



Response to Changes to the R&D Tax Incentive

Senate Standing Committee on Economics

5 November 2018

Executive Summary

The University of Melbourne welcomes the opportunity to contribute to the Standing Committee on Economics' Inquiry into the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018*.

The following submission addresses the changes to the R&D tax incentive that were first announced in the 2018 Budget and that are included in the Bill. The submission reinforces comments the University of Melbourne made in July this year to the Treasury consultation on a draft version of the Bill.

The R&D tax incentive is a major component of Government support for research and development in Australia, with an estimated \$3.1bn worth of support for R&D delivered through the program in 2017/18. The program is the primary mechanism by which the Government aims to drive private sector investment in R&D. As the Government seeks to further increase industry-university research collaboration, it is timely that the R&D tax incentive is refined to ensure that it is delivering upon its intended aims. Any changes to the R&D tax incentive ought to be assessed on the basis of the key objective of driving R&D activity that would not occur otherwise.

The need to get the design of the R&D tax incentive right takes on greater urgency in view of the low level of Government and business investment in R&D relative to other OECD countries. Earlier this year, Universities Australia reported on OECD data, which revealed that Australia spent 1.88 per cent of GDP on R&D in 2015/16, down from 2.11 per cent in 2013/14 and well below the OECD average of 2.38 per cent. For the first time on record, the business investment in R&D declined in 2015/16.¹ Commenting on the decline in business investment, Professor Emma Johnston of Science and Technology Australia said, "We are particularly concerned to see the numbers around business investment and support for private sector research".² This underwhelming performance represents a risk to Australia's future prosperity.

The following comments address two key issues in the design of the R&D tax incentive. Firstly, a 'collaborative premium' was recommended in the recent review of the R&D tax incentive but was not included in the suite of changes announced in the Budget. A premium incentive rate for businesses that engage research institutions to conduct R&D would help ensure an optimal return on the public investment and advance the aims articulate in the Government's National Innovation and Science Agenda (NISA).

The University of Melbourne also offers comment on the proposed exemption of clinical trials from the \$4m refund cap for the refundable component of the tax incentive. While we support this exemption, we have concerns about the narrow definition of 'clinical trials' proposed in the Bill.

¹ Universities Australia (2018), "Media release: Government and business must rev up R&D or we'll risk national prosperity", July 10, 2018.

<https://www.universitiesaustralia.edu.au/Media-and-Events/media-releases/Government-and-business-must-rev-up-R-D-or-we-ll-risk-national-prosperity#.W9ouLuJxWUI>

² https://scienceandtechnologyaustralia.org.au/research-and-development-investment-drooping/?utm_source=STA+Newsletter&utm_campaign=28591dc770-EMAIL_CAMPAIGN_2017_06_16_COPY_01&utm_medium=email&utm_term=0_187e7c9789-28591dc770-580473837

Recommendations

The University of Melbourne recommends that the Government:

- introduce a collaboration premium of up to 20 per cent for the non-refundable tax offset, as was recommended in the 2016 *Review of the R&D Tax Incentive*, and by Innovation and Science Australia.
- adopt a broad definition of ‘clinical trials’, such as that used by the World Health Organisation, to ensure that the new cap on cash refunds does not impede the translation of Australia’s research effort into health benefits.

For further information, or to discuss the submission, Professor Jim McCluskey, Deputy Vice-Chancellor (Research) can be contacted at [REDACTED].

A collaboration premium

The value of research collaboration between industry and publicly funded research organisations is now widely recognised. The Report from the Review of the R&D Tax Incentive noted that collaborative R&D “is considered to be more likely to produce spillovers, so adjusting the programme to encourage collaborative R&D could increase the programme’s effectiveness.”³ Recent modelling from London Economics estimated that research activity from the Group of Eight universities alone made a net contribution of \$24.5b to the Australian economy in 2016.⁴

It is also recognised that Australia enjoys a relatively low level of collaboration between industry and research institutions. Australian businesses are much less likely to conduct R&D activity with the research sector than businesses in other OECD nations. To date, the public investment made through the R&D tax incentive has not driven an increase in industry-research collaboration. In 2013/14, only 9.5 per cent of projects registered under the program reported collaborating with public research organisations.⁵ Moreover, growth in expenditure made through the program has far outstripped growth in research income universities source from industry. Expenditure through the R&D tax incentive grew by 79 per cent between 2008/09 and 2017/18.⁶ Between 2009 and 2016, industry sourced research income grew by less than 20 per cent.⁷

The introduction of “a collaboration premium of up to 20 per cent for the non-refundable tax offset” was one of six recommendations made by the expert panel in its *Review of the R&D Tax Incentive*. In making this recommendation, the Review noted that the low level of R&D collaboration represents “a lost opportunity” for the Australian economy, and that a premium rate would help address this. Innovation and Science Australia (ISA) made the same recommendation in its *Australia 2030: prosperity through innovation*, released in 2017.

It is disappointing that the Government has chosen not to follow the recommendation that came out of the expert review of the R&D tax incentive. The Bill’s Explanatory Memorandum articulates a two-fold rationale for rejecting the expert panel’s recommendation on a collaboration premium:

- i. The Government argues that a “collaboration premium may be limited in its ability to effectively increase the level of collaboration” since it “would not address the significant cultural and structural barriers to collaboration”.
- ii. The Government argues that a collaboration premium may create the potential for ‘distortionary impacts and rorting’. “For example, a company with the internal capability to undertake R&D may choose to outsource the activity simply to receive a higher benefit rate. This would not be an efficient allocation of resources.”⁸

Both these claims are at odds with the findings of the expert panel. On the issue of ‘cultural and structural barriers to collaboration’, the Review made the following comments:

Noting that financing constraints are just one of the potential barriers to enhancing collaborative R&D in Australia, it is expected that the level of collaboration would build over time as cultural barriers and lack of familiarity are reduced and stronger linkages are formed

³ <https://www.industry.gov.au/data-and-publications/review-of-the-rd-tax-incentive> (p.30).

⁴ London Economics (2018), “The economic impact of Group of Eight universities”.
https://www.go8.edu.au/sites/default/files/docs/article/go8_london-economics-report.pdf

⁵ Ibid, (p.13)

⁶ Department of Industry, Innovation and Science (2018), *Science, Research and Innovation Budget Tables 2017-18*.

⁷ Department of Education and Training (2018), ‘Data used in Research Block Grant funding formulae’.

⁸ Point 4.59, p.63.

between business and PFROs. This may mean that the initial cost of a collaboration premium would be small.⁹

In other words, the expectation is that a collaboration premium would deliver incremental gains in breaking down cultural barriers between research and industry. Greater familiarity between industry and the research sector would build over time as businesses respond to the heightened incentive introduced through a premium rate.

The Government's second argument (concerning the risk of 'distortionary impacts and rorting') asserts that a collaboration premium might result in an increase in the number of businesses engaging the research sector without delivering any of the benefits typically associated with collaborative research. This concern is not consistent with a recognition of the nature of the economic impact that research collaboration between business and the research sector promotes. As the *Review of the R&D Tax Incentive* notes, collaborative research drives spillover benefits in greater measure than non-collaborative R&D. "The importance of the industry-PFRO [publicly funded research organisation] over other types is because these types of projects are more likely to provide the basis for disruptive innovations."¹⁰ Given this, there is no serious prospect of large numbers of businesses engaging the research sector to conduct R&D without this driving the intended cultural shift and economic benefits.

The University of Melbourne urges the Government to implement the collaboration premium recommended in the *Review of the R&D Tax Incentive*. This would ensure that the program's design reflects the policy intent of encouraging additional R&D activity, and that it better contributes to Australia's collaborative research ecosystem.

Recommendation

The University of Melbourne recommends that the Government introduce a collaboration premium of up to 20 per cent for the non-refundable tax offset, as was recommended in the 2016 Review of the R&D Tax Incentive, and by Innovation and Science Australia.

⁹ p.33.

¹⁰ Ibid. p.30.

Exemption for clinical trials from the cap on refundable component

The Government is proposing to make clinical trials exempt from the new \$4m cap on annual refunds repayable under the refundable component of the tax incentive. The University of Melbourne welcomes this exemption. Clinical trials are a critical component of medical research in Australia, which itself represents a significant share of all business investment in R&D. It is appropriate that expenditure on trials be exempt from the cap, so that the new arrangements do not constrain the research effort in this area.

We do, however, have concerns about the definition of ‘clinical trials’ to be used to determine eligibility for the exemption. The proposed definition is that used by the Therapeutic Goods Administration (TGA):

A clinical trial is a planned study of the safety or efficacy in humans of an intervention (including a medicine, treatment or diagnostic procedure) with the aim of achieving at least one of the following:

- the discovery, or verification, of clinical, pharmacological or other pharmacodynamic effects;
- the identification of adverse reactions or adverse effects;
- the study of absorption, distribution, metabolism or excretion.¹¹

Our concerns relate to the narrowness of the definition. On advice received, the definition has the effect of limiting clinical trials to therapeutic device and drug trials, and of excluding other clinical interventions such as cognitive behaviour therapy and music therapy trials. There is, in our view, no policy basis for limiting the proposed tax exemption in this way. The trial activity thereby excluded is an increasingly important part of medical research, and ought to be included in the exemption from the new cap on the refundable component. We note also that the exclusion of legitimate clinical interventions from the exemption is likely an unintended consequence of the Bill’s wording.

The University of Melbourne suggests adopting a broader definition that is more reflective of the diverse nature of clinical research. The World Health Organisation (WHO) defines ‘clinical trial’ as follows:

“a clinical trial is any research study that prospectively assigns human participants or groups of humans to one or more health-related interventions to evaluate the effects on health outcomes.”

The WHO definition uses the general term ‘health-related interventions’ and is therefore agnostic as to the type of clinical intervention being trialled. Consequently, this definition is broad enough to capture trials that would be excluded under the proposed TGA definition. Importantly, there is an international trend towards this broader definition of clinical trials. The National Institutes of Health (NIH) in the US also defines clinical trials broadly (in terms of ‘interventions’) for the purposes of determining eligibility for research grants.¹² Adopting the WHO definition would bring Australia into line with international practice.

Recommendations

The University of Melbourne recommends that the Government adopt a broad definition of ‘clinical trials’, such as that used by the World Health Organisation, to ensure that the new cap on cash refunds does not impede the translation of Australia’s research effort into health benefits.

¹¹ See Explanatory Memorandum, point 1.26, p.15.

¹² <https://grants.nih.gov/policy/clinical-trials/definition.htm>