AV-CC

Australian Vice-Chancellors' Committee

the council of Australia's university presidents

(A.C.N. 008 502 930)

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14 April 1999

Dr A. Preston
Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Dr Preston

The Review of Business Taxation

I refer to the discussion paper "A Platform for Consultation, Discussion Paper 2: Building on a Strong Foundation" released in February 1999 as part of the Review of Business Taxation.

The Australian Vice-Chancellors' Committee, representing the Vice-Chancellors of 37 of Australia's universities has considered the paper and endorsed the attached submission.

As requested, I am attaching two copies of the submission and emailing you an electronic version.

My contact details are:

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Please feel free to contact me should you wish to discuss the submission further.

Yours sincerely

Stuart Hamilton
Executive Director

ralphsub.doc

SUBMISSION OF

THE AUSTRALIAN VICE-CHANCELLORS' COMMITTEE

TO

REVIEW OF BUSINESS TAXATION

The Australian Vice-Chancellors' Committee (AVCC) comprises the Vice-Chancellors of 37 of Australia's universities (36 public universities and one private university).

The Federal Government has principal financial responsibility for funding the 36 public universities, although universities are increasingly seeking funds from the wider community as a result of the Government's stated intention to alter the funding mix for universities. In 1997, 31% of higher education funding was provided from non- Commonwealth resources.

In this context, the Review of Business Taxation takes on a heightened significance for universities as key contributors to Australia's development as a knowledge-based, internationally competitive economy. The AVCC believes that any changes to the Australian business taxation system must be designed to enhance innovation, investment and exports – the Government's stated economic drivers.

The AVCC is concerned therefore at the lack of attention paid in the RBT's second discussion paper, *A Platform for Consultation: Building on a strong foundation* to the role of Intellectual Capital as a major economic driver of the future. In the absence of any discussion on the future directions of the world and Australian economies, the paper appears rooted in the present structure, with an implicit assumption that this will continue indefinitely. The Review provides the opportunity to set a taxation framework which will contribute to Australian economic growth for the next one or two decades. The options presented however appear disappointingly tepid.

The AVCC is particularly concerned by the scant reference to business investment in R&D and innovation (Discussion Paper 2, Vol II, p. 474). This concern has been heightened by the response of the Review Chair, Mr John Ralph at the RBT public seminar on 31 March 1999 that the Review Committee is taking a "neutral" view on this issue and on incentives for such investment including the R&D tax concession.

As indicated in its response to the findings of the government-commissioned review of health and medical research (the Wills Report), the AVCC believes that the funding of R&D and innovation, whether through public or private sources, needs to be seen as an investment in Australia's future, not just a cost. There needs to be a coherent, cross-portfolio approach to structural impediments including those in the current taxation system, and the capital gains tax and the inadequacy of the 125% R&D tax concession in particular.

The AVCC believes that greater emphasis needs to be placed on the reform of the business taxation system to achieve international competitiveness. While the concept is addressed and a number of international comparisons are made in the discussion paper, the issue is not presented as seminal. Yet in all other international trading matters, competitiveness in terms of quality, price, etc are considered essential. The same sense of urgency needs to be reflected in the nation's taxation policy, given that we increasingly live in an era of highly mobile financial and intellectual resources.

The AVCC would encourage this issue to be given greater prominence in the final Review Report.

The AVCC notes the Government's imperative that to avoid future Budget deficits, any recommendations and outcomes from the Review must be 'revenue neutral'. The AVCC believes that this is an overly conservative and short-term approach which is likely to have the unintended consequence of hindering Australia's economic and employment growth in the longer term and thereby its international competitiveness.

With these broad considerations in mind, the AVCC wishes to comment on the following aspects of the Review's second discussion paper:

1. taxation of capital gains

2. implications of reform for revenue

Taxation of Capital Gains

The AVCC believes that a nation's tax treatment of capital gains and business regulatory regime are fundamental to its success in securing or dissuading business investment in innovation and commercialisation of R&D, and technology generally.

As an *ex officio* member of the Prime Minister's Science, Engineering and Innovation Council (PMSEIC), the AVCC has provided input on these matters through its participation on the PMSEIC working group on the nexus between science and its applications.

The December 1998 report of the Nexus working group has highlighted a number of related issues. The most significant of these is the less favourable taxation treatment afforded to technology-based start-up companies in Australia when compared to the United States and some other major industrialised countries. As the RBT's second discussion paper notes, both the USA and the UK have reduced their effective rates of CGT and concurrently experienced increased investment and business development.

A related problem with Australia's current business taxation system is that capital losses can only be written off against current or future capital gains. As a result, investors are less prepared to expose their capital to the risk associated with venture capital investments.

These concerns have also been reflected in the findings of the Wills Report and of an earlier PMSEIC working group on the Australian software industry.

The AVCC agrees with a key conclusion of each of these initiatives that the current high rate of capital gains tax is a major impediment to business savings and investment, in particular through venture capital.

Under the current policies, the opportunity costs are certain to grow as the impact of new knowledge based industries grows. The significant deficit in the IT industry is caused by historically low levels of domestic investment in this sector. The same future awaits us in other areas such as biotechnology, nanotechnology, advanced computing etc. unless our taxation, innovation and research policies all reflect international best practice.

With regard to the policy options canvassed in the RBT discussion paper, the AVCC believes that a generalised reduction in the capital gains tax rate across all investment categories would encourage both Australian and international investment.

To be truly internationally competitive, this rate would need to be comparable to the USA, particularly with regard to the facilitation of venture capital investments.

As highlighted in the Wills Report, there has been considerable discussion of the failure of Australia to attract venture capital from US pension funds to commercialise Australian innovation. These funds are a significant source of venture capital world wide. They are tax exempt for income earned on venture capital investment in the US.

There is strong support from various Australian business sectors for a similar exemption from CGT for US pension funds investing in Australia. It is acknowledged, however, that this option may be seen as unacceptable in terms of the government's revenue neutrality framework.

To attract such funds to Australia, and to encourage both Australian and international venture capital investment in small to medium sized enterprises (SMEs) more broadly, it may be more appropriate to consider a stepped approach to lowering CGT along the lines of the UK system of CGT taper relief introduced in 1998.

This option would encourage investors to adopt medium to long term investment horizons, as opposed to focussing principally on speculative short term capital gains. It would improve the international competitiveness of Australia's CGT regime by effectively reducing CGT rates, given that the USA as well as the UK has recently adopted a similar system.

In this context, the AVCC also believes that the suggested scrip-for-scrip rollover relief should be extended to all sectoral interchanges.

Implications of Reform for Revenue

A major concern resulting from meetings around Australia to discuss the RBT has centred on the government's revenue neutrality imperative.

The AVCC believes that this is a short-term approach which is likely to have the unintended consequence of hindering Australia's economic and employment growth in the longer term and thereby its international competitiveness.

Reductions in the level of capital gains tax for medium to long term investment in venture capital need not result in a loss in taxation revenue over time. The fact is that Australia is not in the race internationally at this juncture because of the strictures of the current CGT regime. Without the injection of new equity funding, the capital gains that would give rise to a significant growth in taxation revenue are not now being generated and will not be generated in the future.

The experience in the USA has been that a reduction in CGT increases revenue because individuals and companies are prepared to sell and reinvest whereas higher CGT regimes discourage sales and hence reduce CGT income.

The AVCC therefore supports the view that the RBT is overly conservative in its estimate on net revenue gains as a result of reducing CGT.

The longer term view must be taken with regard to the concept of revenue neutrality. Applying such a constraint in the immediate term will ensure that the potential positive impacts of this Review are reduced.

Other

Industry Research and Development Issues

The R&D Tax Concession and related matters

The AVCC believes that the R&D tax concession is integral to the government's overall strategy to encourage stronger private sector R&D.

The AVCC is therefore concerned that the RBT discussion documentation has not addressed the impact of the taxation reform on the R&D tax concession, the principal government incentive to enhance and increase the level of R&D being conducted within Australia.

However, at the RBT seminars in March 1999, Mr Ralph indicated that all options are "up for grabs" in achieving a revenue neutral trade-off between a broader base and a 30% company tax rate and the implementation of alternative taxation arrangements for capital gains in a revenue neutral manner.

Mr Ralph has since confirmed that removing tax concessions for research and development will be considered as part of the process to achieve a lower corporate tax rate. On the other hand he has stated that the loss of revenue to government through the R&D tax concession is small compared to other potential trade-offs such as the abolition of accelerated depreciation.

Over the past three years, the government has refocussed the R&D tax concession to ensure that it has a more strategic focus on high quality R&D with strong commercial potential. As recently as March 1999, the Minister for Industry, Science and Resources, Senator Nick Minchin, commented that the Government is "committed, as we affirmed in our 1998 election policy, to maintaining the 125 per cent tax concession for research and development".

Australian industry still has limited experience in capturing the benefits from R&D, evolving as it has largely from a tariff protected base. Changing the mind-set of industry to the point where R&D and innovation are seen as essential was always going to take a significant period of time. The pegging of the R&D tax concession at 125% has meant however that, with transaction costs, the benefits to business, and SMEs in particular, are now seen to be negligible.

The uncertainty surrounding the future of the R&D tax concession and the fact that it may be devalued or traded off is very significant, particularly for high technology and mining industries. While it is difficult to quantify the impact of the removal of this incentive, the AVCC believes that it is certain to be negative.

If the corporate tax rate falls to 30% as planned, the benefits of the R&D tax concession would be reduced from nine cents to 7.5 cents in the dollar. To prevent this outcome the R&D tax concession rate would need to be increased to 130% at the very least.

The AVCC submits that to reverse the downward trend of industry investment in R&D as evidenced by the recently released ABS data on Business Expenditure on Research and Development (BERD) and thereby improve Australia's poor international BERD ranking (17th among the member nations of the Organisation for Economic Cooperation and Development), there is a strong imperative not only to retain the R&D tax concession but to increase the rate to 150%.

The AVCC also supports an expansion of the stimulation of R&D expenditure by industry to include small companies that may be in a tax loss situation during the start-up phase. This would provide funding for smaller R& D projects as upfront payments equivalent to taxation relief. The delivery system would be similar to that operating in Canada involving refundable tax credits.

The AVCC believes that the rationale for retention of the R&D tax concession in combination with a targeted incentive for SMEs in a startup or development phase is reflected in the Government's Industry Statement, *Investing for Growth,* which states:

> *While the returns to the nation from R&D are high, this does not always translate into high returns to individual firms investing in R&D. Often the benefits of improved knowledge and technology from R&D spill over to the international community and other firms and cannot be captured by the firm undertaking the R&D investment. This can lead to inadequate levels of R&D investment. Other factors, including the size, structure and culture of industry and capital markets, can also affect the level of investment in R&D.*