INSTITUTE OF PUBLIC ACCOUNTANTS®

Pre-Budget Submission 2018-19

December 2017

Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to present our pre-Budget submission for the 2018-19 financial year. We look forward to working with the Government as it sets its economic agenda in the year ahead and in a constantly changing environment.

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 approximately three-quarters of our members work in these sectors or are trusted advisers to small business and SMEs. The IPA pursues fundamental reforms which will result in boosting productivity and in easing the disproportionate regulatory compliance burden placed on small business.

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 industry sectors. A strong and vibrant small business sector can play an active role in contributing to the economic growth of the Australian economy and help in addressing some of the challenges ahead.

In August 2015, the IPA Deakin University SME Research Centre launched the first Australian Small Business White Paper which contained numerous recommendations to boost small business productivity which is essential to maintaining Australia's overall standard of living. Whilst we continue to advocate for the recommendations which have not yet been adopted by the Government, the Research Centre has commenced work on the next evolution of the White Paper. It is expected to be released in the first half of 2018.

As with the first White Paper, we undertook a national roadshow of urban and regional centres to gain insights and feedback from small business people; and conducted a survey using various distribution channels (including IPA members) to reach as many small business people as possible. Again, we held a small business summit at Parliament House in September 2017 which was attended by the Minister for Small Business, the Hon. Michael McCormack MP, representatives from the office of the Shadow Minister for Small Business, Senator Katy Gallagher, the Treasury, Dept of Industry, Innovation & Science, ACCC, ATO, ASBFEO, Deakin University, Reckon, industry and the private sector.

In addition to building on the initial recommendations from the first White Paper, we have included research, analysis and recommendations in the second White Paper on:

- Productivity of small business – the White Paper examines the technical efficiency of the Australian business sector.
- Job creation and job destruction – based on various factors of Australian employing SMEs over an extended period of time.
- Taxation of SMEs – including their overall contribution to tax collection and how to optimise the tax system.
- Competition policy – following on from the Harper Review, including access to justice.
- Access to finance – including financing principles and alternative sources of finance.
- Internationalisation and free trade – benefits for the small business sector in a changing and challenging environment.
- Family firms – and their contribution to the economy.
- Regulatory overload – and recommendations to address this.

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

Last year we applauded the Government on major reforms which had been the subject of the first Small Business White Paper and which continue to be considered or implemented. The recent reforms to competition policy, innovation, crowdfunding, superannuation and tax rates for small business, are all welcome and the IPA has been vocal in its praise for these various reforms and measures. However, implementation, monitoring and evaluation are all critical to the ongoing success of these reforms and the IPA is intent on ensuring that these processes are undertaken with any necessary amendments being made in the future. Two major reforms for the benefit of small business include the unfair contract terms legislation and the proposed changes to government payment times. Whilst the IPA was extensively involved with these proposals, we believe that the real work is in ensuring their successful application for the benefit of small businesses across the country. We are also disappointed that the Government did not go further with the recommendations of the ASBFEO payment times inquiry, especially in legislating maximum payment times.

We emphasise that major reform cannot always be achieved in a short time frame and we urge the Government to take a longer term view based on a clear, determined and well communicated path for the Australian economy and Australian society.

In particular, the IPA is especially keen to ensure that bold tax reform becomes a priority for the Government and the IPA will continue to voice its disappointment with the stalled tax reform process.

In addition, the IPA urges the Government to continue its effort on innovation policy despite early setbacks with communicating the benefits. The next Small Business White Paper will have more recommendations on innovation policy which can be applied to increase productivity and with flow on benefits for the whole economy.

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

We would be pleased to discuss our recommendations in more detail with the Government and the Treasury. Please address all further enquiries in the first instance to Vicki Stylianou (vicki.stylianou@publicaccountants.org.au or 0419 942 733).

Yours faithfully

Andrew Conway FIPA FFA
Chief Executive Officer
Institute of Public Accountants

Summary of recommendations

'Big bang' tax reform

1. **Recommendation:** The Government should consider releasing a tax reform white paper with broad terms of reference, including the GST. The tax reform white paper should 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. Even though the current political environment has made 'big bang' tax reform extremely difficult for the major political parties, there should be a long term view and genuine public debate on tax reform. One of the main considerations is a rebalancing of the tax mix.

Single Touch Payroll

2. **Recommendation:** The Government should consider a range of integrated strategies and tools, in concert with stakeholders, to bridge the capability and confidence gap small business employers (micro businesses less than 5 employees) face moving into a digital Single Touch Payroll (STP) regime. STP can be a prelude to a more fulsome move towards digital reporting. The Black Economy Taskforce is also looking at the idea of providing tax and other incentives for small businesses who adopt a non-cash business model. The Government has also recently established the Small Business Digital Taskforce and e-invoicing is scheduled to commence in early 2018. There is an opportunity for the Government to bring all these initiatives together to assist the move to a digital environment particularly for small businesses.

Loan guarantee scheme

3. **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

4. **Recommendation:** 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

5. **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.

Payment times

6. **Recommendation:** The Government should adopt all of the recommendations contained in the report of the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) *Payment times and practices*; especially recommendation 9 to legislate maximum payment times for business to business transactions.

‘Big bang’ tax reform

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, 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 international developments (and in particular recent corporate and other tax reform in the US) and sluggish national income growth. Reform is no longer an option given our stubborn deficit, 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.

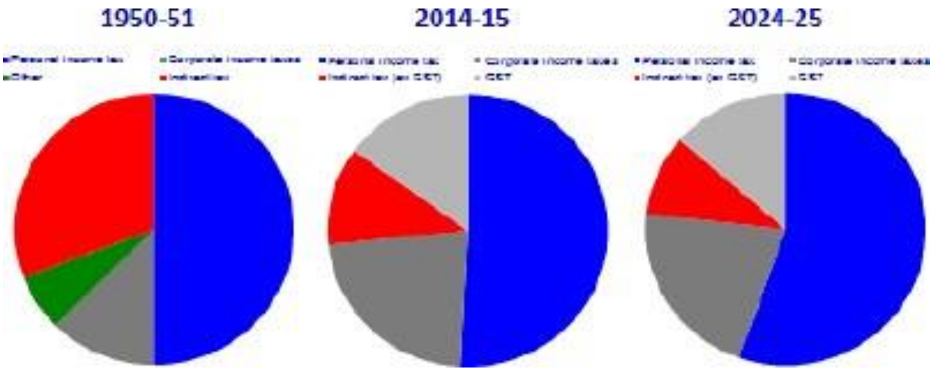
We believe the base and rate of GST must be part of any discussion on tax reform. Consumption taxes such as the GST represent one of the most efficient and sustainable tax bases available. Australia’s GST base is relatively narrow and covers less than 50 per cent of private consumption which gives Australia 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. The Government should start the process of raising awareness with the public of the need for reform, the benefits which can be achieved and the consequences of inaction.

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. An 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.

Recommendation:

The Government should consider releasing a tax reform white paper with broad terms of reference, including the GST. The tax reform white paper should 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. Even though the current political environment has made ‘big bang’ tax reform extremely difficult for the major political parties, there should be a long term view and genuine public debate on tax reform. One of the main considerations is a rebalancing of the tax mix.

Single Touch Payroll and digitization

STP will bring major improvements to system integrity and transparency (especially for the super guarantee) while also creating a building block to enable further government reporting. The benefits to employers lie in improvements to the employee commencement and reporting, and the compliance benefits which will flow from a more level playing field for employers. Employees will gain new transparency over their pay as you go (PAYG) withholding tax position and super contributions as reported by employers each payday. The Government has already legislated STP for eemployers with 20 or more employees who will transition to STP from 1 July 2018. The Government intends to apply STP for smaller employers coming on board from 1 July 2019.

The Government undertook a pilot with small businesses to understand the impacts of rolling out STP for small businesses with less than 19 employees. The pilot acknowledged only limited direct benefits are expected for small business initially. The pilot identified a series of potential barriers to implementation relating to implementation and ongoing costs, trust and convenience issues. These barriers where significant for employers who do not have digital software capability. The pilot concluded that a small but significant minority of small employers will likely struggle with the implementation in the absence of help and support. Depending on the solution pathway a business takes, they are likely to find the change effort and potential cost significant. The pilot research highlights that many of these businesses lack the required digital skills, have poor internet connectivity, are reticent about working online, or simply need a helping hand to embrace and tackle this change.

We encourage the Government to consider a range of strategies and tools, in concert with stakeholders, to bridge the capability and confidence gap these employers face. Intermediaries, such as bookkeepers for example, will play a very important role in advising employers in this segment and assisting with the introduction of Single Touch Payroll solutions.

The Government could use STP incentives particularly for micro businesses (less than 5 employees) who face significant hurdles as a prelude to a more fulsome move towards digital reporting. The Black Economy Taskforce is also looking at the idea of providing tax and other incentives for small businesses who adopt a non-cash business model**.** The Government has also recently established the Small Business Digital Taskforce. This taskforce will work to ensure that more Australian small businesses can thrive in an increasingly digital economy. Evidence shows that when a small business begins to digitise and use digital tools it creates new growth opportunities and diversifies revenue streams. Adopting digital technologies also helps small businesses to access finance, work smarter and enhances the value of the business when it is time to sell. However, many small businesses are not taking advantage of the opportunities that the digital economy offers. The Small Business Digital Taskforce will talk with small businesses across Australia about their concerns and ideas on how they can better engage in the digital economy. The introduction of e-invoicing in early 2018 can significantly reduce the cost of invoicing as compared to paper based invoicing. Only small businesses using a digital platform will be able to take advantage of this initiative.

There is an opportunity for the Government to bring all of these initiatives together to assist the move to a digital environment for small businesses who have yet to adopt a digital platform.

Recommendation:

The Government should consider a range of integrated strategies and tools, in concert with stakeholders, to bridge the capability and confidence gap small business employers (micro businesses less than 5 employees) face moving into a digital Single Touch Payroll (STP) regime. STP can be a prelude to a more fulsome move towards digital reporting. The Black Economy Taskforce is also looking at the idea of providing tax and other incentives for small businesses who adopt a non-cash business model. The Government has also recently established the Small Business Digital Taskforce and e-invoicing is scheduled to commence in early 2018. There is an opportunity for the Government to bring all these initiatives together to assist the move to a digital environment particularly for small businesses.

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.

- 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.

The important public policy question is whether or not 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 to10 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 on affordable and 'reasonable' terms. But the specific scale of potential program demand needs to be established in a detailed feasibility study as this determines the scale of the initial and ongoing demands on the government. Further, more detail is required on (a) the specific characteristics of credit rationed smaller firms in Australia, 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).

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 has considered 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.

Given the declining or insufficient 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, and so on.

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 and the Deakin Research Centre have actively participated in the crowd funding consultation and we welcome the progression of legislation which has been introduced.

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

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.

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 provides a definition of innovation that includes, but goes beyond R&D, and explores what policies can be implemented to improve the performance of Australian SMEs. The White Paper explains the different forms of innovation, 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. The second White Paper contains more discussion and recommendations on innovation policy.

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. Research indicates that 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.

Firstly, 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.

Secondly, 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.

Thirdly, 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 skills0 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.

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.

Payment times and practices

The IPA was represented on the reference group of the ASBFEO payment times and practices inquiry; and fully endorses all of the recommendations of the report. We acknowledge and applaud that the Government has announced that it will mandate that by July 2019 all non-corporate Commonwealth entities are to pay all invoices up to $1 million within 20 calendar days (equivalent to 15 business days) on receipt of a correctly rendered invoice. However, we believe this should be viewed as only the beginning of addressing this critical situation. The consequences of late payments on small businesses across the economy and across all industry sectors cannot be over stated. As the report states, "Payment times matter" or "How I started using small businesses to finance my multinational conglomerate". Unfortunately, this is not frivolous hyperbole, it is a statement of fact. We urge the Government to reconsider its response to the report and to adopt all of the recommendations, especially recommendation 9 to legislate maximum payment times for business to business transactions. In the meantime, the situation is worsening despite payment codes and the impact on cash flow for small businesses is critical. Even though the unfair contract terms legislation will have a positive impact, we believe that it will not be enough to change 'payment culture'.

Recommendation:

The Government should adopt all of the recommendations contained in the report of the ASBFEO *Payment times and practices*; especially recommendation 9 to legislate maximum payment times for business to business transactions.