the extant literature⁵ reports that the entry, exit, expansion and contraction of firms are significantly associated with various measures of productivity and profitability.

The concept of ‘creative destruction’ – a term coined by Austrian-American economist Joseph Schumpeter in 1942 – is an important feature of competitive markets 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. The efficient reallocation of resources between these growing and shrinking firms is critical to aggregate productivity growth and employment.

Accordingly, we examine net employment among SME firms by considering whether size, age and innovation (and the type and processes of innovation) are important determinants of net job creation among SMEs in Australia. We draw on work undertaken by the IPA Deakin SME Research Centre⁶. Understanding these SME firm dynamics will assist in formulating better policy outcomes regarding job creation in the SME sector.

Headline findings and recommendations

- We show that both business size and age are significant determinants of net employment, particularly among start-ups and young firms.
- As firms become older, they contribute significantly less to net employment, whereas younger firms (ie less than 5 years old) have a significant impact on net employment, contributing on average to around 15% in net employment.
- Start-ups and young firms that innovate, particularly those associated with the introduction of new marketing methods, contribute on average to between 7% and 9% in net employment.
- Another significant determinant of net employment is government financial assistance, contributing on average approximately 3% to job creation.
- Our analyses demonstrate that start-ups and young firms are important drivers of net employment in Australia and, when considering the effects of age and innovation together, we find that these factors significantly contribute to job creation and are important sales growth and performance differentiators.

⁵ See Syverson (2011); Foster, Haltiwanger and Krizan (2001).

⁶ See Cowling, Kiaterittinun, Mroczkowski and Tanewski (2018).

- Our results show compelling evidence that the innovation capability of start-ups and young firms underpins the observed firm-employment dynamics, significantly influencing employment outcomes in the Australian economy.
- An important policy objective, therefore, is the early identification of start-ups and young firms that have innovation capabilities, as these firms contribute significantly to net job creation.

Innovation policy – it’s never been more critical

Given that innovative firms (particularly start-ups) are known to create more jobs than any other business category⁷, Federal, State, territory and local governments in Australia must do everything within their scope to assist businesses in understanding the value of innovation and, where appropriate, to provide financial and other incentives to encourage innovative thinking within the small business community. Our road to recovery out of the pandemic is reliant on the innovative enterprises of our small and medium businesses.

However, there is still an apparent lack of appropriate acknowledgement by small businesses of the importance of innovation to the growth of their enterprises. The IPA Deakin SME Research Centre⁷ has noted that the Australian Bureau of Statistics reports that only one in seven small businesses see innovation as important. That statistic alone illustrates that more needs to be done to create and promote incentives for small businesses to improve their prospects of future success.

The IPA Deakin SME Research Centre has undertaken research on R&D in the wake of COVID-19 and concludes there is an urgent need for new thinking in stimulating SMEs through innovation. A major innovation is the patent box. The annexure to this submission contains a detailed consideration of innovation policy and the patent box reform.

Headline findings

- Innovation is a key driver of productivity, jobs creation and economic performance.
- Innovation policy should include measures that encourage the diffusion and uptake of existing innovations by a broad range of firms, as well as encouraging new innovations per se.
- Federal, State and local governments in Australia have a series of grant schemes available for small businesses seeking to grow.
- Government agencies have extensive small business education programs designed to assist small businesses working within the innovation space.
- Public policy to support innovative SMEs should increasingly consider value capture and business model innovation generally.
- Businesses in Australia experience a wide range of barriers to innovation. This suggests policy to support innovation needs to be flexible and broad-based.

⁷ Cowling, Tanewski, and Mroczkowski (2017) ⁷
IPA-Deakin SME Research Centre (2018b).

- Talent, not technology, is the key. If wider skill requirements are not addressed, there are likely to be bottlenecks created downstream in the innovation process.
- Technical skills across the workforce, and particularly interdisciplinary skills that bridge areas of expertise, are particularly important for innovation and are often subject to market failures.
- Patent box initiatives are gathering momentum in offshore jurisdictions.

Recommendations

- Governments should provide more support for research and development by small and medium-sized firms.
- Better linkages should develop between cutting-edge research universities and industry. Typically, only large firms have the resources to fund university-level research and development.
- Governments should provide more support for firms to adapt existing technologies and innovation.
- Measures should be developed and implemented to help the spread of existing innovations to a broader range of firms.
- Encouragement should be given to firms to adopt 'continuous improvement' methods to embed incremental innovation, as this will generate large productivity improvements quickly.
- The Government should provide tax breaks for companies acquiring new technologies not developed in-house.
- A 'matching' service should be developed to promote the building of collaborative relationships between multinational corporations and Australian businesses, both domestically and abroad.
- The Government should provide a tax allowance for companies investing in intellectual property protection (through patents, copyright, trademarks, design rights etc) in-house.
- The Government should provide tax allowances for companies that generate licensing income for in-house new technologies.
- The Government should rigorously continue with its patent box initiatives, as outlined in their current reform agenda.
- The Government should further develop government procurement initiatives to ensure small business procurement targets are met and exceeded by 2022. These programs should be based on programs that are running in the United States.
- The Government should allocate a pool of funds for further research into youth entrepreneurship in Australia, so policy decisions made in this area are based on research evidence.

Trade policy and the need to internationalise

The role of international trade is crucial to the development of national economies in many countries, including Australia⁸. As demonstrated in the White Papers, SMEs play a critical role in contributing to Australian employment and economic growth. But how significant are SMEs in the international trade of Australia?

We have focused on the international activities of SMEs, particularly their exporting behavior, including:

1. The main ways in which SMEs enter export markets
2. Types of SMEs that are most likely to be involved in exporting
3. Exporting performance of Australian SMEs
4. Policy implications.

Headline findings

- There were 2,238,299 actively trading SMEs operating in Australia at the end of 2016-2017. These enterprises generated A\$379 billion worth of industry value added to the economy and employed seven million people.
- Australian SMEs contributed 14% of the total export revenue of goods and 27.4% of service-sector exports (2015-2016).
- The number of firms engaging in direct import is 44% higher than that of exporters. The value of SMEs' exports is about 25% less than that of imports (2009-2013), suggesting an imbalanced trade situation in Australia.
- An already unstable global trade environment (driven by global events and developments such as, for example, Brexit, China-US trade disputes, US withdrawal from TPP etc) has been heightened by COVID-19, making the level of uncertainty and market risk among Australian SMEs even greater. However, such global disturbances may also bring about potential market opportunities.
- The bulk of Australian SMEs are domestically oriented: on average, between 2009 and 2014, 80% of SMEs were active in local markets while 12.5% were involved in overseas markets.
- The majority of Australian SMEs are found to follow the 'Uppsala model' of internationalisation, which suggests a staged approach to exporting, starting out in locations of geographic proximity, allowing an accumulation in knowledge and resources to draw upon when venturing further afield.
- More than one in 10 SMEs generated income from direct exports: with 7.5% of income generated by the direct export of goods and 4.8% by the export of services.
- Internationalisation among SMEs varies by business sector. The three sectors showing the highest levels of internationalisation are wholesale trade, information media, and professional, scientific and technical services.

⁸ Organisation for Economic Co-operation and Development (OECD) (2017).

- Larger and more mature firms have higher levels of engagement in international activities. Medium-sized firms are three times more likely to be active in foreign markets than the self-employed and twice that of small-sized firms. Approximately one half of all internationally active firms have operated for more than 10 years.
- The most popular source of external finance is from the banks. The proportion of SMEs with loans increases with their turnover. However, Australian SMEs have increased their use of credit cards while all other forms of lending sources, including bank finance, have marginally declined.
- Innovation plays an integral role in exporting, both enabling and stimulating subsequent export behaviour. Australian exporters are twice as innovative as importers, particularly in terms of introducing new products or operational processes.

Recommendations

We draw on a range of research literature and Australian official government data to provide a basis for discussion on the performance of Australian SMEs and make suggestions for Australian policy makers. Certainly, there is much to be done to help Australian SMEs 'raise their game' in the international marketplace and especially in terms of trade diversification to help on the road to post-COVID recovery. The evidence presented shows a weak international performance by SMEs but also grounds for optimism.

- Findings from the longitudinal study by ABS suggest the majority of small and young firms are still more domestically oriented, compared with larger firms. In terms of policy interventions, a targeted approach is suggested, aimed at those SMEs that are seeking to internationalise but have not yet done so, and those that are already exporting and are seeking to expand their international reach into additional new markets. Hence, the strategy should be to build upon current successes and to increase the volume of direct exporters. Inevitably, such an approach requires some targeting of different categories of SME with specific types of support.
- Australian interventions should place more priority on facilitating SME exports in the six most internationally-active industries – including mining, agriculture, manufacturing, wholesale, information media, and professional services. These are the main sectors in terms of generating export revenue for the economy. However, as geographic sales of SMEs vary across sectors, this suggests that a tailor-made intervention for each sector is highly recommended to boost the rate of internationalising SMEs. Tailor-made interventions are much more likely to be relevant and effective and would encourage higher levels of take-up by SMEs.
- Size and age of enterprise are also important when designing and delivering support measures. As revealed in the longitudinal data (ABS), the significant difference in the level of international involvement between medium-sized and self-employed firms can be attributed to two reasons: their limited resources (which adds costs and risks in engaging internationalisation) and/or their lower levels of motivation to go beyond their local markets because of their resistance to grow (risk aversion). On the other hand, born globals (who are highly motivated to internationalise) may encounter more challenges in accessing finance, compared with their counterparts, due to the higher risks involved and less-developed networks and lack of experience in the foreign market. Hence, more emphasis should be

placed on encouraging small and self-employed firms to participate in foreign markets by providing targeted export incentives, support for networking and international collaboration, business matching opportunities, and facilitating access to finance.

- Innovation has been acknowledged in literature as a critical factor in enhancing internationalisation. Investment in innovation also contributes to developing competitive advantage for firms to outperform others in the international market, as well as to increase sales revenue. This is consistent with findings of the data collected by the ABS during 2009-2013. Evidence suggests that innovation is more intensive in Australian exporting SMEs than non-exporters. Hence, support for growth and innovation can be helpful to boost the number of exporters and accelerate their international activities.
- In the increasingly uncertain global environment, SMEs would benefit from clear guidance and signposting to identify and assess the risks of internationalisation. More support in terms of detailed information provision would be helpful, such as the provision of tailored advice and a mentoring program for firms internationalising in different geographical markets. In-depth discussion forums and network events, such as how to evaluate the impact of Brexit and opportunities for Australian SMEs, challenges emerging from the policies of the Trump Administration for those involved or seeking to trade in the USA, and how to gain best benefits from the TPP agreement, should be offered. This will not only help the government to understand SMEs' needs, but it will also build a bridge between SMEs and policy makers in designing specific instruments to support their internationalisation. We applaud the work which the Dept of Foreign Affairs & Trade has done to promote the utilization of trade agreements and hope to see this work continue.

Mental health: significant economic implications

The Department of Innovation, Science, Energy and Resources has awarded the IPA-Deakin SME Research Centre a \$2.24 million grant for its "Supporting Small Business Advisors for Better Mental Health" project to train 5,000 accountants. The program will be rolled out over the course of 2021.

The professional accounting bodies, including the IPA, CA ANZ and CPA Australia, have joined forces to ensure their members are equipped to recognise and support their clients, employees and themselves in dealing with mental health issues.

Accountants, as trusted advisers, are on the frontline and are often the first to recognise such stressors amongst their clients, particularly SMEs. The last Federal Budget announced the world's largest investment in support of small business owners' mental health.

In addition to the accounting bodies and Deakin University, the program involves Beyond Blue, WorkSafe Victoria and Mental Health First Aid.

To make a significant and sustainable improvement to mental health and to address the economic and financial impact, there needs to be a holistic approach. In this regard, the IPA acknowledges the Productivity Commission *Mental Health* report released in June 2020 and supports the detailed recommendations, especially:

Recommendation 4 – create a person-centred mental health system

Recommendation 7 – equip workplaces to be mentally healthy

Recommendation 10 – increase informed access to mental healthcare services

Recommendation 11 – expand supported online treatment

Recommendation 13 – improve the experience of mental healthcare for people in crisis

Recommendation 15 – link consumers with the services they need

Recommendation 19 – tailor income and employment support

Recommendation 22 – best practice governance to guide a whole-of-government approach

Recommendation 23 – funding arrangements to support efficient and equitable service provision

Recommendation 24 – drive continuous improvement and promote accountability.

ANNEXURE

Research and Development in the wake of COVID-19 – an urgent need for new thinking in stimulating SMEs through innovation

Setting the tone

The IPA Deakin SME Research Centre (Faculty of Business and Law Deakin University, Melbourne), has strongly urged SME owners, their advisers, as well as governments to stay focused during this pandemic crisis and take lessons from history. Without doubt, ongoing tough decisions need to be made by many businesses over the coming weeks and months to preserve cash flows and stay afloat during these extraordinary times. But decimating any business which has been the blood, sweat and tears of its owners and the staff that have depended on that business, is not the answer. While, the vital SME sector in particular must be protected to ensure the survival of the Australian economy, we need to embrace this hiatus in trade with all of its disruptions, as an opportunity to take stock, to rethink and to plan for the perilous seas ahead.

The IPA Deakin SME Research Centre is continuing to review countless journals, texts, and professional and industry publications, and are finding that many lessons on surviving a crisis on the scale currently presented by COVID-19, can be learned from past catastrophic events. Indeed, there are countless examples in history of companies and other forms of businesses surviving even the harshest of conditions, including world wars, depressions, severe recessions, earthquakes, fires, plagues, tsunamis, hurricanes and other natural disasters⁹. The current COVID-19 catastrophe which continues to develop and grows worse in some countries by the hour, is different from all the other unfortunate events that have impacted the world, its countries, their states, and their collective communities. It's a pandemic which is threatening not only the very existence of mankind, but also the entirety of the commercial foundations which keep economies alive.

Whatever we choose to call the COVID-19 phenomenon, from a business perspective, it is an extraordinary economic shock, and sadly will impact the SME community the most. In essence, this is because SMEs make up the majority of all businesses in most developed countries, for example, in Australia, SMEs account for 99.6% of all businesses, 42.4% of all employment, and contribute to 37.4% of GDP. This has not always been the case, and it has only been in the past 15-20 years that SMEs have emerged as dominant economic players due to technology, and the inundation of young entrepreneurs developing and fostering a constant flow of new and innovative ideas and products that can readily be brought to market. Most strikingly however, was the success of start-ups and micro firms, as well as larger firms that were able to downsize their enterprises to much smaller forms, all of which provided greater flexibility and adaptability in responding to rapidly changing market conditions. As explained in Tanewski and Mroczkowski (2019)¹⁰, larger firms with significant investments in hard assets, along with complex business models and organisational structures, and outmoded logistical support networks, were not able to respond as quickly to changing market conditions. Eventually, these firms fell victim to Joseph Schumpeter's, concept of the 'gale of creative destruction' (1944)¹¹.

⁹ AAA

¹⁰ BBB

¹¹ CCC

However, in the face of COVID-19, will the very attributes and ideal conditions that allowed SMEs to be catapulted to the status of economic heroes, lead to their undoing? This is primarily because customers become silent or even non-existent during economic downturns, revenue concomitantly diminishes, as does cash, which is essential for keeping day-to-day operating activities alive. Without cash, the business of running a business suffers a natural death due to the cessation of revenue. In contrast, larger and more resourced-based firms, and at the risk of being colloquial, have more fat, and can ride the wave out longer. Indeed, even if they have poor cash reserves; 'bricks and mortar' and other hard assets can always be leveraged for debt/equity raising purposes.

However, all is not lost, world-wide disasters of the past have taught us some important lessons, some of which are briefly noted below:

- Surviving a major crisis – lessons from history show that the following initiatives helped firms bounce back with strength and competitive advantage:
 - Continued employment of key and loyal employees (using an array of employment options), particularly employees with special and unique skills which cannot readily be replicated
 - Continued investment in education, retraining and upskilling
 - Increased investment in innovation and technology, including rewarding employees with entrepreneurial skills
 - Cash preservation, via various means
 - Exploitation of government subsidies and other initiatives, such as debt moratoriums, and deferrals on tax and other government imposts.
- Continued focus on marketing key firm strengths (superior and unique products, service delivery using innovative means, assurance of product quality and supply)
- Adoption of risk management initiatives, not only as insurance mechanisms, but as key components of board strategy
- The ability (through prior training and advanced risk management techniques) to recognise early warning signs and the potential to mobilise resources for immediate remedial action
- Flexibility and adaptability of operations during difficult times, sometimes referred to as ambidexterity or the *chameleon phenomenon*, where firms can rapidly change their modus operandi to suit changing environments.
- Preparation, preparation and more preparation for potential risks – research shows that most computer modelling for contingency planning during past disasters were linear and had not factored in 'worst case' scenarios!

Notwithstanding the numerous areas of interest above that we can explore in more detail, our focus in this section of the IPA Pre-Budget submission is what has changed for professional advisers such as accountants and their clients over the past 4-5 months, and how can we learn from these changes to be well prepared and be ready to cope with a brave new world of business post covid-19? Without doubt, the most striking revelation is that most people working within professions such as accounting and law, can now work comfortably from home, without the need to travel or call into the office. Indeed, all files and documents can now be and are in fact, in electronic form and have been for years, and moreover can be readily transferred securely from system to system anywhere around the globe. Payment systems have also been in electronic form for years and again securely executed through encryption systems as have electronic signatures. Transactions have also been successfully conducted online for years and the pandemic has served to further rapidly expand the purchase and distribution of goods more efficiently and expeditiously, aided of course by technological advances in warehousing and transport logistics. More recently too, meetings and

professional development programs can be successfully conducted online, with many forms of video applications (apps) such as Zoom, MS Teams and Webex, and with as many participants, hundreds and even thousands if need be. Educational offerings have also had to quickly adapt their teaching strategies to accommodate online learning, so in effect, the apps mentioned above have given Universities and schools a lifeline at this most critical time. Educational institutions were forced to adapt in order to survive, and the past few months or so has proved not only that it can be done, but also that online learning is more efficient and cost-effective, and enables students to retain between 25-60% more knowledge using online learning compared with between 8-10% in a traditional chalk and talk classroom (Link: <https://www.shiftelearning.com/blog/bid/301248/15-facts-and-stats-that-reveal-the-power-of-elearning>) Shift: Disruptive Learning, Miami, USA*

So, what does all this mean for SMEs? Put simply, and if history is anything to be guided by, SMEs make up the majority of businesses in most countries around the world, and as such will be instrumental in kick starting the economy when the viral tidal wave has passed. More particularly, recent research has shown that start-ups and emerging entrepreneurial firms with an innovative focus, create more jobs than other type of business entity (Tanewski and Mroczkowski, 2019). In this sense, governments should be planning right now for incentivising innovation using new initiatives which reward innovative entrepreneurs at the commencement of their research projects and even more financial incentives at the back end of their research efforts, that is, the commercialisation stage. These incentives are more commonly known as Patent Box incentives and are discussed in more detail below.

Since cash flow deficiencies have now shown to be the main cause of failure for small business (and have been in many countries including Australia already), the immediate establishment of a Federal Government body to provide loan guarantee finance to eligible SMEs during and after the crisis is paramount to keeping businesses afloat as going concerns until the crisis passes and afterwards in the rebuild phase. The UK government has shown policy leadership in this regard with the successful launch of both the Coronavirus Business Interruption Loan Scheme, and the Coronavirus SME Guarantee Scheme which helps small to medium businesses with timely working capital needs. Moreover, in the longer term, an initiative mentioned in the IPA-Deakin SME Research Centre White Paper II (WP II, 2018), the Australian Federal Government should strongly consider the establishment of an independent Federal agency that can provide a range of low-interest loans to qualifying SME firms that are monitored by independently trained loan agents. This body will be akin to the successful US Small Business Agency (SBA) that has successfully provided and guaranteed low-interest loans to thousands of US SMEs with relatively low default rates. Government-backed loans schemes will be a critical part of Australia's recovery through the SME community and will be the subject of an updated versions of the IPA-Deakin SME White Paper III, expected to be released later this year.

Incentivising innovation for SMEs

Consistent with the Government's wider agenda on innovation, the possibility of a introducing an 'IP Box' regime to encourage research and innovation has been widely discussed, particularly in WP II (2018). The Federal Government has previously announced that it is considering offering tax incentives to encourage the development and commercialisation of intellectual property. As articulated in an early patent box policies paper by the Office of Chief Economist (2013), a 'patent box is a policy tool that reduces the rate of corporation tax levied on the income generated from certain types of qualifying intellectual property (IP), particularly patents' (hence the term 'patent box'). IT Box regimes are different to incentives-based schemes used by past governments to encourage research and development. These were usually tax credits and considered 'front-end'

incentives because they were given at the start of a research project. Whereas IP or Patent Box incentives, are tax reductions/breaks for income generated by the intellectual property after the research has been commercialised, that is, the last stage of the innovation lifecycle (ibid).

Given Covid-19 and the importance of innovation in the post Covid-19 recovery period, it is most timely for the Federal government to consider incentives of this nature, as Australia still appears to be lagging considerably behind its international counterparts, that is, in respect of direct research and development funding for business. The OECD (2018) has ranked Australia, 32nd out of 37 countries, making it amongst the lowest spending countries on direct funding for research and development activities, alongside Chile and Mexico being the lowest. Whereas, Russia, Sweden and the US spend the most on direct funding for business research and development.

While falling behind in the global research funding race could be seen by some international bodies as problematic, what might be of greater concern is whether the introduction of an IP Box regime, is the answer for encouraging greater innovation? Moreover, given the experiences of several countries already, whether these schemes are in truth, a mechanism for attracting mobile income via transfer pricing, which is often viewed as potentially harmful preferential tax practice (OECD 2015)

Firstly though, best to put things in perspective by answering a few preliminary questions. How do IP Box schemes work for example? Have these incentives worked in many other countries that have already adopted them? What's the upside/downside of such regimes? What can we expect if Australia was to implement an IP Box regime to encourage innovation?

From the limited literature available, there appears to be two primary models of IP Box regimes in operation, depending on the main objectives of the regime. The first is those regimes which have as their main objective, the incentivising of R&D investment and innovation (as is the case for IP Boxes in the UK, Belgium and the Netherlands), and those which have as their main objective, attracting mobile income (Cyprus, Hungary, and Malta for example). Other countries have a combination of both objectives, China for example, an IP Box Government Incentive Scheme and a separate assistance scheme for innovation

Government plays an important role in creating a regulatory environment that encourages companies and individuals to build businesses and create new products. In turn, demand for new products has the potential to encourage business owners to expand their operations and employ more people.

Johannessen¹² refers to the notion of institutional innovation and the role social institutions (such as governments) fulfil in creating an environment in which small business owners operate. The underlying issues for policy makers are how to encourage small business owners, or those thinking about creating a business, to take the commercial risks required. In some cases, it will be the provision of relief from legal compliance burdens through legislation or via administrative means that assists in minimising the time spent by small business on regulatory compliance. In other cases, there will be a focus on ensuring there are grants or other incentives designed to encourage business creation and growth.

¹² Johannessen (2013).

Given the above, some critical issues need to be considered before Australia can introduce a patent box scheme. For example, what is a patent box and how does it derive its meaning? What economic theories support the introduction of a patent box tax incentive? How do patent box schemes work? Have they worked in the many other countries that have already adopted them? What is the upside/downside of such regimes? Can we expect success if Australia was to implement a patent box regime to encourage innovation?

Firstly, the genesis of the term 'patent box' is interesting, to say the least, and for the uninitiated it conjures up all sorts of imagery – for instance, an imaginary box within which documents relating to patents are stored (anecdotal finding). This is far from the truth, of course. In its simplest form, a patent box is a tax incentive which provides a lower tax regime specifically applicable to income generated from qualifying patents. The term 'patent box' has no prudent dictionary definition as we know it but has become more of a generally accepted term used in tax circles, arguably derived from the European taxation system where, evidently, it relates to a box that needs to be ticked on the tax form¹³.

Over the past 10 years, patent box regimes have increased in popularity as the 'innovation-based' global economy has taken hold and continues to be fuelled by new ideas, new inventions and the increasing global demand for new processes and new end-products. In an effort to capture the essence of this phenomenon, which is clearly a significant driver of economic growth¹⁴, governments are vigorously searching for mechanisms that encourage and support innovation initiatives that grow economies and improve the wealth of societies.

Indeed, governments as far back as the early 1980s have already provided key policy measures, by way of tax incentives for research and development (commonly known as R&D tax incentives). This includes Australia, which has a range of tax incentives schemes currently available across a broad range of industries and activities. By many accounts, tax incentives have been successful in supporting research R&D in most countries, including Australia where the registration of patents has increased over the past 15 years. However, R&D tax incentives are 'front-end' measures to encourage research and development, starting from the initial idea and proposal, but they do not necessarily focus on the commercialisation of the research. Thus, they are, in effect, 'input-based' measures.

Patent box tax incentives operate differently. They are 'back-end', or output-based incentives designed to provide tax relief from income generated by a patent already registered. In this sense, a patent box initiative incentivises the commercialisation of innovation and not just the research component of innovation (ie by providing a firm with a lower rate of tax to qualifying income that would otherwise attract the normal corporate tax rates). Moreover, the strategic nature of a properly constructed patent box tax incentive will ensure that the lower tax rate is only applicable where profits from innovation are actually aligned with the profit-making activity. In this way, the success of the innovation commercialisation is rewarded and, indeed, ultimately it is the commercialisation that leads to growth and prosperity.

The theoretical arguments in support of a patent box tax initiative are drawn from the economic literature, where it appears that there are two schools of thought, both of which relate to multiple market failures or, rather, the lack of failures (ie assuming the normal forces of demand and supply

¹³ Atkinson and Andes (2011).

¹⁴ Atkinson and Andes (2011).

are at play). In this sense, if the market reaches equilibrium through these forces, then there should be no need for governments to use taxation or any other mechanisms to correct for market failure, because markets without external intervention should theoretically maximise a nation's economic welfare.

The point missing here, however, is the existence of positive externalities – that is, the 'spillover' effect which increases the welfare of society, but at the expense of the creator/inventor. To put this argument in another way, knowledge can be freely used by any consumer and thus it is a public good, meaning that one consumer's consumption of knowledge will not affect the consumption of any other consumer. Similarly, the air we breathe is a public good and, again, one consumer's consumption of fresh air will not affect the consumption of any other consumer.

Extending this argument to intellectual property – if the intellectual property of a creator can be used freely by any person, then there is no incentive for entrepreneurs to invest in research and development, leading to the underproduction of knowledge and, in turn, new innovations. Thus, in a purely free market scenario, some public goods will result in market failure (ie the misallocation of resources), which in turn can lead to insufficient innovation and research, leaving society to be worse off in the long term.

An extensive body of economic literature shows that 'companies do not capture anywhere near all the benefits from the research they conduct'¹⁵, thus requiring some form of tax incentives to correct for the apparent market failure. Early studies, as far back as the 1980s¹⁶ also establish this inconsistency in market behaviour: "the median rate of return from twenty prominent innovations was 27%, whereas the social rate of return was 99%, 'almost four times higher'"¹⁷. Moreover, Nordhaus¹⁸ found that inventors "only capture 4% of the total social gains from their innovation; the rest spill over to other companies and to society as a whole". So, from an inventor's perspective, it is not really an appealing proposition when everyone other than the inventor stands to gain much more of the benefits that accrue from the innovation.

In light of the above findings and given that new knowledge is a significant driver of improved public welfare and wealth generally, government intervention is necessary to prevent an underinvestment in the creation and commercialisation of new knowledge. Indeed, Australia has recognised this issue and, along with many other countries, has successfully introduced tax incentives for the 'front-end' of the innovation cycle that commences with the conduct of research. These initiatives have been successful in effectively lowering the cost of research and have thus increased the returns of private investors that might otherwise have rejected an investment in innovation, particularly if the risks are high and the returns are low¹⁹.

Moving on to patent box incentives, the IPA Deakin SME Research Centre has a concern about whether tax incentives at the back-end of the innovation process (ie the commercialisation stage) can have the same effect in stimulating further investment in innovation and thus be similarly successful as R&D tax concessions. Indeed, proponents of patent box regimes argue that providing tax incentives which reward commercialisation and success of innovation, "is an important strategy

¹⁵ Atkinson and Andes (2011).

¹⁶ Tewksbury, Crandall and Crane (1980).

¹⁷ Cited in Atkinson and Andes (2011).

¹⁸ Nordhaus (2005), p 4.

¹⁹ Atkinson and Andes (2011).

for growth, competitiveness and job creation”²⁰. This leads us to a further discussion on the second wave of economic theory relating to market failure – that is, that innovation is now, more than ever, a global, mobile phenomenon. As a consequence, we are witnessing economic inconsistencies (almost akin to a price war) as more and more countries rigorously, aggressively use tax codes and other mechanisms to remain competitive and further grow their economies.

One issue central to the economic argument relating to market failure is the risk factor. Typically, the innovations most likely to ‘change the world’ and have the greatest impact on society, as well as providing the greatest amount of benefits to society, are the longer-term, large-scale research projects. Indeed, in this respect, these are the projects governments should be supporting (ie given that their successful commercialisation will provide the greatest amount of benefits to society and will have the greatest spillover effects as well, thus benefitting hundreds of non-creator firms). However, the longer-term, large-scale research projects have a higher risk profile and require significant investment in research and development over longer periods and, even after these long periods of large investments, may still not be successful commercially. A good example is research undertaken in the pharmaceutical industry, where new medical discoveries such as drugs could take anywhere from 10 to 20 years or more to get to market. Moreover, in competitive global markets with appetites for shorter-term investments, “justifying investment in high-risk [and longer-term] research activities have become much more difficult”²¹.

In the Australian context, the risks associated with long-term innovation projects have been partially offset by tax code initiatives such as R&D incentives (government support), which have proven to be successful at the front-end of the R&D cycle (ie as effective incentives to encourage further research, innovation and job growth)²². Similar R&D initiatives have been successful in many other jurisdictions, including the United States, Japan and a host of countries within the EU²³. From an international perspective, Graetz and Dowd²⁴ provide an extensive account of the positive impacts of R&D incentives on economic growth.

The evidence suggests, therefore, that R&D tax credits have been an effective “tool to lower the costs of conducting research, including high-risk research, so that private returns better approximate social returns, encouraging firms to invest to maximise both”²⁵. Interestingly, however, some researchers suggest that R&D credits alone are not enough for firms to remain globally competitive in a constantly changing global market, and a combination of incentives are required to encourage research, innovation and commercialisation. Indeed, as cited by one author, “there are alternative ways of correcting market failure so that inventors of knowledge are rewarded; we need a mixture of different instruments appropriate to different products and circumstances”²⁶.

Some of the alternative ways suggested include:

²⁰ Atkinson and Andes (2011).

²¹ Krehmeyer, Orsagh and Schacht (2006).

²² IPA-Deakin SME Research Centre (2018).

²³ European Union (2014).

²⁴ Graetz and Dowd (2013).

²⁵ See particularly Atkinson and Andes (2011).

²⁶ Owen (2017).

- government (voluntary or compulsory) buy-outs of patents, thus making them truly public goods without impairing (assuming that a fair value is struck) the benefits attributable to the creators of knowledge
- prizes for inventions
- full government funding for research and development costs.

Other contributors have argued for a patent box regime in addition to R&D incentives, so the input (R&D) and output (commercialisation) phases of an innovation are compensated and rewarded. In this sense, there is a better “matching of firm rewards with societal benefits, including the creation of high-paid jobs”²⁷.

This state of thinking has now led to a proliferation of patent box schemes in several countries across the globe, as evidenced in numerous studies.²⁸ Many of these studies have highlighted the potential benefits that patent box regimes can provide, particularly in terms of supporting further innovation. But many of the studies also highlight the potential pitfalls that have emerged in countries where patent box regimes have been established – particularly countries within the EU that have experienced severe corporate tax competition as more and more countries joined ‘the race to the bottom in corporate taxation,’²⁹ as many of these countries continued to lower their respective tax rates to attract local and foreign investment in innovation (lending support to the theoretical prediction by Zodrow and Mieszkowski)³⁰. In turn, this had the effect of ‘tax code shopping’ where innovation-driven companies (particularly large multinationals) would actively engage in sourcing countries that offered the best tax package.

An even further development was the incidence of profit shifting by large companies to countries (and in some respect, tax havens) where preferential tax treatment was offered through patent box incentives. For some countries, these incentives were offered even though the intellectual property was developed abroad and ownership of the IP remained abroad³¹. On the basis of these and other tax avoidance activities orchestrated via tax havens linked to with patent box tax regimes, several countries have been highly critical of the use of patent box incentives³² – indeed, even to the point of stating that patent box schemes lead to harmful tax competition and may need to be stopped.³³ There have also been calls in Australia to resist the introduction of a patent box scheme given the UK experience where the new patent box rules “created a new way for large businesses to avoid tax in countries in which they operate”³⁴.

Notwithstanding the importance and weight of the many arguments critical of patent box regimes, many of them relate to pre-modified schemes with problematic design features – that is, the original patent box tax incentives before such schemes were modified to include checks and balances aimed at preventing tax abuse as well as ensuring that:

²⁷ Atkinson and Andes (2011).

²⁸ Including Atkinson and Andes (2011); European Union (2014); Griffith, Miller and O’Connell (2014); Alstadsaer, Kopczuk and Telle (2014); de Rassenfosse (2014); Bradley, Dauchy and Robinson (2015); Faulhaber (2016).

²⁹ Alstadsaer, Kopczuk and Telle (2014).

³⁰ Zodrow and Mieszkowski (1986).

³¹ de Rassenfosse (2014), p.5

³² OECD (2014).

³³ Pascal Saint-Amans, OECD, quoted by Fairfax Media, cited in Khadem (2014).

³⁴ Tax Justice Network, quoted in Khadem (2015).

- the IP is developed and remains in the country of origin
- preferential tax treatment is only given in circumstances where the income from the IP is generated in the country of origin.

The modified system is also known as the ‘the nexus’ approach. Following serious criticisms of tax avoidance and the loopholes in patent box schemes, the OECD along with the G20 launched a project aimed at limiting international tax avoidance. The project, referred to as the Base Erosion and Profit Shifting Project (BEPS), developed what has now been termed the ‘nexus’ approach, “where countries, are only permitted to provide benefits under patent boxes, if those benefits are proportionate to the amount of R&D undertaken by the taxpayer receiving benefits or in the country providing benefits”³⁵.

This approach works to limit revenue losses from patent boxes, because it establishes a “link between R&D and the income benefit that may arise, therefore constraining the ability of taxpayers to shift income between countries”³⁶. In essence, the strictly-applied nexus approach would require the R&D and the production associated with the intellectual property (ie IP that is eligible under the scheme) “to be performed in-country in order to qualify for the full-patent box rate”³⁷. And, as mentioned in Atkinson and Andes, the nexus approach is appealing for innovation-based tax incentives “because it would incentivise the back-end of R&D s while, at the same time, tie R&D to commercial outcomes through patent revenues”.³⁸

Given the research undertaken by the IPA-Deakin SME Research Centre, we are of the view that, on balance, a carefully crafted patent box tax incentive based on the ‘nexus’ approach is a plausible mechanism for spawning innovation in Australia. To sum up our view on patent boxes, we quote a statement made to the press by RMIT’s Professor Ian Maxwell³⁹: “If a patent box scheme was introduced, Australia’s large corporations would immediately start looking at means to innovate so that they could claim the patent box incentive. The end result of these R&D efforts would be world-leading products and services with export potential.”

Potential Benefits for Australia (if a patent box scheme is introduced)

If Australian companies are to remain globally competitive, then the focus of the current debate should be on global competitiveness rather than on tax policy and revenue enhancement⁴⁰. In this sense, we strongly recommend that the Australian Government, as a matter of urgency, introduce a nexus-based patent box scheme.

This would not only assist many of our struggling industries that are in much need of government support during the current covid-19 crisis, but it would also help to build a strong innovation culture, the basis of which will assist Australian companies to work smarter, more efficiently and faster.

³⁵ Alstadsaeter, Kopczuk and Telle (2014).

³⁶ Alstadsaeter, Kopczuk and Telle (2014).

³⁷ Atkinson and Andes (2011).

³⁸ Atkinson and Andes (2011).

³⁹ Maxwell (2014).

⁴⁰ Atkinson and Andes (2011).

One industry hit hardest over the past 10-15 years is the manufacturing sector, which was once a vibrant, prosperous sector employing thousands of Australians, and is now reduced to a shadow of its former self. Indeed, almost every year, the manufacturing sector loses companies across a range of industries, with the motor vehicle and associated manufacturing industries being most notable in recent years. Arguably, if a more focused, well-funded innovation and training policy is implemented as a matter of top priority, future collapses of Australian businesses, along with thousands of lost jobs, could be avoided