IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

December 1, 2006 **Advisory No. 215**

UNFINISHED R&D BUSINESS FOR THE LAME DUCK

The election results notwithstanding, the outgoing Congress has unfinished business, and it owes the public a solid week's work before it wraps up for the year. This piece looks at two important items of business that need immediate attention.

Item 1. The R&D credit needs to be extended. There are a number of expiring tax provisions with bipartisan support that should have been renewed as part of earlier legislation. Unfortunately, the earlier vessels sank beneath the weight of more controversial provisions.

The most critical provision is extension and modification of the R&D Tax Credit. The credit was allowed to lapse at the end of 2005. Thousands of businesses have proceeded with R&D work on the expectation that it would be renewed seamlessly for 2006. Failure to renew the credit this month would cause a major shock to the R&D community. There is no guarantee that there will be a tax bill in the early part of 2007, or that the credit, if not renewed by the end of this year, would be reinstated for 2006.

Ideally, the provision should extend the credit for 2006 and 2007, and should include for 2007 the improvement developed by Representative Nancy Johnson and others after much study and hard work in committee. The improvement would provide an additional alternative credit formula that better fits the situation of companies that do not get reasonable access to the current credit. These include firms whose R&D efforts have grown, but whose acquisition of new start-ups or non-R&D-intensive businesses have, respectively, distorted the base period amount, or diluted the share of R&D in the revenues of the combined enterprise. Either of these events reduces the firms' eligibility for the current credit, and results in irrationally unequal research incentives across companies.

The extension and additional formula have had bipartisan support, and have been part of several bills considered earlier in the session, only to be removed as the credit and other extenders were bounced from slot to slot to improve the chances for passage of one bill or another. A two year extension is necessary. If the credit is only renewed through 2006, the fate of the new alternative formula due to become effective in 2007 would be uncertain, which would adversely affect R&D spending in the new year.

The perennial uncertainty surrounding the R&D credit reduces its effectiveness. For any level of the credit, there would be more R&D if it were made permanent and certain. Uncertainty raises the risk-adjusted return that businesses must anticipate if they are to proceed with the R&D projects; with uncertainty, fewer projects qualify for funding.

The United States and other nations offer R&D incentives because there are positive spill-over effects (externalities) from R&D that benefit the whole economy. These benefits make the value of R&D to the country greater than the returns accruing to the researchers, resulting in under-investment in R&D. The incentives are designed to redress this problem.

Multi-national businesses can easily do their R&D either here or abroad. If the United States is not an attractive site for such activity, it will move out. R&D performed here generates export earnings for U.S. companies from license fees and royalties, which are taxable in the United States. R&D performed abroad increases U.S. imports of foreign intellectual property, which generates payments of royalties and fees to suppliers abroad and tax revenue for foreign governments. A competitive R&D credit is a sensible response to these facts of economic life in a global economy.

Item 2. The President's proposal for Treasury to develop the capability for dynamic analysis of tax changes should be funded. One provision of the House-passed Treasury-Postal Appropriations bill (stuck in the Senate) granted the President's new budget request for a modest $535,000 to set up a program in the Treasury's Office of Tax Analysis to research and develop analytical tools to predict the dynamic economic impacts of tax changes. It would show how changes to the tax system would affect saving, investment, employment, wages, and profits. It would alert the Congress to the relative merits of competing tax ideas, and enable the Treasury and OMB to better estimate the revenue and outlay effects of the policy changes.

The unpassed appropriations bills are likely to be replaced by a continuing resolution, which would merely extend spending on old programs at old levels. The new dynamic analysis program should be extracted from the Treasury-Postal bill and inserted either in the continuing resolution or in some other vehicle that can make it through the lame duck session. The new House is unlikely to renew the current rule (and associated funding) requiring the Congressional Joint Tax Committee to pursue this sort of research in dynamic analysis. If any progress is to be made in this area, Treasury will have to carry the ball, and funding the program in this Congress is probably the last chance to get it started next year.

Stephen J. Entin
President and Executive Director

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.