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A submission to the

Review of Australia's Tax System

Prepared by Pfizer Australia

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Disclosure

This submission has been prepared by Pfizer Australia—a wholly owned subsidiary of Pfizer Inc., based in New York. Pfizer Australia is this county's largest manufacturer of prescription medicines, with sales exceeding $1 billion and combined exports worth a further $830 billion a year. We employ a total of 1,700 people around Australia. In 2008, we invested approximately $50 million in Australian R&D.

We have 452 products, used chiefly for the treatment of:

- cancer
- chronic diseases—such as diabetes, arthritis and heart conditions
- factors which increase the risk of heart disease—such as high blood pressure and high cholesterol
- mental illness—including depression, schizophrenia, anxiety and panic disorders
- neurological conditions—epilepsy, Parkinson's disease and Alzheimer's disease
- eye problems—such as glaucoma
- HIV/AIDS
- erectile dysfunction

Other products include:

- medicines to help people stop smoking
- anti-inflammatory medicines to reduce pain
- oral contraceptives
- anti-infective medicines including antibiotics and antifungals
- hormone replacement therapies
- anti-coagulants to prevent blood clotting.

The bulk of our medicines are reimbursed by the Australian Government through the Pharmaceutical Benefits Scheme (PBS). We are also recipients of $10 million over five years from the Australian Government's Pharmaceutical Partnerships Program (P3).

Pfizer Australia is a member of Medicines Australia—the peak industry body for the innovative medicines industry in Australia.

We have no connections with any members of the Review Panel.

For further information…

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Tax the global pharmaceutical industry

Pfizer Australia has prepared this submission to encourage the Australian Government to make this country a more attractive location pharmaceutical and bioscience investment.

The Australian pharmaceutical industry contains around 50 manufacturers and 470 biotechnology firms. It has a total turnover exceeding $18 billion a year, and is Australia's second largest manufacturing exporter with exports worth $3.9 billion in 2007. The industry employees around 40,000 people directly and indirectly.

We anticipate a substantial reduction of this research and manufacturing activity within five years and little opportunity for recovery without government action—in particular, recovery will depend on a re-direction of Australia's tax system so that it encourages more international investment. Tax reform is also needed to help grow Australia's fledgling biotherapeutics industry, so that it can link with the global pharmaceutical industry.

The global pharmaceutical industry is at a crossroads. By 2012, major pharmaceutical companies—which support the bulk of manufacturing and R&D worldwide—will face the expiry on patents worth $100 billion worldwide. While long-term product pipelines are solid, the period 2010–15 will be a period of contraction for the global pharmaceutical industry. Other pressures currently on the industry include:

- increasing costs and duration of drug development
- falling R&D productivity
- the rise of new technologies
- the increasing ability of smaller companies to capitalise on their intellectual property without first having to commercialise a product, and
- increasing competition from generic medicines when patents expire.

Another factor transforming the industry is the declining number of new 'small molecule' medicines which have driven the industry's growth in the last fifty years, and the rise of 'biologics' (an area of potential strength for Australia).

Over the next decade, these pressures on the global pharmaceutical industry are expected to result in:

- centralisation of manufacturing operations globally
- discovery of new medicines to be (1) conducted either close to head offices in Europe and the USA or (2) purchased from external sources, particularly small biotherapeutics firms
- drug development will be conducted wherever cost, quality and speed are most attractive globally—not automatically in developed Western nations.

Because the bulk of Australia's R&D funding and manufacturing operations is conducted by subsidiaries of multinational pharmaceutical companies, this country is particularly exposed to all three changes above. For example:

1. The Australian industry has invested comparatively little in manufacturing infrastructure over the past two decades, with the result that current operations are easy for multinational companies to transfer offshore.
2. The Australian biologics industry is substantially under-resourced and consequently has a poor track record of commercialising products. Companies lack sufficient capital to bring discoveries to maturity, and so go to market too early to attract the interest of multinational companies.
3. Clinical trials—essential for establishing the safety and effectiveness of new medicines—are increasingly globalised. There has been a massive growth in the number of trials conducted in China, South America and Eastern Europe, chiefly at the expense of developed Western nations. At its current rate of growth, China will conduct more clinical trials than Australia within just two years, having started from a base of virtually zero five years ago. While the quality of Australian work remains high, it is more expensive than an increasing number of equally-qualified competitors. In Australia, industry supported nearly 85% of clinical trials conducted in 2007. This is a far higher proportion than most other countries, where universities and independent institutes play a larger role. This leaves Australian researchers very exposed if industry decides to transfer R&D offshore.

There are a number of factors which have lead the Australian industry's current position, but three crucial ones are (1) Australia's comparatively high corporate tax rates, which discourage large investments in manufacturing, (2) the current scheme of 'below-the-line' tax rebates for R&D, which provides no incentive for either major multinational firms nor small, start-up Australian firms, (3) the requirement of past governments to provide short-term increases in R&D activity in return for financial support, but no incentive to sustain long-term investments in Australian research or manufacturing.

One recent decision which we believe will be particularly damaging to Australian industry was the abolition of the Commercial Ready scheme in the 2008 Budget. This provided important support for start-up biologics firms—one of the areas where the global pharmaceutical industry is increasingly looking for new products. The loss of the Commercial Ready scheme will reduce the already-strained commercial viability of small Australian firms, and further reduce the international investments in Australia.

For these reasons, Pfizer Australia strongly urges the Review of Australia's Tax System to recommend:

(1) reducing Australia's corporate tax burden to a level that is competitive to this country's competitors, in order to encourage substantial investment in manufacturing,

(2) tax holidays for major programs in national priority areas, as identified by the Cutler Review

(3) replacing the current system of tax rebates for research and development with 'above the line' incentives for investment in all parts of the R&D chain (from initial discovery, through clinical trials, to commercial development).

All of these have been raised in other inquiries commissioned by the Rudd Government—in particular, the Cutler Review of the National Innovation System, and also by the Pharmaceutical Industry Strategy Group (PISG). But, while acknowledging the importance of tax settings to investment and viability of the Australian industry, these reviews have ruled the issue outside their scope. We urge the Australian Government to adopt these changes because, without the, **we sincerely believe that Australia could lose:**

- **much of the pharmaceutical investment built over the last 20 years**
- **the opportunity to grow an globally significant biotherapeutics industry with strong links to the international medicines industry.**

International leaders in pharmaceutical investment

Before we outline the changes that Pfizer Australia recommends to Australia's taxation system, we want to outline the strategies taken by Singapore and Ireland, which are now world centres for the pharmaceutical and biosciences industries.

Singapore

For the last decade, Singapore has pursued pharmaceutical investment aggressively. For instance, the Singapore Government will pay up to 30% of the cost of new facilities. Coupled with Singapore's low corporate tax rate, the country has now attracted most multinational pharmaceutical manufacturers. Along with Pfizer, GlaxoSmithKline, Aventis, Schering Plough, Wyeth, Merck, and Novartis all have plants in Singapore. We estimate this investment at $A1.5 billion—including around $A800 million in manufacturing infrastructure. Sales are worth roughly $A15 billion a year. The Singapore Government's goal is $SD25 billion ($A20 billion) a year by 2015.

In the wake of manufacturing investment has followed a substantial research program—centred on Singapore's 'Biopolis': a 18.5 hectare research complex. Income from manufacturing also supports substantial investment in training. For example, in 2005 alone, A*Star—the Singapore Government's agency for science and technology investment—offered $286 million in PhD scholarships in biomedical science. These sorts of investments and infrastructure have allowed Singapore to attract top development firms and researchers.

The rise of Singapore in global pharmaceutical manufacturing has been directly at Australia's cost.

In the late 1990s, Pfizer Inc. began looking to build a new global manufacturing hub to produce the bulk of active ingredients for its medicines.

Active ingredients are the major value-add in pharmaceutical manufacturing. In Pfizer, this is only done in a handful of plants around the world. The bulk of our manufacturing plants—including all of those in Australia—create only inactive ingredients or else assemble components. In the 1990s, Pfizer Inc. had one major manufacturing hub—

Ireland—and other plants across Western Europe and North America being progressively closed.

By 1999, Pfizer Inc. had narrowed potential new sites globally to Australia and Singapore. Both countries had a highly skilled workforce, high manufacturing standards, and excellent infrastructure. Australia would have been the cheaper site to manufacture medicines. To encourage Pfizer to invest, the Victorian Liberal Government was prepared to provide a site for the new plant in Melbourne, and it also sent a delegation to Pfizer's headquarters in New York. The chief barrier to investment was taxation. Essentially, the Australian Government was not prepared to match Singapore's corporate tax rate (20%), and did not feel that it should be in the business of 'picking winners'.

The result was that the plant was built in Singapore. Pfizer Inc. invested $SD350 million. The plant opened in July 2004, manufacturing active ingredients for just two products:

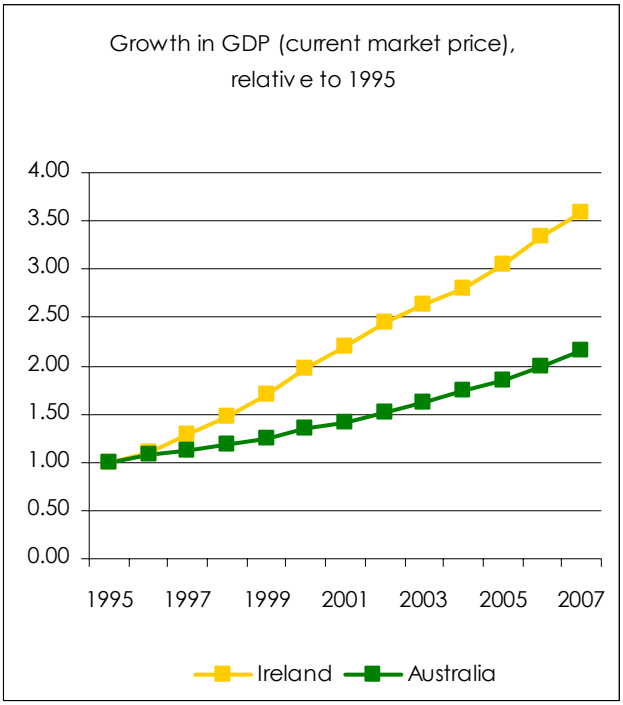
- gabastin (used in Neurotin®) worth $US2.6bn ($A4.2bn) in global sales in 2004
- pregabalin (used in the painkiller Lyrica®) worth $US2.7b ($A4.4bn) in 2004.

To put these figures in context: the value-add of the entire Australian medicines industry in 2004 was $A1.7billion[1], and total sales worth $A7.0 billion.

Since 2004, Pfizer Inc. has doubled the size of its Singapore plant.

Ireland

Between 1995 and 2007, Ireland went from the country with the lowest GDP per capita in the European Union to the highest. The graph below compares the GDP of Ireland and Australia in current prices, indexed to 1995 levels.



[1] ABS (2006) *Manufacturing Industry: Australia*. ABS No. 8221.0. Canberra: ABS.

The pharmaceutical industry was one of the major sectors that contributed to Ireland's growth. It currently generates around €30 billion ($A50 billion) in exports each year—roughly 40% of Ireland's entire manufacturing activity. It also pays more corporate tax than any other sector of the Irish economy. Most multinational pharmaceutical companies have facilities in Ireland—including Pfizer, Allergen, Bristol-Myer Squibb, Eli Lilly, Genzyme, GlaxoSmithKline, Janssen, Merck Sharp & Dohme, Novartis, Ranbaxy, Roche, Schering-Plough, and Wyeth. Pfizer itself has six manufacturing sites as well as a Corporate Bank and a European Financial Shared Services Centre in Ireland.

Key initiatives of the Irish Government that helped achieve this level of investment were:

- reducing corporate tax rates to 10-12.5%
- substantial investment in infrastructure and the Irish educational system
- provision of investment capital and large subsidies to encourage major companies to relocate to Ireland.

Australia and the future

The anticipated contraction in the global pharmaceutical industry in the next 7-8 years means that the world will not see the establishment of major pharmaceutical hubs like Singapore and Ireland in the next decade. And the differences between Australia, Ireland and Singapore that mean their strategies cannot be applied directly in this country—Singapore was impelled to invest in high-tech industries because it lacks natural resources of the type that have underpinned the Australian economy; while Ireland had substantial support from European Union subsidies. But there are lessons from both Ireland and Singapore that Australia could learn from, in order to:

- build its biotherapeutics industry
- retain the investment built up over the past 20 years—despite the global contraction
- secure continuing investment in Australian bioscience, clinical trials and the health sector.

The various reviews ordered by the Rudd Government have recommended many of the same initiatives that propelled Singapore and Ireland to global status:

- physical infrastructure for R&D
- integration of research agencies
- support for publicly-funded science agencies and universities
- investment in education
- support for researchers in their early and mid-careers.

The last major outstanding issue that requires attention, in order to attract and retain pharmaceutical investment, is Australia's tax system. Pfizer Australia recommends that Australian Government:

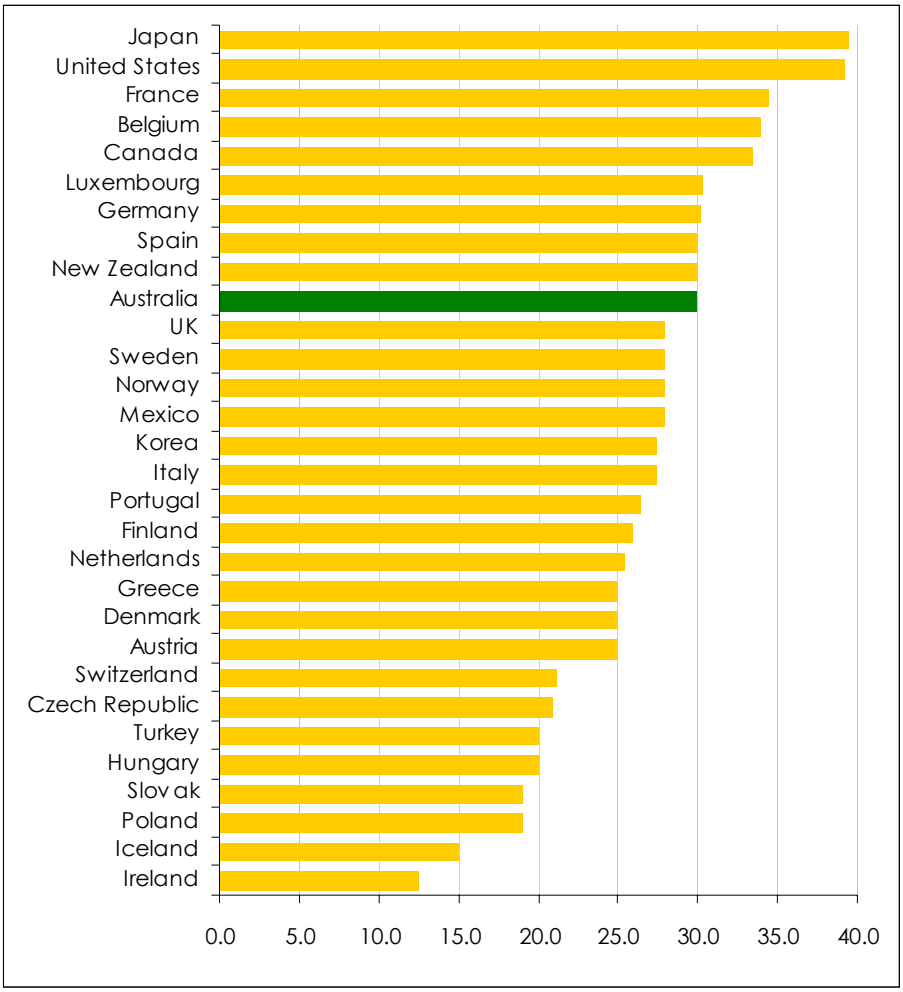
1. **reduce the corporate tax burden to levels that are competitive with Australia's competitors—particularly those emerging outside the OECD, such as China, East Asia, India, South America and Eastern Europe—to encourage investment**
2. **introduce a program of targeted tax holidays in national priority areas—in which we would put the biotherapeutics and pharmaceutical industries**
3. **replace 'below-the-line' R&D tax rebates with 'above-the-line' incentives.**

Manufacturing and corporate tax

The first major area where tax policy affects international investment by the pharmaceutical is the overall corporate tax burden.

It is obviously difficult to compare different countries tax burdens, because they are made up of many components. However, a few key figures together illustrate that Australia's tax settings are falling behind those of our competitors and provide a disincentive for investment here.

First, Australia's effective corporate tax rates are far higher than its competitors for international pharmaceutical investment. The graph below shows the combined central and sub-central corporate income tax rates for OECD countries in 2008.

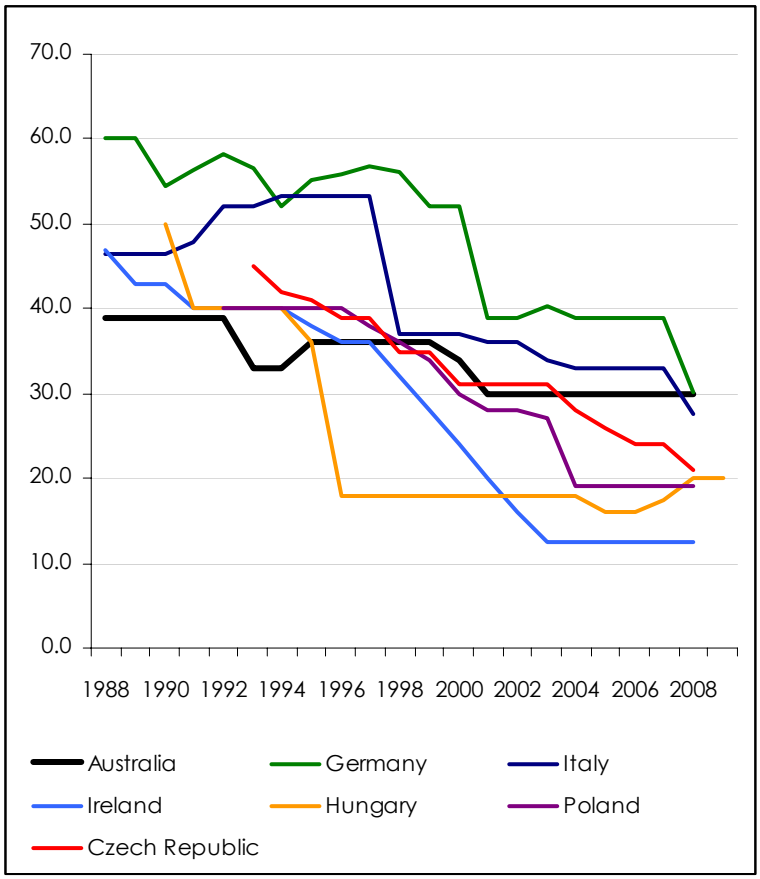


The figures above refer only to OECD countries. But, in the case of the pharmaceutical industry, competition for international investment in manufacturing is increasingly coming from *outside* OECD countries. Rapidly growing centres are:

- Eastern Europe (shown in the graph above)—tax rates are 19-21%

- China—the general corporate tax rate is 33%, but 24% for enterprises located at the coastal cities or 15% for those located at the Special Economic Development Zone
- India—effective corporate tax rate of 34% for domestic companies and 41% for foreign companies.

Second, other economies have cut their rates faster that Australia over the last two decades, leaving this country comparatively disadvantaged. The graph below shows the combined central and sub-central corporate income tax rate for two traditional European centres of pharmaceutical manufacturing (Germany and Italy), one of the global hubs (Ireland), and three Eastern European growth economies (Hungary, Poland and the Czech Republic). As the graph shows, Australian corporate tax rate is significantly higher than growth areas, and even major Western economies have cut their once far higher rates to levels at or below Australia's.



The figures above refer only to the corporate tax rate, as this is readily obtainable and comparable. But out concern is really with the *overall* tax burden. Tax relief could also be achieved through changes to:

- Fringe Benefits Tax
- Payroll Tax (although we appreciate that this is a State responsibility)
- Rules on accelerated depreciation.

What we propose

We support the general position of the Cutler Review, that **Australia's corporate tax rates and tax burden could be significantly cut**, and this would stimulate international investment in the pharmaceutical and biosciences sectors. The cut needs to be sufficiently competitive to attract significant infrastructure investment in Australia, but its needs to be a cut to the *overall* tax burden, not just the corporate tax rate (as suggested in the Cutler Review). As we noted earlier, the pharmaceutical industry has invested comparatively little in Australia—large part because of its comparatively high corporate tax rate—making it relatively easy for multinational companies to withdraw their presence in Australia. By comparison, Singapore's policy of attracting the pharmaceutical industry has seen the investment of around $900 million in manufacturing plants—an investment that the industry will not lightly walk away from. As a result, Singapore has a guaranteed pharmaceutical income from manufacturing for at least the life of its current plants: 15-20 years. While we do not see opportunities to substantially grow Australia's existing manufacturing capacity, Australia is well-placed to develop a biotherapeutics industry.

In order to further accelerate investment, we also urge the Australian Government to adopt a program like that in Singapore's, of **targeted tax holidays or lower corporate tax rates, to attract industries identified as a national priority** by DIISR and the Cutler Review. We regard the biologics and pharmaceuticals industry as two with potential to deliver a major social dividend to Australia—through taxes, contributions to the Australian health system, and support for Australian research community. Such a targeted program for the bioscience and pharmaceutical sectors would need to be integrated into a larger policy, which should also include:

- a clear set of policy objectives on pharmaceutical industry investment
- an investment plan for infrastructure
- investment in education, to ensure a suitably qualified workforce
- incentives for long-term investment in R&D in universities and medical institutions
- a government agency within DIISR specifically tasked with attracting international investment, and provided with sufficient resources to achieve its goals.

Tax rebates and refundable tax credits

The second main area where current tax policy affects international investment by the pharmaceutical industry is R&D incentives.

The chief criteria that multinational pharmaceutical companies apply when deciding where to direct research internationally are:

- cost
- start-up time and time to completion (for both the discovery of new medicines and clinical trials to test the safety and effectiveness of medicines)
- quality of research.

The second two are outside the scope of the Tax Review—although we discussed them in our submission to the Review of the National Innovation System. But, in brief, Australia's advantage in research quality in particular, is being rapidly eroded with the rise of east Asia (especially China).

For nearly twenty years, the Australian Government has provided tax rebates to encourage R&D investment. (These have also been coupled with direct grants, through industry support schemes). In our view, tax rebates are of little use to either:

- publicly-listed multinational companies, who invest the bulk of private R&D funding in Australia
- small and start-up companies, which form the bulk of the Australian biotech industry.

Small start-up firms

The chief concern for small biotech firms—which we anticipate will play an increasing role both Pfizer's and Australia's bioscience future—is generating sufficient cashflow. Companies without an income obviously pay no tax, and hence are ineligible for tax rebates. And, tax rebates do not help them generate operating capital.

The main beneficiaries we see of the current R&D tax rebates are medium-sized companies that have managed to generate sufficient capital to carry a tax debt forward. However, a well-recognised weakness of the Australian biotech industry is that many companies fail to reach this stage because of insufficient capital. The Australian Government needs to provide an incentive scheme that provides 'above the line' incentives for the Australian biotech industry.

Multinational companies

Pfizer Australia does not claim either the 125% or 175% R&D tax rebates, nor are we aware of any other major pharmaceutical company that do so. Pfizer and other publicly-listed firms assess their performance 'above the line'—that is, on earnings-before-interest-and-tax (EBIT). Consequently, there is little incentive to win extra tax rebates, especially when the amounts are small. Also, we feel that the amount we would receive is not worth the administrative burden involved. (Indeed, a problem with all Australian Government support for R&D has been the high transaction costs involved, which can detract significantly from the value of the financial support.)

We do appreciate the Australian Government's intentions in providing these rebates, particularly the removal of the requirement in the 175% international premium rebate that intellectual property be held entirely in Australia. Although we have not used this provision, it did signal that the Australian Government understands the international nature of pharmaceutical research. But, for tax to provide a genuine incentive for investment in R&D by major multinational companies, it needs to provide an above-the-line return.

The returns of investing in R&D

Providing above-the-line incentives obviously involves costs to Government—and not just in tax foregone. But the reviews of the three previous pharmaceutical industry support programs all demonstrated that each generated social dividends. As the Cutler Review reported, for each additional dollar spent by the industry on R&D, there will be a spill-over benefit ranging from 25 to 80.5 cents depending on the type of R&D performed. This suggests that any scheme designed to promote additional pharmaceuticals R&D is well placed to deliver a net economic benefit. We urge the Australian Government to consider these larger returns to the Australian community, and commit to encouraging investment in the pharmaceutical and biotherapeutics industries.