2024-25 PRE-BUDGET SUBMISSION

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AUSTRALIAN INVESTMENT COUNCIL

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ABOUT THE AUSTRALIAN INVESTMENT COUNCIL

The Australian Investment Council (the Council) is the peak body for private capital in Australia. Comprising leading private equity, venture capital, private credit, family offices, superannuation, and sovereign wealth funds, our members collectively manage over $61 billion for investment into the establishment and growth of Australian businesses.[1]

Private capital funds serve an important purpose by pooling capital from a variety of sources to finance economic activity and jobs in Australia. Capital is invested by individuals, Australian superannuation funds, sovereign wealth funds (including the Future Fund), foreign persons, as well as life insurance companies, endowments, and charities.

Private capital invests into a wide range of businesses across every sector of the Australian economy from early-stage to fast growth, turnaround and those requiring expansion capital. These are businesses that provide services such as healthcare, education and hospitality, and are at the forefront of new industries such as aerospace, agriculture, manufacturing, decarbonisation and climate change, financial services and consumer goods.

The Council's members support more than 850 businesses of varying sizes across every sector of the economy, and directly or indirectly employ close to 500,000 people in Australia.[2] Over time, fund managers have invested capital from a wide variety of domestic and offshore institutional investors to support the growth of thousands of high-potential Australian businesses. In addition to providing equity capital, private capital fund managers provide those businesses with a mix of strategic support, mentoring and networking to help them unlock growth opportunities in domestic and international markets, which underpins the creation of new jobs across all sectors of the economy and boosts economic growth.

Private capital makes a significant contribution to the Australian economy and accounts for almost three per cent of Australia's GDP. Economic analysis confirms that one in nine new Australian jobs are created by private capital-backed Australian businesses, which reinforces the important job-creating role that private capital investment play.[3]

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[1] Preqin and Australian Investment Council Private Capital Markets Overview, May 2023.
[2] Funding a brighter Future, EY, May 2022.
[3] *Private equity: Growth and Innovation*, Deloitte Access Economics, April 2018.

OVERVIEW

Australia's private capital investment market has grown steadily and significantly over the past decade, and private equity, venture capital and private debt funds managed $61 billion in assets at September 2022.[4]

But this figure is a relatively small component of the vast pool of funds required to meet Australia's most pressing priorities:

- Australia must attract an estimated $1.5 trillion in capital by 2030 and up to $9 trillion by 2060 to fund the transition to net zero emissions.[5]
- The costs of health, aged care and disability care is expected to grow by more than $115 billion between now and 2062.[6]
- The seven priorities outlined in the $15 billion National Reconstruction Fund to diversify Australia's economy and grow high-value industries will only be achieved with at least $30 billion in private funding.[7]

If private capital contributes even 10 per cent of the total investment required in these three priority areas, it will require upwards of $150 billion in new investment.

Australia is similar to other major economic centres in that private capital is increasingly being called on to meet areas of unmet need or fulfil Australia's economic potential, often in working alongside public capital.

Beyond investing in national priorities, private capital can boost the productivity and performance of home-grown businesses, cultivate jobs in high-value, high-paying industries, and create a more dynamic economy. Private capital can also build wealth for Australians in retirement.

However, several handbrakes are preventing the flow of private capital investment into and within Australia:

Superannuation: Just five per cent of our $3.6 trillion superannuation pool is allocated to domestic private capital markets because a narrow focus on fees and short-term profits have discouraged long-term, high-return investment.[8]

Regulation: Australia ranks eighth of 69 countries for restrictions on foreign direct investment, as long approvals processes and application fees impact appetite to invest.[9]

Taxation: Australia's funds management structures are incongruous with global best practice, which is a deterrent for international investors who are not familiar with the local frameworks.

The recommendations contained in this submission cover one or more of the following economic objectives:

1. Ensuring Australia remains a destination of choice for investment capital in a globally competitive market

2. Attracting investment, growing talent and building businesses with the support of a highly competitive tax regime

3. Attracting, developing, and retaining the talent, skills and capabilities for Australia's long-term growth

4. Building wealth for Australians in retirement

5. Investing in industries and technologies that will help meet Australia's net-zero targets

The Council recognises that in the current environment, there is limited capacity for revenue negative reforms. The proposals contained in this paper are modest and would have minimal impact on the Budget bottom line. However, if implemented, they would have a positive long-term impact on productivity, employment and economic dynamism.

[4]Preqin and Australian Investment Council, *Australian Private Capital Markets Overview 2023*, May 2023.
[5]Net Zero Australia, April 2023: Final Results Summary.
[6]Treasury, August 2023: 2023 Intergenerational Report.
[7]Department of Industry, Science and Resources, November 2022: Establishing the $15 billion National Reconstruction Fund.
[8]Australian Prudential Regulation Authority, September 2023: APRA releases superannuation statistics for September 2023.
[9]OECD, Foreign Direct Investment Regulatory Restrictiveness Index.

SUMMARY: FIVE KEY PRIORITIES FOR THE 2024-25 FEDERAL BUDGET

The Council has identified and made recommendations for five priority areas for the 2024-2025 Federal Budget. These recommendations relate to how Government may catalyse private capital investment.

Priority 1	**Ensuring Australia remains a destination of choice for investment capital in a globally competitive market**

- **Recommendation 1:** Signal that Australia is open for business by fast-tracking investment approvals, offering pre-approvals or reducing the information requirements for trusted and regular FIRB customers. This could be achieved by setting a baseline approval for funds that have previously passed FIRB's direct interest threshold, with exclusions for sensitive areas like defence.

- **Recommendation 2:** Undertake an independent review of the current foreign investment fee structure to assess the extent to which the fees are globally competitive. Fees should cover the cost of administering the FIRB system and not act as an additional tax on foreign investors.

- **Recommendation 3:** Clarify the responsibilities of allocators of capital, managers of capital and portfolio companies under both the legislative and operational requirements of the Register of Foreign Ownership of Australian Assets, and if needed, amend to place the reporting obligations only on the fund manager as the foreign person.

- **Recommendation 4:** Reconsider the use of personally linked applications such as MyGov in the reporting process. Work with relevant stakeholders to develop an alternative registration mechanism.

- **Recommendation 5:** Streamline the process of appointing representatives to report on behalf of the foreign person (including reconsidering the requirement that representatives use their personal MyGov account to report on behalf of the foreign person).

Priority 2	**Attracting investment, growing talent, and building businesses with the support of a highly competitive tax regime**

- **Recommendation 6:** Introduce a Limited Partnership Collective Investment Vehicle as the major outstanding component of a globally competitive Collective Investment Vehicle and funds management regime.

- **Recommendation 7:** Increase the Early-Stage Venture Capital Limited Partnership threshold from $50 million to $100 million, and Venture Capital Limited Partnership threshold from $250 million to $500 million to better align with transaction sizes and valuations in today's market.

- **Recommendation 8:** Review and refine ESVCLP and VCLP programs and introduce an inflation adjustment mechanism such at the CPI to ensure benchmarks remain relevant.

- **Recommendation 9:** Allow for, at a minimum, domestic fund managers to be able to contribute more than 30 per cent of committed capital to an ESVCLP.
- **Recommendation 10:** Amend the tax withholding rates to bring them in line with global averages or consider a broad-based reduction for dividend income, such as in the ESVCLP.[10]

Priority 3	Attracting, developing and retaining the talent, skills and capabilities for Australia's long-term growth

- **Recommendation 11:** In tandem with implementation of the Government's Migration Strategy, align and use the resources of Austrade and DFAT to help boost offshore marketing of skilled and talent-based migration programs. This will encourage some of the world's best and brightest skilled talent to move to Australia, and at the same time, encourage skilled Australians with valuable offshore experience in leading technology and innovation ecosystems to return home.
- **Recommendation 12:** Ensure that the planned revamp of / alternative to the Significant Investment Visa continues to mandate investment into early stage and growth companies as a condition of its granting, to ensure continued support for Australian innovation.

Priority 4	Building wealth for Australians in retirement

- **Recommendation 13:** Transition the focus of performance benchmarking for APRA-regulated superannuation funds from fees to net returns. This would bring Australia into line with international peers and provide fund members with clearer line of sight over the bottom-line impact of investment options on overall superannuation fund balances. It would also encourage development of investment options that deliver superior returns to members.

Priority 5	Investing in sustainability to meet Australia's net-zero targets

- **Recommendation 14:** Establish nationwide and accurate data resources and set clear expectations for how companies should address data gaps in existing climate benchmarks, particularly in relation to Scope 3 emissions. This work could be done in conjunction with the Government's Sustainable Finance Strategy.
- **Recommendation 15:** Provide capability and expertise, especially for climate modelling and assurance and verification work, where skill sets do not exist or are limited in comparison to the level of demand that will develop in the market. This work could be done in conjunction with the Government's Sustainable Finance Strategy.
- **Recommendation 16:** Provide support for start-ups and early-stage entities developing enabling technologies in the decarbonisation space who lack capital or resources to independently scale or compete with established businesses (and therefore fall outside the scope of government programs such as the NRF, ARENA and the CEFC). Support could include:
  - Subsidies for companies developing decarbonisation enabling technology;
  - Tax incentives for private capital investment in businesses focused on decarbonisation enabling technology; and
  - Government acting as an early-stage customer of decarbonisation enabling technology.

[10] See Table 1 (page 13)

PRIORITY 1: ENSURING AUSTRALIA REMAINS A DESTINATION OF CHOICE FOR CAPITAL INVESTMENT IN A GLOBALLY COMPETITIVE MARKET

Foreign investment review regime

Australia relies on a mix of domestic and international capital to support economic activity. At the end of 2022, foreign direct investment in Australia was $4.5 trillion, making Australia the 15th highest destination for international capital in the world.[11] Mining attracts the most foreign investment, with one-third of capital allocated.[12]

While this statistic shows that Australia presents opportunities for international capital, it needs to be considered alongside another statistic: Australia ranks eighth of 69 countries, including all OECD and G20 countries, for restrictions on foreign direct investment.[13]

The Foreign Direct Investment Regulatory Restrictiveness Index (FDI Index) ranks economies across four areas. Australia's FIRB screening and approval process is the second most restrictive in the OECD, second only to New Zealand.[14]

There are strong and obvious reasons for Australia to scrutinise how and where foreign capital is being invested, and to have robust governance frameworks in place. However, FIRB's extensive information requirements, long approvals processes and associated application fees can have a significant impact on appetite to invest within Australia, relative to other countries which are also competing for the same capital.

A 2020 study by the Productivity Commission shows that a 10 per cent increase in the OECD's Foreign Direct Investment Restrictiveness Index was associated with a theoretical decrease in inward investment stocks of 2.1 per cent. Therefore, the restrictiveness of the FIRB regime directly impacts investment.

The median processing time by Treasury for non-real estate transactions was:

51 days in 2020-21

52 days in 2021-22

Changes introduced in July 2022 have reduced the median processing time to 41 days in 2022-23. But this still remains above the standard 30-day legislated period, outlined in the Regulatory Performance Framework Self-Assessment Report (2020-21) and makes foreign investment less competitive than purely domestic investors, particularly where slow and or uncertain FIRB processes can derail commercial negotiations.

The FIRB regime costs significantly less to administer than the revenue it generates through fees. In 2020-21 FIRB proposal fees generated $85.6 million in revenue, but the operational costs of administering the regime were only $36.1 million. This $45.5 million surplus is effectively an additional tax on foreign investment.

[11]Department of Foreign Affairs and Trade, Statistics on who invests in Australia | Australian Government Department of Foreign Affairs and Trade (dfat.gov.au).
[12]Department of Foreign Affairs and Trade, Australian industries and foreign direct investment | Australian Government Department of Foreign Affairs and Trade (dfat.gov.au).
[13]OECD, Foreign Direct Investment Regulatory Restrictiveness Index.
[14]OECD, Foreign Direct Investment Regulatory Restrictiveness Index.

The Productivity Commission has previously suggested the following reforms to FIRB:

- improve transparency and certainty;
- provide greater explanation of decisions and adherence to timeframes; and
- align fees with the cost of administration.[15]

Register of Foreign Ownership of Australian Assets

In addition to obligations under the FIRB process, a new Register of Foreign Ownership of Australian Assets was introduced in 2023. This creates additional reporting obligations for foreign investors in relation to certain interests in Australian land, entities and businesses. The scope of registerable actions is significantly broader than the FIRB regime.

All legal interests (including leases of greater than five years) and some equitable interests in land acquired by a foreign person after 1 July 2023, or where a company becomes a foreign person after 1 July 2023, must be reported to the ATO, which maintains the register. Given the structures of private capital investment, this has the potential to create significant compliance burden on allocators and managers of capital as well as portfolio companies which must register their interests.

The registration must be completed by the relevant directors and public officers personally via their MyGov account (resulting in the disclosure of their personal information) and there is little scope to delegate this to advisors. It is incongruous that the onus for investments made by an entity is placed on individuals. This asymmetry may also be problematic in the event that the relevant director or public officer who has completed the registration leaves the entity.

Further, there remains some uncertainty as to the reporting obligations of each party. This is a meaningful deterrent for foreign investors given the significant penalties in place for non-compliance.

Opportunities

If Australia wants to attract the necessary capital to meet our national priorities, particularly in non-mining sectors, we need to outperform other countries when competing to attract and retain capital.

While Australia is an attractive investment destination, our regulatory frameworks are overly restrictive and expensive. We suggest the following measures could position Australia as a destination of choice for foreign investment:

Recommendation 1

Send a strong signal that Australia is open for businesses by fast-tracking approvals, offering pre-approvals or reducing the information requirements for trusted and regular FIRB customers. This could be achieved by setting a baseline approval for funds that have previously passed FIRB's direct interest threshold, with exclusions for sensitive areas such as defence.

[15] Productivity Commission 2020: FIRB Reforms.

Recommendation 2

Undertake an independent review of the current foreign investment fee structure to assess the extent to which the fees are globally competitive. Fees should cover the cost of administering the FIRB system and not act as an additional tax on foreign investors.

Recommendation 3

Clarify the responsibilities of allocators of capital, managers of capital and portfolio companies under both the legislative and operational requirements of the Register of Foreign Ownership of Australian Assets; and if needed, amend to place the reporting obligations on the fund manager as the foreign entity only.

Recommendation 4

Reconsider the use of personally linked applications such as MyGov in the reporting process. Work with relevant stakeholders to develop an alternative registration mechanism.

Recommendation 5

Streamline the process of appointing representatives to report on behalf of the foreign person (including reconsidering the requirement that representatives use their personal MyGov account to report on behalf of the foreign person).

PRIORITY 2: ATTRACTING INVESTMENT, GROWING TALENT, AND BUILDING BUSINESSES WITH THE SUPPORT OF A HIGHLY COMPETITIVE TAX REGIME

Australia's funds management tax structures are incongruous with global best practice which is a deterrent, particularly for international investors who are not familiar with the local frameworks. There are three areas for reform that would generate efficiencies in Australia's taxation system and make it more navigable for foreign

2.1 Rethink investment vehicles

Australia's funds management structures are broadly considered to be out of sync with global best practice in investment.

Currently, Australia's main managed investment vehicles are unit trusts, such as Managed Investment Trusts (MITs). These structures are not considered standard investment vehicles in other jurisdictions, and as such, these vehicles are unfamiliar to foreign investors and several uncertainties in their application act as deterrents to investment.

Most other comparable jurisdictions have long used a collective investment vehicle (CIV) structure, the globally accepted private capital vehicle of choice. This includes the EU (UCITS), UK (OEIC), Hong Kong (OFC) and Singapore (VCC). Most overseas CIV structures are in the form of limited partnerships; trusts are a concept unique to Australia.

In 2022, Australia introduced the Corporate Collective Investment Vehicle (CCIV) regime. The idea was first proposed in the Johnson Report in 2009 and accepted by the Australian Government in 2016. This 2016 decision included a commitment by the Australian Government to also introduce a Limited Partnership Collective Investment Vehicle (LP CIV).

Given the scale of capital required to meet Australia's most pressing priorities (including the clean energy transition, and the costs of healthcare, aged care and disability care), Australia must be competitive in retaining domestic, and attracting international, capital. An LP CIV, comparable to models in operation in the EU, UK, Hong Kong and Singapore, would make a significant contribution to our competitiveness.

Opportunity

World-class, competitive CIVs that are readily understood by foreign investors are essential to build and expand the pool of capital that can be attracted into the Australian economy. If foreign investors are not familiar with a vehicle, or it is too hard to navigate, their money will be invested elsewhere and will contribute to the business, productivity, jobs and GDP growth of other nations.

If Australia lags, we risk missing out on opportunities to attract investment and bolster the Australian economy. As such, we suggest the following:

Recommendation 6

Introduce a Limited Partnership Collective Investment Vehicle (LP CIV) as the major outstanding component of a globally competitive collective investment vehicle (CIV) and fund regime.

2.2 Update VCLP and ESVLP vehicles

Venture capital and private equity growth funds are an essential element of Australia's innovation system, underpinning the competitiveness of Australian businesses and the growth and vitality of the domestic economy.

Despite a growing venture capital sector, Australia is still small by international standards. According to the OECD, Australia's venture capital investment as a percentage of gross domestic product was 0.034 per cent compared to an OECD average of 0.081 per cent in 2019.

Venture Capital Limited Partnerships (VCLPs) and Early Stage Venture Capital Limited Partnerships (ESVCLPs) were introduced into Australia in 2002 and 2007, respectively to increase venture capital investment in Australia by giving tax concessions to eligible investors. Concessions include flow-through tax treatment, where the income is taxed at the owner's individual tax rate for ordinary income, and the business itself pays no corporate tax. Other concessions include exemptions on income tax on certain capital and revenue profits and taxing fund managers on capital account rather than as income.

The programs were designed to help stimulate venture capital investment and were strongly supported by the private capital industry. Since their introduction, and as at June 2023, VCLPs and ESVCLPs have attracted $30.2 billion in committed capital and supported investment into 2,636 businesses.[16]

However, the investment thresholds have not kept pace with evolution in the market, and do not reflect today's transaction sizes or valuations.

When it was introduced in 2002, the VCLP program applied a threshold to investments such that the investee entity could not have an asset value above $250 million at the time of investment. For the ESVCLP, introduced in 2007, the threshold value for eligible entities was $50 million. Neither of these threshold values has been subsequently updated, despite a compound growth rate in transaction value of eight per cent since the programs were introduced.[17]

In addition, the rules currently state that none of the investors in an ESVCLP can contribute more than 30 per cent of the committed capital unless they are a bank, life insurance entity, widely-held superannuation fund or widely-held foreign venture capital fund. The Innovation Investment Committee can approve an investor with more than 30 per cent committed capital in some circumstances. It is unclear why, for example, a bank can hold more than 30 per cent but other companies or funds cannot.

Opportunities

Ensuring the continued growth and development of innovative and competitive Australian businesses, through increased venture capital funding, is critical to a competitive economy with high-quality jobs at the forefront of new technologies.

Australia has a strong framework for supporting venture capital and private equity growth funding, but it must keep pace with the industry to ensure we amplify the impact of private capital. We suggest the following opportunities to ensure the VCLP and ESVCLP programs remain relevant and continue to attract investment:

Recommendation 7

Increase the ESVCLP threshold from $50 million to $100 million, and VCLP threshold from $250 million to $500 million to better align with transaction sizes and valuations in today's market.

[16] Department of Industry, Science and Resources, 2023, Venture Capital Dashboard FY22/23.
[17] Preqin and Australian Investment Council, Australian Private Capital Market Overview, 2023.

Recommendation 8

Review and refine ESVCLP and VCLP programs and introduce an inflation adjustment mechanism, such as the CPI, to ensure benchmarks remain relevant.

Recommendation 9

Allow for, at a minimum, domestic fund managers to be able to contribute more than 30 per cent of committed capital to an ESVCLP.

2.3 Revisit foreign investment taxes

Australia's taxation system has a reputation for being among the world's most complex.

The University of Navarra's Venture Capital and Private Equity Attractiveness Index ranks Australia ninth overall, of 125 countries.[18] However, for tax incentives and administrative burden, Australia ranks 94th, placing us among many developing nations. This complexity may impact the scale of investment into Australian private equity and venture capital funds.

The complexity was recognised in Treasury's 2015 Tax White Paper:

"Australia's corporate tax system is also extremely complex. Artificial distinctions embedded in the system often create unintended biases towards particular forms of investment, distort business decisions."[19]

Australia has high domestic withholding tax rates on passive income such as dividends, interest and royalties. Australia's withholding tax rates on dividends and royalties are particularly high, compared with the OECD average (demonstrated by Table 1). These are subject to reductions only under tax treaties with nations with which Australia has concluded a double tax agreement. High withholding tax rates put Australia at a disadvantage vis-à-vis our OECD peers when attracting foreign investment of private capital.

Australia does have an imputation system. This means that, when Australian corporate tax is paid in Australia and a franking credit is generated, those profits can be distributed as dividends without additional tax leakage in the form of withholding tax and domestic shareholders receive a credit for the company tax paid.

[18] University of Navarra, 2023, Venture Capital and Private Equity Attractiveness Index.

[19] Treasury, 2015, Tax White Paper.

Table 1: Withholding tax rates in Australia and other comparable countries

Withholding tax obligation	Dividends	Interest	Royalties
Australia	30%	10%	30%
Canada	25%	25%	25%
United Kingdom	0%	20%	20%
United States	30%	30%	30%
OECD Average	20%	16%	19%

Source: EY Worldwide Corporation Tax Guide, 2023.
Note: The above rates are subject to reduction under applicable tax treaties entered into by the above countries with other countries.

Opportunity

Changes to our tax system that bring Australia more in line with our peers in the OECD and improve our ranking in the Venture Capital and Private Equity Attractiveness Index will help position Australia as a destination of choice for foreign investors.

Drawing in more foreign investment will help Australian businesses unlock the capital they need to grow and deploy innovative solutions across our priority policy areas, including aged care, investment in green energy and innovative local manufacturing solutions.

Recommendation 10

Amend the tax withholding rates to bring them in line with global averages or consider a broad-based reduction for dividend income, such as in the ESVCLP.

PRIORITY 3: ATTRACTING, DEVELOPING AND RETAINING THE TALENT, SKILLS AND CAPABILITIES NEEDED FOR AUSTRALIA'S LONG-TERM GROWTH

For generations, Australia's talent pool for labour and skills has comprised:

- locally educated and developed talent;
- migrants engaged in the workforce who have chosen to make Australia their permanent home; and
- short-term migrants who have particular skills and expertise.

An acute shortage of labour and skills in Australia has been pronounced since the COVID-19 pandemic, but it had also existed in certain sectors prior to 2020. For example:

- the number of major infrastructure and construction projects led to a significant shortage of suitably qualified talent such as project managers;
- increasing regulatory and compliance burdens in financial services led to higher demand for risk management professionals; and
- the ongoing digitalisation of the economy led to elevated demand for technology skills across disciplines such as cybersecurity, data analytics and artificial intelligence.

The pandemic widened the shortage of labour and skills across almost every sector of the economy and further highlighted the need to ensure that education and migration policy levers are working in tandem, so that Australia's labour and skills needs can be met in the immediate and longer terms. There is also merit in better understanding whether there are skills and talent already in Australia that are being unutilised or underutilised due to factors such as visa restrictions or recognition of foreign qualifications.

The Council supports a sustainable migration system that recognises the breadth of skills and talent required to meet the current and future needs of a diverse domestic economy, while also addressing unmet community needs. The first phase of the Government's Migration Strategy, released in December 2023, will progress pathways to permanent residency for sponsored skilled employees.

Skilled migration has been a key feature of Australia's migration system, playing an important role in generating economic growth for successive decades. Australia has had a long history of supportive policies to attract business entrepreneurs. However, the rising global mobility of workers and heightened competition for talent means that it is important for Australia to have policy settings that are effective in attracting a critical mass of "new economy" skilled workers. These entrepreneurs will help generate new and sustainable business opportunities within the Australian economy into the future and every effort must be taken to attract and retain that talent.

The Government has foreshadowed its intent to remove further barriers and amplify Australia's efforts in attracting skills and talent in its Strategy's second phase, to be released in 2024. As part of this process, it has indicated that it plans to revamp / provide an alternative to the existing Significant Investor Visa. A well-designed alternative will be an important tool to attract the skills and talent into Australia necessary to support innovation and investment.

Opportunities

The Council has identified two reform opportunities to enhance the effectiveness of the Government's Migration Strategy:

Recommendation 11

In tandem with implementation of the Government's Migration Strategy, align and use the resources of Austrade and DFAT to help boost offshore marketing of skilled and talent-based migration programs. This will encourage some of the world's best and brightest skilled talent to move to Australia, and at the same time, encourage skilled Australians with valuable offshore experience in leading technology and innovation ecosystems to return home.

Recommendation 12

Ensure that the planned revamp of / alternative to the Significant Investment Visa continues to mandate investment into early stage and growth companies as a condition of its granting, to ensure continued support for Australian innovation.

PRIORITY 4: BUILDING WEALTH FOR AUSTRALIANS IN RETIREMENT

Superannuation, valued at $3.6 trillion and equating to more than 150 per cent of GDP, is the largest pool of Australian capital. However, only a small portion of that is invested domestically in Australian private markets. Close to 48 per cent of superannuation assets are now invested overseas, and only 4.9 per cent of assets are invested in private equity and venture capital, which is the type of capital that invests in start-ups, scale-ups and growth businesses.[20]

Consequently, Australians are missing out on two fronts:.

1. Firstly, when superannuation funds limit their investment in private capital funds, Australians may not fully benefit from on the high returns that these investments deliver for their retirement savings over the long term (see Table 2 below).

2. Secondly, restrictions on capital investment in domestic industries limit our ability to reap the benefits that come from nurturing new industries and capabilities, including jobs, productivity and contribution to GDP.

Table 2: Private equity and venture capital returns over time

Index	1-year	3-year	5-year	10-year	15-year
Australian-listed equities	14.3	11.6	7.6	9.2	7.0
Australian bonds	1.1	-3.6	0.3	2.7	4.8
Australian private equity and venture capital	4.6	28.9	17.6	17.9	11.9

Source: Cambridge Associates, 2023.

Two recent developments have impacted the allocation of superannuation into private asset classes: Your Future, Your Super and Regulatory Guide 97.

[20]Australian Prudential Regulation Authority, September 2023: APRA releases superannuation statistics for September 2023

Your Future, Your Super (YFYS)

The intent of the YFYS reforms is logical but, in application, they have unintended adverse consequences. Private capital's challenge is one of timing: a fund is likely to underperform the YFYS benchmark early in its life, while outperforming later on. This limits capital investment by superannuation funds into companies with longer investment horizons, such as Australian research and companies focused on science, technology, engineering and manufacturing. This can have cascading consequences, limiting the ability for Australia to grow or sustain high skill industries, develop manufacturing capabilities, enhance supply chain sufficiency, and attract skilled talent.

Treasury's Review of the YFYS, published in April 2023, found the 'performance' test, introduced as a simple and objective assessment of performance, can "unintentionally affect investment decisions of all funds to reduce the risk of failure and closure by encouraging short-termism and benchmark hugging as well as discouraging certain investments".[21]

Similarly, the YourSuper Comparison Tool allows for default sorting of products by fees. The Review found this can "unintentionally increase the ranking of products with relatively poor investment performance that have temporarily lowered fees".[22]

ASIC's Regulatory Guide 97 (RG 97)

Private capital investments typically require greater resources to execute than liquid investments like bonds and listed equities. There are several reasons for this.

1. Private capital deals often involve extensive due diligence, specialised knowledge and expertise, and proactive management.

2. Private capital investments are usually made over a long-term horizon and require ongoing monitoring, strategic adjustments and a commitment of resources over an extended period. Funds will bring in outside expertise, including advisors, consultants and board members to help the business run more effectively. Investors, therefore, demand a premium for tying up their capital. As a result, fees are higher.

Regulation around fees (such as ASIC's RG 97) encourage superannuation fund competition based on fees, rather than returns after fees, an area in which private markets investments typically do very well.

Both sets of reforms have, understandably, been driven by a determination to protect members and ensure Australians have sustainable retirement savings. However, they have also had unintended consequences.

Reforms to improve transparency and disclosure have delivered meaningful and real benefits to members of super funds. But a narrow focus on fees and costs have promoted only one part of the performance equation. Superannuation fund performance is the product of both a fund's returns and its costs. Put simply: fund performance = returns less expenses.

An investment option that is 'low cost' may not be 'high performing' due to having low returns. Existing policy settings can encourage or nudge superannuants to myopically focus on a fund's expenses or short-term performance.

Private capital, which is an active investment that tends to produce higher returns over 10-plus years, but lower returns year-on-year – as illustrated in Table 1 above – is disadvantaged by these disclosures. Investors may not see the fruits of the management for several years, and only then on exit. Potentially favourable short-term returns, and higher costs, make LPs reluctant to invest in private capital.

Table 3: Superannuation allocation to private capital – Australia vs international

5%	Australian superannuation funds
33%	CPP Investments, Canada
15%	Public Sector Pension Investment Board, Canada
16%	California State Teachers' Retirement System, US

Source: EY, 2023 (as at March-June 2023).

Opportunity

Australian superannuation is a ready stock of capital that could be deployed to private investment while fulfilling members' best interest obligations: however very little gets allocated to domestic private capital markets. We suggest the following opportunity to signal to super funds and members the benefits of private capital:

Recommendation 13

Transition the focus of performance benchmarking for APRA-regulated superannuation funds from fees to disclosure of net returns to encourage funds to allocate more to high return alternative investments and allow fund members to make more informed choices about their long-term investments that provide the best possible returns to members.

The Government's proposed review of the Your Future, Your Super performance test will be a suitable opportunity to consult with relevant stakeholders to determine the best performance benchmarks for superannuation fund members.[23]

[21]Treasury, April 2023: YFYS Review.
[22]ibid.
[23]Treasurer Chalmers, December 2023, Treasurer's Investor Roundtable.

PRIORITY 5: INVESTING IN SUSTAINABILITY TO MEET AUSTRALIA'S NET-ZERO TARGETS

External pressures such recovery from the pandemic, geopolitical instability, and inflationary pressures have the potential to disrupt Australia's plans to transition to net zero. This is a global risk and Australia is not immune. Nevertheless, the Council agrees with the OECD's assessment that

> ***"climate change remains the principal global environmental, economic and social change of this century."*** [24]

It would be reasonable to anticipate that between now and 2050, there may be other as-yet-unforeseen events that also have the potential to disrupt net zero transition plans. Governments can plan for this by continuing to put in place frameworks that enable private capital to efficiently invest in the widest possible range of projects, technologies and businesses that will contribute to a net zero society.

Globally, the implied investment opportunity to achieve net zero by 2050 is $US194 trillion, with an annual investment of $US5.5 trillion per year for the remainder of the 2020s, rising to $US7.4 trillion per year in the 2040s.[25] Two thirds of that level of investment could come from private investment.[26]

Investment is crucial to the risks of climate change being managed, and opportunities being realised. Australia has the potential to be a global leader in decarbonisation, founded on the abundance of resources such as wind and solar, powered by research and development by industry and academic institutions, and necessitated by a reliance on carbon-intensive industries such as mining and agriculture.

Much of the investment in decarbonisation will be in infrastructure, and this attracts a certain type of private capital, notably superannuation, pension and sovereign wealth funds. However, there is also a need for private investment in technologies and businesses that are smaller than a typical infrastructure project. This is where private equity and venture capital funding will be required. There will also be a need for non-bank debt capital. The risk-return profiles for these types of capital vary, and policy levers should be flexible enough to account for the variety of capital needed.

Given the enormity of the task, it is imperative that public and private sectors work together. The Australian Government can pull a number of levers to support private investment in net zero. For new and nascent markets, government can be a cornerstone investor, providing debt financiers with assurance. Government can harness its considerable buying power to lock-in supply contracts that effectively underwrite priority projects or technologies, much as power purchase agreements have underwritten wind farm projects. The Australian Government is in a unique position to facilitate the diverse participants required to contribute to Australia's net zero pathways: Commonwealth and state governments; industry, the investment community and community stakeholders.

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[24] OECD, November 2022, p 13, The Climate Action Monitor 2022.
[25] BloombergNEF, 2022, Executive Summary, New Energy Outlook 2022.
[26] Climate Champions, November 2021, Private investors could drive over two-thirds of the trillions in investment needed to reach net zero.

Government and regulators could provide support to companies in developing the required skills, resources, and capabilities to generate consistencies in climate related disclosures that facilitate progress towards a net zero economy.

Opportunities

A stable investment framework that provides a steady stream of investment capital will be central to achieving the net-zero targets, noting the estimated $12 trillion needed to upgrade the infrastructure to manage the clean energy transition in the decade to 2031.[27]

The following recommendations will help to facilitate the necessary private capital investment into decarbonisation, and ensure Australia develops sufficient levels of clean energy infrastructure and decarbonisation enabling technology.

Recommendation 14

Establish nationwide and accurate data resources and set clear expectations for how companies should address data gaps in existing climate benchmarks, particularly in relation to Scope 3 emissions. This work could be done in conjunction with the Government's Sustainable Finance Strategy.

Recommendation 15

Provide capability and expertise, especially for climate modelling and assurance and verification work, where skill sets do not exist or are limited in comparison to the level of demand that will develop in the market. This work could be done in conjunction with the Government's Sustainable Finance Strategy.

Recommendation 16

Provide support for start-ups and early-stage entities developing enabling technologies in the decarbonisation space who lack capital or resources to independently scale or compete with established businesses (and therefore fall outside the scope of government programs such as the NRF, ARENA and the CEFC). Support could include:

- Subsidies for companies developing decarbonisation enabling technology;
- Tax incentives for private capital investment in businesses focused on decarbonisation enabling technology; and
- Government acting as an early-stage customer of decarbonisation enabling technology.

[27] Australian Financial Review, 10 March 2021, Clean energy transition will cost $12trn: CBA.

APPENDIX: RECOMMENDATIONS BY GOVERNMENT PORTFOLIO

Treasury

- **Recommendation 1:** Signal that Australia is open for businesses by fast-tracking investment approvals, offering pre-approvals or reducing the information requirements for trusted and regular FIRB customers. This could be achieved by setting a baseline approval for funds that have previously passed FIRB's direct interest threshold, with exclusions for sensitive areas like defence.

- **Recommendation 2:** Undertake an independent review of the current foreign investment fee structure to assess the extent to which the fees are globally competitive. Fees should cover the cost of administering the FIRB system and not act as a tax on foreign investors.

- **Recommendation 3:** Clarify the responsibilities of allocators of capital, managers of capital and portfolio companies under both the legislative and operational requirements of the Register of Foreign Ownership of Australian Assets, and if needed, amended to place the reporting obligations only on the fund manager as the foreign person.

- **Recommendation 4:** Reconsider the use of personally linked applications such as MyGov in the reporting process. Work with relevant stakeholders to develop an alternative registration mechanism.

- **Recommendation 5:** Streamline the process of appointing representatives to report on behalf of the foreign person (including reconsidering the requirement that representatives use their personal MyGov account to report on behalf of the foreign person).

- **Recommendation 13:** Transition the focus of performance benchmarking for APRA-regulated superannuation funds from fees to net returns. This would bring Australia into line with international peers and provide fund members with clearer line of sight over the bottom-line impact of investment options on overall superannuation fund balances. It would also encourage development of investment options that deliver superior returns to members.

- **Recommendation 14:** Establish nationwide and accurate data resources and set clear expectations for how companies should address data gaps in existing climate benchmarks, particularly in relation to Scope 3 emissions. This work could be done in conjunction with the Government's Sustainable Finance Strategy.

- **Recommendation 15:** Provide capability and expertise, especially for climate modelling and assurance and verification work, where skill sets do not exist or are limited in comparison to the level of demand that will develop in the market. This work could be done in conjunction with the Government's Sustainable Finance Strategy.

Treasury, Department of Industry, Science and Resources

- **Recommendation 6:** Introduce a Limited Partnership Collective Investment Vehicle as the major outstanding component of a globally competitive Collective Investment Vehicle and funds management regime.

- **Recommendation 7:** Increase the Early-Stage Venture Capital Limited Partnership threshold from $50 million to $100 million, and Venture Capital Limited Partnership threshold from $250 million to $500 million to better align with transaction sizes and valuations in today's market.

- **Recommendation 8:** Review and refine ESVCLP and VCLP programs and introduce an inflation adjustment mechanism such at the CPI to ensure benchmarks remain relevant.

- **Recommendation 9:** Allow for, at a minimum, domestic venture capital funds of funds to contribute more than 30 per cent of committed capital to an ESVCLP.

- **Recommendation 10:** Amend the tax withholding rates to bring them in line with global averages or consider a broad-based reduction for dividend income, such as in the ESVCLP.

Home Affairs

- **Recommendation 11:** In tandem with implementation of the Government's Migration Strategy, align and use the resources of Austrade and DFAT to help boost offshore marketing of skilled and talent-based migration programs. This will encourage some of the world's best and brightest skilled talent to move to Australia, and at the same time, encourage skilled Australians with valuable offshore experience in leading technology and innovation ecosystems to return home.

- **Recommendation 12:** Ensure that the planned revamp of / alternative to the Significant Investment Visa continues to mandate investment into early stage and growth companies as a condition of its granting, to ensure continued support for Australian innovation.

Treasury; Climate Change and Energy

- **Recommendation 16:** Provide support for start-ups and early-stage entities developing enabling technologies in the decarbonisation space who lack capital or resources to independently scale or compete with established businesses (and therefore fall outside the scope of government programs such as the NRF, ARENA and the CEFC). Support could include:

  - Subsidies for companies developing decarbonisation enabling technology;
  - Tax incentives for private capital investment in businesses focused on decarbonisation enabling technology;
  - Government acting as an early-stage customer of decarbonisation enabling technology.

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The Australian Investment Council is the peak body representing Australia's private capital industry, comprising over 200 leading domestic and international private capital firms operating in Australia. Our members comprise private equity, venture capital and private credit funds, as well as institutional investors and leading corporate advisors. Our members form part of a dynamic industry that supports entrepreneurship, commercialises research and empowers established businesses to grow and evolve. Our industry employs approximately half a million Australians and contributes roughly three per cent to Australia's GDP. The Australian Investment Council empowers private capital to invest in Australian businesses, ideas and communities.