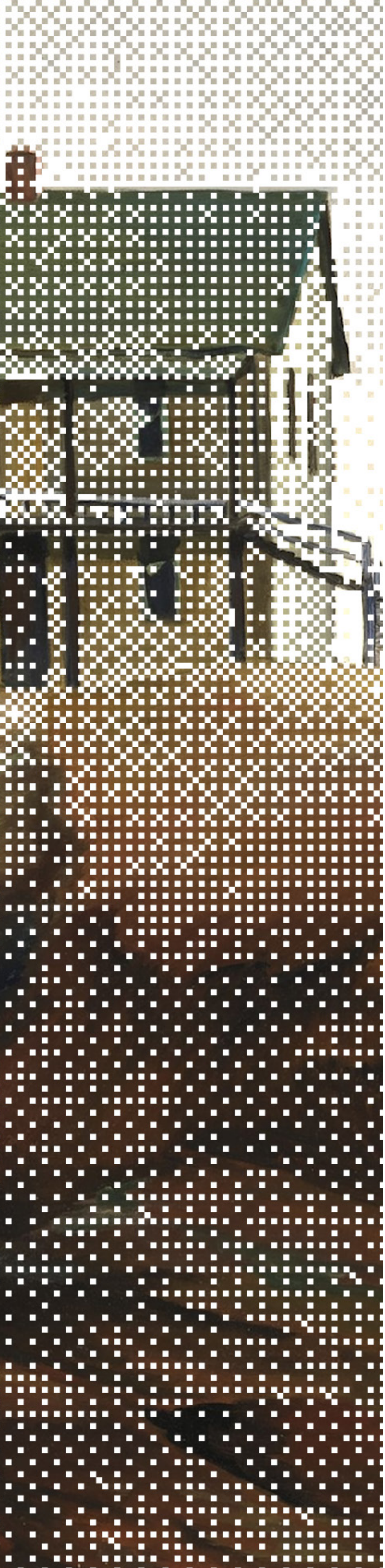

■ Industrial Power

Taxation for Techno-Industrialization

Oren Cass

SUMMARY

The economists who believe that it does not matter what America makes, or whether America makes anything at all, have traditionally celebrated tax reform as an optimal tool for promoting economic growth without "picking winners and losers." Their timeworn goal is to broaden the tax base and lower the tax rate, reducing distortions that might favor some business activities over others while granting to the business owner a higher share of each marginal dollar of profit regardless of its provenance.

Tax policy to promote technological innovation, real investment, and reindustrialization would do the opposite. The corporate tax code should privilege the profits derived through the kinds of high-risk research, development, and capital investment that have the greatest social and economic value.

PROBLEM

The "invisible hand" works, according to Adam Smith, when it directs "industry in such a manner as its produce may be of the greatest value." But in the modern American economy, the capitalist intending only his own gain is more likely to pursue financial engineering that generates greater cash flow from existing assets, or business growth that requires the least possible deployment of long-term capital. If the United States is to reassert itself as the world's leading technological and industrial superpower, it will need to use public policy to alter the return profiles of various business strategies in favor of those that drive technological innovation and build industrial capacity.

SOLUTION

Expiring provisions of the Tax Cuts and Jobs Act of 2017 (TCJA) necessitate substantial tax legislation in 2025. The House Ways and Means Committee and the Senate Finance Committee should make permanent modifications to the corporate tax code that:

- Raise the corporate tax rate from 21 percent to 25 percent
- Permit immediate expensing of all capital expenditures
- Permit immediate expensing of all R&D expenditures
- Expand eligibility for the Qualified Small Business Stock capital gains tax benefit

JUSTIFICATION

Congress erred in lowering the corporate tax rate all the way to 21 percent, far below the 25 percent that had traditionally been the target of congressional Republicans and the corporate lobby based on a desire to match the rate in other developed economies. The much lower rate produced a windfall for profitable corporations and investment firms, and larger federal budget deficits, but not the promised supply-side boom. Indeed, using the metrics chosen by Kevin Hassett, chair of the White House Council of Economic Advisers at the time of TCJA's passage, the $1.7 trillion package had no positive effect on either business investment or economic growth.

Investment may have increased in those firms that received more favorable tax treatment relative to those that did not, but that relative effect did not translate into an absolute one. In aggregate, concludes the Brookings Institution's William Gale, "TCJA changed which firms did the investing but did not necessarily affect the overall level of investment." TCJA did lead to higher corporate profits and enormous repatriations of cash from overseas, but these appear to have been channeled into stock buybacks rather than productive activity.

Perversely, the cost of the lower corporate rate led Congress, seeking revenue elsewhere, to raise the effective tax rate on research and development by requiring amortization of those expenditures. The lower corporate tax rate also weakened useful investment incentives like the immediate expensing of capital investment, because a lower rate on a marginal dollar of income reduces the value of deductions from that income. That incentive was itself made temporary to reduce its cost, and will expire in 2025 absent new legislation.

Reversing course on those decisions would sharply alter returns on investment in favor of real spending on R&D and physical assets. The tax rate on profits derived absent such spending would rise, while the rate on profits in the techno-industrial sector would fall. Evidence suggests that such incentives have dramatic impacts on behavior. For instance, prior reforms allowing for immediate expensing of capital expenditures, or "bonus depreciation," yielded double-digit percentage increases in affected forms of investment. Less research has been conducted on R&D expensing because that model was standard prior to TCJA. But analyses of R&D tax credits like the one first introduced in President Reagan's 1981 tax reform have found elasticities of 1.0 or higher, meaning a 1 percent reduction in the effective cost of the spending leads to at least 1 percent increase in the amount of spending.

A drawback of immediate expensing is that it benefits only firms with taxable profits against which to deduct expenses. Start-ups in their growth phase can benefit, if at all, only by carrying forward a credit against profits at some point in the future. Thus, policymakers should also consider targeted tax measures that address the challenges facing manufacturers at the critical scale-up phase—companies that often struggle to raise investor capital to build production facilities.

One way to do this would be to amend the Qualified Small Business Stock (QSBS) capital gains tax benefit to remove what amounts to an unintentional disadvantaging for asset-intensive, "hard tech" companies. QSBS is a tax incentive used mainly by tech start-ups, which allows investors to exclude capital gains on certain smaller companies from taxation. Relevant here, a company cannot have more than $50 million in gross assets prior to or immediately after the qualifying investment. But while $50 million is a quite high threshold for software and services companies, building a factory often costs more than that. Investors in a hard-tech company's first factory, for instance, typically cannot benefit.

Congress should amend the QSBS asset test by increasing the asset limit to $500 million where the majority of a company's assets are in property, plant, and equipment (a figure already reported by companies in their ordinary tax filings). Such a provision would have dramatic effect for the particular class of start-ups focused on scaling industrial capacity in the United States, but the overall budget impact would be modest. According to the National Venture Capital Association, out of approximately $150 billion of total VC investment in 2023, less than 10 percent went to hardware. Even if the policy succeeded in doubling hard tech investment from around $15 billion to, say, $25 billion annually, the annual cost of amending QSBS would likely remain in the single-digit billions.

Tax reform alone will not bring about a techno-industrial renaissance, but it can play an important role in creating the right conditions, if policymakers will abandon the pretense of a neutral tax code in favor of one that advances the national interest.

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