



SUBMISSION TO THE JOINT SELECT COMMITTEE ON TRADE AND INVESTMENT GROWTH INQUIRY INTO AUSTRALIA'S FUTURE IN RESEARCH AND INNOVATION

Introduction

The Committee has been asked to investigate:

“measures to further boost Australia's trade and investment performance, including, but not limited to, barriers to trade; reduction of red tape and structural challenges and opportunities for the Australian community.

As part of its remit, the Committee will investigate how the research and innovation sector can better assist in overcoming Australia's geographic, economic and labour challenges, with a focus on commercialisation including, how technology imports and exports could be further facilitated.”

Global presence required for success

To realise their potential, Australian technology and innovation businesses must operate globally. This involves owning offshore assets, or operating in partnership with distributors, suppliers and other businesses (so called “Global Value Chains” - GVC). In the contemporary global economy, an ‘export from Australia’ model alone is unlikely to realise our economic potential. As the OECD puts it:

“A country's prosperity depends on its participation in the global economy, which in turn depends on its integration in global value chains. Integrating GVCs helps countries strengthen their productive capacities, access a broader portfolio of technologies, skills or knowledge-intensive assets and supports growth. Countries enter GVCs through Foreign Direct Investment and trade in goods and services.”¹

The open global market in which Australia operates maximises opportunities for growth, but also means our businesses face global competition; as the OECD comments:

“Openness to trade is also crucial because it leads to more innovation via market-size effects, tougher product market competition and larger knowledge flows. Larger market size stimulates investment in knowledge-based capital (KBC) by magnifying the expected profits in the event of successful ventures. However, globalisation means that firms have to differentiate their goods or lower their costs in order to stay competitive. It also promotes productivity-enhancing reallocation via the expansion of the most productive firms into foreign markets (via exports or by becoming multinationals) and the exit of low-productivity firms that are unable to compete in the global market or undertake the costs required to enter the foreign markets. Finally, trade and foreign direct investment (FDI) are associated with increased flows of knowledge from global customers and suppliers.”²

A global strategy is likely to be particularly important for start-up technology companies. “Born global or die local” is the colourful advice from the US entrepreneur and academic, Steve Black, to Australian technology start-ups. He argues that Australian start-ups need

¹ OECD (2014), OECD Science, Technology and Industry Outlook 2014, OECD Publishing, p.36.

² OECD (2013), Supporting Investment in Knowledge Capital, Growth and Innovation, OECD Publishing, p.59.



to achieve a minimum market population of 100 million and develop supporting offshore sales and production facilities.³

The importance of global investment and operations are reflected in the strong growth of foreign direct investment globally. The global stock of outward direct investment has grown twelve-fold to USD26.3 trillion since 1990, while merchandise trade grew less than four-fold. Much of this investment reflects the global trend towards GVCs and the increasing disaggregation and complexity of production.

Benefits of global companies

Offshore investment by global companies generates substantial domestic benefits and is not a substitute for domestic investment. International research shows that offshore investment is associated with higher domestic investment, employment, exports, and research and development.

There has been little research on Australia's global companies. The 2015 ANZ insight report, *Winning the Away Game*⁴ however summarises international research:

- Global companies make substantial contributions to their home economies. In the US, global companies contribute 25 per cent of total economic output, but make up less than 1 per cent of all companies.
- Companies investing internationally also invest at home. A 10 per cent increase in capital investment overseas generates an increase of 2.6 per cent in US domestic investment according to one estimate.
- Global companies contribute significantly to domestic employment, higher salaries at home and have high productivity. Parent company jobs tend to generate smarter jobs. 'Low-wage' jobs in overseas operations do not substitute for jobs in the parent company.
- Investment overseas promotes overall competitiveness. OECD research demonstrates that companies investing overseas are locally and globally competitive and maintain or increase levels of employment in home economies.
- Exports by global companies are higher value-add. Operations established abroad are typically lower skilled and lower unit-value operations, leaving higher skill-intensive and higher unit-value operations in parent economies where the economic comparative advantage is greater.
- US parents of global companies accounted for 74 per cent of all US private-sector research and development expenditures and 29 per cent of all US private-sector investment.
- Sales by foreign affiliates of global companies result in increased domestic research and development spending. A 10 per cent increase in sales by foreign affiliates of US companies leads to a 7 per cent increase in research and development spending in the US.
- Global companies' overseas operations complement their domestic operations. Data analysis from about 70,000 European multinational enterprises shows that the majority employ FDI and exports as complements to their business in the home economy.

³ <http://steveblank.com/2014/10/31/born-global-or-die-local-building-a-regional-startup-playbook/>

⁴ ANZ insight report Issue 7, "Winning The Away Game: Australia-Based Global Companies And The Economy", August 2015.



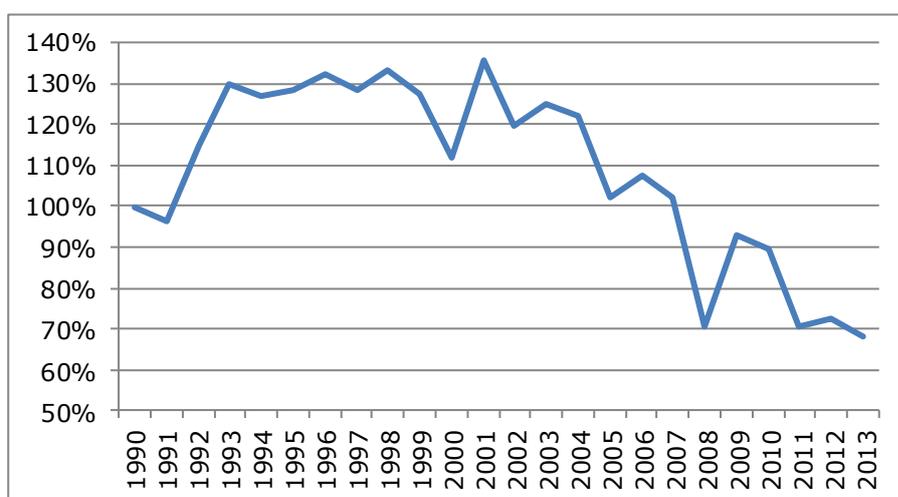
Australia's offshore business performance falling relative to OECD

Some of Australia's most successful companies now do the bulk of their business in overseas markets. 63 of the top ASX 100 companies operate internationally with foreign operations generating 37 per cent of their revenue.

Despite these companies' success, Australian outward direct investment as a proportion of GDP compared to the OECD average has fallen steadily over the last decade. As shown in the chart below, in the decade to 2004, it was around 126 per cent of the OECD average, falling steadily since then to reach 68 per cent in 2013.

Australian outward direct investment compared to OECD average

(Ratio of FDI stock to GDP for Australia compared to OECD, 1990-2013)



Source: OECD

This is a particularly challenging trend given the importance of offshore investment to growth and development of innovative companies.

Taxation as a structural barrier to Australian ownership of offshore assets

Taxation is a key factor affecting the location of global businesses. The existing Australian approach to taxing foreign sourced income at the company level is sound. However, at the shareholder level higher taxes are imposed on dividends paid to Australian shareholders from offshore than on dividends from Australian sources.

When an Australian-resident company distributes foreign income as a dividend, Australian-resident shareholders receive no relief for the company tax that the company – through its subsidiary or affiliate – has paid in the foreign jurisdiction.

As a consequence, those shareholders will pay tax on such a dividend at their full marginal tax rates. The tax rate on foreign sourced dividends is at a 30 per cent higher rate than that applying to franked dividends from domestic sources.

Australia compares unfavourably with other jurisdictions in this area. With the exception of New Zealand, no other comparable jurisdiction has a bias against dividends from foreign sourced profits.



As a result of this bias, dividends paid by Australian companies with significant offshore business, or by the offshore subsidiaries or affiliates themselves, will likely be more valuable to non-Australian shareholders than to Australian shareholders.

This creates incentives for Australians to own fewer shares in Australian companies investing offshore, for moving Australian offshore businesses to a different jurisdiction, and for Australian businesses to sell foreign assets to others who value those assets more highly.

In light of these economic incentives, it is unsurprising that the stock of Australian owned foreign investment as a share of GDP has consistently declined relative to the growth seen across the OECD.

Addressing the bias against Australian ownership of foreign businesses

For the *Winning the Away Game* report, Independent Economics was asked to model the reform to address the bias against shareholdings in foreign assets. It modelled the 2003 Board of Taxation recommendation of a 20 per cent tax credit for dividends from foreign-sourced income that largely eliminates the bias against owning foreign assets.

Independent Economics estimated that the net economic benefit of this reform would be AUD1.02 billion per year. The gross economic benefit would be in excess of AUD2.77 billion per year with a cost of AUD1.75 billion per year in tax revenue foregone by the public purse. An additional AUD300 billion of foreign assets would be owned by Australians. Based on experience in other jurisdictions, this economic benefit would likely be realised in around two years from the reform's introduction.

The economic benefit of providing tax relief for foreign dividends compares very favourably with other opportunities for taxation reform. It is a highly efficient economic reform relative to its revenue cost.

This change would address the present bias against the development of Australia-based global companies. It would contribute to the diversification of the Australian economy, and is central to realising the capabilities of Australian technology and innovation.