

Ai GROUP OPENING COMMENTS

R&D TAX CREDIT: SENATE ECONOMICS COMMITTEE HEARING

MAY 21

Mr Innes Willox

Good morning Chairman, I am Innes Willox, Director - International and Government Relations at the Australian Industry Group and I am accompanied by my colleague Dr Peter Burn, Director - Public Policy.

Thank you for the opportunity to appear today to discuss what Ai Group sees as a critically important issue if we are to move in the right direction in raising the research and development effort and broader innovation effort of Australian companies.

We have a short opening statement in two parts, I would like to make some comments about why we regard the subject matter of this Inquiry to be so critical and I will hand over to Dr Burn to indicate our major concerns with the legislation this committee has been asked to examine.

In essence, Ai Group believes the proposed legislation overall to be deeply flawed and which, if implemented, would significantly reduce the innovation efforts of Australian industry. The feedback from our members indicates very little support for the proposals in core economic growth industries such as mining, manufacturing and construction.

Despite around twenty years of moving in the right direction, Australia continues to lag the OECD average on business expenditure on research and development. Our view is that the Government's proposed R&D scheme will undermine this trend and, more likely, put the country's business R&D effort into reverse.

Why is this so important? It is important because R&D undertaken by a business drives primary improvements in its productivity and equips it for greater global competitiveness. This is, particularly important in the context of the demographic and indeed the environmental challenges we will face over coming years as these challenges give us even more reason to improve domestic productivity and competitiveness.

When business R&D gives rise to new and improved products, services and processes in a primary business, it demonstrates to other businesses avenues whereby they can follow by adopting similar improvements in their own businesses. This process of demonstration, leading and following delivers benefits – called “spillovers” that are not captured by the primary businesses that undertake the R&D.

The presence of these spillovers provides the rationale for public sector incentives in support of the primary R&D process. Without support from

incentives the R&D decisions of the primary businesses will fail to factor in the broader economic and ultimately social benefits that derive from business R&D, and will therefore, in total, be less than the socially optimum level of business R&D expenditure.

By providing an incentive, the government stimulates a level of expenditure beyond that which the primary businesses would otherwise undertake and elevates the quantity of business R&D spending towards the socially optimum level.

The importance of R&D in raising productivity and improving competitiveness is of course relevant across the economy. It is, however, doubly valuable for businesses on the slower side of Australia's two-speed economy. The pressures on key sectors, such as manufacturing, agriculture and tourism, to adjust to the greater call on internal resources, the higher domestic currency and the upwards pressure on interest rates that are associated with the ongoing strength of demand for Australia's mineral commodities put a premium on improvements to productivity and competitiveness improvements.

Moreover, for the manufacturing sector in particular, the same forces driving demand for our mineral commodities – that is the rapid industrialisation of China and other emerging economies – are also driving unprecedented levels of global competition for manufactured products, pulling down prices and challenging Australian producers both in export markets and in our domestic economy.

For these reasons Ai Group has long been a supporter of business R&D and of the tax incentive for business R&D. We regard it as a critical element in the relative success of Australia over the past couple of decades and we regard the role it has to play over coming decades to be of even greater importance.

Dr Burn will now elucidate our formal concerns with the legislation as it is currently proposed.

Dr Peter Burn

Thank you Chair, my name is Peter Burn, Director – Public Policy at Ai Group.

As my colleague has said, Ai Group is a strong supporter of business R&D and of the tax incentive for business R&D.

In this context, there are a number of elements of the proposed changes to the R&D tax incentive that Ai Group fully supports.

These include the change to the form of the incentive from an augmented deduction to a tax credit. This, together with the slightly higher effective rate of the general incentive and the more substantial increase in the rate of the refundable credit for a broader range of small to medium businesses, was warmly received by Ai Group over a year ago and we retain this support.

We also support the proposal to extend eligibility for the tax incentive in cases where the intellectual property is owned offshore and the proposal to partially remove the anomalous treatment of software under the tax incentive.

We supported these changes despite the Government's proposal to remove the Premium 175% concession for certain incremental R&D expenditure.

Our reasoning was that, given the Government's unwillingness to expand its support for business R&D, funds needed to come from somewhere. It was not our preferred position but one we supported in light of the restrictions imposed by the Government.

We support these changes and think they should take effect from 1 July 2010. These changes are positive changes that will improve the tax incentive for business R&D. They are measures aimed at improving productivity and competitiveness.

However, we very firmly oppose the fundamentally new approach to defining business R&D expenditure that is embodied in the legislation before the Committee. It is embodied in the objects clause, the changed definitions of eligible expenditure and the restrictions relating to the treatment of core and supporting expenditure.

Our opposition has three elements: the timetable the Government has imposed; the restrictive nature of the definition of eligible business R&D expenditure and the heavy compliance requirements that we anticipate would arise from the structure of the new approach.

Firstly, the Government has given itself an absurdly short timetable for community consultation and examination by the Parliament of what is a fundamentally new approach to the definition of eligible expenditure. The new approach would apply to all business R&D expenditure undertaken from 1 July 2010 and, under the timetable now before us, business will have about two weeks to examine the new Act before R&D spending will come under the new regime. Further, being a new approach, legal experts and practitioners would undoubtedly discover anomalies and unintended consequences over the coming months. These will require amendment and will require convincing the Government that amendments should be made. Assuming the Government is receptive, the new approach to business R&D will be adjusted on the run.

Putting aside the particular features of the proposed changes, this timetable for introducing a fundamentally new approach will increase the range of grey areas surrounding the tax incentive and the resulting uncertainty will see businesses scale back their expenditure. This outcome sits in stark contrast to the purpose of the R&D tax incentive – which is to encourage additional R&D expenditure by business.

The second and central basis for our strong opposition to the new approach to defining eligible business R&D expenditure is that it is highly restrictive. For

around 25 years our R&D tax incentive has been based on what is known as the Frascati model that has been developed under the auspices of the OECD over a number of decades. Under this model R&D is defined as:

creative work undertaken on a systematic basis in order to increase the stock of knowledge, including knowledge of humanity, culture and society, and the use of this stock of knowledge to devise new applications.

The second part of the definition “*the use of this stock of knowledge to devise new applications*” is central to our objections to the new approach proposed by the Government.

Subdivision 355-A—Object (s355-5) of the Tax Laws Amendment (Research and Development) Bill 2010 states that:

(1) The object of this Division is to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy.

(2) This object is to be achieved by providing a tax incentive for industry to conduct, in a scientific way, experimental activities for the purpose of generating new knowledge or information in either a general or applied form.

Critically this clause omits the second critical element in the Frascati approach – “the use of this knowledge to devise new applications.”

The narrow coverage of the objects clause suggests to us that the Government intends to pare back the role of the R&D tax incentive to fund, almost exclusively, research. It does not intend to include much of what business R&D is about, namely the development of existing knowledge to “devise new applications”. Instead the Government intends that the R&D tax incentive will apply to activities conducted for the purpose of producing new knowledge.

It would be more straightforward to refer to it as the Research Tax Credit.

The definition of Core R&D activities in s355-25(b) confirms the research focus of the new approach to business R&D. Core R&D activities are defined as:

experimental activities:

(a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:

(i) is based on principles of established science; and

- (ii) *proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and*
(b) *that are conducted for the purpose of generating new knowledge (including about the creation of new or improved materials, products, devices, processes or services).*

This approach leaves little room for the majority of what business R&D is actually about – what, in the Frascati model, is called “experimental development”. Experimental development is defined as

systematic work, drawing on existing knowledge gained from research and/or practical experience, which is directed to producing new materials, products or devices, to installing new processes, systems and services, or to improving substantially those already produced or installed.

In its 2007 report *Public Support for Science and Innovation* (p.31), the Productivity Commission broke down the proportion of business expenditure on R&D into four categories: pure basic research, strategic basic research, applied research and experimental development. Based on 2004-05 data it estimated that the total business expenditure on R&D was allocated as follows:

Pure basic research	1.8%
Strategic pure research	5.0%
Applied research	31.6%
Experimental development	61.6%

Critically, the Productivity Commission (at page 8) used exactly the same definition of experimental development as quoted above. The central point about that definition is that it covers systematic work, *drawing on existing knowledge gained from research and/or practical experience.*

It may be contended that while experimental development is excluded from the definition of “core R&D”, it is adequately covered in the definition of “supporting R&D”. We think that it is not and that the neglect of experimental development is further reinforced by the definition of supporting R&D activities.

In the Bill (s355-30), supporting R&D activities are defined as activities directly related to core R&D activities except if they are activities that are: explicitly excluded, or if they are an activity that “produces goods or services”, or “is directly related to producing goods or services”.

One of our advisors put it this way: “it is difficult to think of many supporting activities that don’t fall into one of the three dominant purpose categories given that any activity directly related to production is captured.”

I can summarise the second element of our strong opposition to the changes to eligibility for business R&D in this way: it excludes a large proportion of business spending on R&D.

The third element of our opposition to the proposed approach is that it will increase compliance costs. Under the proposed approach business will need to split its R&D activities into core R&D activities; directly related supporting R&D activities; and supporting R&D activities subject to the new dominant purpose test.

This would be a permanent feature of the new approach and will add substantially to business compliance costs of the program. As is generally the case, the extra compliance costs will fall disproportionately on smaller businesses.

This claim is very different to the claim made by the Government in the Explanatory Memorandum (p.9).

Overall, once the new R&D tax incentive matures, the compliance costs should ... be lower than the comparative costs of obtaining the current benefit of the R&D Tax Concession.

We think this is wrong and it appears to rest on a view of the relative complexity of the 175% premium concession. It is true that the premium concession is complex and has a high compliance cost. However, only 26% of the 7,754 companies who were registered for the tax incentive in the 2007-08 year used the 175% Premium. The other 74% used the 125% concession. (See *R&D Tax Concession Fact Sheet* at <http://www.innovation.gov.au/Section/AboutDIISR/FactSheets/Pages/RDTaxConcessionBERDFactSheet.aspx>.)

Certainly for these businesses the compliance costs under the new arrangements would be higher and our assessment is that for the remaining 26% of businesses, the jury is out on whether the complexity of the Premium concession would match the complexity of the proposed approach.

I have a final point on the compliance cost argument. We think that most businesses that would claim the R&D tax incentive under the new approach would experience an increase in their compliance costs. However, we would concede that once mature, the new approach would involve a reduction in the total compliance costs associated with claiming the tax incentive across the business community. This is because we anticipate a very sharp reduction in the number of businesses that are eligible to claim the new, highly restrictive tax incentive and assess it to be worthwhile to apply for a tax incentive that applies to such a narrow range of their total R&D expenditure.