Australian Private Equity &
Venture Capital Association Limited

30 November 2017

Digital Economy Strategy Team
Department of Industry, Innovation and Science
GPO Box 2013
Canberra ACT 2600

Via email: digitaleconomy@industry.gov.au

Dear Sir/Madam,

Digital economy – Government consultation paper

Thank you for the opportunity to comment on the Government's consultation paper on the digital economy, released in September 2017.

The Australian Private Equity & Venture Capital Association (AVCAL) is a national association which represents the private equity (PE) and venture capital (VC) industry. AVCAL's members comprise most of the active PE and VC firms in Australia, who together manage around $30 billion on behalf of Australian and offshore superannuation and pension funds, sovereign wealth funds, family offices, and other investors. In the financial year ending 30 June 2017, Australian companies received around $3.6bn of investment from PE and VC sources.

1. Overview

AVCAL welcomes the release of the consultation paper seeking stakeholder input on a future digital economy strategy. It is imperative that Australia takes active steps to establish itself as leader in the digital economy, while there is still an opportunity to do so, particularly within the Asia-Pacific region. If Australia is to succeed economically in the 21st century, it will require both the private and public sectors to embrace the opportunities offered by digital transformation. The rewards that are on offer can be enormous.

For example, as at 30 June 2017, the five largest US companies by market capitalisation – Apple, Google, Microsoft, Amazon and Facbook – were all technology focused, with each having received VC funding. Significantly, in 2011, that list was made-up of Exxon, Apple, PetroChina, Shell and ICBC, demonstrating the potential of technology to transform economies in a relatively short period of time.

In particular, Australia should seek to be a world-leader in the digital transformation of those sectors where Australians have already demonstrated significant expertise – for example, natural resources, agriculture, and aspects of biotechnology and financial services. If successful, major productivity gains could be achieved that would contribute significantly to Australia's economic growth, well into the future.

2. Executive summary

- The Government can play an important role, both as a facilitator and a customer, in developing a strong digital economy within Australia;
- Australia's innovation policy must remain internationally competitive at a time when governments globally are trying to position themselves as digital economy leaders;
- Venture capital has played a role in the development of the world's leading technology companies, demonstrating the potential to transform an economy over a short time period; and
- Regulation should facilitate, rather than discourage, innovation particularly in areas where there is an opportunity to take a lead in emerging sectors.

3. Role of Government in the development of Australia's digital economy

The Australian Government can play an important role in the development of a thriving digital economy, primarily via three channels: 1) the Government procurement process; 2) public policies that encourage innovation and investment in new technology; and 3) Government expenditure on research and development.

a. Government procurement process

Firstly, as the single largest purchaser of goods and services in the country, the Government procurement process could be reformed to make it easier for smaller, technology driven companies to win public sector contracts. In the 2017 financial year alone, there were 64,092 Government contracts with a total value of $47.35 billion. The number and value of these contracts means that there is a significant opportunity - if processes are made more user-friendly and less compliance driven - for new market entrants. Incumbency is rewarded by a focus on awarding contracts to those (typically large scale) organisations that are able to meet very stringent Government requirements.

Further we note that around 24% of all Government contracts are for amounts below $5m in value – an aggregate total of $11.5bn - demonstrating that there are many areas where high growth firms could be awarded contracts, while still containing risk.

Looking to the US, its space agency, NASA, has awarded large, long-term contracts on a merit basis, including to new entrants such as SpaceX, showing that taking a less risk-averse approach is feasible. While accepting the need for appropriate probity and quality assurance standards, Australia must be able to do similar.

Accordingly, we believe a comprehensive review of the Government procurement process should be undertaken to identify where there are opportunities to devise more streamlined processes that allow a wider range of market participants to compete for tenders. Without compromising on quality and standards, it may also be worth considering whether a target, or even mandated, percentage (or value) of Government contracts must be allocated to start-ups and SMEs.

By way of example, there are a number of areas of Australian Government digital service delivery – such as myGov - that are ripe for transformation, offering major benefits to citizens, cost savings for Government as well as potential commercial contracts for agile technology firms.

b. Government innovation policy

Secondly, the Government must ensure that it has in place world leading policies that can attract the most innovative domestic and foreign companies to Australia. Since December 2015, a number of initiatives aimed at fostering greater innovation and commercialisation of research have been progressed by the Federal Government as part of the National Innovation and Science Agenda (NISA). These include: new tax incentives for early stage investors; important reforms to the venture capital investment framework; and the creation of a Biomedical Translation Fund (BTF) aimed at commercialising promising health and medical research.

Given time, this set of policies could be transformative for the Australian economy, however more can be done to ensure that scaling-up companies receive the capital and expertise they need. As noted above, venture capital has played a critical role in the growth of some of the world's largest technology companies, and can do likewise in Australia. Accordingly, the Government should look closely at what steps in can take to help develop Australia's rapidly maturing VC sector.

AVCAL's research report, *The Venture Capital Effect*, prepared in collaboration with the University of Sydney, highlights that Australia's VC sector remains less than half the size of the OECD+ average. If we are to successfully become a world leader in the digital economy, this must change, and quickly. While FY2017 saw domestic VC firms invest the highest aggregate amount in the last ten years ($336m), this remains small by world standards – US$51bn was invested by US firms in 2016, while their Chinese counterparts invested US$46bn.

It is also essential that those elements of Australia's innovation policy infrastructure that do work effectively are maintained, if not enhanced. In particular, the research & development tax incentive must remain its bedrock given

it is critical to the growth and functioning of many innovative Australian businesses. The scheme is well-understood and recognised as Australia's most important innovation policy lever. At a time of economic transition, it is vital that policies such as the R&D scheme remain stable and continue to support long-term investment decision-making. It is in that context that AVCAL has cautioned against any cuts to the program (such as those contemplated in the Ferris-Fraser-Finkel review) as it would not be in the long-term interests of the nation.

By way of contrast, the UK in its Autumn (November) 2017 budget statement has committed to:

- increasing its total direct R&D spending to £12.3bn per annum by 2021-22;
- establishing a new £2.5 bn Investment Fund incubated in the British Business Bank;
- investing in a series of private sector fund of funds, starting with an initial commitment of £500m; and
- backing new and emerging fund managers through the Enterprise Capital Fund programme, unlocking at least £1.5bn of new investment.

Despite having a VC sector that is almost twice the relative size of Australia's, the UK has recognised the importance of *further* developing an innovation-driven economy and has committed substantial funding to achieve it – developing an action plan that will unlock £20bn of patient capital investment into innovative firms over ten years.

As highlighted in *The Venture Capital Effect*, there are many countries around the world, including in the Asia-Pacific region, that are likewise seeking to introduce ambitious innovation policies aimed at fuelling economic growth. AVCAL stands ready to work with the Government around a suite of measures that would assist the further development of the local VC sector, and more broadly, the next wave of the NISA. While the Australian VC sector has enjoyed strong growth in recent years, there is more that can be done to ensure its long-term sustainability, including by attracting much greater institutional investment.

c. Government expenditure on R&D

Thirdly, the Australian Government can help boost the development of the digital economy through increasing its own expenditure on research and development.

Although government budgets for R&D have increased since 2008 in Australia, and it has the second highest share of tax support for business R&D in the OECD in 2015, the absolute levels of direct government funding and tax support for business R&D remains lower than many countries.

As a measure of the level of direct and indirect government funding for R&D, the business enterprise expenditure on R&D (BERD) as a percentage of GDP for Australia stands at 0.20%, made up of 0.03% from direct government funding and 0.17% from our R&D Tax Incentive scheme (indirect funding). On the other hand, the USA's direct government funding on the other hand was several times higher than Australia's at 0.18%, and the UK was similarly much higher at 0.10%. In terms of overall BERD, Australia also compared poorly with countries such as Korea and the USA with BERDs at 0.35% and 0.25% respectively.

More broadly, Australia trails a number of developed countries in terms of gross expenditure on R&D (GERD) as a proportion of GDP. OECD data showed that Australia's GERD was 2.105% in 2013, which was 275 basis points lower than the OECD average of 2.380% (2015). The difference is much starker when compared with Australia's Asia Pacific neighbours: South Korea's GERD was 4.232% (2015), while Japan's was 3.286% (2015). Other developed countries also showed higher gross expenditure levels, such as Germany (2.927%), USA (2.78%) and Israel (4.253%).

This international data demonstrates a pressing need for both the Australian private sector and Government to significantly increase their expenditure on R&D if, as a nation, we are to transform our economy.

4. Standards development and regulatory frameworks

A key challenge facing any start-up or high growth company is difficulty navigating the regulatory approval processes for their business. This can be particularly pronounced in sectors that are subject to high degrees of regulation, such as financial services. This means that new market entrants, such as FinTech firms, face the dual

challenges of not only competing against large incumbents with well-established market share, but also companies that have the legal, risk and compliance infrastructure capable of meeting exacting regulatory standards.

While AVCAL supports the Government's previous "red-tape" reduction initiatives, more can be done to ensure that regulation is fit for purpose, and strikes the right balance between consumer protection and fostering innovation. In principle the enhanced regulatory sandbox for FinTechs is an example of an appropriate mechanism for achieving such objectives. However, we are aware that in its current form, the sandbox has garnered minimal industry interest, precisely because the regulatory conditions are too onerous.

While cognisant of the duty to responsibly spend public monies, it is also important that more experimental, agile public policy is developed. Pilot programs, for example, could be more frequently utilised. An example of overly cautious policy-making has been in the realm of the "share economy", where Government regulation/guidance lagged well behind consumer up-take of products and services.

If Australia is to achieve its ambition of being recognised as a world-leader in innovation it must be prepared to attempt bold policies, without necessarily waiting to see how similar programs have progressed in other jurisdictions. To do otherwise would mean that Australia is constantly "playing catch-up", and will forever remain an innovation follower, rather than leader.

5. Barriers to Australian digital adoption

As has been recognised as part of the NISA, cultural change will be important to Australia's economic transition. A more mature approach to risk-taking is important, and has been acknowledged, however one aspect which is rarely discussed is the need to examine culture within organisations.

Challenging established views, and accepted wisdom, is critical to creativity and innovation. This is as crucial in the field of science or research, as it is in the business world. Developing less hierarchical, more inquisitive workplaces is therefore important if we are to effect real change. Similarly, anecdotal feedback is that Australian employers do not highly value postgraduate research studies, making such learning less attractive to students. If we are to truly transform our economy and society, attitudes will need to shift. Given this, it is not surprising that Australian private sector-research community collaboration is lacking by world standards, an issue which must be addressed if we are to achieve ISA's goal of being "counted within the top tier of innovation nations".

In terms of more concrete policy recommendations, consideration should be given to funding commercialisation and business skills courses for tertiary STEM students aimed at fostering entrepreneurship and addressing labour market shortages. Our calculations suggest that this could be achieved with a relatively modest impact on the Federal budget (see AVCAL submission to the ISA 2030 Strategic Plan, dated 31 May 2017).

More broadly, Australia has enjoyed more than 25 years without a recession, removing the "burning platform" to undertake difficult but necessary reform. Indeed much of this economic success has been attributable to Australia's success in the export of primary products (principally from the natural resource and agricultural sectors), with relatively little in the way of complex manufactures or, until recently, high-value services. If Australia is to transition towards a broader based economy, this must change.

Similarly, many of Australia's industrial sectors are dominated by a few key players, removing the incentive to take significant risks in developing a new innovation-driven strategy. When market share and profitability remain strong, there is a diminished appetite to develop significantly new products and/or services. However experience shows that complacency can lead to vulnerability of disruption. A further challenge for listed companies is the continuous disclosure and periodic reporting requirements, which make it more difficult for boards and executives to take a strategic, long-term approach.

A further facet hindering the take-up of digital technologies is access to appropriately skilled workers. Currently, there remains a shortage of appropriately qualified STEM graduates which is hindering the ongoing growth of a number of high-potential Australian companies. Although this is not the main focus of the present consultation, a comprehensive analysis of the current and projected future skills gaps in Australia is necessary to ensure this appropriately addressed, and that our education system is producing the right mix of graduates. In the interim, there will continue to be a need for business to have access to immigration programs that permit skilled workers to

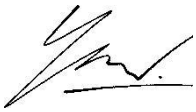
enter Australia. The stability and transparency of these programs is paramount both to maintain confidence in them, and to allow long-term planning by businesses.

6. Next steps

We would like to thank you for the opportunity to provide a submission in relation to the Government's digital economy strategy. It is important that both the public and private sectors work closely together at this time so as to ensure that Australia is ideally placed for the future.

Please do not hesitate to contact either me or Christian Gergis, Head of Policy & Research, on 02 8243 7010, if you would like to discuss any aspect of this submission further.

Yours sincerely,



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