



The Institute of Public Accountants

Pre-Budget Submission 2017-18

January 2017



IPA INSTITUTE OF PUBLIC
ACCOUNTANTS
Partnership beyond numbers

Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to present our pre-Budget submission for the 2017-18 financial year, and looks forward to working with the Government as it sets its economic agenda in the challenging year ahead.

The IPA is one of the three professional accounting bodies in Australia, representing over 35,000 accountants, business advisers, academics and students throughout Australia and in over 80 countries worldwide. In 2015, the IPA merged with the Institute of Financial Accountants of the UK to form 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 two-thirds 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 easing the disproportionate regulatory and compliance burden placed on small businesses.

The IPA is very 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 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 addressing some of the challenges ahead.

Continuing from previous pre-Budget submissions, this year our submission also draws from the Australian Small Business White Paper, which has been produced by the IPA Deakin University SME Research Centre. Contributions to the White Paper have been made by major stakeholders from the public and private sectors and academia, plus over 500 small business people. In addition, this year we have added taxation related recommendations and we are keen to ensure that bold tax reform becomes a priority for the Government on its economic reform agenda. The IPA has previously voiced its disappointment with the stalled tax reform process.

On the other hand, we are pleased to see that some recommendations of the White Paper (including those on crowd funding, competition policy, education and innovation) have already been discussed or adopted to some extent by Government and by the Opposition, and continue to do so. More recently, the IPA has made submissions to both the Treasury and the Senate Economics Committees on the reforms to section 46 (misuse of market power) of the *Competition and Consumer Act 2010*. The IPA has been a long-time supporter of an "effects test". Further, we look forward to ongoing meaningful consultation, implementation and evaluation of more reforms resulting from the Competition Review, the Financial System Inquiry, National Innovation and Science Agenda and the various superannuation changes.

While the IPA continues to advocate for the major recommendations contained in the Small Business White Paper which have yet to be adopted by the Government, the IPA Deakin University SME Research Centre has commenced working on the next evolution of the White Paper; which will also build on the initial recommendations.

A copy of the White Paper can be found on the IPA website, www.publicaccountants.org.au/whitepaper.

We also welcome the Government's outreach program to try and realise the benefits of the free trade agreements which have come to fruition over the last couple of years. While the IPA advocated extensively on the benefits of the Trans Pacific Partnership (TPP), and we are disappointed at its apparent demise, we encourage the Government to continue negotiations on the other regional trade agreements and to incorporate small business/SME provisions (which the TPP contained). We are also hopeful of free trade agreements with the EU and the UK; and continued engagement with the US despite the outcome of the TPP.

We would be pleased to discuss our recommendations in more detail with the Government and the Treasury. Please address all further enquiries to either Vicki Stylianou (vicki.stylianou@publicaccountants.org.au or 0419 942 733) or Tony Greco (tony.greco@publicaccountants.org.au or (03) 8665 3134).

Yours faithfully

Andrew Conway FIPA
Chief Executive Officer
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Executive summary

The Institute of Public Accountants (IPA) makes this submission based on a number of key policy recommendations, focusing on taxation reform; the key pillars required for a more productive and dynamic small business sector (financial capital, human capital and innovation); as well as reform of the regulatory model. More particularly, our recommendations are grouped as follows:

1. Taxation reform
2. Loan guarantee schemes
3. Venture capital fund
4. Building an innovation system
5. Skills and human capital
6. Co-regulation model

The recommendations in this submission are presented against the background of challenging economic times and an uncertain global environment. After more than two decades of prosperity driven by booming prices for mineral exports, Australia still faces the real prospect of a sustained fall in living standards. Aside from a challenging federal budget position, the core of the nation's economic problem is its failure to lift overall business productivity for much of the past 15 years – which is to say that Australia's businesses collectively are barely more efficient than they were at the start of this century. The mining boom, while it lasted, was an adequate cover for the economy's failings. Now that the boom is over, Australia's underlying economic vulnerabilities have been exposed and remedial action is needed. The most recent fiscal outlook has revealed the parlous state of our finances and the size of the budget repair task. The Government is not expecting a return to surplus until 2020/21, some 12 years after the Global Financial Crisis (GFC).

While much of the public and media focus tends to be on big business, it is clear that lifting productivity in the small and medium-sized business sectors will hold the key to our chances of avoiding recession and directing Australia into a new era of prosperity.

Public Accountants in Australia are the trusted advisers to their clients and in establishing a true framework for productivity which embraces the core elements of financial capital, human capital and innovation, the public accountant is well placed to become the trusted productivity adviser.

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

Among the survey findings are that:

- Australian firms have been going backwards since 2007 on seven key indicators – product differentiation, profits, productivity, exporting, outsourcing, training and IT expenditure.

- Only 1 in 7 businesses consider innovation is important.
- Only 1 in 8 businesses have an international market presence.
- Many medium-sized, well established firms with the potential to expand into international markets consider only the national market as their end goal.

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

Whilst we acknowledge that the Government faces severe fiscal constraints, we believe that well targeted policies and programs, which boost overall productivity across the economy, are in the best interests of Australia in the short, medium and longer terms.

It is well understood by the Treasury that tax reform represents one of the strongest levers government has at its disposal to revive productivity, competitiveness and growth. Tax reform will need to be part of a number of broad reform agendas that the government should prioritise to boost productivity growth. That's why future policy settings for tax are critical to maintaining Australia's enviable growth record (ie two decades of economic growth which has contributed to the highest living standards in the world).

Our current tax system is now seen as a drag on economic growth rather than supporting effort. Added to this are a rising number of challenges facing the economy. Unless we lift productivity growth, we risk a long period of sluggish income growth, so Australia faces interconnected twin challenges: ensuring fiscal sustainability, as outlined in the recent budget MYEFO update, combined with the need to boost productivity growth to sustain living standards.

We believe significant economic growth will occur if there is a more supportive regulatory environment. Tax policy is a critical part of the regulatory environment for small business owners. Australia's taxation system, in combination with a myriad of government regulations, imposes an unreasonably heavy compliance burden on small businesses. This burden acts as a disincentive to entrepreneurial activity and employment, and ultimately represents a drag on the performance of the economy as a whole, and the living standards of Australians.

Summary of recommendations

Taxation

- 1. Recommendation:** That the Government carries out its commitment for a promised tax white paper. The terms of reference for the white paper should be broad and include the GST as part of the mix. The tax reform white paper needs to draw on all of the existing work already undertaken including the Henry Tax Review and Tax Forum in formulating a blueprint to prepare our economy for the challenges ahead. The current political environment has made 'big bang' tax reform extremely difficult for the major political parties. As a way forward consideration should be given to establishing an independent tax reform commission to support tax policy decision-making.
- 2. Recommendation:** That the Government carries out its commitment to reform the allocation of roles and responsibilities between the Commonwealth and the States with the aim of improving accountability, efficiency and reduction in public sector waste.
- 3. Recommendation:** Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 also contains company tax relief for larger entities over a 10 year period. Having regard to the importance of small businesses in the Australian economy, we support the removal from the Bill, granting tax relief for entities with turnover in excess of \$10 million, if it meant the Bill could successfully progress through Parliament. Tax relief for large entities might have to wait as there seems little chance that these reforms will pass the Senate and their inclusion in this Bill will be at the detriment of the other tax relief measures for smaller entities.

With respect to the small business income tax offset, the Bill proposes to increase the amount of offset an eligible individual may claim, however the offset will remain capped at \$1,000. The small business tax offset of \$1,000 needs to be also raised over time to mirror the tax relief available to incorporated entities from further company tax cuts in line with the original policy intent for the tax offset.

- 4. Recommendation:** We recommend an ABN withholding tax system at source be introduced for industries not covered by mandatory reporting of payments to contractors. The withholding rate can be industry specific to reflect differences in profitability or a tailored rate that a business applies for to reflect individual tax circumstances. Mandatory reporting has shown to be a very effective mechanism for prompting taxpayers to re-join the tax system ahead of possible detection through data matching. The experience shown in the construction and building industry has proven that mandatory reporting has been able to reverse entrenched longstanding non-compliance behaviour. It has encouraged reluctant contractors to engage with the tax system in a positive way. Not only has taxable payments reporting resulted in measureable improvements in compliance by contractors, it has exposed areas of non-compliance (missing ABN details, invalid ABN's etc.). An ABN withholding tax will also address the risks associated with the increasing number of self-employed businesses generated from the sharing economy.

- 5. Recommendation:** There is an opportunity to rationalise and streamline the Capital Gains Tax (CGT) small business tax concessions from 4 separate concessions down to 2 as recommended by the Henry Review.
- 6. Recommendation:** That Division 7A provisions be written into ITAA 1997 in a simpler and clearer manner to minimise the compliance burden and remove uncertainties.
- 7. Recommendation:** That the Government fast track the implementation of the key recommendations of the Board of Taxation's post-implementation review of Division 7A.
- 8. Recommendation:** As a matter of urgency, appropriate transitional relief should be introduced to deal with contingent principal repayments on Unpaid Present Entitlements (UPEs) held on sub-trust under Options 1 and 2 in accordance with PS LA 2010/4.
- 9. Recommendation:** That the Government review Fringe Benefits Tax (FBT) legislation to more fully recognise modern business practices and to reduce the small business regulatory burden.
- 10. Recommendation:** That the Government reintroduce the ability for companies to claw back tax paid when they incur revenue losses. The loss carry-back provisions recently introduced struck the right balance between allowing losses and limiting the exposure to government revenues by placing a quantitative cap in conjunction with a two-year carry-back period.
- 11. Recommendation:** That a new tax regime for small business entities combining attributes of companies, trusts and partnerships be created.
- 12. Recommendation:** That the Government re-visit the introduction of a taxation discount for interest income.
- 13. Recommendation:** That the alienation of PSI rules be reviewed to take into account modern work arrangements, low levels of compliance and uncertainty. The complex nature of the PSI regime provides scope to simplify and rationalise the existing tests to deliver greater certainty for individuals undertaking self-assessment.
- 14. Recommendation:** That consideration be given to a revised PSI regime that extends to all entities earning a significant proportion of income from the personal services of their owner-managers as recommended by the Henry Review.
- 15. Recommendation:** That the Government reinstate the concessional contribution cap for the over 35's to \$35,000.
- 16. Recommendation:** Consideration be given to a patent box regime that supplements the existing suite of innovation tax incentives to improve the prospects of intellectual property being created in Australia and also being developed and exploited here.

Loan guarantee scheme

17. Recommendation: To help increase the availability of much-needed affordable loan finance to the small business sector, the Federal Government should introduce a state-backed loan guarantee scheme. Australia is one of the only countries in the developed world without such a scheme, which would provide a limited state-backed guarantee to encourage banks and other commercial lenders to increase loan finance available to small business.

Venture capital fund

18. Recommendation: That the Government should introduce a publicly supported venture capital (VC) fund by either providing a significant proportion of funds to assist VC managers to attract other institutional investors to publicly supported VC funds or by becoming an institutional investor in a range of individual VC funds. This type of support by government to small business equity finance will improve the entrepreneurial environment in Australia and act as a catalyst in identifying and overcoming hurdles to successful and profitable investment.

Innovation system

19. Recommendation: Whilst we acknowledge the Government's National Innovation and Science Agenda, we strongly encourage innovation policy to support innovative SMEs in Australia. This can be achieved via governments providing strong support to research and development (R&D), enabling better linkages between cutting edge universities and industry, and by providing support to firms to adapt existing technologies and innovation, and by encouraging firms to develop their ability to search for new options, evaluate them, and successfully implement and adapt them to their specific context. Accordingly, public innovation policy should encourage value capture and business model innovation more generally, including measures that nurture the diffusion and uptake of existing innovations to a broad range of firms, as well as assisting new innovations. Moreover, firms should be encouraged to adopt "continuous improvement" methods to embed incremental innovation as this will generate large productivity improvements quickly. In addition, public policy towards entrepreneurs should shift from increasing quantity to increasing quality, with the focus being on encouraging the growth of a smaller percentage of firms that have the potential to grow, rather than encouraging more new entrants, regardless of quality.

Skills and human capital

20. Recommendation: To address the significant skills deficit in the Australian economy, the Government (in collaboration with State governments) should immediately tackle and reform the education system's ability to increase and improve the stock of knowledge-based workers available for employment. These results also suggest that governments should consider the inclusion of enterprise training at all levels of the education system from early school years

through to further and higher education institutions; and embark on a program to encourage and support life-long learning.

Co-regulation model

21. Recommendation: That the Government seriously consider the establishment of a formal co-regulatory environment in which some of the responsibilities of ASIC are shared with private actors. For example, the Government should consider a horizontal co-regulatory framework for the regulation and monitoring of auditors, along with associated enforcement activities, which is equitably shared amongst key actors including; the state, the accounting/auditing professions and private industry. Eventually, this can be further expanded to other areas regulated by ASIC.

Big bang tax reform needed for optimal tax mix

Our current mix of taxes limits Australia's growth potential. Tax reform represents one of the strongest levers the Government has at its disposal to revive productivity, competitiveness and growth. Australia faces interconnected twin challenges: ensuring fiscal sustainability, as outlined in the recent MYEFO update, combined with the need to boost productivity growth to sustain growth in living standards. A shift to growth supporting taxes is required to sustain Australia's economic momentum and meet all current and future spending needs. The current taxation mix is insufficient to meet expenditure commitments and Australia faces a revenue funding gap, especially in light of the fall in the terms of trade and sluggish national income growth. Reform is no longer an option given the growth in government debt making Australia vulnerable to future economic crises. Our tax base is too narrow, unstable and uncompetitive. The Intergenerational Report stresses the need for significant tax and federation reforms.

The Henry Review provided a comprehensive 'blueprint' for the future of our tax system. The recommendations of this review must now be developed into detailed, workable and affordable long term reform strategies. The Henry Review sought to address some of the fundamental imbalances that exist within the current system. The existing tax mix will struggle to achieve revenue adequacy in the long term in the face of rising expenditures as the population ages and workforce participation declines. Consumption taxes, being the most efficient and sustainable of taxes, are widely regarded by tax policy experts and others as integral to reshaping Australia's future tax reform agenda.

As recommended in the Henry Review, nuisance taxes should be removed and our reliance on direct income taxes decreased. A shift towards greater reliance on consumption taxes will encourage savings and investment and provide a more sustainable source of revenue. Most nuisance taxes which are inefficient, distortive and inequitable are levied by State governments. Reform in these areas will require an examination of the adequacy of State and Territory revenues. Stamp duty is an example of a state based tax which should be either abolished or rates reduced to a level that minimises the drag on the economy. Payroll tax is another tax that should be considered for removal as it acts as a disincentive to employment and does not motivate small entities to grow.

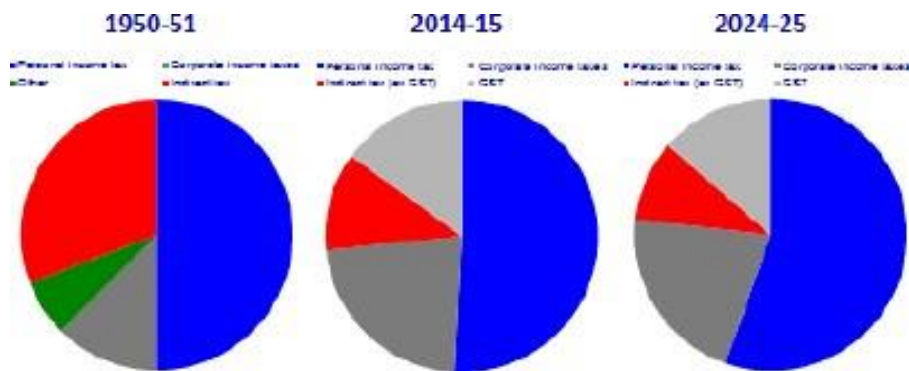
We believe the base and rate of GST must be part of any discussion on tax reform. Consumption taxes such as the GST represent one of the most efficient and sustainable tax bases available. Australia's GST base is relatively narrow and covers less than 50 per cent of private consumption which gives Australia the seventh lowest coverage ratio amongst 32 OECD countries. In addition, the GST rate is relatively low compared to the OECD average of 18 per cent. A review of the base and rate of GST should be an option for addressing the fiscal imbalance between Federal and State governments with a view to achieving a close correlation between states/territories' expenditures and their revenue raising capabilities.

An increase in the base and rate of the GST will be less burdensome on economic growth and can fund the abolition of various inefficient taxes as well as the reduction of personal and corporate income tax.

It is acknowledged that the regressive nature of GST will mean that appropriate compensatory measures for low income households will be required if rates are increased. Any increase in the base or rate will need to be accompanied by increased welfare payments to mitigate the effects on those worst off. It is far better to have targeted policies to address the regressive impacts of any changes to the GST, such as making transfers to low-income households and thereby, removing the regressive nature of the tax for those in need. Our social welfare payment system is better placed to compensate low income earners for regressive changes in the indirect tax mix rather than maintaining the current distortions in the tax system.

There must be a shift of the tax burden to less mobile and less growth-damaging bases to support economic growth and meet spending needs. All taxes represent a drag on economic growth, but indirect taxes do not discourage earnings or investment nearly as much as income and corporate taxes.

Challenge – The tax mix



Our tax mix is heavily weighted towards direct taxes on personal and corporate income. In fact this was identified some forty years ago in the Asprey Taxation Review committee report back in 1975 which recommended that the weight of taxation should be shifted towards the taxation of goods and services and away from the taxation of income. A recent OECD report released in December 2014, highlights that Australia is one of the countries that would benefit greatly if it shifted its tax mix in that direction. Without comprehensive tax reform the tax mix will continue to shift automatically towards a greater reliance on direct taxation.

Despite the introduction of the GST and reduction in corporate and personal tax rates over the last decade, the balance of taxes has remained reasonably consistent. Without changes to current policy settings, our reliance on income taxes, both personal and corporate, will continue to increase. This is in part due to our personal tax thresholds not being indexed and the GST base not including fast moving excluded expenditures (fresh food, health and education). Bracket creep will impact someone on the minimum wage, losing a third of their additional income to tax by 2017-18, while someone on

average wages would be paying a 37 per cent tax rate. The only way out is to start shifting the burden from direct to indirect taxes. Bracket creep is highly regressive as the increase in average tax rates is greater for those on lower income. As a result, the tax burden falls on taxes on labour and business which is not a growth friendly tax mix.

The alternative to major tax reform is to do nothing or simply tinker with the existing system by addressing its increasing failings only as they become unsustainable. To do nothing equates to a denial of the current tax system failings in dealing with the changing realities that are now influencing Australia's economy. To tinker and respond sporadically to the inadequacies of the existing tax system would be equally less than ideal. Partial and stopgap remedies would not address the fundamental problems of an outdated tax system and would make complexity and compliance difficulties even worse. Tax reform in this manner will miss the synergistic benefits available from wider tax reform opportunities. As complexity of the tax system has grown so too has the incentive for tax avoidance and minimisation.

The Government has previously committed to both a tax and federation white paper. The two are inextricably linked and provide a once-in-a-generation opportunity to achieve substantive reform. The tax white paper can focus on the optimal tax mix whilst the federation white paper will examine spending and service delivery, namely allocation of roles and responsibilities. The Henry Review and the Tax Forum have provided a strong foundation to progress tax reform and the ability to commence the process of discussing recommendations to build support for a long term tax reform plan.

- 1. Recommendation:** That the Government carries out its commitment for a promised tax white paper. The terms of reference for the white paper should be broad and include the GST as part of the mix. The tax reform white paper needs to draw on all of the existing work already undertaken including the Henry Tax Review and Tax Forum in formulating a blueprint to prepare our economy for the challenges ahead. The current political environment has made 'big bang' tax reform extremely difficult for the major political parties. As a way forward consideration should be given to establishing an independent tax reform commission to support tax policy decision-making.
- 2. Recommendation:** That the Government carries out its commitment to reform the allocation of roles and responsibilities between the Commonwealth and the States with the aim of improving accountability, efficiency and reduction in public sector waste.

Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016

In the May 2015 budget the Government introduced the concept of a concessional rate of company tax for small businesses, and an income tax discount for the majority of small business owners who do not use a company structure. These initiatives amount to a long overdue recognition by the Government of the disproportionate compliance burden that small business owners carry, relative to larger businesses. These changes go some way towards compensating smaller operators for the regressive nature of tax compliance and finance costs, while rewarding entrepreneurial activity and freeing up more after-tax

income for businesses to reinvest and expand. Importantly, tax relief is what small business owners want. Consultation with businesses by the IPA consistently indicates support for a lower tax rate rather than a multitude of complex, and sometimes inaccessible tax concessions. The IPA was a strong advocate for the introduction of concessional tax treatment for small business entities to address the regressive nature of compliance costs on them.

The May 2016 budget proposed to extend more tax relief to small businesses, with proposals contained in Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016. The Enterprise Tax Plan Bill is currently before Parliament. The IPA fully supports the Government's small business tax measures contained in the Bill and agrees that providing more tax relief to SMEs will generate a growth dividend to the economy in the form of potentially increased employment, higher wages and removing disincentives to business growth caused by the turnover threshold. The current small business turnover threshold of \$2 million discourages growth as entities lose access to tax concessions once they pass the threshold.

Although small businesses are an important source of employment, small businesses with turnover of less than \$2 million tend to be non-employing, have very few employees or are mainly operated by family members. According to ABS data, around 61 per cent of actively trading small businesses are non-employing, while around 28 per cent of actively trading small businesses have between one and four employees and 10 per cent between 5 and 19 employees. Moving the tax threshold for access to small business concessions to entities up to \$10 million can potentially contribute to more employment as such entities are already employing entities. The revenue foregone is likely to be substantially covered by the economic benefits from increased employment, higher wages and lower compliance costs.

Small businesses face significant impediments to participation in economic markets, due to high barriers to entry and exit and difficulties in obtaining access to finance. Other challenges for small businesses in Australia can arise from high compliance costs and the regulatory burden which tend to disproportionately affect small businesses. The time and effort required to comply with tax obligations, in particular, are reported to account for a major portion of small businesses' total compliance costs. In addition, small businesses are typically more vulnerable than larger businesses to shocks and changes in economic conditions. For this reason they have higher failure rates in comparison to larger businesses. It is for these reasons that extending tax relief for SMEs is warranted.

Since 2007 when the \$2 million turnover threshold was introduced, it has never been indexed. The Board of Taxation recommended an increase to the threshold in their 2014 Review of the Tax Impediments Facing Small Business, stating that increasing the threshold would reduce the number of businesses who are at or near the current threshold and so face uncertainty as to their tax treatment. An increase to the threshold was also recommended in the Australia's Future Tax System Review (Henry Review) in 2009.

Increasing the threshold would also assist businesses with a higher aggregated turnover but low margins, to access the concessions. It is estimated that increasing the threshold would allow an additional 90,000 to 100,000 businesses access to the small business tax concessions, decreasing their compliance costs and increasing cash flow. This would enable greater reinvestment in small businesses

and provide the opportunity for these businesses to increase employment and increase wages. It would also provide incentives for small businesses at or near the existing \$2 million turnover threshold to grow, as currently they would lose these concessions once they pass the threshold.

Of particular interest to entities with turnover above the existing threshold limit is access to simpler depreciation rules, lower corporate tax rate and also the newly enacted small business roll-over restructure relief. The simpler depreciation rules allow such entities to access the small asset write-off entitlements. Small business can immediately write-off and deduct most depreciating assets that cost less than \$20,000 each that were bought and used, or installed ready for use from 12 May 2015 until 30 June 2017. Depreciating assets costing \$20,000 or more can be placed in a small business asset pool and the entity can claim:

- a 15 per cent deduction in the first year (regardless of when you purchased or acquired them during the year)
- a 30 per cent deduction each year after the first year

The small business restructure rollover (SBRR) allows small businesses to transfer active assets from one entity (the transferor) to one or more other entities (transferees), on or after 1 July 2016, without incurring an income tax liability. The SBRR is intended to make it easier for small businesses to adopt, or evolve, into a more appropriate legal structure when necessary without incurring tax liability on the transfer. The IPA supports allowing small businesses with aggregated turnover of less than \$10 million access to the small business tax concessions, and small businesses with aggregated turnover of less than \$5 million access to the small business income tax offset.

3. Recommendation: Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 contains company tax relief for larger entities over a 10 year period. Having regard to the importance of small businesses in the Australian economy, we support the removal from the Bill, granting tax relief for entities with turnover in excess of \$10 million, if it meant the Bill could successfully progress through Parliament. Tax relief for large entities might have to wait as there seems little chance that these reforms will pass the Senate and their inclusion in this Bill will be at the detriment of the other tax relief measures for smaller entities.

With respect to the small business income tax offset, the Bill proposes to increase the amount of offset an eligible individual may claim, however the offset will remain capped at \$1,000. The small business tax offset of \$1,000 needs to be raised over time to mirror the tax relief available to incorporated entities from further company tax cuts in line with the original policy intent for the tax offset.

Extend withholding tax at source system for contractor's payments to deal with explosive growth of digital economy and black economy

With the growing number of self-employed businesses acting as contractors, the ATO runs a greater risk of losing tax revenue when compared to collecting PAYG from employed individuals. The use of

contracting has grown to more than 10 per cent of the workforce and the new opportunities generated from the sharing economy will see further growth. The sharing economy is growing rapidly thanks to the far reaching capability of the internet and the growing use of smart phones. The tax system also incentivises individuals to contracting, due to the perceived tax advantages. The tax advantages include the ability to claim a greater range of deductions than an employee, access to lower tax rates and income splitting opportunities. The lower income rate for incorporated businesses has further exacerbated the incentives for a contractor to use a corporate structure to gain access to more favourable tax rates. Employers too are attracted to using contractors as a way to reduce employee on costs such as the superannuation guarantee, leave entitlements and payroll tax.

New entrants into contracting do not need to file a tax return until after the end of the tax year. If they use the services of an accountant it could be 11 months after the end of the year before they need to lodge a return which could be 22 months after starting out depending on when the business began. The business will then need to pay tax on its first year in business as well as some PAYG instalments for the second year which could impose cash flow issues for the business unless they have set aside money to meet their future tax obligations. Imposing ABN withholding on businesses using the services of contractors can help ease the cash flow issues by setting aside amounts to meet future tax liabilities.

When the Australian Business Number (ABN) was introduced, it was intended to make significant inroads into the cash economy. Unfortunately, the ABN system has not been an effective mechanism for dealing with this sector. There are a significant number of ABNs against which there has been no business activity recorded. ABN holders are excluded from the PAYG withholding system unlike employees earning salary and wages. The system requires the payment entity to check the ABN details of the service provider. If this is not done properly it is relatively easy for an entity to use someone else's ABN details so the veracity of the existing system relies very much on this process. The current system requires businesses to self-assess their PAYG income tax instalments on the basis that they are going to declare all their income in their tax returns. There is only one industry sector that requires reporting of payments made to contractors to enable the ATO to perform a data cross check. Apart from this there is no data matching mechanism to ensure that all invoices have been included in the taxpayer's income tax return.

A mandated reporting system was introduced in the 2012/13 financial year for the building and construction industry that requires businesses to disclose payments made to contractors. In its first year of operation an extra \$2.3 billion in voluntary income tax and GST liabilities were reported to the ATO. The majority of the increase can be attributed to the introduction of the taxable reporting system. The reporting system also identified additional liabilities from data matching information reported to it to identify operators in the cash economy. If other industries with a poor compliance history were also brought into the mandatory reporting system, one would expect significant additional tax liabilities being voluntarily reported.

Until the current systems shortcomings are adequately addressed, more controls need to be in place to reduce unfair competition resulting from businesses operating in the black or cash economy.

New Zealand has a contractor withholding tax recognising the effectiveness of a withholding at source system for dealing with the increasing number of self-employed businesses.

It is important to note that a reportable payment system only covers business to business transactions. Other measures will be needed to address businesses dealing directly with the public.

- 4. Recommendation:** We recommend an ABN withholding tax system at source be introduced for industries not covered by mandatory reporting of payments to contractors. The withholding rate can be industry specific to reflect differences in profitability or a tailored rate that a business applies for to reflect individual tax circumstances. Mandatory reporting has shown to be a very effective mechanism for prompting taxpayers to re-join the tax system ahead of possible detection through data matching. The experience shown in the construction and building industry has proven that mandatory reporting has been able to reverse entrenched longstanding non-compliance behaviour. It has encouraged reluctant contractors to engage with the tax system in a positive way. Not only has taxable payments reporting resulted in measureable improvements in compliance by contractors, it has exposed areas of non-compliance (missing ABN details, invalid ABN's etc). An ABN withholding tax will also address the risks associated with the increasing number of self-employed businesses generated from the sharing economy.

Small business CGT concessions

The small business CGT concessions are overly complex. Whilst the rules were subject to a post implementation review by the Board of Tax, the eligibility rules need to be simplified. Their complexity in part is due to having to deal with multiple business structures and anti-avoidance provisions. There is an opportunity to rationalise and streamline the CGT concessions which has also been recommended by the Henry Review. The four current and separate small business CGT concessions require taxpayers to navigate complex legislation. A number of existing concessions such as the 50 per cent reduction and the 15 year exemption are highly concessional, and can eliminate any CGT liability when business owners exit their investment. These concessions are generally uncapped and are generous tax concessions which should be repealed. The savings can be redirected to assist small businesses during more productive times in the business life cycle.

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

- 5. Recommendation:** There is an opportunity to rationalise and streamline the CGT small business tax concessions from 4 separate concessions down to 2 as recommended by the Henry Review.

Rewrite of Division 7A to enhance certainty

The Division 7A requirements are integrity provisions that treat all payments, loans and debt forgiveness by private companies to shareholders (or associates) as assessable dividends (unless within specified exclusions), to the extent there are realised or unrealised profits in the company. Since its introduction, there have been a number of amendments which have turned Division 7A into a highly complex body of law that many practitioners fail to fully comprehend. Bringing Unpaid Present Entitlements (UPEs) to corporate beneficiaries into the Division 7A net has also significantly increased compliance costs for small businesses using trust structures.

The Board of Taxation in 2014 released a second discussion paper of its post-implementation review of Division 7A. The IPA responded and lodged a submission in response to the second discussion paper. Without repeating the points raised in our submission, we were encouraged that the Board took the view that protecting the progressivity of the tax system should not be at the expense of impeding the ability of businesses to reinvest their income as working capital. Facilitating reinvestment supports productivity and entrepreneurial growth.

We support the Board's new simplified regime to replace the existing provisions relating to complying loans. We also support the limited exclusion from the application of Division 7A to UPE's owed by trusts that nominate the 'tick the box' option which will allow trading trusts to reinvest their after tax profits into working capital thereby improving their self-sufficiency and growth. These proposals are more commercially acceptable options with respect to repayment of loans than are currently available under ATO guidance. The current ATO administrative practices contained in PS LA 2010/4 provide three investment options; with the majority of taxpayers choosing option 1 or 2. Both of these options require repayment of the principal at the end of 7 or 10 year terms respectively. If the Board's proposals are accepted there will need to be appropriate transitional relief to deal with contingent principal repayments on UPEs held on sub-trust under Options 1 and 2 since the issue of PS LA 2010/4. This is imperative to ensure that trusts carrying on business activities are not faced with a crisis to fund the repayment of loan principals at the end of a loan term as will be the case in respect of unpaid entitlements which are subject to Options 1 and 2 of PS LA 2010/4.

- 6. Recommendation:** That Division 7A provisions be written into ITAA 1997 in a simpler and clearer manner to minimise the compliance burdens and remove uncertainties.
- 7. Recommendation:** That the Government fast track the implementation of the key recommendations of the Board of Taxation's post- implementation review of Division 7A.
- 8. Recommendation:** As a matter of urgency devise appropriate transitional relief be introduced to deal with contingent principal repayments on UPEs held on sub-trust under Options 1 and 2 in accordance with PS LA 2010/4.

Fringe Benefits Tax overhaul

A comprehensive review of FBT legislation is required. Since its introduction in 1986, there have been significant changes to the workplace that cannot be accommodated by the existing legislative framework. Recent legislative changes constitute a 'band aid' approach to addressing systemic FBT problems. Any review of FBT must address compliance issues facing small business.

FBT is an inefficient tax, intended as a disincentive, rather than a source of revenue. FBT incurs the highest compliance cost relative to the revenue generated and there is considerable scope to reduce the compliance burden on small businesses, including the small Not-for-Profit (NFP) organisations.

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

The complexity of the FBT system is exacerbated by the fact that the incidence of the taxation of fringe benefits falls on employers. The taxation of fringe benefits to employers requires supplementary rules to ensure fringe benefits are factored into the various means tests in the tax and transfer system such as family tax benefits and parenting payments.

In many overseas jurisdictions, fringe benefits are taxed in the hands of employees. The UK Government in its recent autumn statement has announced that salary sacrifice schemes will be subject to the same tax as cash income from April 2017 effectively abolishing salary sacrificing.

It is the Institute's view that the taxation of fringe benefits at the employee level has the potential to deliver greater neutrality in the treatment of cash and non-cash remuneration, whilst simultaneously reducing compliance costs for all parties. Remuneration benefits that are not employment duty related benefits should be part of the employee's assessable income. Benefits that can be readily valued and assigned to an employee should be taxable in the employee's hands and reportable for transfer purposes.

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

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

- 9. Recommendation:** That the Government review FBT legislation to more fully recognise modern business practices and to reduce the small business regulatory burden.

Reintroduce loss carry back regime

With the abolition of the Minerals Resource Rent Tax (MRRT) certain tax measures that were intended to be funded by the MRRT have also been repealed. One of those repealed tax measures was the loss carry-back provisions in the income tax laws.

Loss carry-back allows companies to offset current period losses against previously paid taxes. The loss carry back provisions recently introduced struck the right balance between allowing losses and limiting the exposure to government revenues by placing a quantitative cap in conjunction with a two-year carry-back period. The quantitative cap reduces the government's exposure to large losses incurred by eligible companies. Both the Henry Review and Business Tax Working Group recommended the adoption of loss carry-back.

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

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

While recognising that businesses operate through a range of legal structures, loss carry-back only helps small entities that operate using a company structure. Nonetheless, there are 760,000 small business entities that could benefit from having loss carry-back as part of our tax system. It could make a major difference as it enables a business to survive a tough year as it provides an important boost to cash flow when it is needed most and at a time when it is most critical in ensuring survival of the business.

- 10. Recommendation:** That the Government reintroduce the ability for companies to claw back tax paid when they incur revenue losses. The loss carry-back provisions recently introduced struck the right balance between allowing losses and limiting the exposure to government revenues by placing a quantitative cap in conjunction with a two-year carry-back period.

Simpler structure options for small business to streamline and reduce regulation and red tape and/or extended use of safe harbours

One of the IPA's long term aspirational goals is the simplification of the small business taxation system through the application of a structure which eliminates the need for multiple structures. Multiple structures are commonly needed to achieve tax outcomes which would be otherwise unavailable through a single entity. A simplified small business entity regime can significantly reduce regulation and red tape for small businesses.

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

International evidence exists of entities specifically designed for small businesses that offer a number of advantages such as asset protection, income streaming and retention of after tax profits. The creation of a new small business structure would allow small business entities to use a single simplified structure rather than the current complicated ownership structures such as trusts. If such a structure allowed the optional retention of income at the corporate tax rate, it would allow most of the benefits that can currently be obtained via the use of a company and discretionary trust via a cheaper and simpler vehicle to administer. A simpler structure option could represent a better pathway to avoid the complexity that exists in relation to Division 7A and trusts.

It's unfortunate that the taxation of trusts has not been rewritten and updated to reduce complexity despite numerous recent announcements to this effect. The compliance burden from the use of trusts to the small business sector cannot be underestimated. A simplified taxation of trusts regime could go a long way in creating a flexible small business structure of choice. Recent judicial re-interpretation of trust concepts, hastily introduced legislative streaming amendments and the reversal of long standing administrative practices, have created much uncertainty and increased compliance costs for entities using trust structures to conduct their business.

- 11. Recommendation:** That a new tax regime for small business entities combining the attributes of companies, trusts and partnerships be created.

Tax discount for interest income

The IPA has frequently advocated for the concessionary treatment of interest income; the current tax treatment of which compares unfavourably with other forms of savings such as property and shares.

A tax discount for interest income was planned to come into operation on 1 July 2013 in the form of a 50 per cent discount for interest income capped to \$500. This initiative was abandoned before its introduction.

It is noted that an uncapped 40 per cent savings income discount was recommended by the Henry Review in order to remove the inequitable treatment of interest income and to improve incentives for national savings. The recent Murray Financial System Inquiry (FSI) also highlighted tax system distortions on certain classes of investments such as housing and shares pointing for the need for taxation reform.

12. Recommendation: That the Government re-visit the introduction of a taxation discount for interest income.

Alienation of personal services income

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

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

Whilst we are supportive of the policy intent of the legislation, we believe the existing framework needs to be reviewed to provide more certainty, ease compliance and reduce complexity. The PSI rules are relevant for small businesses and therefore need to be clear, understandable and conducive to the average taxpayer being able to discharge their obligations with certainty. There is too much uncertainty as to the interpretation of key elements of the law. Given that the PSI rules have been developed some time ago, they have not evolved with the proliferation of contracting and self-employment opportunities as a result of the explosive growth of the digital economy. The rules regulating the taxation of such arrangements also need to adapt to ensure that it is as simple as possible for individuals to identify the character of their income for tax purposes. The issues around the PSI rules are sometimes linked to the broader issues regarding the employee/contractor distinction which is a contentious and problematic issue for small businesses. Recent court cases have highlighted that the distinction between employees and contractors can be complex. A legislative definition of employee based on an extended 'results test' would provide greater certainty about the distinction of employee/contractor for small business. Also, the provisions which deem a contractor to be an employee for tax purposes add to the confusion and uncertainty.

The use of interposed entities is often a legitimate commercial means by which contractual arrangements can be satisfied. It should not be viewed prima facie as an attempt to engage in income splitting and/or tax deferral.

The following aspects should be further considered:

- *Simplify key elements of the law:* There is too much uncertainty with respect to interpretation of key elements of the law which make compliance difficult. Individuals who endeavour to comply with the existing rules face difficulties interpreting terms such as the 'results test' in order to determine compliance.
- *Complex attribution rules and PAYG withholding obligations:* Although the ATO has in place a Practice Statement containing simplified methods to address PAYG compliance, there is still room for streamlining.
- *Low levels of compliance:* Reviews into the current system have shown low levels of compliance with existing PSI rules; indicating a systemic issue with the legislation. The contractor reporting rules which came into operation for the building and construction industry highlight deficiencies within the system; particularly the widespread non-reporting of income.
- *Payments to associates for non-principal work for entities that cannot prove they are personal services businesses:* This is a harsh outcome when essential services are performed by an associate and would be otherwise fully deductible if paid to a third party. There needs to be scope for deductibility of legitimate costs subject to integrity measures which ensure charges are at arm's length.
- *Provide more certainty:* This is especially relevant for taxpayers who pass the existing test and whether they are able to income split and/or defer tax by allowing income to be retained within the entity. There appears to be a lack of understanding regarding the interaction between the PSI rules and the general anti-avoidance provisions (of Part IVA).
- *Inflexible rules:* In certain circumstances and for commercial practices the rules are inflexible. For example the unrelated clients test requires making offers or invitations to the public at large or to a section of the public. If the individual or personal services entity relies on word of mouth it is unclear whether they can satisfy this PSI rule. Another example relates to working exclusively for a single client on a major project and satisfying the 80 per cent rule.
- *Provide more clarity:* The distinction between PSI and income generated from a business structure is becoming increasingly unclear and the current framework hinders differentiation.

To promote economic growth, Australia requires a tax system which is consistent, cognisant of commercial reality and encourages productivity. Accordingly, our taxation system should acknowledge the real benefits of contracting arrangements. The Henry Review has called for a revision of the rules and an extension of the PSI scope to cover all entities earning a significant proportion of business income from the personal services of their owner/managers. This recommendation if implemented in conjunction with the potential relaxation of the independent contractor rules under the industrial relations regime has the potential to dramatically simplify current arrangements. Flexible workplace arrangements have been identified as part of the options to arrest

Australia's sliding productivity. Almost all of the complexity with the current rules would be lessened if all income from personal exertion is taxed on the same basis regardless of the legal structure through which it is operated.

13. Recommendation: That the alienation of PSI rules be reviewed to take into account modern work arrangements, low levels of compliance and uncertainty. The complex nature of the PSI regime provides scope to simplify and rationalise the existing tests to deliver greater certainty for individuals undertaking self-assessment.

14. Recommendation: That consideration be given to a revised PSI regime that extends to all entities earning a significant proportion of income from the personal services of their owner-managers as recommended by the Henry Review.

Superannuation non-concessional caps

The Government's superannuation reforms were passed by Parliament on 23 November 2016. One of the changes contained in the superannuation reforms were changes to the concessional superannuation caps. The concessional contribution cap has been reduced to \$25,000 per year for all eligible contributors. IPA does not support the reduction of the contribution caps to \$25,000 and in particular, the reduction of the current cap of \$35,000 for individuals aged over 50 years of age. People aged over 50 should be encouraged to make further superannuation contributions especially when they have the capacity to do so to address any super balance shortfall.

The situation is further exacerbated as the Government has also announced the deferral of the proposed catch up measure until 1 July 2018, which effectively means the first catch up will not be available until the 2019/20 financial year. The deferral was a budgetary decision to partially offset the cost of re-introducing an annual non-concessional contributions cap. The current annual concessional contribution cap for over-50s which is \$35,000 is less than a third of what the cap was 10 years ago. The May 2010 Henry Tax Review supported a higher contribution cap for Australians aged 50 or over.

15. Recommendation: That the Government reinstate the concessional contribution cap for the over 35's to \$35,000.

Patent box tax regime

The Government has recently introduced a suite of measures which will help drive investment, economic growth and jobs in our transitioning economy by encouraging innovation, risk taking and an entrepreneurial culture in Australia. One such measure is The Tax Incentive for Early Stage Investors which gives concessional tax incentives through a non-refundable tax offset and CGT exemption.

These new initiatives supplement the existing R&D incentive scheme. To ensure intellectual property developed under various government initiatives is exploited in Australia, a patent box regime similar to schemes adopted in other countries should be considered. Britain, Ireland, Italy and the Netherlands

are examples of countries that offer a lower corporate tax rate for income from intellectual property developed in their respective countries.

Australian businesses face a challenging set of economic circumstances which can hinder the growth and success of businesses seeking to commercialise intellectual property they have developed. High wages and costs, uncompetitive tax rates, limited access to start-up capital and so on can drive many businesses to take their intellectual property offshore to countries that are more attractive and supportive by offering preferential tax regimes to attract manufacturing. Many OECD countries have endorsed patent box type tax regimes offering a lower tax rate to companies that develop and exploit intellectual property in their respective countries.

Unless Australia introduces similar preferential tax regimes, it runs the risk that the migration of intellectual property and advanced manufacturing will continue to be attracted to low-tax jurisdictions.

- 16. Recommendation:** Consideration be given to a patent box regime that supplements the existing suite of innovation tax incentives to improve the prospects of intellectual property being created in Australia and also being developed and exploited here.

Loan guarantee scheme

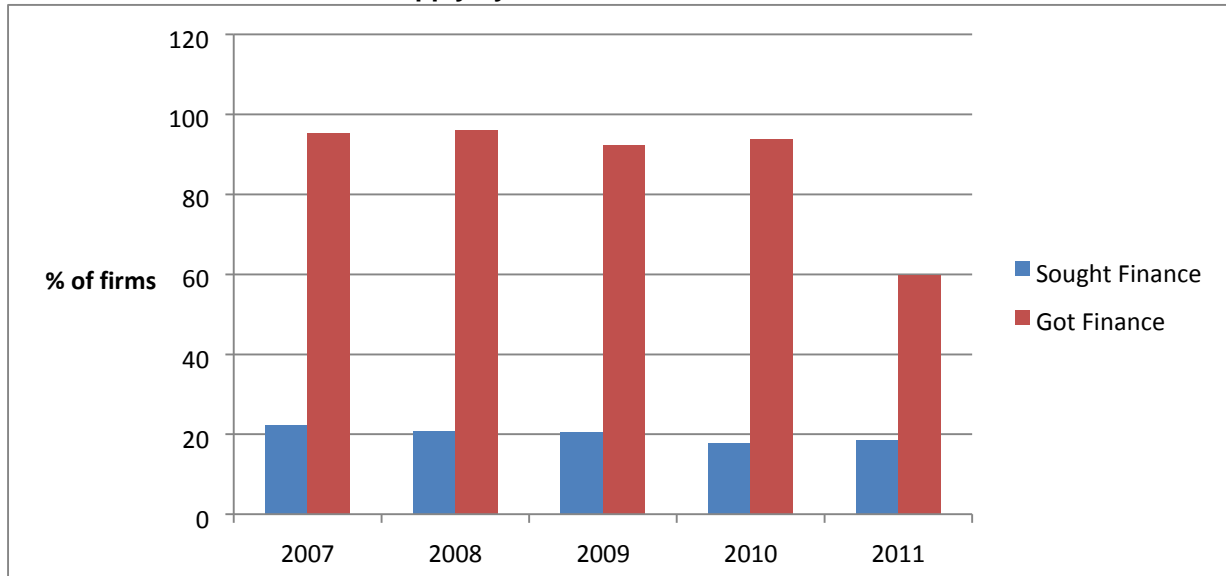
Main points

- The rationales for public intervention to improve SMEs' ability to access private financing are twofold. First, the spill-over hypothesis argues that SMEs are able to generate positive externalities by creating new jobs, new ideas and new abilities that other industries and the economy as a whole may enjoy. The second rationale for government intervention is the existence of market failures, such as the presence of asymmetric information in terms of adverse selection and moral hazard.
- On average, 28,000 Australian businesses per annum face a binding finance constraint, whilst 118,000 face some access to finance issues.
- The focus of investment has shifted from investments in new productive capacity and efficiency enhancing towards more basic survival and liquidity related expenditures.
- By comparable international standards the cost of debt is high.
- Australian lending banks are cautious in their general lending policies and that risk-adjusted lending is not the norm.
- Our recommendation is that a loan guarantee scheme is justified, on a modest scale, for a trial period.
- External equity is of particular relevance for those high growth/high potential, young businesses, where the current revenue capability cannot sustain a guaranteed payment of loan interest thereby ruling out debt finance.
- But there is a real danger that equity market pump-priming by the state translates into a permanent arrangement, with private investors happy to leave the onus and challenge of early-stage investing to the government. Legal (statutory) prevention of the government from becoming a cornerstone investor addresses this concern.
- Governments with a strong commitment to economic growth via R&D investment facilitating greater enterprise and innovation activity are faced with a direct choice. They must find a means to ensure that early-stage venture capital (VC) finance remains available to high-potential, young firms or risk a reduction in the new commercialisation opportunities stemming from national investments in science and technology.

Smaller business and financial markets in Australia

When considering the demand for and supply of external finance to smaller business in Australia, the first issue we focus on is the demand for finance. Here we observe that at any point in time, only 1 in 5 businesses (representing around 400,000 Australian businesses per annum) are seeking external funding from the market. This is in line with evidence from other developed economies (Cowling, Liu and Ledger, 2012), which shows that the dominant (or preferred) source of external finance is bank lending.

External finance demand and supply dynamics



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

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

The important public policy question is whether or not these constrained businesses are of poor quality and hence are too risky to invest in, or whether they are constrained for non-quality based reasons such as lack of assets to place as security or lack of a sufficiently long track record. The former implies no role for public policy and is simply an indicator of the market operating efficiently and sorting out the 'good' from 'bad' propositions. The latter implies unfair rationing and a case can be made for public policy intervention to correct for a market failure.

The most widely used, and long-standing, public policy mechanism worldwide for supporting small firms is the (partial) credit guarantee scheme. Well established examples of these schemes include the SBA 7(a) loan program in the US, founded in 1953; the Canadian core guarantee program

(CSBFP), founded in 1961; and the UK Small Firm Loan Guarantee program, founded in 1981. A World Bank guarantee scheme survey by Beck, Klapper, and Mendoza, (2008) identified loan guarantee programs in a total of 46 different countries across the world including France, Germany, Sweden, India, Korea, Indonesia, and Macedonia. We note that Australia is unique in the developed world in that it has no guarantee scheme.

Critical indicators of the need for loan guarantee programs:

Having considered why credit may be rationed among smaller firms, and which firms are most likely to face severe problems with accessing debt finance from conventional sources, we now outline the critical indicators that policy-makers might consider when assessing the specific need for policy intervention in the form of loan guarantee type programs. These are:

- a highly concentrated banking sector (few large banks)
- less dense local branch networks and a general lack of relationship banking
- low levels of housing or general (tangible) asset ownership
- most commercial loans require assets to be placed as security
- falling or stable asset values
- a diverse entrepreneurial, and latent entrepreneur, population (poor as well as rich potential entrepreneurs)
- access to loans is conditional on criteria not related to the quality of the entrepreneur or their investment proposal (eg, collateral availability)
- the spread of interest rates on bank loans is narrow (indicating rationing is favoured over risk adjusted lending)
- there is substantial diversity in the relative quality of lending institutions.

The case for an Australian loan guarantee scheme

The evidence is broadly supportive of the use of financial engineering instruments to correct for (lack of) collateral issues in debt markets and to a lesser degree lack of a track record. Loan guarantee schemes have the advantage of being simple to design and administer and typically require that investment appraisal is conducted on a commercial basis thus minimising deadweight. Instruments of this type are most effective when the entrepreneurial population is more widely distributed than wealth throughout the general population. This gives loan guarantee schemes the potential to have disproportionately high and positive effects in countries and regions where (a) collateral based lending is the norm, and (b) a significant proportion of the entrepreneurial population is not asset rich. As a

tool for promoting local economic development, loan guarantee schemes have been shown to be relatively successful as a means of public policy intervention.

To a degree, these three pieces of evidence, high costs of debt, low interest margins and cautious lending are consistent with credit rationing theories. That is, margins imply relatively low risk lending and a backward bending loan supply curve, while riskier loans are choked off as they would attract a higher interest rate margin and raise the default rate above the banks expected profit maximising level.

Designing a loan guarantee scheme

One of the key success factors of loan guarantee programs throughout the world is the simplicity of their basic parameters and the general level of flexibility that these parameters allow policy-makers to reshape or refocus programs. The fact that commercial banks conduct due diligence (in most but not all cases) effectively transfers some of the downside risk back to banks, although the government clearly bears most of the default risk. Important in the Australian context is that banks might become more willing to expand the supply of loans significantly when a large share of the outstanding loan is guaranteed and still not suffer from excessively high default rates. The core parameters of a loan guarantee program are:

- the level of guarantee (the percentage share of the outstanding debt that is covered by government in the event of default);
- the interest rate premium (the margin that the government receives for guaranteeing the loan);
- the maximum (and in some cases minimum) loan amount available;
- the maximum (and in some cases minimum) loan term available; and
- the arrangement fee.

Importantly, these parameters are easily understood by most people who have ever taken out a personal or business loan and/or insurance. So loan guarantee schemes benefit from being simple to create and operationalise and also from being widely understood by all actors in the debt market. This helps avoid the problem of many complex government programs which are only understood and accessed by those with a high level of awareness, skills, knowledge and resources to clear all the necessary hurdles and deal with the complexities of application. This is generally why smaller firms do not bid for government contracts and why in many cases scheme deadweight can often be high.

As a guideline, the typical range across these core parameters for established loan guarantee schemes are as follows; guarantee 65 per cent to 85 per cent; interest rate premium 0.5 per cent to 2.5 per cent; loan size, minimum A\$8,000, maximum A\$500,000; loan term 1 to 10 years; arrangement fee, 0.25 per cent to 3.0 per cent of the total loan value.

We conclude that there is a case for the design and implementation of a loan guarantee program in Australia to correct for the specific problems of smaller firms being unable to finance new investment opportunities through normal commercial bank channels. But the specific scale of potential program demand needs to be established in a detailed feasibility study as this determines the scale of the

initial and ongoing demands on the government. Further, more detail is required on (a) the specific characteristics of credit rationed smaller firms in Australia, and (b) the specific characteristics of smaller firms capable of generating the highest value added when unconstrained in debt markets, and (c) the scale of unmet loan demand. This would then help determine the actual values of the key program parameters (level of guarantee, interest rate premium, loan term, and loan size).

17. Recommendation: To help increase the availability of much-needed affordable loan finance to the small business sector, the Federal Government should introduce a state-backed loan guarantee scheme. Australia is one of the only countries in the developed world without such a scheme, which would provide a limited state-backed guarantee to encourage banks and other commercial lenders to increase loan finance available to small business. We refer to the IPA Deakin White Paper for further detail. The White Paper identifies a number of specific problems that smaller firms have in accessing finance from commercial banks, particularly smaller and younger start-up firms. Our evidence suggests that, by international standards, the cost of debt for Australian small businesses is high and risk-adjusted lending is not the norm in Australia. There is, hence, a strong case for designing and implementing a loan guarantee program in Australia to help remedy the specific problems of smaller and younger start-up firms being unable to finance new investment opportunities through normal commercial channels. When appropriately designed and administered, loan guarantee programs can deliver value for taxpayers through their support of employment growth, productivity, innovation and exporting.

Venture capital fund

Main points

We acknowledge that the Government through the National Innovation and Science Agenda is considering measures to increase the availability of VC in Australia.

VC remains a valuable but 'niche' source of risk capital for a small cohort of an economy's highest potential young firms. Such firms are commonly involved in 'new knowledge' industries and particularly the early commercial application of new technologies.

VC remains an important part of a modern entrepreneurial 'ecosystem' given its contribution to a spectrum of entrepreneurial finance products employed by high growth, and particularly innovative, young firms.

The persistently unattractive returns to a majority of investors in VC as an 'asset class' over the period since the year 2000 (and the contemporary collapse of the 'technology bubble') has meant that institutional investors have reduced their interest and commitment to VC funds.

The skew to VC returns whereby a small minority of general partners (VC managers) have produced the majority of best performing funds over several years, and where the access to such funds by new investors is severely limited, has further reduced the attractiveness of VC to investors.

Given the declining supply of VC finance from the private sector, governments have deemed that they need to either support or substitute for private VC equity in order to ensure that risk capital is made available for high potential young firms. This absence of VC is seen as one barrier on the development of new innovation capabilities in an economy. Weaknesses and problems in the banking sector have meant that debt finance for young firms has been rationed. Young firms in uncertain technological or new knowledge environments are particularly likely to be unattractive to bank providers of debt. Such firms without access to external finance are likely to be severely cash constrained with consequent effects on investment, growth, internationalisation, etc.

In this environment, governments have increasingly moved to directly support early-stage VC activities. Increasingly, this public support is provided in concert with the established, private VC industry in the formation of programs to create hybrid VC funds (ie, including public and private investors) targeted towards new knowledge and/or new technology based firms.

The majority of publicly supported VC programs have produced poor returns to private investors. However, the introduction of such schemes can still have positive benefits to government when a full cost-benefit analysis is undertaken. (See Murray & Cowling's 2009 evaluation of the Australian IIF program.)

There is some international evidence that government supported VC programs have become increasingly effectively focused and managed over time. Evidence supports this positive trend, for example, in the UK, Finland, Denmark and New Zealand.

Given the disparity between the interests of private investors and the state as limited partners in a VC fund, it is likely that private (institutional) and individual investors will have to continue to be incentivised by the state to command their attention and loyalty.

Business angels are seen as an alternative to VC. In reality, business angels are increasingly investing as networks and are emulating their VC counterparts. Business angels are increasingly assuming the first and earliest investments and are also co-investing with VC funds. This co-investment and syndication is a measure of the growing sophistication of many business angel networks particularly (but not exclusively) in the UK and the USA.

Crowd-funding has recently come into the funding escalator at the earliest stages of external equity and debt provision. This market is still very immature. Governments will still need to see how they can best collaborate to support legitimate, early-stage risk capital and debt providers while seeking to ensure proper regulation and governance in the protection of retail investors. It is likely that fiscal incentives available to business angels will also play a part in crowd-funding for the larger deal sizes. An ideal future outcome would be crowd-funders, business angels and venture capitalists each working on contiguous parts of the market for entrepreneurial finance. However, the entrepreneurial ecosystem is still immature in most nations and the wide variation in the skills, competencies and experience of entrepreneurial funders remains problematic. The IPA would encourage the Government to introduce debt crowd funding as early as possible. We acknowledge the introduction of equity crowd funding legislation and the IPA has actively participated in the process, including lodging a major submission which includes country comparisons.

Why should government be interested in VC?

VC as a policy instrument for promoting high-growth enterprises has almost universal appeal to governments across both the developed and developing world, regardless of political colour (Lerner, 2009). The reason for their enthusiasm is simple: VC, despite its well-publicised difficulties, is seen as a critical component of a modern enterprise economy. It is particularly associated with the identification and support of young new-knowledge/new-technology firms with the potential to bring about major disruptive changes to markets and their users, and thus spur innovative and economic progress (Hellmann and Puri, 2000; Lerner and Khortum, 2000).

These concerns have seen the government's role as a provider of VC grow rapidly to the extent that the government is now the biggest single investor in early-stage VC funds across Europe (EVCA, 2013). These actions are not designed to permanently replace private VC firms by public investment. Rather, the actions of the government, and the support they give the sector via specialist funding agencies, are there to 'pump prime' the supply of VC by both sharing risk and incentivising investors

to re-examine and re-enter this sector of the equity market. However, this aspiration to temporarily pump-prime or act as a catalyst in the VC market before withdrawing in favour of private actors entering the (now more developed) market, may be an ambition rather than a commitment in the absence of private market substitution of the state's commitment (Luukkonen et al., 2013). Government has to determine the nature and degree of its intervention in the VC sector. It has to also decide on the type of involvement it wishes to make in the actual entrepreneurial process or VC cycle of enterprise investment, nurturing and exit. The pros and cons of each level of intervention are summarised in the IPA Deakin University Small Business White Paper.

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

Governments, international agencies such as the OECD, the World Bank and the European Commission, and academic and industry researchers have over time built up a substantial body of empirical and theoretical knowledge on the practice and performance of VC.

Ten indicators of good practice in a public-private 'hybrid' VC program (not ranked)

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

18. Recommendation: That the Government should introduce a publicly supported VC fund by either providing a significant proportion of funds to assist VC managers to attract other institutional investors to publicly supported VC funds or by becoming an institutional investor in a range of individual VC funds. This type of support by government to small business equity finance will improve the entrepreneurial environment in Australia and act as a catalyst in identifying and overcoming hurdles to successful and profitable investment. The Small Business White Paper highlights the funding problems faced by young firms in uncertain technological or new knowledge environments because of their unattractiveness to bank lenders. It is a lost opportunity to the economy when innovative firms with a high commercial potential are constrained by the absence of external finance. Accordingly, governments with a strong commitment to economic growth via R&D investment facilitating greater enterprise and innovation activity must find a means to ensure that early-stage VC finance remains available to high-potential, young firms or risk a reduction in the new commercialisation opportunities stemming from national investments in science and technology.

Building an innovation system

Main points

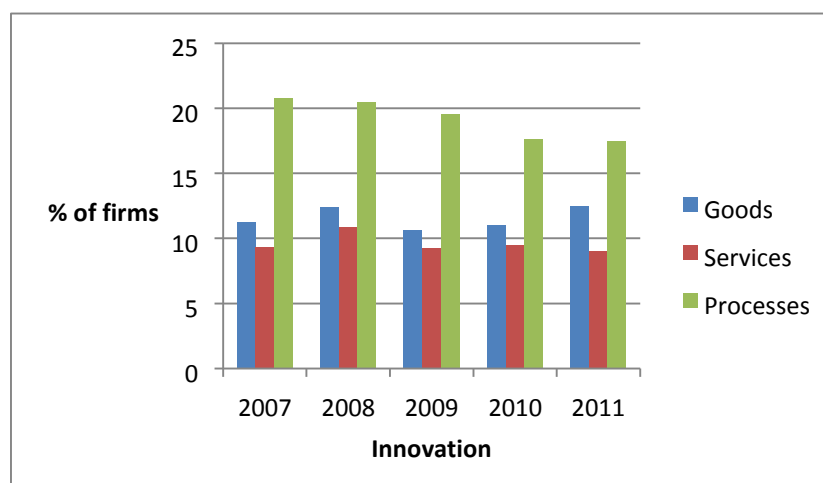
- Even if Australian SMEs are not the initial investors or innovators, they can still capture some of the value of innovations developed elsewhere.
- New-to-the-country, and particularly new-to-the-firm, innovations are often more economically important for improving national productivity. Innovation policy should include measures to encourage the diffusion and uptake of existing innovations to a broad range of firms, as well as encouraging new innovations.
- Firms that can adopt “continuous improvement” methods to embed incremental innovation can generate large productivity improvements.
- There appears to be a very low incidence of co-operative behaviour in the Australian business sector, typically less than 1 in 10 businesses co-operate on any level, and this could be a major barrier to innovation, and more generally to productivity growth.
- Large firms often find it hard to change their business model to capture value, but SMEs can change them more easily. Public policy to support innovative SMEs should increasingly take into account value capture and business model innovation more generally. This includes ensuring regulations help firms to capture value while balancing the benefits other firms receive from the wider diffusion of value.
- Businesses in Australia experience a wide range of barriers to innovation, with no one barrier dominating. This suggests policy to support innovation needs to be flexible and broad based.
- Talent not technology is the key. Without addressing wider skill requirements, research shows it is likely to create bottlenecks downstream in the innovation process. Technical skills across the workforce, and particularly interdisciplinary skills that bridge areas of expertise, are particularly important for innovation and are often subject to market failures.

Innovation is widely regarded as a key driver of productivity growth, job creation and superior economic performance. At a firm, sector and national level, higher levels of innovation are associated, both directly and indirectly, with superior economic performance.

Despite the importance of innovation, it is often misunderstood. There is a tendency to equate innovation with high tech manufacturing, and it is assumed that it is something that only happens in

R&D labs. However, only around 3 per cent of firms are high tech, and many firms innovate outside formal R&D. Financial services, for example, have very low measures of R&D intensity, despite being highly innovative. While not all Australian firms are innovative, the figure below shows that significant numbers of Australian firms, roughly 10 per cent, produce innovative goods and services. Moreover, many more (between 16 per cent and 21 per cent) innovate in their underlying business processes. These percentages are higher than the percentage of high tech firms observed in the Australian economy, highlighting the need for a broader understanding of innovation, to provide the foundation for effective SME policy (Nesta, 2006).

Innovation modes and prevalence



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

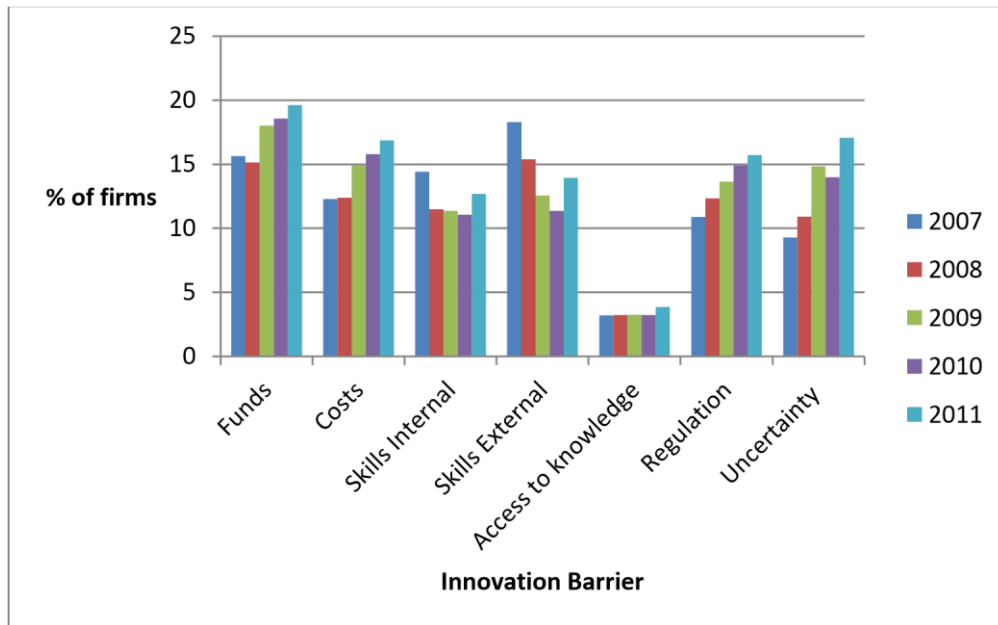
The focus should be on how innovation in Australia can be enhanced and made more effective. To provide a broader framework for understanding the basis of innovation policy, the Small Business White Paper explains what innovation is, that includes, but goes beyond R&D, and explores what policies can be implemented to improve the performance of Australian SMEs. It defines innovation and explains the different forms it takes, the importance of capturing value and diffusing existing innovations throughout the economy. The section concludes by discussing the policy options that are available to support innovation and innovative Australian SMEs.

Because innovative SMEs are often more nimble than larger firms, they play important roles in the economy in developing new innovations. However, because they lack the internal resources of larger firms, they often need to source support externally. As the figure below shows, firms in Australia experience a wide range of barriers to innovation, with no one barrier dominating. This suggests policy to support innovation needs to be flexible and broad based.

Many successful SMEs receive support from professional equity investors, such as VC funds, providing them with the managerial capabilities that they lack internally, and building the complementary assets they need to capture the value of their innovation (Nightingale, et al BVCANESTA 2009). Similarly, effective support for skill development that addresses the market

failures in human capital accumulation, are particularly important to smaller firms. This need for wide ranging policy measures to support innovation in Australian SMEs suggests a number of important policy implications.

Barriers to innovation



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

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

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

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

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

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

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

19. Recommendation: Whilst acknowledging the Government's National Innovation and Science Agenda, the IPA strongly encourages the Government to support innovative SMEs in Australia. This can be achieved via governments providing strong support to R&D, enabling better linkages between cutting edge universities and industry, and by providing support to firms to adapt existing technologies and innovation, and by encouraging firms to develop their ability to search for new options, evaluate them and successfully implement and adapt them to their specific context. Accordingly, public innovation policy should encourage value capture and business model innovation more generally, including measures that nurture the diffusion and uptake of existing innovations to a broad range of firms, as well as assisting new innovations. This focus on diffusing knowledge and innovation, regardless of its origin, will help create a robust innovation system. Moreover, firms should be encouraged to adopt "continuous improvement" methods to embed incremental innovation as this will generate large productivity improvements quickly. In addition, public policy towards entrepreneurs should shift from increasing quantity to increasing quality, with the focus being on encouraging the growth of a smaller percentage of firms that have the potential to grow, rather than encouraging more new entrants, regardless of quality.

Skills and human capital

Main points

- Where businesses have a high demand for skilled labour, but are constrained by lack of internal and/or external skills, then this represents a prima facie case for government intervention.
- Training and skills development is widely cited as a classic case of market failure as individual businesses often cannot appropriate the full returns to their investments in these areas, and hence tend to invest at a sub-optimal level.
- The strongest argument for government intervention relates to the potential for positive spill-overs into the wider economy, as highly skilled workers move around employers and disseminate their knowledge.
- The general pattern suggests that the smaller the business, the fewer skills deployed in the business. This has important, and negative, implications for their absorptive capacity and particularly their ability to deal with unanticipated shocks to their environment.
- 1 in 6 businesses in Australia faces a problem around skills deficiencies. Deficiencies are most apparent in trades, but 64,000 businesses have an identifiable skills deficiency in relation to finance professionals, 55,000 businesses in relation to marketing professionals, and 44,500 (and probably many more) businesses are deficient in IT professionals. This suggests that whilst the immediate labour market problem Australia faces relates to the construction boom and a lack of skilled trades people, the underlying problem might be in high value added professional services.
- The sectors we predict are going to be key sectors in delivering future growth and productivity increases, communications and professional services, have a high, and unmet, demand for IT workers at professional and technical levels. And more importantly, these are sectors characterised by high knowledge intensity and a disproportionately high smaller firm presence.
- The findings of a detailed study of the effects of enterprise training throughout the education system provide strong support for an interventionist and broad strategy of policy development and provision in the area of enterprise education at all levels of the education system.

The ability to start and develop a sustainable business is fundamentally related to the internal capacity and capabilities of the entrepreneurial team, top management, but also to that of the core workers (Cowling, 2001). And for smaller businesses, with a greater probability of being credit constrained and under-capitalised, their human capital capability takes on a more prominent role as firms are more likely to adopt labour intensive modes of production. To this end, the ability to successfully

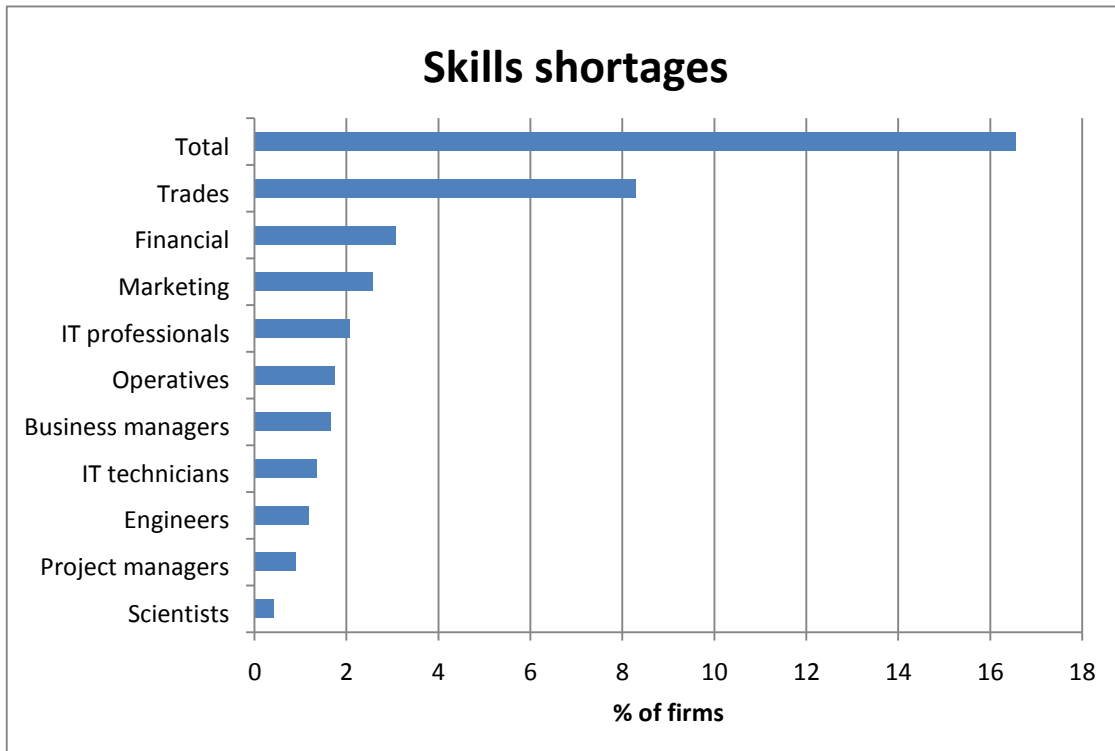
recruit and retain high quality workers at all organisational levels is paramount, as it is the skills embodied in these people that drive business capacity and capability (BIS, 2013). Human capital largely determines the level of absorptive capacity a business has, and hence its ability to effectively deploy different types of knowledge and resources. Detailed productivity analysis (Cowling, 2001) shows there is an identifiable productivity enhancing effect from all levels of human capital in the firm from the founding entrepreneur, the board of directors, through to the management team, and most importantly from the core workforce. Thus absorptive capacity is directly related to human capital (the presence of talented people) throughout the business.

We note that human capital is a fundamental driver of productivity in its own right. But in combination with innovation and physical capital its economic impact, through efficiency gains, is even larger. Poor internal skills are a key indicator of low productivity and high staff turnover. It also imposes additional costs to businesses by having to recruit externally rather than promote internally. In contrast, high skill levels are associated with higher productivity in a direct sense, and also with a productivity enhancing effect on other co-workers. Our research presents evidence relating to skills demand in the Australian business sector and identifies specific skills shortages. We contend that where businesses have a high demand for skilled labour, but are constrained by lack of internal and/or external skills, then this represents a prima facie case for government intervention. On the firm side, this may relate to training of their own workforce, and in the wider economy, this may include policies relating to education and training of the wider labour force.

Training and skills development is widely cited as a classic case of market failure as individual businesses often cannot appropriate the full returns to their investments in these areas, and hence tend to invest at a sub-optimal level – below that which is socially desirable for the Australian economy. Further, information gaps and asymmetries can mean that employers do not fully understand the total benefits arising from training their workers. But perhaps the strongest argument for government intervention relates to the potential for positive spill-overs into the wider economy, as highly skilled workers move around employers, and disseminate their knowledge.

In aggregate, the figure below shows that 1 in 6 businesses in Australia faces a problem around skills deficiencies. Deficiencies are most apparent in trades, but 64,000 businesses have an identifiable skills deficiency in relation to finance professionals, 55,000 businesses in relation to marketing professionals, and 44,500 businesses (and probably a lot more) are deficient in IT professionals. This suggests there might be an underlying problem in high value added professional services.

Skills shortages



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

Boosting skills demand and supply

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

- co-ordinate employment, skills and economic development policy which aligns, to a greater extent, the labour market, training and economic policy;
- create a lifelong learning culture which delivers a workforce that is more adaptable and better able to transfer between firms and sectors as a dynamic and productive economy requires that resources (investment and people) flow to those areas of the economy that have the most productive potential; and
- move out of a low skills trap where some sectors of the economy are stuck in a low-skills equilibrium where firms offer low-skilled jobs and operate in low-cost markets.

A key part of this is educating and training managers and entrepreneurs to stimulate demand for higher skilled jobs. Entrepreneurs have a major role to play given the centrality of entrepreneurial businesses in net job generation. But helping the entrepreneurial sector to achieve its potential requires policy support across many areas, including; business growth support (initiating and managing growth); core entrepreneurship skills; business training; skills development; network building; and mentoring.

Moving out of the low-skills equilibrium

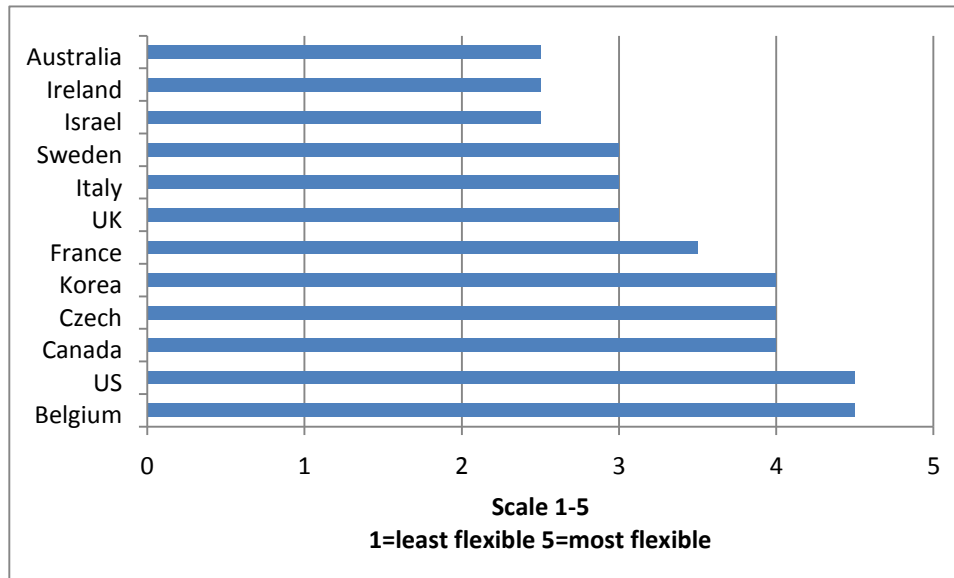
For the entrepreneurial population, this would require the skills and capabilities to develop and implement new market based strategies. This, in turn, would stimulate demand for higher skilled workers. On the supply-side, the Skills Australia (2012) “Better Use of Skills, Better Outcomes” report identified seven key skills based issues that would deliver more productivity in the workplace. These are: job redesign; employee participation; autonomy; job rotation; skills audits; multi-skilling; and knowledge transfer.

But, as with most government policy, it is designed for, and in consultation with, large employers and large employee representative bodies. If implemented in a large employer there would be a period of consultation with employee representatives, the development of formal systems and processes, and lots of bureaucracy and additional costs. Many of these practices occur already, on an informal basis, in small firms by the very nature of their working arrangements and the workforce employed, not least the absolute number of people employed within the business. But the evidence on the relative (lower) productivity of smaller firms compared to large suggests that these supply-side solutions are, at best, only part of a more complex solution.

So what about the role of institutions in resolving skills mismatches at the firm and sector level and where low-skills equilibria exist?

The OECD (2014) strongly supports the need for flexibility at the local level in designing and delivering policy and programs in the area of employment. The figure below suggests that Australia has adopted a top down, one size fits all, strategy in this area which does not allow for programs to take into account local labour market conditions and specific skills demand and supply issues. This could equally be applied to the unique issue of the relative low-skills equilibrium faced by significant elements of the small business sector. Here, the OECD recommends that policies and programs are adjustable at a ‘local’ level in terms of strategic orientation, program design, and performance and budget management. The one caveat being that this level of flexibility requires strong ‘local’ leadership and capacity.

Flexibility in the management of employment policies and programs



20. Recommendation: To address the significant skills deficit in the Australian economy, the Government (in collaboration with State governments) should immediately tackle and reform the education system's ability to increase and improve the stock of knowledge-based workers available for employment. These results also suggest that governments should consider the inclusion of enterprise training at all levels of the education system from early school years through to further and higher education institutions; and embark on a program to encourage and support life-long learning.

Co-regulation model

The IPA has previously provided to the Treasury a more detailed submission on a co-regulatory model as part of the consultation into the proposed industry funded model for ASIC. Essentially, if industry is to share the cost and burden of regulation in a co-regulatory framework then it must have sufficient legislative and legal support to make the model work as effectively and efficiently as possible.

The IPA proposes that the Government seriously consider the establishment of a formal co-regulatory environment in which some of the responsibilities of ASIC are shared with private actors. For example, the Government should consider a horizontal co-regulatory framework for the regulation and monitoring of auditors, along with associated enforcement activities, which is equitably shared amongst key actors including; the state, the accounting/auditing professions and private industry.

To enhance the Government's position in using general (flat rate) metrics or specific metrics (flat fee and graded fee) for different user groups, an activity based costing (ABC) system which identifies the correct cost drivers (ie business activities) applicable to the appropriate group being charged could be implemented, resulting in a fairer system that appropriately allocates fixed and variable costs and which would be continually monitored via a dashboard system. The accounting profession, as represented by the three peak professional bodies and their respective research partners, is well placed to undertake research of this nature.

Our initial recommendation for a co-regulatory model relates to financial reporting and auditing, which can be equitably shared amongst key actors including the state, the accounting/auditing professions and private industry. A starting point is to present a horizontal co-regulatory framework for the regulation and monitoring of auditors, along with associated enforcement activities. In simple terms, a horizontal framework implies a partnership between actors, whereby most, if not all, actors are all on the same hierarchical level.

More recently, there has been concern that a lack of resources may impair ASIC's ability to effectively perform regulatory activities, as noted in the ASIC Annual Report (2014-15). In the financial reporting and audit sectors, one ASIC staff member has to manage and oversee 144 registered company auditors on average (ASIC, 2014-15). Lacking sufficient funding and human resources may delay the efficiency of ASIC activities. For example, based on the number of surveillances that ASIC conducted in 2014-15, it is estimated that it would take ASIC approximately 17 years to conduct high-intensity surveillance of the biggest four audit firms, and 50 years for next biggest 20 audit firms (ASIC, 2014-15).

Based on the recommendations of the Australian Government's Financial Systems Inquiry (FSI) in 2013, the Australian Government is currently proposing an industry funded model to support the work of ASIC and increase its efficiency (Commonwealth Government, Treasury, 2016). The FSI was established to assess and set out a plan for Australia's financial system over the coming decade.

Findings from the FSI suggest that both industry members and consumers have little understanding of the actual costs associated with ASIC supervision. Accordingly, the Inquiry found that ASIC holds little accountability for the activities it undertakes and the reasons for these activities. The Government proposes that an industry funded model for ASIC could enhance the transparency of costs and funding associated with ASIC and provide more funding certainty.

An industry funded model for ASIC would ensure that those companies creating the need for regulation will be responsible for the cost of regulation. This funding model proposal aims to improve the efficiency of regulation by establishing clear price signals that would influence the behaviour of regulated entities to only apply for the licenses that they will realistically need. This would ensure that oversight resources are targeted at those entities who are actually providing the services. Additionally, subjecting ASIC to more rigorous reporting of its regulatory costs would enable industry to more easily hold ASIC accountable for its efficiency when conducting regulatory activities.

The proposed industry funded model would mean that ASIC continues to be funded in part by the Government, with a large portion of its budget accrued through charging industry levies and fees. It is estimated that in 2016-17, the Government would recover around \$6 million through a levy on auditors. The proposed industry funding model would see increased self-regulation of the accounting industry. In our submission to the Treasury we consider the efficiency of the audit industry to self-regulate and whether a co-regulation framework, as exists in other professions and industries, may be an appropriate model to regulate auditors. Various funding models in other jurisdictions are briefly explored (as they have some relevance in the overall co-regulatory movement), as well as a discussion on models where the regulation, monitoring and enforcement in particular industries/professions has been shared by various public and private actors.

We begin by briefly defining co-regulation based on the academic literature and definitions used in different jurisdictions. The submission focuses on drawing out the experiences of regulatory activities in different countries in order to understand how co-regulation may be applied in the Australian context.

What is co-regulation?

The term co-regulation is used in academic and policy literatures to describe a regulatory framework that involves participation from both the public and private sectors in the regulation of specific public policy interests or objectives (Martinez, 2013). A co-regulation strategy encourages the co-operative involvement of the private sector with a public authority, with the aim of becoming more flexible, adaptable and effective in the legislative process (Marsden, 2011).

According to Senden (2005), co-regulation is situated somewhere between legislation and pure self-regulation, while he describes co-regulation as a “conditioned self-regulation.” In the EU, a legal framework for the use of co-regulation at the European level was created in the Interinstitutional Agreement on Better Law Making. This legal framework provides a number of rules and conditions that a co-regulatory scheme must comply with, namely, that any use of a co-regulatory scheme must

be consistent with community law and meet the criteria of transparency and representativeness of the actors involved. It also states that the use of co-regulation must add value for the general interest (Interinstitutional Agreement on Better Law Making Act, 2003).

Martinez et al. (2013) proposes two models of co-regulation. The first is a top-down approach in which private sector actors enforce regulation or legislative mandates drawn up by the government. In this approach a public actor appoints a private entity to undertake a specific regulatory task or, through a legal decision, and empowers the entity to perform regulatory activity. In this framework, the private sector actors are still subject to oversight and control by the public sector. The public sector remains in charge of standard-setting, verifying and approving regulation or legislation, as well as monitoring compliance of the private sector. The second model Martinez describes is a bottom-up approach, which involves collaboration between the public and private sectors, in which the public sector acknowledges, facilitates or supports the regulatory activities of a private entity. In this model public actors no longer monopolize regulation, but allow the private sector to undertake regulatory activities as well as assist in implementing public regulation or legislation. In this approach, private sector actors play significant regulatory roles, beyond what the public sector plays.

More challenging perspectives on the meaning of 'co-regulation' are articulated by Stuerer (2013), who argues that the term 'governance' "became the catch-all concept for various forms of steering by state and non-state actors". It is the ways in which governing is carried out, without making any assumptions as to which institutions or agents do the steering (Stuerer, 2013). He further argues that co-regulation is an 'umbrella' for co-operative forms of steering in which actors from different societal domains aim to achieve common objectives or supply public services jointly. Citing Cafaggi (2001), Stuerer explains that a key feature of co-regulation is that respective practices join not only regulators from different domains, but also those who are regulated and/or the beneficiaries of regulation. Van der Voort (2015) similarly emphasises and supports the 'governance' perspective for co-regulation, and argues that there has been a shift in today's context from governing to governance. However, he explains that co-regulation is itself a paradoxical notion, representing, as it does, a horizontal concept with hierarchical implications. Notwithstanding, he explains that the co-regulation concept holds promise for public regulators wishing to target their scarce resources at non-compliant regulatees (van der Voort, 2015). Indeed, "self-regulating industries and firms may provide indicators with which public regulators can do this effectively. Co-regulation also provides a channel for self-regulating industries to apply their profound knowledge of the industry being regulated" (van der Voort, 2015).

Co-regulatory schemes can strengthen the level of monitoring and enforcement, and reduce the costs of burden for the government (OECD, 2002; Martinez, 2013). At the same time, co-regulatory schemes provide the private sector with the opportunity to apply their knowledge of the industry being regulated (Hood et al., 2001; Albareda, 2008; Hirsch, 2011; van der Voort, 2015).

There are numerous useful examples of regulatory models in other jurisdictions such as the USA, UK and Singapore, as well as other examples which can be drawn from various industry sectors. Further information and analysis is provided in our submission to Treasury as mentioned above.

A proposed model of co-regulation for auditors

The issue of financial and resource constraints facing regulatory regimes (fuelled by globalisation and growing information needs of rapidly changing local and international markets) is a main argument which highlights an urgent need for governments to recognise other forms of regulation. A formal co-regulatory model is a possible mechanism to more efficiently and effectively regulate and monitor key actors in the financial reporting arena, while at the same time reducing the financial and physical burdens on the corporate regulator. It also recognises the fact that the private sector (ie the three professional accounting bodies) are already regulating their members (though membership of a professional body is not compulsory). There are numerous successful examples of this in other countries.

Therefore, we ask, “Should Government consider re-instating the accounting profession in one form or another as key actors in the governance of auditors?”

Before answering this question, we revisit why the profession lost its privileged role in co-regulation in the first instance? In other words, what changed so dramatically allowing government to by-pass the existing co-regulatory arrangements, which were seemingly working well and endorsed by government (see particularly, Commonwealth of Australia, CLERP 9 Proposal, 2002). It would be fair to say, given the countless articles and research papers over the last 10-15 years, the profession generally suffered significant reputational damage following the collapse of Enron, WorldCom and HIH (in the Australian context), along with the collapse of Arthur Anderson (Ball, 2009). These collapses and others, created the perception which became what is now commonly described as the ‘expectation gap’. Regrettably, it also resulted in the loss of confidence and trust in the audit profession. Miller (1995) further argues that Australia was ‘infected with global madness, and along with the biggest array of corporate collapses in Australia’s history, the 1980’s also witnessed wide-ranging regulatory failure. In this context, regulatory performance was evaluated in terms of the ‘greatest doubt’ in the mind of the community, with respect to the effectiveness of auditors and the capacity of the AASB to deal with future challenges given its perceived past mistakes (Miller, 1995).

Moreover, the extent of these failures significantly contributed to a climate of major reform. It also meant that after the fallout, the regulatory arrangements at that time, which were positioned somewhere between “associationism” (ie, reliance on the market and the community through self-regulation of profession association) and “corporatism” (ie, the government acting more as an overseer and leaning to private-sector associations to achieve public interest goals), had moved to a more “legalism” framework (ie, the exclusive reliance on the legislative and coercive powers of the government) (Miller, 1995). The failures also led to widespread criticisms of auditors, somewhat typified in the comments of Sykes (1994), who stated that “If the audit profession cannot function anymore usefully than it did in Australia in the 1980’s, then it might as well be abolished” (cited in Miller, 1995).

Miller also argues that for most countries, the issue is not whether government regulation is better than private sector regulation, but more a matter of whether the balance between the two is correct (citing Bromwich, 1992, p252). This important point can perhaps be the starting objective for justifying a revisit to the co-regulation model.

What is evident, despite being derailed in the early eighties for reasons explained above, is that co-regulation of the accounting profession has not only worked well in the past, but co-regulatory models have also been supported by authoritative parties for decades, including the government (Commonwealth of Australia, 2002), the professional bodies (see CPA, 2002), and ASIC (Bosch Committee report, 1990). Moreover, there are many examples (as provided in the IPA's submission) of successful co-regulation arrangements currently in place within industries and areas that support the changing landscape of financial reporting and accountability within local and globalized platforms.

With increasing demands being placed on the public purse to finance and resource legislative reforms, we propose that the time is perhaps opportune not only to consider 'user-pay' models which assist in funding seriously under resourced regulatory agencies via a levy system, but also to consider systems which share monitoring and enforcement obligations and thus ensure that responsible government agencies undertake their duties efficiently and diligently.

The wider issue now is whether there are sufficient checks and balances in place, which would bolster public confidence and trust in a co-regulatory environment. The fundamental basis of the successful operation of any co-regulatory system is the issue of trust, which is widely agreed to be a matter of significant relevance (van der Voort, 2015). Van der Voort (2015) explains that trust fuels the viability of interactions and that trust is an individual indicator that actors involved will feel that the interaction will be fruitful (p. 505).

So where to from here? Can the accounting profession and its three peak bodies restore confidence in Government sufficiently to regain a place on the co-regulatory table? We believe the answer is an overwhelming 'yes', and to understand this perspective, we need to return to the Ramsey Report (2002).

The Working Party's Report (Ramsey, 2002), recommended that the corporate regulator be given authority to delegate its powers for the registration and regulation of auditors to the professional bodies. However, it also recommended the following conditions before any functions could be delegated to an accounting body, among other things, each accounting body has and will continue to maintain:

- A comprehensive and mandatory code of ethics and other rules dealing with the conduct of members who provide auditing services;
- Mandatory requirements for the continuing professional education of its members and for professional indemnity insurance for those members in public practice;
- A comprehensive program for the periodic review of the work of members who provide auditing services: and

- Appropriate disciplinary action.

Without question, all of the above measures have been rigorously implemented and enforced by the professional bodies for many years since issues of credibility came to the fore in the early 1980's. Indeed, coupled with strong regulatory measures via the application of the tough provisions within the *Corporations Act 2001* along with the by-laws of the various bodies within the accounting profession, the auditing profession is now well regulated. Given the various arguments outlined above, it is time for Governments to recognise the substantial efforts that have been made by the peak professional bodies to regain public confidence and trust, and thus concomitantly acknowledge that accountants with all their specialised industry and technical and operational knowledge, can, as they have for many years in the past, regain a joint role in setting auditing standards as well as monitoring the performance of auditors.

It has been a long standing tradition of the professional accounting bodies to educate and discipline their own, if for no other reason than for reputational purposes, that is, to ensure and maintain the prestigious and privileged status afforded to members of their profession by the public; a profession of integrity and trust.

In the end, we see this recommendation as one which raises several issues, but more importantly we hope that it opens a dialogue for further discussion on co-regulation of the accounting profession, with particular emphasis on areas of practice once under siege but now enjoying a good balance of strong public interest and regulatory approval, that is, auditing. We wish to be more involved as a credible body of professionals in the ever increasing burden of regulation and monitoring, fuelled by globalisation, complexities in constantly changing financial markets, increased scrutiny from the public and ongoing restraints on the public purse. The fact that the professional accounting bodies are already undertaking regulation of their members, at their own cost (ie, no government funding at all) means there is an existing regulatory overlap.

Consistent with the words of a former president of the ICAA (now CA ANZ), we are “firmly of the view that in the long term, regulation of accountants is best done by the profession itself, on the grounds that only accountants are in the best position to evaluate professional performance” (Grice, 1993). In light of the above, we are of the view that further discussion and dialogue would focus on issues of trust, openness, neutrality, independence and greater liaison between co-regulatory actors, as well as corporate governance mechanisms for auditors. We welcome the opportunity to further discuss any of the above matters.

21. Recommendation: That the Government seriously consider the establishment of a formal co-regulatory environment in which some of the responsibilities of ASIC are shared with private actors. For example, the Government should consider a horizontal co-regulatory framework for the regulation and monitoring of auditors, along with associated enforcement activities, which is equitably shared amongst key actors including; the state, the accounting/auditing professions and private industry.

Contact

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IPA Divisional Offices are located in the following cities:

Melbourne

Sydney

Brisbane

Adelaide

Hobart

Perth

Canberra

The IPA has offices in:

London

Kuala Lumpur

Beijing

Hong Kong

For enquiries within Australia call **1800 625 625** or your nearest Divisional Office. International enquiries can be directed in the first instance to IPA Head Office.