SUBMISSION TO THE REVIEW OF BUSINESS TAXATION

To:

The Secretary
Review of Business Taxation
Department of Treasury
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From:

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Executive Summary

The main focus of this submission is the tax incentive for research and development.

Michael Johnson & Associates Pty Ltd (MJ&A) is one of Australia's leading R&D support consultancies. We are a firm of consultants with backgrounds in law, science, business, and finance, and have specialised in the area of government and technology since 1983.

Our experience over the past 16 years has exposed us to many of Australia's most innovative companies, both large and small. As advisers, we are privy to a significant amount of anecdotal evidence about the way in which the R&D tax incentive has been of benefit to those companies and the comparative effectiveness of granting schemes as opposed to tax incentives.

Our submissions are three fold.

- Firstly, and most importantly, we maintain that the current *Review of Business Taxation* is not the appropriate forum to determine Australia's Industry policy and that no final recommendations about the tax incentive for R&D should be included in the Review Committee's recommendations.

- Secondly, attacks on the R&D tax incentive since 1996 have already seen Australia's R&D performance fall significantly and our performance remains very poor compared with other OECD countries. Without proper economic modelling of the effects of the incentive, any decision to remove it entails the risk of reducing innovation, with consequent reductions in competitiveness and an ultimate reduction in profitability and a flow-on loss of tax revenue. An apparent saving in the first few years may result in a significant loss of revenue in subsequent years, as well as a change in the balance of payments as imports from more innovative countries compete against Australia's technologies as they gradually fall behind the pace of innovation in other countries.

- Thirdly, the proposed reduction to the company tax rate will further erode the already marginal value of the R&D incentive and consideration should be given to increasing the rate of deduction to provide an appropriate level of support, preferably at around the original rate of support - 23 cents in the dollar.

Is this the appropriate forum to decide Industry Policy?

From *A Platform for Consultation* and *A Strong Foundation*, and from the public meetings which I have attended, it is clear that the brief of the *Review of Business Taxation* is essentially to recommend a revenue neutral way to achieve the Government's desired outcome of a 30% tax rate.

This might be stating the obvious, but it emphasises the fact that the RBT's brief is not to decide what the best possible company tax regime would be, nor to conduct any significant modelling of the effects of the possible options. The revenue predictions are based simply on the actual revenue to be forgone under a 30% tax rate and the actual amounts to be clawed back by the abolition of accelerated depreciation etc.

The allowance made for growth in *A Platform for Consultation* is so minimal as to suggest that the Review Committee members do not have faith that the changes will in fact produce the intended outcomes. If a 30% tax rate is going to increase growth and decrease unemployment, then the revenue neutrality calculations should include both the increased revenue from taxation of increased company profits produced by that growth, and the increased revenue from income taxation levied on the newly employed. Failure to include such an allowance casts doubt on the value of the whole review process.

It is unfortunate that the Review is not able to really investigate the issue of what kind of company tax regime would maximise growth, tax revenue, and employment.

The Review of Business Taxation is not the appropriate forum to determine industry policy for the following reasons:

- as stated above, the Review is premised on the assumption that the Government's aims will produce the required results

- the Government stated its requirements for the Review at the same time as it was repeatedly reiterating its intention to retain the tax incentive for R&D

- neither *A Platform for Consultation* nor *A Strong Foundation* made any significant reference to the R&D concession and this, combined with the Government's election promise to retain the concession, gave the impression that it was not under consideration by the Review Committee

- it was only after a question from this firm at the Sydney consultation session on *A Platform for Consultation* that the idea that the concession was up for grabs made it into the press, and thereby into the public consciousness

- there was no focus group organised for users of the concession or to consider the needs of the R&D industry generally (in fact it appears that the Review Committee intends to rely on its attendance at the R&D Tax Workshop organised by the Department of Industry Science and Resources as its only substitute for a proper focus group in this area)

- John Ralph and Senator Nick Minchin have created confusion in the minds of the R&D community by repeatedly coming out in the press with conflicting opinions about whether the R&D concession is up for grabs in the RBT process.

For all these reasons, many companies that use the concession to further their R&D activities will not have been adequately forewarned of the potential for its abolition. In addition, the Department of Industry Science and Resources is planning an Innovation Summit later this year to discuss policy directions and that forum is a more appropriate starting point for any changes to the R&D concession.

The need for proper modelling and considered responses

Principles

Michael Johnson & Associates supports the basic principle that *'tax incentives should be provided only following a formal assessment of their net impact on the national . . . objectives'* (Page 26 paragraph 95, *A Platform for Consultation*, Vol.1). However, the objectives against which incentives should be assessed should not be restricted to *taxation* objectives but should include all the economic, social, and other objectives relevant to the particular incentive.

Where an incentive is already in place, and is stated to have as its aims many of the same aims as the *Review of Business Taxation* (economic growth, competitiveness, etc), it is equally important that that incentive should not be removed without a formal assessment of the effect of removing it on the ability of the tax regime to achieve the stated goals.

Under the discussion of the tax incentive benchmark, the following sentence appears*: 'By starting with a principle that fosters pure market decision-making, it is possible to identify how rules in practice will affect investment decisions'* (Page 25 paragraph 90, *A Platform for Consultation*, Vol.1). The R&D tax incentive is predicated on the fairly obvious fact that 'pure market decision-making' (if such a thing exists outside the realm of fantasy) has consistently failed to produce a culture of innovation in Australian companies.

The admission in the discussion paper that it is open for any Government to consciously use the tax system to achieve economic or social ends is welcome but the idea deserves more discussion and a stronger and prouder emphasis instead of being hidden in seven brief paragraphs with a tone of apology to economic rationalism.

Without detailed modelling of the benefits of the concession, taking account of the spillover effects of R&D, it is not possible to determine whether removing the concession would increase or decrease revenue. If the concession contributes to growth and employment, and increases competitiveness, its removal may tend to produce the opposite effects and the net saving on the concession may be less than the net loss to revenue caused by the reduced profitability of companies which may cut back their technology development strategies.

The RBT is not in a position to provide the required analysis and so should not make any recommendation to remove the concession.

RBT Benchmark

In the same way as it has proposed a benchmark for tax incentives, *the Review of Business Taxation* should propose:

(i) an effective timetable and mechanism for evaluating the effects of the implementation of its own recommendations so as to determine whether the stated policy goals are achieved in practice, and

(ii) an effective mechanism for proposing and implementing further changes, if required.

Process

As stated already, the RBT is not the appropriate forum in which to make significant changes to industry innovation policy. What is required is a considered analysis based on sound economic modelling.

In recent years there have been numerous reports issued on innovation policy. There is now a need to review the recommendations of these reports and develop a comprehensive innovation strategy for the next millennium. The appropriate forum for this is the Innovation Summit to be held by the Department of Industry Science and Resources later this year.

A brief summary of the view of some of the most recent reports appears below.

- *The Global Information Economy: The Way Ahead*. ('The Goldsworthy Report') July 1997. Report of the Information Industries Taskforce, Department of Industry, Science and Tourism.
  This report recommended a *National Information Industries Strategy* and included a recommendation to introduce a competitive R&D Tax Concession.

- *Make or Break - 7 Steps to Make Australia Rich Again*. July 1997. A Report for Metal Trades Industry Association by the Economist Intelligence Unit.
  This report recommended a 200% concession for qualified R&D.

- *Going for Growth: Business Programs for Investment, Innovation and Export.* July 1997. The Mortimer Review.
  Mortimer recommended replacing the existing plethora of programs with a unified support program that could be provided as a tax concession, rebate, or cash option as appropriate to the particular company.

- *Priority Matters*. June 1997. Report of the Chief Scientist Professor John Stocker.
  Professor Stocker's report noted industry concern over the decrease of the rate of the R&D tax concession from 150% to 125% and also over the changes to details of the concession in 1996 which emphasised the research part of R&D at the expense of experimental development in industry. Professor Stocker recommended that any changes should move towards a broader coverage of activities at an increased rate of support, with increased simplicity and lowered compliance costs.

- *Research and Development*. Industry Commission Report Number 44. May 1995.
  Concluded that the concession had brought net gains to the Australian economy and recommended its retention as well as the introduction of a generally available grant at a value equivalent to the tax concession, to provide R&D assistance for tax loss companies. It also favoured looking at ways to make the incentive more targeted, such as supporting incremental R&D.

- *R&D, Innovation and Competitiveness - An evaluation of the research and development tax concession*. 1993. Bureau of Industry Economics Research Report 50.
  The BIE concluded that the tax concession had induced an increase in BERD and had increased the BERD/GDP ratio but noted that Australia's relative position in the OECD had not changed. It also concluded that the concession had encouraged innovation and was inclined to the view that, on balance, the concession was welfare enhancing.

The need for an increased rate of concession

Views of Australia's Innovative Companies

On 24 March 1999, an R&D Tax Workshop was held in Sydney, organised by the policy section of the Department of Industry Science and Resources. The workshop was attended by invited R&D companies, research organisations, interested Government Departments, and company advisers. The company attendees expressed overwhelming support for the retention of the R&D tax incentive. The workshop also expressed a high level of concern at the eroded value of the incentive, and stressed the need to increase the rate to return the value to its original level.

Consideration needs to be given to the rate at which the R&D tax concession will act effectively as an *incentive* to the conduct of additional R&D. Since detailed analysis and modelling appears to be outside the Review's brief, such a determination is outside the scope of the Review's capability. Ideally any recommendations for change would be made as part of a comprehensive review of industry policy.

However, since the Review committee has belatedly put the R&D concession up for grabs, notice should be taken of the fact that there have been repeated public calls, in the media and at workshops and forums on innovation, for the retention of the R&D incentive at an increased rate of deduction.

Grants versus Tax Incentives

The R&D Tax Workshop expressed a strong preference for tax incentives, combined with targeted grants schemes, rather than for a wholesale reliance on grants as the sole means of Government support. Grants have their place but they support at most 300-400 companies a year and they presume that Government is able to accurately select projects which will be technical and commercial *winners*.

The tax incentive, on the other hand, is a market driven program which can support an unlimited number of companies and projects without the administrative burden of a grants scheme. Using a tax incentive allows companies to chose which R&D projects to conduct and which to commercialise, and this means that a tax incentive has a greater ability to encourage and foster a culture of innovation when compared with a more limited grants scheme.

Rate of Deduction

At a tax rate of 30%, the 125% incentive provides minimal benefit when compared with the compliance costs, which have been steadily increasing in recent years. This position is exacerbated for small to medium companies where the compliance cost is close to the effective benefit.

The table below shows how the rate of after-tax benefit of the R&D incentive has changed over time, where *after-tax benefit = additional rate of deduction x company tax rate*.

Financial Year(s)	Tax rate (%)	Incentive Rate (%)	After Tax Benefit
85/86 to 86/87	46	150%	23
87/88	49	150%	24.5
88/89 to 92/93	39	150%	19.5
93/94 to 94/95	33	150%	16.5
95/96 to Aug 96	36	150%	18
96/97 to present	36	125%	9
Future	30	125%	7.5

To retain the R&D incentive at its current level the rate of deduction would have to be 130% if the company tax rate is 30%. To return it to its original level would require an incentive of at least 175%.

The appropriate rate of concession, and the determination of whether modifications are required to ensure that the R&D incentive achieves its desired outcomes, should be determined after proper consideration of all the evidence. At a minimum however, the current after-tax benefit should be maintained while these issues are considered. This means recommending no less than a 130% rate of concession.