Michael Johnson Associates

Suite 4, 332 Darling St, Balmain
PO Box 542 Balmain NSW 2041
W mjassociates.com.au
T 02 9810 7211
F 02 9818 2297

21 September 2012

Business Tax Working Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Business Tax Working Group Discussion Paper

Michael Johnson Associates (MJA) welcomes the opportunity to comment on the Business Tax Working Group (BTWG) Discussion Paper (DP).

The DP seeks feedback on 4 possible options for the R&D tax incentive:

- the removal of the 40% tax offset entirely, for groups with a turnover of more than $10 billion;
- the removal of the 40% tax offset entirely, for groups with a turnover of more than $20 billion;
- capping the total eligible expenditure at $100 million; or
- cutting the rate of the non-refundable tax offset to 37.5 per cent.

Rather than choosing the lesser of these, MJA advises that all these options should be equally rejected. In doing so, MJA wishes to express its dismay at the inclusion of the further changes to R&D tax incentive as an option to "fund" reductions in corporate tax rates for the following reasons:

- The R&D tax incentive has only recently been through a lengthy and thorough review process,
- This review clearly identified and articulated the need to encourage more businesses to do more R&D and thereby help create a better future for Australia as a vital plank of the Government's policy on innovation, science, research and technology,
- The first claims for the R&D tax incentive are only now just being made. To seek to change this again before most businesses have made their first application is premature and will create more uncertainty,
- There is insufficient data to determine the impacts of the new program, let alone any proposed changes to it,
- The requirement for any change to corporate tax rates to be revenue neutral means that innovative companies that are investing in our future will be required to pay more tax to fund a lower tax rate for businesses that don't, and
- Evidence from the introduction of the R&D tax concession, the cutting of the R&D benefit in 1996, its reinvigoration in 2001 and various studies done by or for AusIndustry or the Productivity Commission on the effectiveness of former R&D tax concession shows that, ultimately, a reduction in the incentive for businesses to do R&D will reduce R&D done in Australia and this may reduce economic growth and future tax revenue.

The R&D incentive is not a tax issue.
It is a corrective measure for market failure – the failure of most businesses to invest sufficient economic resources in research and development activities and commercialising these for the benefit of the Australia. It is only delivered through the tax system because this is the most efficient way of providing this incentive. The next best alternative method could be to provide the benefit through a grant scheme. The size and cost of

administering a grant program the size of the R&D tax incentive would be prohibitive. As it is not a tax issue it should not be considered as a method of broadening the tax base to enable a change in the tax rate.

Why we need the R&D tax incentive

The need for the R&D tax incentive is shown in the history of its predecessor, the R&D tax concession. Prior to the R&D tax concession Australian Business Expenditure on R&D (BERD) was only 0.39% of GDP. The success of the program in encouraging BERD, that might not otherwise have occurred, is shown the growth of BERD to 1.35% of GDP by 2008. Whilst this is still below the OECD average, it compares very favourably with New Zealand's BERD which, with no R&D tax incentive, still languishes at around 0.5% of its GDP. Further proof that businesses need encouragement to invest enough in R&D was shown in 1996 when the rate of encouragement was halved and eligibility tightened. BERD fell significantly and did not fully recover until corrective action was taken in 2001. A number of studies were undertaken by AusIndustry and for the Productivity Commission up to 2007. All these studies identified that the R&D tax concession helped contribute more to taxation revenue than it ever cost. Despite this clear evidence, some still stay that the R&D tax incentive does not encourage businesses to invest more in R&D because much of that R&D would have occurred anyway. The changes since 1985 and in 1996 show this claim to be unjustified. Indeed, it is easy to understand why a business that is not driven by innovation would state openly that they would prefer a general tax cut at the expense of the incentive. However these statements are anecdotal and do not reflect the real success of the program.

With all this in mind, the R&D incentive program has only recently been through a protracted and thorough review. This commenced in 2008 with the Cutler review. A major part of the Government's response to this is the introduction of the R&D tax incentive in 2011. This reform sought to tighten eligibility to seek to better target the benefit but provide a higher rate of benefit to forestall the reductions in BERD that have accompanied changes like this in the past. To eliminate or reduce the benefit so soon after this could be disastrous. At the time the DP was released most businesses had been through 4 years of uncertainty on the future of the program and had yet to make their first claim under the new program before its future was cast into doubt.

Potential Impacts of reducing the R&D tax incentive

The message that the BTWG is sending with this DP could undermine the years of protracted submissions and reform and create further uncertainty at a crucial time in our economic development:

- Increasing the effective tax rate (after the R&D tax incentive) on innovative manufacturers could be the last straw,
- Equally, with new resources being generally lower grade and more difficult to extract and the resources boom in, possibly, its final phase, productivity and profitability are falling quickly with a number of potential innovative projects cancelled or at risk,
- Agricultural and food tech industries are strongly reliant on R&D,
- New technology industries in biotech, information technology, communications and the service sector are extremely easily relocated to countries with better R&D incentives.
- Businesses are being encouraged to reduce their carbon footprint via the Carbon Tax, but are being threatened with a reduction or elimination of the R&D incentive program that would encourage businesses to undertake R&D to find new ways of reducing their impact on the environment,
- The flow on effect from this could be a reduction in the perception of Australia as a centre for BERD and therefore for academic research and education.

This is not the environment to discourage R&D by trading off an effective, worthwhile and successful incentive for an untargeted broadly-based tax cut. If BERD is significantly reduced by this change then it is likely that future tax revenues will also be adversely affected. On the basis of publically available forward estimates predicting systemic future deficits, these deficits will be increased and the tax cuts may be short lived, and in the meantime Australia's R&D base may have been irreparably damaged. Even if the change could be sustained as 'revenue neutral', this approach to implementing a company tax cut must result in a compromised impact. It alters the tax mix but may not alter the overall tax burden in the productive economy.

The lack of analysis of the impacts of the proposals
The DP does not reflect an analytical approach to the area and is not emblematic of good tax reform. The proposed cuts read like a shopping list with Treasury-affixed price tags. With respect to the R&D program, the BTWG itself recognises that its paring back may lead to the relocating of significant R&D effort to other countries as reductions will put Australia at a disadvantage competitively. The options are unfocused. The point at which the R&D tax incentive could be eliminated range from quite small businesses with turnovers of only $20 million to very large businesses with turnovers three orders of magnitude higher at $20 billion. The focus on the $20 million cut-off point is very misplaced. The $20 million group turnover was the Government's limit around its preparedness to pay cash refunds to loss-making companies. The Cutler Report had pushed for a much higher limit at $50 million, but this was not seen as affordable. The $20 million limit has not been established as a discriminator between the innovators who should be supported and those who were less deserving. That this level of turnover is considered an option alongside $10 billion or $20 billion indicated that these options are not the result of any analytical decision making processes to ensure revenue neutrality, but just reflect ambit claims on options to increase taxes.

Broad support for leaving the R&D tax incentive untouched
The prospect of further changes to R&D incentives so soon after a major overhaul of these has resulted in many others voicing their rejection of these options. Some of these have contributed to the debate on R&D incentives over the last four years but some have expressed their dismay at these short sighted proposals. The following is a sample of people and organisations that have raised their voice against this:

- CSIRO Chair and 2011 Australian of The Year, Simon McKeon
- Australian Industry Group Chief Executive, Innes Willox
- Greens MP, Adam Bandt
- Universities Australia Chief Executive, Belinda Robinson
- Knowledge Commercialisation Australia Chair, Andy Sierakowski
- University of Western Sydney Adjunct Fellow, Office of UWS Innovation, Robert Dalitz
- Coalition Opposition Spokeswoman, Sophie Mirabella
- Medicines Australia Chief Executive, Dr Brendan Shaw
- Industry Minister Greg Combet who stated last month that “I’m very mindful of the importance of the R&D Tax Incentive in our innovation effort” and that the Incentive is “a very important contributor to innovation”.

In conclusion, in our opinion we are faced with a dilemma if asked to select from any of the options proposed in the DP in regards to the 40% R&D tax offset. The best choice here is to do nothing. The R&D tax incentive is a new program that has only recently been introduced following a protracted review that concluded that it is an essential part of preparing our economy to meet the economic, technological, environmental and social needs into the future, **not** an undue benefit providing windfall gains. To trade these off for a tax cut to those who do not undertake R&D or do not consider R&D important enough in their businesses to factor this into their decision making processes is short sighted and poor economic policy.

Yours sincerely,
Mr Ian Ross-Gowan
Director