

# Ai GROUP SUBMISSION

**Senate Standing Committees on Economics**

**Treasury Laws Amendment (Research and  
Development Tax Incentive) Bill 2019**

2020



## About Australian Industry Group

Ai Group is a peak national employer association representing and connecting thousands of businesses in a variety of industries and sectors across Australia. Our membership and affiliates include private sector employers large and small from more than 60,000 businesses employing over 1 million staff. Ai Group promotes industry development, jobs growth and stronger Australian communities. Our members have a common interest in creating more competitive businesses and a stronger economic environment. We provide advice, services, networks and advocacy to help members and industries thrive, and the community to prosper.

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## Summary

While Ai Group supports two of the four measures proposed in the Bill, we are deeply concerned that the proposed intensity approach is not supported by convincing arguments and would create a disturbing range of anomalies and inequities. We urge that the Committee recommend that the intensity approach be shelved.

In relation to the proposed increase in the cap on R&D spending, we urge that the Committee recommends that the cap be removed. Clearly a higher cap would be preferable and short of its removal, we would support the proposal to raise it from \$100 million to \$150 million.

We also urge the Committee to recommend against the Bill having retrospective effect.

## Submission

The Australian Industry Group (Ai Group) welcomes this opportunity to make a submission to the Committee in relation to the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019 [Provisions].

### **Business Research and Development**

Ai Group is a strong supporter of business research and development activity as a key driver of improvements in productivity and, though that, of higher incomes and commensurate benefits across the broader community. We also recognise the external benefits that can flow from business R&D by its contribution to knowledge that can be used by others without payment.

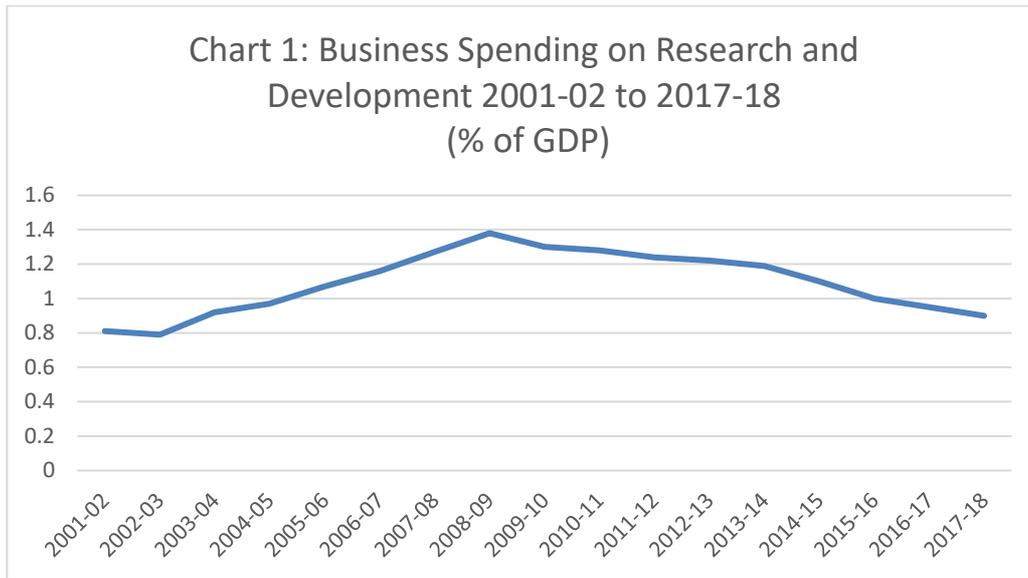
These “positive externalities” or “spillovers” are benefits that accrue to others and are not captured by the individual business undertaking the R&D. Because of this, an individual business left to its own devices would finance less R&D than is socially optimal because it does not get rewarded for the full benefits flowing from the R&D activity. Accordingly, Ai Group supports public backing for business research and development activity as a means of lifting the total amount of business R&D to more closely approximate its optimum level.

### **The Research and Development Tax Incentive**

In Australia the R&D Tax Incentive (R&DTI) has served as the central means of delivering public backing for business R&D. Over much of the period during which business spending on R&D has been backed with the tax incentive, business expenditure on R&D (BERD) has increased markedly. In 1981-82 BERD was recorded at 0.24% of GDP. With the support of the R&DTI, BERD measured as a proportion of GDP rose, albeit in fits and starts, peaking at 1.38% of GDP in 2008-09.

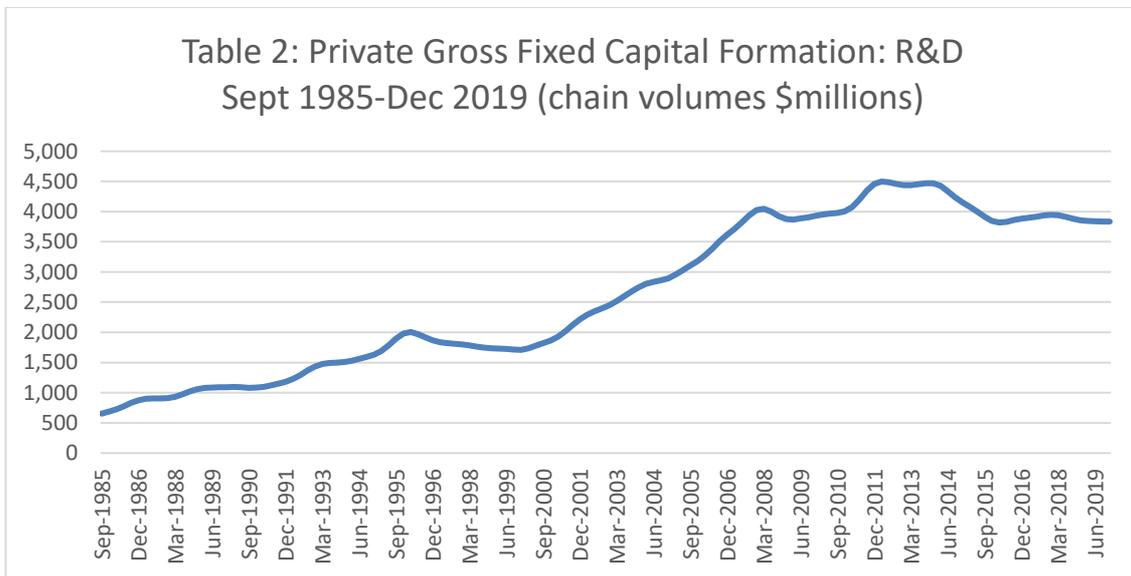
Since that time, under governments of various persuasions, concerns with the cost of the R&DTI have seen numerous inquiries, proposals and modifications to the R&DTI with the set of changes under examination by the Committee being the latest episode in this long-running series (albeit very similar to a previous episode examined by the Committee barely a year ago.) Over this period of more than a decade, the uncertainty surrounding the R&DTI and the various measures to pare back its cost, have seen business R&D fall back towards levels last seen in the 20<sup>th</sup> century.

Chart 1 below presents the change in BERD over the years from 2001-02 to 2017-18 which is the most recent year for which these data are available.



Source: ABS 8104.0 - Research and Experimental Development, Businesses, Australia, Various Years.

These broad patterns are also evident in National Accounts data on private sector investment in research and development which, further, show the decline in R&D spending continuing to the end of calendar 2019. This is shown in Chart 2 below.



Source: ABS 5206.0 Australian National Accounts: National Income, Expenditure and Product, Table 2. Expenditure on Gross Domestic Product.

### Effectiveness and Integrity

Ai Group is very conscious of the importance of using taxpayers’ funds efficiently and in ways that generate national benefits. For this reason, we have supported measures to improve the integrity of the R&DTI and other programs and we support measures to prevent misuse of these programs. We would also support measures that promised to improve the targeting of the R&DTI in ways that were fair and effective.

## **Measures proposed in Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019**

The Bill proposes four measures:

1. Increasing the R&D expenditure cap from \$100 million to \$150 million and making the threshold a permanent feature of the law;
2. Linking the R&D tax offset for refundable R&D tax offset claimants to claimants' corporate tax rates plus a 13.5 percentage point premium;
3. Capping the refundability of the R&D tax offset at \$4 million per annum (however, offset amounts that relate to expenditure on clinical trials do not count towards the cap); and,
4. Reducing the Incentive for most R&D entities by half, leaving the amount of the Incentive unchanged for some and raising the Incentive for a relatively small number of R&D entities according to the proportion of R&D expenditure to total expenditure by these entities.

Ai Group supports Proposal 1 (albeit with an important qualification) and we support Proposals 2 and 3. We oppose Proposal 4.

### *Lifting the R&D expenditure cap.*

While a cap of \$150 million is preferred to the existing cap of \$100 million, as discussed further below we do not accept that a convincing case has been made that having a cap will improve the effectiveness of targeting of R&DTI. Of course, the cap reduces the cost of the program, but brings with it a reduction in the benefits of the R&DTI. While a higher cap is more in line with the criteria of additionality, no cap would be preferable as would retaining the temporary nature of the cap so that it could be subject to further analysis.

### *Linking the R&DTI to claimants' corporate tax rates*

Ai Group supports this change. It better accommodates the current dual company tax rate arrangements and it reduces the complexity that might be associated with future changes to corporate tax rates.

### *Capping the refundability of the R&DTI*

Ai Group supports this measure as we share concerns that the refundability of the offset attracts some misuse. Limiting refundability will reduce this. We recommend that a close watch be maintained on the refundability of the tax offset for any signs of further misuse.

### *Introducing an Intensity basis*

We oppose the proposal to change the R&DTI so that businesses with a lower proportion of R&D to total spending will have their incentive to undertake research and development halved while some others will face an unchanged incentive and a small number of businesses will face a higher incentive.

Ai Group does not believe the case has been made that a business with a higher proportion of R&D spending to total spending will generate more positive spillovers than other businesses undertaking R&D. Nor do we think that the case has been made that a business with a lower proportion of R&D

spending to total spending would be less likely to undertake additional R&D if it faced the same incentive as other businesses.

### **Research and development intensity**

While the 2016 Review of the R&D Tax Incentive discussed some possible associations between high R&D intensity and additionality and the extent of spillovers, the discussion (in section 3.2 of the Review) at times conflated R&D intensity with a range of other business characteristics. These include the size of the firm; whether they are consistent R&D performers that make use of R&D Plans, whether they are subject to tough competitive pressures; and whether they are exporters. However, there was no evidence put forward to suggest that these characteristics are strongly correlated with R&D intensity.

Further, the Review cited a study (on page 16) by Acemoglu *et. al.* appearing to point to benefits it identified from the reallocation of R&D incentives away from those with a low R&D intensity towards those with a high R&D intensity. However, while the study did differentiate between “high-type” and “low-type” businesses performing R&D, it did not argue that R&D intensity was the basis for the demarcation between these types of businesses.

Perhaps because these arguments do not lend themselves to a definitive conclusion the Review’s finding in relation to R&D intensity (Finding 5 on page 16) is appropriately tentative:

*There are limits in the ability to target additional R&D in a volume-based scheme. Additionality could be sharpened by better targeting access by larger companies, possibly by the introduction of an intensity requirement.*

This is clearly well short of a ringing endorsement of an approach based on R&D intensity: it could, possibly, generate greater intensity; possibly it could not.

### **Anomalies with the proposed intensity approach**

The Review did not consider the practicalities of an intensity approach.

The three-tier intensity approach proposed in the Bill would provide different degrees of backing for business R&D depending, not on the characteristics of the R&D undertaken, nor on the spillovers that might be expected, nor on the additionality that would be generated, but on the ratio of R&D spending relative to total expenses. This gives rise to any number of anomalous outcomes.

Four anomalies of a general nature are presented here to highlight the range of issues that have been raised by Ai Group members:

- An R&D entity with costs spread internationally would likely fall into an R&D intensity range that is higher than would be faced by an R&D entity which was identical in all respects other than having its costs concentrated in Australia. There is no apparent reason why the entity with its costs concentrated in Australia should receive a lower rate of R&D backing. Yet this is what is proposed.
- Identical R&D projects undertaken or contemplated by two different businesses one large (and with greater non-R&D costs) and the other small (and with less non-R&D costs) would

receive or stand to receive different levels of backing for these identical projects. Yet the social benefit of the projects - via their spillovers – would be expected to be similar.

- An external proponent of a specific R&D project considering approaching two different businesses would confront a greater willingness on the part of a more R&D intensive business to undertake the project than would be the case with a less R&D intensive business even if the business with the lower overall R&D intensity would be a better fit in all other respects.
- An R&D entity close to an intensity threshold and contemplating additional non-R&D expenditure will face a disincentive to undertake this expenditure that would otherwise make commercial sense. For example, a business looking to increase its employment of trainees or apprentices not related to its R&D projects would be reducing its R&D intensity lowered and could face the prospect of reduced backing for its R&D expenditure.

These anomalies are inherent in the tiered approach based on R&D intensity. It is an approach that is likely to distort the allocation of R&D and the generation of associated intellectual property in favour of businesses with greater overall R&D spending or with less non-R&D costs and against businesses with less overall R&D spending or with greater non-R&D costs.

In the absence of a convincing rationale for the deliberate introduction of this distortion, Ai Group is not convinced that the proposed approach is one that should be supported.

### **The incongruity of the intensity approach and the cap on R&D expenditure**

While Ai Groups is supporting the proposal to raise the cap on R&D spending from \$100 million to \$150 million, this is more because the higher cap would be better than the lower cap rather than because we see merit in the cap proposal in itself.

The rationale for the R&DTI is that it generates positive spillovers. There is no reason to suggest that these would be lower once the amount of R&D spending exceeded a certain level. Indeed, under the logic implicit in the intensity approach proposed in the Bill, the external benefits flowing from a business undertaking more R&D spending are higher (other things being equal) than for a business with a lower R&D intensity.

This same logic would appear to be an argument against a cap on the level of R&D spending that can receive backing from the R&DTI. Yet the Bill proposes both the intensity measure and retaining the cap (albeit at a higher level).

The Bill also proposes removing the temporary nature of the cap without the sort of analysis that might be expected to justify this measure.

The clear risk of the cap is that a business near the cap and contemplating additional R&D projects will be less likely to locate its R&D projects in Australia. This is not a desirable policy stance.

## **Economic impact of the measures**

The Explanatory Memorandum (EM) accompanying the Bill estimates budgetary savings in fiscal balance terms of \$1,765 million over the four years from 2019-20 to 2022-23.

Notwithstanding the claim (EM page 3) that “[t]he Bill improves the administrative framework supporting the Incentive by making information about R&D expenditure claims transparent, enhancing the guidance framework to provide certainty to applicants and streamlining administrative processes, it also identifies an annual average increase in business compliance costs of \$26.3 million.

There is, however, no recognition of the impacts of the lower level of backing for business R&D in terms of loss of associated spillovers. Nor is there any argument that the reconfiguration of backing so that the small number of businesses with the highest level of R&D intensity will generate sufficient spillovers to offset the loss of spillovers from the many businesses for which R&D backing would be reduced. This is an important gap in the information available for the Committee to properly assess the economic impact of the proposed changes to the R&DTI.

## **Retrospectivity**

In general, the measures proposed in the Bill would apply from the start of the income year beginning 1 July 2019.

Both existing and new R&D projects will face the changed levels of backing for R&D. Many businesses that had made decisions based on the existing R&DTI will be disadvantaged in respect of plans that are already in place.

This is a further undesirable feature of the Bill.

## **Conclusion**

While Ai Group supports two of the four measures proposed in the Bill, we are deeply concerned that the proposed intensity approach is not supported by convincing arguments and would create a disturbing range of anomalies and inequities. We urge that the Committee recommend that the intensity approach be shelved.

In relation to the proposed increase in the cap on R&D spending, we urge that the Committee recommends that the cap be removed. Clearly a higher cap would be preferable and short of its removal, we would support the proposal to raise it from \$100 million to \$150 million.

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