



## A Big Push for a Small Credit

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According to news reports, President Obama will use an upcoming speech in Cleveland to announce a proposal to expand and make permanent the R&D tax credit. The tax credit provides businesses with a credit for certain research and experimentation expenditures. These expenditures are generally fully deductible from income, which means that the credit provides a tax offset whose value is greater than full expensing. The Administration had already proposed making the R&D credit permanent in its February budget request, so this is not really a new policy proposal. In fact, every Administration's budget request since fiscal year 2003 has proposed making some version of the R&D tax credit permanent. The Obama Administration proposes to streamline the calculation of the tax benefits, which would make the credit marginally more generous for businesses and therefore more "expensive" in terms of lost revenue. Reports suggest the proposal would cost \$100 billion over ten years, about 20% more than a permanent extension of the current credit.

As e21 argued in a June editorial, the main problem with the R&D tax credit had been its temporary nature. Although the credit was first enacted in the Reagan tax cut legislation in 1981, it had been temporary for 28 years, which included annual renewals, periods when it was allowed to lapse, and retroactive applications. The goal of the R&D tax credit is to change behavior. The credit is not supposed to reward businesses for spending on basic research and experimentation that would have occurred in the credit's absence; it's supposed to induce businesses to commit additional resources towards basic research. The problem is that since

most R&D projects involve multi-year expenditures, a decision to increase R&D budgets in response to the credit has to be weighed against the probability that the credit would not be extended.

As President Obama is likely to argue in Cleveland, this introduces so much uncertainty into the business planning process that it's unlikely that the credit had done much to induce incremental R&D expenditures. The certainty provided by a permanent extension is likely to be of considerable value to businesses considering increases in fundamental research budgets.

Secondly, a permanent extension would also reduce the deadweight costs the legislative process imposes on the economy. Again, as argued by e21 in June, the recurring expiration of the R&D tax credit led to the creation of a coalition to lobby for its annual extension. The businesses impacted by the expiration of the tax credit know who they are. Making the tax credit permanent would obviate the need for these businesses to spend the time and money necessary to form these coalitions, lobby for the credit's extension, or make campaign contributions to lawmakers on the tax-writing committees. Eliminating these expenses allows business to redirect these funds towards more productive uses.

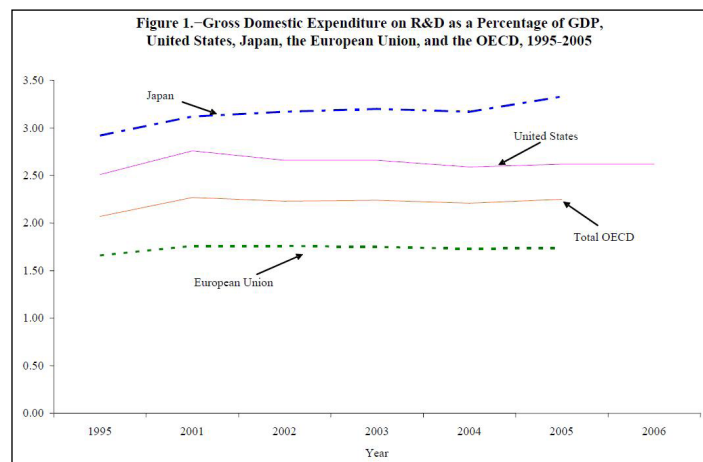
While the Obama Administration's proposal is certainly better than keeping alive this annual "tax extenders" charade, it seems that the benefits of permanent extension are being seriously oversold. Economists tend to favor subsidies to encourage corporations to invest in fundamental research and experimentation in the belief that innovation is the

essential driver of productivity growth. But it's not at all clear how effective the credit is at stimulating incremental research expenditures, with some research suggesting a 10% increase in the credit induces increases in research spending of between 2% to 5% (see page 159 of the JCT document – previous link).

Some, like economist Amar Bhide in his book *The Venturesome Economy*, have argued that an emphasis on traditional R&D spending is misplaced. "High-level" inventions drawn from R&D in the United States have been successfully exploited by for-profit firms in East Asia and Europe, and the reverse is also true. It is the commercialization, diffusion, and consumer embrace of new ideas and inventions that creates value for economies, not "high-level" inventions per se. Insofar as the goal of tax policy is creating a more attractive climate for investment overall, encouraging traditional R&D while stymieing other forms of business-model innovation through an increased tax and regulatory burden will likely prove counterproductive.

More perplexing is the relationship between the research expenditures and productivity growth. It seems quite clear that technological advancement is the key to productivity growth, which, in turn, is the driver of higher living standards. Most research also concludes that R&D spending has important spillovers that contribute to technological advancement. So one would certainly expect some positive externalities from whatever additional R&D expenditures generated by the proposal, but precise claims about the proposal's impact on output and employment is almost surely wild speculation with no basis in fact. According to JCT, 81% of the tax benefits from the R&D tax credit go to businesses with more than \$50 million in assets. This is due partly to the accounting and back office investments necessary

to comply with the credit's copious documentation requirements. The U.S. already spends 25% more on R&D as a share of its economy than the average rich country, making talk of "falling behind" discordant with the facts. Somewhat ironically, the only country that spends substantially more on R&D is Japan, whose economy has been virtually stagnant since 1991.



While the Obama Administration's proposal is likely to improve outcomes at the margin, it is a strange policy to propose with such fanfare. As explained above, a permanent extension has been proposed across two Administrations in each of the past eight years, without any hint that the proposal has the capacity to deliver the sorts of economic benefits now claimed by the Administration. It is also an interesting pivot, in less than one week, from the focus on the so-called "small business jobs bill" and the bizarre claim that "small businesses have put hiring and expanding on hold while waiting for the Senate to act on this bill."

The hyperbolic rhetoric surrounding these proposals has an air of desperation, which is not surprising given that even media outlets like NPR are asking "Whatever happened to recovery summer?" Unfortunately, the damage to the Administration's prestige – inflicted by the ineffectual stimulus – is



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only likely to get worse with exaggerated claims about the impact of modest changes to tax credits to subsidize this or that favored activity.