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## The Additionality of R&D Tax Policy in Australia

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## **Abstract**

Previous statistical analysis has failed to confirm that investment in research and development (R&D) by Australian firms is responsive to tax subsidies, which is in contrast with international evidence. It is notoriously difficult to find a control group in order to estimate the impact of R&D tax incentives because they are entitlement schemes; factors that determine benefits also influence their R&D investment decisions. In this paper, we exploit newly available firm level data to undertake a difference-in-difference analysis around the policy reform in 2012. The results suggest that Australian firms spend approximately an additional \$1.90 on R&D for every dollar of tax revenue foregone due to the policy.

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## Introduction

This article estimates the amount of additional R&D investment firms undertake for every dollar of tax revenue forgone. International evidence suggests business investment in research and development (R&D) is responsive to tax subsidies. However, to date, evidence in the Australian context has been lacking. The two most comprehensive statistical studies on the additionality of R&D tax subsidies in Australia were unable to identify any statistically significant effect of tax subsidies on R&D investment. These are Thomson (2010) and Bureau of Industry Economics (1993). Whether these findings reflect shortcomings of the prior studies or some fundamental underlying structural feature of the Australian context that renders tax policy impotent has remained an open question. We use newly available and comprehensive data from the ABS Expanded Analytical Business Longitudinal Database (EABLD) covering close to the population of R&D-active firms for the years 2005 to 2012 to undertake a difference-in-difference analysis around important policy reforms of 2012.

The challenge of identifying the causal impact of R&D tax subsidies arises because all identical firms can access the same benefit from the tax incentive policy. Any statistical relationship between the benefits a firm receives from subsidies and the amount of R&D they perform tells us little about the effect of policy if the factors that determine benefits also influence their R&D investment strategy. For example, firms which do not perform R&D do not benefit from the schemes and therefore do not register. The problem of simultaneity is particularly acute for the R&D Tax Concession policy where incremental expenditure over and above the previous three-year average was eligible for a bonus concessionary rate.

The introduction of the R&D Tax Incentive policy in 2012 provides an opportunity to undertake difference-in-difference analysis comparing the impact of the policy reform on claiming and non-claiming firms. Causal inference under difference-in-difference is based on the assumption is that R&D investment by claiming and non-claiming firms move in parallel over time because they are subject to the same macro-economic conditions (the 'parallel trends assumption'). That is, even though claiming and non-claiming firms exhibit a different level of R&D investment driven by unobserved factors that determine the decision to claim, it is plausible that they exhibit the same trend over time. We find that the introduction of the R&D tax incentive led to a 14 per cent increase in R&D spending by the sample of firms claiming in both 2011 and 2012. We undertake counterfactual analysis to derive the implied additionality ratio that reveals that firms increase R&D investment by 1.9 dollars for every dollar of tax revenue forgone.

## Background

### *Australian R&D tax Policy*

Tax subsidies for R&D were first introduced in Australia with the introduction of the R&D Tax Concession in 1985. The Concession provided an allowance of 150 percent; that is, firms could deduct from their taxable income 150 percent of the value of their eligible R&D expenditure. Since its inception, the scheme has undergone a number of reforms. Salient features of the scheme within the time period analysed are outlined below and further details about historical aspects of the policy can be found in Thomson (2010). A chronology of important reforms is discussed below and these are summarised in Table 1.

The Tax Concession scheme underwent a major reform in 1996. The rate of deduction was cut from 150 per cent to 125 per cent of eligible expenditure and the scope of eligible expenditure was revised. An incremental scheme, known as the 175 per cent premium deduction, was introduced in 2001. Under the incremental scheme, firms could claim an additional 50 per cent deduction on the portion of expenditure exceeding average nominal expenditure over the prior 3 years. This was in addition to the 125 per cent deduction available on all R&D investment, meaning 'incremental' expenditure attracts a 175 per cent deduction in total. The rationale behind the bonus concession is to provide additional incentives while limiting deductions on infra-marginal R&D investment – i.e. investment that would have occurred in the absence of the Concession.

A small businesses tax offset scheme was introduced in 2001. Under the tax offset scheme, firms with a turnover of less than \$5 million can claim the Concession as a tax offset (rebate) of 30c for each dollar of eligible R&D investment, provided the expenditure is between the floor (\$20,000) and a maximum (cap) of \$1 million. A special scheme for foreign contract R&D was introduced in 2007. Up until 2007, eligibility for the Concession depended on the resultant intellectual property being vested with the researching firm, which reduced the attractiveness of the scheme to an Australian affiliate of a foreign-owned firm (BIE 1993; ATO 2002).

The R&D Tax Incentive has been in place since the 2011/12 financial year and replaces the R&D Tax Concession. It comprises a 45 percent offset (rebate) for small companies (turnover less than \$20 million) and a 40 percent offset (rebate) for large companies (turnover greater than \$20 million). The 45 percent R&D tax offset is a refundable tax offset, which means that if a company's tax liability is reduced to zero, companies may be entitled to a refund of any unused offset amount. The 40 percent R&D tax offset is non-refundable, which means that companies cannot access a refund for any unused offset amount if their corporate income tax liability has been reduced to zero. However, any excess offsets may be carried forward for use in future income years.

The refundable offset has a potentially large impact on the effective relative generosity of the policy for companies which have no taxable profit. If all R&D is expensed, a company with a positive tax liability is only 15 percentage points better off with the Tax Incentive scheme. In contrast, for a company with no tax liability the policy reduces the after tax cost of R&D by a full 45 percent.

**Table 1. History of the R&D Tax Subsidies in Australia**

Year	Policy Event
1985	R&D Tax Concession established Available to Australian companies Enhanced deduction of 150 per cent on R&D expenditure, resulting in a benefit of 23 cents in the dollar (corporate tax rate was 46 per cent)
1987	Corporate tax rate increased to 49 per cent, resulting in an increased benefit of 24.5 cent in the dollar
1988	Corporate tax rate reduced to 39 per cent, resulting in a reduced benefit of 19.5 cents in the dollar
1993	Corporate tax rate reduced to 33 per cent, resulting in a reduced benefit of 16.5 cents in the dollar
1995	Corporate tax rate increased to 36 per cent, resulting in an increased benefit of 18 cents in the dollar
1996	Enhanced deduction rate was reduced from 150 to 125 per cent, resulting in a reduced benefit of 9 cents in the dollar (corporate tax rate was 36 per cent)
2001	Corporate tax rate reduced to 30 per cent, resulting in a reduced benefit of 7.5 cents in the dollar Introduction of the 175 per cent Premium (Incremental) Tax Concession for additional investment in R&D Introduction of a refundable R&D Tax Offset for small companies in tax loss that undertake R&D, enabling them to 'cash out' their R&D tax losses
2007	Introduction of the 175 R&D International Premium, designed to encourage additional R&D investment in Australia by firms in which the IP is held by an overseas company in the same enterprise group
2011	R&D Tax Incentive replaces the R&D Tax Concession Available to companies that are resident in Australia for tax purposes, and foreign companies in certain circumstances Refundable 45 per cent tax offset available to companies with turnover of less than \$20 million, providing a benefit of 15 to 45 cents in the dollar for these companies Non-refundable 40 per cent tax offset available to other companies, resulting in an benefit of 10 cents in the dollar for these companies
2015	\$100m R&D expenditure threshold introduced. Companies expending more than \$100m on R&D can receive a tax offset at the corporate tax rate for the R&D expenditure in excess of \$100m

Source: Department of Industry, Innovation and Science.

### ***Measuring success***

Additionality is the amount of R&D invested for every dollar of tax revenue forgone which can be written as:

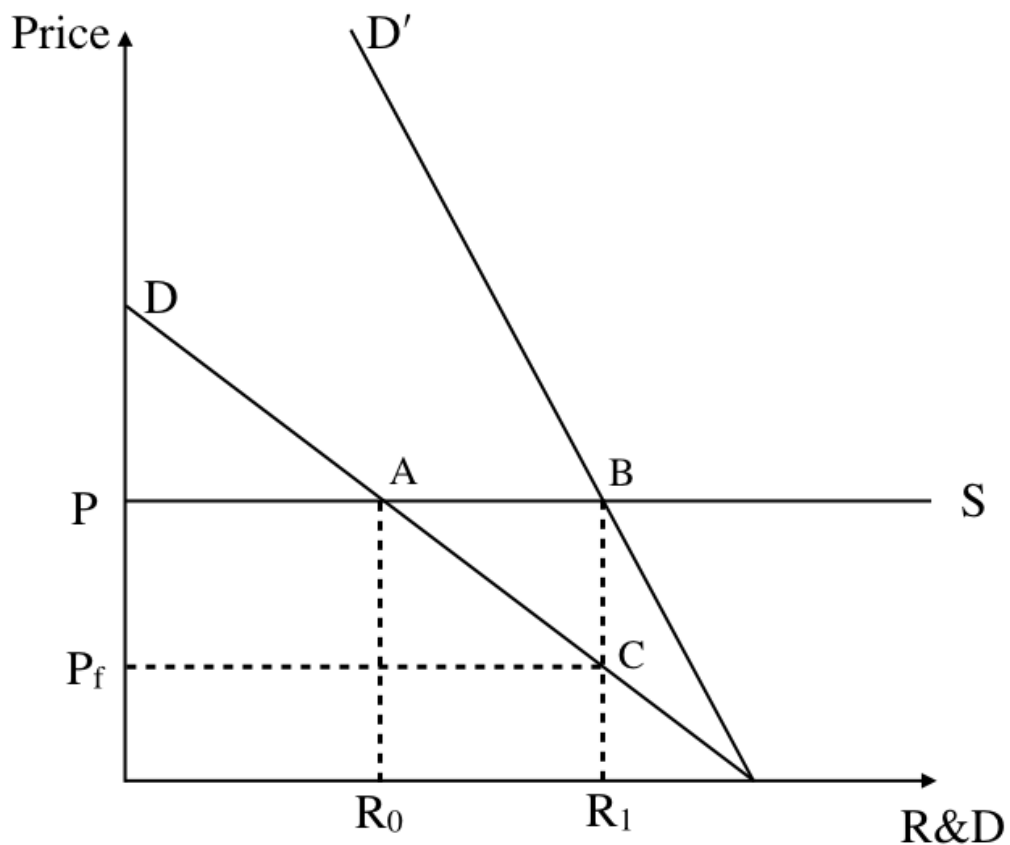
$$\text{Additionality} = \frac{R\&D_{1|1} - R\&D_{1|0}}{T_{1|0} - T_{1|1}}$$

Where  $R\&D_{1|1}$  amount of R&D performed by the firms which claim the tax subsidy (the 'treated' group) and  $R\&D_{1|0}$  is denotes the amount of R&D that would hypothetically be invested by the same group of firms in the

absence of tax subsidies. Analogously,  $T_{1|1} - T_{1|0}$  is the amount of tax revenue forgone due to the policy (which is the negative of the change in the firms' tax liability).

Figure 1 provides a graphical representation of how R&D tax subsidies impact on the amount of R&D investment and what we mean by additionality. The x-axis is the amount of R&D activity and the y-axis reflects the price. Figure 1 applies to all R&D activity, but for illustrative purposes, we can think of Figure 1 as depicting the market for scientists (the number of scientists employed and their wage, respectively). The supply curve is denoted by  $S$  and we depict this as flat (entirely elastic) though it may be upward sloping, for example if the number of scientists and technicians are limited (see Thomson and Jensen 2013). The demand curve, the amount of R&D demanded by firms in the absence of any tax subsidy is denoted by  $D$ . The market equilibrium when firms demand a quantity of R&D equal to  $R_0$  at a price of  $P$  is at point  $A$ . An ad valorem tax subsidy paid on firms R&D investment pivots the demand curve outwards. The new equilibrium is at point  $B$ , where firms demand a quantity of R&D equal to  $R_1$ . At the new equilibrium firms pay  $P_f$  and the government pays the difference  $(P - P_f)$ . We define additionality as the additional R&D per dollar of tax revenue forgone. In Figure 1, the additional R&D induced is given by the area bounded by the points  $R_0R_1BA$ . The cost to government in terms of revenue forgone is given by the area bounded by the points  $PP_fCB$ .

**Figure 1. Graphical Illustration of the impact of R&D tax incentives**



The R&D Tax Incentive is an ad valorem (percentage or proportional) subsidy and as such, the more firms spend on R&D, the more benefit they receive (and correspondingly the greater the tax revenue forgone). For example, with a 10 percent subsidy, there are 10 cents revenue forgone for every extra dollar of R&D performed, by policy design. On the chart, this would be represented as a shift outward in the R&D demand curve for a fixed subsidy. In order to estimate the additionality that is caused by a subsidy, it is necessary to have exogenous variation in the rate of subsidy either between firms or industries or over time. In practice, most firm level data reflect a great deal of variation in R&D expenditure between firms, and little or no exogenous variation in subsidy level (or rate). The empirical challenge is to isolate this variation in subsidy and control for variation related to changes in demand for R&D.

Additionality is defined here in gross terms. An additionality of 0.7 means private firms only increase their spending by 70 cents for every dollar the government gives them; 30 percent of private spending that was already happening has been displaced by the government subsidy. An additionality of 1 means the government gives firms \$1 and they spend it on R&D – so there are no private investments displaced by government spending. The same gross investment on R&D could be achieved via spending on intra-mural or higher education R&D. In this case, with an additionality of unity (ignoring administrative costs), tax incentives provide a means for harnessing market forces to allocate the spending on R&D. That is, in the case of tax incentives, government resources are allocated and spent by private firms in contrast to government or higher education R&D, which must be allocated by other means. There are arguments as to the efficacy of government allocation of R&D spending but these are outside the scope of this report. An additionality above unity implies that policy is leveraging more private spending than it is costing government in terms of forgone revenue. The magnitude of the additionality depends on the slope of the R&D demand and supply curves.

Our definition of additionality does not take into account potential additional tax revenue from firms that have higher future taxable income due to the increased R&D investment on account of the policy. Finally, it is vitally important to bear in mind that inducing additional R&D is not an end in itself. The rationale for subsidising R&D is to induce positive spill-over benefits to other firms and consumers. If left to themselves, for-profit organisations will under-invest in R&D and thereby forgo welfare-enhancing spill-over benefits. Sound theory and extensive empirical evidence suggest each dollar of R&D investment makes a contribution to the material well-being of Australians considerably greater than one dollar.

Finally, note that we focus entirely on the intensive margin, which is to ask: given that a firm invests in R&D, do tax subsidies influence the amount of R&D they perform? In principle, R&D tax incentives might also impact on firms' decision whether or not to do any R&D (called the extensive margin) but this is not assessed here.

### ***Evidence of Additionality***



Most existing studies on the effects of tax policy on private sector R&D have taken one of two approaches: cross-country or firm-level (within-country) analysis. Cross-country analysis exploits variation in policy between jurisdictions, and as such aims to disentangle contemporaneous macroeconomic events (Bloom *et al.*, 2002). These studies have found an elasticity ranging from 15 per cent in the short run to about unity in the long run (see Guellec & Van Pottelsberghe, 2003; Falk, 2006). An approach that has been used to evaluate the effect of fiscal incentives using firm-level data is to estimate an investment demand equation with policy shift dummies (Eisner *et al.*, 1984; Bernstein, 1986; Thomas *et al.*, 2003). This approach does not provide a strong basis for identification as it is difficult to separate the effects of tax policy from other changes over time. Using this approach, Eisner *et al.* (1984) failed to observe a significant effect of the tax subsidy in the USA. A second approach using firm level data is to model R&D investment on firms' effective benefits from the prevailing tax policy in a single country. Since tax policy treats all equivalent firms the same way, variations in firms' effective benefits from tax subsidies essentially arise due to differences between firms, typically differences in firms' profit status and historic R&D investment. Unfortunately, from a statistical perspective, these generally depend on the firm's current choice of R&D investment (Hall and van Reenen 1999). Results from firm-level analyses have varied widely, with estimates of the short-run elasticity between 0.07 and 0.85, and a long-run elasticity ranging of about unity (Hall, 1992; Dagenais *et al.*, 1997). A summary of estimates from salient papers is provided in Table 2.

Australian R&D tax policy has been subject to a number of studies. Survey evaluations of the Australian R&D Tax Concession found that while the majority of beneficiaries of the policy describe it favourably, approximately 30 per cent concede that their R&D endeavours would be neither smaller nor have been completed at a slower rate in the absence of the programme (DITR, 2005, 2007a). However, the limitations of basing conclusions on subjective survey results are well-known. A comprehensive assessment of the Australian R&D Tax Concession which reports both survey data as well as analysis of firm financial data was undertaken in 1993 by the Bureau of Industry Economics (BIE, 1993). Data used for the statistical analysis include a mix of firms that are registered to receive the credit and other firms, with observably similar characteristics, that are not registered to receive the credit. The data suggest a modest effect over the year the policy was introduced, but not over longer periods and the report cautions that this observed increase may simply be due to reclassification of existing expenditure. The oft-cited inference of the report, namely that the Concession induces between \$0.6 and \$1 of additional R&D for each dollar of forgone revenue, rests primarily on subjective survey responses (see p. 155).

A more recent, comprehensive evaluation of R&D tax policy in Australia also found no identifiable impact. Thomson (2010) considers an unbalanced panel of financial data of approximately 500 large Australian firms between 1990 and 2005. The role that cost of capital plays in R&D investment decisions is investigated. The

measure of cost of capital incorporates both a financial cost (imputed cost of capital derived from a CAPM model) and the impact of the R&D Tax Concession. However, only time series variation in tax policy was used because the author did not have access to firms' actual tax claims or registration status. R&D investment is not found to be impacted by the measured cost of capital.

Table 2. Overview of selected previous elasticity estimates

<u>Authors</u>	<u>Policy measure</u>	<u>Specification</u>	<u>Country</u>	<u>Obs.</u>	<u>Price elasticity</u>	<u>Additionality (approx)<sup>†</sup></u>
BIE (1993)	Dummy	R&D demand (levels).	Australia	1,400	Insignificant	0
Thomson (2010)	UCRD	R&D demand. (PA)	Australia	2,025	Insignificant	0
Lokshin and Mohnen (2007)	UCRD	R&D stock demand.	Netherlands	2,615	-0.27 (SR)	0.37
					-0.39 (LR)	0.50
Mulkey and Mairesse (2013)	UCRD	R&D demand (ECM)	France	10,850	-0.40 (LR)	0.51
Koga (2003)	UCRD	R&D demand (levels)	Japan	5,738	-0.68	0.80
Dagenais et al. (1997)	UCRD	R&D stock demand (PA)	Canada	4,859	-0.07 (SR)	0.11
					-1.09 (LR)	1.05
Harris <i>et al.</i> (2009)	UCRD	R&D demand (static and dynamic models).	Northern Ireland	2,063	-0.21 (SR)	0.23
					-1.40 (LR)	1.35
Parisi and Sembenelli (2003)	UCRD	R&D demand	Italy	4,356	-3.27	1.7
Hall (1993)	Credit rate	Euler equation	US	9,167	-0.80-1.50 (SR)	2.0
					-2-2.7 (LR)	na
Guellec and Pottelsberghe (2003)	Tax component of UCRD	R&D demand. (PA)	Cross country	199	-0.28 (SR)	0.37
					-0.31 (LR)	0.41
Falk 2006	Tax component of UCRD	R&D demand. (PA)	Cross country	92	-0.22 (SR)	0.30
					-0.84 (LR)	0.89
Bloom <i>et al.</i> 2002	UCRD	R&D demand. (PA)	Cross country	179	-0.16 (SR)	0.23
					-1.10 (LR)	1.06
Thomson and Jensen (2014)	Tax component of UCRD	R&D labour demand (PA & ECM).	Cross country	373	-0.19-0.32 (SR)	0.27-0.42
					-1.30-3.3 (LR)	1.18-1.83
Wilson 2009	UCRD	R&D demand. (PA)	US states	365	-1.26-1.43 (SR)	1.19
					-2.29-2.58 (LR)	1.64

Notes: papers ordered by long run elasticity estimate. Abbreviations: Policy measure: UCRD user cost of R&D. Specification: partial adjustment (PA), error correction model (ECM), no dynamics modelled (levels); Price elasticity: LR long run, SR short run. Additionality except in the case of Hall 1993, these are approximated using  $\frac{dR}{d(sR)} = \frac{\eta}{1-s-\eta s}$ , where  $s$  is unity less after tax cost and  $\eta$  the elasticity of R&D with respect to tax-price (see Thomson forthcoming). Approximated at the hypothetical margin where R&D is expensed ( $s$  given by unity less corporate income tax rate using the midpoint of sample corporate income tax rates in the absence of sample weighted average).

## Data

The data used for this study are the most comprehensive that have been available to researchers looking at the Australian context to date. The data for this study is from the ABS Expanded Analytical Business Longitudinal Database (EABLD). We restrict our attention to enterprise groups for which data for wage bill and sales are available.

The main variable of interest is business expenditure on R&D from the ABS *Business Expenditure on R&D survey* (BERD). The business expenditure survey uses standard consistent definition of R&D activity. Between 2005-06 and 2011-12 the Survey of R&D, Businesses aimed to be a complete enumeration of businesses within the Australian business sector (i.e. all businesses and the private non-profit institutions mainly serving them) with intramural expenditure on R&D of \$100,000 or more during the reference period. R&D investment data cover approximately 5000-6000 firms per year prior to 2012 and for approximately 2500 firms in 2012 after the shift to the sample approach.

Note that it is not possible to use registered or claimed R&D expenditure since the definition of eligible R&D under each scheme has been revised at various points of policy reform (including over the transition to the R&D Tax Incentive) and varied with policy. Our analysis is therefore based on those firms for which data on R&D investment is available in the BERD survey. Table 3 shows that the number of R&D-performing firms is very similar across the three sources, such that the BERD survey is very likely to pick up a large and representative portion of R&D-performing firms. Table 3 displays the number of firms for which we have R&D data for the last three financial years from each source. For brevity, we show data from the last three financial years only but the same trends are visible across the entire time coverage of the dataset (financial years 2005 to 2012).

**Table 3. Number of Businesses for which R&D Data is available, by Source.**

FY	Panel (a). All Businesses.		
	BERD	Dept. Industry	Company tax return
2009/2010	5472	7907	6731
2010/2011	5825	8398	7267
2011/2012	2671	9072	7303

### *Claiming and non-claiming firms*

As in the case of the BIE (1993) study, several methods applied in this report involve comparing firms that claim R&D tax subsidies with those that do not. It is important to consider whether this is a valid comparison. We begin by providing a statistical overview of the two groups. For the period 2005-2012, 22 percent of R&D active firms do not claim any R&D tax subsidy. Companies not claiming are either

unaware or ineligible. Survey evidence suggests that many firms remain unaware of R&D support programs even many years after they are introduced (Thomson and Webster 2012). There are a number of reasons that firms may be ineligible to claim the tax subsidy. First, not all R&D activities are eligible. For example, some R&D activities are not eligible such as software development and social science research. R&D financed by other Australian firms is not eligible. Lastly, clawback provisions act to prevent companies receiving a benefit on amounts received through other sources of government support. Although companies would be eligible in these instances, they may opt not to claim under the programme as it is more beneficial to pursue other funding sources (such as government grants). Table 4 shows a breakdown of firms by claiming status and grant recipient status.

**Table 4. Claiming Status for R&D tax subsidies and other forms of government support**

	Claiming	Not Claiming
Grants > 0	5,816	3,181
Grants = 0	24,757	1,288

Table 5 shows the distribution of surveyed firms across the two schemes over time. Over the observation period of 2005 – 2012, the number of firms claiming the Concession appears to rise steadily from 2,969 in 2005 to 4,597 in 2011. In addition, the proportion of R&D active firms, not claiming the subsidy decreased in the 6 years to 2011 (from 0.29 in 2005 to 0.16 in 2011). The pattern of increasing policy uptake could be driven by several factors, though it is consistent with a process of learning and adoption as non-claiming firms learn about the policy and begin to claim it. Because the BERD became a survey of a sample of firms in 2012, we do not have information on all R&D-performing firms in 2012.

**Table 5. R&D Active Firms Claiming Concession, Incentive or Neither.**

Financial Year	Claim Concession	Claim Incentive	Not claim	Total	Not Claim / Total
2005	2,969	0	1,195	4,164	0.29
2006	3,225	0	969	4,194	0.23
2007	3,308	0	908	4,216	0.22
2008	3,630	0	885	4,515	0.20
2009	3,924	0	871	4,795	0.18
2010	4,241	0	889	5,130	0.17
2011	4,597	0	868	5,465	0.16
2012*	368	1,646	519	2,533	0.20
Total	26,262	1,646	7,104	35,012	0.20

Notes: Data includes firms at the enterprise group level with non-zero R&D spending (BERD survey) and non-missing turnover and wage data (BAS survey). \*: based on a sample survey only.

Table 6 shows that, while non-claiming firms are typically smaller than claiming firms on average, the distributions of covariates within each group display such a wide spread (as the standard deviations are very large relative to the means), which gives the algorithm a large variety of firms to pick matches

from. It is interesting to observe that while the R&D spend for non-claiming firms is smaller on average, such firms are similarly R&D intensive in terms of R&D per turnover or R&D per wage bill.

**Table 6. Summary Statistics**

Variable	Claiming	Not Claiming
R&D Expenditure [std dev.]	\$ 3,749 [24,614]	\$ 1,411 [3,750]
Turnover [std dev.]	\$ 318 million [2.96 billion]	\$ 81.5 million [373 million]
Wages [std dev.]	\$ 27.9 million [201 million]	\$ 12.3 million [54.9 million]
Assets [std dev.]	\$ 969 million [17 billion]	\$ 48.1 million [358 million]
Profits [std dev.]	\$ 39.4 million [480 million]	\$ 2 million [33.9 million]

## Results and Discussion

We first estimate a linear regression model using ordinary least squares (OLS). This method allows us to identify if there is a correlation between receiving the subsidy and R&D outcomes while holding constant some other observable firm attributes. The OLS model is:

$$\ln(R\&D\ exp)_{it} = \alpha + \beta R\&D\ tax\ credit_{it} + X_{it} \delta + v_{it} \quad (1)$$

Equation (1) represents a linear relationship between R&D investment by firm  $i$  and year  $t$  and firm-level attributes  $X$ , a stochastic error term  $v$ , and a dummy variable  $R\&D\ tax\ credit$  set equal to 1 if firm  $i$  claims an R&D tax subsidy and zero otherwise. We can interpret  $\beta$  as the causal effect of tax policy on R&D investment under the assumption that no unobservable factors (factors not included in the model) influence both the amount of R&D performed and also the firms' propensity to register for the subsidies.

Table 7 displays the results of the OLS estimates of firm level R&D investment. Column (1) indicates that, on average across all years and all firms considered, firms that received a Tax Incentive or Concession spent approximately 50 percent more on R&D than firms that did not claim an R&D tax

break.<sup>1</sup> This difference is statistically significantly different from zero at the 1 per cent level, meaning that the observed difference is less than 1 per cent likely to be due to chance. We therefore reject the null hypothesis that there is no association between R&D investment and receiving an R&D tax break. This conclusion holds true for both the Concession (columns 1-3) and the Incentive (columns 4-5). As expected, the effect of the Incentive is considerably higher for small firms with zero profits (column 5). However, the effect is smaller for both small firms (column 2) and firms not paying franked dividends (column 3). We cannot explain these results. Nonetheless, overall we document a robust significant relationship between R&D tax subsidies and R&D expenditure using OLS.

Using ordinary least squares and matching estimators to control for observable firm attributes including industry, company turnover, wage bill and any benefits from government R&D grants, we find that claiming firms invest on average 40 per cent more R&D than 'similar' firms which are not registered to receive the subsidies. This estimate can only be interpreted as the causal impact of tax policy if we assume that there are no unobservable factors that determine both R&D investment and also firms' registration status. *A priori* this assumption is plausible, but it is certainly not possible to rule out the possibility that such unobservable factors exist. Approximately 22 per cent of R&D active firms do not claim an R&D tax subsidy. Companies not claiming are either unaware or ineligible. For example, they may perform ineligible R&D activities, perform R&D for other Australian firms, or their R&D may be financed by other forms of government support and hence is ineligible for the scheme benefits. We highlight that the 1993 study by the Bureau of Industry Economics followed a similar estimation strategy and did not report a robust significant difference between these groups, controlling for other factors. Results using OLS are similar to those reported below using matching estimators which are discussed in greater detail below.

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<sup>1</sup> The interpretation of the coefficient on dummy variables when the dependent variable is in logarithmic form has drawn some discussion. Let  $c$  denote the coefficient estimated on a dummy variable in such a case. Here, we follow the traditional interpretation that when the dummy variable switches from 0 to 1, the dependent variable increases by  $100 * c$  percentage points. Halvorsen and Palmquist (1980) propose a correction that estimates the effect on the dependent variable to be  $100 * [\exp(c) - 1]$ . Kennedy (1981) proposes a further correction that takes into account the variance of  $c$ . In Kennedy's correction, the effect of interest is  $100 * [\exp(c - \frac{1}{2} \text{var}(c)) - 1]$ . Most recently Krautmann and Ciecka (2006) show that both the Halvorsen and Palmquist (1980) and the Kennedy (1980) corrections may be misleading

Table 7. Ordinary Least Square Estimates. Dependent variable: In R&D Investment (BERD).

	(1)	(2)	(3)	(4)	(5)
	Tax Concession	Tax Concession small firms	Tax Concession. No franked dividends	Tax Incentive	Tax Incentive small firms, no profit
Treated' (claiming subsidy dummy)	0.508*** (0.0189)	0.364*** (0.0194)	0.405*** (0.0213)	0.193** (0.0758)	0.924*** (0.176)
Other government finance (e.g., grants)	0.156*** (0.00361)	0.160*** (0.00362)	0.151*** (0.00388)	0.149*** (0.0151)	0.139*** (0.0250)
Turnover	0.141*** (0.00337)	0.0196*** (0.00299)	0.108*** (0.00339)	0.140*** (0.0133)	-0.00776 (0.0145)
Wages	0.0457*** (0.00258)	0.0669*** (0.00296)	0.0472*** (0.00285)	0.0622*** (0.0112)	0.0977*** (0.0136)
Industry controls	Y	Y	Y	Y	Y
Observations	32,354	24,810	25,191	2,147	699
R-squared	0.284	0.178	0.235	0.276	0.225



Propensity score matching provides a potentially stronger basis for evaluating program effectiveness than OLS. Propensity score matching involves matching firms that claim tax subsidies with similar firms that do not. Similar to OLS, the results from the matching analysis can only be interpreted as causal if there are no unobserved factors (factors not included in the matching algorithm) which determine treatment and also determine R&D investment. However, unlike OLS, matching estimates essentially only make comparisons between ‘similar’ firms, which reduces the potential for unobserved variables to influence the result. Because matching focuses on comparable firms, firms that are very dissimilar from all others are only given a small weight in the final result, whereas with OLS, all observations are weighted equally.

Let  $Y_{1i}$  denote the outcome (R&D investment or human resources devoted to R&D) for firm  $i$  if it receives the treatment and let  $Y_{0i}$  denote the outcome for the same firm  $i$  if it does not receive the treatment. The effect of the treatment would therefore be  $Y_{1i} - Y_{0i}$ . Of course, in the real world, we never get to observe both  $Y_{0i}$  and  $Y_{1i}$ , since each firm  $i$  either receives the treatment or does not, but cannot both receive and not receive the treatment at the same time. We therefore need a method for the imputation of these missing outcomes; for this, we rely on the propensity score matching estimator. This method first computes, for each observation, a propensity score, which is the likelihood that the observation receives the treatment, conditional on its pre-treatment characteristics. Rosenbaum and Rubin (1983) formally define the propensity score as:

$$p(X) = \Pr(\text{Treatment} = 1 \mid X) = E(\text{Treatment} \mid X) \quad (3)$$

Equation 3 states that the probability of treatment,  $p(X)$ , is equal to the probability that the treatment is received by an observation with characteristics  $X$ , and also equal to the conditional mean of  $\text{Treatment}$  given some values for  $X$ , which is referred to as  $E(\text{Treatment} \mid X)$ . If the propensity score is known, then we calculate the average treatment effect on the treated as:

$$\beta = E [ E \{Y_{1i} \mid D_i = 1, p(X_i)\} - E \{Y_{0i} \mid D_i = 0, p(X_i)\} \mid D_i = 1 ] \quad (4)$$

Where  $\beta$ , the average treatment effect for the treated, is the net effect of R&D tax subsidies on firms which receive them,  $D$  is a dummy variable denoting whether firm  $i$  has received the treatment or not,  $Y_{1i}$  is the R&D outcome for firm  $i$  if it receives the treatment (Incentive or Concession), and  $Y_{0i}$  is the R&D outcome for firm  $i$  if it does not receive the treatment.

The result is  $\beta$ , the average treatment effect on the treated, which informs us on what the net effect of the policy is. The key strength of propensity score matching is that, for a given propensity score, the assignment to treatment or control is essentially random, which is of central importance for causal

questions (see Becker and Ichiro, 2002). Importantly, we only match treated firms to untreated firms within the same two-digit industry code, which allows us to account for all industry-specific factors.

We compute the propensity score based on several dimensions: industry, turnover size, the wage bill and receipt of a government grant (R&D financed by State or Commonwealth Governments). In practice, this means that we are comparing R&D investment for firms which receive tax subsidies and firms which do not, with both types of firms being equally likely to be treated (as the propensity score, or probability of treatment, is the matching variable). We also only match firms within the same industry, which ensures that we are not matching, say, an aerospace engineering firm to a textile production firm simply because their turnovers, wages and R&D grants are similar. Intuitively, we would expect the two firms to be very poor counterfactuals for each other, despite being similar along other observable characteristics. Therefore, the within-industry matching allows for a stronger explanatory power of the matching estimates.

To implement the exact matching on industry and year, we first use the coarsened exact matching method of Iacus, King and Porro (2012) to prepare the sample. We then implement a standard propensity score matching procedure with bootstrapped standard errors. Table 9 displays the results obtained with propensity score matching estimation when R&D investment is the dependent variable. The *Treatment* variable is significant in all specifications. The parameter estimates on *Treatment* suggest an average treatment effect of 43.8 percent for the tax Concession sample (column (1)), which is slightly smaller than the average treatment effect obtained with OLS estimates (which was about 50 percent). Columns (2) present the results for small firms separately, defined here as firms with a turnover below 20 million. As observed previously, firms which do not pay franked dividends benefit more from tax subsidies and it is anticipated that they will exhibit greater policy response. However, this is not borne out by the data. As can be seen in column (3), the estimate for firms without franked dividends is marginally smaller than for the full sample. We interpret this as cautious support for the hypothesis that any efficacy of tax policy is not substantively diminished by the existence of the dividend imputation system. Column (4) presents the estimates for the impact of the Incentive policy in 2012 only. This is not significant at conventional levels though the coefficient is of similar magnitude to the OLS results and the lack of significance may reflect the lack of precision due to the smaller sample, which is supported by the difference-in-difference results presented in the next section. The results in column (5) cover the sample of firms that we anticipate benefiting the most from the R&D Tax Incentive – small firms with no profits. These firms receive a refundable offset of 45 percent as compared to no deductions at all in the absence of policy. The estimated treatment effect for these firms is considerably larger than the other samples.

Overall the variation between samples are not large and do not provide a great deal of additional insight into the effect. In light of the limitations of the matching approach we caution against reporting separate additionality values for each group of firms (small, no franked dividends etc). We are not aware of any strong a priori case that the Incentive and Concession policies should differ in their rate of additionality except in so far as they may induce different types of firms to claim.

**Table 9. Matching results: treatment effect. Dependent variable: ln R&D Investment (BERD).**

	(1)	(2)	(3)	(4)	(5)
	Concession	Concession Small firms	Concession No Franked Dividends	Incentive	Incentive Small & no profit
<i>Treatment</i>	0.438*** [0.026]	0.358*** [0.0292]	0.353*** [0.0307]	0.153 [0.109]	0.823*** [0.248]
Obs.	32,354	24,788	25,182	2,147	670
Untreated	6,553	5,066	5,331	515	64

\*\*\* significant at 1 per cent

We estimate representative additionality implied by our statistical estimate of the treatment effect for both the Concession and the Incentive scheme. While the estimated treatment effect of the Incentive scheme is only significant at 16 percent, we argue the magnitude has some illustrative value, particularly in the context of the significant difference-in-difference result, the OLS result and that the scheme appears to have a strong effect on the subsample used in column (5). We apply a simple counterfactual analysis using ABS BERD data to calculate the approximate additionality implied by the treatment effect reported above. Details of the method are outlined below.

The definition of the average treatment effect on the treated is that R&D expenditure in treated firms is  $\beta$  percent larger than the amount of R&D expenditure in untreated firms. The counterfactual R&D (what the R&D would have been in the absence of the policy) can be written as:

$$R\&D_{1|0} = \frac{R\&D_{1|1}}{(1+\beta)} \quad (5)$$

We estimate the tax revenue forgone as follows. For the R&D Tax Incentive note that the tax revenue forgone is given by:

$$T_{1|0} - T_{1|1} = \text{OFFSET} \times R\&D_{1|1} - \frac{\text{CTR}}{1+\beta} R\&D_{1|1} \quad (6)$$

where T are tax liabilities R&D is NPV of eligible R&D expenditure; CTR is the corporate tax rate; and, OFFSET is the value of the tax offset given by the R&D Tax Incentive program (either 40 percent or 45 percent). Using the equation (5) we can write:

$$T_0 - T_1 = \left( \text{OFFSET} - \frac{\text{CTR}}{1+\beta} \right) \times \text{R\&D}_{1|1} \quad (7)$$

We estimate tax revenue forgone for each firm in the sample using R&D data from the BERD making the simplifying assumption that all R&D is eligible. We do not model differences in firm's ability to benefit from the Incentive due to lack of taxable profits, the refundable offset or time costs of money associated with carry-forward/back. Time costs associated with allowable depreciation rates for capital type R&D expenditure is also not modelled. The implication of these assumptions is minimised since we focus on the difference in tax liabilities – the same assumptions are applied to the no policy case (the counterfactual with 100 percent deduction at 30 percent corporate income tax rate) and the policy case. Using ATO data could potentially improve these estimates, but the potential for incomplete data would need to be carefully considered and accommodated (since firms can carry forward and back claims and update their tax position ex-post). Carry forwards also introduces the complexity of discounting revenue forgone.

An analogous estimate for the R&D tax Concession shows that

$$T_0 - T_1 = \text{CTR} \left[ \left( \frac{1.25\beta + 0.25}{1+\beta} \right) * \text{R\&D}_{1|1} + 0.5\text{INC} \right] \quad (8)$$

Where  $\text{INC} = \max \left\{ \left( \text{R\&D}_{1|1} - \frac{1}{3} \sum_{t-1}^{t-4} \text{R\&D}_{1|1} \right), 0 \right\}$  is the component of R&D eligible for the incremental Concession (expenditure above a 3 year lagged moving average). For tractability we assume that INC is independent of treatment.

We arrive at an estimated additionality for the R&D tax Incentive Policy of approximately 0.8 dollars of additional R&D per dollar of revenue forgone. For the Concession, the estimated policy impact suggests an additionality of 1.7.

### ***Difference-in-difference***

The R&D Tax Incentive, introduced in 2012, is somewhat more generous than the R&D Tax Concession it replaced. The Tax Incentive comprises a 45 percent offset (rebate) for small companies (turnover less than \$20 million) and a 40 percent offset (rebate) for large companies (turnover greater than \$20 million). Under the Concession scheme firms could deduct 125 percent of eligible R&D spending and an additional 50 percent of expenditure over and above the average of the past three years (with a corporate income tax rate of 30 percent in 2011). For a hypothetical large firm increasing nominal R&D spend by 5 percent per year, the Incentive policy reflects an increase from about 8.9 cents on the dollar to 10 cents on the dollar. This figure is higher for small firms and firms that do not increase their R&D spend and smaller for firms that typically increase their R&D spend more than 5 percent per annum.

The policy change allows us to implement a difference-in-difference estimator. The difference-in-difference approach can provide a substantially stronger basis for evaluating the causal effects of policy than either propensity score matching or OLS. Difference-in-difference estimators do not rely on the assumption that there are no unobserved factors which determine both selection and R&D investment. Instead, difference-in-difference is based on what is known as the ‘parallel trends assumption’. The parallel trends assumption states that, even though claiming and non-claiming firms exhibit a different level of R&D investment (and this may be determined in part by unobserved factors which also determine the decision to register) it is plausible that they exhibit the same trend over time. That is, the assumption is that R&D investment by claiming and non-claiming firms move in parallel over time because they are subject to the same macro-economic conditions.

The difference-in-difference method reflects the change in outcome variable (R&D) exhibited by the treated firms over and above the change in outcome variable exhibited by the control group. In this case, the treated sample consists of 1256 firms which claimed the Concession in 2011 and the Incentive in 2012. The control group consists of 206 R&D active firms which do not claim any tax subsidy in either 2011 or 2012. Denoting R&D expenditure by firms in the control group by  $R\&D_{0|2011}$  and  $R\&D_{0|2012}$  and R&D expenditure by the treated group in 2011 and 2012 by  $R\&D_{1|2011}$  and  $R\&D_{1|2012}$ , respectively, then the difference-in-difference estimator can be written as:

$$(R\&D_{1|2012} - R\&D_{1|2011}) - (R\&D_{0|2012} - R\&D_{0|2011}) \quad (9)$$

For statistical inference, it is straightforward to derive the difference-in-difference estimate using a regression model given by:

$$R\&D_{it} = \beta_0 + \beta_1 Registered + \beta_2 Y2012 + \beta_3 (Registered \times Y2012) + u \quad (10)$$

Where *Registered* is a dummy for the firms registered for tax subsidies in both 2011 and 2012.  $\beta_1$  reflects the average difference in R&D spending between registered and unregistered firms in both years, *Y2012* is a period dummy and is equal to 1 in 2012 and 0 in 2011. The coefficient  $\beta_2$  reflects the average growth in R&D between periods. The coefficient of interest is  $\beta_3$  (the interacted term) which can equivalently be retrieved from a model of the form:

$$\Delta R\&D_i = \beta_3 Registered + \varepsilon \quad (11)$$

The latter model reflects the first difference transformation of equation (10) thereby controlling for individual fixed effects. Controlling for individual attributes does not impact on identification of the coefficient of interest, but can increase the efficiency (Angrist and Pischke 2009). Results for the

estimates are presented in table 10 below; column 1 presents baseline result (equation 11) and in column 2 additional time varying firm-level controls are added. These indicate that the transition from the Concession to the Incentive policy led to an increase in R&D spending of around 13 per cent for those firms which transitioned in 2012 and is statistically significant at the 5 per cent level.

**Table 11. Difference-in-difference estimates. Dependent variable: growth in R&D expenditure**

	(1)	(2)
Firms receiving R&D tax subsidies (Concession in 2011 and Incentive in 2012)	0.136** (0.0560)	0.126** (0.0558)
Growth in turnover		0.0246** (0.0114)
Growth in wages		0.0350*** (0.0125)
Grant		0.0424*** (0.0112)
Observations	1,462	1,462
R-squared	0.004	0.026

Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

The difference-in-difference results suggest that the introduction of the more generous R&D tax Incentive policy led to a 13.6 percent increase in R&D spending by the sample of firms registered in both 2011 and 2012. Using an analogous counterfactual type approach as described in the previous section we estimate the policy impact translates to 1.9 dollars of additional R&D invested per dollar of tax revenue forgone for the sample of firms. In this case, we use the difference between the estimated counterfactual R&D in 2012 (see equation 5) and recorded R&D in 2011 as a proxy for the share of R&D eligible for the augmented 175 percent Concession rate.

Observe that the estimate of 1.9 is considerably higher than the additionality for the same program estimated using the matching approach (which was 0.8 and not significant). We have no immediate explanation for this difference. It may simply reflect the lack of precision with which the treatment effect is estimated using matching. We also note also that the sample used for difference-in-difference include only firms which have R&D expenditure recorded in both 2011 and 2012 and omits firms which transition from claiming to not-claiming status (and visa-versa). We tentatively suggest that the difference-in-difference provides more confidence that the effect is causal, however, since the data used to derive the estimate exclude many claiming firms, we cannot claim that this is representative of the effect on all claiming firms. It would be valuable to investigate this difference more deeply, possibly including undertaking matching before performing the difference-in-difference estimates.

Recall that the assumption underlying the difference-in-difference approach to policy evaluation is that the trends in R&D expenditure by treated and untreated firms would move in parallel over time, in the absence of policy change. To provide some empirical support to this proposition we undertook a falsification test using data from the same sample of firms over the 2010 to 2011 period – that is, the years immediately prior to the policy shift. The falsification test effectively involves estimating the same model using the data for the same firms in the year that no policy shift occurred was introduced. The result indicates that the groups of firms do exhibit parallel trends between 2010 and 2011 (the coefficient on the interacted term is insignificant when the prior year data is used). This increases our confidence in the parallel trend assumption and therefore in interpreting our result as causal is valid.

We also undertook a regression discontinuity design (see for example Imbens and Kalyanaraman, 2012; Calonico *et al.*, 2014). The R&D Tax Incentive has a discontinuity for firms with a turnover above \$20 million – firms with annual turnovers over \$20 million are eligible to claim a 40 percent non-refundable tax offset, while firms with turnovers below \$20 million are eligible to claim a 45 percent refundable tax offset. The idea behind the regression discontinuity design we setup is that firms which are just above and just below the \$20 million cut-off are highly likely to be very similar in all respects other than in the benefit they get from tax subsidies. Unfortunately based on data available at the time of this study, only 43 firms were close enough to the size threshold for inclusion in the regression discontinuity design. While no significant effect could be isolated using these 43 firms, we believe this simply reflects the small number of observations available.<sup>2</sup> Results for the RDD are available from the authors on request.

There are a number of caveats to the estimates that should be discussed before concluding. The analysis focuses on the intensive margin. The difference-in-difference estimates relate only to the firms that were claiming for the Tax Concession in 2011 and the Tax Incentive in 2012. We estimate the additionality implied by the statistical estimates of policy impact using counterfactual type analysis based on a number of simplifying assumptions. For example, we assume all R&D is eligible, and we do not model loss making firms' differential ability to benefit from the Incentive due to the refundable offset or time costs of money associated with carry-forward/backwards. There is no strong reason to expect this would substantially change the estimated average additionality.

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<sup>2</sup> Goldberger (1972) observes that in order to generate the same explanatory power as a randomized controlled trial, which is the best scientific method for causal inference, regression discontinuity designs need 2.75 times as many observations.

## Conclusion

As R&D tax policies are entitlement schemes it is notoriously difficult to find a control group in order to estimate their impact. Using newly available comprehensive firm level data from the EABLD, made possible through new initiatives of the ABS, has allowed us to make important inroads in understanding the efficacy of the R&D tax subsidies in Australia.

We report a significant difference in R&D spending between firms that benefit from the tax subsidies and those that do not, controlling for other observable firm level characteristics comprising industry, turnover, wages and participation in other forms of government support. The most compelling evidence of a causal effect of policy comes from the difference-in-difference estimates. These suggest that firms which were claiming the R&D tax Concession in 2011 and benefited from the more generous R&D Tax Incentive in 2012 increased their R&D spending by approximately 14 per cent.

Our analysis suggests gross additionality in the range of 0.8–1.9, with our preferred approach fall toward the upper end of this range. Our estimated additionality falls within the range provided by the international literature and is quite close to Hall's (1993) seminal estimate that the US R&D tax credit in the 1980s induced around 2 dollars of additional R&D for every dollar of tax revenue forgone. In the estimates presented in this report, some firms in the sample had been claiming for many years, whereas others may be claiming for the first time. As such, the estimate can be thought of as a weighted average long-run and short-run effect.



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