Tax Breaks for Innovation Pay Off

Capital investments grow in countries offering lower rates for new ideas

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Based on the research of Lisa De Simone

As policymakers examine strategies to jump-start business growth, they often consider the benefits of cutting corporate taxes.

Because innovation is key to growth in high-tech economies, one strategy has been to give it a tax break. As of 2022, 21 countries worldwide had reduced rates for income resulting from intellectual property (IP), such as patents, copyrights, and trademarks. Prior research has shown that such policies, known as "innovation boxes," boost IP indicators such as patents.

A new Texas McCombs study shines a light on the economic effects of such incentives. It finds that they lead to two kinds of economic growth: in capital investment and in highly compensated jobs.

The study looked at seven countries for which relatively complete data was available. The U.S. did not have an innovation box tax policy during the study period, 1999 to 2017.

"We showed the tangible results of tax cuts for IP," says Lisa De Simone, McCombs associate professor of accounting, who researches how tax policy influences where companies decide to put their offices, factories, and people. "This is important information for policymakers as they consider changes to tax regulations."

Innovation-related tax cuts had several impacts, according to De Simone's findings:

Increased Asset Investment. Countries reducing tax rates for innovative activities saw 2.6% higher levels of capital expenditures, including assets such as factories and machinery, relative to similar countries offering no tax incentive. But a significant rate cut — 60% or more — was needed to show results.

"You can't just discount your rate a little bit if you want to attract the types of investment and employment that you're trying to attract. You have to offer a pretty big benefit to see an effect," De Simone says.

Higher Pay for Some. The study found no bump in hiring or overall compensation from innovation box policies. But it found increased average pay for employees, probably including higher-skilled research and development workers. Workers earned at least 46,844 euros more, equal to $49,525 in U.S. dollars.

"It seems to show a change in the mix of employment, and overall employment might even dip," says De Simone, who co-authored the paper with Shannon Chen of the

University of Arizona, Michelle Hanlon of the Massachusetts Institute of Technology, and Rebecca Lester of Stanford University.

Changes to Corporate Tax Forms. The name "innovation box" or "patent box" comes from a box that was added to corporate tax returns. Companies check the box to indicate that they have income derived from innovation, which qualifies for the lower rate.

U.S. Innovation Box Possible. The U.S. enacted something similar to an innovation box in the Tax Cuts and Jobs Act of 2017, a foreign derived intangible income provision.

This provision gives a deduction to U.S. companies for sales exported to foreign countries, but it was enacted after most of the sample period, so it was not included in the study.

"It is sort of like giving a reduced tax rate on innovative income that's being earned from overseas. But, some people would argue that it's not really an innovation box," says De Simone. "The idea was to try to increase investment in the U.S., but there's a problem with the way that policy was passed. It actually includes incentives to reduce investment in the U.S., based on the way the benefit is calculated.

"If it is changed to a true innovation box comparable to the ones we study in this paper, it could increase investment in the U.S."

"The Effect of Innovation Box Regimes on Investment and Employment Activity" is forthcoming, online in advance in The Accounting Review.

Story by Sandra Kleinsasser

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