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RESEARCH SUMMARY

CAN A RESEARCH AND DEVELOPMENT TAX CREDIT BE PROPERLY DESIGNED FOR ECONOMIC EFFICIENCY?

The research and development (R&D) tax credit—the fourth-largest corporate tax expenditure, with an annual cost of more than $9 billion—is one of about 50 "tax extenders" that Congress periodically reauthorizes on a temporary basis. While the tax credit is intended to help expand the economy by incentivizing private companies to invest in new and innovative technologies, it may not be the best policy to accomplish these goals.

A new study published by the Mercatus Center at George Mason University surveys the current economic literature on research and development tax incentives. The study investigates design and implementation problems the R&D credit faces, including legal ambiguities, policy uncertainty, insufficient definitions of "research," and special-interest lobbying. The study finds that the R&D tax credit's unseen costs undermine its predicted benefits, and recommends that the credit be eliminated and the resulting savings used to lower the tax rate for all corporations.

To read the study in its entirety and learn more about its authors, Jason J. Fichtner and Adam N. Michel, please see "Can a Research and Development Tax Credit Be Properly Designed for Economic Efficiency?"

KEY FACTS

- *The credit has no proven results.* Economic literature suggests that tax incentives for R&D have a small and uncertain ability to increase private research spending—essentially, a dollar in R&D tax incentives amounts to a dollar in increased R&D spending. But this extra spending is not shown to significantly increase measures of innovation, and may even reduce the quality of research.

- *"R&D" is poorly defined.* Imprecise definitions of qualified research make it impossible to successfully target socially beneficial R&D. Moreover, the definition of qualified research

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used for the tax credit is different from the definition used in other sections of the tax code, which increases administrative and compliance costs.

- *The credit drives additional costs.* Because the credit cannot be precisely defined, businesses are incentivized to spend large amounts of time and money lobbying Congress and tax regulators to ensure the credit is renewed and tailored to suit their specific interests. Significant resources are also wasted as parties attempt to interpret, litigate, and follow the law. These rent-seeking costs decrease the predicted positive effects of the credit and diminish any resulting economic growth.

- *Temporary tax policy creates uncertainty*. Since 1981, when the R&D credit was first voted into law, it has expired and been extended 16 times—on average, every two years. Uncertainty about the future of the tax credit paralyzes business investment and harms economic growth.

- *The credit favors big business.* The R&D tax credit is chiefly used by the largest corporations; the top 1 percent of US firms claim more than 82 percent of all research tax credit dollars. The smallest 95 percent of firms claim less than 5 percent of credit dollars.

POLICY RECOMMENDATIONS

The most economically sound proposal is to eliminate the R&D tax credit entirely and lower the corporate tax rate with the resulting savings. This proposal would benefit the whole economy, because lower corporate tax rates have been shown to encourage research and development.

Absent ideal reform, a second best alternative would include four substantive changes to the credit to increase its effectiveness and decrease some of the associated costs:

- *Make the credit permanent.* A permanent credit will provide tax certainty for business investments and decrease the wasteful lobbying currently needed to ensure reenactment. The House of Representatives voted in May 2015 to permanently extend the R&D tax credit, but the Senate has not yet taken action.

- *Eliminate credit claims on amended returns.* Amending tax returns to take advantage of the research credit violates the underlying principle of the legislation—it is impossible to incentivize research through a retroactive tax break.

- *Use the definition of research from the Internal Revenue Code section 174*. Expanding the definition of qualified research and development using a reliable and already-in-use definition will decrease administrative and compliance costs by simplifying the tax code.

- *Use the alterative simplified credit (ASC)*. The ability to choose between the regular research credit and the ASC increases costs and creates different rules for similar firms. Requiring the use of the ASC would decrease administrative and compliance burdens and treat firms more consistently.