AMBITIONS FOR AUSTRALIA

FEBRUARY 2007

Ai Group's Submission to the 2007-08 Federal Budget

AUSTRALIAN INDUSTRY GROUP

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1. Executive Summary

The Australian economy has performed strongly over an extended period. GDP has grown for sixteen years in a row and unemployment has fallen to levels not seen since the 1970s. While these are notable achievements, Australia's economic growth performance has slowed markedly in the past two years even though non-rural commodity prices have risen very strongly. GDP expanded by just 2.7% in 2005-06 and 2.6% in 2004-05 compared with average annual growth of 3.6% in the first 13 years of the current economic expansion.

The lower rates of growth are associated with a distinct slowdown in the pace of productivity improvement; the limited capacity of existing infrastructure; the tightness of labour markets and sharp rises in key input costs. Notwithstanding the weakness in demand, particularly in New South Wales, South Australia and Victoria, these factors are also contributing to heightened concerns about inflation

Against this background, medium-term economic policy should be set to ward off further deterioration of performance and build a new phase of prosperity by improving productivity and workforce participation and by raising the capacity of the economy. The latter requires measures to encourage and facilitate business development, skills augmentation and investment in infrastructure.

Along with other arms of policy the 2007-08 Budget must be proactive in steering towards these objectives. At the same time it must avoid excessive fiscal stimulation that would add to the risk of a further drift upwards in the pace of inflation and interest rates.

Ai Group's policy priorities are framed to achieve this balance. They are tightly targeted measures aimed squarely at raising the capacity of the economy. Additional measures are put forward to accelerate progress in the more efficient use of energy and water and reduction of greenhouse gas emissions. In most cases these measures have already been put forward by Ai Group to be adopted in the Government's foreshadowed Industry Statement.

Policy Priority Areas

- Skills Augmentation
- Improved Infrastructure Planning and Development
- Business Development
    - Improving incentives for investment;
    - Building Australia's business capabilities;
    - Expanding innovative activity;
    - Reforming regulation;
    - Extending the Small Business OH&S Advisors Programme;
    - Extending the Employer Advisor Programme; and
    - Encouraging and facilitating trade and international investment.
- Introducing incentives for businesses to develop and adopt improvements in the management of water and energy use and to reduce emissions of greenhouse gases.

Superannuation and Personal Tax Change to Improve Saving and Workforce Participation

While the high rates of revenue growth evident over the past few years are not likely to be repeated, Ai Group expects collections to remain very strong in 2007-08. There is plenty of scope for measures to add to the Government's recent achievements in reducing the disincentives that inhibit saving and workforce participation.

In general, Ai Group supports returning funds to individuals rather than holding taxation at high levels and running high budget surpluses. Lower taxes improve incentives for investment, saving and workforce participation and increase the range of choices people face in making individual decisions about the allocation of resources.

We recognise the arguments behind the creation of the Future Fund and support the Commonwealth's move to cover its previously unfunded liabilities. Nevertheless in view of the substantial contributions already made, the objectives of the Future Fund will now be able to be met readily with modest annual contributions from this and future Budgets and we see no strong argument for asking current taxpayers to finance an unnecessary acceleration of this process.

At the same time Ai Group also recognises the importance of policy options that attenuate the risks of adding to inflationary and interest rate pressures.

Accordingly, in the circumstances of the 2007-08 Budget, Ai Group proposes balancing these objectives by giving precedence to measures that increase individuals' superannuation savings. These measures would not add to inflationary pressures and would improve the capacity of individuals to provide for their own retirement incomes thus reducing future requirements for budgetary support.

Ai Group proposes directing new changes to superannuation towards lower and middle income earners to complement the farsighted changes to the taxation of superannuation announced by the Government in the 2006-07 Budget. Consideration should be given to:

- Refunding into the superannuation accounts of low income people, the 15% tax paid on compulsory employer contributions;
- Adopting a similar measure that extends eligibility to middle income earners aged over 50; and
- Increasing the amounts available under the Superannuation Co-Contribution Scheme.

Further, subject to close assessment of the risks of adding to inflationary and interest rate pressures, the Government should introduce from 1 July 2007 further personal income tax reform by reducing the rate of tax on incomes between $25,000 and $30,000 to 15 percent (from the present level of 30%).

While additional relief from high rates of personal income taxation is desirable, the current risks to inflation may weigh against more comprehensive easing of personal income tax burdens at this time. Nevertheless, Ai Group proposes that the Government commit to the following targets for adoption as soon as practical:

- Reducing the rate of tax on incomes between $75,000 and $100,000 to 30 percent (from the present level of 40%);
- Taxing all income above $100,000 at no more than 40 percent (under the present scale income above $150,000 is taxed at 45%).

2. Economic Overview

Australia's economic growth performance has slowed markedly in the past two years. GDP expanded by just 2.7% in 2005-06 and 2.6% in 2004-05, and compared with average annual growth of 3.6% in the first 13 years of the current economic expansion.

The more recent moderation in growth also rests against the backdrop of an unprecedented rise in the terms of trade (and the accompanying positive 'demand shock'); generally neutral or accommodative macro-economic policy settings; record corporate profitability in aggregate; exceptionally strong growth in business investment and a large increase in employment and the size of the workforce (reflecting both strong net immigration and record levels of labour force participation).

Addressing the sources of this rather perplexing and disappointing performance, and preparing for an inevitable peak and decline in the terms of trade (although not necessarily to previous cyclical lows), must remain at the core of the Commonwealth's 2007-08 fiscal and economic strategy.

At one level, the relatively lacklustre performance reflects a prolonged period of household balance sheet consolidation, following the earlier spiral in housing prices and household borrowing. Much of this process of consolidation appears to have been concentrated in those states relatively sheltered from the large export-driven increases in incomes, and is associated with the slower segment of the so-called 'two-speed' economy. Indeed, the rise in the terms of trade, as well as underpinning the faster areas of Australia's polarised growth performance, has also provided an important cushion against the effects of subdued household spending growth.

At the same time, there are also important 'supply-side' aspects to the recent weakening in Australian GDP growth. Widespread shortages of labour, transport infrastructure bottlenecks, and the lengthy lags between commencement and completion of new investment projects, have all been material constraints on production growth.

The stark divergence between the rates of GDP and employment growth has also been reflected in deterioration in measured labour productivity growth. In the event this is primarily attributable to structural, rather than cyclical influences, a weaker labour productivity performance would also constrain potential GDP growth.

Both the demand and supply-side developments have contributed to a gradual intensification of inflationary pressures with the Reserve Bank of Australia lifting the official cash rate (and real short-term interest rates) to the highest level since 2000. However, there is growing evidence tighter monetary policy will have only limited impact on demand growth in the resource-rich states (where inflation is generally higher), as well as threatening a renewed round of household balance sheet consolidation across those states sheltered from strong income growth.

Along with the deepening impact of the drought (the last serious drought in 2002-03 was estimated to have directly subtracted ½ of a percentage point from GDP growth), and notwithstanding expectations of a strengthening in mineral resource export volume growth (as new capacity is increasingly brought online), there are growing reasons to believe GDP growth will remain below trend in 2006-07 and possibly in 2007-08.

A weakening in the terms of trade would increase the probability of a more prolonged period of weaker growth, unless accompanied by a significant depreciation of the exchange rate (although it is important to note the exchange rate has not appreciated commensurately with the rise in the terms of trade and therefore may not necessarily weaken in tandem with falling export prices). Such a scenario would represent some risk to current budget baseline forecasts.

Ai Group believes it is possible to provide the foundations of stronger GDP growth (and against the backdrop of a growing risk from a peaking in the terms of trade), without a further rise in inflation, by implementing policies to strengthen international competitiveness, productivity growth, and labour force participation. Previous budget initiatives illustrate the Commonwealth Government is already firmly moving in this direction. However, the 2007-08 Budget is a crucial opportunity to further strengthen this approach.

3. Skills Augmentation

Ai Group welcomes the recent $837 million *Skills for the Future* commitment to developing the national skill base. This commitment is a well-targeted and necessary set of strategies designed to lift the skills of Australia's working age population.

Ai Group has advocated the re-orientation of both the training system and funding mechanisms to meet the needs of business and industry to up-skill and re-skill existing workers. The Australian Government has taken an important first step.

Despite this bold step and new direction, there remains an on-going imperative to significantly lift the skill and educational attainment levels of the Australian population. Indeed, OECD data suggests that for every one year increase in the average level of education, a nation's GDP will increase by between 3 and 6 per cent.

While progress has been made in recent times with the average level of education in Australia generally rising, Australia is only ranked 18th out of thirty developed countries when comparing the proportion of GDP spent on education (5.8%). Clearly other developed countries are moving ahead of Australia. This is evidenced by the deterioration from Australia's previous ranking of 8th.

A major challenge facing Australia is to increase, in tandem, employment participation and education attainment levels. A significant increase in the national education and training effort will be required. This increased effort will need to become available to individuals throughout their working lives while particular attention should be placed on improving the training opportunities for people transitioning from welfare to work.

Data to support the call for the need to increase expenditure in education and training include:

- Access Economics projects that by 2025, the cost of the VET necessary to achieve the target scenario of no decline in overall employment participation will amount to $9.8bn in today's prices. This amounts to an extra $2.5bn over the projected cost of continuing past policies that can be expected to lead to a decline in employment participation.

- Access Economics projects that GDP in real terms would be 2% higher by 2010 and 12% higher by 2025, if employment and GDP rose as projected as a result of additional training. This in turn means that the overall cost of VET would then only rise slightly from 0.5% of GDP today to 0.6% of GDP in 2025.

- The Centre for the Economics of Education & Training (CEET), Monash University, has predicted a shortfall of 240,000 qualified people over the next decade if supply remains at its current level.

- CEET estimate that the resource base for VET will need to expand by 5 per cent per annum over the next decade to avoid the predicted shortfall in qualified people.

With these considerable challenges facing the Australian economy it is imperative that the national training system be strengthened. Industry must lead this strengthening. This should be managed through on-going commitment to the National Industry Skills Committee and support for and clarification of the role of Industry Skills Councils – the two remaining' industry-only' aspects of the national training system.

Ai Group proposes the following specific measures.

- An increase in expenditure on the delivery of VET programs, to be matched by the States and Territories to secure a 5% per annum expansion of expenditure in real terms of the national VET system over the next decade.

- A trial expansion of the Careers Advice Australia scheme to encompass adult career development and other transition services for workers beyond the 13-19 year old group. This pilot should focus on increasing workforce participation, particularly for mature-aged Australians of working age.

- A commitment of appropriate funding for the ten declared industry skills councils (subject to performance) to oversee the ongoing development and improvement of national training packages. The role of the ISCs should be extended to providing strategic advice and the development of product and service relating to lifting the skills of existing and older workers.

- An expansion of the *Skills for the Future* initiative to encompass the development of broader business capabilities (see further below).

In addition we propose that the Commonwealth Government should commission a new study into the development of Australian managers. The aim of the study should be to identify ways to improve management education and the development of leadership and management skills in Australia. Over the last two years management positions have grown faster than any others – faster than all other professionals, trades and associate professionals.

The proposed study would support this growth by identifying and sharing best practice in the latest in management thinking and education. This initiative would inform an important dimension of Ai Group's Business Capabilities proposal discussed further below.

4. Infrastructure Planning and Development

In recent years Australian governments have rediscovered the importance of maintaining and renewing infrastructure.

This follows a period of substantial neglect as emphasis was placed on reducing levels of general government debt and as attention was directed to budgetary cash positions and net borrowing requirements. In the main, progress on these fronts did not occur through strict discipline over the growth of real levels of recurrent expenditure. Rather, it occurred with the assistance of asset sales and alongside a decline in public sector infrastructure investment expenditure that was insufficiently matched by increased private sector involvement in its provision. In some cases it also occurred alongside a high degree of underspending by the public sector on infrastructure maintenance.

More recently, Local governments, States, Territories and the Commonwealth Government have moved to catch up on infrastructure investment – both through direct public sector investment and though a greater use of partnerships of various kinds with the private sector. While these are very welcome developments, they are constrained by the immediate capacity of the engineering construction sector which is also experiencing strong demand from the minerals sector.

While in Ai Group's view the infrastructure backlog remains substantial, the short-term limits to capacity inhibit an immediate commencement of new projects or further acceleration of existing projects. In the present environment such projects would add to the significant cost pressures being experienced in the construction sector.

That said there are very important improvements that can and should be made to the processes of infrastructure planning and development in Australia. A leading benefit of better planning and coordination lies in improving the signals sent to investors and infrastructure service providers to help ensure that adequate capacity is available to meet future requirements.

The Commonwealth Government should take the lead in encouraging all levels of government in Australia to coordinate in devising an effective forum for the medium to longer-term planning and development of infrastructure.

5. Business Development

a) Improving Incentives for Investment

Phasing a reduction in the company tax rate to 25%

As a key policy initiative to stimulate investment and improvements to business performance, Ai Group proposes a phased reduction in the rate of company tax to 25%. Ai Group proposes the phase down be completed by the 2011-12 year.

While the 30% company tax rate appears competitive by international standards, the comparatively broad base on which company tax is levied is a leading contributor to Australia's status as having one of the highest company tax to GDP ratios among OECD countries.

Ai Group's proposal would further improve the attractiveness of Australia's headline rate of tax on corporate income and would make significant inroads into the relatively heavy taxation of business income in Australia.

Ai Group favours a phased reduction in the company tax rate above the alternative of reducing the burden of taxation on business income through tax-base narrowing measures such as introducing accelerated depreciation.

- Many measures to narrow the tax base carry benefits related to the timing and not the quantity of tax paid. A reduction in the rate of company tax in contrast delivers a permanent benefit.

- A reduction in the company tax rate provides an incentive to improve profitability regardless of the source of that improvement. In contrast, tax-base narrowing measures generally improve incentives only for a restricted subset of activities. Thus incentives to undertake profitable investments in diverse areas such as management skills, organisational improvements and innovation may well be unaffected.

- Further, providing an incentive for a narrow class of activities can draw resources away from particular activities and industries. This will generally be to the detriment of aggregate improvements in productivity.

Expanding the scope of Invest Australia incentives

Ai Group also favours strengthening the role of Invest Australia to further directly support affiliates of foreign entities to retain and expand their investments in Australia.

b) Building Australia's Business Capabilities

"If we are going to up-skill our labour force, if we are going to innovate, if we are going to automate, if we are going to pursue overseas markets, then we need good management skills. People who are well trained. People with vision. People who know what they have got to do in the future to make manufacturing grow in this country."

Managing Director, engineering business, regional NSW

The *Business Capability Initiative* is a proposal by the Australian Industry Group to establish an industry advisory service. The aim of the initiative is to accelerate the development of business capabilities amongst Australian industry to achieve global fitness.

The proposal is to focus initially on the delivery of the initiative in the manufacturing sector, the sector that is currently under considerable pressure due to the twin forces of the terms of trade effects and intensification of international competition, particularly from China. Ai Group envisages that the initiative could be expanded to other sectors, tailored to their specific needs.

Ai Group's *Manufacturing Futures: Achieving Global Fitness* highlighted the objectives for building capacity through the creation of skills and capabilities, the generation of new knowledge and the dissemination of knowledge to become agile, flexible and responsive in an intensely competitive global marketplace.

The *Business Capability Initiative* draws upon the successful strategies already adopted through Enterprise Ireland, the United Kingdom Manufacturing Advisory Service, and the United States Manufacturing Extension Partnership. In addition, it includes the most successful strategies identified by industry for knowledge building and sharing to achieve world class capabilities.

The proposal is to provide industry organisations with the capacity to deliver strategic management advice to manufacturing firms of all size, across a range of business capabilities relevant to the needs of the particular firm. A diagnostic process on the whole of the firm will identify capability needs that meet business objectives. Advisors will work with companies to identify solutions to improve the operation of the business across the whole value chain.

The program will link manufacturers with outside advice and government programs (both Commonwealth and State) to address identified business growth strategies. Under the banner of the *Business Capability Initiative* the program could access a new voucher system for the delivery of workshops or training in areas of identified need through an expanded *Skills for the Future* initiative.

Further details are set out in the Appendix below.

Appendix

Design Features of Ai Group's Business Capability Proposal

Ai Group's Business Capability initiative is aimed at improving the skill sets brought to bear in the management and transformation of Australian businesses.

This Appendix sets out in some detail the proposals Ai Group has developed with specific reference to the manufacturing sector. The general shape of the program has the potential to add value across the economy and could be adapted for other industry sectors.

Products and services

For Australian manufacturing to have a strong future businesses need to have a strategic plan for growth. Ai Group's research conducted for *Manufacturing Futures* identified that one third of manufacturers had not identified new strategies to deal with intensified international competition in their markets. A large proportion of these were small businesses (those with less than 25 employees).

Ai Group's proposal is for industry organisations to competitively tender for the delivery of a capability advisory service to industry. The advisory network will work directly with an area or region's manufacturers, utilising existing relationships.

Industry associations will be contracted to support a network of *Business Capability Advisers*, drawn from industry with expertise across the range of manufacturing business practices associated with world-class firms.

Business Capability Advisers will be experienced management consultants to guide manufacturing firms through strategic planning and implementation from needs assessment, market analysis and strategic planning to organisational commitment, project implementation and management. They will develop business strategies suitable to their clients markets, customers, operations and organisation. Importantly, Advisers will assist manufacturers to apply world class business practices to execute their identified strategies and plans as well as measure the outcomes.

The strategy would be adapted to the particular firm needs. However, *Business Capability Advisers* would assist manufacturers to develop lean enterprise strategies and build capability in the following areas:

- Process improvement; e.g. lean manufacturing
- Tendering;
- Innovation strategies;
- Global sourcing and supply chain management;
- Transport and logistics;
- Marketing development;
- Environmental management; and,
- Skill development strategies.

Services will be delivered in a number of phases with deliverables required at each phase. These include:

Phase 1: Advisers will offer a free one-day diagnostic consultancy to small and medium sized manufacturers and subsidised diagnostic service to large employers. The deliverable under Phase 1 of the service will be the development of the business plan and a report on capability needs. This may range from process improvements, to workforce skill development strategies and business management practices.

Phase 2: *Business Capability Advisers* will provide a follow up service to manufacturers and offer solutions to identified capability needs by advising the business of available:

- specialised expertise from outside consultants (see specialist network below);
- government programs (Commonwealth and State), and,
- knowledge sharing activities of existing and newly established regional industry collaboration networks (see proposal below).

The deliverable under Phase 2 will be a report to the business outlining available support. It will also include introduction of the business to an existing or newly established network where this is required.

Phase 3: Phase 1 and 2 will assist Advisers to identify common capability needs of employers within an area or region. Advisers will then organise and deliver workshops to build capability (for example lean manufacturing). Individuals would be able to access the vouchers for capability development through an expanded *Skills for the Future Initiative* (see Skilling proposals) for delivery of this phase of the service.

Performance Measures

Evaluation of the *Business Capability Initiative* will be a key part of the program. The outcomes will be used to improve the level of service provided to clients and to identify key regional activities necessary to remove barriers to business capability development.

By measuring short-term and long-term impacts, economic returns on Commonwealth investment in business capability can be assessed. In taking the lead from the UK Manufacturing Advisory Service program, it is recommended that performance is measured by the total "added value" to manufacturers.

Advisory Group

The Business Capability Initiative would establish an Advisory Group to provide guidance and advice on the services delivered under the Business Capability Program. The Group would consist of representatives from the Australian and State Governments, industry and specialists in areas such as manufacturing, academia, and economic development.

The Advisory Group would represent the views and needs of all stakeholders on the strategies and services delivered by the Business Capability Initiative, including an assessment of performance of the program. In this capacity, the Advisory Group would provide feedback to the Australian Government on the value of public investment.

Regional and industry collaboration

Across Australia a number of regional and industry networks or clusters have developed to encourage capability development, identify opportunities for trade or new ventures. The *Business Capability Advisers* would link in with networks developed within their area or region with the aim of sharing the knowledge and benefits of advice to manufacturers locally. The network will provide the opportunity to show case the benefits of the program. It would also identify any barriers to business capability development and seek to establish local processes to overcome these barriers. The networks would seek to draw local expertise from across the range of areas covered under the *Business Capability Initiative* and link them for mutual benefit.

The proposal seeks to take networking to a new level by providing a national forum for networked groups in regions and areas to share knowledge, experience and world class practices. Formation of this national forum would also support a "Team Australia" approach to marketing the capability of Australian industry.

Network of specialist organisations

The Initiative would establish a network of specialist organisations identifying their various expertise in meeting capability needs. The services of these organisations would be drawn upon to deliver additional services (at the expense of the individual business) to supplement the support from the *Business Capability Advisers.*

Links with other government programs

The *Business Capability Initiative* is intended to work with already established programs offered by Australian and State Governments. For example, Ai Group sees that the initiative would work closely with customer service managers in both the AusIndustry and AusTrade Programs. It is envisaged that the initiative will lead to more successful outcomes for programs within other portfolios by identifying and addressing any capability issues that may inhibit success for the firm in achieving business objectives.

There are strong links between the *Business Capability Initiative* proposal and the *Skills for the Future Fund* announced by the Prime Minister in October 2006. BCI would provide a strategic approach to the identification of skill development needs within industry and allow for clustering of skill development needs among individuals to access training programs. We propose an expanded *Skills for the Future Fund* that takes into account the benefits of developing broader business capabilities.

Ai Group does see that over time the program may replace the Small Business Field Officers initiative, part of the Australian Government's Building Entrepreneurship in Small Business Program. This program is restricted to small business in regional locations covering all business sectors. This is in contrast to the *Business Capability Initiative* which is a targeted program delivering a more indepth approach to business capability within an industry sector. Ai Group does envisage that this targeted approach could be adopted across other industry sectors.

Business Capability Advisers would also work closely with State and Territory regional development agencies providing a forum of advice on industry needs. Where state programs exist to support capability, the advisory network would be able to link businesses to these programs. In this way, the initiative does not duplicate, but rather complements the various programs available at a state and national level.

c) Expanding Innovative Activity

Innovation is critical to the future development of the Australian economy. As the OECD has recently highlighted "new and improved products and services – and new and improved ways of producing them – have for a long time been the main motor of economic growth. It is thus important that society allows innovation to flourish."[1]

An important element in the comparatively higher rates of productivity growth in Australia over the past decade and a half has been the comparatively rapid growth of business R&D expenditure. As a recent report of the Productivity Commission illustrates, between 1981 and 2002 the ratio of expenditure by business on R&D to GDP rose by 262.5% in Australia. This compares with growth of 19.4% among the EU15.[2]

While the exceptional rate of growth in the ratio of BERD to GDP in Australia over this period occurred from a very low base, it should also be borne in mind that Australian GDP increased relatively rapidly in this period. Thus the rise in the ratio of BERD to GDP could understate the extent of the transformation of business practice in Australia over the past couple of decades.

The R&D tax concession is widely supported by industry. There is, however, concern that the low rate (125%) is no longer a sufficient incentive. The challenge for the Australian Government is to make the tax concession more effective so that Australian business R&D efforts continue to improve and Australia becomes a leader in business research and development. Ai Group believes this can be achieved by making two fundamental improvements.

A Step-Up Supplement to the 125% R&D Tax Concession

The first improvement is to supplement the R&D tax concession by incorporating an incentive-based dimension. We propose that 175% tax concession be replaced by a more generally available "Step-Up R&D Tax Concession" that provides an incremental improvement to the concession according to the change in the level of R&D spending by companies.

Implementation of the Ai Group proposal would reward companies for improvements in R&D expenditure, with the aim of significantly lifting overall expenditure on business R&D and promoting the entry of new companies into the R&D regime.

Ai Group envisages that the Step-Up R&D tax concession would operate in the following manner. A company would receive a higher tax concession for the incremental increase in R&D spent in one year relative to the average of the previous three years.

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[1] OECD, *Going for Growth 2006*, OECD 2006, p.56
[2] Productivity Commission, 2006 Draft Research Report on *Public Support for Science and Innovation*.

This would be on top of the base rate of 125% for R&D expenditure at or below the average of the previous three years[3]. Companies with an irregular history of expenditure (that is, where there is no or reduced expenditure in one or more of the three years) would only be entitled to the 125% tax concession, as under current arrangements, to encourage them to maintain existing levels of expenditure.

The incremental concession would step-up by the level of improvement achieved in that year. The new scheme would build on the present 175% incremental concession by applying to all additional expenditure, and not just the incremental expenditure on labour related R&D expenditure as currently applies under the 175% Premium R&D tax concession.

The incremental rates would be set in line with the following table:

Increase of current year's eligible expenditure over average of previous three years' eligible expenditure	Rate of concession to apply to the *increase* in eligible R&D expenditure
0% or less	125%
>0% to 5%	150%
>5% to 15%	175%
>15%	200%

All companies eligible for the current 125% concession would retain their entitlement to this rate of concession on their base level expenditure with the higher rate applying to the increased portion of their expenditure.

An example of how the proposed tax concession would work is the case of a company with an average expenditure of $1 million that spends an additional $200,000 (or 20%) in the following year. Under the current 125% R&D tax concession, the business would receive an after tax benefit of 7.5 cents for the additional R&D expenditure at the company level. Under Ai Group's Step-Up tax concession, the company would face an incentive of 30 cents in the dollar for its incremental expenditure (again at the company level). For this company the average benefit for the company would rise from 7.5 cents in the dollar to 11.25 cents in the dollar under the incremental scheme, an incentive to increase their R&D expenditure of $60,000 compared with the $15,000 incentive provided by the 125% concession.

The improved scheme would require adjustments to the R&D tax offset for companies with a turnover of less than $5 million that undertake up to $1 million in R&D. This could be done at a relatively small additional cost.

[3] This is different from the current Premium 175% tax concession, where eligible expenditure is calculated on the basis of the average incremental increase for the previous three years. To be eligible there must be an incremental increase in eligible R & D expenditure in each of the previous three years.

Removing the Clawback of the R&D Tax Concession

The second improvement to the present tax concession proposed by Ai Group aims to address the situation whereby, for most companies, the effectiveness of the current R&D tax concession is substantially eroded by the workings of Australia's imputation system.

Companies eligible to receive the R&D tax concession pay less company tax. However, they also do not accumulate franking credits in respect of the saving in company tax. The shortfall in franking credits implies a higher level of tax paid by shareholders on dividends received. For many companies, the saving in company tax due to the R&D tax concession is exactly offset by the higher level of tax paid by shareholders on unfranked dividends.

In order to remedy this situation, Ai Group proposes that companies be allowed to credit their franking accounts by the amount of company tax saved as a result of the R&D tax concession.

d) Reforming Regulation

The objective of reducing the burden of business regulation has been embraced by all levels of government and is a feature of the recent statements of shared intentions made by the Council of Australian Governments (COAG). In addition several governments have separately committed, or have announced their intention to commit to potentially substantial reform programs.

Three particularly encouraging developments are:

- The Victorian Government's commitment in *Reducing the Regulatory Burden* to reduce the administrative burden of business regulation by 15% over the next three years and by 25% over the next five years. The Victorian Government's preliminary estimates are that if its targets are achieved, administrative costs imposed on business would fall by around $500 million per year after three years and by over $800 million per year after five years.

- The Commonwealth Government's initiative in asking the Productivity Commission to develop quantitative and qualitative performance indicators and framework options for ongoing assessment and comparison of regulatory regimes across all levels of government. Subject to consideration by COAG, this initiative is to be followed up by the application and ongoing assessment of the indicators.

- The Commonwealth Government's commitment in its full response (on 15 August 2006) to the report of the Taskforce on Reducing the Regulatory Burden on Business, Rethinking Regulation, to adopt a range of measures to address the underlying causes of over-regulation. This includes its endorsement of the following regulatory principles:
  – Establishing the case for regulatory action;
  – Examining the alternatives to regulation;
  – Adopting the option that generates the greatest net benefit to the community;
  – Providing effective guidance to relevant regulators and affected stakeholders;
  – Reviewing regularly to ensure the regulation remains relevant and effective; and,
  – Consulting effectively with stakeholders at all stages of the regulatory cycle.

While these steps, along with other promising developments are only the beginning of the process of systematically reducing regulatory costs, they have the potential to produce demonstrable and on-going benefits for business and the broader community.

Ai Group urges governments at all levels to continue to implement reforms that will reduce regulatory burdens and improve the effectiveness of regulation. Two fundamental elements of this are the measurement of burdens (and the refinement of these measures over time) and clear commitments to reduce these burdens. The Commonwealth Government in particular should take the lead in adopting clear targets for reducing regulatory burdens.

e) Extending the Small Business OH&S Advisors Programme

In October 2005, the Hon. Kevin Andrews MP, Minister for Employment and Workplace Relations, launched the Small Business OHS Advisers Programme – an initiative of the Australian Government, delivered by Australian Industry Group.

In subsequent months 26 Advisers were recruited, marketing and promotion commenced and the programme gained momentum.

The programme, which combines seminar attendance with on-site assistance, is designed to build the skills and knowledge of business owners and managers to enable them to manage OH&S into the future.

By the end of October 2006, more than 3,500 businesses had registered their interest in the programme, with 1,550 having commenced active participation. Our target is to deliver services to 4,400 by the time funding expires on 30 June 2007.

Feedback from the programme has been very positive, and a media release by the Minister in October stated "Feedback from the programme is extremely positive and show that Ai Group is delivering a professional but more importantly, a practical and useful workplace safety programme that is benefiting Australian small business".

Ai Group proposes that this program be extended to further improve the occupational health and safety knowledge and practices of small businesses.

f) Extending the Workplace Reform Employer Advisor Programme

The Employer Advisor Programme (EAP) is a national network of industry-based advisors across Australia.

The objective of the EAP is to provide information and to assist in the implementation of the workplace relations reforms. The EAP draws on the extensive knowledge of grassroots organisations such as Ai Group to inform employers and employees of the specific application of WorkChoices.

Ai Group's contact with the Australian business community suggests very strongly that many businesses remain relatively uninformed about these significant changes to the regulation of workplace relations. This not only raises the risks of non-compliance it also suggests an under-realisation of the potential improvements to flexibility and productivity that the new regime is aimed at stimulating.

Ai Group proposes building on the achievements of the Employer Advisor Programme by extending it for a further year.

g) Encouraging and Facilitating International Engagement

As an open, medium-sized economy, Australia's economic success relies on its ability to contribute to and draw from global economic development. Policy needs to encourage and facilitate trade links; the easy movement of personnel supporting international engagement; immigration – particularly skilled immigration; and international investment.

Facilitating Trade Links

A sustainable strengthening of Australia's export performance is critical if Australian industry is to maintain global competitiveness. The Australian Government must set in place policy settings and programs to strengthen Australian exports and to continue to seek a more equitable trading environment for Australian goods and services.

Australia is already among the most open economies in the world, with low average tariffs and virtually no non-tariff barriers. This is stark contrast to many of our trading partners, including some of the key developed economies, which still maintain high tariff and other barriers to open trade in some sectors. Australia has to continue to pursue vigorously market access opportunities for Australian companies through multilateral, regional (such as APEC) and bilateral trade facilitation and liberalisation mechanisms. These efforts must address tariff and non-tariff barriers, and also seek to liberalise the services sector and investment.

The stalling of the current Doha Round of World Trade Organization negotiations in the middle of 2006 is leading to an increased emphasis on regional and bilateral preferential trading agreements. These are important tools for achieving market access in the short to medium term, particularly as prospects for the conclusion of a global trade round in the next few years have dimmed.

While maintaining its efforts to revive the momentum of WTO negotiations, Australia should continue to examine the potential for future preferential trade agreements with important trading partners. Australia should also take the opportunity presented by its hosting of the Asia Pacific Economic Cooperation forum in 2007 to revitalise regional efforts in trade liberalisation and business facilitation.

Export Promotion and Facilitation

The Export Market Development Grants (EMDG) Scheme is the key Federal Government Program for promoting exports by Australian companies, including SMEs. Despite this, for more than a decade the real value of funding for the program has been generally decreasing, with this trend being accompanied by a narrowing of the eligibility criteria applied to companies seeking to utilise the Scheme. Ai Group recommends that annual funding for the Scheme be increased to $300 million, and that steps be taken to substantially widen its eligibility criteria in order to improve access to the Scheme for both potential and existing exporters.

The EMDG Scheme should be complemented by targeted efforts to assist Australian companies to begin exporting and to develop new export markets. It is recommended that Austrade's *TradeStart* program, which assists companies to begin exporting, be augmented with a new program designed to fund specialists placed in either industry organisations or in strategic off-shore locations. These specialists would focus on key sectors and seek to capitalise on FTA or other treaty arrangements, or pursue special project activities, as well as government procurement opportunities.

Access to sufficient credit for export remains a concern for growing SMEs. The Australian Government should continue to support and as appropriate, strengthen programs such as the Export Finance and Insurance Corporation's *Headway* program, designed to assist growing SMEs to access working capital for exporting.

Anti-Dumping

Australian companies competing with imported goods need to have effective recourse to mechanisms to address unfair practices by overseas competitors. Australia should ensure that it has an effective and rigorous anti-dumping regime, consistent with the World Trade Organisation's Anti-Dumping Agreement. Australia's anti-dumping system, through ensuring transparency in its processes and consistency in its application, needs to be easily accessible to industry, especially SMEs, and must reflect a realistic commercial application of injury.

The recent decision by the Government following the Joint Ministerial Review of Anti-Dumping Administration has shown real progress in meeting these objectives.

Government Procurement

Government procurement is a substantial market across the world. For example, it is estimated that the US Government alone spends about $200 billion each year on goods and services. The Federal Government should seek, through its trade policy and trade facilitation programs, to maximise opportunities for Australian companies to access overseas government procurement markets.

The Movement of Skilled Labour

Australian industry's growing integration with the global economy is not restricted to trade. Australian companies are integrating with global production supply chains and are investing substantially in offshore markets. These changes need to be facilitated by efforts to assist the flow of skilled and managerial labour. Improved visa arrangements to ensure access to foreign markets by Australian skilled and managerial workers should be pursued.

Australia's skilled migration program should be expanded to assist the growth of Australia's skills base in support of domestic measures to address skill shortages.

Ai Group welcomes Federal Government initiatives in this regard, notably the strengthening and streamlining of the Category 457 employer-sponsored visas and the placement of DIMA officials in industry associations.

- The two officers outposted to Ai Group have provided immigration information and advice to in excess of 2,000 companies and they have assisted several hundred Ai Group members gain access to overseas skilled tradespersons with sponsors from the construction, manufacturing and mining sectors. These efforts have accounted for some 26% of primary visa grants for the year ending 30 June 2006. This represents an 83% increase for these sectors from the previous year. It is estimated that over one thousand visas have been granted to Ai Group member companies since the outposted officers commenced their placement in 2005.

Ai Group welcomes the Government's recent announcement to extend this highly successful outposted immigration officer program.

Removing Impediments to Offshore Investment

Ai Group recommends that the Australian Government adopt the Board of Taxation's recommendations to remove tax barriers to offshore expansion by Australian companies. These barriers effectively penalise Australian companies who invest abroad because dividends paid to domestic shareholders from foreign source income are taxed twice whereas the Australian imputation system relieves shareholders from company tax paid on Australian profits.

Removing this distortion would address a significant barrier to what, for a growing number of Australian companies, is a vital avenue of global engagement. For an Australian company with high growth potential from offshore investments, a failure to address this bias against offshore expansion from an Australian base would create pressures to relocate to another country.

6. Improving Water and Energy Efficiency and Reducing Greenhouse Gas Emissions

Improving the efficiency of water and energy use of the business sector is a central element in addressing the leading environmental challenges of water and greenhouse gas emissions.

While business does face private incentives to improve water and energy efficiency, in general these do not match the full social benefits to be derived from additional efficiency-improving measures in these areas.

For the 2007-08 Budget Ai Group proposes the adoption of measures to encourage businesses to develop and implement measures to improve their energy and water use and to reduce greenhouse gas emissions.

Improved information

The Commonwealth Government should work closely with the States and Territories and with industry to develop and distribute industry-specific information on emerging developments and current practices in the reduction of water and energy use.

Incentives to reduce water and energy use

Business should be encouraged with a structured set of incentives to increase the efficiency of the use of these scarce resources. While the full details of measures require further development, Ai Group proposes that the following principles guide the design and implementation of the measures.

- The incentives should be targeted to achieve additional water and energy savings. They should apply to new reductions in water and energy intensity beyond the levels recorded in a base year.
- The incentives should be available regardless of the structure of business ownership so that businesses operating as companies, partnerships, joint ventures or as sole traders would be equally eligible.
- Measures should be designed to keep additional compliance and administrative costs as low as possible.

7. Changes to Superannuation and Personal Taxation to Improve Saving and Workforce Participation

While the compounding growth of income tax receipts (most notably from company taxation) evident in recent years is expected to ease in 2007-08, revenues will still be very healthy and there is no question that the Government could afford to adopt the policy priorities advocated by Ai Group.

At the same time, in an environment of considerable concern over inflation, there may be substantial risks associated with large-scale personal income tax cuts and/or significant boosts to recurrent expenditure that would materially add to inflationary pressures.

Ai Group's proposals discussed to this point are not likely to add noticeably to near-term inflationary pressures and indeed, over the medium to longer-terms, would reduce inflationary pressures due to their positive impacts on productive capacity.

The more serious questions about inflationary pressures are posed by election-year pressures to deliver significant personal income tax reductions and increases in income support payments.

Changes to Superannuation

One way to address inflationary concerns is to target changes to income tax and income support to deliver benefits through the superannuation system. Ai Group supports a balancing of the farsighted changes to superannuation announced in the 2006-07 Budget with new measures that would target benefits to low and middle income earners.

Consideration should be given to:

- Refunding into the superannuation accounts of low income people, the 15% tax paid on compulsory employer contributions;
- Extending eligibility for this tax relief measure to middle-income people aged 50 and above in recognition of the anticipated inadequacy of superannuation-based retirement incomes for people of this age group; and
- Increasing the amounts available under the Superannuation Co-Contribution Scheme.

These measures would not contribute materially to inflationary pressures.

Personal Income Tax

Subject to assessment at the time of the Budget of their being low risks of adding to inflationary pressures, Ai Group proposes raising the threshold at which the 30% tax rate applies to $30,000 (from its present level of $25,000).

- While this will only deliver a moderate income tax cut of about $14.50 per week for taxpayers earning $30,000 a year and above, it will provide some compensation for the impacts of fiscal drag over 2006-07; and will further address work disincentives faced by many low to middle income families by reducing effective marginal tax rates from their present level of 50% to 35%.

Ai Group also supports further changes to income tax scales with the top rate of 45% remaining a barrier to saving and investment and the efficient conduct of commercial activity. Reducing this rate to 40% and extending the 30% bracket to $100,000 (from its current level of $75,000) should be adopted as medium term-measures in line with Ai Group's proposal to phase a reduction of the company tax rate to 25%.

At this stage Ai Group assesses that introducing these additional income tax reductions in the 2007-08 Budget would add to the risk of inflationary pressures unless almost totally funded by reductions in recurrent government expenditure. Accordingly, Ai Group proposes that these measures be announced for introduction as medium-term targets.

Current and Target Income Tax Scale for Adoption over the Medium Term

Current Scale			Target Scale*		
Tax thresholds ($)		Tax rate (%)	Tax thresholds ($)		Tax rate (%)
0	6,000	0	0	6,000	0
6,001	25,000	15	6,001	30,000	15
25,001	75,000	30	30,001	100,000	30
75,001	150,000	40	100,001	+	40
150,001	+	45			

* Additional changes should be made to the Low Income tax Offset to raise the level of tax relief available for people earning below $30,000.

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