MANUFACTURINGAUSTRALIA

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Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
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Dear Committee Members,

Submission in response to the Inquiry into the provisions of the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019 (*the Bill*)

This submission is provided in support of those presented by several large Australian manufacturing companies, including some of Manufacturing Australia's member companies, primarily in response to the proposed changes set out in Schedule 1 of the Bill. Manufacturing Australia is supportive of the increased integrity and transparency measures set out in Schedules 2 and 3 of the Bill.

About Manufacturing Australia
Manufacturing Australia (MA) is led by the CEOs of some of Australia's largest manufacturing companies: Adelaide Brighton, Bluescope, Brickworks, Capral, Cement Australia, CSR, DuluxGroup, Incitec Pivot, Orora, Rheem and Tomago Aluminium. MA's members employ more than 50,000 Australians directly and operate around 500 plants and facilities around Australia.

MA's member companies are amongst Australia's largest R&D investors, with numerous projects run both in-house and in partnership with universities. Collectively, they have invested around $2 billion in R&D over the past decade, which includes more than 50 partnerships with Australian universities and research institutes. Notably, MA members have a strong track record for commercialisation and application of R&D projects in their Australian plants, both to improve the performance of existing plants and to support the business case for new manufacturing investment. Innovations developed in the laboratory or incubator are applied directly on the production line or factory floor by MA members, leading to job creation, economic opportunity and broader benefits flowing directly into Australian communities.

Some current examples include:

- Incitec Pivot operates one of the largest commercial plant nutrition R&D programs in Australia, with more than 30 replicated research trials per annum. Its technologies are helping its customers drive efficiencies and improve environmental impact. For example, IPL is developing technology to improve nutrient use efficiency to improve farm yields and support sustainable farming practices.

- BlueScope operates one of Australia's largest in-house manufacturing R&D centres at its Port Kembla steelworks, with more than 30 PhD scientists working on future innovations. For example, it is currently exploring next generation alloy coating processes for coated steel production, which includes products with greater corrosion resistance and therefore longer life and improved product performance.

- Cement Australia is trialing more efficient ways to operate its cement kilns, including using alternative fuels to replace coal as a fuel source.

- Orora has developed a transport simulator testing environment allowing many industry sectors to assess packaging performance in diverse transportation conditions to ensure products are delivered in pristine condition.

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- DuluxGroup employs approximately 150 scientists in four locations across Australia and further facilities in New Zealand, and around 20% hold PhD degrees. Its Dulux Paint & Coatings Innovation Centre at Clayton in Victoria is world-class and focuses on primary research, particularly in polymer science, into leading edge concepts for longer development. This is often in collaboration with Australian universities. For example, it is investigating solutions to develop high performance water borne systems to replace solvent borne products, which is a significant challenge to the global coatings industry.

- Rheem Australia's Rydalmere plant houses Paloma Rheem Global's R&D centre of excellence for renewable energy water heaters. Over the last few years Rheem Australia has developed the world's first smart electric water heater, capable of scavenging excess rooftop PV, reducing costs for householders and aiding grid stability.

- Brickworks undertakes research and trials of alternative biofuels and substitutes to reduce its reliance on natural gas, as well as the development of new, innovative building products and more fuel efficient and sustainable kilns. In 2019, alternative biofuels made up 11% of the Group's energy requirements, with fuel sources including landfill gas and sawdust.

- Capral Aluminium partners with Australian robotics and automation experts to integrate advanced robotics and laser measurement into aluminium profile manufacturing. These programs have made it one of the leading technical subtractive machinists of aluminium in the world. One project, undertaken in partnership with a NSW robotics company, has enabled Capral to develop the world's first fully automated robotic packing line for aluminium extrusions. These projects enable Capral to not only improve the competitiveness of its existing operations, but also to undertake manufacturing that was previously the preserve of imports.

- CSR's dedicated innovation team focusses on advancing building science and building performance across residential and commercial construction sectors, from daylight & glazing, moisture management & mould control, ventilation strategies, comfort indicators for occupants and energy efficiency.

In addition, MA companies provide industry placements, mentorships, sponsorships, guest lectures and academic prizes to university students, as well as being a major employer of STEM graduates to ensure we build the next generation of science talent in this country.

Response to proposed changes in Schedule 1 of The Bill

The R&D Tax Incentive program has helped drive MA companies' strong commitment to investing in R&D that not only delivers productivity and Australian jobs, but has spill-over benefits to the broader economy and offers opportunities to grow and retain the best of our science talent here.

Under the proposed changes set out in Schedule 1.34, **every MA company will have its R&D Tax Incentive eligibility almost halved** from the current 8.5% tax credit to 4.5%.

Over the past four years, the Government has received consistent and continuous feedback from hundreds of companies, including MA companies, that the proposed '**Intensity Measure**' would have negative unintended consequences.

The 'Intensity Measure' does not truly measure a company's R&D strength. It is fundamentally wrong to define a company's relative R&D strength based on its R&D spend as a proportion of its overall operating costs. It would punish strong R&D performers that manufacture locally and therefore have a higher operating cost base. Whereas a company with an equal or lesser R&D commitment, that doesn't invest in local plants, supply chain and thousands of jobs would be deemed more 'R&D Intensive' under the Bill and receive a much greater tax incentive benefit.

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The 2018-2019 Senate Economic Legislation Committee Inquiry, chaired by Senator Jane Hume, concluded in February 2019 that:

2.102 The committee shares participants' concerns that this intensity measure may have unintended consequences for larger R&D entities undertaking eligible R&D activities. ***In particular, the committee notes the possibility that businesses that manufacture in Australia may be disadvantaged compared with businesses that manufacture overseas.*** *Further, the committee notes that the proposed intensity measure may also disadvantage those R&D entities that require large capital investment and operate on small margins.*

2.103 The committee considers that, as currently drafted, the proposed intensity measure has possible unintended consequences that may disadvantage a range of Australian R&D entities. ***Therefore, the committee agrees that the intensity measure should be re-examined in order to ensure that Australian businesses are not unfairly disadvantaged.***

Following that, the main change made in the current Bill (as set out in Schedule 1.34) is to reduce the number of 'Tiers' from four to three. This fails to address the Committee's concerns. Australia's biggest R&D investors, including manufacturers employing hundreds of thousands of Australians and paying local Australian taxes, remain unfairly disadvantaged.

Further:

1. This cut from 8.5% to 4.5% would follow a cut from 10% to 8.5% in 2016. A 55% combined cut since 2016.
2. New Zealand has recently introduced a 15% tax incentive for R&D investment up to $120 million. This New Zealand R&D incentive is 3.33 times Australia's proposed 4.5% R&D incentive for most companies.
3. No other advanced economy uses an intensity model such as this, and a volume-based tax incentive combined with direct incentives is seen as best practice.
4. On a global basis, Australia's R&D Tax Incentive is becoming increasingly less attractive and this measure will make it even more difficult for Australia to compete for R&D investment.
5. Published Science, Research and Innovation (SRI) budget figures show that total incentives going to companies with turnover of greater than $20 million will be less than a third of what they were a decade ago, under these proposed changes.
6. Because a company's R&D Intensity is calculated based on total expenditure, it cannot be known until the end of the year. Therefore, **the Intensity Measure cannot work as an incentive for encouraging prospective investment.** Instead, it creates more uncertainty and makes it harder for companies like MA members to effectively plan and budget their R&D program.
7. The complexity of the Intensity Measure will increase compliance costs, further diminishing its net benefit and its effect as an incentive
8. The Bill is retrospective, back to 1 July 2019, and captures projects in progress and budgeted under the current R&D Tax Incentive regime. Most companies plan their R&D program at least three years out.
9. The Intensity Measure will make it even more challenging for Australia to reach its R&D target of 2.2% of GDP. Companies require a stable, predictable and cost-effective R&D incentive regime. This Bill delivers the opposite of that. Companies with a clear choice about how and where they do their R&D will respond accordingly, to Australia's detriment.

Impact of the proposed changes

Many of MA's members operate large plants in Australia as well as overseas. While some specific R&D must be undertaken in Australia (for example fertilizer R&D that requires testing in local soil conditions) most R&D can be undertaken overseas. The proposed intensity measure is likely to encourage large Australian manufacturers to explore R&D investment options in more favourable jurisdictions, particularly where a logical alignment with overseas operations exists.

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The Intensity Measure would also of course increase costs (by reducing incentives) relative to imports. Large Australian manufacturers compete in a global marketplace, in which business outcomes are a "zero sum game." A fundamental commercial objective for every Australian manufacturer is to reduce costs relative to import competition. When costs increase, that needs to be offset somewhere else in the business. Removing this incentive will create financial pressure on businesses to reduce costs (not just in R&D but across the board) and this will most likely result in job losses either elsewhere in the business or directly from R&D activities, as well as reducing industry support for the university sector.

An Alternative Solution

In Manufacturing Australia's view, fairer approach to meeting the objectives of the R&D Tax Incentive Review, while supporting R&D investment in the right areas would be to:

1. Remove the proposed tiered R&D Intensity Measure as the basis for determining the tax offset rate for companies with turnover of greater than $20 million, given it is not an equitable approach.
2. Retain the current volume-based non-refundable tax incentive to companies with turnover of greater than $20 million. However, reduce the rate across the board from 8.5% to 8%. This would amount to a 2% cut (from 10%) over the past three years.
3. MA supports the Bill's proposed $4 million annual cap on cash refunds for companies with an annual turnover of less than $20 million (noting that any excess amount can be carried forward as a non-refundable tax offset). This will continue to provide much needed support and incentive to innovative smaller and start-up businesses in their formative years but will also apply a higher level of control to the overall cost, given the recent growth has been in the uncapped component.
4. Further, reduce the generous cash refundable component from 13.5% above the entity's corporate tax rate by 1–2% (i.e. to between 11.5% and 12.5%). Again, given this is where the escalation in the Government cost of the R&D program has occurred over the past decade.
5. MA proposes that a mechanism be included to 'grandfather' existing company investments and/or projects that were made under the umbrella of the existing legislation.
6. Implement the integrity and transparency measures set out in Schedules 2 and 3 of the Bill.

Conclusion

Introducing an Intensity Measure would run counter to the objective of a more efficient, less complex, rigorous and consistent R&D incentive program. It is also very likely to have the unintended negative consequence of discouraging Australian manufacturers from undertaking R&D in Australia.

I ask that you carefully consider these issues and those raised with you by MA members as part of the submission process, in your deliberations.

Please do not hesitate to contact me should you require any further information on the impacts of changes to the R&D Tax Incentive on large enterprise manufacturers in Australia.

Yours sincerely,

Ben Eade
Chief Executive Officer
Manufacturing Australia