INSTITUTE OF PUBLIC ACCOUNTANTS®

PRE-BUDGET SUBMISSION 2.0 2020-21

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Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to present our second pre-Budget submission for the 2020-21 financial year. We look forward to working with the Government on its economic agenda set against the difficult COVID-19 environment.

The IPA is one of the three professional accounting bodies in Australia, representing over 38,000 accountants, business advisers, academics and students throughout Australia and in over 80 countries worldwide. The IPA Group is the largest accounting body representing the small business/SME sectors in the world.

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

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

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

Both White Papers were the result of widespread consultation with small business people and our members through a regional roadshow, survey, and a summit at Parliament House with a range of public and private stakeholders.

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.
- Regulatory overload – a risk adjusted approach is needed, whilst also relying on regtech solutions, which can shift the conversation from the amount of regulation to the way we deal with it.
- Taxation of SMEs – including their overall contribution to tax collection and how to optimise the tax system.

- Workplace relations – ensuring we have policies which facilitate growth-based small businesses.
- Net employment dynamics – also known as job creation and job destruction. This is based on various factors of Australian employing SMEs over an extended period of time.
- Innovation policy – incremental innovation can be achieved across the economy with the message that innovation creates jobs.
- Competition policy – we need to improve access to justice if we are to realise the benefits of the Harper reforms.
- Trade policy and internationalisation – the performance of small business and SMEs needs to improve so a more meaningful contribution can be made to the economy.

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

www.publicaccountants.org.au/whitepaper.

For the sake of brevity, we have not repeated large sections of the White Paper in this Pre-Budget submission. However, if more research and analysis is required please refer to the website noted above.

In terms of an updated analysis of productivity, we refer to the latest Productivity Commission *Productivity Bulletin*, released in May 2019, which States that 'while output growth in Australia is relatively buoyant, this has not translated into significant productivity growth because growth has reflected input growth rather than 'doing things better'. The result is that the labour and multifactor productivity performance of the market sector, where measurement of performance is most accurate, has deteriorated further from the previous two years. Economy-wide generalisations do not capture the fact that some industries have experienced strong productivity growth'. The Bulletin also notes, however, that Australia has relatively high productivity levels by international standards, with Australia being placed Australia 15th highest among the 36 OECD economies, making it one of the more productive (and affluent) economies in the world.

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. A piecemeal approach is sub-optimal and may even prove harmful to long term reform.

In addition, the IPA urges the Government to continue its effort on innovation policy despite past setbacks with communicating the benefits. The Small Business White Paper contains 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).

Yours faithfully

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Small Business: Big Vision recommendations

Below are the aspirational recommendations of the IPA:

1. Broaden the base and lift the rate of GST (subject to appropriate equity measures).
2. Cut direct taxes.
3. Undertake a zero-base design of a thoroughly modern taxation system.
4. Reform and simplify the personal income tax scale and the transfer system.
5. Standardise a company tax rate at 25%.
6. Reform fiscal vertical imbalance between the Federal Government and the States to deal with accountability problems due to a mismatch of revenue raising and expenditure responsibilities. States and Territories should be held accountable to the Intergovernmental Agreement on Tax Reform to eliminate payroll tax and stamp duties.
7. The Prime Minister should form and chair a small business advisory council to provide direct policy input and options to the government to inform its agenda with a core focus on productivity.
8. The Federal Small Business Minister should remain a permanent position in Cabinet, preferably with its own department.
9. Government should facilitate small businesses joining global value chains to remain competitive and access global markets.
10. Government should establish a small business agency modelled on the US Small Business Administration.

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

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

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

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

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

Understanding productivity in the Australian economy

Productivity findings

- Many parts of the Australian economy are characterised by firms with decreasing (or, at best, constant) *returns-to-scale*. This means scaling up may not impact productivity in any meaningful way, or indeed may reduce productivity. In turn, this would imply that typical businesses need to focus on being smarter at their current levels of operation rather than seeking to expand.
- Loss-making businesses account for around one third of the total business stock and these firms may benefit from growth due to their under-utilisation of current resources. Alternatively, the wider economy may benefit from reallocating the unproductive resources held in these businesses.
- There are large differences in the way businesses organise their production to yield the same level of output, which may indicate that specific classes of firms suffer from capital or labour constraints.

  Labour-intensive classes of firms include those in the bottom 25th percentile of value-added creating businesses, loss-making businesses, medium-sized firms, and younger firms below 6 years in age.
- Capital-intensive classes of firms include those in the top 25th percentile of value-added creating businesses, profitable businesses, large firms, and firms over the age of 5 years.
- The 'State of technology' available to different classes of firms varies considerably across the economy.

- High 'State of technology' classes of business include new firms and younger firms more generally, small firms, profitable firms, and those creating average levels of value-added.
- Low 'State of technology' classes of firms include old firms, medium-sized businesses, and loss-making businesses.
- Financial services appear to be the most productive industry in the economy and mining the least productive.
- Other relatively productive industry sectors include agriculture, forestry, fishing, rental, hiring, real estate, transport, postal, warehousing, and construction.
- Other relatively unproductive industry sectors include administrative and support services, manufacturing, public administration and safety, and other services.

Efficiency findings

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

  Overall, the three industry sectors with the highest average efficiency rates are (highest first): financial and insurance services; transport, postal and warehousing; construction.
- Overall, the three industry sectors with the lowest average efficiency rates are (lowest first): mining; manufacturing; electricity, gas, water and waste.
- The 'State of technology' in common usage within the business sector is *highest* among younger firms (0-5 Years old), small firms, and profitable firms.
- The 'State of technology' in common usage within the business sector is *lowest* among old firms (10 years plus), medium-sized firms, and loss-making firms.

Productivity recommendations

- Introduce initiatives to improve managerial capabilities in SMEs

- Review capital market efficiency to address the problem of ‘zombie companies’ (those businesses that require bailouts to survive), where too much capital is currently held
- Review the regulatory framework around insolvency resolution (Australia has the fourth-longest insolvency resolution time in the OECD) as this creates resource misallocation and reduces growth opportunities for efficient firms.

Efficiency recommendations

- Encourage business start-ups to stimulate efficient, dynamic resource reallocation
- Introduce initiatives to enhance the technological absorption rates in ‘older’ firms
- Speed up the roll-out and increase the coverage of high-speed broadband and enable SMEs to connect their premises all the way with the latest technology
- Introduce supply-chain efficiency initiatives
- Introduce initiatives to enhance firms’ marketing capabilities
- Ensure the education system produces enough STEAM (science, technology, engineering, arts and maths) graduates, and that the business sector is capable of absorbing them at an efficient rate.

Regulatory overload

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

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

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

Further corroboration of the impact of regulatory imposts on SMEs is supported by recent research undertaken by the Centre (2017)[1], using an extensive ABS data set covering the period 2006-2014.

Headline findings

- Surveys undertaken by industry, financing and professional bodies show an increasing number of small businesses continue to be concerned with the impact of laws and regulations on their ability to run their business and innovate.

[1] IPA-Deakin SME Research Centre (2018a).

- Recent studies show that Australia has a complex regulatory structure for charities and the not-for-profit sectors that needs urgent attention.
- The Federal Government has been attempting to consolidate regulatory bodies to achieve efficiencies and reduce the cost of regulation. This process has impacted accounting and audit standard-setting.
- Risk-based regulation should be considered as a preferred approach for dealing with regulatory challenges.
- Concerns about the compliance with accounting standards by charities and not-for-profits have led to proposals for 'pro forma' reporting.
- Accounting standard-setters are currently reviewing accounting frameworks to determine whether the way in which accounting standards currently apply to a range of small entities ought to change.
- The use of special purpose financial reports for regulatory lodgments is also being reviewed, with the possibility of removal and replacement with a third tier of reporting.
- We note the Inquiry by the Parliamentary Joint Committee on Corporations and Financial Services, into the regulation of auditing to which the IPA made a submission.

Recommendations

- The Government should continue to emphasise the need for 'risk-based' regulation, so individuals and entities that are at a 'low risk' of non-compliance are not subjected to inappropriate and unnecessary regulatory scrutiny.
- The Government should continue to contribute to the work of the OECD in enhancing global awareness of good regulatory practice.
- The Government should continue to conduct periodic reviews of regulatory agencies/bodies and statutory boards to ensure that public interest is well served.
- The Government should continue to use the Office of Best Practice Regulation (OBPR) to ensure that laws and regulations take account of the needs of small business. The government should also strengthen the use of small business regulation impact Statements.
- The Government should ensure that company extracts and financial Statements lodged with the regulator are made freely available. We refer to previous consultation on this proposal.
- The Government should pursue all necessary measures to implement one regime for registration and regulation of charities and not-for-profits. We refer to previous consultation on this proposal.
- The Government should consider the role of regtech (technology-based solutions applied to regulatory compliance) and facilitate the introduction, development and application of regtech solutions (especially by small business) as a means of easing the regulatory burden.
- The Australian Accounting Standards Board (AASB) should continue to review existing accounting frameworks to ensure they reflect the needs of the community and maintain the

integrity of the measurement and recognition requirements contained in international financial reporting standards.

- Preparers of special purpose financial Statements will need to review the format of their financial Statements following changes made by international accounting standard-setters to the conceptual framework.

Regulatory burden

The IPA has joined with CPA Australia, Chartered Accountants Australia and New Zealand, Financial Planning Association of Australia and SMSF Association, to develop and advocate for a new consumer-centric regulatory framework that enables consumers and small business owners to access affordable, independent quality advice in their best interests from their choice of trusted professional adviser.

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

Please advise if you have queries or would like more information.

Taxation reform – time to act

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

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

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

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

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

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

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

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

An effective taxation system should be premised on achieving:

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

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

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

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

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

Division 7A

- The Government announced in the 2017 Federal Budget that amendments would be made to Division 7A incorporating recommendations from the 2014 Board of Taxation’s final report on the ‘Post Implementation Review of Division 7A of Part III of the Income Tax Assessment Act 1936’ (BOT report). The start date was to have been 1 July 2018, although the Government in its most recent Federal Budget deferred the start date again to 1 July 2020.

- Treasury released a Consultation Paper in September 2018, to seek stakeholder views on proposed amendments to Division 7A. The consultation paper draws on but includes significant departures from the recommendations in the BOT report. If legislated in its current form, there is potential for a substantial increase in compliance costs and tax payable by business entities using trusts for business purposes.

- Some key elements of the proposed new regime outlined in the Consultation Paper include:

    - New “simplified” single ten-year loans with interest charged at the Reserve Bank overdraft rate for small business (which is much higher than the current Division 7A rate).
    - Not adopting the amortisation model with principal repayments at the 3, 5, 8 and 10 years as recommended by the BOT report and instead requiring annual interest and principal payments.
    - Regardless of when a repayment occurs during the income year, interest will be for the full year.
    - The transitioning of both 7 and 25 year loans under Division 7A into the new regime. The BOT report had recommended grandfathering (preserving) 25 year loans under the existing arrangements.
    - Both existing 7 and 25 year loans will be subject to the new higher overdraft interest rate as from 1 July 2019.
    - Existing 7 year loans will keep their current outstanding term when transitioned into the new regime, but existing 25 year loans must be put on new 10 year complying

loan arrangements prior to the lodgment day of the company tax return for the 2021 income year.

- The removal of the concept of distributable surplus such that there is no limit to the amount that may trigger a deemed dividend under Division 7A.

- The extension of the review period for Division 7A to 14 years after the end of the income year in which the loan, payment, or debt forgiveness are triggered, or would have triggered, a deemed dividend.

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

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

Recommendations

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

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

Compensation for Detriment Caused by Defective Administration

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

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

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

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

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

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

Recommendations

The inadequacy of the CDDA scheme falls upon the ATO's narrow interpretation as to what constitutes "defective administration". The ATO maintains that major IT system failures are not "defective administration". It maintains that its service standards are aspirational targets and are not a formal agreement between the ATO and the tax profession and it should not be subject to the same service standards as a commercial entity. In light of this, we recommend that the Government in conjunction with the ATO, consider the implementation of a fairer and more accessible CDDA scheme dedicated to tax practitioners as recommended by the IGT. The CDDA scheme is currently not fit for purpose in providing redress for digital reliant tax practitioners when things go badly wrong.

Black Economy Taskforce

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

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

Recommendations

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

White Paper recommendations

Headline findings

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

Recommendations

- The Federal Government should renew its commitment to a comprehensive tax reform process – a new process to draw on all the work already undertaken (including the Henry Tax Review and Tax Forum) in formulating a blueprint to prepare our economy for the challenges ahead. The Government should realign our tax system to reduce its heavy reliance on individual and corporate income tax.
- The Federal Government and Federal Opposition should explore changes to the GST.

- The Federal Government should explore the use of a parliamentary forum (such as a committee) to seek further stakeholder views on tax reform. Such an inquiry should also use the Parliamentary Budget Office to model various scenarios.
- The Federal Government should investigate the potential implications of adopting tax incentives for new businesses, such as those operating in countries such as Singapore.
- The Federal Government should explore options with the States and Territories to either remove payroll taxes or, at the very least, to ensure the laws and the way they apply are consistent in every way across the country.
- The in-house facilitation process for resolving taxation disputes should be constantly promoted and recommended by professional advisers as a potentially effective and cost-efficient means to resolving tax disputes.
- Small business tax concessions need to be consistent, with the policy objectives as defined. A holistic review of all the current concessions needs to be undertaken to ensure the suite of tax concessions work collectively to support small businesses through all stages of a business life cycle. Small business tax concessions must be benchmarked against the policy objectives to ensure they are well-targeted and remain so. The IPA Deakin SME Research Centre supports the independent self-initiated review of small business tax concessions conducted by the BOT. The consultation guideline which sets out the principles for evaluating and improving the current suite of tax concessions for small business is an appropriate basis for undertaking a holistic analysis. We await the release of the BOT report by the Government.
- That the instant asset write-off be made a permanent feature of the small business tax regime.
- A whole-of-government approach is required for small business assistance programs. Accountants are well placed to deliver such programs, as they already act as advisers to small businesses.
- The tax system should provide targeted assistance towards stress points in a business life cycle, such as the start-up phase or during a temporary setback. Most tax concessions (excluding the SBCGT concession and refundable R&D concession) are merely timing benefits that bring forward tax deductions to reduce the amount of tax payable, which is only useful if the taxpayer is in a tax paying position. If a small business is in the start-up stage or undergoing a temporary downturn, the bringing forward of deductions may not provide essential cash flow benefits other than more carried-forward losses. Loss-carry-back for corporate entities is one way the tax system can assist taxpayers deal with a temporary setback. Non-corporate entities, while problematic, may also require similar relief to assist with the survival of viable businesses.
- To avoid incentives towards complex business structures, consideration should be given to the creation of a simplified small business entity. Our current tax rules provide an incentive for small businesses to use complex structures. Tax outcomes depend on business structures, and multiple structures are needed to achieve tax outcomes that would be otherwise unavailable through a single entity.

Policy responses – a useful framework

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

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

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

Recommendation

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

Academic research – what does it tell us?

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

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

- programs are more likely to yield positive results when GDP growth is higher and unemployment lower;
- programs aimed at building human capital, such as vocational training, independent worker assistance and wage subsidies, show significant positive impact; and

- program length, monetary incentives, individualized follow up and activity targeting are all key features in determining the effectiveness of the interventions.

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

Recommendation

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

Stimulus measures worth keeping – government guarantee scheme

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

Recommendation

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

Supply chains – the need to diversify

The new normal will depend on the reaction to globalisation and integrated supply chains. For Australia, which has the most concentrated trade profile in the world, this crisis has glaringly exposed the vulnerabilities of our supply chains. There is now widespread speculation about re-industrialisation and becoming more self-sufficient in the crucial medical supplies that matter in a pandemic.

Recommendation

The IPA strongly believes that the Government needs to reassess its industry and innovation policies, digitisation policy, trade and investment policies in light of the pandemic. Whilst the stimulus measures have assisted during the crisis, our concern is that we may miss the opportunity to 'reset' or ‘reboot’ our policies and programs in these critical areas. Again, political will is needed and a willingness for genuine and robust reform.

Supporting businesses to survive COVID-19

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

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

Government support in the form of a grant or other mechanism to enable businesses impacted by the pandemic to access professional advice is urgently required. This would be consistent with the COVID-19 Recovery Plan developed by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO), which recommends a small business viability funding program to enable small businesses to obtain funding of up to $5,000 to access advice. The ASBFEO recommendation has two components: the first allows for an amount of up to $3,000 for advice from a professional (accountant) to assess the current financial position and viability; the second, includes $2,000 for insolvency advice if the business needs to be wound up based on its non-viability.

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

Accountants as trusted advisers have been key to the successful implementation of the Federal Government’s major stimulus packages including JobKeeper and JobSeeker. They have assisted clients to navigate and access the funding support to sustain operations during the peak of the crisis. With the Government’s initiatives flowing via the tax system, accountants have been the first port of call for thousands of businesses. Even though this has been a huge increase in their workload, many IPA members have advised they are under constant pressure from clients to either waive or reduce their fees, with some work being simply unbillable. This in turn has placed significant pressure on their own survival.

It is likely that accountants will be required again to support clients through the recovery period and beyond. It is clearly noted that not all small businesses will survive the impact of the pandemic (and the extensive bushfire season in large areas of the country that preceded the pandemic). However, to provide businesses with the best opportunity to recover or to make the assessment to exit, many will require advice and guidance from their professional and trusted adviser.

The IPA has collaborated with other stakeholders, including the professional accounting bodies in developing this proposal.

Recommendation

The Federal Government should urgently fund a grant (or other support) to enable businesses, with priority given to small businesses, impacted by COVID-19 to access professional advice to assess their financial position and determine their viability and future prospects in the recovery phase.

Workplace relations – the need for simplicity

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

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

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

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

Businesses that rely on paying their people (minimum) award terms and conditions are less likely to succeed. Business owner-managers who do not demonstrate that they value their people are less likely to achieve such results[2].

Headline findings and recommendations

- The small business sector is often perceived in the business and political media as a homogeneous group. It is, however, very diverse and a critical distinction needs to be made between growth (entrepreneurial) and non-growth-oriented owner-managers. While the latter group is numerically significant, growth-oriented entrepreneurs, in the main, do the heavy lifting when it comes to new job creation. New and small businesses are subject to vulnerabilities – that is why the survival rates are relatively low for such businesses. The longer they survive and the more they grow, the more sustainable they become. Growth-oriented businesses have the opportunity to contribute more significantly to employment growth.
- In broad terms, the workplace relations system appears to work reasonably well. Some will undoubtedly be critical, often on political or ideological grounds, while others will see merits

[2] Fox and Smeets (2011); Ichniowski and Shaw (2003); Lazear (2000).

in the current arrangements, perhaps with some changes. This is inevitable for an area that is highly contested and has seen many significant changes over time. Whenever fundamental changes have ensued, the impact has been felt at the coal-face, by employers and employees who have had to turn to third parties for assistance in interpreting and operationalise system changes. Whether the changes are worth the resulting confusion and instability (and money) is often not known for some time.

- Owner-managers of small businesses, including entrepreneurs, will benefit from a workable workplace relations framework that delivers consistency and stability. Such owner-managers are time-poor and lack resources to deal with too many ongoing changes, particularly of a significant nature. Such owner-managers, especially the entrepreneurial types, are looking for (sustainable) advantages to outdo their competition. These players will need to know how to operate optimally within the workplace relations system.

- Continued effort is required to ensure small business owner-managers understand their legal rights and responsibilities with regard to workplace relations. To achieve this:

  - Easy-to-understand regulatory material needs to be readily available. The efforts of the Fair Work Ombudsman (FWO) have been welcomed.

  - Small business owner-managers should be given the opportunity to make enquiries regarding workplace relations matters anonymously (to encourage a more accurate, timely information flow).

- Penalty rates are a highly contested area of the workplace relations landscape. They were introduced as a deterrence against the use of longer, unsociable working hours by employers, as well as to compensate employees for working such hours. Over time, consumer preferences have changed to longer trading hours in the retail and hospitality sectors. The Fair Work Commission (FWC) has addressed this issue recently and, through transitional arrangements, is aligning Sunday penalty rates with existing Saturday rates. This seems to be a sensible approach as it removes inconsistencies for undertaking any weekend work.

- The main direction and operation of Federal unfair dismissal provisions appear to be fulfilling important fairness and justice standards and need to remain. We note that the Productivity Commission, in its review of the workplace relations framework, did not see any evidence to justify removing such provisions. Importantly, it concluded that unfair dismissal provisions are not playing any significant role in employers' hiring and firing decisions.

- Due to resource constraints experienced by small business owner-managers, it is important that regulators, at all levels of government, continue to address and remain vigilant to the compliance burden. Regulatory requirements need to be simplified and associated cost-burdens minimised where they are unable to be removed (such as with the wording and administration of awards and the inspectorate role of the FWO).

- While improvements to the workplace relations systems will continue to be important in addressing any anomalies and modernising outdated provisions, substantive and sustainable improvements to business productivity and competitiveness are more likely to arise from changes made at the firm level. Major differences in productivity and competitive advantage will be shaped, to a large extent, by what happens in specific workplaces and not so much by legislative or governmental changes at the national level.

Net employment dynamics of Australian SMEs

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

While evidence in the literature suggests that employment growth is generated by a few rapidly growing firms in a number of developed economies[3], these high-growth firms are not necessarily small and young. More importantly, to date there is limited evidence on better understanding employment growth in Australia in relation to firm characteristics such as size, age, innovation and other firm factors.

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

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

Notwithstanding this inverse relationship between employment and firm size, we also note that there are significant, persistent productivity differences between different SME firm size and age classes that possibly affect both firm survival and growth. Moreover, the extant literature[4] reports that the entry, exit, expansion and contraction of firms are significantly associated with various measures of productivity and profitability.

The concept of 'creative destruction' – a term coined by Austrian-American economist Joseph Schumpeter in 1942 – is an important feature of competitive markets that are dominated by small firms. The concept describes what happens when new entrepreneurial small businesses challenge

[3] Henrekson and Johansson (2010).
[4] See Syverson (2011); Foster, Haltiwanger and Krizan (2001).

existing incumbents, driving productive ‘churn’ whereby inefficient firms exit and the efficient grow. The efficient reallocation of resources between these growing and shrinking firms is critical to aggregate productivity growth and employment.

Accordingly, we examine net employment among SME firms by considering whether size, age and innovation (and the type and processes of innovation) are important determinants of net job creation among SMEs in Australia. We draw on work undertaken by the IPA Deakin SME Research Centre[5]. Understanding these SME firm dynamics will assist in formulating better policy outcomes regarding job creation in the SME sector.

Headline findings and recommendations

- We show that both business size and age are significant determinants of net employment, particularly among start-ups and young firms.
- As firms become older, they contribute significantly less to net employment, whereas younger firms (i.e. less than 5 years old) have a significant impact on net employment, contributing on average to around 15% in net employment.
- Start-ups and young firms that innovate, particularly those associated with the introduction of new marketing methods, contribute on average to between 7% and 9% in net employment.
- Another significant determinant of net employment is government financial assistance, contributing on average approximately 3% to job creation.
- Our analyses demonstrate that start-ups and young firms are important drivers of net employment in Australia and, when considering the effects of age and innovation together, we find that these factors significantly contribute to job creation and are important sales growth and performance differentiators.
- Our results show compelling evidence that the innovation capability of start-ups and young firms underpins the observed firm-employment dynamics, significantly influencing employment outcomes in the Australian economy.
- An important policy objective, therefore, is the early identification of start-ups and young firms that have innovation capabilities, as these firms contribute significantly to net job creation.

[5] See Cowling, Kiaterittinun, Mroczkowski and Tanewski (2018).

Innovation policy – it's never been more critical

Given that innovative firms (particularly start-ups) are known to create more jobs than any other business category[6], Federal , State, territory and local governments in Australia must do everything within their scope to assist businesses in understanding the value of innovation and, where appropriate, to provide financial and other incentives to encourage innovative thinking within the small business community.

There is still an apparent lack of appropriate acknowledgement by small businesses of the importance of innovation to the growth of their enterprises. The IPA Deakin SME Research Centre[7] has noted that the Australian Bureau of Statistics reports that only one in seven small businesses see innovation as important. That statistic alone illustrates that more needs to be done to create and promote incentives for small businesses to improve their prospects of future success.

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

Headline findings

- Innovation is a key driver of productivity, jobs creation and economic performance.
- Innovation policy should include measures that encourage the diffusion and uptake of existing innovations by a broad range of firms, as well as encouraging new innovations per se.
- Federal, State and local governments in Australia have a series of grant schemes available for small businesses seeking to grow.
- Government agencies have extensive small business education programs designed to assist small businesses working within the innovation space.
- Public policy to support innovative SMEs should increasingly consider value capture and business model innovation generally.
- Businesses in Australia experience a wide range of barriers to innovation. This suggests policy to support innovation needs to be flexible and broad-based.
- Talent, not technology, is the key. If wider skill requirements are not addressed, there are likely to be bottlenecks created downstream in the innovation process.
- Technical skills across the workforce, and particularly interdisciplinary skills that bridge areas of expertise, are particularly important for innovation and are often subject to market failures.

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

- Patent box initiatives are gathering momentum in offshore jurisdictions.

Recommendations

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

Competition policy – we must realise the benefits of the reforms

The much-awaited Harper Reforms came into operation on 6 November 2017. The key changes, from the perspective of small businesses, are the introduction of an ‘effects test’ for the misuse of market power, a prohibition on concerted practices, and the inclusion of a power for the Australian Competition and Consumer Commission (ACCC) to grant class exemptions.

Headline findings

- The Harper Reforms are now in operation:
    - The law has widened in relation to restricting anti-competitive behaviour, as it now covers 'concerted practices' (something less than an 'arrangement or understanding').
    - The reforms introduce a more effective test for determining the misuse of market power.
    - The ACCC now has the power to grant class exemptions to practices that do not harm competition or where the benefit outweighs any harm.
- The reforms have the potential to benefit small business if access to justice can be achieved. Consideration needs to be given to:
    - encouraging private actions for damages (representative or otherwise) for breaches of competition law
    - encouraging voluntary compensation schemes to provide redress to those harmed
    - increased penalties for breach as a means of deterrence
    - other affordable, simple solutions such as online tools and materials and alternative dispute resolution (ADR) for simpler competition law cases.
- Clearer guidelines are needed to help small businesses (and their industry bodies) understand the changes to the law.
- Consistent definitions of 'small business' and 'franchise', 'franchisee' and 'franchisor' are needed so SMEs do not need to apply different thresholds when dealing with different laws (or parts of the law).

Since the 2015 *Small Business White Paper*[7], a number of changes have been introduced to competition policy and law that will benefit small businesses. These changes have mostly arisen out of recommendations (Harper Reforms) made by the *Competition Policy Review Final Report* (the Harper Review)[8]. We make further recommendations regarding the way in which the Harper Reforms should be implemented – that is, to be effective for small business, as well as raising issues that the IPA-Deakin SME Research Centre considers are still outstanding.

Recommendations

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

- The ACCC should bring cases on the new provisions as quickly as possible to provide clarity on how they will apply in practice. Additional government funding may be required to achieve this.

[7] IPA-Deakin SME Research Centre (2015).
[8] Harper, I, Anderson, P, McCluskey, S and O'Bryan, M (2015).

- The ACCC should apply the amended misuse of market power provision to exploitative practices as well as exclusionary practices.

- Separate tailored guidance should be available for small businesses on the new concerted practices provision, including practical examples. This is an extremely complex legal area and small businesses are unlikely to understand when conduct is (or isn't) a 'concerted practice'.

- The ACCC should produce separate guidance (which does not take an overly cautious approach) on concerted practices for industry associations and their members. The introduction of a concerted practices prohibition is particularly relevant to industry associations, where small business competitors meet to discuss legitimate matters (but the risk of crossing into illegitimate matters may be high). An overly restrictive approach to concerted practices vis-à-vis associations risks stifling the important work that associations do on behalf of their SME members.

- The small business community should consider lobbying the ACCC for a class exemption in relation to identified common commercial transactions that are technically at risk of breaching competition law but are unlikely to do so in practice. This could significantly improve legal certainty for small businesses.

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

- Changes are made to facilitate *representative* private damages actions. For small businesses that are not able to bring private actions themselves, we need to understand why there are so few representative actions for breach of competition law and make changes to enhance this ability. Use of the Federal Court 'fast-track' procedure for simple competition law cases would be beneficial.

- Procedural changes are made to encourage private actions for damages, as the market could be less reliant on the ACCC to bring action. Although small businesses are unlikely to be in a position to bring actions themselves, larger competitors could, and the risk of a private claim may itself deter anti-competitive conduct. Significant reforms have taken place in Europe and the UK in the last five years to encourage private damages. Australia needs to consider similar reforms.

- Higher penalties be imposed on firms that break competition law, creating a greater deterrence effect. The level of penalties imposed in Australia is very low compared with many overseas jurisdictions. This is supported by the recent OECD report *Pecuniary Penalties for Competition Law Infringements in Australia 2018*[9].

- Encouragement is given to compensation schemes for those who have suffered as a result of a breach of competition law. This may be achieved by enhanced use of the section 87B procedure or a separate compensation scheme process.

- Online tools and materials be available to assist in the early resolution of competition law disputes, either with or without the use of online alternative dispute resolution procedures.

[9] Organisation for Economic Co-operation and Development (OECD) (2018).

- The introduction of online court processes be considered, particularly for simpler cases.

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

Trade policy and the need to internationalise

The role of international trade is crucial to the development of national economies in many countries, including Australia[10]. As demonstrated in the White Paper, SMEs play a critical role in contributing to Australian employment and economic growth. But how significant are SMEs in the international trade of Australia?

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

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

Headline findings

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

[10] Organisation for Economic Co-operation and Development (OECD) (2017).

- More than one in 10 SMEs generated income from direct exports: with 7.5% of income generated by the direct export of goods and 4.8% by the export of services.
- Internationalisation among SMEs varies by business sector. The three sectors showing the highest levels of internationalisation are wholesale trade, information media, and professional, scientific and technical services.
- Larger and more mature firms have higher levels of engagement in international activities. Medium-sized firms are three times more likely to be active in foreign markets that the self-employed and twice that of small-sized firms. Approximately one half of all internationally active firms have operated for more than 10 years.
- The most popular source of external finance is from the banks. The proportion of SMEs with loans increases with their turnover. However, Australian SMEs have increased their use of credit cards while all other forms of lending sources, including bank finance, have marginally declined.
- Innovation plays an integral role in exporting, both enabling and stimulating subsequent export behaviour. Australian exporters are twice as innovative as importers, particularly in terms of introducing new products or operational processes.

Recommendations

We draw on a range of research literature and Australian official government data to provide a basis for discussion on the performance of Australian SMEs and suggest pointers for Australian policy makers. Certainly, there is much to be done to help Australian SMEs 'raise their game' in the international marketplace. The evidence presented shows a weak international performance by SMEs but also grounds for optimism.

- Findings from the longitudinal study by ABS suggest the majority of small and young firms are still more domestically oriented, compared with larger firms. In terms of policy interventions, a targeted approach is suggested, aimed at those SMEs that are seeking to internationalise but have not yet done so, and those that are already exporting and are seeking to expand their international reach into additional new markets. Hence, the strategy should be to build upon current successes and to increase the volume of direct exporters. Inevitably, such an approach requires some targeting of different categories of SME with specific types of support.

- Australian interventions should place more priority on facilitating SME exports in the six most internationally-active industries – including mining, agriculture, manufacturing, wholesale, information media, and professional services. These are the main sectors in terms of generating export revenue for the economy. However, as geographic sales of SMEs vary across sectors, this suggests that a tailor-made intervention for each sector is highly recommended to boost the rate of internationalising SMEs. Tailor-made interventions are much more likely to be relevant and effective and would encourage higher levels of take-up by SMEs.

- Size and age of enterprise are also important when designing and delivering support measures. As revealed in the longitudinal data (ABS), the significant difference in the level of international involvement between medium-sized and self-employed firms can be attributed to two reasons: their limited resources (which adds costs and risks in engaging internationalisation) and/or their lower levels of motivation to go beyond their local markets because of their resistance to grow (risk aversion). On the other hand, born globals (who are highly motivated to internationalise) may encounter more challenges in accessing finance, compared with their counterparts, due to the higher risks involved and less-developed networks and lack of experience in the foreign market. Hence, more emphasis should be placed on encouraging small and self-employed firms to participate in foreign markets by providing targeted export incentives, support for networking and international collaboration, business matching opportunities, and facilitating access to finance.

- Innovation has been acknowledged in literature as a critical factor in enhancing internationalisation. Investment in innovation also contributes to developing competitive advantage for firms to outperform others in the international market, as well as to increase sales revenue. This is consistent with findings of the data collected by the ABS during 2009-2013. Evidence suggests that innovation is more intensive in Australian exporting SMEs than non-exporters. Hence, support for growth and innovation can be helpful to boost the number of exporters and accelerate their international activities.

- In the increasingly uncertain global environment, SMEs would benefit from clear guidance and signposting to identify and assess the risks of internationalisation. More support in terms of detailed information provision would be helpful, such as the provision of tailored advice and a mentoring program for firms internationalising in different geographical markets. In-depth discussion forums and network events, such as how to evaluate the impact of Brexit and opportunities for Australian SMEs, challenges emerging from the policies of the Trump Administration for those involved or seeking to trade in the USA, and how to gain best benefits from the TPP agreement, should be offered. This will not only help the government to understand SMEs' needs, but it will also build a bridge between SMEs and policy makers in designing specific instruments to support their internationalisation. We applaud the work which the Dept of Foreign Affairs & Trade has done to promote the utilization of trade agreements and hope to see this work continue.

ANNEXURE

Research and Development in the Wake of Covid-19 – an urgent need for new thinking in stimulating SMEs through innovation.

Setting the Tone

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

The IPA Deakin SME Research Centre is continuing to review countless journals, texts, and professional and industry publications, and are finding that many lessons on surviving a crisis on the scale currently presented by COVID-19, can be learned from past catastrophic events. Indeed, there are countless examples in history of companies and other forms of businesses surviving even the harshest of conditions, including world wars, depressions, severe recessions, earthquakes, fires, plagues, tsunamis, hurricanes and other natural disasters[11]. The current COVID-19 catastrophe which continues to develop and grows worse in some countries by the hour, is different from all the other unfortunate events that have impacted the world, its countries, their states, and their collective communities. It's a pandemic which is threatening not only the very existence of mankind, but also the entirety of the commercial foundations which keep economies alive.

Whatever we choose to call the COVID-19 phenomenon, from a business perspective, it is an extraordinary economic shock, and sadly will impact the SME community the most. In essence, this is because SMEs make up the majority of all businesses in most developed countries, for example, in Australia, SMEs account for 99.6% of all businesses, 42.4% of all employment, and contribute to 37.4% of GDP. This has not always been the case, and it has only been in the past 15-20 years that SMEs have emerged as dominant economic players due to technology, and the inundation of young entrepreneurs developing and fostering a constant flow of new and innovative ideas and products that can readily be brought to market. Most strikingly however, was the success of start-ups and micro firms, as well as larger firms that were able to downsize their enterprises to much smaller forms, all of which provided greater flexibility and adaptability in responding to rapidly changing market conditions. As explained in Tanewski and Mroczkowski (2019)[12], larger firms with significant investments in hard assets, along with complex business models and organisational structures, and outmoded logistical support networks, were not able to respond as quickly to changing market conditions. Eventually, these firms fell victim to Joseph Schumpeter's, concept of the 'gale of creative destruction' (1944)[13].

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[11] AAA
[12] BBB
[13] CCC

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

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

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

Notwithstanding the numerous areas of interest above that we can explore in more detail, our focus in this section of the IPA pre-budget submission is what has changed for professional advisers such as accountants and their clients over the past 4-5 months, and how can we learn from these changes to be well prepared and be ready to cope with a brave new world of business post covid-19? Without doubt, the most striking revelation is that most people working within professions such as accounting and law, can now work comfortably from home, without the need to travel or call into the office. Indeed, all files and documents can now be and are in fact, in electronic form and have been for years, and moreover can be readily transferred securely from system to system anywhere around the globe. Payment systems have also been in electronic form for years and again securely executed through encryption systems as have electronic signatures. Transactions have also been successfully conducted online for years and the pandemic has served to further rapidly expand the purchase and distribution of goods more efficiently and expeditiously, aided of course by technological advances in warehousing and transport logistics. More recently too, meetings and professional development programs can be successfully conducted online, with many forms of video applications (apps) such as Zoom, MS Teams and Webex, and with as many participants, hundreds an even thousands if need be. Educational offerings have also had to quickly adapt their teaching strategies to accommodate online learning, so in effect, the apps mentioned above have given Universities and schools a lifeline at this most critical time. Educational institutions were forced to adapt in order to survive, and the past few months or so has proved not only that it can be done, but also that online learning is more efficient and cost-effective, and enables students to retain between 25-60% more knowledge using online learning compared with between 8-10% in a traditional chalk and talk classroom (Link: https://www.shiftelearning.com/blog/bid/301248/15-facts-and-stats-that-reveal-the-power-of-elearning) Shift: Disruptive Learning, Miami, USA*

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

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

Incentivising innovation for SMEs

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

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

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

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

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

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

Johannessen[14] refers to the notion of institutional innovation and the role social institutions (such as governments) fulfil in creating an environment in which small business owners operate. The underlying issues for policy makers are how to encourage small business owners, or those thinking about creating a business, to take the commercial risks required. In some cases, it will be the provision of relief from legal compliance burdens through legislation or via administrative means

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[14] Johannessen (2013).

that assists in minimising the time spent by small business on regulatory compliance. In other cases, there will be a focus on ensuring there are grants or other incentives designed to encourage business creation and growth.

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

Firstly, the genesis of the term ’patent box’ is interesting, to say the least, and for the uninitiated it conjures up all sorts of imagery – for instance, an imaginary box within which documents relating to patents are stored (anecdotal finding). This is far from the truth, of course. In its simplest form, a patent box is a tax incentive which provides a lower tax regime specifically applicable to income generated from qualifying patents. The term ‘patent box’ has no prudent dictionary definition as we know it, but has become more of a generally accepted term used in tax circles, arguably derived from the European taxation system where, evidently, it relates to a box that needs to be ticked on the tax form[15].

Over the past 10 years, patent box regimes have increased in popularity as the ‘innovation-based’ global economy has taken hold and continues to be fuelled by new ideas, new inventions and the increasing global demand for new processes and new end-products. In an effort to capture the essence of this phenomenon, which is clearly a significant driver of economic growth[16], governments are vigorously searching for mechanisms that encourage and support innovation initiatives that grow economies and improve the wealth of societies.

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

Patent box tax incentives operate differently. They are ‘back-end’ or output-based incentives designed to provide tax relief from income generated by a patent already registered. In this sense, a patent box initiative incentivises the commercialisation of innovation and not just the research component of innovation (i.e. by providing a firm with a lower rate of tax to qualifying income that would otherwise attract the normal corporate tax rates). Moreover, the strategic nature of a properly constructed patent box tax incentive will ensure that the lower tax rate is only applicable

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[15] Atkinson and Andes (2011).

[16] Atkinson and Andes (2011).

where profits from innovation are actually aligned with the profit-making activity. In this way, the success of the innovation commercialisation is rewarded and, indeed, ultimately it is the commercialisation that leads to growth and prosperity.

The theoretical arguments in support of a patent box tax initiative are drawn from the economic literature, where it appears that there are two schools of thought, both of which relate to multiple market failures or, rather, the lack of failures (i.e. assuming the normal forces of demand and supply are at play). In this sense, if the market reaches equilibrium through these forces, then there should be no need for governments to use taxation or any other mechanisms to correct for market failure, because markets without external intervention should theoretically maximise a nation's economic welfare.

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

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

An extensive body of economic literature shows that 'companies do not capture anywhere near all the benefits from the research they conduct'[17], thus requiring some form of tax incentives to correct for the apparent market failure. Early studies, as far back as the 1980s[18] also establish this inconsistency in market behaviour: "the median rate of return from twenty prominent innovations was 27%, whereas the social rate of return was 99%, 'almost four times higher'"[19]. Moreover, Nordhaus[20] found that inventors "only capture 4% of the total social gains from their innovation; the rest spill over to other companies and to society as a whole". So, from an inventor's perspective, it is not really an appealing proposition when everyone other than the inventor stands to gain much more of the benefits that accrue from the innovation.

In light of the above findings and given that new knowledge is a significant driver of improved public welfare and wealth generally, government intervention is necessary to prevent an underinvestment in the creation and commercialisation of new knowledge. Indeed, Australia has recognised this issue and, along with many other countries, has successfully introduced tax incentives for the 'front-end'

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[17] Atkinson and Andes (2011).

[18] Tewksbury, Crandall and Crane (1980).

[19] Cited in Atkinson and Andes (2011).

[20] Nordhaus (2005), p 4.

of the innovation cycle that commences with the conduct of research. These initiatives have been successful in effectively lowering the cost of research and have thus increased the returns of private investors that might otherwise have rejected an investment in innovation, particularly if the risks are high and the returns are low [21].

Moving on to patent box incentives, the IPA Deakin SME Research Centre has a concern about whether tax incentives at the back-end of the innovation process (i.e. the commercialisation stage) can have the same effect in stimulating further investment in innovation and thus be similarly successful as R&D tax concessions. Indeed, proponents of patent box regimes argue that providing tax incentives which reward commercialisation and success of innovation, "is an important strategy for growth, competitiveness and job creation"[22]. This leads us to a further discussion on the second wave of economic theory relating to market failure – that is, that innovation is now, more than ever, a global, mobile phenomenon. As a consequence, we are witnessing economic inconsistencies (almost akin to a price war) as more and more countries rigorously, aggressively use tax codes and other mechanisms to remain competitive and further grow their economies.

One issue central to the economic argument relating to market failure is the risk factor. Typically, the innovations most likely to 'change the world' and have the greatest impact on society, as well as providing the greatest amount of benefits to society, are the longer-term, large-scale research projects. Indeed, in this respect, these are the projects governments should be supporting (i.e. given that their successful commercialisation will provide the greatest amount of benefits to society and will have the greatest spillover effects as well, thus benefitting hundreds of non-creator firms). However, the longer-term, large-scale research projects have a higher risk profile and require significant investment in research and development over longer periods and, even after these long periods of large investments, may still not be successful commercially. A good example is research undertaken in the pharmaceutical industry, where new medical discoveries such as drugs could take anywhere from 10 to 20 years or more to get to market. Moreover, in competitive global markets with appetites for shorter-term investments, "justifying investment in high-risk [and longer-term] research activities have become much more difficult"[23].

In the Australian context, the risks associated with long-term innovation projects have been partially offset by tax code initiatives such as R&D incentives (government support), which have proven to be successful at the front-end of the R&D cycle (i.e. as effective incentives to encourage further research, innovation and job growth)[24]. Similar R&D initiatives have been successful in many other jurisdictions, including the United States, Japan and a host of countries within the EU[25]. From an

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[21] Atkinson and Andes (2011).

[22] Atkinson and Andes (2011).

[23] Krehmeyer, Orsagh and Schacht (2006).

[24] IPA-Deakin SME Research Centre (2018).

[25] European Union (2014).

international perspective, Graetz and Dowd[26] provide an extensive account of the positive impacts of R&D incentives on economic growth.

The evidence suggests, therefore, that R&D tax credits have been an effective "tool to lower the costs of conducting research, including high-risk research, so that private returns better approximate social returns, encouraging firms to invest to maximise both"[27]. Interestingly, however, some researchers suggest that R&D credits alone are not enough for firms to remain globally competitive in a constantly changing global market, and a combination of incentives are required to encourage research, innovation and commercialisation. Indeed, as cited by one author, "there are alternative ways of correcting market failure so that inventors of knowledge are rewarded; we need a mixture of different instruments appropriate to different products and circumstances"[28].

Some of the alternative ways suggested include:

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

Other contributors have argued for a patent box regime in addition to R&D incentives, so the input (R&D) and output (commercialisation) phases of an innovation are compensated and rewarded. In this sense, there is a better "matching of firm rewards with societal benefits, including the creation of high-paid jobs"[29].

This state of thinking has now led to a proliferation of patent box schemes in several countries across the globe, as evidenced in numerous studies.[30] Many of these studies have highlighted the potential benefits that patent box regimes can provide, particularly in terms of supporting further innovation. But many of the studies also highlight the potential pitfalls that have emerged in countries where patent box regimes have been established – particularly countries within the EU that have experienced severe corporate tax competition as more and more countries joined 'the race to the bottom in corporate taxation,'[31] as many of these countries continued to lower their respective tax rates to attract local and foreign investment in innovation (lending support to the theoretical prediction by Zodrow and Mieszkowski)[32]. In turn, this had the effect of 'tax code shopping' where

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[26] Graetz and Dowd (2013).

[27] See particularly Atkinson and Andes (2011).

[28] Owen (2017).

[29] Atkinson and Andes (2011).

[30] Including Atkinson and Andes (2011); European Union (2014); Griffith, Miller and O'Connell (2014); Alstadsaeer, Kopczuk and Telle (2014); de Rassenfosse (2014); Bradley, Dauchy and Robinson (2015); Faulhaber (2016).

[31] Alstadsaeer, Kopczuk and Telle (2014).

[32] Zodrow and Mieszkowski (1986).

innovation-driven companies (particularly large multinationals) would actively engage in sourcing countries that offered the best tax package.

An even further development was the incidence of profit shifting by large companies to countries (and in some respect, tax havens) where preferential tax treatment was offered through patent box incentives. For some countries, these incentives were offered even though the intellectual property was developed abroad and ownership of the IP remained abroad[33]. On the basis of these and other tax avoidance activities orchestrated via tax havens linked to with patent box tax regimes, several countries have been highly critical of the use of patent box incentives[34] – indeed, even to the point of stating that patent box schemes lead to harmful tax competition and may need to be stopped.[35] There have also been calls in Australia to resist the introduction of a patent box scheme given the UK experience where the new patent box rules "created a new way for large businesses to avoid tax in countries in which they operate"[36].

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

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

The modified system is also known as the 'the nexus' approach. Following serious criticisms of tax avoidance and the loopholes in patent box schemes, the OECD along with the G20 launched a project aimed at limiting international tax avoidance. The project, referred to as the Base Erosion and Profit Shifting Project (BEPS), developed what has now been termed the 'nexus' approach, "where countries, are only permitted to provide benefits under patent boxes, if those benefits are proportionate to the amount of R&D undertaken by the taxpayer receiving benefits or in the country providing benefits"37.

This approach works to limit revenue losses from patent boxes, because it establishes a "link between R&D and the income benefit that may arise, therefore constraining the ability of taxpayers to shift income between countries"38. In essence, the strictly-applied nexus approach would require the R&D and the production associated with the intellectual property (i.e. IP that is eligible under the

[33] de Rassenfosse (2014), p.5

[34] OECD (2014).

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

[36] Tax Justice Network, quoted in Khadem (2015).

[37] Alstadsaeter, Kopczuk and Telle (2014).

[38] Alstadsaeter, Kopczuk and Telle (2014).

scheme) “to be performed in-country in order to qualify for the full-patent box rate”[39]. And, as mentioned in Atkinson and Andes, the nexus approach is appealing for innovation-based tax incentives “because it would incentivise the back-end of R&D s while, at the same time, tie R&D to commercial outcomes through patent revenues”.[40]

Given the research undertaken by the IPA-Deakin SME Research Centre, we are of the view that, on balance, a carefully crafted patent box tax incentive based on the ‘nexus’ approach is a plausible mechanism for spawning innovation in Australia. To sum up our view on patent boxes, we quote a statement made to the press by RMIT’s Professor Ian Maxwell[41]: “If a patent box scheme was introduced, Australia’s large corporations would immediately start looking at means to innovate so that they could claim the patent box incentive. The end result of these R&D efforts would be world-leading products and services with export potential.”

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

If Australian companies are to remain globally competitive, then the focus of the current debate should be on global competitiveness rather than on tax policy and revenue enhancement[42]. In this sense, we strongly recommend that the Australian Government, as a matter of urgency, introduce a nexus-based patent box scheme.

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

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

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[39] Atkinson and Andes (2011).

[40] Atkinson and Andes (2011).

[41] Maxwell (2014).

[42] Atkinson and Andes (2011).