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REVITALISING THE AUSTRALIAN ECONOMY: NAVIGATING THE HEADWINDS

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The role of small business

Small business continues to be the engine room of economic growth. The latest government statistics indicate that of the 2.24 million businesses in Australia, there were 2.18 million (97.3%) micro and small businesses (those with less than 20 employees). Of these, there were 1.4 million (64.2%) micro businesses that did not employ any staff. Small business contributes 30% of GDP, employs 44% of all workers and generates 40% of new jobs. The annual turnover for 60% of these small

businesses is less than AUD\$200,000.

However, if small business is to prosper, some things need to change. Innovation processes are less common in small businesses, with 60% engaged in innovative activity compared to 67% for medium sized businesses and 80% for large businesses. Small businesses also report slower rates of productivity improvements compared to large firms (28% compared to 36%). Whilst small businesses represent 44% of all businesses that export goods, they only account for 0.5% of exports by value. Despite increases in the number of small businesses that are 'born global', significant scope exists for them to become more dynamic, innovative and efficient.

Recent research by the OECD and others indicates that small business can play an important role in lifting national productivity growth and, more importantly, national living standards through a variety of ways, including improved diffusion of knowledge, products, processes and technologies across businesses.

However, significant challenges have emerged.

"Governments play a significant role, directly and indirectly, in the effective operation of the Australian economy."

The global environment

The global environment has been impacted with the election of Donald Trump as US President, Brexit, rising protectionism, the rise of China as a super power, a 'trade war', ongoing technological advances with the advent of the Fourth Industrial Revolution, continuing demographic shifts, transnational cybercrime, the impacts of climate change and continuing refugee crises. At the same time, our world has continued to become increasingly interconnected and interdependent with scientific and technological advances in one country driving economic growth globally.

Other global challenges abound, including increasing urbanisation, environmental degradation and the rising demand for sustainable food sources, water and energy. It is not inconceivable that these could become political, economic and security disruptors over the longer term. For Australia, and for any of our trading partners, these issues have the potential to undermine regional stability, contribute to conflict and affect economic interests. For instance, the OECD estimates that 60% more food will be needed by 2050 with growing demand by middle classes for more resource intensive food like meat (which has spawned a new non-meat industry led by Bill Gates and others). The United Nations estimates that, if no changes are made to the way water is used, demand will outstrip supply by over 40% by 2030. In addition, the United Nations estimates that the world needs to create around 40 million new jobs every year, just to keep pace with the growth of the global working age population.

While Asian economies are largely growing, we note that, in the developed world, the headwinds are gathering as productivity gains associated with past technological advances have largely been exhausted, while the benefits for productivity from current and future technological advances have not yet been realised. Real wage growth is not expected to improve in developed economies unless productivity increases. Other constraints on global growth include ageing populations especially in Japan, China and the European Union; high public debt and low official interest rates; and China's slowing economy as it matures (which the OECD estimates will peak at 27% in the 2030s and then slowly decline).

These events and trends have all combined to create an environment of further uncertainty and change. What we need to consider is the impact of these factors on the Australian economy and the need to develop appropriate domestic policy responses for the benefit of small business, SMEs and more broadly.

Being a small, open economy, Australia is particularly susceptible to the rise in global protectionism. This could damage future economic growth and undermine the global rules that underpin our trade and investment. At a time when productivity remains stagnant, this could have serious consequences for the Australian economy and our future living standards. These economic 'headwinds' continue to strengthen and present potential challenges for the Australian economy going forward. Successfully navigating these headwinds will be essential to maintain, if not boost, Australian productivity growth, improve national income and raise living standards.

The challenges for Australian policymakers are increasing, making the need for action immediate.

Productivity – headwinds are gathering

The long-term trend in Australian labour productivity growth has been declining over the last half century, with annual productivity growth being flat for over a decade. This trend is more clearly indicated by the downward revisions to the 30 year average growth rate made by the Commonwealth Treasury in its successive Intergenerational Reports, falling from 1.75% to 1.5% in its last report.

However, sluggish productivity growth in the Australian economy is not unprecedented, nor is weak national income growth. The recent strong growth in Australia's terms of trade boosted growth in Australian national income to the envy of most other developed countries and gave rise to the mining boom. Unfortunately, the mining investment boom is now behind us. Looking ahead, it is growth in the non-mining sector that will largely determine the prospects for Australian incomes and living standards.

These declines in productivity growth partially reflect the effects of longer-term structural change in the Australian economy that has seen a decrease in the relative importance of many traditional goods producing industries such as manufacturing and agriculture, and an increase in many service sector industries.

More recently, multi-factor productivity (MFP) has underpinned labour productivity growth in most industries, with 9 of the 16 industries for which MFP is reliably measured, experiencing positive average MFP over the current productivity cycle. However, productivity headwinds are strengthening and have the potential to make it harder for Australia to maintain, let alone improve, living standards into the future.

Governments have an essential role to play in addressing these headwinds.



Productivity – governments have a vital role to play in boosting productivity and living standards

Governments play a significant role, directly and indirectly, in the effective operation of the Australian economy. Governments set the rules by which markets operate, they regulate and enforce the rules; levy taxes; and provide or fund significant services and infrastructure for the community. These rules, taxes and expenditures affect business profitability and may create artificial incentives for them to alter their behaviour in search of higher returns which can result in unintended consequences or excessive compliance costs. Governments also exert significant influence on wider productivity in the private sector.

Given these myriad of ways that governments directly and indirectly impact on productivity growth, it is essential that these activities are selected, funded and managed as efficiently and effectively as possible to ensure the significant potential benefits are realised.

New and improved policies are also important. For example, significant scope exists to improve productivity growth in the delivery of education and skills development, as would updating regulatory settings to reflect the current economic realities.

Technology simultaneously creates and destroys jobs. To the extent that technological shifts require more advanced or new skills from workers, there is a role for government to ensure education and labour market policy settings enable upskilling and retraining.

Government also has a role to play in enabling research and providing access to data. We note that recent improvements in data collection and research, such as the development of the BLADE (Business Longitudinal Analysis Data Environment) framework, which was boosted by funding in the 2017-18 Budget, offers great potential for improving productivity growth through better targeting of government policy and the effectiveness of government programs at the firm level.

Australia should follow the lead of New Zealand in promoting more collaboration between the public sector, private sector and academia to improve the contribution of policy to increasing productivity growth 'by connecting people, shaping research agendas and sharing research'. This will improve the evidence base needed for robust policy development.



Productivity – investment will also need to play an essential role going forward

Given that past investment has fuelled the capital deepening that has been an important source of historical productivity growth, investment needs to play an essential role going forward to underpin productivity growth and maintain living standards.

Prospects for two of the key main industries that contributed to this historical capital deepening – manufacturing and mining – are likely to be more subdued going forward than has been the case historically. If this occurs, future Australian productivity growth will be harder to sustain without capital deepening in other areas of the economy or through improvements in multi-factor productivity (requiring a significant and sustained reform effort).

Despite lower official interest rates and surveys indicating above average business confidence, investment remains muted. This implies that businesses are likely to be waiting for improved business conditions and greater certainty before making significant new investments.

The longer-term structural change towards service sector industries that are more reliant on labour has reduced measured labour productivity growth. These industries also tend to rely more on investment in intangible capital, such as research and development, information and communications technology, brand equity and organisational capital, all of which affect productivity, and are harder to quantify. However, studies suggest that investment in intangibles is significant but a significant portion may not be treated as investment in the national accounts; and that average annual growth in intangible investment was about 130% that of tangibles since 1974-75.

This weak outlook for investment is supported by the International Monetary Fund, which observed in 2017 that the prolonged periods of uncertainty and sluggish private investment after the Global Financial Crisis have further held back productivity growth, especially in the advanced economies; and that this slow growth is likely to make challenges such as the population ageing harder to address.

The OECD in its 2018 policy paper, *The Long View: Scenarios for the world economy to 2060*, also referred to slowing global growth, limited income convergence and rising fiscal pressures as being the long-term baseline projection. However, structural policy reforms can brighten the outlook substantially in all countries (including Australia). For instance, reforms through 2030 to make product market regulation in OECD countries as friendly to competition as in the five leading countries raise living standards by over 8% in aggregate (and up to 20% in some countries). For this reason it is imperative that Australia ensures that the benefits of the recent competition policy reforms flow through to small business.

Globalisation – presents significant opportunities for Australian businesses

Australia is the world's 20th largest export economy. One in five Australian jobs are trade-related and one in seven relies on exports. Over 50,000 Australian businesses export, contributing over AUD\$350 billion in export income per annum. Exporting firms on average employ more people and pay higher wages than firms focused on the domestic market alone. Trade liberalisation delivers AUD\$8,448 extra income per year for the average family.

Whilst these figures sound commendable, have we made the most of the opportunities presented by internationalisation? According to the Bertelsmann Stiftung 2018 Globalisation Report, *Who Benefits Most from Globalisation?* Australia's internationalisation has developed similarly to the median for all 42 countries assessed in the report. Low commodity prices have reversed some of the structural changes since 2012 that arose from the mining boom, which has resulted in a decrease in trade. This report notes further that Australia is in the middle in terms of per capita income gains from internationalisation.

Australia has very low tariff rates by international standards. This has helped to increase the competitiveness and flexibility of domestic Australian markets. Despite this, Australia is ranked 95th for

ease of trading across borders in the 2018 World Bank's Doing Business survey. This indicates that further significant improvements are possible.

Australia needs to improve its performance against these and other measures if it is to seize the opportunities presented by international developments.

These opportunities exist by exploiting the 'complementarity' of our economy with those of our rapidly developing regional neighbours. That is, Asian economic growth relies on what Australia produces. China and India together make up more than 60% of Asia's economic activity. By 2030, Asia will produce more than half of the world's economic output and consume more than half of the world's food and 40% of its energy. By then, over 600 million more people will live in Asian cities. These countries will not only need Australian minerals and energy but also the services that we produce to fuel this growth.

Technological progress, urbanisation and rising incomes are leading to an increase in the share of services in economic activity across the globe. Australia has an opportunity to capitalise on the growing demand for tradable services, particularly from Asia. Our comparative advantage in services is in financial services and personal and recreational services. The ageing population is another opportunity. There are already more people over 65 years of age in Asia than the whole population of the United States. Aged care services, health services, nursing, asset management, insurance services, could all represent opportunities from this demographic change. However, in these industries there are often high domestic barriers to entry, which our trade agreements will have to overcome if these opportunities are to be realised.

At the same time Australia is looking beyond Asia to find new opportunities in South America, Africa and the Middle East.

The Australian government will need to maximise economic growth in the region by facilitating the ability of Australian businesses to tap into global value chains; and to increase our relatively low investment in Asia which may be hindering our ability to tap into these global value chains. This includes manufacturing businesses. Manufacturing makes up \$44 billion or 13% of our exports. More than four out of five manufacturing businesses are SMEs. They rank fifth among advanced economies for business innovation. This should be applauded, encouraged and improved through government policy settings. Services make up a growing share of our exports, rising to over 20% of exports. For instance, Australia is the world's third largest provider of education to international students.



UN Sustainable Development Goals

In terms of international collaboration, the United Nations 2030 Agenda for Sustainable Development presents further opportunities. Its 17 Sustainable Development Goals (SDGs) seek to reduce poverty, protect the environment, and promote gender equality, responsible consumption and production, decent work and economic growth, quality education, peace, justice and strong institutions, industry, innovation and infrastructure and partnerships to achieve these goals. In addition to opportunities for Australian SMEs, the SDGs provide a useful, consistent and aspirational framework to inform policy development in Australia and other countries across the world. Humane Entrepreneurship has emerged as a useful tool for achieving the SDGs. It is built on the premise that countries and organisations should extend their priorities beyond the profit margin; and shift their focus onto their people, the environment and society. Human oriented businesses are deemed to perform better, produce better products and satisfy their customers.

Global trade – benefits for the Australian economy

The Australian domestic market is small compared to many international markets. Future economic and population growth in the region will only further increase the size of these markets. For example, it is estimated that Asia's total infrastructure investment needs will exceed \$26.2 trillion by 2030, which is roughly 15 times the current size of the Australian economy.

Australian businesses and the Australian economy have long gained benefits from accessing these markets through trade, investment and other strategic partnerships. Yet there remains significant untapped potential for Australian businesses to improve engagement in these potentially lucrative markets. To do this, Australian businesses need to be internationally innovative and competitive as well as having management that can identify and exploit these opportunities.

Domestic policies can help or hinder the international competitiveness of Australian businesses. Excessive or poorly targeted regulation can reduce the competitiveness of Australian business or result in unintended collateral damage.

International policies can also indirectly present opportunities for Australian businesses and the Australian economy. For instance, by encouraging APEC countries to improve their productivity growth — whether by supporting education and training, competition, good governance and market openness, including in services, through helping to improve investment settings, regulatory frameworks, taxation systems, management of natural resources, workforce participation by women or the design and management of national budgets — the ensuing economic growth would increase demand for the goods and services that Australia produces.

Australian domestic and international policies need to support or reinforce each other to strengthen the resilience and competitiveness of Australian businesses through innovation, science and technology and an environment that facilitates improvements in productivity and a desire to drive exports. SMEs can play a vital role in this process.

Domestic policy must reflect this global reality.

It is pleasing, therefore, that the federal Government has reinforced that it will assist Australian businesses, including over 50,000 SMEs, to access international markets, through Austrade and EFIC ('Finance for Australian Exporters'). It has stated that it will also partner with the private sector through Asialink Business,

chambers of commerce and other programs. The Government has also developed a new trade agreement portal and other online resources to enable small businesses and others to more readily access the benefits of our trade agreements. Navigating these headwinds whilst taking advantage of global trends and regional opportunities will define Australia in the coming decades.

The Small Business White Paper released in September 2018 produced by the IPA Deakin SME Research Centre can be found at <https://www.publicaccountants.org.au/news-advocacy/small-business-white-paper>.



About the International Council for Small Business (ICSB)

The ICSB Gazette is a weekly edition of a key topic that ICSB will showcase. The content is varied from research, practice, policy, and education. The editor of the ICSB Gazette is Mr. Kyle Lyon, ICSB Junior Project Manager. He will be soliciting ideas and articles from ICSB members world-wide.



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