

21 October 2022

From Mr. Bill Ranken

**Mr Michael Brennan, Chair, and fellow Commissioners,
The Productivity Commission,
Level 8, Two Melbourne Quarter,
697 Collins Street,
Docklands, Victoria, 3008, Australia**

Dear Mr Brennan and fellow Commissioners,

Submission to The Productivity Inquiry

AUSTRALIA FACES A SERIOUS STRUCTURAL IMPEDIMENT TO PRODUCTIVITY GROWTH AND PROSPERITY.

There is a Great Disconnect in our productivity policy. The businesses which employ 7.4 million Australians are seriously handicapped, and have been for a long time. There are 3.2 million Australians in poverty. This is the Great Disconnect. It is explained below. This submission also shows the mechanics by which it can be fixed, (building on UK and USA precedents), followed by a discussion of overseas and local precedents, and a recommendation.

THE GREAT DISCONNECT

Small and medium size businesses (SMEs) have serious difficulty raising debt and equity finance, or 'capital', especially longer-term capital, on globally competitive terms.

Our global rankings and domestic data are evidence that we are seriously uncompetitive.

This matters: productivity and prosperity depend on the successful combination of labour and capital.

We cannot succeed long term if our small and medium businesses cannot access capital on globally competitive terms.

This is because small and medium businesses:

- employ c.66 % of the private sector work force, or 7.4 million people,
- contribute c.\$700 billion or 54 % of value added¹,
- are the source of much innovation²,
- grow more jobs than any other sector - 57% of jobs growth between 2013-2017, ³

¹ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, Page 5, 6, Small and medium business defined as those with fewer than 200 employees or turnover less than \$50 million, and workforce excludes finance and insurance businesses, and public enterprises. <https://www.pc.gov.au/research/completed/business-finance>

² Atlassian was started by two people in 2002, reportedly with a \$10,000 credit card. It now has a stock market value of US\$33 billion. <https://www.atlassian.com/company>, and <https://nira.com/atlassian-history/>, <https://www.nasdaq.com/market-activity/stocks/team>

³ Gilfillan, Geoff, Small business sector contribution to the Australian economy, Parliamentary Library, Canberra, January 2020

SMEs therefore are key to helping people lift themselves out of poverty:

- we have 3.2 million people living in poverty⁴ (with many perhaps under-employed), and
- significant numbers of those in poverty appear to be stuck in multi-generational poverty⁵.

Long term productivity growth by SMEs, our largest employer group, is critical to help fix this poverty.

In turn, achieving this productivity growth requires that small and medium businesses have globally competitive access to capital.

Without competitive access to capital for our SMEs, we will fall further behind our global competitors, and poverty will increase.

Certain overseas countries have solved this challenge. We can learn from them. We can fix this.

Given the size of this Great Disconnect, indicated by the employment, value added and poverty numbers above, we must take bold structural steps now.

(Please note SMEs also face other challenges, which are not addressed in this submission. They include quality and quantity of potential employees, the absolute and international relative cost of energy, and availability of gas. Also, and partly because of the relative decline of SME business banking over time (which is evidenced below), there are not as many experienced bankers to help SMEs through good times and bad.)

THE PROBLEM: WE ARE UNCOMPETITIVE.

We have shockingly poor global rankings for small and medium business access to capital:

- 32nd globally for financing of small and medium businesses - World Economic Forum (WEF) survey in 2019, (the most recent WEF survey to assess this).⁶
- 46th globally for venture capital availability (WEF 2019).

We need to be in the top 10 globally to achieve our productivity and prosperity goals long term.

Other global rankings indicate we are well outside the top 10 on important prerequisites for globally competitive productivity growth. A significant contributor to these poor rankings is relatively poor access to capital for SMEs:

- 65th in the world for gross capital formation as a percentage of GDP (World Intellectual Property Organisation (WIPO) 2022).⁷

⁴ Poverty in Australia 2020, ACOSS and UNSW, "We use two poverty lines – 50% of median income and 60% of median income, whereby people living below these incomes are regarded as living in poverty." <https://povertyandinequality.acoss.org.au/poverty/>, and "About 13% percent of people are in poverty based on the 50% poverty threshold, and 20% based on the 60% threshold. In both cases the poverty rates are above the OECD average." Income Poverty of Households in Australia - Evidence from the HILDA Survey, OECD Working Paper Number 1539, 2019, page 8

⁵ Davis, Glyn, On Life's Lottery, Hachette Australia, Sydney, 2021, especially pages 29, 30, 40.

⁶ http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf, pages 66, 69

⁷ https://www.wipo.int/global_innovation_index/en/2022/?gclid=Cj0KCQjwy5maBhDdARIsAMxrkw0f2mebw_1ojrLCVtnMcS235RQuWIL9mJ5AZADnha4h_ISs8IEXyQcaAIMDEALw_wcB, pages 25, 240

- 62nd out of 100 for economic transformation readiness (WEF in 2020).⁸
- 57th for access to information and communications technology (ICT), (WIPO 2022).⁹
- 41st for patents versus 7th for scientific and technical documents, and for citations or references to those documents (WIPO 2022).¹⁰
 - This evidences what many Australian University Vice-Chancellors say: we have world class ideas, but we do not have access to the money or ‘capital’ that our SMEs need to translate those ideas into practical applications.
 - A structural change is needed urgently to address this disconnect - so our SMEs can fund translation competitively.
 - If we do not address this disconnect, then overseas companies will continue to buy up our best ideas, in large part because they have access to the necessary capital.
- 36th for attitudes to entrepreneurial risk (WEF 2019).
- **25th overall in the world on the Global Innovation Index 2022 and 2021 (WIPO).**¹¹
 - **On top are Switzerland, USA, Sweden, UK, Korea, Netherlands, Singapore, and Germany.**
 - **We are behind New Zealand, Ireland, Norway, Malta, Iceland, Luxembourg, Estonia, Austria.**
- 14th for digital competitiveness, among 64 countries ranked by the Swiss-based IMD World Competitiveness Center in 2022, (up from 20th in 2021, which is great).¹²
 - Denmark, USA, Sweden, Singapore, Switzerland, Netherlands, Finland, Korea top the list for digital competitiveness.
 - The list considers the capacity and readiness of economies to adopt and explore digital technologies as key drivers of economic transformation in business, government and wider society.
- The ten largest ASX listed public companies are largely the same companies, or types of companies, as were in the list 20-40 years ago.
 - The opposite is the case in the USA.
 - Companies like Alphabet, Amazon, Facebook, Apple, Tesla and others have emerged.
 - These US companies were non-existent or were SMEs 20-40 years ago.
 - In other words innovation has not happened here at the same pace as in the USA.
 - Relatively poor access to capital for our SMEs is a significant contributor to our under-performance.

THE POOR GLOBAL RANKINGS ARE CONFIRMED BY AUSTRALIAN DATA:

⁸ <https://www.weforum.org/reports/the-global-competitiveness-report-2020>, pages 30, 51

⁹ https://www.wipo.int/global_innovation_index/en/2022/?gclid=Cj0KCCQjwy5maBhDdARIsAMxrkw0f2mebw_iojrLCVtnMcS235RQuWIL9mJ5AZADnha4h_ISs8lEXyQcaAlMDEALw_wcB, pages 25, 238

¹⁰ https://www.wipo.int/global_innovation_index/en/2022/?gclid=Ci0KCCQjwy5maBhDdARIsAMxrkw0f2mebw_iojrLCVtnMcS235RQuWIL9mJ5AZADnha4h_ISs8lEXyQcaAlMDEALw_wcB pages 25, 248-9

¹¹ <https://www.wipo.int/edocs/pubdocs/en/wipo-pub-2000-2022-section1-en-gii-2022-at-a-glance-global-innovation-index-2022-15th-edition.pdf>, page 19, and https://www.wipo.int/edocs/pubdocs/en/wipo_pub_gii_2021.pdf, page 4

¹² <https://www.imd.org/centers/world-competitiveness-center/rankings/world-digital-competitiveness/>, page 28 and <https://www.imd.org/centers/world-competitiveness-center/rankings/world-digital-competitiveness/>, page 24

- Judo Bank, a new Australian bank focussing on SMEs, reported a \$119 billion shortfall, or lending gap, in finance needed by SMEs in 2020.¹³
- “A survey of finance brokers found that 46% of SME finance inquiries were not referred onwards to a loan application.” Productivity Commission 2021¹⁴
- “...smaller businesses find it a challenge to access finance.” Reserve Bank of Australia 2021¹⁵
- “It is generally accepted that SMEs are more likely than large business to face challenges obtaining finance.” Productivity Commission 2021¹⁶
- “SMEs may be able to access finance but not at the price or on terms they would like.” Productivity Commission 2021¹⁷
- **30-year structural decline:** “Lending to businesses represented 55 per cent of Australian banks’ lending (excluding lending to government) in 1990, but declined to 32 per cent by 2020” Productivity Commission.¹⁸
 - **Bank lending to business is way down over the last 30 years, as a percentage of their total lending.**
- Interest rates paid by small businesses are roughly double the rates paid by large businesses, (and about 50% more for medium business).¹⁹
 - **The price of loan finance for SMEs is 50 – 100% above the price paid by large business.**
 - Price is a theoretical indicator of an imbalance in supply versus demand, so this is evidence that supply is inadequate.
 - This high cost of finance also partly reflects a heavy reliance on short term debt funding. Smaller SME debt funding is 2.1 times the level of debt in larger SMEs (derived from a 2021 Productivity Commission report - debt as a percentage of equity (defined as assets less debt)).²⁰ More debt funding means higher risk of failure and hence higher interest rates charged by banks to reflect the higher risk. (Whereas large SMEs and larger companies, using proportionately much less debt funding, are less vulnerable to failure, and pay lower interest rates).
 - This heavy reliance on short term debt funding by SMEs thereby evidences the poor availability to SMEs of longer-term capital on suitable terms.
 - It also makes them much more vulnerable to failure.
 - **Our SME’s will be less vulnerable to failure, and their cost of finance will decline if they have access to more long-term debt and equity funding.**

¹³ <https://www.judo.bank/sme-insights/sme-banking-insights-2021>

¹⁴ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, Page 22, <https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

¹⁵ Kent, Christopher, Assistant Governor, Reserve Bank of Australia, Small Business Finance in the Pandemic, Address to the Australian Finance Industry Association, Sydney, 17 March 2021, page 1, 2, available at <https://www.rba.gov.au/speeches/2021/pdf/sp-ag-2021-03-17.pdf>

¹⁶ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, Page 9, <https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

¹⁷ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, Page 24, <https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

¹⁸ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, page 17 and especially page 23 <https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

¹⁹ RBA Chart Pack October 2022 page 24, <https://www.rba.gov.au/chart-pack>, Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, Page 25, <https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

²⁰ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, Page 5, 8, 19, <https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

- Something seems amiss when the businesses which employ 7.4 million Australians pay 50 - 100% more for loans. Why do we “punish” our largest employer group?
- “SMEs with more assets were also more successful in their debt finance applications.” Productivity Commission 2021 ²¹
 - “Limited competition – and risk-weighted appetite focussed on real estate – limits lending to SMEs.”²² (i.e. Bank capital adequacy regulations which favour bank loans secured by mortgages.)
 - This implies that younger SMEs and people without significant assets, or a home to mortgage, find it more difficult and/or more expensive to raise SME finance.
 - This holds back entrepreneurs, like those who started Atlassian reportedly using a \$10,000 credit card²³, and younger people wanting to start businesses.

In summary, our SMEs - our single largest employer group, the source of most job growth and innovation - are seriously disconnected from competitive access to capital, and if this is not fixed, it will hold back productivity and prosperity, with a consequent rise in poverty. We must fix this Great Disconnect. We must aim for the global top 10.

HOW TO FIX IT - EXAMPLE MECHANICS

The mechanics below are based on UK and USA precedents. The UK and the USA have adopted programs such as Enterprise Investment Schemes, Venture Capital Schemes, Collective Investment Schemes, Seed Capital Investment Schemes, Small Business Investment Companies, and Opportunity Zones.^{24 25 26}

The mechanics are designed to have a significant impact, fix the Great Disconnect, and help lift us quickly into the global top 10, (within 5 – 10 years).

1. **\$30-150 billion over time** – assumes 1% to 5% of super funds. Household savings additional.
2. **100% income and capital gains tax relief** to any tax paying investor who provides long term, minimum 5-year, loan or equity finance to eligible small businesses.
 - All income and capital gains on the investment will be tax free forever for the original investor only.
 - If the original investor sells then tax benefits do not apply to the new investor.

²¹ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, Page 22, <https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

²² <https://www.asbfeo.gov.au/policy-advocacy/policy-insights/affordable-capital-sme-growth-inquiry-2018>, pages 11, 12

²³ <https://www.atlassian.com/company>, and <https://nira.com/atlassian-history/>

²⁴ See <https://www.gov.uk/topic/business-tax/investment-schemes>

²⁵ See <https://www.sba.gov/partners/sbics/apply-be-sbic> and <https://www.irs.gov/credits-deductions/businesses/opportunity-zones>

²⁶ Opportunity Zones Best Practices Report to the President from The White House Opportunity and Revitalization Council, Washington DC, May 2020, page 6

- Policy levers are to change minimum term, the levels and duration of benefits, the total value which can be claimed in any year, and the types of investors who are eligible.
- 3. **Tax relief only applies if the investment is held for the minimum 5 years.**
 - Earlier sale of investment is permitted any time, but results in clawback of tax incentives.
 - Policy lever is to change the term from 5 years.
- 4. **100% capital gains tax (CGT) relief on sale of any asset, where the sale proceeds are used to make an eligible investment in small businesses.**
 - Same clawback applies if the investment is sold early.
 - Policy levers are to change the total value which can be claimed and level of CGT relief.
- 5. **Private sector investors, not Government, will take the risks, provide the money and decide who receives the money:**
 - Investments can be made into any Australian SMEs (by normally eligible investors), and through collective investment vehicles - like investment trusts and companies. (The latter are essential to enable superannuation trustees to invest prudently in a diversified portfolio with expert investment management.)
 - Policy levers are to select which investors can invest, and/or sectors or geographies the funds can be invested into.
 - For example, eligible investors might be limited to superannuation funds, banks and private individuals, to help manage the cost of tax revenue foregone - superannuation funds in particular having very low tax rates, meaning revenue foregone is minimised. However such limits will reduce the impact, and the size of funding available to SMEs. Achieving a global top 10 position requires wide eligibility.
- 6. **Motivates a long-term structural pivot away from Government and Philanthropic funding:**
 - Private investors provide most of the money. The tax incentives motivate them to do this.
 - Taxpayer funds are leveraged, and tax dollars are driven further because the short-term cost to Government is only the tax foregone.
 - This starts a pivot from Government and Philanthropic balance sheets to the private sector.
 - Longer term the cost of the tax incentives is repaid, as SMEs succeed and start paying tax, and as their employees do likewise.
- 7. **SME Eligibility for Investment:** All small, medium and family businesses, unlisted and listed on the Stock Exchange (ASX), with a stock market value up to A\$1,000m, to be eligible.

- A key policy question is whether to define eligibility by existing domestic definitions of SMEs or to update our definition of SMEs to be globally competitive and relevant.
- For example, the USA Small Business Administration supports loans of US\$5.5 – 500m for ‘small’ businesses.²⁷ The ASX definition of a ‘small’ business is one with a mean equity/stock market value of A\$1,283m, and the global definition of ‘small’ businesses is those with an equity/stock market value up to US\$2 billion.²⁸
- This globally relevant definition of an SME would extend eligibility to small businesses listed on the ASX. This will help Australia achieve a top 10 global position in 10 years.
- Policy levers are to change the A\$1,000m eligibility threshold, exclude ASX listed companies, or specify which industries or geographies are eligible.
- A lower threshold and exclusion of ASX companies will significantly reduce the short-term impact of this policy.

8. Accommodate SME owner concerns about losing control and/or excessive dilution of ownership when finance is raised.

- Long term loan and equity capital investment terms into SMEs must balance the interests of SME owners and new investors.
- Loan and equity funds must be committed without excessive protection for the lender for a minimum of 5 years (i.e. so that SME owners are not deterred by the threat of bank foreclosure during a short-term business downturn).
 - Private and public capital providers in Australia already use convertible debt and convertible equity structures to achieve this objective.
 - If a business does well, then when it is time to repay a loan, or convert a loan or preference share into ordinary shares, the dilution of ownership is nil or much less, and vice versa.

HOW TO FIX IT - PRECEDENTS

United Kingdom Examples. The UK gives tax incentives for investors to provide long term finance for a very wide range of SMEs, and has established an eco-system to fund growing businesses - from very small businesses to SMEs involved in translation of university science and of business innovations into commercial practice, and for larger SMEs.²⁹ There is an Alternative Investment Market (part of the London Stock Exchange) which offers much easier access to public finance markets for SMEs.³⁰ The UK also has a relatively large number of SME bankers and advisers who help SMEs to prosper, and to survive through tough times. As a result, the UK has a relatively large share of global SME innovation and capital formation, delivering productivity and prosperity gains.

United States Examples. Opportunity Zones in the USA create long term capital formation and jobs in the poorest 10% of zip codes, and do this by providing tax incentives for the private sector to

²⁷ <https://www.asbfeo.gov.au/policy-advocacy/policy-insights/affordable-capital-sme-growth-inquiry-2018>, page 18

²⁸ <https://www.spglobal.com/spdji/en/indices/equity/sp-asx-small-ordinaries/#overview>, see Fact Sheet page 3,

<https://www.nasdaq.com/articles/market-cap-explained-2018-04-26>

²⁹ See <https://www.gov.uk/topic/business-tax/investment-schemes>

³⁰ <https://www.londonstockexchange.com/raise-finance/equity/aim>

make long term capital investments in those zip codes.³¹ Small Business Investment Companies (SBICs) use their own capital and special government loans to make investments in SMEs.³² The Small Business Administration (SBA), “... reduces risk for lenders and makes it easier for them to access capital. SBA guarantees against default portions of business loans, which can range from US\$5.5 to \$500 million.”³³

Tax Incentives are Efficient. Both nations drive tax dollars further by encouraging private investors to fund SMEs, with tax incentives. Because private investors put up most of the money, the Government contributes much less: it only contributes the “cost” to Government revenue of the tax incentives.

SME businesses in the UK and USA which otherwise would not attract long term loans or equity investment thereby are able to do so.

It Pays for Itself. The final stage of this ecosystem, from a Government cash flow perspective, is that the original tax incentives pay for themselves over time: As SMEs succeed and grow over time, they pay taxes, and their employees do likewise. In addition, their success reduces poverty, and welfare transfer payments decline long term.

Tax Incentives Work. Australia already has evidence of the positive long-term impact of tax incentives and regulation. As noted above, since 1990 Australian bank lending to business as a share of bank total lending has declined from 55% to 32%.³⁴ The corresponding growth has been largely in mortgage lending. Mortgage lending for housing, and for securing loans to small business, has grown in response to tax incentives offered to housing investors and homeowners, government subsidies for certain home buyers, and bank capital adequacy rules which favour loans by banks which are secured by mortgages.

We Have the Capability. Australia also has an established industry capability to promptly drive-up financing for SMEs. Our banks have the people who know most about lending to the SME sector. In addition the private capital investment management industry has capability: with assets under management of a record \$90 billion as of June 2021.³⁵ As this capability grows, it will deliver a larger workforce of bankers and advisers who can help SMEs through good times and bad.

Efficient Long-Term Allocation of Capital. Private investors invest their own money. They must invest for the long term - at least 5 years in the example above. They will only invest their money when they can see good business performance over the long term: Long term business prospects will drive investment decisions. Provided that investors are able to choose any sector of the economy, or any business, then this policy delivers efficient long-term allocation of capital. For example investors may favour businesses with national comparative advantage or special long-term need - like natural resources, agriculture, defence industries, affordable housing, climate, energy, health and aged care etc.. Because investors want good long-term results, their capital will be allocated to businesses with perceived long-term and comparative advantages.

³¹ Opportunity Zones Best Practices Report to the President from The White House Opportunity and Revitalization Council, Washington DC, May 2020, page 6. See <https://www.sba.gov/partners/sbics/apply-be-sbic> and <https://www.irs.gov/credits-deductions/businesses/opportunity-zones>.

³² <https://www.sba.gov/partners/sbics/apply-be-sbic>

³³ <https://www.asbfeo.gov.au/policy-advocacy/policy-insights/affordable-capital-sme-growth-inquiry-2018>, page 18

³⁴ Small Business Access to Finance; The Evolving Lending Market, Productivity Commission, 2021, page 17

<https://www.pc.gov.au/research/completed/business-finance/business-finance.pdf>

³⁵ <https://aic.co/common/Uploaded%20files/Yearbooks/Australian-Private-Capital-Market-Overview-A-Pregin-and-Australian-Investment-Council-Yearbook-2022.pdf>. Page 7, 9

RECOMMENDATION

To achieve productivity gains and prosperity, Australia must drive-up long-term loan and equity investment in SMEs. This money can be provided by the private sector, motivated by cost-effective tax incentives. The UK and the USA have shown how to drive-up investment in SMEs. They do it. We can too. Our own experience in the housing sector shows that tax incentives work. We also have the practical capacity, in our banking and private capital industries, to make this happen. In addition, these SME investment tax incentives will pay for themselves long-term. I recommend that The Productivity Commission take a leading role in helping to make this happen.

This is a game changer if it becomes a structural change policy for the Nation.

There is potential for \$30-150 billion of private sector investment over time.

Over 5 – 10 years this level of investment will deliver globally competitive finance to our SMEs. It will help solve the Great Disconnect.

It will create productivity gains and prosperity through SMEs involved in:

- poverty alleviation,
- affordable housing,
- social enterprises,
- defence industries,
- climate,
- energy,
- water,
- health and aged care,
- building and construction,
- natural resources,
- agriculture,
- fishing,
- real estate,
- infrastructure,
- medical and bio tech,
- advanced technology,
- advanced manufacturing,
- artificial intelligence
- the internet of things,
- information and communications technology,
- games and creative arts,
- and many more.

Can we imagine a future when these businesses flourish, and Australia is amongst the top ten globally for productivity and innovation, brought about largely by much better SME access to capital, and that one result is that poverty is much lower than otherwise? I hope so.

Yours Faithfully,

Bill Ranken

My thanks to those who generously contributed ideas for this submission.