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About Australian Industry Group

The Australian Industry Group (Ai Group) is a peak industry association in Australia which along with its affiliates represents the interests of more than 60,000 businesses in an expanding range of sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other industries. The businesses which we represent employ more than one million people. Ai Group members operate small, medium and large businesses across a range of industries. Ai Group is closely affiliated with more than 50 other employer groups in Australia alone and directly manages a number of those organisations.

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1. Summary and Recommendations

While trade is an important component of global growth, recent events in the USA and UK have brought to light the negative impact of globalization and economic structural changes on segments of their respective populations. Similar demographics can also be found in Australia. DFAT’s response to these events should be to improve the agility of Australian foreign and trade policy and Australian businesses to ensure that we can survive future global disruptions.

If we believe in the economic and political value of an open and connected economy, we should welcome the opportunity to defend these principles and be a global advocate for the benefits of Trade. However, we also need to ensure that our companies are competing on a level playing field and be actively defending their interests when our trading partners increase their protectionist activities.

We are signing Free Trade Agreements today that are setting trade rules for technology that hasn’t been invented yet.

Against this background, Ai Group’s policy recommendations for the 2017 DFAT White Paper are:

- Create an inclusive Australian brand for all trade activity
- Implement a development agenda that improves the governance and administration capabilities of economies in our region
- Use the tools and mechanisms available under various international agreements to defend the economic interests of Australian companies.
- Encourage and support Australian Global Value Chains
- Develop internal capabilities to ensure Australia’s digital interests are protected
- Support industry development programs that will position Australian businesses to thrive in an uncertain global environment.

**Underlying values of the Australian Government International Strategy recommended**

- Support a domestic and international business environment where those that can - do.
- Don’t leave those who can’t behind.
2. The Economic Context

Ai Group’s latest annual CEO survey indicates that Australian CEOs’ outlook for 2017 is cautiously optimistic. Australian business is far from exuberant, with expectations tempered by the failure of actual business conditions in 2016 to live up to the expectations of a year earlier (and a similar experience of disappointingly slow growth in 2015). In many respects the mantra of ‘slower for longer’ has become the accepted outlook for both the global and domestic economies and is now built into the expectations of much of the local business community.

On the positive side, many of the foundations of domestic growth are in place. These include low interest rates; low wage and inflationary pressures; relatively low unemployment (albeit with weak jobs growth); a domestic currency trading in a more comfortable range than a few years ago; stronger commodity prices and, importantly, a recovery in real national incomes.

The Federal Budget must be mindful of this fragile and fragmented context. New opportunities are emerging, but significant risks abound, from both international and domestic sources. Among a raft of social, demographic, economic, political and technological trends, key economic risks for Australia in 2017 include (but are not limited to): slow global growth; volatile commodity cycles and prices; foreign exchange volatility; financial market volatility; household debt levels; low business confidence and investment; low jobs and incomes growth; and the housing construction cycle. These risks demand a careful approach to fiscal policy.

2.1 Global economic growth: slower and lower for longer

In its latest assessment of the global economy\(^1\), the International Monetary Fund (IMF) says that global output and trade growth is still ‘moving sideways’ rather than improving. The IMF estimates that global growth slowed to 3.1% p.a. in 2016, which was well below 3.4% expected at the beginning of 2016 and the slowest year for global growth since 2009 (see Table 1). Global growth will recover to 3.4% in 2017 (previously expected to be 3.6% one year earlier) and 3.6% in 2018.

This latest in a long series of growth downgrades reflects a more subdued outlook for advanced economies following the UK vote to leave the EU (Brexit) and a weaker economic recovery in the US in 2016 than had been expected. The IMF expects growth of just 1.5% p.a. in the UK in 2017 and 1.6% in the EU, with persistent weakness exacerbated by the Brexit vote. In the US, the growth outlook is downgraded and the risk profile is heightened by 2016’s Presidential election result. In October, the IMF noted that continuing subdued conditions across the larger developed economies ‘may fuel further political discontent’ and ‘protectionist sentiment’ more widely.

More positively for Australia, the IMF remains optimistic about China in 2017 and 2018, following new domestic policy supports and firmer commodity prices. It says that emerging Asian economies

\(^1\) IMF January 2017, World Economic Outlook, www.imf.org/external/pubs/ft/weo/2016/02/
and India are also showing more robust growth, while Japan (Australia’s second largest trade partner) is expected to grow by 0.8% in 2017 and 0.5% in 2018, instead of shrinking further.

### Table 1: IMF estimates and projections for Global Growth, Jan 2016 and Jan 2017

<table>
<thead>
<tr>
<th>Change in GDP, % p.a.</th>
<th>IMF in Jan 2016</th>
<th>IMF in Jan 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>3.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Advanced economies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>1.9</td>
<td>2.1</td>
</tr>
<tr>
<td>Euro area</td>
<td>1.5</td>
<td>1.7</td>
</tr>
<tr>
<td>UK</td>
<td>2.2</td>
<td>2.2</td>
</tr>
<tr>
<td>Japan</td>
<td>0.6</td>
<td>1.0</td>
</tr>
<tr>
<td>Emerging / developing economies</td>
<td>4.0</td>
<td>4.3</td>
</tr>
<tr>
<td>China</td>
<td>6.9</td>
<td>6.3</td>
</tr>
<tr>
<td>India</td>
<td>7.3</td>
<td>7.5</td>
</tr>
<tr>
<td>ASEAN-5</td>
<td>4.7</td>
<td>4.8</td>
</tr>
</tbody>
</table>

Sources: IMF, World Economic Outlook, January 2016 and January 2017.

#### 2.3 Key global risks in 2017: commodity prices and exchange rates

One of the key global risks to the Australian economy and the Australian dollar is always the commodity cycle and commodity prices. Higher commodity demand and prices (especially for iron ore and coal) add to Australia’s national income, but they also tend to push up the Australian dollar, which makes other exports less competitive and reduces the competitiveness of domestic producers vying against imports for local market share.

### Chart 1: AUD-USD, commodity price index and terms of trade, to Dec 2016

Sources: RBA, ABS.
This dynamic was evident again through 2016, with strong rises in ore and especially coal prices. The RBA’s bulk commodities index rose by 15.6% m/m in November, to be 61.9% higher than a year earlier. This helped push the Australian dollar above US0.75 by October from US0.70 cents in 2015. It ended the year lower, largely due to a stronger US dollar in recent months (see chart 5).

The Australian dollar is also closely influenced by international market movements and especially by Australian-US interest rate differentials, as global investors seek out the best returns and the lowest risks. In mid-December 2016, the US Federal Reserve lifted its benchmark interest rate by 25 basis points to a range of 0.50% to 0.75%. This is only the Fed’s second interest rate hike since the GFC. It was enabled by stronger US labour market and inflation expectations. Importantly, it may signal an end to an unprecedented period of record low interest rates (near zero) for the US.

The Fed said it intends to raise rates a further three times in 2017, provided the US economy continues to strengthen. If it does so, this would further strengthen the US dollar (USD) against the Australian dollar (AUD) in 2017, since the difference between US and Australian interest rates (a key factor for the AUD-USD exchange rate) will reduce. This would help to counter the influence on the AUD of resurgent non-farm commodity prices, which had been pushing the AUD higher in 2016, compared to its recent trough of 70 US cents in Sep 2015 (see chart x). At 72 US cents in December, the AUD ended 2016 comfortably under its long-term average of 75 US cents.

The lower Australian dollar and Australian businesses’ active responses to it have played a significant role in the improvement of business conditions and optimism in 2015 and 2016 compared to earlier years. Ai Group research\(^2\) confirms that although there is no hard and fast rule about which level of the Australian dollar best supports manufactured goods exports, the history of the Australian PMI\(^6\) since around 2004 suggests a TWI value of around 70 points or under (approximately equal to a dollar value of around 75 US cents or under) is a reasonable benchmark at which manufactured goods exports begin to expand (see Chart 6). This relationship is not automatic or immediate however, as many other factors affect performance and competitiveness.

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2.4 Key local risks in 2017: weak business confidence and investment

Ai Group’s annual ‘Business Prospects’ survey of Australian CEOs shows that the majority of CEOs expect general business conditions and their own business performance to be stable or better in 2017 than the actual conditions they experienced in 2016. However, compared with their expectations one year earlier, CEOs are more pessimistic about 2017 than they were about 2016.

This suggests a moderation in expectations in light of recent experiences and trends. The ‘slower growth for longer’ forecasts for Australian and global economies by the RBA, OECD, IMF and others appear to have become normalized across much of the Australian business community.

Just one third (33%) of CEOs expect to see an improvement in business conditions in 2017. This is somewhat lower than the proportion of CEOs who had expected better conditions for 2016 (39%), but well up from only a quarter who had expected better conditions in 2015 and 2014 (see chart 7).

Around half of CEOs expect their own sales revenue to improve and 42% expect their profitability to improve in 2017. For business investment and employment, modest rises or no changes are planned by the majority of CEOs for 2017. Input prices are expected to rise for 38% of businesses in 2017 and a whopping 51% expect their energy costs to rise. Around 36% will attempt to recover their costs in selling prices while 10.6% are planning a price cut.

Chart 3: CEO’s expectations for key business indicators, 2013 to 2017

This weak business optimism - reflecting weak profitability and weak risk appetite - is contributing to the continuation of flat business investment across the economy, despite record low interest rates. This lack of investment has been in contrast to the local housing investment cycle, which peaked in 2016 but was already waning by the end of the year. This indicates that loose monetary policy is helpful but not sufficient to kick-start Australia’s business investment cycle back into gear.
Confirming these widespread expectations of another slow year in 2017, business capital expenditure (CAPEX) dipped by a further 4% in Q3 2016, to be 13.7% lower than a year earlier. For the non-mining industries, a long-awaited pickup in CAPEX is proving elusive. Manufacturing CAPEX fell a further 4.9% q/q in Q3, while other non-mining industries’ CAPEX fell 1.9% q/q, but were still up 6.4% up on a year earlier. Across the states, CAPEX fell in Q3 in all states except Victoria and Queensland. It was higher in Q3 than a year earlier in only NSW and Victoria.

Of even greater concern to the outlook, after adjusting for typical realisations of investment (applying a ‘realisation ratio’), the latest (fourth) estimate of CAPEX for 2016-17 implies a drop of around 19% in 2016-17 compared to 2015-16 (see table 2). This includes a further fall of 34% in annual mining CAPEX in 2016-17. Manufacturing CAPEX is expected to fall by a further 1%, its smallest annual fall since 2011 (when it increased CAPEX by 7%). All of the fall in manufacturing CAPEX is expected to be in spending on buildings, with spending on plant and equipment remaining stable or even increasing a touch. For other industries, CAPEX could fall by a similarly modest 1.5% p.a. in 2016-17, with most of this coming through in equipment.

Table 2: Actual and expected annual nominal CAPEX, by type and industry

<table>
<thead>
<tr>
<th>Nominal annual CAPEX</th>
<th>2014-15 (actual)</th>
<th>2015-16 (actual)</th>
<th>2016-17 (estimate 4)*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$mn</td>
<td>% p.a.</td>
<td>$mn</td>
</tr>
<tr>
<td>Mining</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings and structures</td>
<td>67,622</td>
<td>-16.5</td>
<td>47,560</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>8,495</td>
<td>-10.0</td>
<td>5,892</td>
</tr>
<tr>
<td>All mining</td>
<td>76,117</td>
<td>-15.8</td>
<td>53,452</td>
</tr>
<tr>
<td>Manufacturing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings and structures</td>
<td>2,483</td>
<td>-7.4</td>
<td>1,945</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>6,145</td>
<td>-6.2</td>
<td>6,562</td>
</tr>
<tr>
<td>All manufacturing</td>
<td>8,628</td>
<td>-6.5</td>
<td>8,507</td>
</tr>
<tr>
<td>Other selected industries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings and structures</td>
<td>27,625</td>
<td>19.2</td>
<td>27,727</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>38,286</td>
<td>8.9</td>
<td>37,768</td>
</tr>
<tr>
<td>All 'other selected industries'</td>
<td>65,910</td>
<td>13.0</td>
<td>65,496</td>
</tr>
<tr>
<td>All buildings and structures</td>
<td>97,729</td>
<td>-8.5</td>
<td>77,232</td>
</tr>
<tr>
<td>All plant and equipment</td>
<td>52,925</td>
<td>3.5</td>
<td>50,223</td>
</tr>
<tr>
<td>ALL CAPEX</td>
<td>150,655</td>
<td>-4.6</td>
<td>127,455</td>
</tr>
</tbody>
</table>

* five year average realisation ratio applied.

Source: ABS, CAPEX, Sep 2016.
3. Australia’s Engagement with the World.

As a mid-sized economy Australia needs a comprehensive engagement strategy with the world; to build economic and security alliances and to work towards a positive global environment that supports the efforts of our businesses and citizens as they operate in a dynamic and connected world. The basic building block of this engagement is the image that “Team Australia” presents to the world. DFAT is one of many Federal and State Agencies that represents Australian interests and messages to the world. This leads to fragmented messaging which compromises DFAT’s ability to project a positive image of Australia as a preferred destination for business, investment, tourism and study. Currently, Australia has different national brands for each of these elements of trade, which are also competing with State and sub-regional agencies’ individual brands for attention in a loud and crowded market place.


As we compete to attract the attention of an increasingly sophisticated consumer we risk losing ground to those countries who have the will and the discipline to present a united brand to the world.

Recommendations

• Invest in the development of a national brand strategy that is inclusive of business, investment, tourism and study.

• Make the use of the brand mandatory for any agency receiving Federal funds and operating internationally.

• Implement the strategy effectively to increase the value and desirability of the brand, encouraging State agencies, industry associations and Australian businesses to use the brand, subject to conditions.

3.1 Aid Supporting Trade

While other countries take a transactional view to Foreign Aid; building infrastructure that requires the purchase of materials and expertise from the donor country, Australia focuses on capacity building that will make a material difference to transforming the recipient’s economy. Ai Group understands and supports this view, however we ask that priority be given to industries that match Australia’s economic interests. This will assist in removing the behind the border barriers that limit the success of Australian exporters and prevent developing economies from reaching their potential.

Priority areas for training and capacity building:
4. Defending Rules and Values

Australia prides itself in being an open economy and Australian companies are meeting the challenge of increased competition by improving productivity, investing in product development and expanding into international markets. However, our commitment to these rules must extend to ensuring that the markets in which our companies trade use the same rules. Australia’s participation in WTO disputes is low in comparison to similar sized economies. We are only responsible for initiating 1% of disputes, the average for comparable WTO members is 3% and we have not initiated a case since 2003, meanwhile non-tariff barriers continue to restrict Australian exporters’ access into new and existing markets. Confidence in Free Trade Agreements and the WTO would rise if Australia’s economic interests were defended. This requires adequate resourcing of DFAT to initiate and join disputes. Australia has completed a number of high profile trade agreements, and is continuing to negotiate agreements with important trading partners. Now work is needed to ensure that Australian companies are in a position fully engage with the opportunities available to them.

Ai Group welcomed the commitment in the 2015-16 Budget to boosting FTA awareness among Australian businesses. Another important element in the success of converting opportunities from free trade agreements into commercial outcomes is the role of Austrade as well as State trade agency staff operating in market and advising companies in Australia. Such commitments are expensive and resource-intensive, but the significant investment by the Government has made in negotiating these agreements – $350 million according to the Productivity Commission Report into Bilateral and Regional Trade Agreements – warrants a significant investment post implementation to ensure that Australian companies benefit from the gains secured by DFAT. Austrade and State

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**Magic Mobility** — designs, builds and repairs electric wheelchairs in Victoria. They employ over 20 people skilled in engineering, fabrication and technology, as well as supporting a local supplier network. Their export sales to the US were suddenly threatened by changes to US regulations on medical equipment standards testing and they approached Ai Group for assistance. Ai Group worked with DFAT to successfully reverse this decision and Magic Mobility were able to continue having their machines compliance tested in Australia. The value of this action by DFAT is not restricted to Magic Mobility. The true value is the potential protection of Australia’s access to the largest medical technology market in the world. Australia exported roughly US$69.7 million in instruments to the US in 2015, making it the second largest destination of Australian medical devices following New Zealand (Source: TradeMap, 2016).
Government staff assisting companies in these markets need to be trained in the rules of all agreements and the new opportunities that free trade can offer Australian companies. They also need access to appropriate tools to assist them in educating their clients and stakeholders. These needs extend to both onshore and offshore staff. Importantly, they should also be given instructions on the protected rights of Australian companies and the mechanisms for review if unsuccessful. Given the high turnover of staff in these areas this training should occur every three years and include other agreements that complement the training.

**Recommendations**

- Ensure DFAT has sufficient funds to become more proactive in promoting compliance among our competitors and trading partners in the rules of WTO and relevant FTAs
- Conduct outreach activities among Australian exporters and investors to ensure that they understand their rights under Australia’s international agreements and provide a contact point for companies facing non-tariff barriers.

**5. Encouraging Global Value Chains**

Global Value Chains (GVCs) are at the heart of modern trade, with 75% of trade consisting of intermediate goods and services. While Austrade has a strategy to encourage greater Australian participation in GVCs, there is little support for companies looking to build an Australian centric GVC. Participation in GVCs contributes to a country’s investment attractiveness and means that economies are more interconnected and can specialize in specific activities rather than industries.

As a significant exporter of mineral products, Australia’s role in GVCs can look high, however the GVC export participation rate among Australian manufacturer is among the lowest in the OECD. What is missing in the Australian trade narrative is the important role that imports and overseas investment can have on improving competitiveness and gaining control of GVCs. While successive Government policies have reduced Australia’s tariffs, improving access to the Australian market for imports, we do very little to support Australian companies who wish to invest offshore to take ownership of their supply chains. Time and distance are contributing factors to GVC participation that do not work in Australia’s favour and Australian companies must expand their footprint closer to their customers and suppliers. Support for companies setting up offshore manufacturing or distribution facilities is limited as most trade services are focused on transactional exports.

Multilateral Free Trade Agreements that have modern and comprehensive rules of origin and cumulation rules provide the architecture that supports GVCs. More effort should be spent on explaining the benefits of these agreements to exporters and outbound investors as well as defending their interests if members are not compliant with the terms of the FTA.

The Australian Trusted Trader Scheme was a welcome initiative that will ensure that Australian exporters and importers who already comply with the rules can focus their attention on building their businesses rather than being caught in a web of red tape. With our major trading partners already employing such a scheme, Australian companies can now realise the productivity gains across their supply chain that their competitors already enjoy. The Program that has been
deployed is a good example of government working with industry to design a regime that is both business friendly and meets government compliance requirements. Priority should now be given to negotiating Mutual Recognition Arrangements with our key GVC trading partners such as China, Japan and the US.

**B&R Enclosures** is a family owned advanced manufacturer of electrical enclosures with a 60-year history. Establishing a facility in China in 2011 to manufacture their commodity products allowed their Australian operations to focus on high value products and design and innovation. This strategy provided the critical mass that allowed them to focus on growth markets in Australia and overseas and was so successful that it gave them the confidence to establish a joint venture in Saudi Arabia and a distribution centre in Malaysia, taking advantage of the benefits of AANZFTA. Both the operations are showing positive effects on brand exposure and increasing reach in market due to being in the market place and provides possible expansion on partners and distributors. This strategy supports the growth of the entire business, including the Australian operations, as it gives B&R Enclosures greater control of their supply chain and demand channels.

According to Managing Director Ken Bridges:
- Internationalisation of our business has assisted in driving down our cost base and improving our overall competitiveness in withstanding the impacts of imports into our Australian markets
- Internationalisation has provided us with opportunities otherwise not possible with access to high value customers and supply chains seeking high quality competitive suppliers capable of delivering support close to their International operations
- Internationalisation has enabled us to be closer to our suppliers, competitors and targeted customers ensuring we maintain relevant, current and can build relationships that we are now successfully leveraging across our business.

**Recommendations**

- **Prioritise multilateral Free Trade Agreements that have modern rules of origin that support GVCs.**

- **Celebrate the success of Australian companies that expand their businesses through overseas investment by introducing a new award category at the Australian Export Awards**

- **Provide more support to companies who undertake international expansion, including advice on local regulations, introductions to local officials and political risk insights.**

**6. Protecting our Digital Future**

The Australian Government has trade experts who are highly skilled in 19th and 20th century trade issues such as anti-dumping, quotas and tariffs. In order to protect Australia’s future economic interests, greater effort should be made to both recruit expertise in digital trade issues and develop internal talent. Australia also needs to be a strong advocate for the development of a
structure and nomenclature within WTO and other multilateral bodies to address digital trade barriers.

Digital technology has revolutionized modern trade and the products and services that we are able to sell to the world. Block chain Technology, Industrial Internet of Things (IOT) and electronic communication are all essential elements of a globally competitive industry. A common characteristic of all successful businesses is their ability to harness the benefits of digital technology to support their strategic goals.

IOT refers to a digital ecosystem where everything connects and communicates, including inanimate objects like everyday devices and industrial equipment, and living organisms such as people and animals. With all these types of things connecting, they can form an entire network of things, resulting in a smart home, factory or business – or an entire smart city or global community. A UK Government study estimates there were about 14 billion devices connected in 2013, and predicts that there will be between 20 and 100 billion connected devices by 2020 across the globe.

The manufacturing sector is one of the top users of IoT, with 25 per cent of global manufacturers estimated to currently use IoT technologies. This is estimated to grow to over 80 per cent by 2025 and according to Deloitte’s recent Tech Trends report, ambient computing (where real business value is extracted from the use of IoT) is one of the “exponential” technologies whose performance (relative to cost and size) will experience rapid growth, and create new competition and opportunities. In a recent World Economic Forum survey, 72 per cent of businesses believed that the development of IoT will be disruptive to their businesses and industries – and 79 per cent of businesses think those disruptions will occur within the next five years.

Unfortunately, our multilateral rules bodies have not kept up with the changes to the digital landscape, particularly when faced with protectionist barriers.

Recent action taken by China to pass Cyber Security Laws is a good example of the way governments around the world are introducing restrictions to trade and the free flow of data. While the stated motivation might be security, these new laws are a significant protectionist measure that inhibits innovation and disadvantages small to medium sized businesses. Businesses most at risk will be those with special hardware and systems for network management.
The rules state that companies operating in China must provide the government with their anti-hacking proprietary security hardware and software, which could then be passed on to relevant Chinese firms. And having access to the hardware and software means firms would have access to the data as well. The law also requires business information and data on Chinese citizens gathered within the country to be kept on domestic servers and not be transferred abroad without permission. This means that Australian businesses who sell networked enabled machines to China will need to share their intellectual property and establish their own servers in China. Those countries

Australis Engineering is a family owned materials handling equipment manufacturer established in Sydney in 1983. Recently they embraced the potential of IoT and now supply network enabled machines around the world. Providing an IoT enabled machine gives them a competitive advantage over ‘dumb’ machines as manufactures are demanding equipment that can interact with other components on an assembly line or can provide real time performance data. A significant part of their post sales service is monitoring the performance of those machines by accessing the data online and repairing machines located anywhere in the world. Should they export their machines to China once these new laws are enacted they would be forced to either ignore their competitive advantage and sell a ‘dumb’ machine or build and own servers in China, and share their intellectual property with a Government keen to support a local high tech industry.

Digital Transformation Agency

Ai Group supports the Federal Government’s previous Digital Transformation Office (DTO), which was aimed at improving the experience of Australian businesses and citizens dealing with the Government through more efficient and effective online government services. The digitisation of government agencies will create opportunities to streamline the way they collect and use data from businesses, and reduce compliance and regulatory costs for businesses and governments.

A challenge for the previous DTO was implementing projects in practice, since it was formed to demonstrate ICT solutions. The Digital Transformation Agency (DTA) should build on the work of the former DTO and improve engagement between more government agencies across the Commonwealth and States, as well as increase investment in ICT procurement. As the DTA builds its capability and strengthens whole-of-government digital strategy, the Government should be ready to increase and redirect investment accordingly.

Digital skills for business

In a soon-to-be-released analysis of business use of, investment in, and plans for digital technologies, we find that there are low levels of business use with respect to a number of digital technologies that are core to the fourth industrial revolution (or otherwise referred to as Industry 4.0 and more broadly the Internet of Things (IoT)); and that, while cyber security is a growing risk for many businesses, use of and investment in cyber security technology are considered a relatively low priority for many businesses.
Australian Industry Group Submission to the DFAT White Paper

Although digital technology investment is positive, there appears to be a disconnect between digital capabilities and businesses’ strategies to drive growth. Related to strategy and investment, we also found that 17% of businesses plan to do nothing to improve technology skills.

Employee skills and perceived lack of relevance are among the major reasons that inhibit businesses from investing in digital technologies.

These findings suggest that businesses and the workforce would benefit from public support to help them realise the potential value of digital technologies, as well as in cyber security.

Those businesses not planning to improve digital skills may also benefit from support to understand the longer-term benefits of upskilling their staff.

Digital Transformation Agency

Ai Group supports the Federal Government’s efforts to make more effective use of digital technologies. More efficient and effective online services can improve the experience of Australian businesses and citizens dealing with the Government. The digitisation of government agencies will create opportunities to streamline the way they collect and use data from businesses, and reduce compliance and regulatory costs for businesses and governments.

A challenge for the previous Digital Transformation Office (DTO) was implementing projects in practice, since it was formed to demonstrate ICT solutions. The new Digital Transformation Agency (DTA) should build on the work of the former DTO and improve engagement between more government agencies across the Commonwealth and States, as well as increase investment in ICT procurement. As the DTA builds its capability and strengthens whole-of-government digital strategy, the Government should be ready to increase and redirect investment accordingly.

Cyber Security Growth Centre

Ai Group welcomes the Government’s recent establishment of the Cyber Security Growth Centre (CSGC) and appointment of Craig Davies as its CEO, along with the government’s allocation of $31.9 million to fund the growth centre from 2016-17 to 2019-20.

The benefits of this initiative will be lost however, if the regulatory and policy framework does not strike the appropriate balance between risk and opportunity. The Federal Government’s current cyber security processes need to deliver an outcome that is consistent with the objectives of the Government’s revised National Cyber Security Strategy and NISA. Failure could mean that more companies move the investment and development of cyber security digital technology solutions offshore. Ai Group understands this was the experience in New Zealand, where more stringent legislative cyber security requirements led to some companies shifting their investment in research and development of innovative digital technologies offshore to Australia and the USA.

Along with the CSGC, we look forward to working with the Government on its various cyber security initiatives announced in the revised National Cyber Security Strategy.

Recommendations
• DFAT should build internal capability to address emerging issues that may inhibit Australia’s exports of digital technology

• Businesses need to maximise benefits from IoT and related digital technologies. Existing Government business capability initiatives may be helpful, including the Entrepreneurs’ Programme and support for collaboration. However, there is still a gap in support for building workforce digital skills. A program similar to the recently closed Industry Skills Fund could offer a viable solution and should be reconsidered.

• Government agencies should be ready to increase and redirect investment in ICT procurement, once the Digital Transformation Agency (DTA) builds its capability and strengthens its whole-of-government digital strategy.

7. Improving Innovation and Business Capabilities

Innovation and the development of business capabilities are central to the successful ongoing development of the Australian economy and its ability to generate the well-paid and challenging jobs and the dynamic and competitive industries that are necessary conditions to the building of strong, resilient and cohesive communities.

6.1. Innovation and research capabilities

With the initiatives from the Government’s National Innovation and Science Agenda (NISA) still being bedded down, the major innovation issue for resolution in the 2017-18 Budget is the response to the Review of the Research and Development Tax Incentive. The R&D Tax Incentive has been heavily and repeatedly amended over the past decade, to the point where it has become so unstable and unreliable that it is growing more difficult for it to have its intended effect of underpinning sustained increases in innovation investment. While the Review produced some valuable ideas, it is very important to return a measure of continuity and stability to the policy. There should be no further reductions in the overall level of support for business research and development, which would be damaging for innovation and for the credibility of public policy. However, it is reasonable to take well-tailored steps to control the growth of innovation policy costs.

The Review recommends two measures that would control the cost of the R&D Tax Incentive, including: a cap in the order of $2 million on the annual cash refund payable to smaller claimants in a tax loss situation; and limiting non-refundable claims to spending above an R&D intensity threshold of between 1 and 2 per cent of total business costs.

AI Group broadly supports the proposed cap, which appears necessary to control extreme growth in the refundable element of the Incentive reflecting a shift to business models entirely predicated on the Incentive rather than traditional finance options. Assuming it is indexed to preserve its real value over time, a $2 million cap appears adequate to support reasonable activity by startups in most fields. However, the Government should consult further with the biomedical sector to ensure
that the proposed level does not damage the ability of startups to conduct clinical trials and establish a growth path.

Ai Group does not support an R&D intensity threshold, which would cut the value of the incentive for all businesses in a highly uneven and arbitrary fashion. It would also substantially increase the compliance and accounting burden relative to the value of the incentive, since spending below the threshold would also need to be substantiated, and reduce the reliability of the incentive, since the amount claimable would depend heavily on final costs elsewhere in the business.

An increase in the value of incentive claims is no bad thing if it represents an increase in Australian innovation activity. There is no policy case for further reductions in the overall value of innovation support. If broader budgetary pressures require control of cost growth, a cut to the headline rate of the Incentive would be substantially simpler and less distorting than an intensity threshold.

The Review also proposes encouraging collaborative innovation through a new premium of 10 to 20 per cent for claims relating to employment of recent PhD graduates or to collaborative projects. Ai Group research strongly supports the value of collaboration in easing innovation and increasing its value. The collaboration premium is a positive initiative, but it needs to be designed in close consultation with industry to ensure a design that encourages genuine collaboration both between businesses and between business and research organisations, while having workable definitions and evidentiary requirements.

An experimental initiative like the collaboration premium will certainly need to be refined and reviewed over time, and the proposed four-year cycle is appropriate. However, the broader Incentive badly needs stability and the Government should commit to maintain its settings and value to eligible businesses over the medium term following the amendments now under consideration.

**Recommendations:**

- **Avoid further reductions in the overall level of support for business research and development.**

- **Control growth in the costs of the R&D Tax Incentive by adopting a $2m cap on the refundable element.** If further savings are required, a reduction in the headline rate for both the refundable and non-refundable elements would be greatly preferable to more distorting changes such as intensity thresholds.

- **Work closely with industry to design a premium for R&D Tax Incentive claims related to employment of new PhD graduates or to collaborative projects.**

- **Commit to maintaining broad stability for the overall Incentive, while reviewing and refining the collaboration premium over time.**
6.2. Entrepreneurs’ Programme

The environment for Australian business is increasingly characterised by intense competition, rapid change and disruptive technologies. There is a growing need for effective business planning and strategies and it is important that planning extends the horizons for businesses – including by incorporating innovation and greater global engagement.

Ai Group’s 2016 CEO Survey identified a number of areas where Australian businesses can improve their planning to lift their future competitiveness including the importance of planning for the development of the business and not simply its growth.

Australian businesses currently lag their developed nation peers in measures of innovation and sophistication. Further, the pace of innovation growth in Australian business is not strong. Strategic initiatives need to focus on how to leverage digital technologies, how to develop higher value products in the value chain and how to become more engaged across industries; with research organisations; and with supply and distribution networks globally.

The Entrepreneurs’ Programme is a highly effective initiative to address these imperatives. Through a national network of more than 100 experienced private sector Advisers and Facilitators, EP provides businesses with access to tailored advice and support to improve their productivity and competitiveness and improve the frequency and quality of collaboration between business and researchers.

EP continues to build significant recognition and should continue to scale up in line with business demand and economic opportunity.

Recommendation

Following a period of successive re-brandings and changes in scope it is important for the Entrepreneurs’ Programme’s core activities and existing funding to remain stable in the 2017-18 Budget and beyond.

6.5. Export Market Development Grants

The Export Market Development Grants scheme (EMDG) plays an important role in encouraging small and medium-sized businesses to export new products and services, and to access new markets. Ai Group supported the review of the scheme by Mr Michael Lee Implement selected findings of Michael Lee’s June 2015 review of the Export Market Development Grants Scheme

Mr Lee’s report shows a strong return for the money invested in EMDG scheme:

“KPMG found that each EMDG dollar generates an economic benefit of $7.03 when industry spillovers and productivity gains are taken into account. The scheme effectively redistributes productive resources from Australian taxpayers (including firms) to new and emerging exporters. To the extent that this transfer of resources results in an increase in community welfare than would otherwise be the case, the scheme can be judged to be efficient.”
The success of the program ultimately depends on the funding committed in the Budget and we encourage the Government to continue funding the program so that it remains a viable program where the benefits to applicants outweigh the costs of applying. Our recommendations are designed to support the continued success of the EMDG scheme.

**Recommendations**

- Progressively increase the budget allocation for EMDG by $12.4 million per year over the next three years to $175 million.

- Augment Austrade’s budget with a new amount equivalent to 5 per cent of the EMDG administered funds, thus freeing up the entirety of the EMDG funding, currently $137.9 million, for export promotion grants.

- Funding of roughly $8.5 million dollars to upgrade Austrade’s IT system should be explored in regards to reinvesting this funding allocation to incorporate EMDG into the Single Window for trade.

- Encourage Austrade to take a proactive role in advising clients on the strategic importance of each of their eight grant applications, especially in the early years of application.

### 6.6. Building defence industry capabilities

The *2016 Defence White Paper, 2016 Defence Industry Policy Statement* and 2016 Integrated Investment Program underpins the Federal Government’s plan to invest $195 billion over the next decade on replacing or upgrading some 85 per cent of all equipment and systems currently operated by the Australian Defence Force. The program includes expenditure of $1.6 billion through to 2026 on innovation and science essential for maintaining a capability edge in an increasingly uncertain strategic environment in our region.

The investment program emphasises the Federal Government’s commitment to one of the most extensive and ambitious shipbuilding activities anywhere in the world to modernise the Australian Navy. This includes continuous Australian naval ship and submarine build programs which will see 12 new conventional submarines, 12 new Offshore Patrol Vessels and 9 new anti-submarine frigates to replace 8 Anzac frigates. Ai Group Defence Council member company, Austal, has been awarded a $305 million to build up to 21 new Pacific Patrol Boats at its Henderson facility in Western Australia.

The first two F-35A Joint Strike Fighter Aircraft were delivered to the RAAF during 2016. The Government has contracted to acquire 72 F-35s at a cost amounting to some $15 billion. Australia’s defence industry has been contracted to provide $US484 million worth of specialist parts and systems for the JSF program, with an estimated return of at least $1.5 billion over the life of the JSF production phase. The Minister for Defence Industry, Christopher Pyne, is seeking US Administration support to make Australia the regional hub for maintaining the JSF regional fleet.
On 28 July 2016, Defence announced that two tenderers – BAE Systems Australia and Rheinmetall – had been selected to participate in the next stage of evaluation for Land 400, Phase 2, Army’s Mounted Combat Reconnaissance capability to replace the existing ASLAV fleet of vehicles. Land 400 Phase 3 will focus on replacement of the ageing MII3 fleet of armoured personnel carriers. Both program phases will amount to expenditure of up to $12 billion.

A very high priority should be attached to ensuring that enduring and broadly-based benefits for the Australian community are derived from the very large pipeline of defence procurement. This requires careful strategic planning in close consultation with industry to ensure that the capabilities of domestic businesses and their workforces are developed.

**Recommendations**

- Develop a systematic approach to the training and skilling of Australia’s workforce to manage the ramp up of defence industry involvement in this major capital investment program.

- Further improve export opportunities for Australian-made equipment and services over the coming decade and beyond. An important example is Thales Australia’s new Hawkei armoured support vehicle designed and built in Bendigo which has considerable export potential to regional partners.