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Dr Kathleen Dermody
Committee Secretary
Senate Economics References Committee

By email: economics.sen@aph.gov.au

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Dear Dr Dermody

Submission: Inquiry into the Australian Innovation System

Please find below, our submission in relation to the inquiry into Australia's innovation system referred to the Senate Economics References Committee for inquiry on 18 March 2014.

About Swanson Reed - Specialist R&D Tax Advisors

Swanson Reed is Australia's largest specialist R&D Tax Incentive provider.

Since its introduction in May 2009, Swanson Reed has conducted over 250 workshops on the R&D Tax Incentive to some of Australia's most innovative companies. The workshops have identified that many small and medium size enterprises (SMEs) are concerned that the program will be subject to further cost cutting and accordingly have become hesitant to implement long term innovation planning strategies.

Swanson Reed is of the view that any measures demonstrating stable and generous support to SMEs' Innovation, particularly in the manufacturing sector, will assist with improving confidence and entice them to invest in long term projects with spill over benefits to the economy.

Summary

Australia needs to focus on key areas of policy and investment in order to ensure Australia remains globally significant in an increasingly competitive world.

- With the rise of Asia, a well executed innovation strategy involving full and fair stakeholder consultation will be Australia's best chance at driving jobs, maintaining global competitiveness and growing the economy.
- Australia needs to become a world leader in innovation if we are to maintain our standard of living.
- IP intensive industries and globally connected technology hubs are key to driving economic growth.
- A stable and certain R&D Tax and Grant system will be crucial in providing companies with the confidence to invest in innovative activities.

Australia needs to develop a well executed innovation strategy that involves full and fair stakeholder consultation

The Australian manufacturing workforce and associated industries have been steadily declining¹. This trend can be attributed primarily to manufacturers in the developed world experiencing increasing cost pressures from their competitors in the developing world, where labour costs are lower². In order to fill this gap, there needs to be increased investment in high skill areas, such as innovation and R&D.

Innovative capacity is crucial to the success of a strong economy and is required for Australia to remain a leader in an increasingly competitive global environment. Australia has transformed itself from an adopter to a producer of global technology. However, a significant amount of work is still needed to establish us as a first tier innovator on the world stage. Investment in innovation will be crucial to driving growth and employment; and improving living standards. Demands for new skills, knowledge and flexible competencies for globalised economies will require system-wide innovation and reform³. As emerging economies in developing countries continue to grow, Australia will need to increase its global competitiveness through utilising its intellectual capacity. Ground breaking innovations will be required to keep us economically prosperous, improve the nation's gross domestic product (GDP) and build a more sustainable future.

Swanson Reed recommends that an innovation strategy considering our opportunities and threats be developed as soon as possible. As the policy needs will be very broad and diverse, it will be important for the government to give full opportunity for contribution by a wide and diverse range of stakeholders including Universities, Business, Government Agencies and Advisors.

¹ Lowe, P. (2012). *The Changing Structure of the Australian Economy and Monetary Policy* (RBA report). Retrieved from the Reserve Bank of Australia website: <http://www.esa.doc.gov/Reports/intellectual-property-and-us-economy-industries-focus>

² Bates, K. A., Flynn, J. E. & Flynn, B. B. (2009). The pressure to perform: Innovation, cost, and the lean revolution. *Business Horizons*, 52, p. 215-221.

³ Luke, A., Freebody, P. Shun, L. & Gopinathan, S. (2005). Towards Research-based innovation and Reform: Singapore schooling in transition. *Asia Pacific Journal of Education*, 25(1), p. 5-28.

To maintain our high standard of living, Australia needs to become a world class innovator

There are increased pressures globally for first world countries to innovate as populous low income countries, such as China and India, continue to broaden their expertise. These developing countries are renowned for specialising in manufacturing and bulk production techniques. However, these countries are increasingly able to compete with advanced economies in more high-tech sectors by employing science and engineering specialists; although such staff represent a small proportion of their workforces⁴.

This threatens to undo the North-South pattern of trade in which advanced countries dominate high tech industries while developing countries specialise in less skilled manufacturing. Australia needs to focus on developing and investing in high skilled jobs in order to increase their global competitiveness. In advanced countries such as

Australia where labor costs are relatively high and there is equal access to global markets, producing standard products using standard methods is not viable to sustain a competitive advantage⁵. Australia needs to differentiate itself on a world stage through developing innovative technologies and products.

According to the Global Competitive Report 13/14, "Australia delivers a consistent and essentially unchanged performance... the business community cites labor regulations and bureaucratic red tape as being, respectively, the first and second most problematic factor for doing business in their country". Individual companies are the ultimate engine for innovation, with the national innovation environment having a strong influence on whether companies are able to develop and commercialise new products, processes and technology.

⁴ Jaffe, A. Lerner, J. & Stern, S. (2006). *Innovation Policy and the Economy*, 6, p. 5-157.

⁵ Porter, M. E., & Stern, S. (2001). National innovative capacity. *The global competitiveness report, 2002*, 102-118.

IP intensive industries and globally connected technology hubs are key to economic growth

The OECD's testimony to the US Senate Committee on Finance suggested that globally connected technology hubs with strong intellectual property rights could be the main driving factor of local and foreign investment.

*“The evidence suggests that the decisions of companies, especially multinational enterprises to conduct R&D in a certain country are certainly influenced by the availability of tax incentive. However, it also suggests that other factors are typically more important. These factors include access to local science and technology, proximity to university research and centres of excellence, availability of a skilled workforce, including engineers and scientists, and strong intellectual property rights. And, if the focus is on development, not on the research but mainly on development access to a large market is particularly important as well”.*⁶

IP is a key element in promoting economic growth indirectly by stimulating the accumulation of inputs from R&D and physical capital⁷. There needs to be an increased focus on industries such as health, technology and biotech which are IP intensive and require the conduct of R&D Activities. Investing in intangible assets alongside physical capital and infrastructure should also be a priority for maximising future economic growth and competitiveness. According to Porter and Stern⁸, the best innovation incubation occurs when companies are centred around other companies that are involved with *disruptive innovation*: that is to create new products and processes that shift the innovation frontier and displace earlier technology and ideas.

⁶ Pilat, D. OECD. (2011) Testimony to the US Senate Committee on Finance Hearing on Tax Reform Options: Incentives for Innovation. Retrieved from SourceOECD database, p. 13-14.

⁷ Park, W. & Ginarte, J. (1997). Intellectual property rights and economic growth. *Contemporary Economic Policy*, 15(3), p. 51-61.

⁸ Porter, M. E., & Stern, S. (2001). National innovative capacity. *The global competitiveness report, 2002*, 102-118.

A principal driver of innovation will be a stable and certain R&D tax incentive

The R&D Tax Incentive is the Australian Government's primary incentive program for innovation. Since its recent introduction in 2011, the government has already proposed two *policy reversals*:

- from 1 July 2013 for the 2014 financial year, an exclusion for large companies with a turnover over \$20 Billion; and
- from 1 July 2014 for the 2015 financial year, a 1.5 percent decrease to the refundable and non-refundable R&D tax offsets (a significant drop in the permanent tax benefit of the incentive for the 2015 financial year, one year before its realignment to the proposed reduced corporate tax rate commencing from 1 July 2015).

As a consequence of the proposed amendments and growing speculation of their passage through the current Senate, many R&D tax claimants have become hesitant to implement any long term innovation strategies. It is important that innovators have a clear understanding of the R&D Tax Incentive rules so that they can make corresponding planning and investment strategies.

The OECD has recently warned against R&D tax *policy reversals*:

*"For countries that have experienced a large number of R&D tax policy reversals, the impact of R&D tax credits on private R&D expenditure is greatly diminished. It is therefore important that governments do not repeatedly tinker with such policies to minimise policy uncertainty for firms."*⁹

Further, the OECD has suggested that stable government incentives increase innovation:

*"The available evidence shows that R&D tax incentives do increase business expenditure on R&D, with the effects typically being larger in the long run than in the short run. The evidence also suggests that smaller firms seem to be more responsive to the R&D tax incentive than larger firms, typically because these firms are much more credit-constrained. The stability of the R&D tax incentive scheme over time also plays an important role. Expectations that R&D incentives are permanent strengthen their impact on R&D investment."*¹⁰

Competitive grant funding schemes should also be available where worthy projects are provided with the necessary seed capital not available through private means. Noting current budgetary constraints and the recent closing of Commercialisation Australia, such a grant scheme should provide funding to only high merit projects with significant potential for spillover.

⁹ OECD. (2013). Maximising the benefits of R&D tax incentives for innovation. *Directorate for Science, Technology and Industry*. Retrieved from SourceOECD database.

¹⁰ Pilat, D. OECD. (2011) Testimony to the US Senate Committee on Finance Hearing on Tax Reform Options: Incentives for Innovation. Retrieved from SourceOECD database, p. 13-14.

Conclusion

In order to encourage competition and innovation globally, and particularly in Australia, stable policy with a strong emphasis on fostering innovation is required. Policies to promote innovation need to reflect the ways in which innovation takes place and practically equip an economy with the right tools to thrive in a highly competitive world.¹¹

A robust R&D tax incentive program will be key to increase our country’s innovative capacity through encouraging companies to undertake R&D activities. However, companies need a stable legislative platform to provide them with the confidence to make long term decisions in anticipation that support will be available.

In the United States and other leading economies, it has been found that protection of IP rights, globally connected technology incubators and tailored government incentives are vital to promoting innovation. Such activity has flow on effects for high skilled jobs and becomes an essential element of our free-enterprise, market-based system¹².

1. Australia needs to develop a well executed innovation strategy that involves full and fair stakeholder consultation.
2. To maintain our high standard of living, Australia needs to become a world class innovator.
3. IP intensive industries and globally connected technology hubs are key to economic growth.
4. Australia needs a stable and certain R&D Tax Incentive program as well as a merit based grant funding system for provision of seed capital.

Please do not hesitate to contact us on (07) 3221 1499 if you would like to discuss any aspect of this submission.

Signed on behalf of Swanson Reed - Specialist R&D Tax Advisors:



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Damian Smyth



Amy Nolan

¹¹ OECD. (2010). The OECD Innovation Strategy: Getting a Head Start on Tomorrow. Retrieved from Source OECD database.

¹² Economics & Statistics Administration. (2012). Intellectual Property and the U.S. Economy: Industries in Focus. Retrieved from <http://www.esa.doc.gov/Reports/intellectual-property-and-us-economy-industries-focus>