Industry Lobbies Hard for R&D Tax Credit

Congressional support appears strong, but proponents of the expiring R&D tax credits worry that the legislation could perish in budget battles

It was a breakthrough for proponents of the federal research and development tax credit when President Reagan in his State of the Union message called for making the credit permanent. The 25 January message removed doubts about the strength of the Administration's support for continuing the tax credit, which is due to expire at the end of 1988. But the White House endorsement will hardly guarantee the tax credit's future.

The fate of the measure instead may hinge on its cost and impact on the federal deficit—and on what steps are taken to make it more effective. The tax credit was instituted in 1981 to spur industry to hike its spending on R&D where market forces make such investment only marginally attractive. Companies can apply up to 20% of new incremental outlays in a given year as a credit against taxes owed the government.

At risk for companies that are fighting to preserve the tax credit is the loss of substantial R&D subsidies in the future. Linked with this drive is a second battle. Companies also want to renew a tax credit for industry-funded research conducted at American colleges, universities, and nonprofit institutions. This credit was enacted by Congress in 1986 and is estimated by the Joint Economic Committee to cost about $60 million annually in lost tax revenues. The industry R&D credit will cost the government close to $1 billion in 1988.

To persuade Congress and the Administration to retain these credits, 152 companies, colleges and universities, trade associations, and other groups have formed the Council on Research and Technology (CORETECH). The organizations have been conducting a coordinated lobbying effort since last spring. "Corporate R&D funding involves long-term commitments," says Joseph A. Saloom, chairman of CORETECH. "For the R&D credit to be most effective, it should be permanent," he says.

At first glance it appears as though there is no contest. Stuart E. Eizenstat, former domestic policy adviser to President Carter, and lead lobbyist for CORETECH, says that within a few weeks he will have 220 or more House sponsors backing legislation (H.R. 1957) that would make the credit permanent. On the Senate side, Senator John C. Danforth (R–MO) has 27 cosponsors on similar legislation (S. 58) that also would raise the credit to 25%, the level allowed prior to 1986.

Despite this momentum, Eizenstat says the legislative path for the R&D tax credit is not clear. "The problem is the budget," he says. "We are in an incredible budget squeeze."

Indeed, Saloom, who also is senior vice president for M/A-Com, Inc., of Burlington, Massachusetts, fears that congressional support may prove fleeting. "Few members of Congress come out against research and development," Saloom noted in testimony delivered to the Joint Economic Committee in December. "Yet when the crunch comes, R&D provisions are often pushed off the table."

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Congress, in fact, could cut revenue losses by allowing the R&D tax credit to die. At its peak in 1985, the R&D tax credit cost taxpayers $1.6 billion. The annual cost of the subsidy has declined partly because the credit was cut from 25 to 20% in 1986 and because of lower growth in corporate R&D expenditures. But the Joint Economic Committee estimates that the tax credit's cost could rise to $1.7 billion by 1992.

Macro budget considerations are not the only thing that may snag the tax credit. There is an ongoing debate within industry, government, and economic circles about the current structure of the credit—and its overall effectiveness.

The chief beneficiaries of the tax credit have been the electronics, machinery, automobile, petrochemical, and instrumentation industries, according to Treasury Department data. And about 70% of the credits were concentrated in companies with assets of $100 million or more. Start-up companies and firms that do not have substantial tax liabilities are not able to use it.

Martin Neil Baily, an economist at the Brookings Institution and a consultant to CORETECH, contends that the R&D credit has produced significant effects. Analyses done by himself and another Brookings economist, Robert Z. Lawrence, indicate that the credit increased R&D spending by about 7% between 1982 and 1985, Baily says.

But Edwin Mansfield, director of the Center for Economics and Technology at the University of Pennsylvania, estimates that companies increased their R&D spending by only 1% to 2% a year in response to the tax credit. "I don't quarrel with the idea of an R&D tax credit," says Mansfield, "But, gee, the effects of this one look to be pretty small."

Robert Eisner, a professor of economics at Northwestern University, is even more critical, calling the credit "a failed experiment." He contends that there is no clear evidence to support claims that the measure spurred industry to invest significantly more money in R&D than it would have without the credit. While Eisner admits to an ideological bias against federal efforts to prod industry to spend more on research, he says that has not colored his findings that the tax credit "is a turkey."

While economists are split on the measure's effectiveness, they generally agree that the credit would work better if the mechanism governing its use were restructured. Currently, companies may claim a credit for expenditures that exceed base R&D spending. The base is defined as the average of R&D outlays for the previous 3 years. But for a company that doubles its research outlays, the value of the credit is diluted after the first year. This occurs because the company's R&D spending base is pegged to a rolling average of its total research budget. "It's more like a 6% credit, instead of a 25% credit," says Mansfield.

Officials at the National Science Foundation (NSF), Mansfield, and numerous other economists have suggested establishing a new mechanism for determining the base. They favor using a fixed historical period to set a company's base R&D expenditures. This would then be linked with some inflation factor or industrial index. Baily agrees that such an approach could make the tax credit more effective.

But the legislation before the House and Senate makes no changes of this sort. "It's a small credit—one that's not busting the

budget and one that works at the margin of R&D investment," says Eizenstat. CORETECH's members, he says, are not necessarily opposed to making substantial changes in the credit's mechanism. But he notes that the legislative calendar is short and that tinkering with the law can produce delays, especially if changes have the potential for raising the annual cost of the tax credit.

Despite the potential legislative pitfalls, the White House Domestic Policy Council has ordered the Treasury Department to examine options for making the law more effective. Treasury officials say they are looking for ways to index the base without increasing overall costs. NSF sources say that Treasury is considering an option that would actually reduce federal expenditures by setting a high threshold for qualifying for the tax credit.

Congress also may insist on improving the tax credit's workings. A key uncertainty for the credit's proponents is whether Representative Dan Rostenkowski (D–IL), chairman of the House Ways and Means Committee, will support the legislation. So far, he has withheld judgment. But, aides indicate that favorable committee action could hinge on what is done to reduce the credit's cost, to tighten qualifying standards, and to make it more effective in pushing companies to spend more on R&D.

Representative Buddy MacKay (D–FL), a member of the House Science and Technology Committee with a reputation for scrutinizing research programs, also favors retooling the credit to correct deficiencies. But he says his colleagues in the House are not likely to concern themselves too much with the program's overall effectiveness. MacKay predicts they will renew the R&D tax credit for industry. "Symbolically, it would be a mistake at this time to do away with the tax credit," he says.

Even so, nothing is set in stone at this point. With Congress wrestling with proposals to fund costly new R&D ventures such as the Space Station, Superconducting Super Collider, and mapping the human genome while trying to cope with the budget deficit, anything could happen. "It's one thing to get a majority of members to sign a bill supporting the tax credit," observes one Ways and Means staffer. "But it's not clear that you can get a majority of members to agree on a proposal to pay for it." ■

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ADDITIONAL READING

"Interaction Between U.S. Tax Policy and Domestic Research and Development," hearing report (S.H. 100–156) by the Subcommittee on Taxation and Debt Management, Senate Committee on Finance, 3 April, 1987.

Edwin Mansfield, "The R&D Tax Credit and Other Technology Policy Issues," *American Economic Review*, May 1986.

Red Tape and Federal Grants

The National Institutes of Health and several other research agencies have recently urged the Office of Management and Budget (OMB) to adopt new rules that could greatly reduce the red tape associated with the administration of research grants. After reviewing data from an experiment involving 10 research institutions in Florida, the five agencies that have supported the experiment are recommending the widespread adoption of procedures that would allow researchers to shift grant funds from one area to another, carry over unspent money from one fiscal year to the next, and extend time allotted for various projects—all without prior approval from Washington. Researchers would also be able to spend grant funds up to 90 days before a check from Washington arrives on campus. The recommendation comes from a review committee headed by NIH deputy director William Raub.

Until now, OMB has taken a hands-off approach to the Florida project. Now, OMB will review issues involved in extending its scope. According to one OMB official, a simple expansion of the demonstration project to include additional universities could be accomplished quickly and without much fuss. But a move to make it universal could require rewriting federal regulations—perhaps OMB Circular A-110 which governs universities and is currently under revision.

For more than a year, nine campuses of the Florida State University system and the University of Miami, have been testing rules that allow unprecedented flexibility in handling federal research funds. NIH, the National Science Foundation, the Office of Naval Research, and the departments of Agriculture and Energy have also been participants in the "Florida Demonstration Project," which is being cited for saving time and energy that can be more productively spent on research (*Science*, 27 February 1987, p. 966).

There are few data to suggest that the flexible rules are leading to cost savings but, according to Thomas Walsh, director of sponsored research at the University of Florida at Gainesville, they "have removed about 99% of the anguish" involved in managing grants. Walsh estimates that 10% to 15% of an investigator's time previously spent on administration was redirected to research.

The Florida project, a brainchild of the National Academy of Sciences' government-university-industry research round table, has also been evaluated by NAS, which has taken polls of participating scientists to determine how the project is meeting its goals. Modification of the requirement that every shift receive prior approval from Washington "was by far the most frequently mentioned benefit," according to the most recent poll. Administrative changes that used to take a month can be handled in half that time now, the round table reports.

But one aspect of the experiment seems not to have caught on. Researchers have been extremely reluctant to merge funds for related research from separate federal agencies, even though the five participating agencies have given it their blessing. Don Phillips of the round table speculates that researchers are afraid they will have a hard time getting new grant money from federal agencies if they pool funds from NIH and NSF, for example. Only 20 requests to merge funds have been made; so far, 11 of them have been approved, 5 are still pending, and 4 have been denied. Reasons for rejecting some of the merger requests include the opinion that one group of grants proposed for merging, "theoretical approaches are not related."

Although the Florida project has only included grants, OMB has suggested including contract research as well, an idea that has been endorsed by Vice President George Bush in his capacity as chairman of the White House Task Force on Regulatory Relief. In a speech at Yale some months ago, Bush also said he would be sympathetic to implementing the Florida project nationally as part of the Administration's campaign to reduce red tape throughout the government.

The Florida project is being looked at as the first step in what could be a long process of untangling confusing and overlapping research regulation. Research administrators hope that its failure to prove effective as a cost-cutting measure will not cause OMB to scrap it. Robert Rosenzweig, president of the Association of American Universities, argues that the "right measure" of the Florida project's success should be whether it improves the conduct of research. ■ **GREG PEARSON**

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