

TREASURY LAWS AMENDMENT (RESEARCH AND DEVELOPMENT TAX INCENTIVE) BILL 2019

Response to the Inquiry by the Senate Economics Legislation
Committee

March 2020

ABOUT RESEARCH AUSTRALIA

Our vision: Research Australia envisions a world where Australia unlocks the full potential of its world-leading health and medical research sector to deliver the best possible healthcare and global leadership in health innovation.

Our mission: To use our unique convening power to position health and medical research as a significant driver of a healthy population and contributor to a healthy economy.

Our role:

Engage

Australia in a conversation about the health benefits and economic value of its investment in health and medical research.

Connect

researchers, funders and consumers to increase investment in health and medical research from all sources.

Influence

government policies that support effective health and medical research and its routine translation into evidence-based practices and better health outcomes.

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Summary of recommendations

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| <p>Research Australia does not support the Bill</p> | <p>With expenditure on the R&DTI Scheme failing to meet the earlier projections (which precipitated concerns about the escalating cost of the scheme) much of the rationale for the amendments contained in the Bill is no longer valid.</p> <p>The Senate Economics Legislation Committee should recommend the Senate oppose the passage of the <i>Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019</i>.</p> <p>The R&DTI Scheme must be retained as a vital component of Australia's ambition to create a more innovative and diverse economy that exports a range of goods and services to the world.</p> |
| <p>Additionality and Spillovers</p> | <p>There is evidence that the R&DTI Scheme is delivering additionality and spillovers as intended , so the proposed changes to the R&DTI are not warranted.</p> <p>There should be no amendments to the R&DTI Scheme until, and only if, the consequences of those amendments for additionality and spillover benefits are understood and have been properly evaluated.</p> |
| <p>Reduction in the refundable R&DTI rate</p> | <p>For small innovative companies in their early stages that are currently paying little or no tax, the reduction in the rate of the R&DTI offset is not offset by the reduction in the company tax rate, and results in a direct reduction in the support provided to when they need it most.</p> <p>The proposal to reduce the rate of the refundable R&DTI offset and to link it to the corporate tax rate should be rejected by the Senate.</p> |
| <p>\$4 million cap on the refundable R&DTI</p> | <p>Imposing a cap of \$4 million and introducing an exemption for clinical trials is not warranted by the net effect of reducing the amount of the refundable offset claimed by 20 companies.</p> <p>The impact of this measure on the overall expenditure of the RDTI Scheme is negligible, and may well be exceeded by the additional administration and compliance costs imposed on the Australian Taxation Office and the claimants.</p> |
| <p>Intensity Measure</p> | <p>By linking the R&DTI to the value of R&D as a percentage of total expenditure, the proposed Intensity Measure not only provides an incentive to increase R&D, but to reduce other expenditure, including moving other expenditure, such as manufacturing, to other countries.</p> <p>The intensity measure proposed in the Bill should not be supported by the Senate, as it could have the unintended consequence of discouraging non-R&D business investment (e.g. manufacturing) in Australia.</p> |

TREASURY LAWS AMENDMENT (RESEARCH AND DEVELOPMENT TAX INCENTIVE) BILL 2019

RESPONSE TO THE INQUIRY BY THE SENATE ECONOMICS LEGISLATION COMMITTEE

Introduction

Research Australia welcomes the opportunity to make this submission to the Senate Inquiry on the *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019* (the Bill) which seeks to amend the Research and Development Tax Incentive (R&DTI) Scheme.

Research Australia is supportive of the R&DTI in its current form and opposes the proposed amendments.

An objective of the current Bill is to reduce the total level of the Government's expenditure through the R&DTI Scheme. Such a reduction was first announced in the 2014-15 Budget with tax offsets available under the research and development tax incentive for the first \$100 million of eligible expenditure reduced by 1.5 percentage points.

This measure was followed by the *2016 Review of the R&D Tax Incentive*, which is the genesis for the proposals contained in the current Bill.¹ The initial Budget announcement and the Review occurred against the backdrop of expenditure on the R&DTI which was increasing at a rate that exceeded successive budget forecasts.

The *2016 Review of the R&D Tax Incentive* relied on estimates that the total cost of the R&D Tax Incentive in 2017/18 would be \$3.485 billion.² The latest figures published by the Department of Industry, Innovation and Science estimate the actual cost in 2017/18 at \$2.579 billion, some \$800

¹ Mr Bill Ferris AC, Chair, Innovation Australia, Dr Alan Finkel AO, Chief Scientist, Mr John Fraser, Secretary to the Treasury; *Review of the R&D Tax Incentive* 4 April 2016

² Ibid, p.24

million lower than the forecast in the Review's report.³ The latest estimate of expenditure for 2018/19 is \$2.059 billion.⁴

Research Australia submits that with expenditure on the R&DTI Scheme failing to meet the earlier projections (which precipitated concerns about the escalating cost of the scheme) much of the rationale for the amendments contained in the Bill is no longer valid.

While Innovation and Science Australia's 2017 Report supported a reduction in expenditure on the R&DTI in the context of increased government expenditure on other measures to support innovation and a commitment to a funding 'floor' of its medium-term average of 0.63 per cent of gross domestic product (a modest proposal), no such commitment to increase expenditure to support innovation has been made by Government.⁵ Instead, Australian Government support for Australian R&D through all programs, including through the R&D Tax Incentive, has fallen from 0.67% of GDP in 2011-12 to 0.48% of GDP in 2019-20.⁶

Research Australia submits that the Senate Economics Legislation Committee should recommend the Senate oppose the passage of the *Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019*.

Finally, Research Australia notes that this current Bill is the latest in a succession of Bills seeking to amend the R&D TI. This submission reiterates many of the arguments put by Research Australia to the Senate Economics Legislation Committee's Inquiries into previous attempts to amend the R&DTI through the *Tax and Superannuation Laws Amendment (2014 Measures no. 5) Bill 2014*, and the *Budget Savings (Omnibus) Bill 2016*, and Schedule 1 of the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and other measures) Bill 2018*.

Further arguments and evidence in support of our position are provided below.

Why invest in innovation?

Per capita, Australia is one of the wealthiest countries in the world. And while it is no longer true that Australia rides on the sheep's back, for a wealthy country our economy remains poorly diversified. This places Australia's long-term future at risk; a decline in the export value of just a few key commodities can jeopardise our whole economy and standard of living.

The Coronavirus has exposed Australia's reliance on one major export partner, China, for three of our major exports: minerals, tourism and higher education. Such a concentrated reliance on one export partner and a few exports is unparalleled in the developed world, and it is a situation we need to change dramatically by creating a more innovative and diverse economy that exports a range of goods and services to the world.⁷ This means supporting the companies in Australia, both

³ Australian Government Department of Industry, Innovation and Science, 2019-20 Science, Research and Innovation Budget Tables, Large Australian Government R&D programs and activities valued at over \$100m in 2019-20, Table 1

⁴ Ibid

⁵ Ibid, Recommendation 6

⁶ Australian Government Department of Industry, Innovation and Science, 2019-20 Science, Research and Innovation Budget Tables Australian Government investment in R&D by sector and sub-sector, and other analyses Table 6, Australian Government investment in R&D as a percentage of Gross Domestic Product

⁷ See for example, the *Atlas of Economic Complexity*, developed by Harvard University, which rates the complexity of Australia's economy as the 93rd most complex economy in the world, behind Morocco,

small and large, that are engaging in research and development, creating new jobs and opportunities and diversifying our economy. These are the companies that utilise the R&DTI and which will be disadvantaged by the proposed changes.

In general, the complexity of a country's economy, measured in terms of the diversity of its international trade, is a good measure of the economy's strength and resilience, and its capacity for continued innovation and growth.

The *Atlas of Economic Complexity*, developed by Harvard University, rates the complexity of Australia's economy as the 93rd most complex economy in the world, behind Morocco, Uganda and Senegal.

'Australia is a high-income country, ranking as the 8th richest economy per capita out of 133 studied. Its 24.6 million inhabitants have a GDP per capita of \$54,093 (\$49,653 PPP; 2017). GDP per capita growth has averaged 0.9% over the past five years, below regional averages.'

Australia ranks as the 93rd most complex country in the Economic Complexity Index (ECI) ranking. Compared to a decade prior, Australia's economy has become less complex, worsening 22 positions in the ECI ranking. Australia's worsening complexity has been driven by a lack of diversification of exports. Moving forward, Australia is positioned to take advantage of a moderate number of opportunities to diversify its production using its existing knowhow.'

Australia is less complex than expected for its income level. As a result, its economy is projected to grow slowly. The Growth Lab's 2027 Growth Projections foresee growth in Australia of 2.2% annually over the coming decade, ranking in the bottom half of countries globally.⁸

To summarise:

- The key to long term, sustainable prosperity is a more complex economy.
- Greater complexity requires greater diversification of exports.
- Existing knowhow provides a moderate number of opportunities to diversify our production.
- The key to diversifying our exports and our economy is new knowledge creation and innovation, that includes smart manufacturing as an example.

It is clear that we need to do more. While there are signs that Australia is becoming more innovative, a concerted long-term investment in innovation by the Government and the private sector is required over decades if we are to see innovation have a real impact on our exports and permeate our economy.

The R&DTI Scheme provides an excellent mechanism for market forces to determine where and how R&D investment dollars should be invested. It has been highly effective at allocating scarce investment into areas where Australia and its research community have strengths, particularly in health and medical research and innovation. The R&DTI Scheme is a more effective and predictable system for incentivising investment in small and large businesses than other

Uganda and Senegal. *'Australia ranks as the 93rd most complex country in the Economic Complexity Index (ECI) ranking. Compared to a decade prior, Australia's economy has become less complex, worsening 22 positions in the ECI ranking. Australia's worsening complexity has been driven by a lack of diversification of exports... Australia is less complex than expected for its income level. As a result, its economy is projected to grow slowly.'* Accessed on 26 February 2020 at <http://atlas.cid.harvard.edu/countries/14>

⁸ Harvard University Growth Lab, Centre for International Development, Atlas of Economic Complexity, Australia Profile, accessed on 19 November 2019 at <http://atlas.cid.harvard.edu/countries/14>

mechanisms such as grant schemes, which are less predictable and tend to be targeted to deliver a specific policy outcome, rather than encouraging market led investment.

The Government commissioned Innovation and Science Australia to develop a plan for innovation, which was delivered to the Government in 2017.⁹ *Australia 2030: Prosperity through Innovation* outlined a plan for how the Australian Government could drive innovation across the whole economy through investment at the medium-term average level of 0.63%.

While Research Australia contends that this level of Government investment in R&D is too low, even this modest target has not been achieved, with the **Government's expenditure on R&D across all areas having fallen to less one half of one percent of GDP**.

Australian Government investment in R&D as a percentage of Gross Domestic Product¹⁰

| Financial Year | | | | | | | Forecast | |
|----------------|-------|-------|-------|-------|-------|-------|----------|-------|
| 11-12 | 12-13 | 13-14 | 14-15 | 15-16 | 16-17 | 17-18 | 18-19 | 19-20 |
| 0.67 | 0.64 | 0.62 | 0.61 | 0.58 | 0.54 | 0.56 | 0.48 | 0.48 |

This underinvestment by the Government in innovation will condemn Australia to a low growth future, highly dependent on just a few key exports.

It also makes the role of the R&DTI Scheme even more critical. While the Government's rhetoric around amendments to the R&DTI scheme is about better targeting of its support for R&D, the reality is that the Government has not responded to the decline in expenditure on the R&DTI scheme by redirecting savings to other programs. Not only has the Government's support for R&D as a percentage of GDP declined; it has declined in dollar terms, having peaked in 2017-18.

Australian Government R&D programs and activities valued at over \$100 million in 2019-20, 2009-10 to 2019-20 (\$m inflation adjusted, 2017-18 dollars)

| Financial Year | | | | | | | Forecast | |
|----------------|---------|---------|---------|---------|---------|---------|----------|---------|
| 11-12 | 12-13 | 13-14 | 14-15 | 15-16 | 16-17 | 17-18 | 18-19 | 19-20 |
| 6,625.8 | 7,022.1 | 7,322.7 | 7,439.7 | 7,278.4 | 7,810.2 | 9,166.0 | 8,490.4 | 8,651.9 |

Research Australia submits that the R&DTI Scheme must be retained as a vital component of Australia's ambition to create a more innovative and diverse economy that exports a range of goods and services to the world.

⁹ Innovation and Science Australia 2017, *Australia 2030: prosperity through innovation*, Australian Government, Canberra.

¹⁰ Australian Government, Science, Research and Innovation (SRI) Budget Tables, 2019-20, Australian Government investment in R&D by sector and sub-sector, and other analyses Table 6, Australian Government investment in R&D as a percentage of Gross Domestic Product

Additionality and Spillovers

One of the arguments advanced in favor of amending the R&DTI Scheme is that it does not encourage additionality or spillovers. This position is summarised in the following extract from the Regulatory Impact Statement.

The (Ferris Finkel Fraser) review panel, drawing on work conducted by the Centre for International Economics (CIE), found that the R&DTI falls short of meeting its stated objectives of additionality – encouraging R&D investment that would not occur in the absence of the program – and spillovers. The panel identified a number of areas where improvements could be made in order to improve the effectiveness and integrity of the program, primarily achieving a stronger focus on additionality....

There is, however, no evidence that specific industries or types of R&D produce additionality and spillovers in greater amounts than other industries or types of R&D. Therefore it is important that the R&DTI is industry-neutral, aiming to incentivise novel R&D in all sectors of the economy. This is catered for under the R&DTI through the broad definition of what constitutes eligible R&D.

The Review found a relatively low level of additionality under the current R&DTI, stating that “volume-based tax instruments such as the Incentive not only subsidise this additional R&D but also support the activities a company would have done anyway.” That is, the program provides the same level of support for all eligible R&D activities undertaken by a claimant, with no requirement to demonstrate that it is additional to ‘business-as-usual’ R&D that would have been progressed in the absence of government support.

However, it should be noted that volume-based tax instruments tend to impose a lower regulatory burden on claimants, as eligibility is largely self-assessed.

The CIE Report

The CIE Report referred to above makes some specific findings in relation to what it describes as ‘biological and medical R&D’. These indicate that both **spillovers and additionality for companies undertaking biological and medical R&D are higher than for all R&D as a whole**. It also makes specific findings in respect of small versus large companies and R&D for new products and processes versus improvements to existing products and processes.

Arguments for greater additionality and spillovers for biological and medical R&D relative to other R&D

| | Additionality | Spillovers |
|---------------------|--|--|
| SMEs | High novelty (especially first to world R&D) Especially dependent on R&DTI for cashflow- R&D wouldn’t happen, or at a slower rate without R&DTI | Clinical Trials provide significant spillovers Spillovers are greater for new products and new to world R&D |
| Larger firms | Higher percentage of novel and first to world R&D among large biological and medical firms than ‘average’ larger firms (needs to be tested/proven) | Clinical Trials provide significant spillovers Spillovers are greater for new products and new to world R&D |

The report concludes that additionality is highest for SMEs, and that this effect is **particularly strong for start-ups undertaking biological and medical R&D**.

‘(The) evidence consistently suggests much higher additionality rates for small firms versus large firms:

- Results from our survey, under all alternative approaches, suggest that SME additionality is **between two and three times higher** than that for large firms.’*
- There is also compelling evidence from consultations and interviews that small start-ups, **particularly in the research-focused biological and medical areas** that receive a cash refund from the offset, rely on it to be able to continue their research. In their case, additionality is relatively high.’¹¹*

Higher additionality for new products

The CIE report provides some limited evidence that additionality is higher for innovation to develop new products and processes rather than improving existing processes and products.

‘R&DTI has the greatest impact on new projects and start-ups, less on improving processes because the improvements are needed to survive and compete.’¹²

This raises the question: are large companies in the HMR sector undertaking relatively more R&D on new products and processes than other large companies? Consider for example, a pharmaceutical company developing a new medicine versus a mining company seeking to improve the efficiency of the extraction of minerals. If there is a greater proportion of novel and new to the world R&D, it provides an argument for greater additionality for large companies in the HMR sector.

Spillovers and new products/processes

While the CIE report concludes that evidence on spillovers is ‘harder to gather’ it does identify a link between relatively greater spillovers from new products and processes.

Evidence on spillovers is considerably harder to gather. There is limited information in the international literature, and some of the best work in this area remains that done by the Productivity Commission and reported in its Public support for science and innovation report (PC 2007).

...

- In our survey results, we note that on average 56% of R&D spending is targeted at new products or processes. This breaks down into 67% for small firms and 55% for large firms. To the extent that there are more spillovers associated with new products, these results suggest higher (marginal) spillovers from small firms.*
- Considering other outcomes from R&D, the survey results suggest that 32% of R&D results in products or processes new to Australia (31% for large firms and 59% for small firms). Again, this suggests higher (marginal) spillovers from small firms (to the extent that novelty is associated with higher spillovers).*
- Further, the survey suggests that 24% of R&D results in products or processes new to the world (24% for large firms and 46% for small firms). This is consistent with other survey results.’¹³*

¹¹ Centre for International Economics, Final Report R&D Tax Incentive Programme Review, 29 March 2016, p.6. The CIE report is available at <https://archive.industry.gov.au/innovation/InnovationPolicy/Research-and-development-tax-incentive/Pages/R-and-D-Tax-Incentive-Review-report-and-submissions.aspx>

¹² Ibid, p.163

¹³ Ibid, p.6

Spillovers from Clinical Trials

Clinical Trials are identified by the CIE Report as a form of R&D with significant spillovers.

A clear area of significant spillovers is in the medical research (clinical trials) area:

- *Australian patients get early access to new products and treatments (and continued access after the trial period)*
- *faster regulatory approval*
- *Treatments are fully funded by the researching firm (with no cost to the public health system).¹⁴*

These spillovers benefits are a clear public good.

Increasing additionality

The CIE Report makes the following findings in relation to the scope for reform of the R&DTI Scheme to increase additionality.

*‘Because additionality is a central driver of the benefits of the programme, efforts to increase it would be worthwhile. Our analysis concludes that a 0.1 increase in the average additionality rate could yield benefits of between \$77 million and \$566 million per year. As noted, however, the additionality rate for an individual firm is determined by a range of factors outside the control of the programme. Therefore, **efforts could be focused on increasing the average rate under the programme by changing the composition of firms in the programme.***

*Average additionality could be maximised by **increasing the proportion of participants with high individual firm additionality.** We therefore recommend that the programme maintain its relative focus on small firms (which empirically have higher additionality rates).¹⁵*

Other research

More recent research also identifies considerable evidence of both additionality and spillovers for companies engaged in health and medical R&D.

AusBiotech is the peak body for Australia’s biotechnology sector (and a Research Australia member). In 2019, AusBiotech commissioned a report from Evaluate drawing on a survey of its members in relation to their experience of the R&DTI Scheme.

Some of the key findings of the report are:

- 63 per cent of respondents advise that the RDTI materially influenced the decision to undertake R&D.
- 61 per cent of respondents advise that the proposed changes would not only affect their expenditure on R&D but would also threaten the sustainability of their businesses.
- 57 per cent advise that changes would impact on the amount of R&D their companies undertake in the future.
- 29 per cent (mean) reduction in R&D was anticipated.

¹⁴ Ibid, p.165

¹⁵ Ibid, p.12-13

- Clinical trials are critically important to survey respondents, and to businesses who provide third-party services for clinical trials. However, the broader ecosystem shows that the volume of clinical trials is dependent upon the health of companies relying on broader R&DTI contributions.
- As well as the additional R&D that occurs due to the R&DTI, significant spillovers are also generated in relation to employment, training and skills development, together with growth of the sector and advances in health and innovation.¹⁶

This report reinforces the importance of the R&DTI Scheme to the sector, and the significant additionality and spillover benefits it provides.

Research Australia submits there is evidence that the R&DTI Scheme is delivering additionality and spillovers as intended, so the proposed changes to the R&DTI are not warranted.

Assessing the impact of the R&DTI Scheme

Research Australia is concerned that the proposed reductions in the R&DTI Scheme are being undertaken without assessing the impact it has had on R&D activity in Australia since its inception in 2011. Nor has there been an assessment of the impact of the subsequent reductions in the R&DTI offset rate.

While there is evidence of additionality and spillovers benefits at the company level (see above), there has been no attempt to quantify the impact of the RDTI Scheme as a whole. Research Australia accepts that an assessment at the economy wide level will always be difficult; there are many factors that affect the level of R&D undertaken in any country at any time, of which the R&DTI is only one.

The currently proposed amendments to the R&DTI Scheme risk destroying the additionality and spillovers benefits the Scheme is designed to create, simply because there is not a sufficient understanding of where and how the additionality and spillovers benefits are being created and where this is not being achieved.

This position is consistent with the recommendation of the Senate Committee in its response to Schedule 1 of the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and other measures) Bill 2018* that the Senate defer consideration of the bill until further examination and analysis of its impact is undertaken.

Research Australia submits that there should be no amendments to the R&DTI Scheme until, and only if, the consequences of those amendments for additionality and spillover benefits are understood and have been properly evaluated.

¹⁶ AusBiotech and Evaluate, 2019, *R&D Tax Incentive: Additionality and spillovers for the life sciences industry*; <https://www.ausbiotech.org/documents/item/606>

Amendments to the Refundable Component of the R&D Tax Incentive

Proposed reduction in the rate

When the R&DTI Scheme was introduced in 2011, the rate at which the refundable component of the R&DTI offset was paid was 45%. Effectively this meant that for every \$100 spent on eligible R&D activity, the company was entitled to a refund of \$45. This refund was paid regardless of whether the company had paid any or even no tax in the relevant year.

While the R&DTI is described as a tax measure and as a tax offset, this hides the reality that many of the recipient companies pay little or no tax and yet still receive the full value of the R&DTI.

Part of the argument advanced for the reduction in the refundable R&DTI is that small companies benefit from the reduction in the company tax rates. On face value it appears that the reduction in the rate of the R&DTI offset would be revenue neutral for the companies involved; i.e. the benefit of the R&DTI will be reduced but this loss will be made up by a corresponding reduction in tax paid.

However, this reasoning is fundamentally flawed; it assumes that the companies receiving the refundable R&DTI are paying sufficient income tax to receive the benefit of the reduction in the tax rate. This is clearly not the case for the small research-intensive companies in the startup phase that are undertaking R&D activity to commercialise their prototype product; many of these 'pre-revenue' companies are paying little or no income tax because they are operating at a loss for several years while they are in the process of developing products for market.

This fact is recognised in the design of the R&DTI Scheme, and is the reason why the refundable component is refundable i.e. it is **expected** that the value of the R&DTI may exceed the value of the tax payable. This is recognised in the CIE Report referred to above, and is also highlighted by the AusBiotech report. In this circumstance, the reduction in the rate of the R&DTI offset is not 'revenue neutral'; it results in a direct reduction in the support provided to small innovative companies in their early stages when they need it most.

Paragraph 4.85 of the Regulatory Impact Statement dismisses these pre-revenue companies as 'unprofitable SMEs' and asserts that the proposed change means that profitable and unprofitable SMEs will be treated equally. This assessment misses the point that these pre-revenue companies are in the start up phase, and this is precisely where the additionality benefit of the R&DTI Scheme is greatest. Driving additionality rather than equitable treatment with profitable SMEs is the objective of the R&DTI Scheme.

Research Australia opposed the 1.5% reduction in the rate of the refundable R&D Tax component in 2016 when the Committee conducted its Inquiries into the Budget Savings (Omnibus) Bill 2016; and Schedule 1 of the *Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and other measures) Bill 2018*; and we oppose the further 1.5% reduction now, for the same reasons.

Research Australia submits that the proposal to reduce the rate of the refundable R&DTI offset and to link it to the corporate tax rate should be rejected by the Senate.

The consequence of the Bill will be to reduce the level of Government support for the R&D undertaken by thousands of small research-intensive companies, regardless of reductions in the

corporate tax rate. This has a direct impact on the capacity of these companies to undertake research and development, including their ability to employ the staff they need. And it is occurring against the backdrop of a decline in Government support for R&D more generally.

The \$4 million cap

The current Bill proposes an annual cap of \$4 million on the refundable R&DTI. It also includes an exemption from the cap for expenditure related to clinical trials, in recognition of the costs associated with this specific activity. As explained in the Evaluate report commissioned by AusBiotech, implementing the cap and administering the exemption will be complex for both the ATO and for those companies that are undertaking clinical trials. It will require careful and detailed accounting to separate the eligible costs associated with clinical trials from other R&D expenditure.

‘These issues are compounded by the lack of clarity as to the definition of a clinical trial for purposes of the RDTI. Key questions here include:

- Are the entire salaries of researchers employed in clinical trials incentivised or only the component they spend working on the trials themselves (not, for example, reporting, undertaking administration or applying for funding)?;*
- Are the salaries of project administrators overseeing funding, procurement and staffing to be included?;*
- Is a percentage of overhead able to be hypothecated to clinical trials and, if so, at what rate?;*
- What percentage of plant is applicable to the clinical trial?; and,*
- Is the exclusion only applicable from the commencement of the trial or does it include the extensive preparatory work such as planning, fundraising and ethics approvals, which precede the trial?’¹⁷*

When the \$4 million cap and exemption of clinical trials was first put to the Senate in 2018, there was no information provided about how many companies would be directly affected by the introduction of a \$4 million cap, and Research Australia urged the Senate Committee to reject the amendment until such time as there was enough information available to understand the impact of this measure.

The situation has now been remedied, with paragraph 4.83 of the Regulatory Impact Statement revealing *‘It is estimated that a \$4 million cap would impact the cash refund values of around 20 claimants receiving the refundable offset, taking into account other elements of the package.’*

While we still don’t have any information about the value of the amounts excluded, or the size, industry sector or financial position of the claimants, the estimate of **20 affected companies** is in itself informative.

¹⁷ Ibid, page 36

In 2017/18, 10,750 SMEs made a claim for the refundable R&DTI.¹⁸ The 20 affected companies represent a tiny fraction, and yet **the compliance burden of this provision will be carried by a much greater number**. And it is not as if the cap will prevent these 20 companies from claiming a benefit for an 'illegitimate' expense- they will still be undertaking legitimate R&D in Australia, which, except for the cap, would be eligible for the refund. The impact of this measure on the overall expenditure of the RDTI Scheme is negligible, and may well be exceeded by the additional administration and compliance costs imposed on the Australian Taxation Office and the claimants.

Research Australia submits that imposing a cap of \$4 million and introducing an exemption for clinical trials is not warranted by the net effect of reducing the amount of the refundable offset claimed by 20 companies.

¹⁸ Australian Government, Department of Industry, Innovation and Science, Presentation to the R&DTI Industry Roundtable, November 2019

Amendments to the Non-Refundable Component of the R&D Tax Incentive

Intensity Threshold

Research Australia notes that the objective of the intensity measure, as initially proposed by the *2016 Review of the R&D Tax Incentive*, is to reward additional R&D by large companies. In proposing that the R&DTI only be available for R&D in excess of a fixed percentage of total expenditure (not the proposal contained in his Bill), the Panel acknowledged ‘There are limits in the ability to target additional R&D in a volume-based scheme’.¹⁹

Some of the difficulties with using the R&DTI to target additional R&D are highlighted by the proposed measure in this Bill.

By linking the R&DTI to the value of R&D as a percentage of total expenditure, the proposed measure not only provides an incentive to increase R&D, but an incentive to reduce other expenditure. One obvious way to do this is to retain R&D in Australia but move other expenditure, such as manufacturing, to other countries. It also acts as a disincentive to companies undertaking R&D in Australia to increase manufacturing in Australia, and to bring manufacturing on shore.

In an increasingly global economy, decisions by large corporations, and multinational corporations in particular, about where to undertake activities such as R&D, manufacturing and distribution are based on a range of factors, and many countries offer a range of incentives to win their business. In this context, it is a mistake to view R&D activity (and expenditure) in isolation from other business activity.

While the R&DTI will never be the only consideration in where a company undertakes its activities, it can be an important one, and anything that could act as a disincentive to further investment in non-R&D activity in Australia should be avoided, unless there is good reason.

The changes made to this measure between the 2018 Bill and its current form do not address this basic flaw.

Research Australia submits that the intensity measure proposed in the Bill should not be supported by the Senate, as it could have the unintended consequence of discouraging non-R&D business investment in Australia.

Lifting the expenditure threshold to \$150 million

The current cap on the non-refundable R&DTI component of \$100 million is too low. When legislated in 2015, the threshold was intended to be a temporary measure, with a sunset of 1 July 2024.

Raising the cap to \$150 million immediately would be of benefit to some large research intensive companies, although such a measure should also include a sunset clause, to ensure that it is reviewed in future.

¹⁹ Mr Bill Ferris AC, Chair, Innovation Australia, Dr Alan Finkel AO, Chief Scientist, Mr John Fraser, Secretary to the Treasury; *Review of the R&D Tax Incentive* 4 April 2016, page 4

Conclusion

Private sector R&D is critical to Australia's future prosperity as a nation. The R&D Tax Incentive is still a relatively new scheme introduced to better target and streamline Australian Government support for private sector R&D. It has already been subjected to several changes, the effects of which have not been evaluated.

The proposed reduction in the R&DTI Scheme occurs at a time when Australia needs to boost rather than wind back its support for R&D.

'Looking towards 2030, innovation will be integral to the expansion of Australia's economy, keeping its workforce strong, and addressing societal challenges. Australia will need to be competitive in a global innovation race by scaling up more high-growth industries and companies; commercialising more high-value products and services; fostering great talent; and daring to tackle global challenges.'

*'Yet just at the time when Australia needs to accelerate its innovation performance, we are falling behind our global peers, particularly in student performance in science and mathematics, and in business investment in research and development. This is more than a canary chirp in our economic mineshaft: it is a clarion call for national action.'*²⁰

Research Australia supports these views expressed by Bill Ferris AC, the then Chair of Innovation and Science Australia. And since these remarks were made by Mr Ferris in 2017, the Government's investment in R&D has declined further.

Research Australia is of the view that in this current climate the measures in this Bill to restrict expenditure on the R&DTI Scheme are ill-advised and lack longer term risk-benefit weighting.

It is at odds with the need to accelerate Australia's innovation performance, and we urge the Committee to consider the role of the R&DTI Scheme in increasing private sector R&D rather than focusing on constraining the scheme, when the most recent evidence is that the feared 'blow out' in expenditure on the scheme has not materialised.

Research Australia is pleased to have had the opportunity to make this submission and is willing to contribute further information and use its convening power in the health and medical research and innovation sectors to respond to any further questions the Committee may have.

²⁰ Innovation and Science Australia 2017, *Australia 2030: prosperity through innovation*, Australian Government, Canberra. p.iii

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