REVIEW OF THE R&D TAX INCENTIVE

Response to the Consultation

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RESEARCH AUSTRALIA

AN ALLIANCE FOR DISCOVERIES IN HEALTH

ABOUT RESEARCH AUSTRALIA

Research Australia is an alliance of 160 members and supporters advocating for health and medical research in Australia. Research Australia's activities are funded by its members, donors and supporters from leading research organisations, academic institutions, philanthropy, community special interest groups, peak industry bodies, biotechnology and pharmaceutical companies, small businesses and corporate Australia. It reflects the views of its diverse membership and represents the interests of the broader community.

Research Australia's mission is to make health and medical research a higher priority for the nation. We have four goals that support this mission:

- A society that is well informed and values the benefits of health and medical research.
- Greater investment in health and medical research from all sources.
- Ensure Australia captures the benefits of health and medical research.
- Promote Australia's global position in health and medical research.

Nadia Levin
CEO & Managing Director
02 9295 8547
Nadia.levin@researchaustralia.org

www.researchaustralia.org
384 Victoria Street Darlinghurst NSW 2010

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Introduction

Research Australia welcomes the opportunity to make a submission in response to the Review Panel's report of its review of the R&D Tax Incentive Programme.

The R&D Tax Incentive Programme is a critically important component of the Australian Government's support for the commercialisation of research and development. In place in its current form since 2011, the Review has concluded that the Programme has many features that are recognised internationally as best practice, such as its focus on small to medium enterprises (SMEs).

While Research Australia recognises the need for the Australian Government to ensure the integrity of the R&D Tax Incentive Programme, and acknowledges the concern about the continued increase in the Programme's expenditure, any changes need to be made with an understanding of the economic ramifications and their potential impact on the Australian Government's broader objective of boosting the commercial returns on its investment in research.

Research Australia's interest is in how implementation of the Review Panel's recommendations would affect the commercialisation of health and medical research (HMR). Our ability to respond to the Report's recommendations has been hindered by a shortage of sufficiently detailed publicly available data about the R&D Tax Incentive Programme. In responding to Recommendations 3, 4 and 5 it would have been useful to have access to deidentified information about R&D expenditure based on companies' nominated Fields of Research, whether they are claiming for the refundable or non-refundable tax offset, and the anticipated value of expenditure. This information is collected in registration applications but is not made publicly available.

This data, without identifying companies, would assist stakeholders to understand the profile of the companies claiming the R&D Tax Incentive in different industry sectors, and to respond appropriately to the recommendations. Research Australia has also made a suggestion for some financial modelling of the effects of implementing Recommendations 4 and 5. Research Australia urges the Department to undertake this modelling and release both the modelling and further data as part of its response to the Review Panel's report in the next stage of the consultation process to enable high quality, considered advice from the sector.

Summary

The following is a summary of the submissions Research Australia makes in relation to each of the Review Panel's six recommendations.

Recommendation 1 **Retain the current definition of eligible activities and expenses under the law, but develop new guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses.**	Research Australia supports retaining the current definition of eligible activities and expenses. Research Australia submits that the potential impact on participants' confidence needs to be a primary consideration in any proposed changes to the R&D Tax Incentive. Research Australia supports the Review Panel's proposal for the development of new guidance, case studies and public rulings.
Recommendation 2 **Introduce a collaboration premium of up to 20 percent for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations. The premium would also apply to the cost of employing new STEM PhD or equivalent graduates in their first three years of employment. If an R&D intensity threshold is introduced (see Recommendation 4), companies falling below the threshold should still be able to access both elements of the collaboration premium.**	Research Australia shares the Review Panel's commitment to increasing Australian levels of R&D collaboration, and supports this recommendation. In addition to the collaboration premium, Research Australia submits consideration should be given to reduced requirements in the initial or subsequent registration process and/or the claims process for companies that are collaborating with publicly funded research organisations. Another incentive for companies that collaborate could be earlier access to Refundable R&D Tax Incentive payments. These measures provide the opportunity to provide incentives for collaboration that do not require additional Commonwealth expenditure.
Recommendation 3 **Introduce a cap in the order of $2 million on the annual cash refund payable under the R&D Tax Incentive, with remaining offsets to be treated as a non-refundable tax offset carried forward for use against future taxable income.**	Research Australia submits that a cap in the order of $2 million should not be applied to the annual cash refund payable under the R&D Tax Incentive where the company is seeking to commercialise HMR. Doing so has the potential to rob innovative Australian companies of the critical 'first to market' advantage in a globally competitive industry. Research Australia submits that exempting the commercialisation of health and medical research from the cap is administratively easy and would not substantially affect the total expenditure on the Programme, or make the Programme unsustainable.

Recommendation 4 **Introduce an intensity threshold in the order of 1 to 2 percent for recipients of the non-refundable component of the R&D Tax Incentive, such that only R&D expenditure in excess of the threshold attracts a benefit.**	Research Australia submits that an alternative approach would be to apply an R&D intensity threshold of 1 to 2%, but to pay the non-refundable R&D Tax offset on all the R&D expenditure of companies that exceed the cap. In this circumstance, only companies that failed to meet the threshold because they undertake relatively little R&D would be disadvantaged.
Recommendation 5 **If an R&D intensity threshold is introduced, increase the expenditure threshold to $200 million so that large R&D-intensive companies retain an incentive to increase R&D in Australia.**	Research Australia submits that financial modelling of the likely effect of Recommendations 4 and 5 would assist in evaluating the effect of these proposals on the behaviour of companies and the overall cost/saving to the Programme. This modelling should be undertaken and the results provided when the Australian Government provides its response to the Review's report.
Recommendation 6 **That the Government investigate options for improving the administration of the R&D Tax Incentive (e.g. adopting a single application process; developing a single programme database; reviewing the two-agency delivery model; and streamlining compliance review and findings processes) and additional resourcing that may be required to implement such enhancements. To improve transparency, the Government should also publish the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed.**	Research Australia submits that efforts to improve the administration of the Programme should be targeted at the refundable R&D Tax Incentive as this is where the bulk of registrations are made, the claims are smallest and where compliance costs are likely to be greatest as a percentage of the financial assistance provided. It is also where the greatest additionality is likely to be achieved by allowing more funds to be directed to R&D activities. Research Australia submits that in considering the design of the registration and claims processes for the R&D Tax Incentive, consideration should be given to reduced requirements in the initial or subsequent registration process and/or the claims process for companies that are collaborating with publicly funded research organisations. Research Australia supports the publication of the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed.

Recommendation 1

Retain the current definition of eligible activities and expenses under the law, but develop new guidance, including plain English summaries, case studies and public rulings, to give greater clarity to the scope of eligible activities and expenses.

Research Australia supports retaining the current definition of eligible activities and expenses.

Research Australia is mindful of how important it is that potential beneficiaries of the R&D Tax Incentive are able to be confident of its continued availability and have certainty about the benefits it will deliver. This is crucial for a scheme that requires an investment by companies in anticipation of a future tax benefit. Uncertainty about whether the benefit will be available can adversely affect decision making and mean that R&D activities are reduced, are not undertaken at all, or are undertaken elsewhere.

Innovation Australia has previously clearly articulated the importance of policy stability in this area and the potential negative consequences of policy instability.

> *Innovation Australia emphasises the critical importance of having consistency in government policies, particularly incentives designed to encourage businesses to innovate and to improve their productivity and growth trajectory. The constant churn in policies with the electoral cycle prevents the continual improvement of programs, and, more importantly encourages business to take any incentives offered as 'windfalls' which undermines the dominant purpose of the incentives, which is not to channel funds to firms that are already innovative, but to influence firms to become more innovative.* [1]

The R&D Tax Incentive has only existed in its current form since 2011, and has already been the subject of changes to the rates of the tax offsets and a cap on the non-refundable component.

Research Australia concurs with the Review's conclusion that the Programme has not yet operated for long enough to be able to make a proper assessment of how successful it is, and that no change to the definition of eligible activities and expenses should be made without clear justification for doing so.

Research Australia submits that the potential impact on participants' confidence needs to be a primary consideration in any proposed changes to the R&D Tax Incentive.

A more comprehensive assessment of the economic benefits of the R&D Tax Incentive will only be possible when the scheme has been in place for a longer period. Any significant amendments to the R&D Tax Incentive should be considered upon completion of such an investigation.

Research Australia shares the Review Panel's interest in protecting the integrity of the Programme and in reducing registration and claim costs for participants.

Research Australia supports the Review Panel's proposal for the development of new guidance, case studies and public rulings.

Recommendation 2

Introduce a collaboration premium of up to 20 percent for the non-refundable tax offset to provide additional support for the collaborative element of R&D expenditures undertaken with publicly-funded research organisations. The premium would also apply to the cost of employing new STEM PhD or equivalent graduates in their first three years of employment. If an R&D intensity threshold is

[1] Innovation Australia, Submission to the Financial System Inquiry Interim Report, 26 August 2014, p.2

introduced (see Recommendation 4), companies falling below the threshold should still be able to access both elements of the collaboration premium.

Research Australia shares the Review Panel's commitment to increasing Australian levels of R&D collaboration, and supports this recommendation.

Collaboration needs to be supported and encouraged, and barriers to collaboration need to be reduced. This requires a research culture, funding models and organisational structures that better facilitate, support and reward collaboration, both nationally and internationally.

In addition to the collaboration premium, Research Australia submits consideration should be given to reduced requirements in the initial or subsequent registration process and/or the claims process for companies that are collaborating with publicly funded research organisations. Another incentive for companies that collaborate could be earlier access to Refundable R&D Tax Incentive payments. These measures provide the opportunity to provide incentives for collaboration that do not require additional Commonwealth expenditure.

Recommendation 3

Introduce a cap in the order of $2 million on the annual cash refund payable under the R&D Tax Incentive, with remaining offsets to be treated as a non-refundable tax offset carried forward for use against future taxable income.

Research Australia notes the following reasoning provided in the report for this recommendation.

> *'The considerable growth in the cost of the refundable component is, however, impacting the programme's long-term sustainability. Refundability is likely to provide fewer tangible benefits for SMEs with larger R&D expenditures, who will be* ***more able to find alternative sources of finance at relatively lower costs in comparison with firms with lower R&D expenditure.*** *The panel finds that placing a cap on the amount of cash refund that can be received, for example, at $2 million would maintain strong cash-flow support for SMEs up to that limit, while improving the sustainability of the programme. While refunds would be capped, any remaining entitlement to a tax offset through the programme would be carried forward and able to be offset against any future tax liability.*

Research Australia is focused on health and medical research (HMR) and its commercialisation. Relative to many other sectors, the commercialisation of health and medical research into new drugs, therapies diagnostics and devices is highly research intensive. This R&D activity is characterised by:

- relatively longer timeframes, because the scientific and regulatory hurdles to market are greater and take longer to overcome; and
- relatively higher expenditure on R&D, particularly in later stages with activities like clinical trials.

While a typical firm spending in excess of $4.5 million per year on R&D (roughly equivalent to the expenditure required to reach the proposed cap of $2 million) might be expected to be relatively large and have significant assets and revenues, this is much less likely to be the case when it comes to the commercialisation of HMR by an early stage SME where the company's only asset is likely to be the intellectual property it is seeking to develop; its sole activity is R&D; and it frequently has no revenue.

Research Australia submits that such a company is not, in fact, '*able to find alternative sources of finance at relatively lower costs in comparison with firms with lower R&D expenditure*.'

Innovation Australia has previously made the following observations in respect of Australia's innovative SMEs and access to capital.

> *The mechanisms for providing growth capital to new, early-stage and rapidly growing SMEs in Australia are deficient, particularly in relation to technology-based and other innovation intensive opportunities (this stands in marked and largely unexplained contrast to the skill, experience and willingness of the Australian market to provide risk- capital to mining exploration or start-up ventures)…*
>
> *In the circumstances where provision of venture capital currently appears to be adequate, it is often narrowly focused on fast-moving, software-based and web-mediated innovation that is disruptive to existing businesses and business models.*
>
> *Major economically and socially important areas of innovation that are linked to the national R&D effort and have larger capital requirements and longer development cycles (e.g. biotechnology, new materials, new manufacturing, energy efficiency) continue to be starved of capital.*[2]

Research Australia supports this assessment, and while we are hopeful that success in commercialising Australian HMR will lead to a deeper and more sophisticated venture capital sector in Australia in the future, at present alternative sources of finance are not readily available to companies seeking to commercialise HMR. This has been recognised by the Australian Government, which has created the Medical Research Future Fund (MRFF) and the Biomedical Translation Fund (BTF) specifically to help provide financial support to the sector for early and later stage R&D respectively. However, these new funds will take time to permeate within the system and will not mitigate the current barriers in the short to medium term. It is important to note both these funds will complement and reinforce (rather than supplant) the refundable R&D Tax Offset. Capping the refundable R&D Tax Offset available to SMEs to commercialise health and medical research will potentially reduce the effectiveness of programs such as the MRFF and the BTF.

The Financial System Inquiry conducted for the Australian Government in 2014 found that venture capital markets are underdeveloped in Australia relative to other nations, and that SMEs have *'few options for external financing outside the banking system compared with large corporations.*[3] SMEs that are trying to commercialise HMR are likely to be without revenue for many years and therefore have little or no capacity to service debt, meaning the banking system is not, in fact, a viable option. The Inquiry's only substantive recommendation to assist SMEs was to facilitate the crowd sourced equity funding for SMEs. While the Government has acted on this recommendation, crowd sourced equity funding is still in its infancy.

Research Australia submits that a cap in the order of $2 million should not be applied to the annual cash refund payable under the R&D Tax Incentive where the company is seeking to commercialise HMR. Doing so has the potential to rob innovative Australian companies of the critical 'first to market' advantage in a globally competitive industry.

The application of this cap will materially affect the ability of many companies to successfully commercialise their HMR. Even if the cap was only to have the effect of lengthening rather than stopping the R&D process, this has the potential to rob many Australian innovative companies of the 'first to market' advantage.

Research Australia notes that the argument advanced by the Report for the introduction of the cap is that the growth in the refundable R&D Tax offset is 'unsustainable'. While there is no publicly available data on the refundable R&D Tax Incentive by the Field of Research, data is available for the R&D Tax Incentive Programme overall. In 2014-15, companies nominated $18.4 billion in R&D expenditure in relation to the R&D Tax Incentive. Of this, $1.01 billion related to R&D activity that falls broadly in the classification of HMR (Medical and Health Sciences, $855.19 m.; Biological Sciences $154.49 m.; and Psychology and Cognitive Sciences $1.87m.)[4]

With HMR related R&D expenditure accounting for only around 5.5% of total R&D expenditure, exempting HMR-related commercialisation from the refundable R&D Tax Offset cap would have little impact on overall

[2] Innovation Australia, Submission to the Financial System Inquiry Interim Report, 26 August 2014, p.8
[3] Financial System Inquiry, Final Report, November 2014, p.14, 15
[4] Innovation Australia 2014-15 Annual Report Figure 2.3: Field of Research (data set)

expenditure on the Programme. It would also be administratively relatively easy to do, as AusIndustry already collects the Field of Research information needed to determine whether the cap should be applied.

Research Australia submits that exempting the commercialisation of HMR from the cap is administratively easy and would not substantially affect the total expenditure on the Programme, or make the Programme unsustainable.

The particular characteristics of the commercialisation of HMR (long time frames, relatively high expenditure, lack of revenue) provide a basis for treating the commercialisation of HMR as a special case. This claim to special treatment is further reinforced by the strategic importance of the sector to the future of the Australian economy, recognised by the Australian Government's decision to nominate Medical Technologies and Pharmaceuticals as an industry sector of competitive strength and strategic priority under its Industry Innovation and Competitiveness Agenda.

Case Study- what does Australian success in commercialising HMR look like and how long does it take?

Three large Australian health companies- CSL, Cochlear Limited and CSL - are often cited as examples of Australian innovation.[5] The path to success of these three companies is instructive.

CSL was initially an Australian Government owned enterprise, created in 1916, before it was incorporated in 1991 and listed on the ASX in 1994[6]. (CSL has a current Australian market capitalisation of approximately $48 billion.)

Cochlear Limited took nearly 25 years from the commencement of research to its listing on the Australian stock exchange. Its initial research was supported by philanthropy and the Australian Government was a significant investor in the company in the 1980's.[7] (Cochlear Limited has a current Australian market capitalisation of approximately $8 billion.)

Resmed is based on research initiated at the University of Sydney in the early 1980's. It initially received funds from the US health care company Baxter which later withdrew as an investor, and was formed as a company in 1989, approximately six years before listing on NASDAQ and a decade before it listed on the ASX. (Resmed has a current Australian market capitalisation of approximately $12 billion.)

Recommendation 4

Introduce an intensity threshold in the order of 1 to 2 percent for recipients of the non-refundable component of the R&D Tax Incentive, such that only R&D expenditure in excess of the threshold attracts a benefit.

Research Australia accepts the rationale for this recommendation- i.e. that the R&D Tax Incentive is intended to encourage additional R&D, and not to reward R&D that would be undertaken otherwise. Establishing a threshold to be met as a ratio of R&D expenditure to total expenditure is a reasonable approach, resulting in

[5] For example, at the outset of the Financial System Inquiry, then Assistant Treasurer Senator Sinodinos said that the Inquiry could look to identify 'gaps in the capital market for innovation' and identified three Australian success stories: CSL, Cochlear Limited and Resmed, and indicated that he wanted more of them. Sinodinos says government keen to unlock funds for innovation, The Australian, 27 November 2013

[6] http://www.csl.com.au/about/history.htm

[7] http://www.cochlear.com/wps/wcm/connect/au/about/company-information/history/history

companies that do not spend at least 1 to 2% of their total expenditure on R&D will then be ineligible for the non-refundable R&D tax incentive.

Research Australia is concerned, however, with the effect that this will have on the more research intensive companies that exceed the 2% threshold, which will be penalised by the loss of the R&D tax offset on the first 1 to 2% of their R&D expenditure. If Recommendation 5 is adopted, revenue saved by this measure will be used to increase the expenditure threshold to $200 million. Effectively, expenditure on the R&D Tax Incentive will be transferred from small to medium businesses to large businesses. This appears to be **contrary** to the research referred to in the Review's initial Issues Paper which suggests that the greatest additionality is achieved by providing incentives for smaller rather than large companies.

Research Australia submits that an alternative approach would be to apply an R&D intensity threshold of 1 to 2%, but to pay the non-refundable R&D Tax offset on all the R&D expenditure of companies that exceed the cap. In this circumstance, only companies that failed to meet the threshold would be disadvantaged.

Research Australia's ability to comment in more depth on this recommendation is limited by a lack of data on R&D expenditure patterns and claims for the R&D Tax Incentive, which would enable detailed modelling of the impact of the Review's proposed recommendation and Research Australia's alternative proposal.

Recommendation 5

If an R&D intensity threshold is introduced, increase the expenditure threshold to $200 million so that large R&D-intensive companies retain an incentive to increase R&D in Australia.

The Review report indicates that approximately 25 very large companies are affected by the existing $100 million expenditure threshold, but does not provide any further information about these companies such as the industries in which they operate, the nature of the R&D for which they make claims, or whether they are Australian or overseas companies.

There are a number of questions that need to be addressed before these recommendations can be properly evaluated. For example, the maximum additional benefit to the 25 or so large companies (assuming they all claimed the full $200 million) would be approximately $250 million. What would be the saving achieved by not paying the non-refundable tax offset to all companies for the first 1 to 2% of R&D?

What would be the saving achieved by Research Australia's alternative outlined in response to Recommendation 4?

If the non-refundable tax offset is not paid to companies that fail to meet the R&D threshold of 1 to 2%, what impact does this have on the number of registrations and claims made, and the cost of administering the Programme?

Research Australia submits that financial modelling of the likely effect of Recommendations 4 and 5 would assist in evaluating the effect of these proposals on the behaviour of companies and the overall cost/saving to the Programme. This modelling should be undertaken and the results provided when the Australian Government provides its response to the Review's report.

Recommendation 6

That the Government investigate options for improving the administration of the R&D Tax Incentive (e.g. adopting a single application process; developing a single programme database; reviewing the two-agency delivery model; and streamlining compliance review and findings processes) and additional resourcing that may be required to implement such enhancements. To improve

transparency, the Government should also publish the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed.

Research Australia supports the proposal to investigate options for improving the administration of the R&D Tax Incentive.

In our submission in February 2016 to Innovation Australia in response to the R&D Tax Incentive Issues Paper, Research Australia proposed an approach to simplifying the administration of the Programme which is reproduced below.

One way to improve the effectiveness of the R&D Tax Incentive would be to reduce the compliance costs associated with registering for and claiming the R&D Tax Incentive. The Issues Paper refers to estimates by CIE that the compliance costs for participating firms were around $437 million per annum. This figure represents around 14% of the total value of benefits provided by the scheme in 2013-14. These costs appear to be a suitable target for efforts to improve the effectiveness of the scheme. Understanding how and where these costs could be reduced requires a more detailed analysis than is provided in the Issues Paper, including:

- whether costs are significantly higher in the first year due to the initial registration process.
- whether costs differ between the refundable and non-refundable schemes, and why. It is possible, for example, that larger firms with significant production activities incur greater costs in segregating R&D expenses from the normal costs of production.
- the division of costs between the registration process (AusIndustry) and claiming the R&D Tax Incentive from the ATO.
- the costs associated with separating core and supporting activities.
- the extent to which costs associated with substantiating claims for R&D activities are additional costs to those that would be incurred anyway in the normal course of undertaking R&D activities. It is reasonable to expect, for example, that any experimentation and development activities would be documented together with the expenditure on various items, and that documentation relating to these activities would be retained even in the absence of the R&D Tax Incentive.

Research Australia submits that efforts to improve the administration of the Programme should be targeted at the refundable R&D Tax Incentive as this is where the bulk of registrations are made, the claims are smallest and where compliance costs are likely to be greatest as a percentage of the financial assistance provided. It is also where the greatest additionality is likely to be achieved by allowing more funds to be directed to R&D activities.

Research Australia shares the Review Panel's commitment to increasing the levels of R&D collaboration, and collaboration with a publicly funded research organisation provides some assurance that the R&D is genuine and will have spillover benefits.

Research Australia submits that in considering the design of the registration and claims processes for the R&D Tax Incentive, consideration should be given to reduced requirements in the initial or subsequent registration process and/or the claims process for companies that are collaborating with publicly funded research organisations.

Research Australia understands the Review Panel's concern to assure the integrity of the Programme and appreciates that compliance activities must be balanced with the additional costs imposed on the Programme's administrator and participants.

As a general principle, the cost of compliance imposed by the R&D Tax Incentive scheme should be proportionate with the potential losses to the scheme arising from non-compliance. In 2013-14, 72% of all claims for the refundable tax offset related to R&D expenditure of less than $500,000 and only 1% related to

claims for R&D expenditure in excess of $5 million. Conversely, 23% of claims for the non-refundable tax offset related to research expenditure of less than $500,000 and 21% of claims related to R&D expenditure in excess of $5 million.[8] In the absence of specific indications of non-compliance, compliance activities should be directed at the larger claimants.

Research Australia welcomes the Review Panel's arguments in favour of greater transparency and supports the publication of the names of companies claiming the R&D Tax Incentive and the amounts of R&D expenditure claimed.

Conclusion

Research Australia is pleased to have had this opportunity to respond to the Review of the R&D Tax Incentive Programme. This Programme is a cornerstone of Commonwealth support for the commercialisation of Australia's excellent research. To some extent, the Programme has been the victim of its own success, with expenditure exceeding forecasts, and yet it is still too early to make an accurate assessment of the overall contribution the Programme is making and can make to Australia's necessary ambition to be a successful, modern knowledge based economy.

A key opportunity for the nation is capitalising on the contribution that HMR can make to GDP. In this context, Research Australia urges caution in making changes to the Programme which might lead to short term gain in reductions in Programme expenditure, but do longer term damage to our **fragile innovation environment.**

Research Australia reiterates the importance of making further data about the Programme publicly available and of undertaking further modeling of the Review's recommendations to ensure risk assessed and considered advice can be provided from this significant sector, as key contributors to enabling longer term economic stability for the nation.

Research Australia looks forward to the Government's response to the Review's recommendations and the feedback received as part of this consultation process.

Research Australia would be pleased to assist in any way we can.

[8] Innovation Australia Annual Report 2014-15 Figure 2.4, p. 25

RESEARCH AUSTRALIA LIMITED
384 Victoria Street, Darlinghurst NSW 2010
P +61 2 9295 8546 **ABN** 28 095 324 379
www.researchaustralia.org