20 September 2002

The Secretary
Standing Committee on Science and Innovation
House of Representatives
R1 Suite 116
The House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam

Submission to the House of Representatives
Standing Committee on Science and Innovation
Inquiry into Business Commitment to Research and Development in Australia

I would like to thank you, on behalf of the Tax Institute of Australia (TIA) Research and Development (R&D) Group, for the opportunity of making a submission to the House of Representatives Standing Committee on Science and Innovation Inquiry into Business Commitment to Research and Development in Australia.

This Group represents the interests of may Australian companies utilising Government programs to encourage Research & Development (R&D).

Introduction

This submission focuses on Government support programs for R&D in Australia and their particular relevance to the three major questions to be addressed by the Committee, namely:

- what would be the economic benefit for Australia from greater private sector investment in R&D?
- what are the impediments to greater business investment in R&D?; and
- what steps need to be taken to better demonstrate to business the benefits of higher private sector investment in R&D?

Economic benefits to Australia from Greater Private Sector Investment in R&D

Technological progress is well recognised as an important catalyst in economic growth. Empirical evidence indicates that technological progress, through its impact on production, is a key determinant of long term economic growth. Technological progress can, typically, be accelerated in an environment that fosters innovation and continuing research and development activities, by both the private and public sector.

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In the mid 1980's the Government recognised that investment in research and development was not regarded by the private sector as a critical priority. In 1985, the Government introduced the 150% tax concession for research and development. Since that time, the R&D tax concession has been a major factor in the rapid increase in the level of business expenditure on R&D in Australia.

The Industry Commission, in 1995, examined the economic impact of R&D and concluded that, "the estimated aggregate rates of return to Australia's R&D range widely, but are generally high." Further, the Industry Commission concluded that a reduction in the rate of subsidy for R&D would not only lead to a decrease in Federal revenue, but a reduction in GDP.

The recent Australian Bureau of Statistics report on R&D investment by business in Australia indicates that the R&D intensity in Australia is still below that of most other OECD countries.

Feedback from many Australian companies indicates that R&D investment requires a long-term commitment by business, but that business is unable to strategically plan its R&D investments, when the regulatory environment is constantly changing and Government's continually question the value of business input into R&D. Regulatory certainty and bipartisan government policy commitment are pivotal to increased business investment in R&D.

There must also be a clear understanding that research and development covers a broad range of activities from theoretical investigations to applied and practical applications. Whilst, to some extent, the private sector is involved in many areas of R&D, it should be recognised that business R&D will, ultimately, have a strong commercial focus and activities in applied R&D and product development add significant value to the overall Australian economy and export revenue. A positive recognition of this reality should be reflected in any government R&D policy.

There is unequivocal evidence that the R&D tax concession has been effective in achieving its original objectives of improving Australia's Business R&D spending comparative to other OECD countries. The Mortimer Report, "Going for Growth – Business Programs for Investment, Innovation and Export" acknowledged that there is a clear nexus between continuous growth in R&D spending and economic growth and that it is critical that the Government should retain the R&D tax concession in order to promote both short term and long term certainty in business investment in R&D.

There is also evidence that the reduction of the concession from 150% to 125% has directly contributed to R&D projects moving offshore and to the abandonment of other R&D projects in Australia. The Business Council of Australia, in its 1998 survey on R&D expenditure, concluded that the fall in the rate of the R&D tax concession has contributed to the dramatic fall in R&D expenditure in Australia by one-third in 1998 (or $1.5 billion).

Importantly, a discussion paper released by the House of Representatives' committee on Industry, Science and Resources on 8 April 1999, indicated that R&D spending by Australian business ranked a poor 17th among the OECD countries, although Australia had one of the highest growth rates, over a ten year period, in business spending on R&D. It is evident that other OECD countries have greatly increased their business spending on R&D and, currently, Australia is struggling to achieve the OECD average rate of R&D spending as a percentage of GDP. Recently, many other OECD countries, such as the UK and France, have also introduced tax concessions for R&D activities. Further, we understand that many European countries, in particular the UK, is also conducting inquiries for developing policy to increase R&D spending by the private sector, especially small to medium enterprises. There are also European union grants and assistance programs available for small business to further develop their inventions and to market these ideas. This highlights the need for the Australian Government to increase its support for R&D in Australia.

There is a real danger that Australia's future prospects for growth and its ability to effectively operate in a global market place in this new millennium will be stifled by ongoing changes to, and uncertainty surrounding, industry policy. The R&D tax concession has a well established infrastructure and, if it is appropriately maintained, is a very effective vehicle for fostering an innovative culture in Australia.

The R&D tax concession has been an important platform in the Federal Government's suite of industry programs and is regarded by Australian business as critical for their continuing investment in R&D in Australia.

The TIA applauds the Government for the introduction of the 175% premium deduction for incremental R&D spending. The new concession will, no doubt, encourage Australian business to strategically plan to increase their R&D spending in Australia in preference to overseas.

Notwithstanding this, it would be prudent to evaluate the outcome of this new program in the near future to ascertain its effectiveness.

Impediments to Greater Business investment in R&D

Australia's business investment in R&D has long been significantly lower than other OECD countries. Some of the reasons for low business R&D levels may be attributable to Australia's industrial profile:

- Small scale of our manufacturing sector;
- Different industry structures within manufacturing; and
- Low R&D intensity within manufacturing industries in Australia.

Further, it has been identified by Professor Jane Marceau in the report, *The High Road or Low Road?,* that Australia's R&D expenditure is highly concentrated with the top ten R&D spenders accounting for nearly 30% of Business R&D.

Whilst many experts can, no doubt, speculate as to the key impediments to greater business investment in R&D, the following feedback has been elicited from a number of companies:

- in established companies, short-term profitability/cash flow is often considered to be a more critical priority, particularly for small to medium sized business.
- high intensity R&D companies, especially small 'start-ups' are, necessarily, compelled to focus on R&D, but the resources available to accelerate such R&D hinder their ability to appropriately capitalise on innovative ideas.
- whilst *Backing Australia's Ability* was a welcome reform package which demonstrated the Government's recognition that the diversity of businesses requires a flexible regime of Government R&D assistance programs, further programs should be implemented to cater for those bona fide companies which, for a variety of reasons, do not neatly fit 'into the new program categories.

Therefore, there should be appropriate Government support to small to medium enterprises for encouraging them to invest in in-house R&D, foster linkages with public research agencies and commercialising Australian innovations.

The Government provides a range of industry programs to assist small businesses, including:

- R&D Start grants
- Concessional loans for commercialisation
- COMET

Further, the R&D tax rebate for small business is another new initiative that is aimed at assisting small business.

These programs provide valuable assistance to many Australian businesses. However, these programs are not very well known by many small businesses and many businesses may be deterred from accessing these programs, due to the work required for preparing relevant grants applications.

Some companies have indicated that it would be constructive to implement a more comprehensive system, based on the model of the R&D tax rebate, to support the various areas that the Government wishes to encourage, including:

- Investment in R&D
- Collaborative R&D between the private and public sectors

- Commercialisation and demonstration of new products
- Improvement in management capabilities

This could streamline the administrative aspects of the current grant systems and enable small businesses to more readily access these programs.

International Comparisons

Although Australia has a well qualified research capability and competitive cost advantage, in respect of cost of living, many countries offer more attractive fiscal incentives to attract multinational companies to locate their R&D facilities in their countries. These countries recognise the importance of creating a critical mass in research capability, in providing effective knowledge transfer to their respective economy and fostering employment opportunities for university graduates.

As such, from an international perspective, Australia does not offer the most attractive incentives for multinational companies to relocate their R&D facilities. As Australia is a relatively small economy, there are no natural reasons for foreign companies to develop full manufacturing and research facilities in Australia. Australia is physically located at the fringe of the Asia Pacific Rim and the distance between Australia and the Asian market is, clearly, an issue. Further, as ASEAN countries are forming a free trade zone with extensive bilateral tax free trade agreements that are currently being negotiated with Japan, South Korea and other countries, Australia may be kept out of this significant market. Therefore, it is possible that multinational corporations may locate their operating hubs for the region in Asia rather than Australia, despite our political stability and advanced communication infrastructure.

As such, in order to compete with other countries, it is necessary to provide more attractive incentives for companies to locate their operations to Australia. This proposition is demonstrated by the exponential growth of the Irish economy. In the last twenty years, the Irish government has extended extremely attractive tax concessions for companies to locate their operations to Ireland. Incentive offers include a reduced tax rate for manufacturing operations in specified areas and the provision of a 400% tax concession for research and development.

Recently, the British Government recognised the importance of private sector R&D and has introduced new tax incentive for research and development undertaken in the United Kingdom by large enterprises.

Other countries that provide attractive tax incentives for R&D include Canada, Japan, South Korea, US, France, Singapore and Malaysia. Many of these countries exhibit a much higher R&D intensity than Australia.

In conclusion, in order for Australia to attract multinational companies to locate their R&D facilities in Australia, it is necessary to provide greater tax incentives for these companies. It is necessary for our policy makers to recognise that any tax revenue foregone by providing greater tax concessions to these companies are more than compensated by increases in employment taxes and economic activities.

Therefore, we recommend that an inquiry be established to examine the benefits of any tax incentives in generating tax revenues through:

- Increase in employment
- Increase in corporate tax revenue through improvements in competitiveness and cost reduction
- Increase in consumption tax revenue through greater economic activities

The result of such inquiry should be examined by policymakers in determining whether there would be benefits for the Australian economy in providing a greater level of tax incentives for R&D investment.

Conclusion

The TIA recommends to the Committee that the R&D tax concession should continue to be viewed as a major instrument for encouraging innovation by Australian companies. With the increasingly globalised economy and mobile workforce, companies will consider Government assistance and infrastructure as vital factors affecting their decisions on the location of their R&D projects.

The R&D tax concession should be integral to any development of industry policy in Australia and should be unambiguously endorsed as a permanent feature of Australia's taxation system.
In order for Australia to enhance its competitiveness, it would be necessary to enhance the current level of benefits to levels that are offered by other economies. We recommend that an inquiry be established to quantify the benefits of tax incentives to the Australian economy and to provide empirical evidence for policy makers to determine whether greater incentives should be provided. Further, the current grants system should be replaced by a general tax rebate system for small business in providing greater access for small companies to benefit from the Government's industry platform.

If you have any questions in relation to the above, please do not hesitate to David Gelb on (03) 9288 6160.

Yours sincerely

Barry Low
President