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Ivan A Deveson AO

Lord Mayor

17 March 1999

Mr John Ralph AO
Chairman
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Mr Ralph John

On behalf of the City of Melbourne, I am pleased to submit the attached submission to the 'Review of Business Taxation' for your consideration.

The submission concentrates on the need to ensure that Melbourne, and Australia, is well placed to participate in the new global economy of the 21st century, comprising new technologies and knowledge-rich industries which will be increasingly important to the future creation of new industries, employment and rising living standards.

The City of Melbourne, in partnership with the Committee for Melbourne, is actively developing and promoting Melbourne as a smart world city. This program entitled *Thinking Melbourne*, is designed to highlight and build upon Melbourne's strong research tradition, world-class education and scientific institutions, highly sophisticated industry and skilled people.

The *Thinking Melbourne* program recognises that knowledge rich industries will provide the basis for future economic growth and prosperity and that Melbourne is currently well placed to participate globally in this area. Accelerating Melbourne's capacity to continue along this road – particularly in generating the investment required to spawn jobs and growth in knowledge-intensive industry – is the key objective of *Thinking Melbourne*.

Consultation and forums with experts across the business, industry, finance and research and development (R & D) sectors over the past 12 months have identified a number of areas which need to be addressed to ensure that Melbourne, and indeed Australia, is better positioned to establish a competitive edge.

Concern with Australia's current taxation structure, in particular, the scope and rate of capital gains tax and the taxation of limited partnership entities, is consistently highlighted as a fundamental impediment to significant growth in local knowledge-based industry.

City of Melbourne

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Research indicates that Australia is one of the few industrialised countries whose tax regime subjects non-residents to capital gains tax - those countries which have experienced success and growth in their high technology industries and R & D sectors in recent years do not have such impediments to investment in R & D in their tax regime.

The retention and development of new Australian technology is one of the lynchpins to our future. Real tax incentives to venture capitalists, both domestic and foreign, and the exposure of our local venture capital industry to the methods and strategies of successful overseas operators is essential to the achievement of this goal.

Your 'Review of Business Taxation' provides the Government with the opportunity to achieve real tax reform in an area which will stand us in good stead internationally into the next century.

Taxation needs to be geared to encourage productive investment in innovative export-oriented industries. It is our plea therefore that your Review and the Government contribute to Melbourne and Australia's future economic prosperity in the high growth sectors by facilitating the growth in the availability of venture capital. The provision of greater taxation concessions will provide a much-needed catalyst for the growth of a local venture capital asset class and the attraction of venture capital funds from overseas.

I look forward to creative, innovative and valuable recommendations relating to this issue resulting from your Review. Officers of the City of Melbourne would welcome the opportunity to work with your team to make a difference to Melbourne and Australia.

If you require further information or have any queries please contact Mr Geoff Lawler, Manager, Economic and Strategic Planning on 9658 8897.

Yours sincerely

Ivan Deveson

Ivan A Deveson AO
Lord Mayor

CITY OF MELBOURNE

SUBMISSION TO THE RALPH INQUIRY INTO BUSINESS TAXATION

January 1999

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TECHNOLOGICAL INNOVATION AND ECONOMIC DEVELOPMENT

Regional Competitiveness

The City of Melbourne believes that local, regional and national prosperity in a world of disappearing trade barriers will be determined by the capacity for technological and commercial innovation.

Such innovation includes product differentiation, both through the introduction of entirely new goods and services and the innovative packaging and design of existing offerings. It also means finding ways of delivering the same or superior quality outcome for customers at lesser cost. In other words, competitiveness demands continuous investment in the 'knowledge intensity' of goods and services.

For small, trade exposed economies, growth is increasingly dependent on the capacity to tap 'brainpower' and is less able to be underwritten by natural resource endowment. Guided by these principles, the City is preparing local economic development strategies aimed at making Melbourne a centre for knowledge based industries (see below).

The Link between Innovation and Economic Growth – Some Evidence

The nexus between innovation and growth is demonstrated by the superior performance of new ventures versus established enterprises. White (1998) quotes a survey of comparative performance of 400 mainly US companies over 33 years (1962 – 95). This showed that new entrants during this period achieved, on average, a 20% return for shareholders, compared to 13% for the whole sample. The largest 50 firms managed an average return of only 10%.

Murray (1997) shows that during the first half of the 90's, venture backed new technology based firms (NTBF) outperformed large, well established companies in employment and sales growth in both the US and Europe. NTBF's were also strongly global in orientation, displaying strong growth in export sales (see Table 1).

Table 1

Comparative Performance of Venture Backed NTBF's in Europe and the US

	Europe 1991 - 95		US 1990 - 94	
	EUR - NTBFs	Top 500 EUR	US-NTBFs	Fortune 500
Employment Growth %	15	2	20	-0.9
Sales Growth %	35	14	35	2
Exports Growth %	30		57*	
R&D / Sales Ratio	8.6	1.3		
R&D / Equity Ratio			30	14.7

Source: Coopers and Lybrand *Economic Impact Surveys* of the US and Europe, 1996
quoted in Murray (1997), page 9
* 1994 growth figure

Australian evidence paints a similar picture. A study of more than 100 'venture backed' companies conducted by Coopers and Lybrand and the Commonwealth Department of Industry, Science and Tourism (1997) revealed that these firms increased staff numbers by 20% per year in the five years to 1996. This compares with the 2% annual increase in staff numbers within Australia's top 100 companies over the same period. Sales within the venture backed companies grew by 42% per year compared with 6% for the top 100 corporations. In this regard, Australian experience was found to be comparable to those in the UK and the US where C&L had conducted similar surveys (see Table 1).

Like their counterparts in the UK and US, the Australian venture backed companies also demonstrated strong export intensity (Table 2).

Table 2
Comparative Sales and Export Performance of Venture Backed Companies

	Ave Annual Growth in Sales	*Ave Annual Growth in Exports*
Venture backed - Australia	42%	27%
Venture backed - UK	34%	29%
Venture backed - US	35%	23%
Top 100 companies - Australia	6%	na

THE CITY OF MELBOURNE'S RESPONSE

Melbourne's Latent Potential for Knowledge Driven Growth

The City of Melbourne has recognised that Greater Melbourne and Victoria generally have great potential to develop innovative, 'knowledge based' economies.

Victoria continues to lead the nation in the dedication of resources to R&D. Research spending accounts for about 1.9% of Victoria's Gross State Product (GSP), compared to 1.6% for Australia as a whole and 1.5% for NSW. To some extent, this leadership is due to the historically strong representation of Commonwealth funded and non profit R&D institutes in Melbourne (e.g. the CSIRO and various medical and health research institutes clustered in the Parkville area). But the main driver of Victoria's R&D effort over the past decade has been business spending.

Business expenditure on R&D represented some 1.1% of Victoria's GSP in 1996/97 (the equivalent ratio for NSW was 0.8%). Victoria now ranks in the same territory as countries like Canada and the UK, which reported business R&D spending of 1.03% and 1.3% of GDP respectively for the same period. Moreover, Victoria has one of the world's fastest growing business funded R&D sectors.

The State's economy is now sharply differentiated from the commodity based orientation of much of the Australian economy. Overseas exports of Elaborately Transformed Manufactures (ETMs) from Victoria are 1.4 times greater than those from NSW, and more than twice the level shown by the rest of the country when counted on a per capita basis.

The changing direction of the Melbourne and Victorian economies towards dependence on high value added and high knowledge content products appears to be flowing through to the educational and career choices of young people. Victoria's enrolments in university science and engineering courses are significantly higher than those in NSW, both in proportional and absolute terms. Victoria overtook NSW in this area in 1993 and the trend has intensified ever since.

Analysis of the changing composition of jobs in Melbourne and Sydney between 1986 and 1996 highlights this shift in the structure of the Victorian economy (Jureidini and Healy, 1998). It also signals the continuing potential for a new partnership between these cities. Globalisation has seen a deepening of Sydney's specialisation in finance and business services, while Melbourne has developed as the nation's principal centre for advanced manufacturing, communications, research, transportation and several parts of the arts and culture industries.

Unlocking the Potential

Amongst the initiatives undertaken by Council to promote and develop the City as a centre for knowledge intensive industry has been joint leadership (with the *Committee for Melbourne*) of the ***Thinking Melbourne*** Program.

The objectives of the Program are to:

- significantly increase the spin off of new enterprises from Melbourne's institutional research base and support the growth and further development of these businesses; and
- accelerate the take up of new technology in Melbourne's traditional industries.

Until recently, the program's main focus has been a general marketing campaign to raise awareness of Melbourne's R&D, design and advanced manufacturing capabilities. Addressing specific opportunities for, and barriers to, investment in targetted industries is the priority in the current phase of the program. To this end, the City and the Committee for Melbourne has prepared a Strategic Business Plan for the Program, to guide activities over the next 3 years.

BUSINESS TAX ISSUES

Access to Venture Capital in Australia

Preparation of the business plan for ***Thinking Melbourne*** included consultations with business, research institutions, technology commercialisation specialists and other stakeholders.

The impact of Australian tax laws on access to venture capital loomed large in these discussions.

Many participants indicated that the problem facing small and medium sized enterprises (SMEs) in financing high technology initiatives was not a lack of venture capital funds per se. This is corroborated by the 1998 AVCAL survey which reported that respondent venture capital firms had access to almost $800 million in uncommitted funds.

Not all of these funds would be immediately available as there is usually an extended draw down period (often 3 years) on capital raisings. Also, fund managers require a degree of liquidity for new investments and follow on investments. Nevertheless, the extent of uncommitted funds is suggestive of a relatively risk averse nature in the Australian venture capital industry.

Other AVCAL figures support this hypothesis. Only 5% of funds raised by venture capital firms are invested as seed capital in start up enterprises. In recent years, the industry has been directing most financing support to existing, well established companies which are seeking to expand. As AVCAL puts it, "this supports the perception that the industry in Australia has attempted to lower the risk profile by investing in companies with a longer track record". It is also telling that the majority of venture capital funds (60%) are being directed into general industrial and service enterprises rather than hi-tech businesses.

There is, therefore, a general perception that venture capital is difficult to source in Australia. Of the 46 countries covered by the World Competitiveness Yearbook, 1996, Australia ranked only 20th in terms of whether 'venture capital is readily available for business development' (Lawn, 1997).

These access difficulties, together with the competitive disadvantage of a small domestic market, have been authoritatively quoted as stifling the growth of Australian NTBF's. For example, in their review of Australia's information industries, Charles, Allan and Buckeridge (1997) concluded that….

> *"Australians do have a propensity to innovate, to take a risk, to form their own company. The Bureau of Industry Economics estimates that in the last five years 7,000 new companies have been formed in the information industries. However, few develop to any scale, Where Australians have developed technology it is often world class. However, we are not competitive in growing companies that successfully market overseas and thereby evolve into sustained businesses of scale. Australia is a tough market in which to grow technology companies because of:*
>
> - *the relatively small size of the domestic market;*
> - *the lack of a venture capital industry to provide patient risk capital and management expertise and assistance in nurturing the companies through the difficult early years; and*
> - *the intense competition from multinational companies. " (p 11)*

Tax Laws and Barriers to Entry in the Australian Venture Capital Industry

A distinguishing feature of the Australian venture capital industry is its ***non - globalised*** nature. For example, whereas the UK venture capital industry sources more than a third of its funds in the USA and a further 20% from continental Europe and other non UK countries, Australia has failed to attract significant investment interest from off-shore.

Aside from the large pool of uncommitted venture capital funds in Australia, industry participants in the ***Thinking Melbourne*** consultations put the lack of foreign involvement in the domestic venture capital market down to Australia's tax laws. In particular, they referred to;

- Australia's policy of taxing limited partnerships as companies. Limited liability partnerships (LLP) are the favoured vehicle through which US investors take up equity in new technology ventures. Many of these investors enjoy tax exempt status in the US (e.g. as university or community based endowment funds). This status is usually extended to LLP vehicles within the US and, reportedly, in other countries. Australia's policy was said to make this country less attractive to US endowment fund investors by effectively negating their tax exempt status.
- The scope and rate of capital gains tax in Australia is a disincentive to both overseas and local investors.

Charles et al (1997) encountered very similar views in their consultation program.

> *"It is very difficult to attract international investors to invest in Australian venture funds. US institutions in particular, who have had very good experience in venture capital in the US, are now seeking to put some of that money to work in venture capital in international markets. At the moment none of this money is flowing into Australia.*
>
> *For example three US funds have recently raised over US$300 million for venture capital in Asia - Robertson Stephens, Hancock Venture Partners and Hambrecht & Quist Venture Partners. None of these funds have placed any money with Australian venture capital managers. When interviewed by us, they gave two reasons:*
> - *Australia is not a country that they would readily think of as a place to invest in technology; and*
> - *When some of them have assessed Australia and Australian venture capital management capabilities, the application of the Australian capital gains and withholding tax regime has been a show-stopper." P 81*

Arguably, the main damage done by tax laws to Melbourne's aspirations as a centre for high technology investment is not the reduced stock of venture capital as such. Rather it is the reduced exposure of the domestic venture capital industry to the methods and strategies of aggressive operators from the US and elsewhere.

The effective 'protection' of Australia's venture capital industry fuels the tendency towards risk aversion. It dampens the competitive imperative to fully investigate new start up and early stage investment opportunities. The fact that Australian venture capital fund managers have achieved only modest returns on their investments by comparison with best practice overseas (the median Internal Rate of Return on realised investments reported by respondents to the 1998 AVCAL survey was only 21%) may be symptomatic of dulled competitive pressure.

In turn, the modest performance of Australian venture capital funds has slowed the growth of this sector. Over the past 35 years, the US venture pool dedicated to private equity investment has grown to US$43.5 billion. In contrast, the Australian venture and mezzanine finance pool reached $A1 billion for the first time at the end of 1996. Demonstrated strong returns have led to US institutions allocating some 3% to 4% of their funds to venture capital (Charles et al, 1997). In Australia, major institutions have been sluggish in dedicating any of their funds to private equity investments as a distinct asset class.

American experts have also commented on the conservative nature of the Australian venture capital industry and the impact this has on growth of this sector and NTBF's. In an article published in *PC Week* in December 1996, Bruce Frederickson, president of US based Channel Tactics, was quoted as saying that venture capital was a major obstacle to industry development in Australia and implied that the finance sector needed to lift and diversify its risk assessment skills. *"Unlike the US, potential funders in Australia are very risk-averse, even though when it comes to a gold mine they are not risk-averse. Funders need to take the view that not every company will succeed, but the few that do will be very successful".*

Similarly, Charles et al (1997) argue that opening up the Australian venture capital market to foreign involvement by (amongst other things) addressing capital gains and other tax issues, would speed up the development of local risk assessment skills.

> *"If Australia does attract some international institutional money, this would be a major boost to the local venture capital industry and would be likely to stimulate Australian institutions. Knowing that leading US institutions, experienced in venture capital, were co-investing with them in a particular venture capital fund and applying their expertise to the critical decision of selection of a particular venture capital manager would assist the relatively less experienced local venture investor to evaluate risk." p 81*

The Cost of Inadequate Venture Capital Competition

By erecting effective barriers to the involvement of 'best practice' venture capital operators in Australian markets, Australia's tax laws may be suppressing the formation of innovative, export oriented firms. Moreover, they may be fostering a conservative business culture in which people with management and leadership talent choose to pursue 'safe' careers with established corporations rather than in newly established enterprises, to the detriment of the general innovation capacity of regional economies.