Ai GROUP SUBMISSION

2017-18 Federal Budget Submission

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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

In framing the 2017-18 Federal Budget, the Government's first priority must be the promotion of a meaningful and effective pathway to stronger, more stable and more inclusive economic growth as the economy continues to transition in the wake of ongoing disruptions that stem from the period of record commodity prices and the associated mining and energy investment booms; the subsequent unwinding of both of these; the rise of China; and the protracted struggle of the global economy to emerge from the long shadow of the 2008 crisis.

Equally important, the Government must maintain an effective pathway back to fiscal sustainability.

The economic context this year is again one of slow global and local growth, with the prospect of a stronger recovery pushed out into the future. Risks to this modest outlook are numerous and come from a wide range of sources. Key risks for the Australian economy in 2017-18 include:

- Global disruption to trade flows, economic growth and financial markets;
- Global disruption to commodity prices and demand trends and/or Australia's exchange rate;
- Ongoing weakness in Australian business investment (possibly coinciding with a period of weaker housing investment as the recently buoyant housing cycle cools); and
- Ongoing weakness in Australian employment, participation, profitability and incomes growth.

Against this background, Ai Group's policy recommendations for the 2017-18 Budget are:

Fiscal Policy

- Ai Group broadly supports the current trajectory of budgetary consolidation. We are wary that large addional cuts to spending or tax increases in the 2017-18 year would exacerbate the fragility of economic growth. However, we would welcome any sensible savings that removed inefficiencies in spending. These could be reinvested in productivity-enhancing initiatives to improve economic growth; job opportunities; and the tax base.
- Ai Group urges further efforts examining how the states and territories are allocated funds and we would welcome measures to lift the efficiency and effectiveness of the federation.
- Ai Group strongly supports the determination to return the Budget to a position of long-term sustainability and to provide room to put in place stimulatory fiscal measures in the event of a major threat to aggregate demand.

Infrastructure Investment

- While we support the budgetary discipline of ensuring that recurrent outlays are covered by recurrent revenue, Ai Group believes there is a clear rationale for using public-sector borrowing to finance rigorously and transparently assessed public sector investment in productivity-enhancing, intergenerational infrastructure.

- Ai Group believes the case can be made for further investments in carefully-selected projects across the country particularly in road, rail and ports.

Taxation Policy

Ai Group supports the policy directions proposed in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*. In the context of the current impasse in the parliament, we have proposed that priority be given to the more modest steps of:

- Lifting the small business entity threshold from aggregated turnover of $2 million per annum to aggregated turnover of $10 million per annum;
- Increasing the tax discount for unincorporated small businesses entities from its current level of 5 per cent to 8 per cent; and
- Legislating to phase in the 27.5 per cent company tax rate for companies with turnovers below $100 million by the start of the 2019-20 year.

As part of this proposal we have also suggested that the case to: a) extend the 27.5 per cent rate to larger companies; and b) reduce the company tax rate to 25 per cent (while making comparable further changes in the tax discount for unincorporated small business entities) be re-prosecuted by the Government and others ahead of the next election. If successful at the next election, the Government could re-present the remainder of the Enterprise Tax Plan to the new Parliament. This could be achieved without changing the schedule of the ETP.

In the context of this approach to the Enterprise Tax Plan, Ai Group also supports renewed efforts for meaningful community-wide discussion of the role that more balanced and resilient tax arrangements – both at federal and state and territory levels – can play in improving current and future community well-being.

We also support maintaining the value and stability of the R&D Tax Incentive.

Skills, Education and Training Policy

Ai Group has identified a number of skills, education and training problems that should be addressed in this year's budget.

- The Commonwealth and COAG should address declining investment in VET and the increasingly uneven investment across jurisdictions including by examining the possibility of moving towards a nationally-funded and nationally-operated tertiary education system.
- Implement measures to achieve full national consistency for all apprenticeships across Australia, including consideration of an oversighting body to ensure programs and arrangements meet current and emerging occupational needs.
- In consultation with industry, develop measures designed to increase the level of participation in apprenticeships/traineeships; review the employer incentive regime; and develop incentives for first time participants in the system.

- Initiate a review of school-based apprenticeships to determine the reasons for low levels of participation and to develop strategies to facilitate greater participation by schools and industry.
- Establish an industry leadership development taskforce that identifies and funds innovative leadership development programs including by recording and promoting good models for education institutes and industry.
- Develop and effectively resource a national STEM skills strategy in conjunction with industry to expand the STEM-qualified workforce; increase the level of STEM participation in the VET sector; introduce employer incentives in STEM-related areas; develop specific measures to expand the STEM workforce in SMEs through cluster/network models; and support STEM skills workforce projects through Industry Growth Centres.
- A national foundation skills strategy needs to be provided with a sufficient budget to support workforce literacy and numeracy programs, including the development of a new program dedicated to the workforce.
- Ensure adequate funding is allocated to implement a new higher education system which includes policy settings that drive innovation, quality, access and skills alignment.
- Commit resources to funding and promoting innovative models of connecting between industry and higher education providers including establishing a grant program to support student placements and work integrated learning in SMEs.
- The Government should consult with key stakeholders of the now-cancelled Industry Skills Fund to gain a broader understanding of the benefit to industry and design and implement a selective program for enhancing workforce capability in sectors operating in areas of the economy experiencing higher levels of growth and innovation.

Innovation and Business Capability Development

Innovation and research capabilities

- 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.

Entrepreneurs' Programme

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

Digital capabilities

- 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.

Making the most of FTAs

- Ensure Austrade has sufficient funds to build and maintain the skills and resources to support Australian companies to access global value chains and to invest abroad.
- 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
- Increase the availability of one-on-one support for new and emerging exporters.
- Continue and expand programs, such as the Colombo Plan, that develop the international business skills of Australian professionals. The relative neglect of new markets such as Latin America in these programs should be addressed.

Export Market Development Grants

- 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.

Building defence industry capabilities

- 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.

Effective, efficient and fair anti-dumping arrangements

- Maintain funding of the Anti-Dumping Commission.
- Reassess the decision to house the International Trade Remedies Advisory Service within the Department of Industry, Innovation and Science rather than in business organisations with established relationships of trust with small and medium-sized businesses.

Energy and Environment Priorities

- Provide new funding to fast-track near term energy security options developed by the Finkel Review and COAG Energy Council;
- Increase resources for the National Energy Productivity Plan; and
- Make a $200 million bridging commitment to the Emissions Reduction Fund.

Annual Skilled Migration Program

- The annual permanent migration planning level should be lifted to 210,000 per year in 2017-18 and beyond, from the current maximum cap of 190,000; and
- Stronger priority should be given to the skilled migration stream within the permanent migration program and especially to the demand-driven components of skilled migration.

2. The Economic Context

The Australian economy remains fragile and fragmented in 2017. This fragility was exposed in a surprising and startling manner by the rare reversal of growth in Q3 of 2016. Real Australian GDP shrank by 0.5% in Q3, with annual growth slowing to just 1.8% p.a., well below the long-run average (or 'trend') rate of 3¼%. This was the first outright fall in real output since Q1 2011 (due to the Queensland floods) and the largest quarterly fall since Q4 2008 (due to the GFC). It was disappointing but not unexpected. It was the result of a confluence of negative factors including: the ongoing retreat from the mining investment boom; a decline in residential construction activity from recent peaks; a sharp reversal in the quarter in public sector investment; slow household consumption and a negative contribution from net exports. Nationally, the drivers of growth are clearly shifting back in favour of the eastern states and especially the larger cities. This shift is adding to existing concerns about the distribution and inclusiveness of growth at present.

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.

[1] IMF January 2017, *World Economic Outlook*, www.imf.org/external/pubs/ft/weo/2016/02/

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 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

	IMF in Jan 2016			IMF in Jan 2017			
Change in GDP, % p.a.	2015	2016	2017	2015	2016	2017	2018
World	**3.1**	**3.4**	**3.6**	**3.2**	**3.1**	**3.4**	**3.6**
Advanced economies	**1.9**	**2.1**	**2.1**	**2.1**	**1.6**	**1.9**	**2.0**
US	2.5	2.6	2.6	2.6	1.6	2.3	2.5
Euro area	1.5	1.7	1.7	2.0	1.7	1.6	1.6
UK	2.2	2.2	2.2	2.2	2.0	1.5	1.4
Japan	0.6	1.0	-0.1	1.2	0.9	0.8	0.5
Emerging / developing economies	**4.0**	**4.3**	**4.7**	**4.1**	**4.1**	**4.5**	**4.8**
China	6.9	6.3	6.0	6.9	6.7	6.5	6.0
India	7.3	7.5	7.5	7.6	6.6	7.2	7.7
ASEAN-5	4.7	4.8	5.1	4.8	4.8	4.9	5.2

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

2.2 Australian economic growth: vulnerable and variable

In early December 2016 the Organisation for Economic Co-operation and Development (OECD) updated its global forecasts. Like the IMF and others, it expects global growth to remain moderate at best in the near term. For Australia, the OECD expects Australian GDP to pick up to 3% p.a. by 2018, following growth of 2.7% in 2016 and 2.6% in 2017. That is, Australian growth is expected to remain below the long-run average of 3¼% for the foreseeable future. Mining investment is still tapering off. Household consumption, non-mining investment and exports are providing moderate but not stellar growth. Wages and employment are expected to pick modestly, with unemployment expected to fall to around 5.3% by 2018. Inflation is expected to remain relatively weak, picking up to only 2.1% by 2018, from the current low CPI rate of 1.3% p.a.

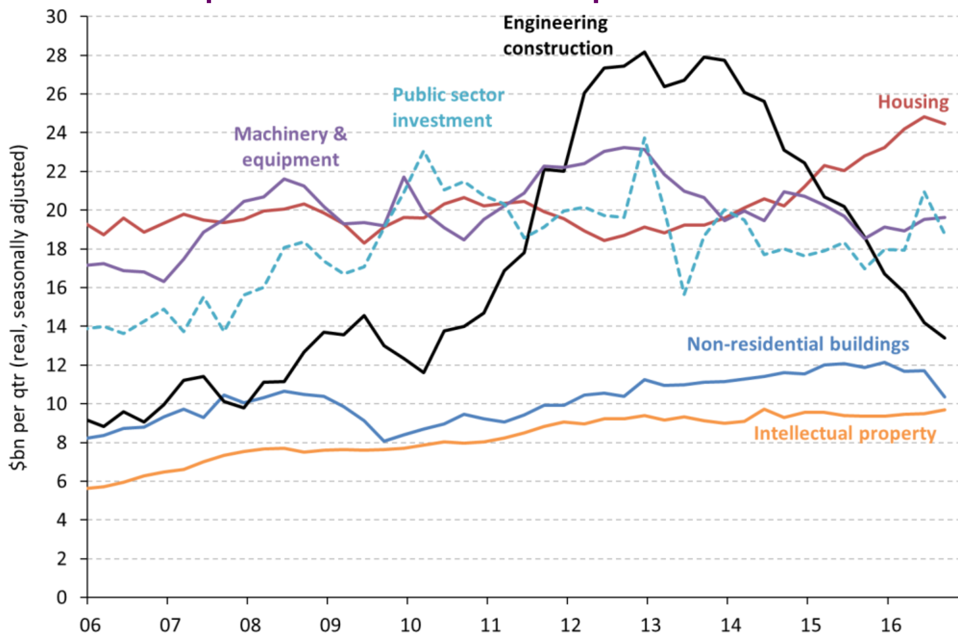
More controversially, the OECD said it expects Australia's Reserve Bank (the RBA) to start lifting the cash rate from the current record low rate of 1.50% in late 2017, in response to perceived asset-pricing risks in Australia's housing market. The OECD also suggested a more expansionary fiscal policy (that is, government spending and investment) would be appropriate in Australia in response to slow economic growth, given the relatively low level of Government debt. The OECD recommends

more Australian Government investment in infrastructure (transport and telecommunications) and in workforce skills development, to boost national productivity.

Confirming the slow and vulnerable nature of the Australian economy in 2016-17, Australian real GDP (inflation-adjusted and seasonally adjusted) fell by 0.5% in Q3 2016, the first quarterly fall since Q1 2011. In nominal terms, GDP grew by 0.5% q/q and 3.0% p.a. in Q3. This was slower than in Q2 (3.3% p.a.) but a significant improvement on the sub-2% growth in nominal GDP through 2014 and 2015. The *National Accounts* indicated a combination of factors contributed to this unwelcome dip, with notable falls across several key categories of investment (see chart 1):

- engineering investment fell another 5.6% q/q and 28% over the year, as the mining investment boom continues to wind down from its peak in 2013;
- Housing investment fell by 1.4% q/q (but remained 7.2% up from a year earlier) as the current house construction cycle begins to move down from a peak some time in Q2 2016 (and as building activity was disrupted or postponed due to inclement weather); and
- Public sector investment fell by 10.4% q/q after rising by a similar amount in Q2, as a few large projects by various state governments were completed.

Chart 1: Components of investment expenditure



Source: ABS, *National Accounts*, Sep 2016.

In addition to these drops in all types of investment, government consumption shrank by 0.2% q/q in Q3 after growing strongly in previous quarters. This was the first such quarterly decline in spending by Australian governments (federal, state and local) since June 2014. Household consumption growth slowed to just 0.4% q/q (its slowest since June 2013) after growing at an average quarterly pace of 0.7% q/q over the preceding three years.

Even exports did not save GDP in Q3 2016 (as happened in previous quarters). Despite a relatively low dollar, imports grew more strongly than did exports and so net exports detracted 0.2 percentage points from growth. Exports of goods fell by 0.3% q/q while exports of services (mainly tourism and education) rose by 2.4% q/q, mirroring recent rises in tourist and student arrivals.

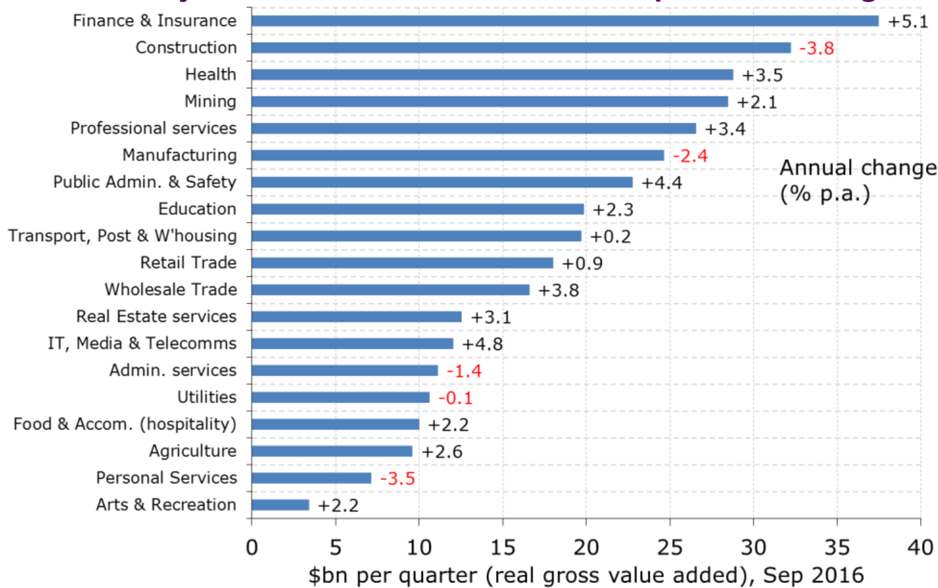
On the positive side, a further recovery in the terms of trade in Q3 (up a further 4.4% q/q from its recent low in Q1 2016, due to stronger commodity prices) saw a lift in national income, effectively ending the decline in national income (the 'income recession') from 2011 to 2015. Real net national disposable income (the ABS' favoured measure of national spending capacity) grew by 0.8% q/q in Q3 2016, its third quarter of recovery.

Looking at the distribution of national income, compensation for employees (wages and salaries) picked up in 2016 (+3.1% p.a. in Q3) but weakness persisted in profits for non-financial corporations, which were down a further 1.0% p.a. in Q3 2016, despite small recoveries in some quarters. This ongoing lack of profitability helps to explain their reluctance to invest (see below).

Other positives in 2016 were stronger output growth across some services industries and most manufacturing sectors. Abstracting from some significant data revisions in the *National Accounts* in Q3 2016[2], growth continued to be concentrated in the services sectors in 2016.

Output from all of the industrial sectors (mining, manufacturing, utilities, construction) shrank in Q3, with only mining showing growth in real value-added output over the year to Q3 (see chart 2).

Chart 2: Major industries' value-added output, size and growth, Q3 2016



Source: ABS, *National Accounts*, Sep 2016.

In line with **Australian PMI®** trends in 2016, the *national accounts* show that total manufacturing output expanded by 0.5% q/q in Q2 (following seven consecutive quarters of decline) but then contracted by 0.1% q/q again in Q3. The more detailed data reveals that Q3's decline occurred in just two manufacturing sectors: machinery and equipment manufacturing (including automotive manufacturers who are in the midst of a planned industry-wide exit from Australia); and petroleum, coal, chemical and rubber products, which includes everything from basic chemicals to coatings, cosmetics, detergents and advanced pharmaceuticals.

[2] The value-added output or 'chain volume' production estimates published in the *National Accounts* for each industry were re-based in Q3 2016, so as to take into account the latest information on industry pricing, inputs and output volumes. This has affected the estimated 'base level' (i.e. size) of the output for some industries, but not their estimated growth rates. This has had the biggest impact on the mining and construction industries, due to large price movements in recent years. As a result, mining is now estimated to be Australia's fourth largest industry in output terms (previously estimated to be the second largest) while construction and healthcare have moved to second and third largest (previously third and fourth largest) place, based on their revised 'value added' output size (that is, all of their outputs minus all of their inputs, which provides an estimate of the value each industry adds to the economy).

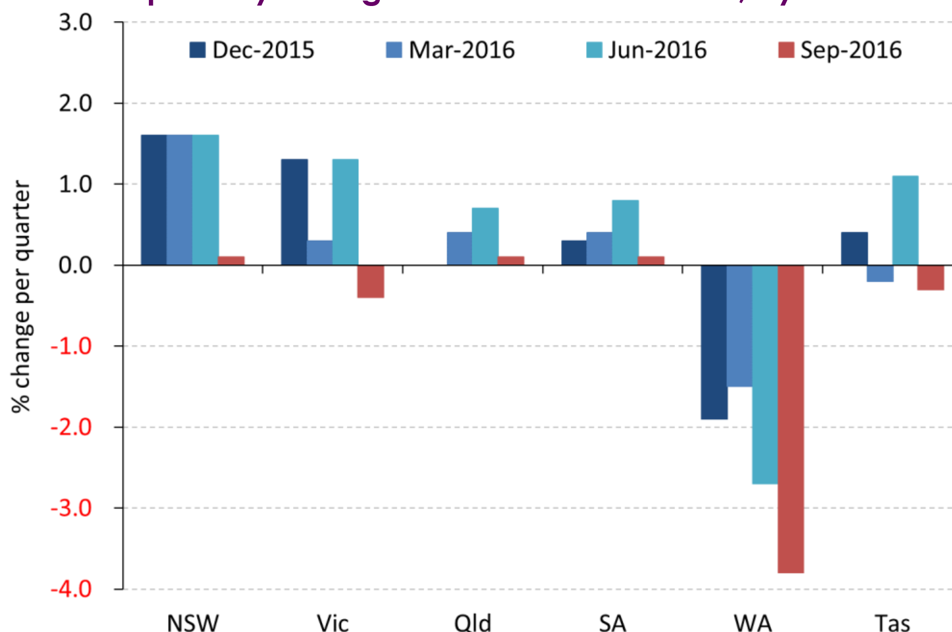
All other segments of manufacturing showed output growth in the *National Accounts* in Q3, with especially strong growth in food and beverages production, which grew by 3.0% q/q and 5.4% p.a. in Q3 and now accounts for 27% of all manufactured output in Australia.

The geographic centres of growth continued to shift from West to East during 2016, even as final demand slowed across all states. As of Q3, the strongest growth rates were in NSW, Queensland and South Australia (see chart 3). Growth in NSW was more resilient in 2016, largely thanks to private (housing) investment, which provided the only source of growth in the Q3.

State final demand growth contracted in Victoria in Q3 but was relatively strong over the year, due to better quarters earlier in 2016. Victorian government investment and spending declined in Q3, with household spending and private investment too weak to counter this fiscal tightening.

Western Australia's state final demand shrank by 3.8% in Q3 (-9.5% p.a.), its worst single quarter since Q3 1989. This was due to a large quarterly decline in private investment as large mining projects were completed. Queensland and South Australia sustained weak growth in state final demand, sustained only by mild growth in household consumption.

Chart 3: quarterly change in state final demand, by state

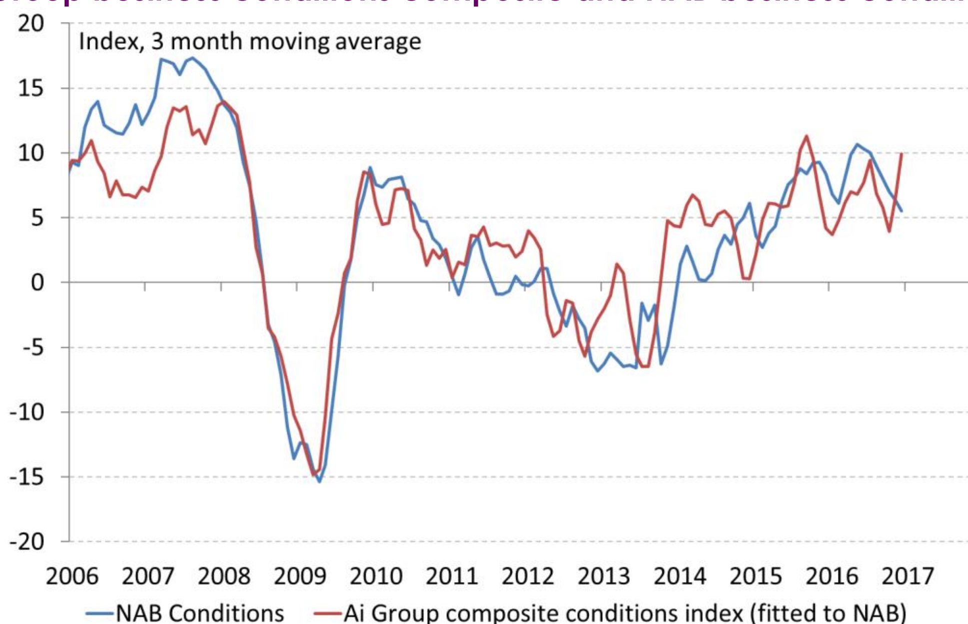


Source: ABS, *National Accounts*, Sep 2016.

The more timely business activity indicators also showed an unwelcome dip during Q3, including Ai Group's Australian PMI® and Australian PSI® (both of which contracted in August and September but subsequently recovered through Q4 of 2016) and the NAB monthly survey of business conditions.

In aggregate, these business surveys suggest business activity at the beginning of 2017 is mildly expansionary but not overly positive. Both Ai Group's composite index of business conditions and NAB's business conditions index stayed mildly positive through most of 2016, but with no indication of returning to stronger pre-GFC conditions (see chart 4).

Chart 4: Ai Group business conditions composite and NAB business conditions

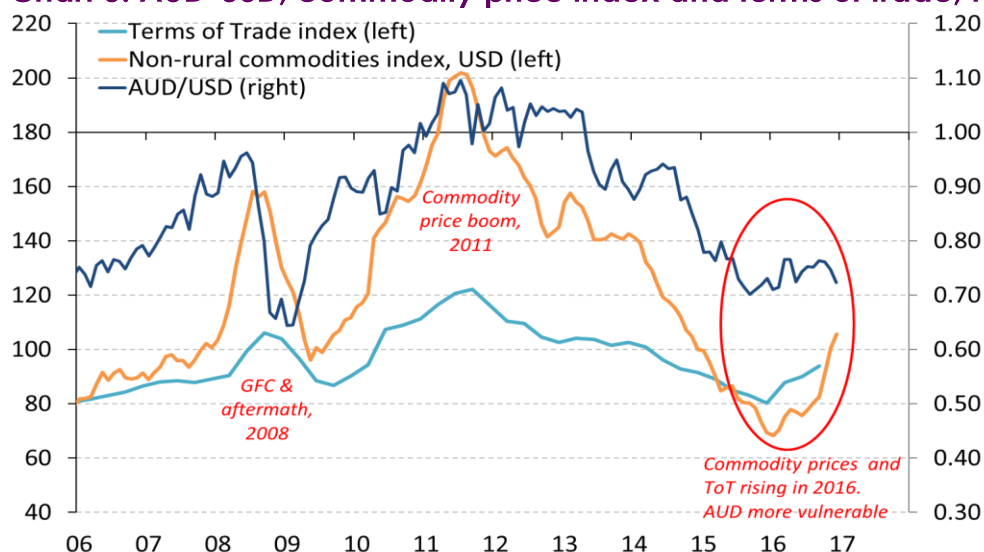


Source: Ai Group (composite of Australian PMI® Australian PSI® Australian PCI®) and NAB.

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 5: 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

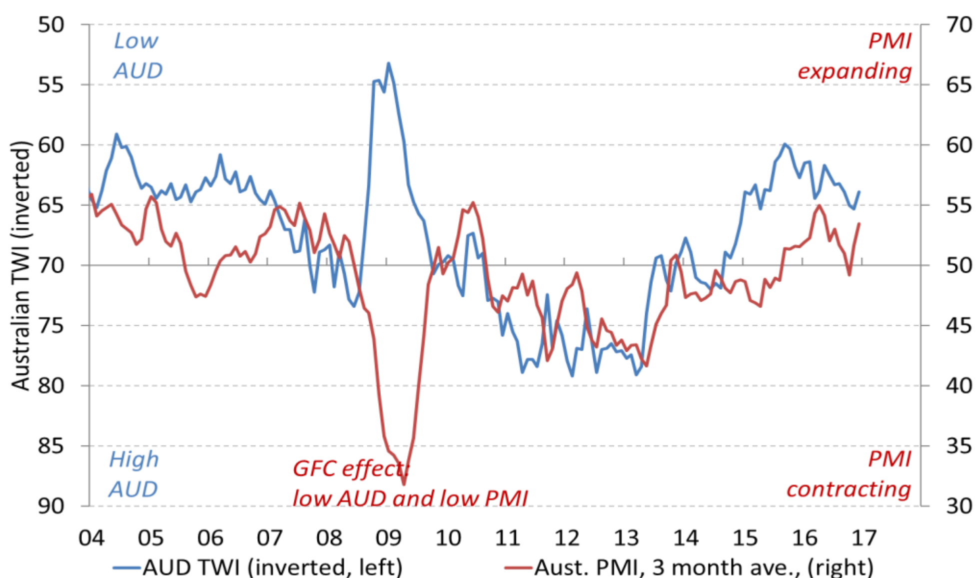
earlier. This helped push the Australian dollar above US0.76 by October from US0.70 cents in 2015. It ended the year lower, largely due to a stronger US dollar in recent months (see chart 5).

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[3] 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® 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.

Chart 6: AUD-TWI and Australian PMI, to Dec 2016



Sources: RBA, Ai Group.

[3] Ai Group, *National CEO Survey 2016: Business Responses to the Australian Dollar*, August 2016.

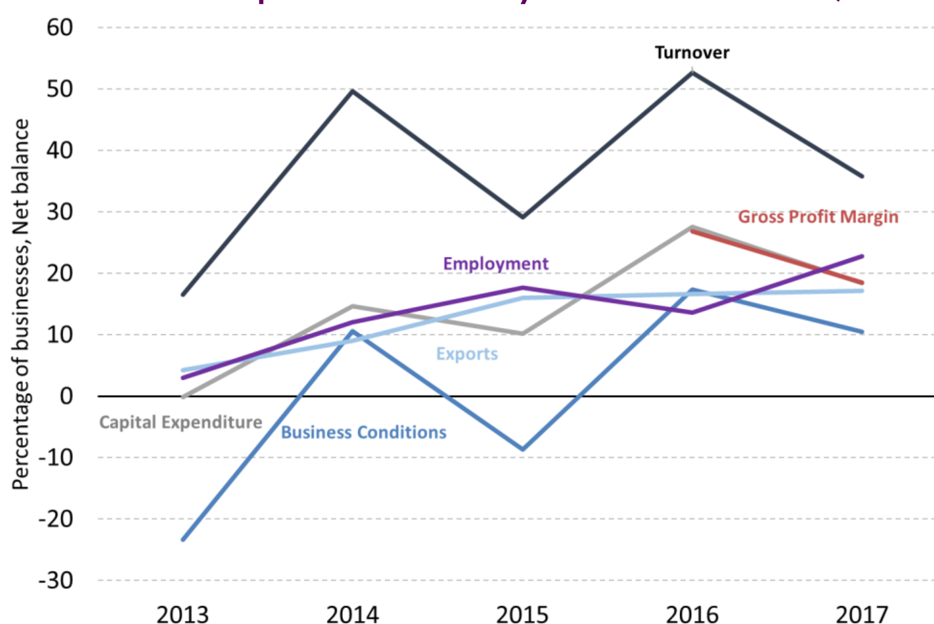
2.4 Key local risks in 2017: weak business confidence and investment

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 7: CEO's expectations for key business indicators, 2013 to 2017



'net balance' = share of businesses that are positive about each indicator, less the share that are negative. Source: Ai Group.

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

Nominal annual CAPEX	**2014-15 (actual)**		**2015-16 (actual)**		**2016-17 (estimate 4)***	
	$mn	% p.a.	$mn	% p.a.	$mn	% p.a.
Mining						
Buildings and structures	67,622	-16.5	47,560	-29.7	29,799	-37.3
Plant and equipment	8,495	-10.0	5,892	-30.6	5,413	-8.1
All mining	76,117	-15.8	53,452	-29.8	35,188	-34.2
Manufacturing						
Buildings and structures	2,483	-7.4	1,945	-21.7	1,877	-3.5
Plant and equipment	6,145	-6.2	6,562	6.8	6,597	0.5
All manufacturing	8,628	-6.5	8,507	- 1.4	8,419	-1.0
Other selected industries						
Buildings and structures	27,625	19.2	27,727	0.4	27,980	0.9
Plant and equipment	38,286	8.9	37,768	-1.4	35,989	-4.7
All 'other selected industries'	65,910	13.0	65,496	- .6	64,496	-1.5
All buildings and structures	97,729	-8.5	77,232	-21.0	58,533	-24.2
All plant and equipment	52,925	3.5	50,223	-5.1	46,829	-6.8
ALL CAPEX	**150,655**	**-4.6**	**127,455**	**-15.4**	**103,504**	**-18.8**

* *five year average realisation ratio applied.*

Source: ABS, *CAPEX*, Sep 2016.

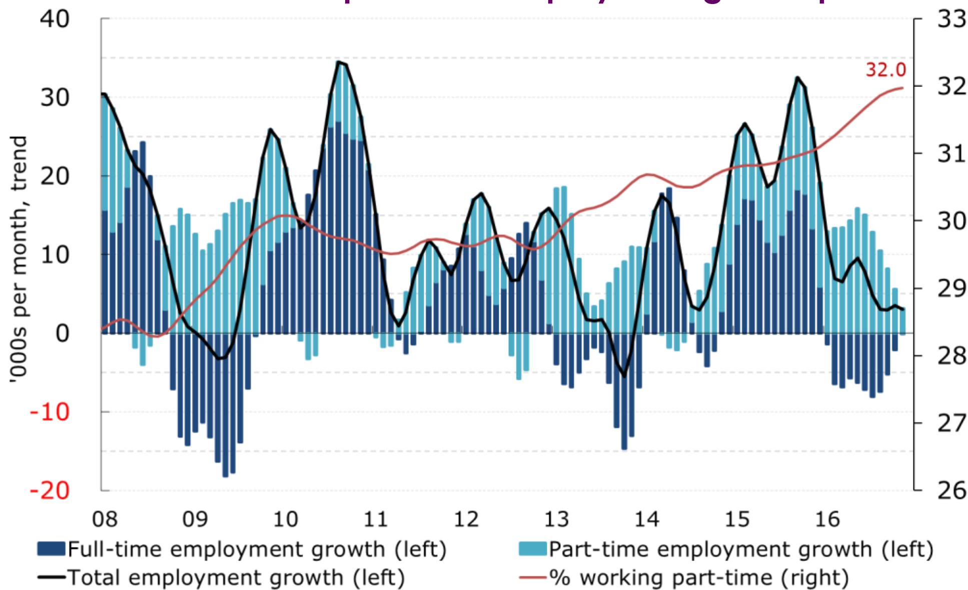
2.5 Key local risks in 2017: weak jobs growth and participation

Australian employment growth weakened notably through 2016. In trend terms[4], total employment grew by just 87,300 over the year to November. Employment growth slowed to just 0.7% p.a. from 2.6% p.a. one year earlier. Growth in aggregate hours worked across the economy slowed even more, expanding by just +0.3% p.a. over the year to November 2016. This was largely because jobs growth was concentrated in part-time work (defined by the ABS as less than 35 hours per week). Part-time employment grew by 3.8% p.a. in the year to November (up 138,000) while full-time employment declined by 0.6% (down by 51,000). The proportion of the workforce on part-time

[4] The ABS continues to warn about volatility in the seasonally adjusted labour force data. It recommends that the '*Trend series smooth the more volatile seasonally adjusted estimates and provide the best measure of the underlying behaviour of the labour market*'. These data are therefore presented here in trend terms, unless otherwise stated.

hours (most typically 3 days per week) is now at a record high of 32% (see chart 8). Part-time work for women has risen to 47% of the female workforce while for men it has risen to 19% of the male workforce.

Chart 8: Full-time and part-time employment growth per month (trend)



Source: ABS

Much of this increase in part-time work is due to the ongoing structural shift towards employment in services (which tend to have more part-time work) rather than industrial sectors. In the year to November 2016, jobs growth was again strongest in the large services sectors including: education services (up 46,000 or 5% but with 40% working part-time); food and accommodation services (up 37,000 or 4.5% but with 60% working part-time); public administration (up 31,000 or 4.3% but with 19% working part-time); administrative services (up 20,000 or 4.9% but with 43% working part-time); and healthcare (up 6,000 or 1% but with 45% working part-time).

In contrast, services sectors connected with the movement of goods all shed labour in the year to November 2016, due to a combination of technological change (e.g. online shopping), subdued household discretionary spending and long-term consumer shifts towards spending on services over goods. Retail trade shed 51,000 jobs (-4% p.a.), wholesale trade shed 7,400 (-2% p.a.) and transport services shed 9,000 jobs (-1.4% p.a.). The giant finance and insurance sector also shed workers in 2016 (-12,500 or 2.9% p.a.), as did the smaller real estate services sector (-1,600 jobs).

Among the industrials, mining and utilities shed labour, but construction employed an additional 10,600 people in the year to November 2016 (up 1% p.a.) and manufacturing recovered 61,000 jobs (+7%) after shedding 190,000 (-18%) between 2008 and 2015. Further detail in the ABS labour force data show that manufacturing jobs recovered across most sub-sectors in 2016, excepting wood products, petroleum products and textiles clothing footwear. Employment in transport equipment was broadly stable, despite the inclusion of automotive assembly in this sector in a year in which the auto assembly sector moves closer to exiting from Australia. November's estimate showed an especially big jump in jobs in manufacturing 'not further defined', which could possibly indicate growth in new and emerging product categories that are difficult to classify.

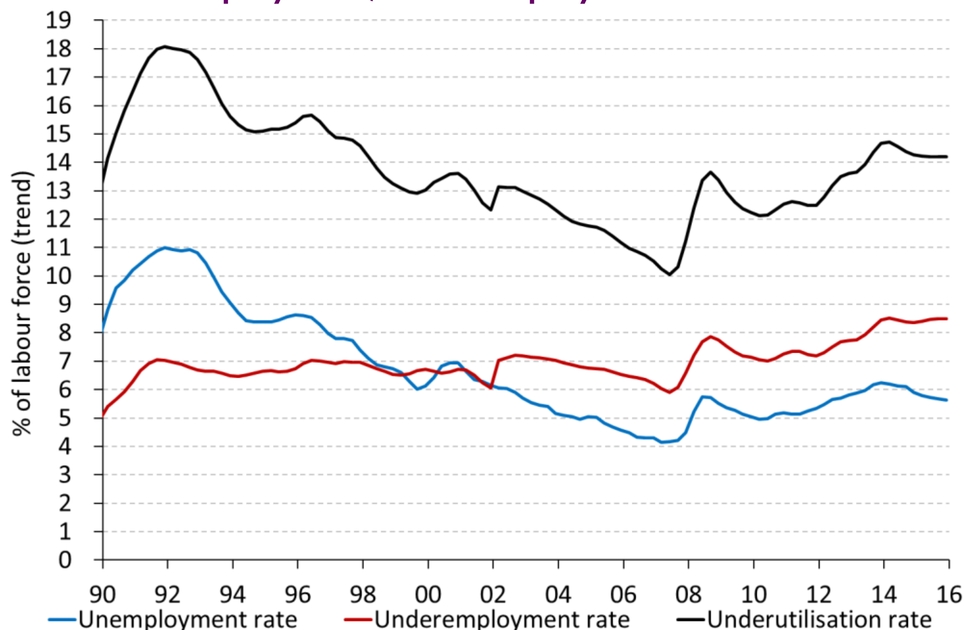
Despite exceedingly weak employment growth, the unemployment rate fell to 5.6% by November

2016 from a recent peak of 6.2% in 2014 (trend, see chart 9). This was because the labour force participation rate fell to 64.5% of the adult population, its lowest rate since 2006. Some of this fall is function of the ageing population (since older people have lower participation rates) but some of it may reflect a short-term ‘discouraged worker’ effect, as people cease to actively seek work.

In addition to around 715,000 unemployed people (those out of work but actively seeking employment), just over one million people (8.6% of the labour force and 9.1% of the workforce) were underemployed (working part-time but willing and able to work more hours) in November 2016. Underemployment has been relatively stable since early 2014, even as the unemployment rate drifted lower (see chart x) and part-time work drifted higher. Reflecting the fact that far more women than men work part-time, 11% of employed women and 7% of employed men are underemployed. Across industries, underemployment is concentrated in the industries with high part-time work rates. 20% of workers in food and accommodation services are underemployed (60% part-time), as are 17% in retail trade (49% part-time), 14% in administrative services (43% part-time) and 10% in each of education and healthcare services (40% and 45% part-time).

Added to the unemployment rate, this relatively high underemployment rate means that 14% of the labour force was underutilized as of November 2016 (unchanged from a year earlier), with an additional (but unknown) population who are currently discouraged from actively seeking work. In short, there is considerable ‘spare’ capacity across Australia’s labour market, despite a relatively low (and falling) national unemployment rate.

Chart 9: Unemployment, underemployment and underutilization rates (trend)



Source: ABS

3. Budget Position, Debt and Public Sector Investment

Putting the Federal budget on a sustainable footing remains an outstanding policy priority.

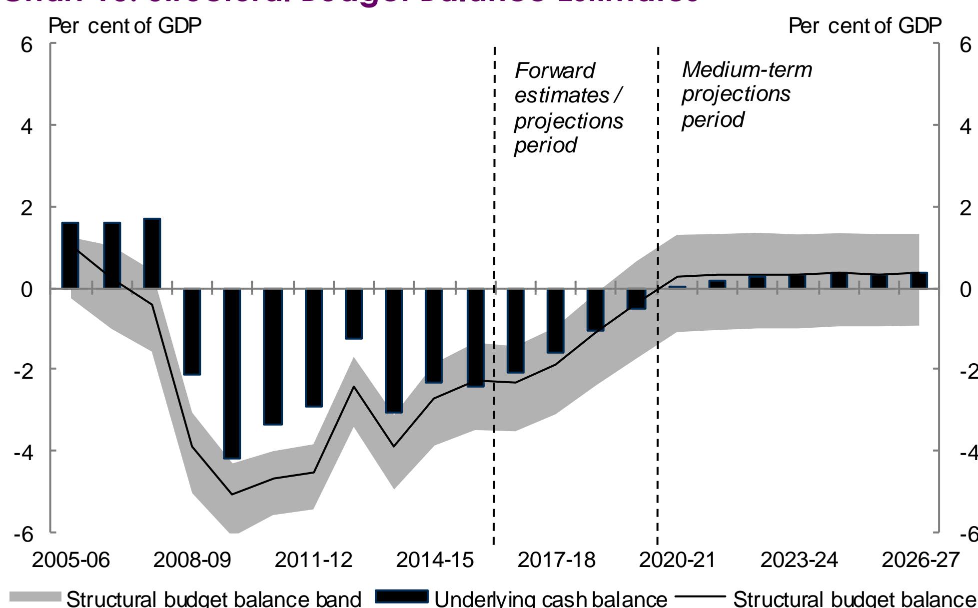
Recent speculation over whether Australia will remain one of the handful of countries with a AAA credit rating has reignited concerns with the budget bottom line and the stock of public sector debt that has built up since the global financial crisis. From Ai Group's point of view, a focus on credit ratings is a lesser order issue alongside more fundamental fiscal objectives of:

- Rigorously assessing and prioritising spending;
- Raising taxation revenue as efficiently as possible;
- Ensuring that recurrent spending is comfortably covered by recurrent revenue; and
- Rebuilding a fiscal buffer against the possibility of another crisis that will again call for expansionary fiscal measures to underwrite aggregate demand.

With the fiscal balance for the 2016-17 year estimated in MYEFO to be in deficit by over $40 billion (or 2.4 per cent of GDP) we are clearly well short of these objectives.

However, with the economy persisting to grow at below-trend rates (and indeed with the contraction in GDP in the September quarter raising creating the distinct possibility that the economy will have closed calendar 2016 in a technical recession), there are clear risks to moving too rapidly on fiscal consolidation in the 2017-18 year. Aggressive cuts to aggregate spending and/or raising taxes beyond current projections in the attempt to more rapidly improve the budget bottom line would further slow the economy to the detriment of growth, employment, private sector demand and tax collections.

Chart 10: Structural Budget Balance Estimates



Source: MYEFO, December 2016.

In our view, the fragility of the economy and the risks posed by a more aggressive approach to the budget bottom line provide strong reasons to support the more moderate pace of fiscal consolidation put forward in the 2017 Budget and reiterated in December's Mid-Year Economic and Fiscal Outlook (MYEFO, see chart 10).

While we do not favour a more aggressive approach to the consolidation of budgetary aggregates, we do support further efforts to remove waste and inefficiencies in Commonwealth programs. Such savings should be reallocated to underwrite sustainable rises in domestic living standards by accelerating the expansion of economic and social opportunities. In particular, as we detail in this Submission, we encourage additional funding to help lift the capabilities of the future and current workforce; in developing business capabilities; and in further support of advances in Australia's innovation record.

Expanding economic and social opportunities will have long-term benefits both for the pace of improvement in productivity and material living standards and for the inclusiveness and cohesion of Australia's communities. Lifting the capabilities of the future and current workforce is particularly important to the dynamism of the economy and to a broader distribution of its benefits.

In addition to efforts to find further savings and efficiencies in Commonwealth programs but as part of the broader agenda of improving the efficiency of government in Australia, Ai Group supports renewed national leadership to improve the workings of the Australian federation. There is strong potential to reduce duplication between jurisdictions; to clarify and more rationally allocate responsibilities and accountabilities; and to provide national leadership and coordination to a range of policy areas that would assist in raising economic and social opportunities.

In relation to the end point of fiscal consolidation, Ai Group does not have a firm adherence either to running a cash surplus or to a position of zero net debt. We certainly support a highly disciplined approach to spending and taxation and to ensuring that recurrent spending is comfortably covered by recurrent revenue over the course of the business cycle. We also support rebuilding a fiscal buffer that could be deployed in the event of another crisis that posed a substantial threat to aggregate demand.

However, we do not see advantages in denying the scope for governments to borrow to finance investments that would generate a return sufficient to cover borrowing costs, maintenance and depreciation. While in many cases such investments will be better financed by the private sector, in other cases – such as where there are highly dispersed benefits (including intergenerational spillovers) that cannot be adequately captured with user-charges – public investment and ownership can be the most efficient approach.

Where publicly-owned assets can be better managed under private-sector ownership, such as in electricity generation and transmission, we strongly support asset sales or long-term lease arrangements coupled with appropriate regulatory arrangements that address market power and performance concerns. As demonstrated in a number of Australian jurisdictions, tapping into the private sector to realise the value of publically-owned assets can be a fruitful way to finance new investment or to reduce the stock of public-sector debt. We strongly support further consideration

by the Commonwealth of potential asset sales and any encouragement that it can provide to the states and territories.

Recommendations

- **Ai Group broadly supports the current trajectory of budgetary consolidation. We are wary that large addional cuts to spending or tax increases in the 2017-18 year would exacerbate the fragility of economic growth. However, we would welcome any sensible savings that removed inefficiencies in spending. These could be reinvested in productivity-enhancing initiatives to improve economic growth; job opportunities; and the tax base.**
- **Ai Group urges further efforts examining how the states and territories are allocated funds and we would welcome measures to lift the efficiency of workings of the federation.**
- **Ai Group strongly supports the determination to return the Budget to a position of long-term sustainability and to provide room to put in place stimulatory fiscal measures in the event of a major threat to aggregate demand.**
- **While we support the budgetary discipline of ensuring that recurrent outlays are covered by recurrent revenue, Ai Group believes there is a clear rationale for using public-sector borrowing to finance rigorously and transparently assessed public sector investment in, for example, productivity-enhancing, intergenerational infrastructure.**

3.1 Strengthening infrastructure selection processes

Ai Group believes that transparency and rigorous selection criteria are vital for infrastructure projects, a case that was also made in the Productivity Commission's final report on Public Infrastructure released in early 2014. While changes have been made to strengthen the role of Infrastructure Australia, we believe this organisation could take a more prominent role in the national debate around the development and financing of infrastructure.

Sound project selection plays a major role in productivity and growth outcomes according to work by the International Monetary Fund. They examined the institutional environment underpinning infrastructure investment management across four different stages: project appraisal, selection, implementation and evaluation. The research found that the quality of public investment, as measured by variables capturing the adequacy of project selection and implementation, is statistically significant in explaining variations in economic growth across countries. They concluded that these studies highlight the importance of going beyond discussions of spending levels and addressing issues of the broad institutional framework underpinning the provision of investment.

3.2 Strengthening infrastructure funding processes

Ai Group believes each proposed infrastructure project should be subject to thorough and transparent cost-benefit analysis to ensure the government gets the best possible use of taxpayer funds. A clear and transparent process also helps to foster public support for infrastructure projects and avoid costly delays in construction. Furthermore, having independent planning bodies like

Infrastructure Australia improve the integrity around infrastructure planning and prioritization. Not only does this build public support for major projects, it also ensures governments can access private finance to invest in infrastructure. Having a transparent and rigorous project creates confidence among investors ensuring that lower-cost financing and a deep pool of investment funds exists for future projects. Together with transparency, Ai Group believes that certainty must exist when it comes to projects.

Ai Group also believes governments should not display a clear preference for one type of infrastructure over others. Rail is an important component of the infrastructure mix, and Ai Group believes that each project regardless of the type should be assessed on a sound cost-benefit analysis performance relative to the alternatives, with the project with the strongest business case proceeding, regardless of its type.

Recommendation

- **Ai Group believes the case can be made for further investments in carefully-selected projects across the country particularly in road, rail and ports.**

4. Taxation Reform

Ai Group strongly supports the need for the Government's Enterprise Tax Plan (ETP).

As set out in more detail in the Appendix to this Submission, Australia has a high recourse to the taxation of business profits in the form of company taxation. OECD data[5], which is available for the period since 1965 shows that, compared to other advanced economies:

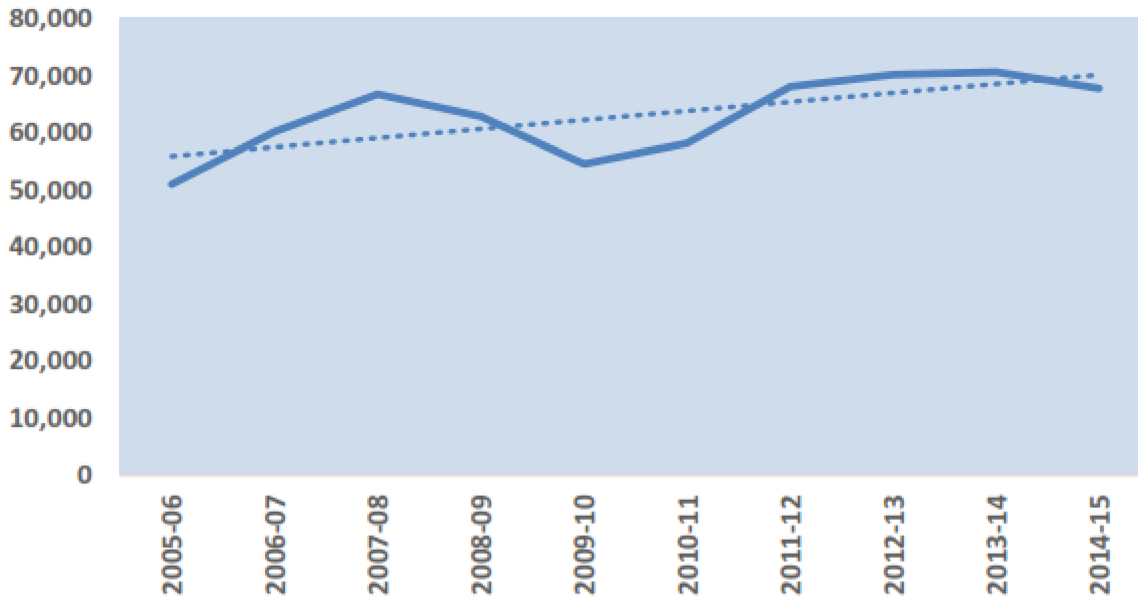
- Over the past half-century, Australia's reliance on company taxation has consistently been above the average of OECD countries;
- For the second half of this period, coinciding with the major tax reforms of the mid-1980s, both the share of company tax in total tax collections and the gap between the share in Australia and the average share among OECD countries has trended higher;
- For each year since 1990 Australia's share of total taxation contributed by company taxation has ranked in the top three OECD countries and has ranked in the top two OECD countries since 2004;
- Australia's reliance on company tax intensified during the recent period of high commodity prices and has since retreated somewhat to a level that is broadly consistent with the rising trend since the mid-80s.

Relative to the OECD as a whole, Australia also stands out having one of the highest company tax to GDP ratios. This is despite Australia's lower-than-average overall tax to GDP ratio. Further, the gap between the Australian experience and the OECD average has tended to widen since the mid-1980s as the share of company tax to GDP in Australia has trended higher (against the more gently rising OECD trend).

ABS data also confirm that Australian company tax collections tend to be high (see Chart 10). This decade-worth of data from the ABS, plotted here along with a linear trend line, suggest that Australian company tax collections continue to be high (even though they reflect the GFC and, more recently, falling commodity prices). There is certainly no collapse of company tax collections from their high levels relative both to the OECD as a whole or to Australia's historical experience.

[5] See Charts in Appendix 1 drawn from the OECD databank available at https://data.oecd.org/tax/tax-revenue.htm.

Chart 10: Australian company tax collections ($mn) 2005-06 to 2014-15



Source: ABS 5506.0, *Taxation Revenue Australia, 2014-15*. Released 26 April 2016.

In response to this high taxation burden and the erosion of national competitiveness that it fosters, Ai Group supports the policy changes proposed in the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016*. Reducing the rate of company tax can be expected to have a positive impact on the health of the economy. Lowering the company tax rate can be expected to lift investment in Australia with the following ramifications:

- Higher quantities of capital per employee;
- More rapid modernisation of the capital stock;
- Increased labour productivity; and
- Higher real wage rates and higher living standards.

While we support the ETP we also recognise the political impasse surrounding it. Ai Group has proposed the following compromise aimed at securing a near-term benefit for micro, small and medium-sized businesses.

Recommendations

For 2017-18 Federal Budget, Ai Group recommends:

- **Lifting the small business entity threshold from aggregated turnover of $2 million per annum to aggregated turnover of $10 million per annum;**
- **Increasing the tax discount for unincorporated small businesses entities from its current level of 5 per cent to 8 per cent effective from the 2016-17 year;**
- **Legislating to phase in the 27.5 per cent company tax rate for companies with turnovers below $100 million by the start of the 2019-20 year.**

As part of this proposal we have also suggested that the case to: a) extend the 27.5 per cent rate to larger companies; and b) reduce the company tax rate to 25 per cent (while making comparable further changes in the tax discount for unincorporated small business entities) be re-prosecuted by the Government and others ahead of the next election. If successful at the next election, the Government could re-present the remainder of the Enterprise Tax Plan to the new Parliament. This could be achieved without changing the schedule of the ETP.

In the context of this approach to the Enterprise Tax Plan Ai Group also supports renewed efforts for meaningful community-wide discussion of the role that more balanced and resilient tax arrangements – both at federal and state and territory levels – can play in improving current and future community well-being.

As discussed in more detail in Section 6 below we also support maintaining the value and stability of the R&D Tax Incentive.

This incentive has been subject to frequent changes in recent years and is currently being reviewed by Government. Any changes to how innovation incentives in the tax system should take place in the context of the broader taxation reform package, with the taxation reform package having a strong focus on the role the tax system could play to boost innovation in our economy.

5. Skills, Education and Training

Ai Group has identified a number of skills, education and training problems that must be addressed within this year's budget as a matter of urgency. These are discussed in detail below.

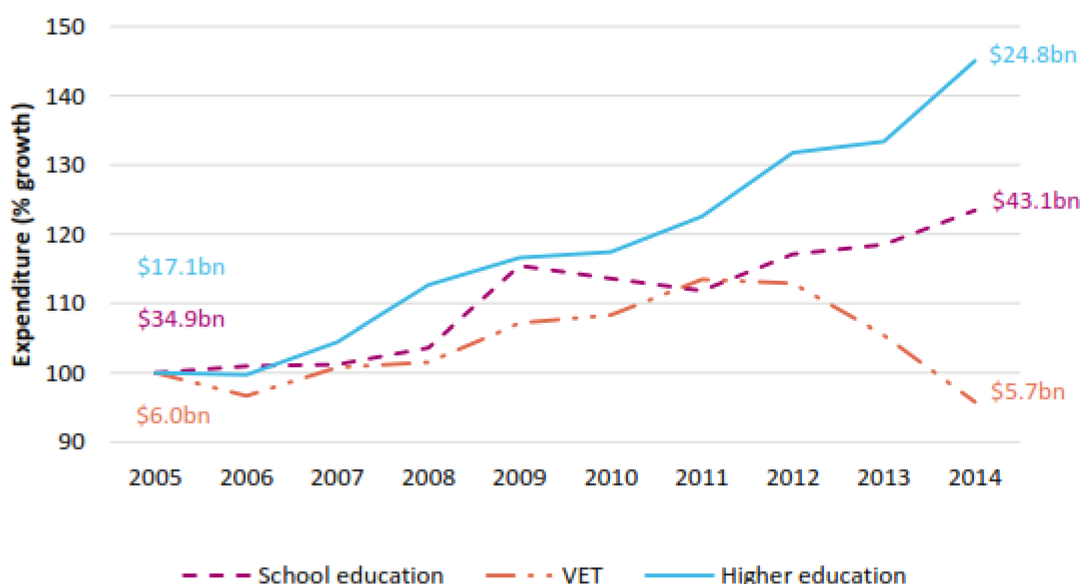
5.1 Reform of Australia's VET system

The funding of the Australian VET system has been in some difficulty for several years. This difficulty occurs in two main ways. Firstly, the levels of total VET funding are inadequate to meet existing and future skills needs of the workforce. The level is too low in absolute terms and also relative to the funding arrangements in both the higher education and school sectors.

The most recent national analysis of VET demand remains that undertaken by the former Australian Workplace Productivity Authority.[6] This report made the case for a 3 per cent per annum increase to 2020 to meet the demand for VET qualifications required by the workforce. Current VET funding levels are well short of this. Further, there is an increasing gap in the public expenditure for VET compared to other sectors of education.

Research by the Mitchell Institute shows there has been a much lower rate of growth in VET spending compared with other education sectors. Government expenditure on VET in 2014 – 15 is now below expenditure levels 10 years earlier, in real terms. From 2005 – 06 to 2014 – 15 national expenditure fell by 4.2 per cent and in the most recent year it fell by 9 per cent or $600 million.[7]

Chart 11: Change in expenditure on education by sector 2005-06 to 2014-15



Source: ACIL Allen Consulting analysis based on Australian Bureau of Statistics data

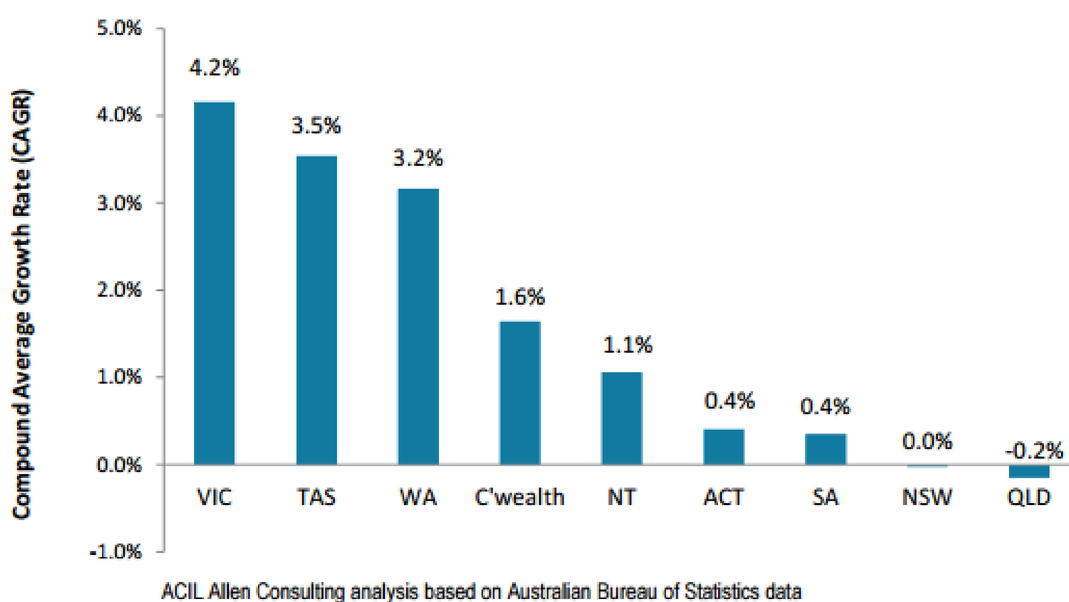
In stark contrast, higher education expenditure has grown rapidly with a 45 per cent increase over this period. In the last year there has been an 8.7 per cent increase or $2 billion increase in

[6] Skills for prosperity: a roadmap for vocational education and training, Skills Australia, 2011.
[7] Megan O'Connell and Kate Torii, Expenditure on education and training in Australia, December 2016, Mitchell Institute.

expenditure. The increase in higher education represents a mirror image of the decrease in expenditure for VET. This disparity between the VET and higher education sectors makes any movement towards a national tertiary system more difficult.

The second factor is the composition of public funding for VET, or more precisely, the differential shared contributions between the Commonwealth and the States/Territories. The funding by the jurisdictions is falling in absolute terms and also relative to Commonwealth expenditure. The relative funding shares between the Commonwealth and the jurisdictions vary significantly. These differences have been aggravated by the introduction of differential student training entitlement funding models by all states and territories. The jurisdictions have used in-built flexibility parameters resulting in differences in the eligibility requirements, the courses eligible for an entitlement, course subsidy levels, the quality requirements of providers, and the information provided to students.[8]

Chart 12: Differential VET Expenditure by Jurisdiction



The shared funding arrangements are impacting on the effectiveness of the VET system. Different mixes of Commonwealth and States and Territories funding and different ways of funding each VET system are causing confused messages for employers engaging with the system, particularly those operating nationally. In some instances, within individual state systems the needs of industry, businesses and students have not been met.

Given these difficulties it is time to consider major reform of the funding of the VET system. The November 2015 COAG meeting, in the context of major reform of Australia's Federation, considered

[8]Kaye Bowman and Suzy McKenna, NCVER, Jurisdictional approaches to student entitlements: commonalities and differences, 2016.

reform of the vocational education and training sector, recognising its importance in building a better trained workforce essential to grow our economy.[9]

It has been estimated that Commonwealth funding for VET delivery will fall by $500 million in 2017 – 18 given the expiration of the National Partnership Agreement on Skills Reform in mid-2017.[10] It is imperative that a new Partnership Agreement be developed through COAG to adequately fund the VET sector within a broader tertiary education context.

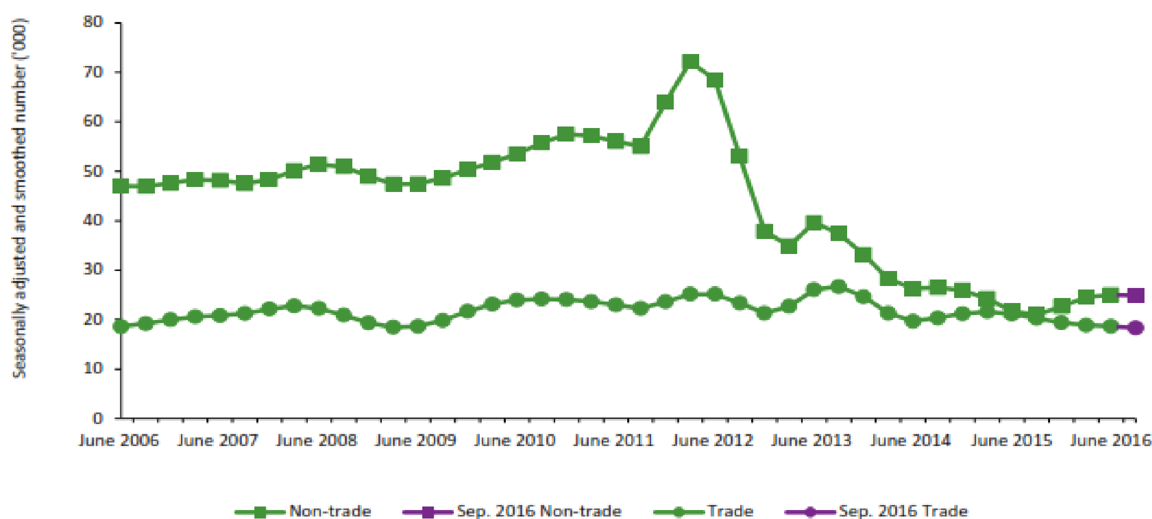
Recommendation

- **The Commonwealth and COAG should address declining investment in VET and the increasingly uneven investment across jurisdictions including by examining the possibility of moving towards a nationally-funded and nationally-operated tertiary education system.**

5.2 Reform of Australia's apprenticeship system

The major issue confronting apprenticeships and traineeships is a major downturn in activity (see chart 13). The latest NCVER data indicates there were 282,9 00 apprentices and trainees in training at the end of June 2016.[11] This is a decrease of 7.8 per cent from the previous year and represents the lowest level of participation for a decade. The percentage of Australian workers employed as an apprentice or trainee has declined from 3.3% to 2.7% during this period.[12] Similarly, commencements are the lowest for a decade and are currently around half of what they were in June 2012. Trades commencements decreased by 17.3 per cent in the June quarter 2016 compared to the June quarter 2015.

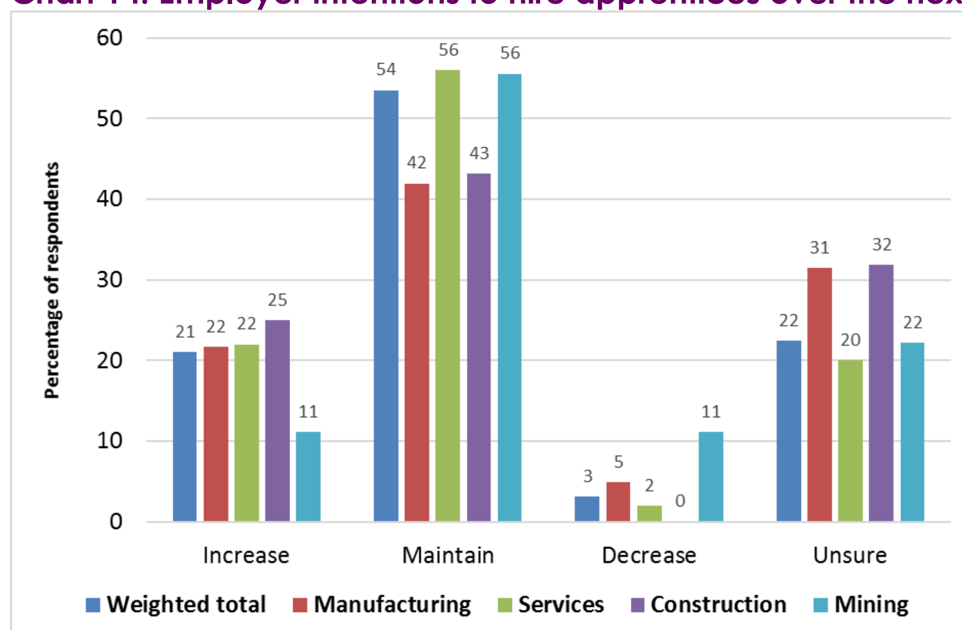
Chart 13: Trades and non-trade commencements, seasonally adjusted and smoothed, June 2006 – September 2016



[9] Communique for the COAG Industry and Skills Council Meetings, Skills Ministers, November 2015.
[10] Megan O'Connell and Kate Torii, Expenditure on education and training in Australia, December 2016, Mitchell Institute.
[11] Apprentices and trainees 2016 June Quarter, NCVER, Commonwealth of Australia.
[12] Apprentices and trainees 2014, NCVER, Commonwealth of Australia, 2015.

There is an urgent need to stimulate and support this vital training pathway. In the Ai Group survey of workforce development needs in 2016, only 11% of employers intended to increase apprentices and trainee numbers over the next twelve months (see chart 14).[13]

Chart 14: Employer intentions to hire apprentices over the next 12 months, 2016



Source: Australian Industry Group Workforce Development Needs Survey 2016

It is clear from the Ai Group survey data and the NCVER data indicate that the school-based apprenticeship pathway is significantly underutilised. The pattern reveals low levels of participation, recent declines in national participation (5.3 per cent) and a very uneven spread across jurisdictions (see table 3).

There needs to be Commonwealth sponsored review of these arrangements to determine the reasons for the under-utilisation of this pathway and develop strategies to assist schools and industries to more actively participate.

Table 3: School-based apprentices and trainees, by state, 2011 to 2015

	2011 ('000)	2012 ('000)	2013 ('000)	2014 ('000)	2015 ('000)	2014–15 % change
School-based apprentices and trainees						
New South Wales	2.4	2.3	2.5	2.8	2.2	-21.0
Victoria	3.9	4.2	3.6	3.9	3.6	-8.2
Queensland	8.9	13.2	13.1	11.7	11.1	-4.6
South Australia	1.1	0.9	0.9	0.3	1.1	**
Western Australia	1.1	1.2	1.1	1.2	1.2	-0.1
Tasmania	0.6	0.7	0.6	0.7	0.6	-7.0
Northern Territory	0.1	0.1	-	0.2	0.2	0.6
Australian Capital Territory	0.4	0.4	0.3	0.2	0.1	**
Total school-based apprentices and trainees	**18.5**	**23.0**	**22.1**	**21.0**	**20.1**	**-4.2**

To facilitate greater industry involvement in apprenticeship arrangements the current regime of employer incentives needs to be reviewed and rationalised. In particular, there needs to be a focus

[13] Workforce Development Needs Survey Report, December 2016, Ai Group,page 15. .

on employer incentives for first time participants in the arrangements. European research suggests that direct subsidies are more effective in encouraging companies to start training than for companies which are already training.[14]

A national body is needed to manage the implementation of these measures including overseeing national consistency and ensuring programs and arrangements meet current and future workforce needs. Confronted with similar apprenticeship issues, the UK is establishing an independent and employer-led body, the Institute for Apprenticeships, to regulate the quality of apprenticeships in the context of anticipated rapid expansion of the program.[15] It is timely for Australia to review the governance arrangements for apprenticeships with a view to providing a genuinely national approach.

Recommendations

- **Implement measures to achieve full national consistency for all apprenticeships across Australia, including consideration of an oversighting body to ensure programs and arrangements meet current and emerging occupational needs.**
- **In consultation with industry, develop measures designed to increase the level of participation in apprenticeships/traineeships; review the employer incentive regime; and develop incentives for first time participants in the system.**
- **Initiate a review of school-based apprenticeships to determine the reasons for low levels of participation and to develop strategies to facilitate greater participation by schools and industry.**

5.3 Developing Australia's industry leadership capabilities

The Ai Group continues its call for a focus on building new leadership capabilities in Australia's workforce that will enable us to embrace disruptive technologies and innovation. New business models are emerging that lend themselves to a more volatile environment. The evidence from both academic research and business surveys shows that workplaces with more effective leadership and management capabilities are more productive, profitable and innovative.

Australia scores a lower ranking for management practices than for its overall competitiveness on an international scale.[16] In research released by the Centre for Workplace Leadership in May 2016, findings show we will largely depend on the capability of our leadership and employee engagement levels in order to sustain and grow our competitiveness.[17] This research, drawing on data from over 8000 respondents looked at the ability of leaders to respond to emerging challenges in workplace environments facing disruption from new technologies and other forces. The report found few Australian organisations report high levels of innovation; too many Australian organisations underinvest in leadership development, especially at the frontline; leadership in Australian

[14] The effectiveness and cost-benefits of apprenticeships: results of the quantitative analysis, European Commission, September 2013.
[15] English Apprenticeships: Our 2020 Vision, Department for Business, Innovation and Skills, 2015.
[16] International Institute of Management Development World Competitiveness Yearbook, 2016.
[17] Centre for Workplace Leadership, The Study of Australian Leadership, May 2016

organisations does not reflect wider social diversity, and that many senior leaders do not draw on strategic advice in making decisions about the future.

Significantly, the report found workplaces that invest in a range of leadership development activities have more capable leaders with a stronger belief in their ability to do the job, and this is associated with better performance and more innovation.

The new research mirrors much of the discussion in Ai Group's 2015 policy paper, *Addressing Enterprise Leadership in Australia*.[18] A concentrated effort is needed to build in and support new ways of working which incorporate the development of an organisation's people and culture. Collective leadership capability development which meets organisational business goals, in addition to individual leadership development frameworks, needs to be nurtured.

The new research released during the year strengthens the need to address this important policy area. Ai Group sees that addressing the leadership imperative is a joint responsibility. The reform of leadership and management education, in particular through context specific programs, must be encouraged. Best practice approaches to the development of emerging/frontline managers, including developing management skills within an industry context, and involving collaboration across companies, need to be reinforced.

Recommendation

- **Establish an industry leadership development taskforce that identifies and funds innovative leadership development programs including by recording and promoting good models for education institutes and industry.**

5.4 Developing Australia's Science, Technology, Engineering and Maths (STEM) capabilities

The Education Council's National STEM School Education Strategy is now one-year old.[19] Initiatives within this include the establishment of a STEM Partnership Forum to promote these partnerships, however this has not yet occurred. The Ai Group continues to welcome the opportunity to participate in this.

While some progress has taken place there are still gaps in the national approach to STEM skills and the initiatives released to date do not constitute an overall national strategy. In particular, there is little focus on measures to support and expand the STEM-qualified workforce and no reference to the importance of Vocational Education and Training (VET) sector in this policy area.

Ai Group's long-standing concerns about the state of STEM skills and the impact on the economy are well documented.[20] A major focus needs to be on growing the STEM workforce. Modelling by PwC finds that shifting just 1 per cent of the workforce into STEM roles would add $57.4 billion to

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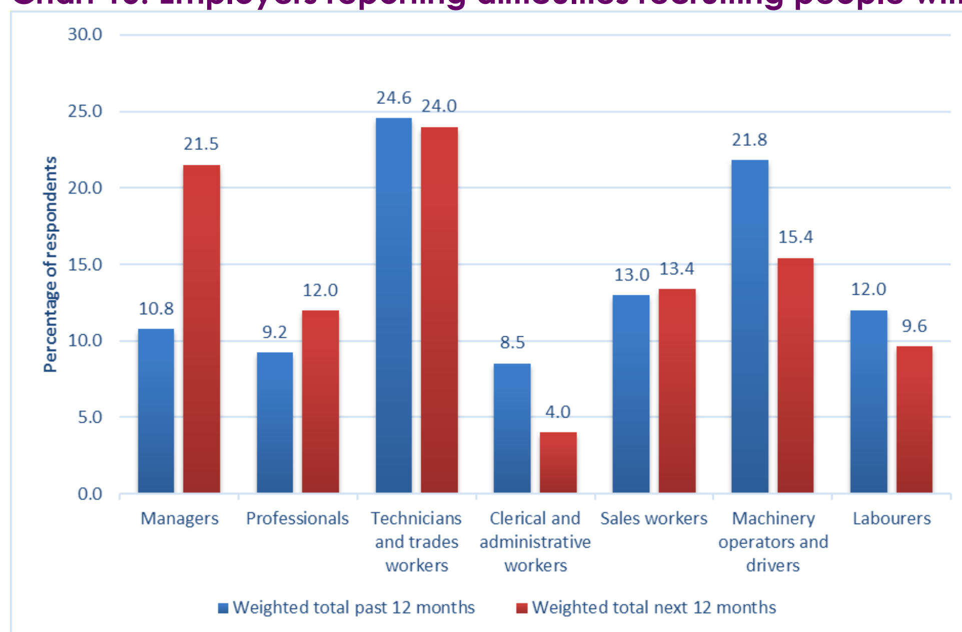
[18] The Australian Industry Group, Addressing Enterprise Leadership in Australia, June 2015.
[19] *National STEM School Education Strategy*, Education Council, December 2015.
[20] *Progressing STEM Skills in Australia*, Australian Industry Group, February 2015.

GDP.[21] Skilled technicians are often the most pressing area of shortage for companies rather than graduates as Ai Group workforce development surveys reveal. The latest data indicates that around a quarter of employers anticipated difficulties recruiting technicians and trade workers with STEM skills (see chart 15). Accordingly, there needs to be a renewed focus on apprenticeships and traineeships in STEM-related areas. Employer incentives could be targeted in these areas.

Chart 15: Employers reporting difficulties recruiting people with STEM skills, 2016



Source: Australian Industry Group Workforce development needs Survey 2016

While longer-term solutions to the STEM skills shortfall properly concentrate on the school sector, there is much to be done to reduce short-term pressure. In addition, support for existing workers to retrain in STEM areas would also assist to meet the relatively short-term needs of the economy.

Strategies are also required to meet the particular needs of SMEs given their prominence in the economy. Government could support these companies via networks or clusters and engagement with group training companies. Support for sectoral and supply-chain companies working with larger companies also warrants consideration.

The Industry Growth Centres initiative has significant potential to promote and implement STEM skills. All six of the Centres announced to date overlap with STEM skill areas. The centres are tasked with improving the management and workforce skills of key growth centres.[22] The long-term strategies to be developed by each of these centres needs to focus on the development of workforce STEM skills. There has been research by NCVER about the readiness of five of these growth industries to meet the demand for skills. Among a number of findings to overcoming limitations this research found there is a requirement to have:

[21] *A smart move*, pwc, April 2015, page 4.

[22] www.business.gov.au/advice-and-support/IndustryGrowthCentres

> *"a priority focus on STEM, including the development of workplace skills in STEM undergraduate or research degrees and opportunities for continuing professional development in STEM disciplines."*[23]

To address this issue the Ai Group supports the call from the Chief Scientist and others for an overall national STEM skills strategy. The government can take a leadership role, potentially through the Commonwealth Science Council, in the development of this strategy in conjunction with industry. A multi-pronged approach is needed to address school, university, VET and industry involvement. Sufficient resourcing is required to develop a co-ordinated and systemic response to the issue.

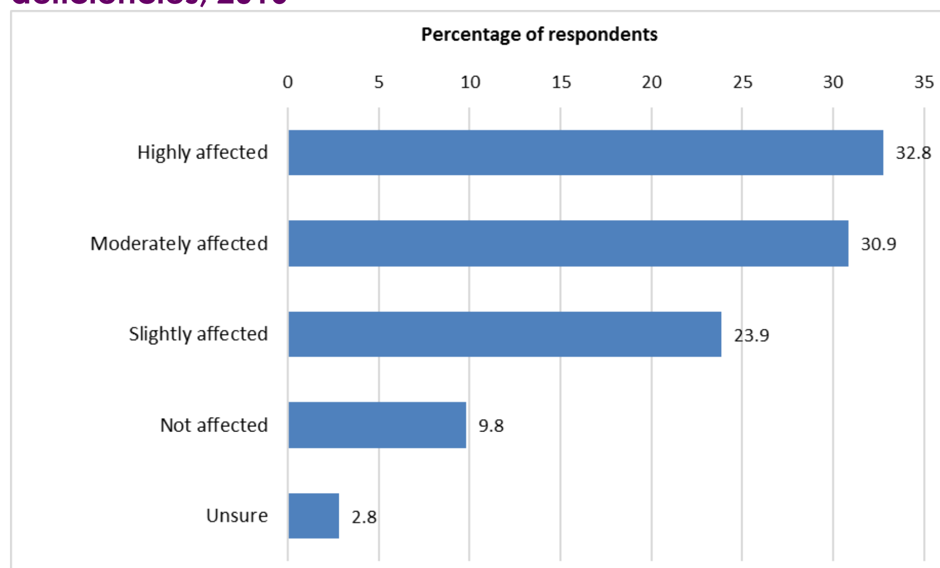
Recommendation

- **Develop and effectively resource a national STEM skills strategy in conjunction with industry to expand the STEM-qualified workforce; increase the level of STEM participation in the VET sector; introduce employer incentives in STEM-related areas; develop specific measures to expand the STEM workforce in SMEs through cluster/network models; and support STEM skills workforce projects through Industry Growth Centres.**

5.5 Developing Australia's workplace literacy and numeracy capabilities

Ai Group research confirms that the low levels of workplace literacy and numeracy are a major concern to employers. The most recent survey indicates that over 87 per cent of employers reported low levels of literacy and numeracy having an impact on their business (see chart 16).[24]

Chart 16: Employers affected by workplace language, literacy and numeracy deficiencies, 2016



Source: Australian Industry Group Workforce development needs Survey 2016

This has a negative impact on productivity, labour mobility and the capacity of the economy to achieve the higher levels of skills needed for the increasingly knowledge-based economy. There

[23] Francesca Beddie et al; *Readiness to meet demand for skills: a study of five growth industries*, NCVER, 2014.
[24] Workforce Development Needs Survey Report, December 2016, Ai Group, page 16..

remains an urgent need to address the language, literacy and numeracy needs of the Australian workforce.

The Ai Group has conducted a return on investment to employers' program with very positive results.[25] In addition to the benefits for participating employees, there is also now a firm business case for employer investment in workforce literacy and numeracy. There needs to be program for them to invest in.

A national literacy and numeracy strategy needs support especially for workplaces. A key component of this is the development and implementation of a new co-contribution program specifically for workplaces. Such a program would be based on tight outcomes for both individual participants and employers. The use of the Australian Core Skills Framework could be mandatory to measure individual improvement and return on investment measures could be utilised to demonstrate benefits to the employer including direct linkages to productivity. The program could also be nationally accredited through the use of the Foundation Skills Training Package adapted to suit particular workplace needs. The Ai Group conducted a small pilot study with three workplaces during 2016 based on these approaches with significant success.[26] This combination of measures could be implemented through a larger national pilot program in concert with industry.

Recommendation

- **A national foundation skills strategy needs to be provided with a sufficient budget to support workforce literacy and numeracy programs, including the development of a new program dedicated to the workforce.**

5.6 Reform of Australia's higher education system

The Ai Group recognises the fundamental importance of a well-placed higher education sector to drive a successful business sector. Higher education, in close collaboration with industry, needs to produce high quality, employable graduates in sufficient quantity to meet Australia's current and future labour needs.

The government has undertaken an extensive review of Australia's higher education system over the past year in order to determine a future plan for higher education which encourages excellence and innovation and is sustainable. Ai Group agrees with the premise for change, stressing however the now urgent need for decision and implementation. It is essential that the government's current consultation process now results in the timely implementation of definitive new policy settings, including a sustainable funding model, that drive informed student choice, student access, the maintenance of quality and that have an appropriate impact on VET sector training choices.

In its submission to the review of the HE system, Driving Innovation, Fairness and Excellence in Australian Higher Education, Ai Group commented on the significant growth seen by the sector in university undergraduate participation, particularly since the introduction of reforms in 2009.

[25] *Investing in Workforce Literacy Pays*, Australian Industry Group, August 2015.
[26] Forthcoming Ai Group publication.

Noting that this has been attributed to the uncapping of undergraduate places27, Ai Group has supported the student demand based funding system for higher education as a potentially effective mechanism for meeting industry's growing demand for skills and qualifications, and recognised its flexibility. The system must be able to adjust continuously and automatically to meet needs assuming that young people make informed decisions about labour market opportunities. Industry needs to be assured that students are best suited to the level and emphasis of the programs they are undertaking, and that they have the opportunity to undertake courses that are most relevant to them, thereby creating the best talent pipeline for the workforce. The new policy settings must set up the system to better lead to these outcomes.

As part of its submission to the Review, Ai Group provided industry's views on subsidies for graduate courses and expanding access to sub-bachelor courses, which will positively impact on students who would more typically become vocational education and training (VET) students. The industry requires a steady supply of VET graduates to the workforce, in addition to bachelor level and above.

The demand driven system has been successful in increasing the volume of students participating in higher education to meet the growing demands of industry. Industry needs a skilled workforce with the most capable graduates drawn from all environments. It needs a diverse workforce that is better able to fuel local and global interaction, collaboration and innovation. Ai Group supports the need for greater educational support and other measures to assist suited students from low SES backgrounds to complete degrees.

Related to the equity issue discussed above, it is essential that quality regional and remote teaching and learning is available to students. In considering its support for this learning, the Government should focus on virtual teaching spaces, networks (including with businesses and their facilities) and collaborative technology usage, only augmented by physical spaces. Innovative approaches to infrastructure must match innovations in the social and business world.

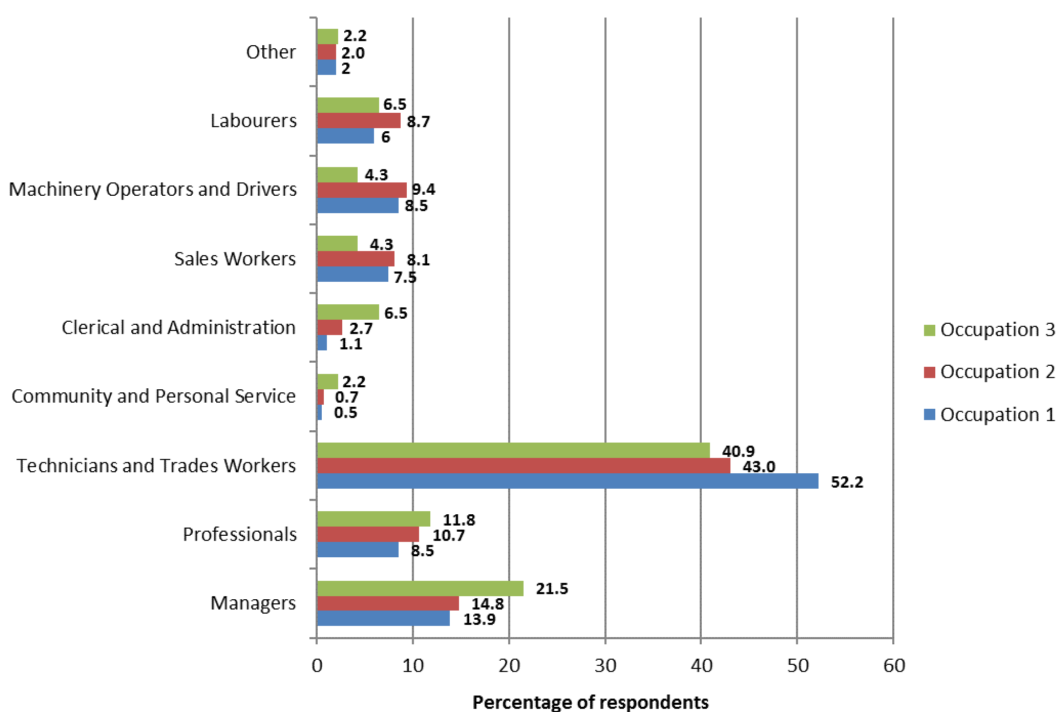
Industry is keen for matches between educational supply and workforce demands to be better monitored as failure to address the supply of skills where needed can severely risk business productivity and contribute to resource wastage. Increased student demand has not always aligned with industry demand. This is closely related to the persistent issue of skills shortages in the Australian economy. Ai Group's 2016 survey on Employer's Workforce Development Needs focused on the prevalence and location of skill shortages within workforces. Surveyed employers were asked to identify their experience of skill shortages in the past 12 months by occupational grouping.

Managers and Professionals constitute the second largest group of concern, with Technicians and Trades Workers being the largest group. Employers reported the following skills shortages for Managers: (13.9 per cent) as the first occupation, 14.8 per cent as the second occupation and 21.5 per cent as the third occupation. The same pattern was reported for Professionals at slightly lower rates: 8.5 per cent as the first occupation, 10.7 per cent as the second occupation and 11.8 per cent as the third occupation.[28]

[27] The Hon Dr David Kemp and Andrew Norton, Review of the Demand Driven Funding System.

[28] Workforce Development Needs Survey Report, December 2016, Australian Industry Group, page 9.

Chart 17: Employers reporting skill shortages in 2016, top three occupations in shortage, by skill level



Source: Australian Industry Group Workforce development needs Survey 2016

Of significance are employers' views of anticipated skills shortages for professionals and managers over the next twelve months. Shortages of Professionals are expected to increase with 14.1 per cent ranked this grouping as the first occupation, 13.1 per cent as the second occupation and 10.7 per cent as the third occupation. Shortages of Managers are expected to remain at a similar level.[29]

Industry regards the quality of information provided to students as an important factor in developing graduates with the correct motivations, suitability and employability for specific industry areas/occupations. High-quality information is the beginning point for the effective operation of a market-based system. It is essential that industry's need for the skills generated by higher education are not lost in a system dependent on student demand that is not well informed. As laid out in Ai Group's submission to the current Review, additional government funding to obtain quality information activities is considered necessary. Information gathered from employers' surveys must cover the breadth of industry areas and all sizes of business – small, medium and large – all of whom have differing needs and operations.

The Ai Group supports the principle of a student loan system, recognising that it reduces barriers to higher education for capable students. These students are needed for industry to be innovative and competitive by gaining the best possible graduates it can to develop a productive workforce. A student loan system has benefits for the whole community which is the basis of the shared cost by taxpayers and students. In recognition that a student loan system into the future needs to be fair

[29] Workforce Development Needs Survey Report, December 2016, Ai Group, page 10.

and affordable, Ai Group acknowledges changes need to be more closely considered in order that the system is sustainable. Pressures have been placed on Australia's Higher Education Loan Program through the debt level, VET FEE-HELP blow-out, higher level and longer qualifications and post graduate qualifications. More debt repayments are less likely and there are questions around the broad public benefit for the taxpayer. The Government's re-casting of the VET FEE-HELP framework needs to be integrated with a review of the overall loan system for higher education.

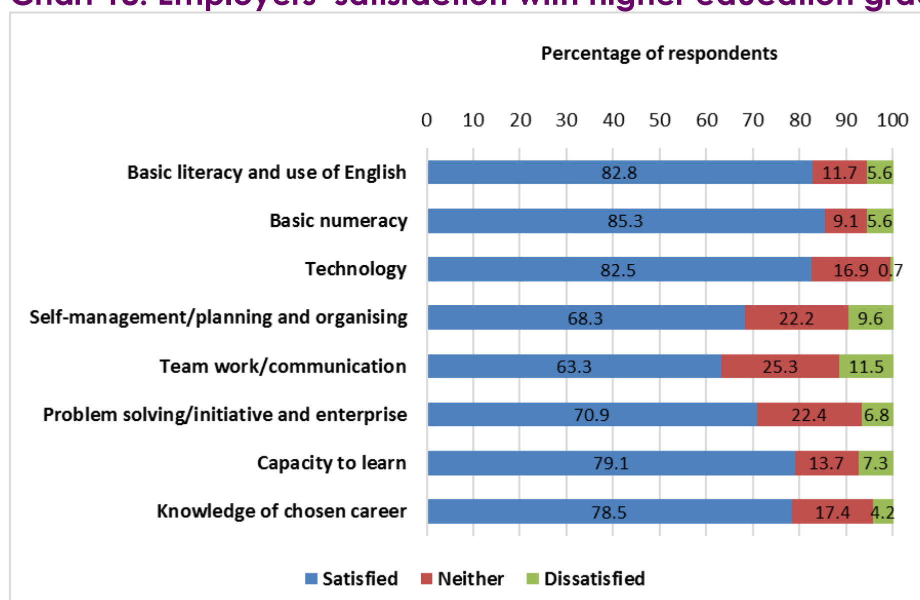
5.7 Developing the employability of Australian graduates

The employability of graduates is affected by a number of factors within and external to the higher education system. The Australian economy is being affected by disruptive global changes, including technological advancement and borderless commerce. These changes are rapidly transforming jobs, with uncertainty around the shape of jobs to come. Different skill sets are needed for the emerging economy with a base in STEM skills, entrepreneurship, critical thinking and adaptability. Within this context, employers have indicated some dissatisfaction around the work readiness and employability of university graduates for some time.

In October 2016, Ai Group released its latest policy statement, *Connecting for Productivity: University and Industry partnerships*[30], which includes new data from members gathered through the 2016 Workforce Development Needs Survey. With regard to graduate capabilities, members expressed their highest levels of dissatisfaction around graduates' levels of team work, self-management and capacity to learn (see chart 18).

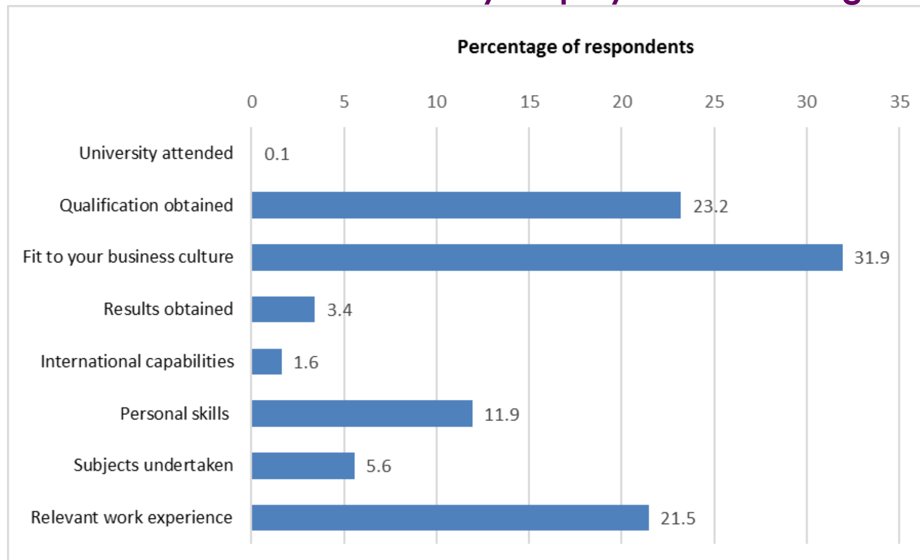
Employers also indicated the most important factors when employing higher education graduates. Fitting in with business culture was ranked by 31.9 % of respondents as the most important factor when recruiting higher education graduates. The type of qualification obtained was ranked first by 23.2 % of respondents, while 21.5 % ranked relevant work experience first (chart 19).

Chart 18: Employers' satisfaction with higher education graduates's skills, 2016



[30] The Australian Industry Group, Connecting for Productivity: University and Industry partnerships, October 2016.

Chart 19: Factors considered by employers in recruiting tertiary graduates, 2016



Source: Australian Industry Group Workforce development needs Survey 2016

Industry, higher education providers and government all need to work together and commit resources to enable Australian graduates to have the adaptive capabilities needed for the fast changing world of work. National strategic discussion must result in the architecture for closer connections and equip graduates for new economy characteristics. There must be a broader awareness of innovative models of connecting between industry and higher education providers, and learning and teaching practices in higher education providers need to better embed employability, through work integrated learning approaches. A system of support for greater industry involvement, particularly for SMEs needs to be implemented.

For its part Ai Group has been working closely with industry and other stakeholders to facilitate the changes needed for future-ready higher education graduates. As a partner to the National Strategy for Work Integrated Learning in University Education since early 2015, Ai Group has actively participated with other partners to progress the actions detailed in the Strategy which also encourages increased government commitment to WIL.

Recognising that a key solution to a lack of work readiness is to expose students to the workplace and to integrate the experience with their studies, Ai Group has focused on assisting employers to become engaged. In July 2016 we released a guide for employers - Uni Students – Good News for Your Business. The guide assists employers to get involved with university students by providing information on the benefits to the business, types of involvements, legal requirements, tips on successful relationships, examples and contacts to get started. Ai Group is also involved in WIL through its chairing role on the reference group of a two-year national Successful Work Integrated Learning in Science project funded by the Office of Learning and Teaching. In addition, to assist employers find the right current graduates, Ai Group has developed a Graduate Employment Service which screens and prepares candidates, supports companies and mentors these new graduates.

For many employers, particularly SMEs, providing work exposure for HE students in the form of work integrated learning activities, can result in real benefits to the company but can also be resource intensive. There are costs for the employer in terms of time determining

activities/projects; in some cases paying the students; in support, supervision and mentoring by one or more people in the company; in providing feedback and evaluating the experience with the HE provider.

These students become better prepared for workplaces and their cultures, and will be more productive earlier as graduates, leading to a beneficial effect on the economy. Students can bring fresh ideas to companies resulting in more innovative SMEs and Australia's graduates will possess greater employability characteristics. Government support to assist SMEs' involvement with students for work integrated learning will help realise these benefits. Support that covers the salaries of students during WIL activities is needed. Placements can focus on specific fields, such as STEM, and ensure regional areas are represented. As a leader in this space, the Canadian Government in its 2016 Budget allocated $73 million over four years to placements and work integrated learning opportunities. Significantly the Canadian Government has linked this initiative to advancing its Innovation Agenda to spur economic growth.

Recommendations

- **Ensure adequate funding is allocated to implement a new higher education system which includes policy settings that drive innovation, quality, access and skills alignment.**

  Commit resources to funding and promoting innovative models of connecting between industry and higher education providers including establishing a grant program to support student placements and work integrated learning in SMEs.

5.8 Industry Skills Fund

With the Australian Government's decision in December 2016 to close the Industry Skills Fund, an important source of support for business growth was removed. The decision was made as part of a range of changes to programs through the Mid-Year Economic and Fiscal Outlook.

Ai Group is concerned that the axing of the Industry Skills Fund will potentially detract from the development of the economy and the dispersal of gains across the community. The decision removes the only national program focused on upskilling Australia's existing workforce. Its reach included every state and territory.

The Fund has proven to be very successful in lifting workforce skills at a time when the existing workforce needs to be upskilled to meet the growth and innovation demanded by the new economy. 50 per cent of businesses taking up the Fund were medium-sized businesses and 40 per cent were small and micro business – this total group representing the engine room of Australian business.

Whilst the Fund targeted a number of priority sectors, training places and support services were often taken up by the Enabling sector – i.e. enabling technologies and service industries that support one or more of the priority areas (27 per cent), again demonstrating important capability development in existing workforces.

Recommendation

- **The Government should consult with key stakeholders of the now-cancelled Industry Skills Fund to gain a broader understanding of the benefit to industry and design and implement**

a selective program for enhancing workforce capability in sectors operating in areas of the economy experiencing higher levels of growth and innovation.

6. Improving Innovation and Business Capabilities

Innovation and the development of business capabilities are central to the successful ongong 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.

6.3. Digital capabilities

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.

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.

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.

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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

- **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.**

6.4. Making the most of FTAs

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 mission 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 Government staff assisting companies in these markets need to be trained in the rules of the agreement and the new opportunities the 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.

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.

Opening markets through FTAs is only one element of creating a successful exporter. Companies, particularly SME's require additional coaching to ensure that they export efficiently and successfully. TradeStart has been an important partnership program for Austrade to deliver export coaching services across the country.

Recommendations

- **Ensure Austrade has sufficient funds to build and maintain the skills and resources to support Australian companies to access global value chains and to invest abroad.**
- **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**
- **Increase the availability of one-on-one support for new and emerging exporters.**
- **Continue and expand programs, such as the Colombo Plan, that develop the international business skills of Australian professionals. The relative neglect of new markets such as Latin America in these programs should be addressed.**

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.**

6.7. Effective, efficient and fair anti-dumping arrangements

Recent changes have improved Australia's approach to allegations of dumping in the domestic market. It is critical for all affected parties and potentially affected parties that the Anti-Dumping Commission is able to initiate, investigate and conclude its deliberations in an efficient and fair way.

Increased pressures on global markets, including steel have resulted in more Australian SME interaction with the Australian Anti-Dumping System. The International Trade Remedies Advisory Service (ITRA) is an important service that supports all SMEs deal with the complexity of the system. It is important for all affected parties including the many businesses who would face higher prices if anti-dumping actions are successful. The pilot of the ITRA was housed by the Australian Industry Group and we believe that its transfer to the Department of Industry has severed an important link between the service and its target group. Housing the service within membership organisations, outside Canberra, will enable the advisors to be more proactive in their interactions with industry and ensure more collaboration with other industry programs such as the Entrepreneurs Program and Tradestart.

Recommendations

- **Maintain funding of the Anti-Dumping Commission.**
- **Reassess the decision to house the International Trade Remedies Advisory Service within the Department of Industry, Innovation and Science rather than in business organisations with established relationships of trust with small and medium-sized businesses.**

7. Energy and Environment Policy Priorities

Australia aims to have an affordable and reliable energy system while meeting our Paris emissions commitments and contributing to a global goal of net zero emissions in the long term. Our energy market designs and policy frameworks fall far short of what is needed to achieve affordability, reliability or sustainability. Reform is needed, and soon: the status quo will not continue, with older baseload generators becoming less profitable, new baseload uninvestable, and an electricity market not designed to integrate high levels of variable renewables. Without nationally coordinated and durable action price increases and supply risks are likely to intensify. Industry investment and employment is threatened.

These issues are largely being addressed outside the Budget process through the Review of Australia's Climate Change Policies and through the Independent Review into the Future Security of the National Electricity Market, also known as the Finkel Review. This is proper and these processes should run their course and consider all options. However, there are several steps that should also be taken into account in the 2017-18 Budget.

Firstly, the Finkel Review and COAG are likely to consider and recommend a range of specific near-term projects and investments that can contribute to energy security and proceed in parallel with, rather than subsequent to, reforms to market design and policy settings. We understand that these may include options like the conversion of closed power stations into 'spinning condensers' that stabilize the grid, or the construction of energy storage projects that can provide a range of services. While the private sector and the States will play a role in financing these projects, the Government should be ready to commit significant funding towards them if necessary to enable early action and build Australian experience of construction and operation of these technologies. While ARENA and CEFC seem appropriate sources of funding, an additional Government commitment may be needed since these projects may be unable to meet the hurdle rate of return (despite overall community benefits) prior to the completion of market reforms to reward inertia, frequency control and other services.

Secondly, the substantial price rises under way for electricity and gas can be softened by good policy but are unlikely to be reversed. Greater efficiency and productivity in the use of energy will be needed to limit the extent to which higher prices translate to higher final costs. The Government's existing National Energy Productivity Plan aims to assist this, but to date the measures have been exploratory or had only minor funding implications. The Government should be ready to significantly increase resources for the NEPP, including to provide detailed information and advice to energy users of different sorts, to better resource the implementation of existing standards and rating systems, and to assist energy saving upgrades and retrofits, particularly where State efficiency schemes do not apply.

Finally, the Emissions Reduction Fund is the main plank of the Government's current climate policy. While the future of the Fund and other policies is properly part of the major review to be conducted this year, the Fund has also almost fully committed its existing $2.55b funding allocation. This may well be exhausted at the next ERF auction round. An extended gap may result, with no new activity

between the allocation of the current commitment and the outcome of the Review, leaving domestic offset providers in limbo. To avoid this the Government should make a bridging commitment of further ERF funds for allocation in 2017-18. The Government has previously suggested its longer term ERF commitment might be $200m per year. This would be an appropriate sum for a bridging commitment.as its potential longer term annual commitment.

Recommendations

- **Provide new funding to fast-track near term energy security options developed by the Finkel Review and COAG Energy Council.**
- **Increase resources for the National Energy Productivity Plan.**
- **Make a $200 million bridging commitment to the Emissions Reduction Fund.**

8. Annual Skilled Migration Program

The whole Australian community benefits significantly from a well-planned program of permanent migration which includes skilled, humanitarian and family entry streams. In 2016 the Productivity Commission (PC) formally reviewed Australia's migration program (April 2016). It found that both the level and the composition of migration matter. The greatest benefits to the community come from younger, highly skilled migrants. In the long-term, the PC found that the current immigration program delivers a 'demographic dividend' which will raise output and incomes for everyone:

> *"Continuing [Net Overseas Migration] NOM at the long term historical average rate [of 0.6% of the population] and assuming the same young age profile as the current intake is projected to increase GDP per person by around 7 per cent (equivalent to around $7000 per person in 2013 14 dollars) in 2060 relative to a zero NOM scenario. Increasing or decreasing the level of NOM from this rate is projected to have a corresponding impact on GDP per person, all other factors equal.*
>
> *The results reinforce the importance of age and skills in the migrant intake. Increasing the average age structure of NOM to reflect that of the Australian population is projected to reduce real GDP per person, while increasing the share of migrants entering in higher skilled occupations is projected to lead to an expansion in real GDP per person."* (PC, p. 15).

Ai Group strongly supports the Productivity Commission finding that Australia's permanent migration program should strengthen its focus on skilled migration. Skilled migrants generate the greatest benefits to the Australian community, since they contribute directly to our national employment and skills base. Many also bring specialist knowledge that provide even bigger benefits, by deepening our entrepreneurship, innovation and international linkages. Those that enter via the 'demand-driven' streams such as employer sponsored migration experience a better skills match and faster entry to the labour market - therefore utilising more of their skills more quickly on arrival in Australia – than those who arrive independently and seek work after arrival.

Department of Employment projections (updated in February 2016) indicate that over the next few years to 2020, close to one million new jobs (989,700 jobs or 8.3% growth) are likely to be added to the Australian economy, with about half of this future jobs growth coming from three of the largest services industries: professional services, education and healthcare. This implies both workforce growth and further industrial restructuring. It illustrates the scale of the challenges and opportunities before us and suggests a commensurately larger policy response is required.

As noted by the PC, in the absence of a national population policy, the annual migration program is an important policy lever for the Government in meeting these ongoing labour force needs, especially as the population ages. This presents a compelling argument for lifting the annual migration intake to 210,000 in 2017-18 from the current cap of 190,000. Indeed, in the Federal Budget for 2016-17 (May 2016), Australia's total Migration Program Planning levels were kept unchanged for a fifth consecutive year, at 190,000 places. Within this total, skilled migration has remained capped at around 128,000 visas per year. Consequently, permanent skilled migration has not kept pace with growth in the Australian population or in the Australian workforce.

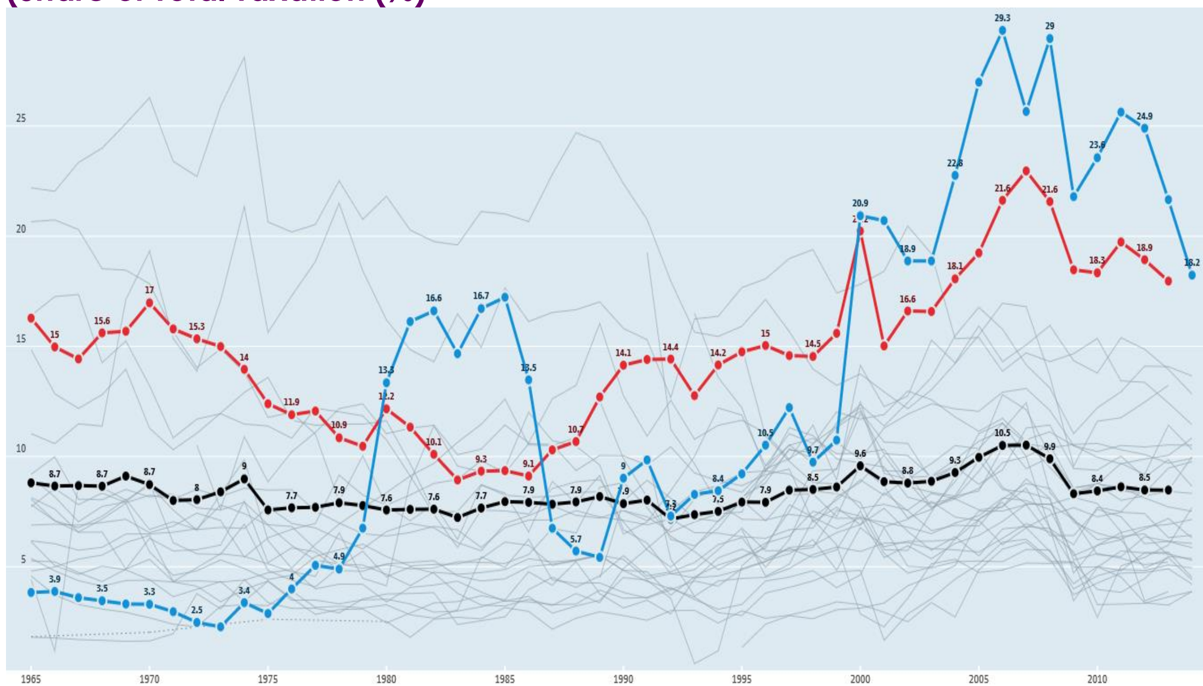
Recommendations

- **The annual permanent migration planning level should be lifted to 210,000 per year in 2017-18 and beyond, from the current maximum cap of 190,000; and**
- **Stronger priority should be given to the skilled migration stream within the permanent migration program and especially to the demand-driven components of skilled migration.**

Appendix A: Australia's High Recourse to Company Taxation

Australia has a high recourse to the taxation of business profits in the form of company taxation. This is shown very clearly in Chart A1 which compares the company tax share of total tax collections for all OECD countries over the period between 1965 and 2014 (which is the latest year for which comparative data are available). In all Charts below, Australian data are highlighted in red, the average of all OECD countries in black and, to emphasise some particular features, Norwegian data are highlighted in blue.

Chart A1: Taxation of Corporate Profits in OCED Countries 1965 – 2014 (Share of Total Taxation (%)



Source: https://data.oecd.org/tax/tax-revenue.htm

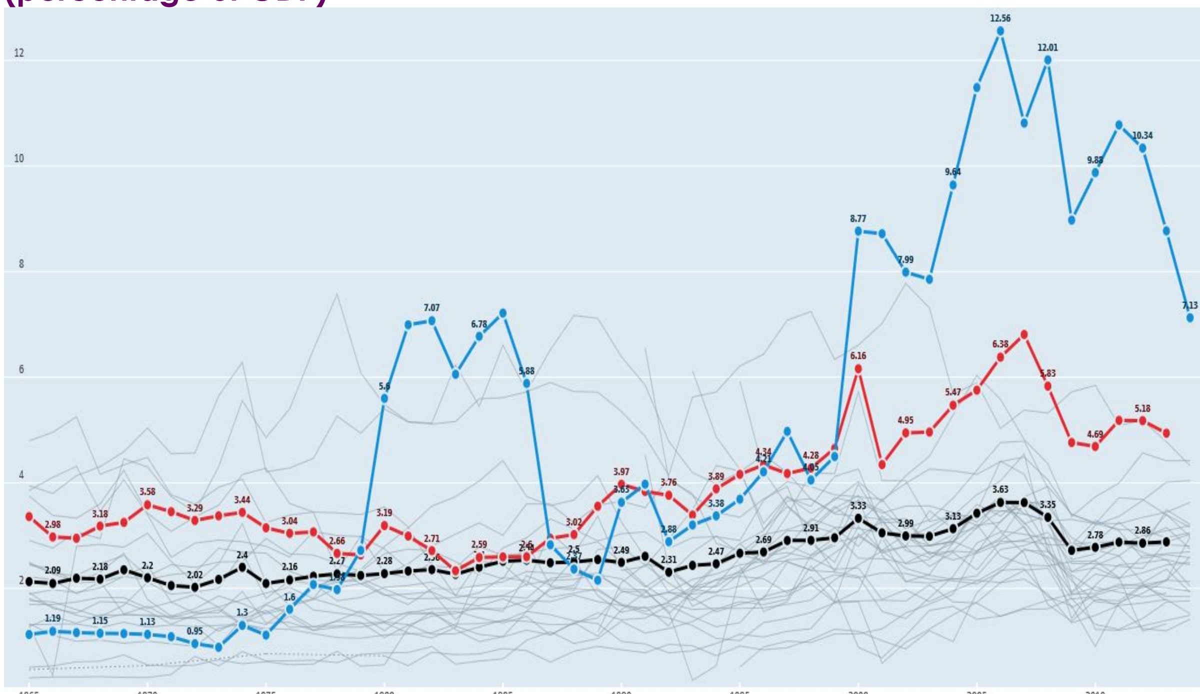
A number of points can be emphasised:

- Over the past half-century, Australia's reliance on company taxation has consistently been above the average for all OECD countries;
- For the second half of this period, coinciding with the major tax reforms of the mid-1980s, both the share of company tax in total tax collections and the gap between the share in Australia and the average share among OECD countries has trended higher;
- For each year since 1990 Australia's share of total taxation contributed by company taxation has ranked in the top three OECD countries and has ranked in the top two OECD countries since 2004;
- Both for Australia and Norway, the reliance on company tax intensified during the recent period of high commodity prices and has since retreated somewhat (in Australia's case to a level that

is broadly consistent with the rising trend since the mid-80s and in Norway's case more dramatically – in line with its particular reliance on resource rent taxation).

Some further features of the relative size of Australia's recourse to company taxation can be made with reference to Chart A2 below which compares the company tax relative to GDP across the OECD countries, again between 1965 and 2014 (which is the latest year for which comparative data are available).

Chart A2: Taxation of Corporate Profits in OCED Countries 1965 – 2014 (percentage of GDP)



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Source: https://data.oecd.org/tax/tax-revenue.htm

Before looking at Australia's relative position in relation to the share of company taxation to GDP, it is worth noting that, just prior to the Global Financial Crisis, there were record high levels of company tax collections relative to GDP for the OECD as a whole. This was followed by a sharp fall in the years 2008 and 2009 and a gradual recovery in the ratio of company tax to GDP across the OECD. The most recent years plotted in Chart 2 show a gradual rise in the ratio of company tax to GDP to a point where the ratio of company taxation to GDP for the OECD as a whole is higher than in any year prior to the mid-to-late-1990s.

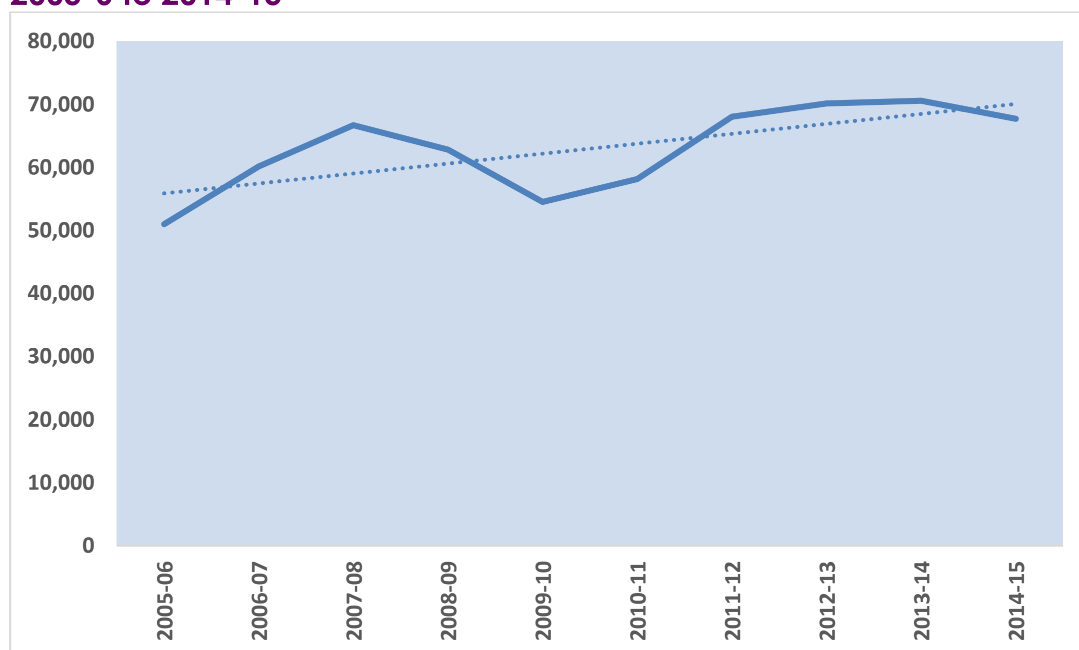
As is the case with the share of corporate tax to total tax collections, relative to the OECD as a whole Australia stands out having one of the highest company tax to GDP ratios. This is despite Australia's lower-than-average overall tax to GDP ratio. Further, the gap between the Australian experience and the OECD average has tended to widen since the mid-1980s as the share of company tax to GDP in Australia has trended higher (against the more gently rising OECD trend). While it is clearly not the only factor, as is suggested by the Norwegian experience, some of the relative rise in Australia in more recent years is associated with the period of very high commodity prices.

Interestingly the upwards trend in the share of company taxation to GDP across the OECD has occurred alongside the trend of falling headline company tax rates. This points to a progressive broadening of OECD company tax bases. Locally, the fall in the headline company tax rate from 47 per cent before the 1980s reforms and from 36 per cent at the turn of the century to its current level of 30 per cent, has not been accompanied by a fall in company tax to GDP shares. In fact, the data suggest very strongly that Australia's rate reductions have been more than offset by various base-broadening measures.

What is less readily explained is that alongside the rise in the company tax to GDP ratio there has been an increased perception of profit shifting and tax base erosion both in the OECD and in Australia. At the aggregate level, certainly for Australia, this perception does not match the reality in which recent levels of company tax to GDP are noticeably higher than was the generally case before the commodity price boom. Even for the OECD as a whole, the empirical evidence of a generally rising company tax to GDP ratio is not suggestive of increased profit shifting and tax base erosion (although it is true that for the OECD as a whole, profit shifting between OECD countries would not be reflected in this measure).

To close off this excursion into the facts of company tax in Australia, and to address questions that might arise from the fact that the latest OECD comparisons lag by a couple of years, Chart 3 below plots Australian Bureau of Statistics data on company tax paid in Australia.

Chart A3: Australian Company Tax Collections ($million) 2005-6 to 2014-15



Source: ABS, 5506.0 - Taxation Revenue, Australia, 2014-15, 26/04/2016.

This decade-worth of data from the ABS, plotted here along with a linear trend line, suggest that Australian company tax collections continue to be high (even though they reflect the GFC and, more recently, falling commodity prices). There is certainly no collapse of company tax collections from their high levels relative both to the OECD as a whole or, to Australia's historical experience.

It is therefore clear that Australia has a relatively heavy recourse to taxes on company profits.

While it is true that across the OECD there has been something of an increase in both the relative reliance on company taxation and the ratio of company tax to GDP, the Australian experience has seen:

- a higher than average reliance and a higher growth in this reliance on company tax; and
- a higher than average ratio of company tax to GDP and a faster than average growth of the ratio of company tax to GDP.

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