Australian Academy of Science

Submission to the Business Tax Working Group

Australian Academy of Science response to the Business Tax Working Group Discussion Paper

Focus of the Academy's response

The Australian Academy of Science is pleased to provide a submission to the Business Tax Working Group in response to the release of their Discussion Paper.

The discussion paper puts forward potential measures that could be taken to fully offset a cut in the company tax rate. One of the measures put forward includes making changes to the Research and Development (R&D) tax incentive (option 3 in the paper). It is this area of the Discussion Paper that the Academy wishes to provide comment.

The government has stated that undertaking high quality R&D to drive innovation is essential to increase productivity and competitiveness[1]. Direct fiscal support for businesses investing in R&D has been provided by the government for many years through the tax system. In outlining its innovation agenda in 2009 for the next decade the government noted that Australia's innovation performance has not kept pace with the rest of the world and that despite some recent increases business spending on R&D, Australia lags behind the countries that we compete with[2]. Australia's GERD/GDP ratio (gross expenditure on R&D) is still far behind other developed nations such as Sweden, Japan, Korea, the United States, and Germany[3], and in 2008-09 Australia had only the 11th highest GERD/GPD ratio amongst other OECD countries[4].

To help arrest this relative decline, specific measures have been introduced by the government to provide further and more targeted support, particularly for small and medium sized businesses through the introduction of a new R&D tax incentive[5].

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1 DIISRTE (2009) Powering Ideas: An Innovation Agenda for the 21st Century.
2 *Ibid*
3 ABS (2010) Research and Experimental Development, all sector summary. http://www.abs.gov.au/ausstats/abs@.nsf/PrimaryMainFeatures/8112.0
4 *Ibid*
5 Treasury and DIISR joint submission to the Senate Economics Legislation Committee Public Hearing. Tax Laws and Amendment (Research and Development) Bill 2010 https://senate.aph.gov.au/submissions/comittees/viewdocument.aspx?id=a05822e7-6399-4c37-9551-d709c8d38604

Redeploying revenue from parts of the R&D tax incentive elsewhere

Within the option three proposals in the Discussion Paper there are four different changes to the new R&D tax incentive that could be pursued. Each one of these changes would see a total reduction in the amount of government financial support available through the new R&D tax incentive scheme, with this saving used to offset a cut in the company tax rate. The reduction in support would be targeted towards larger firms, and this is justified in the Discussion Paper based on the differing R&D profiles between larger and smaller businesses.

The Discussion Paper states that larger firms are likely to engage in some R&D without public support, but that smaller firms are less likely to do so, and that this can be because they lack access to external finance. The limited evidence referred to by the Discussion Paper states that tax incentives have different impacts on the R&D performed by smaller firms relative to larger firms, and that where the incentive is unlikely to be effective in influencing company R&D investments there is an argument that the revenue foregone could be better deployed.

There are two important but separate issues that this point in the Discussion Paper raises. Firstly, whether there is a case, supported by evidence, for better deploying the R&D tax incentive revenue. Secondly if the case is supported, how should the revenue be better deployed.

1. Does the evidence show that parts of the R&D tax incentive could be better deployed?

The proposal to decrease some of the fiscal support provided through the R&D tax incentive scheme to larger firms would represent a significant change from recent policy moves to increase the amount of support available. Recently the government stated that "…70 per cent of our business R&D is done by firms with 200 or more employees, and we can't afford to see this capacity compromised"[6]. Therefore a strong case outlining the broader economic costs and benefits associated with making changes to the R&D tax incentive should be outlined before significant changes are made that might impact on a large proportion of businesses undertaking R&D. Unfortunately such an analysis and presentation of evidence is absent from the Discussion Paper.

Instead of providing an analysis, the Discussion Paper states that "…the tax system may not necessarily be the best tool for achieving such [R&D] policy goals and if existing concessions are not influencing investment consistent with the policy rationale then there may be a case for their removal (at least in part)". Whilst this statement is correct insofar as stating that there may be a case, no evidence is presented to support it.

2. If the evidence supported redeployment, where should it be deployed?

Should the Business Tax Working Group, or others, undertake the missing analysis and determine that the current R&D tax incentive is not influencing the R&D investment decisions of large firms then there might be a case for deploying some of the fiscal support for the R&D tax incentive elsewhere. The Discussion Paper assumes that such a deployment be automatically applied to offsetting the cost of a reduction in the company tax rate, without any discussion or detail as to why this would be the case. Instead consideration should be given to redeploying any such fiscal saving to

[6] DIISTRE (2009) *Op Cit.,* P.45

further the government's stated policy of increasing the number of businesses investing in R&D[7] by increasing the amount of support available[8].

Given that undertaking new R&D is essential to ensure that Australia is able to make the most of the challenges and opportunities within a transforming economy[9]. Therefore rather than using any savings made from reducing existing R&D fiscal support to fund a tax cut elsewhere, full consideration should be given to refocussing the current fiscal support for any R&D supported activity that shows limited impact to areas where support is shown to be working. Such continued financial support for R&D activities would be fully in line with the government's innovation policy position[10].

Providing a stable environment in which to make R&D investment decisions

The recent reforms to the R&D tax incentive scheme have only very recently been enacted. These changes represent the most profound changes in over 25 years in how we encourage businesses to carry out R&D. Making changes to the R&D tax incentive scheme when it has not been in operation for one tax year is likely to disrupt both sector and investor confidence in their support for ongoing R&D activity. It is important to recognise that R&D activities and investment decisions are often high-risk, and providing both fiscal incentives along with stable economic conditions is necessary to encourage investment in innovation[11]. Therefore it is important that there is stability in the current frameworks used to support R&D so that those charged with making R&D related investment decisions can have confidence that the decisions they make are not likely to be adversely affected by repeated policy changes.

After the very recent significant changes made to the R&D support system, both time and stability are now needed to see how the new system performs, the level of R&D it encourages, and the broader economic benefits it encourages. Future changes to the R&D tax incentive should be based on sound and detailed evidence, which unfortunately is not presented within the Discussion Paper.

Summary of response

In pursuing option three there is a risk that the short term increases in the tax base come at the expense of the long term productivity gains that are brought about through R&D led innovation. The Discussion Paper suggests that some of the fiscal support provided through R&D tax incentives, specifically to larger firms, might not be having the desired policy impact, and moreover that this support could be better used elsewhere. Unfortunately no evidence is provided to support this assumption. Furthermore, the conclusion that arises from this that the best redeployment of this support would be to offset a company tax rate cut is presented without any foundation. Instead any such redeployment that is shown by evidence to be necessary should be targeted towards initiatives that would increase the total amount and number of businesses engaging in R&D activities, in line with the government's existing innovation policy.

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[7] DIISRTE (2009) *op cit,* p.40
[8] Treasury and DIISR (2010) *op cit*
[9] *Ibid*
[10] *Ibid*
[11] OECD (2006) Going for Growth. Paris: OECD