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Business Tax Reform

Background

The Group of Eight (Go8) is a coalition of Australia's eight most research intensive universities. They collectively employ approximately 44 000 people. The members of the Go8 are: The Australian National University, The University of New South Wales, The University of Adelaide, The University of Queensland, The University of Melbourne, The University of Western Australia, Monash University and The University of Sydney. The distinguishing features of these universities are the intensity and breadth of the research they perform, the research-informed nature of the education they offer and the leadership they bring to community consideration of complex issues.

Together the Go8 universities account for the major proportion of the research carried out by Australian higher education sector, both that funded by government and that funded by business. In 2010, for example, the Go8 universities entered into 6 385 contracts and consultancies having a total value of nearly $546 million and accounted for 95 per cent of the revenue received from their commercialisation activities by the Australian universities that are members of Knowledge Commercialisation Australasia.[1]

Importance of tax reform

The Go8 appreciates the opportunity to provide comment on the Business Tax Working Group's discussion paper that canvasses ways in which it might be possible to fund a cut to the company tax rate.

The Go8 recognises and welcomes the benefits that would arise from decreasing corporate tax rates and from removing the complexity and distortions introduced by the many concessional and deductibility arrangements that currently exist. Such changes could lead to reduced administrative costs and help ensure that firms allocate their scarce resources to their most productive use.

Need to consider positive spillovers

While the Group of Eight believes that the high level principles of reform described in the consultation document are appropriate, the Group also believes that in some cases there are good and economically sound justifications for incentives within the tax system that favour particular forms of investment.

This situation holds when a specific type of investment produces significant benefits that flow generally to society, including other businesses, and which the firm making the investment cannot capture itself. Such benefits include, for example, knowledge flowing out of the firm,

[1] http://www.kca.asn.au/images/stories/KCA_Metrics_Survey_Report_2010.pdf

advanced skills development, and the way in which other firms and users identify applications for research outputs not recognised by the firm that produced them. One consequence of such a situation is that firms try to free ride on each others' investment and there is a clear market failure in which the level of investment is less than what would be in the national interest. Incentives provided through the taxation system can help to address this market failure. The discussion paper itself recognises this by stating (page 22):

> There may also be cases where departures from uniform tax treatment are justified on economic grounds, social or environmental grounds, for example where particular activities generate large negative or positive spillovers. In such cases, favourable tax treatment ensures that investment continues in activities such as R&D and innovation, despite the benefits being enjoyed by entities outside the investing organisation.

Investment in research provides one of the most obvious and generally accepted examples of market failure and is a driver of productivity improvement, innovation and the diversification of business, including through the development of new businesses. A recent study of American firms found that the public benefits of research and development were roughly double the private benefits and suggested that the optimal rate of research and development would be twice as high as the actual rate, and possibly higher.[2]

Any measure that reduces business investment in research is likely to result in outcomes which are the reverse of those that business tax reform is attempting to achieve. This makes it all the more surprising that one of the three areas on which the discussion paper focuses is the research and development tax incentive.

The importance of supporting research and development by large firms

The Go8 recognises that in evaluating the effectiveness of a policy intervention it is important to consider whether the intervention produces activity additional to what would have taken place anyway. This quest for additionality is presumably one reason why the discussion paper's saving options based on the research incentive target larger firms. Such enterprises may be more likely to continue research investments to maintain their competitiveness, even in the absence of a tax incentive. Unfortunately, targeting companies with a high turnover might have unintended consequences.

One reason for this is that foreign-owned firms are responsible for a significant proportion of business expenditure on research and development, and such firms are usually large. In 2010-11 almost 30 per cent of business research and development expenditure in Australia came from firms having over 50 per cent foreign ownership and over 42 per cent from businesses having some degree of foreign ownership. However, foreign-owned firms have a variety of options as to where they perform their research and can easily transfer their research activities to countries offering a more favourable environment. This option is not readily available to small Australian-owned firms.

Over the period 2008-09 to 2010-11 for example, businesses having some degree of foreign ownership decreased their research and development expenditure by a greater amount (in dollar terms and as a proportion of expenditure) than did wholly-owned Australian

[2] Nicholas Bloom, Mark Schankerman and John Van Reenen (2010) Identifying Technology Spillovers and Product Market Rivalry. http://cep.lse.ac.uk/pubs/download/dp0675.pdf

businesses.[3] In 2008-09, firms having some degree of foreign ownership were responsible for 55 per cent of business expenditure on research and development; by 2010 this had fallen to 42 per cent. One plausible explanation is a transfer of research activity in response to the less competitive environment for research resulting from the high Australian dollar, as well as the tendency of multinational enterprises to concentrate research effort in the home country during times of economic uncertainty.

A less favourable treatment of research as would result from implementing any of the discussion paper's options might lead to additional transfers of research activity out of Australia.

Australia benefits from research performed by overseas businesses, not least because such research will frequently involve direct technology transfer into Australia from other countries. In addition, there is inbuilt export-market potential for the technology or services developed through the research of firms that already have operations in other countries. Moreover, when an overseas-owned business contracts research to universities, it can help strengthen the research capability of the university directly but will also add to the university's international contacts, networks and reputation.

In at least some cases the spillovers from research performed by a foreign-owned company in Australia will be greater than those from research performed by Australian companies. Moreover, a competitive taxation environment for research is an important factor in the decision of MNEs to locate and perform research in a particular country. (Equally important is having a strong university research base on which the companies can draw – and the Go8 universities play an important role in this regard.) Removing or reducing the tax incentive for business research would send the wrong message to companies considering possible investments in Australia and this would have flow on effects beyond any reduction in business research and development.

Another reason the Go8 does not support a reduction in the tax incentive for large firms to fund research is that in general it is the larger firms that have the capacity to fund the more basic research. Such research is long term and more uncertain in its direct ability to provide commercially significant outputs but it has the potential to create major and very novel commercial opportunities. Moreover, the more basic and fundamental the research, the greater the positive spillovers it is likely to produce. Reducing the taxation incentive to perform research is likely to result in firms allocating their research funds to more tactical, low-risk research. This would be at the expense of the longer term, strategic research that provides the foundation for Australia's future economic development and the continued competitiveness of its businesses.

Tax incentives are an effective mechanism for supporting business research and development

In acknowledging the case for the favourable tax treatment of business research and development expenditure, the discussion paper notes that 'the tax system may not necessarily be the best tool for achieving such policy goals.' While there are many mechanisms through which the government can and does support business research expenditure, the tax approach has a number of advantages.

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[3] http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/8104.0Main%20Features22010-11?opendocument&tabname=Summary&prodno=8104.0&issue=2010-11&num=&view=

Using the tax system is equitable and the incentives provided within the tax system are available to all firms funding research as defined under the legislation. Compared to other approaches such as competitive grant schemes, tax incentives involve a minimum of government intervention in business operations and maximise certainty. Moreover, as all firms are subject to the national tax regime, the transaction costs involved in providing support through the tax system are likely to be less than those of using other mechanisms. And while all businesses are aware of the tax system and have access to advice on tax matters, the awareness among business of other government programs tends to be patchy at best. This can be a particular issue as some firms, especially the smaller ones, appear to perform research as it becomes necessary to deal with immediate problems or opportunities; they do not have continuing programs of research. More generally, a 2007 study found that 75 per cent of the Australian firms examined had moderate to highly variable patterns of research and development expenditure over time.[4]

Providing support through the tax system also facilitates the use of those best practice approaches to research management which include rapid response, fast failure and flexibility. One problem with other government support mechanisms is that they can involve contractual commitments which limit the ability of the business to respond to change, whether that change results from the research process itself or from changes in the business environment.

Conclusion

For the reasons outlined in this paper, the Go8, while supporting the simplification of the tax system and the reduction of corporate tax rates, believes that it is important to keep in place the current tax incentives for the business funding of research and development.

The Group believes that implementation of any of the three options presented in the paper which target tax incentives for research would have negative consequences for Australia, not only by reducing the level of business research and development but also by making Australia a less favourable country for foreign direct investment and by limiting the flows of technology into Australia that occur when overseas owned firms perform research here.

In arguing this, the Go8 also notes that any reduction in corporate tax rates would itself reduce the value of the tax incentive supporting business research.

[4] http://www.innovation.gov.au/Innovation/ReportsandStudies/Documents/RandDExpenditureVariability.pdf