Senate Standing Committee on Economics

Tax Laws Amendment (Research and Development) Bill 2013

January 2014

Overview

The Australian Industry Group (Ai Group) welcomes the opportunity to provide input to the Senate Economics Legislation Committee's inquiry into the Tax Laws Amendment (Research and Development) Bill 2013.

If enacted, this Bill would deny larger businesses access to Australia's Research and Development Tax Incentive. Ai Group is opposed to this Bill due to our concern at the consequences of denying access to some of the largest contributors to Australia's research and development effort.

Innovation by business, including innovation associated with business engagement with research and development, is critical to the future success of the Australian economy. It is particularly important at the moment because we have a legacy of low productivity growth to address and because there is a need for new sources of growth to emerge to assist the economy rebalance as the boom in mining investment wanes. Business research and development is a key path in the development of these new sources of growth, alongside a holistic approach to innovation policy that maximises Australia's areas of competitive advantage and attractiveness as a site for investment.

Australia's public support for business research and development has been a spectacular success with business expenditure growing very rapidly over a long period. Over the decades since the tax incentive was introduced Australia has gone from a country with a noticeably low level of business research and development activity to one whose spending on research and development as a proportion of GDP is larger than in most OECD countries.

This expansion of research and development spending has been led by large businesses. Large businesses make a disproportionate contribution to overall business research and development activity. They also lend considerable support to Australia's broader innovation system through their relationships with other innovative businesses; their commercial links – particularly with businesses supplying technical and scientific services; and the links and contracts they have with Australia's publically funded research organisations.

Denying the Research and Development Tax Incentive to the largest companies will lead to a decline in the level of their research and development spending and a commensurate reduction in, and weakening of, their extensive links with Australia's broader innovation system.

The proposed change would increase the likelihood that research and development spending by larger businesses will be undertaken offshore. Denying access will decrease research and development spending itself; it will decrease the extent of spillovers associated with such spending; and, it will detract from the longer-term performance of the Australian economy and thus from the corporate tax base.

The rationale for the discriminatory denial of the tax incentive for larger businesses is that larger businesses are less responsive than other businesses to the tax incentive. This is simply asserted rather than being backed with evidence or argument. In fact there is no evidence that larger businesses are less responsive to tax incentives than other businesses. Rather, the share of research and development spending by larger businesses has risen over the period that research and development tax concessions have been in place. This is contrary to what would be expected if larger businesses were less responsive than other businesses.

We are particularly concerned that the proposed changes will impact in a discriminatory way on domestically-based companies that derive income in other countries. In contrast to the treatment of other corporations, the offshore income of Australian-based multinationals is proposed to be included in "aggregate assessable income". As a result, an Australian-based company could be denied access to the research and development tax incentive (based on their taxable turnover) while a similarly-sized competitor based in another country could retain eligibility.

Finally, the Bill proposes that the tax treatment of business expenditure on research and development law be changed retrospectively from 1 July 2013. This proposal for retrospective application is contrary to sound policy principles and sets a dangerous and confidence-sapping precedent.

The Research and Development Tax Incentive has been a spectacular success.

For a long time Australian business had a reputation for low levels of spending on research and development (R&D). Typically the basis of this reputation was the OECD comparisons of the amount of Business Expenditure on Research and Development (BERD) as a proportion of Gross Domestic Product.

Over the past three decades the basis for this reputation has been undermined by the much faster rate of growth in BERD in Australia compared with the OECD average. While Australia's BERD to GDP ratio is still below the OECD average (which reflects the very high R&D intensities of a small number of countries), it is now above the OECD median and is higher than key comparable countries. Table 1 summarises the broad trends in BERD as a share of GDP.

Table 1: Business Expenditure on Research and Development as a Share of GDP

	1981	**1991**	**2001**	**2010**
	BERD : GDP (%)			
Australia	**0.2**	**0.6**	**0.8**	**1.3**
Canada	0.6	0.8	1.3	0.9
New Zealand	0.2	0.3	0.4	0.5**
United Kingdom	1.5	1.4	1.2	1.1
United States	1.6	1.9	2.0	1.9
OECD Average	*1.2*	*1.5*	*1.5*	*1.6*
Australia/OECD Average (%)	**18.2%**	**37.8%**	**53.0%**	**80.7%**

Source: OECD Stat Extracts, Main Science and Technology Indicators
** 2009 data (2010 data not available)

Across the OECD, BERD has generally grown somewhat faster than GDP, as reflected in the rising ratio of BERD to GDP. In Australia, BERD has risen very much faster than the pace of GDP growth. This is due to more than just Australia's very low starting point, because Australia now has a higher BERD to GDP ratio than either the United Kingdom or Canada. Whereas Australia's BERD to GDP ratio was below one fifth of the OECD average in 1981, in 2010 it was four fifths of the OECD average.

The Australian R&D Tax concession has been a major feature of the Australian R&D landscape over this period and has been an important driver of the increase in R&D activity in Australia. In the same period Australia has moved steadily up the international rich list and, in part due to the additional R&D activity undertaken, is currently the twelfth richest country in the world.

A perplexing change of policy direction

In recent years, the former Government put in place refinements to the R&D tax arrangements with the stated objective of better targeting the tax expenditures on activities that generate greater external benefits. From its own point of view, it tried to make a very successful program even better.

These “refinements” have not yet been in operation long enough to be evaluated in full. Nevertheless, the proposal now is to deny larger businesses access to what is promoted as a more effectively targeted tax expenditure.

The rationale for this is the assertion that large businesses are less responsive to the R&D Tax Incentive than other businesses. The Explanatory Memorandum released with the draft legislation make the following assertions:

- The amendment better targets the R&D tax incentive to businesses that are more likely to increase their R&D spending in response to government incentives, delivering a greater return for taxpayer funds. (Paragraph 1.1)

- There is broad support internationally for the view that the R&D spending of small firms is more responsive than that of large firms to government incentives. (Paragraph 1.6)

- These amendments limit the R&D tax incentive to entities with aggregated assessable income of less than $20 billion in an income year. An entity with aggregated assessable income in excess of $20 billion treats its R&D expenditure in the same way as it treats its other expenditure, for example, as a deduction. This denies access to the R&D tax incentive for very large entities, which are less likely to engage in additional R&D in response to Government incentives. (Paragraph 1.11)

The claims in the Explanatory Memorandum are made without any evidence or argument. They are bald, unsupported assertions. The same was true of the Explanatory Materials presented to the Parliament when similar legislation was proposed by the former government.

The absence of supporting evidence for the assertion that larger businesses are less responsive to the R&D tax incentive is highlighted by this statement in Paragraph 1.7 of the Explanatory Memorandum:

> The Government has committed to using the scheduled 2014 review of the R&D tax incentive to review access to R&D support, and the taxation White Paper to consider the effectiveness of existing tax incentives for innovation.

Ai Group fully supports a proper consideration of the effectiveness of existing tax incentives for innovation and particularly of the effectiveness of the R&D Tax Incentive. However, by proposing to deny larger businesses access to the tax incentive before this evaluation can be conducted, the current Bill puts the cart well and truly before the horse.

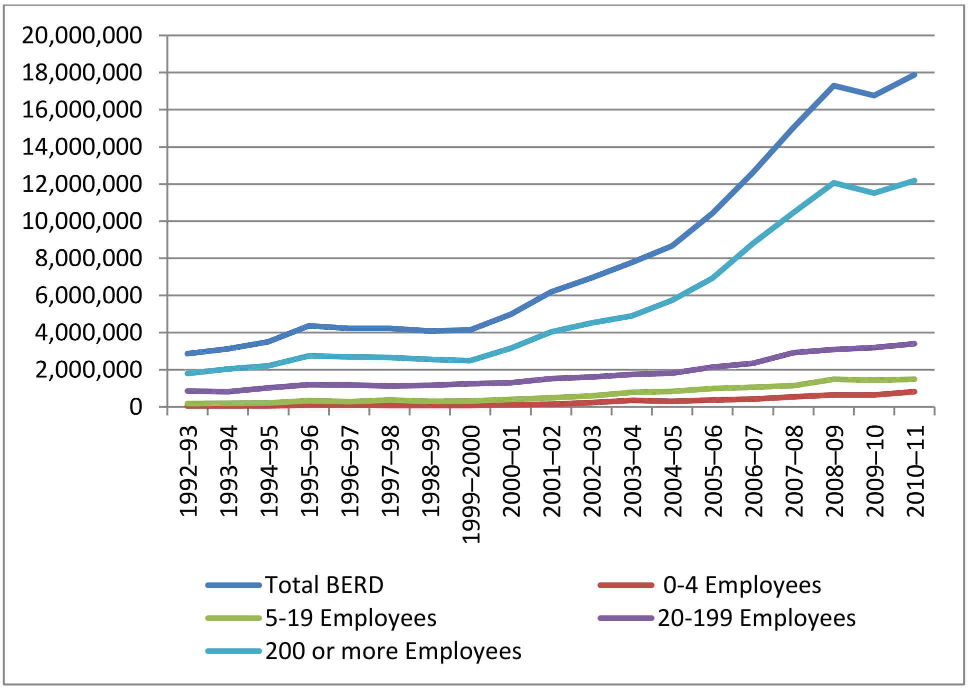
Are larger businesses less responsive to R&D tax incentives than other businesses?

There are substantial reasons to doubt the vague assertions that large businesses in Australia are less responsive to the R&D tax incentive.

One test of the hypothesis that larger businesses are less responsive to research and development tax incentives would be whether large businesses responded less to Australia's former R&D Tax Concession. If larger businesses were less responsive to this tax incentive, the rate of increase in R&D expenditure by large businesses could be expected to have been lower than those of the medium or smaller businesses that would have responded more actively to the tax incentive.

The following chart looks at business expenditure on R&D between 1992-93 and 2010-11 by businesses of different sizes (based on the number of employees).

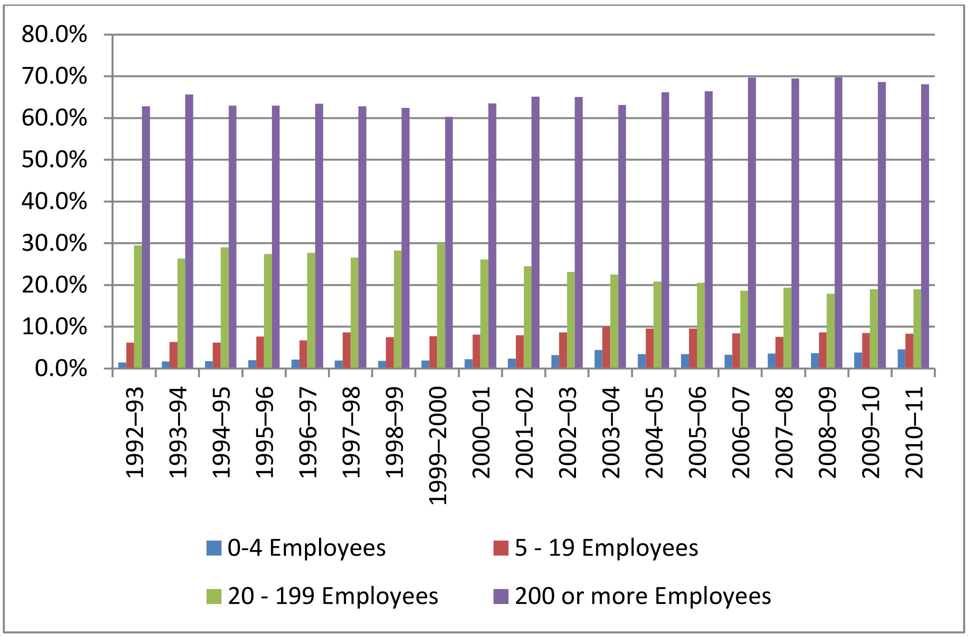
Chart 1: Business Expenditure ($'000) on R&D:
Total BERD and BERD by Size of Business
1992-93 to 2010-2011



Source: ABS, 8104, *Research and Experimental Development, Businesses,* Australia, 2010-11

While Chart 1 presents very clearly the disproportionate role of larger businesses in total R&D spending by businesses in Australia, it disguises the strong rise in R&D spending by smaller businesses from a very low base. Chart 2 below illustrates the change in proportions of total R&D spending over this period for businesses of different sizes.

Chart 2: Business Expenditure on R&D:
Share of BERD by Size of Business
1992-93 to 2010-2011



Source: ABS, 8104, *Research and Experimental Development*, *Businesses*, Australia, 2010-11

Chart 2 suggests very strongly that it is far from apparent that larger businesses have been less responsive. In fact, the share of R&D spending by larger business tended to increase over time in direct contrast to what would be expected if larger businesses were less responsive to the tax incentive.

The data in Table 2 below confirm this by looking at the annual average growth rates of business expenditure on R&D for businesses of different sizes.

Table 2: Rate of Growth of Business Expenditure on R&D
1992-03 to 2010-11

	Annual average rate of growth
0–4 persons	17.9%
5–19 persons	12.5%
20–199 persons	8.0%
200 or more persons	11.2%
Total business expenditure on R&D	*10.7%*

Source: ABS, 8104*, Research and Experimental Development, Businesses,* Australia, 2010-11

This data presents very starkly the extremely high (indeed double digit) annual rate of growth of (nominal) spending on R&D over a long period. They certainly do not lend support to the hypothesis that larger businesses are less responsive to the R&D Tax Incentive. Notwithstanding the higher spending base from which larger business grew its R&D expenditure, and the high proportion of total spending accounted for by larger businesses, the rate of growth of spending by larger businesses has been *above* the average for business as a whole.

On this evidence, it is far from apparent that larger businesses have been less responsive to R&D tax incentives as asserted in support of this Bill.

Discrimination against Australian-based Multinational Corporations

Under the proposed changes, a resident company will be assessed for eligibility on the basis of its assessable income which will include ‘their ordinary and statutory income from all sources”. In contrast, a foreign resident company with a permanent establishment in Australia would include only that income that is “attributable to the permanent establishment”. Thus an Australian resident company could find that it was denied access to the research and development tax incentive whereas a similarly-sized competitor that was a foreign-based multinational company would remain eligible.

While this sort of outcome may be unavoidable given the discriminatory nature of the proposed change, it is clearly a perverse outcome and creates perverse incentives.

Retrospectivity

The Bill proposes that the tax treatment of business expenditure on research and development law be changed retrospectively from 1 July 2013. This proposal is contrary to sound policy principles and sets a dangerous and confidence-sapping precedent.