Hearing Summary – September 20, 2011
Senate Finance Committee
"Tax Reform Options: Incentives for Innovation"

Witnesses

Dr. Scott Wallsten, Vice President for Research & Senior Fellow, Technology Policy Institute and Senior Policy Fellow, Georgetown Center for Business and Public Policy, Washington, DC

Mr. Michael D. Rashkin, Author, Practical Guide to Research and Development Tax Incentives: Federal, State, and Foreign, Saratoga, CA

Ms. Annette Nellen, Professor, Department of Accounting & Finance, College of Business at San Jose State University, San Jose, CA

Dr. Dirk Pilat, Head, Structural Policy Division, Organisation for Economic Co-operation and Development Directorate for Science, Technology and Industry, Paris, France

Members in Attendance

Democrat:	Republican:
Baucus (Chairman)	Hatch (Ranking Member)
Bingaman	Grassley
Carper	
Wyden	

Purpose & Summary

On September 20th, CHI attended a hearing of the Senate Finance Committee entitled "Tax Reform Options- Incentives for Innovation." The hearing featured witnesses which discussed the R&D tax credit, comparative national tax system among OECD members, and other tax reform policy options. The witnesses unanimously agreed upon the importance of making the R&D tax credit permanent in order to maximize its utility. Chairman Baucus took the opportunity to promote the GROWTH Act introduced by him and a bipartisan group of Finance Committee colleagues. The bill would both increase the R&D credit and make it permanent.

CHI Highlights

Member Opening Statements

Chairman Baucus:
-We still lead the globe in patent filings, but China is quickly closing the gap
-US ranks 17th in tax incentives, and the R&D credit currently provides no certainty -- we've relied on 14 short term extensions since the 1990's
-Technology is the single largest determinant of long-term growth
-Tax incentives must be designed to give us the most bang for our buck given our current crisis
-In response, Finance committee members have introduced the Greater Research Opportunities With Tax Help Act (GROWTH Act).
-Let us be innovative and creative and think like businesses, let us lead not follow

Hatch:
How can we be assured that research and development is occurring at a pace that insures innovation and economic growth?
-Generally speaking, the answer is by promoting a vibrant free market. But, the government does act to promote research and development in certain limited contexts. Patent protection, direct funding, and tax incentives to promote and reward R&D.
-One of the keys to successful tax policy is permanence. Unfortunately, the R&D credit has always been temporary and is currently scheduled to sunset yet again in 3 months.

Witness Statements:

Dr. Scott Wallsten, Vice President for Research & Senior Fellow, Technology Policy Institute and Senior Policy Fellow, Georgetown Center for Business and Public Policy, Washington, DC

There is a gap between the optimal and actual levels of RD for 2 reasons:
1) Businesses are likely to invest at levels below optimal *societal* good, because they are only interested in their own good
2) The cost of capital for research is higher than other goods because it's risky

-Identifying where gov't should fund is not always easy- the trick is to find where businesses wouldn't already be doing it on their own
-RD tax credit is different than direct investment and two factors have blunted its effectiveness 1) its temporary nature- permanent tax credit would be more consistent with how businesses make decisions. 2) The current system only rewards *incremental* R&D above and beyond what a business is already engaging in. This requires careful consideration of what is the baseline spending and what is a marginal increase.

Mr. Michael D. Rashkin, Author, Practical Guide to Research and Development Tax Incentives: Federal, State, and Foreign, Saratoga, CA

Many reason for our decline, but one reason above all others is our tax policy. We couldn't have done better job in forcing firms oversees.

Companies take new technology and park it in overseas tax havens where they receive incentives from other nations.
3 recommendations:
-Eliminate tax deferral for tax havens
-Increase RD credit to 30% but limit it to "breakthrough products and innovative research"
-Provide 0% or low tax rate for those that open manufacturing facilities in the US

Current RD credit has been ineffective
-Must do something that multiplies the value we give companies
-Credit should be refundable or transferrable, small companies have no liability to defer

Ms. Annette Nellen, Professor, Department of Accounting & Finance, College of Business at San Jose State University, San Jose, CA

-Any credit must be usable for startups; perhaps refundable
-Suggested numerous specific changes to the code section to encourage investment from individuals among other "fixes."

Other OECD nations not only have a lower nominal corporate tax rate, they also offer incentives

Dr. Dirk Pilat, Head, Structural Policy Division, Organisation for Economic Co-operation and Development Directorate for Science, Technology and Industry, Paris, France

26/34 OECD countries offer tax incentives
-These incentives vary widely
-While solutions for small European nations may not apply to US, there may be useful info in studies and data
-Stability of tax credit over time is important
-Credits like the R&D credit are more important for small, credit constrained firms than large established ones
-firms typically evaluate fundamentals of research locations including: pool of available labor, market size, intellectual property protections, etc BEFORE moving to considerations of incentives from individual nations.

Select Questions:

Baucus: Thoughts on the idea of going the other direction and eliminating tax expenditures, including the RD tax credit and significantly lowering the base rate.

A: Nellen - Tech companies don't pay dividends, so a lower rate is very likely to result in more money going back into RD.

Grassley: What are advantages to targeted tax incentives, and how can targeted incentives be designed so as to limit administrative costs.

A: Nellen - Start-ups are going to have losses rather than a liability, plus they can carry forward their operating losses, which makes credit even less useful. Perhaps a grant or loan that gets start-ups cash sooner?

Bingaman: Is direct funding a good way to do this, or should we use the tax code?

A: Wallsten - You don't want to fund things that would have happened anyway. SBIR program in my opinion simply crowds out private funding. Too many successes in this area signify an unsuccessful government policy in my opinion. A certain number of failures are needed, but how many is the right number? Plus, no one wants to run a program in which grantees routinely fail.

A Rashkin: Companies go offshore to seek lower rates
Response: Pilat- We do find a lot of IP located in small islands like the Caymans, etc, but we don't believe that on the whole tax incentives alone draw companies away- they are much more interested in markets and availability of personnel.

Baucus: Do any of you think that the current credit creates jobs?

A: Nellen - Yes
A: Wallsten - Don't think RD leads to jobs growth in the short run. Adding money to RD without increasing the supply only serves to increase those salaries. That might lead to more RD and professionals in the long run, but it's not a short-term solution.

Grassley: Refundable credits have long history of fraud and abuse. How do we prevent or reduce that?

Nellen: One solution is to limit credit to companies in first maybe 5 years of operation.
Rashkin: Perhaps a system that requires pre-approval for the credit