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Proposed Extension of Corporate Tax Credit: Throwing Good Money After Bad

Even as the ink dries on a new federal tax cut for wealthy investors, Congressional tax writers are poised to extend a controversial, recently-expired corporate tax break, the Research and Experimentation (R&E) Tax Credit. The R&E credit has no proven track record of encouraging corporate research—and the extension currently under discussion would ensure that this track record remains unsullied by success.

Background on the R&E Credit

The R&E tax credit was enacted with much fanfare as part of a huge package of corporate tax incentives adopted in 1981. The stated purpose of the credit was to encourage businesses to invest in research in areas that they would otherwise find too risky or unprofitable. The 1981 law gave corporations a credit equal to 25 percent of the amount by which their "qualified" research expenditures exceeded their previous baseline level of research spending. Initially set to expire in 1986, the R&E credit has been extended eleven times since its enactment. The most recent extension of this credit ended on December 31, 2005, at which point the credit expired.

Congress is now debating whether (and how) to revive the expired R&E credit. Last fall's House reconciliation bill included a one-year extension of the credit, with a price tag of $9 billion. The Senate's bill included a two-year, $20 billion extension. But the recently agreed-upon reconciliation bill's $70 billion tax cut did not include any extension of the credit—and all indications are that the R&E credit will be temporarily extended in a separate bill outside the reconciliation process.

Why the R&E Credit Doesn't Work

For the supply-side advocates of the 1981 corporate tax cuts, the R&E credit made a lot of sense. The credit, they promised, would lead to a big surge in research and development spending by businesses. But flaws in the design of the credit make it much less likely that such a surge in research spending will ever materialize—and make it hard for lawmakers to know whether any additional research spending is due to the credit.

First, the R&E credit can be claimed against virtually any growth in a company's research spending—even though it was ostensibly designed to encourage risky and unprofitable investments. As a result, the credit rewards corporations for lucrative investments that they would likely have undertaken anyway.

Second, administering the R&E credit as a tax cut rather than as a direct spending program complicates the tax code. A constantly-changing set of regulations must police the definition of "qualifying" research expenses, and must determine the "additional" amount of research expenses by each corporation in a given year. And the vagueness of these regulations gives corporations an incentive to game the system by classifying normal business expenses as R&D.

But perhaps the most damaging flaw in the credit is its temporary nature. Uncertainty about the likely effectiveness of the credit led lawmakers to make the original R&E credit temporary, expiring in 1986. While the tax break has been extended repeatedly since 1981, it has always been done on a temporary basis. As a result, even the corporations that might find such an incentive most helpful cannot factor the credit into their long-term investment decisions. And the expiration of the R&E credit last fall reinforces the perception that this credit cannot be counted on as a permanent reward for corporate investment in R&D.

"Permanently extending the R&E credit would be both unaffordable and counterproductive," said CTJ director Robert S. McIntyre. "But temporarily extending this expensive tax giveaway amounts to nothing more than payback for big corporation campaign donations."

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