

Good tax policy: Tax exemptions and Economic Development

Stephen C. Cooke
Department of Agricultural Economics and Rural Sociology
University of Idaho
Moscow, Idaho

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Scenario

- Assume a Fortune 500 business is considering locating a branch plant in Eagle, Idaho
- Assume the company's site location consultant calls the mayor of Eagle with news that the city is one of several under consideration for a new plant that expects to employ as many as 360 people.
- Assume the consultant will be in Eagle next month and would like to meet with the mayor to discuss
 - 1) possible plant sites in town,
 - 2) the quality of public services in the state, county, and city, and
 - 3) what, if any, package of tax abatements, incentives, and exemptions will be offered the business to locate there.
- What should the mayor do? How will home owners' react? What is the Chamber's of Commerce position?

Portrait of a low transaction cost location decision

The good old days when businesses would:

- purchases land, hires a developer and employees
- obtain building permits, comply w/ zoning and environmental regulations
- pays taxes on property, employees, sales, & income
- little direct contact w/ public sector (p. 142)

Portrait of a high transaction cost location decision

Institutional and political causes:

- falling transportation and communication costs
- vertical disintegration of firms & greater spatial division of labor
- rise of site consultants
- devolution
- strategic behavior by local politicians (p. 2)

May lead to lg tax breaks & use of eminent domain

Business Location Game:

Demand & Supply for Public Service X

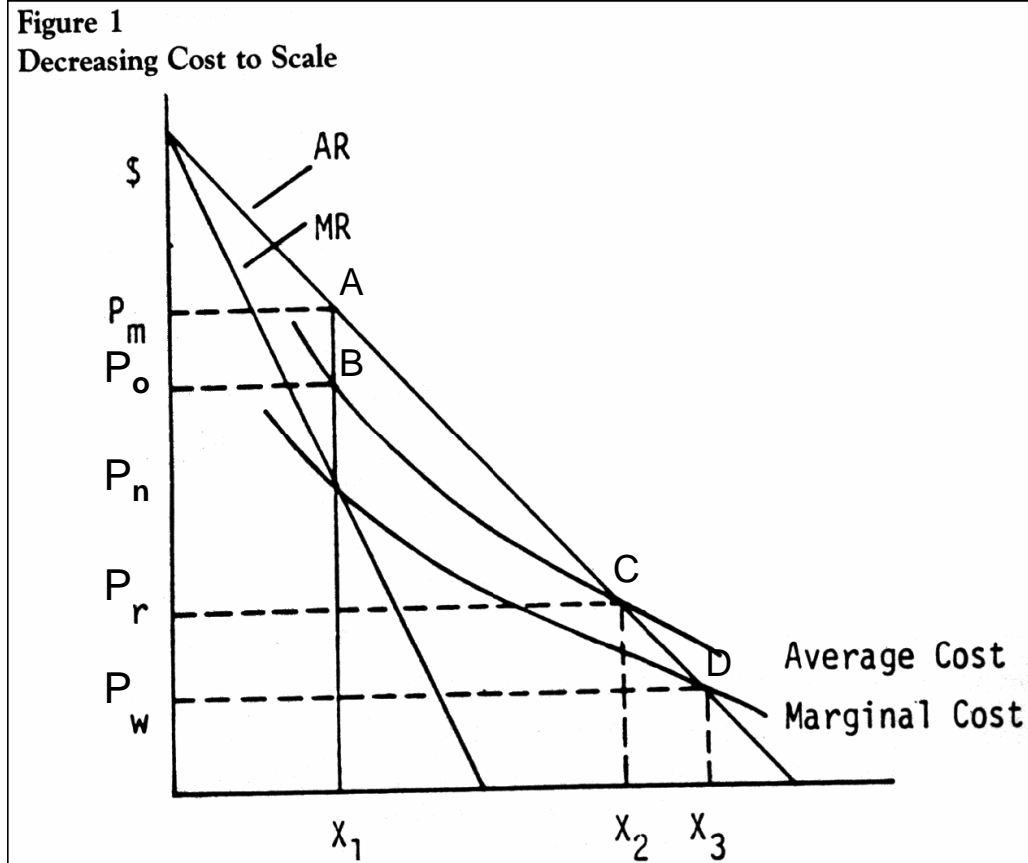
Demand for X by Business

- AR is the average revenue demand curve by the monopsonistic business for X
- MR is the marginal revenue demand curve of the firm for X

Supply of X by Government

- Average cost is the avg. supply curve of monopolistic gov't to provide X (includes variable and fixed costs)
- Marginal cost is the gov't marginal supply curve to provide X (includes only variable costs)

- Rent seeking strategies for a public service (X) with extraordinary economies of scale (firm = industry)



A. Allan Schmid, *Property, Power, and Public Choice*, 1987, p. 70

Business Location Game: Rent from Public Service X

Object of the Game: Maximize Rent

- $P_r CDP_w$ is the monopsony rent sought by the business for X_3

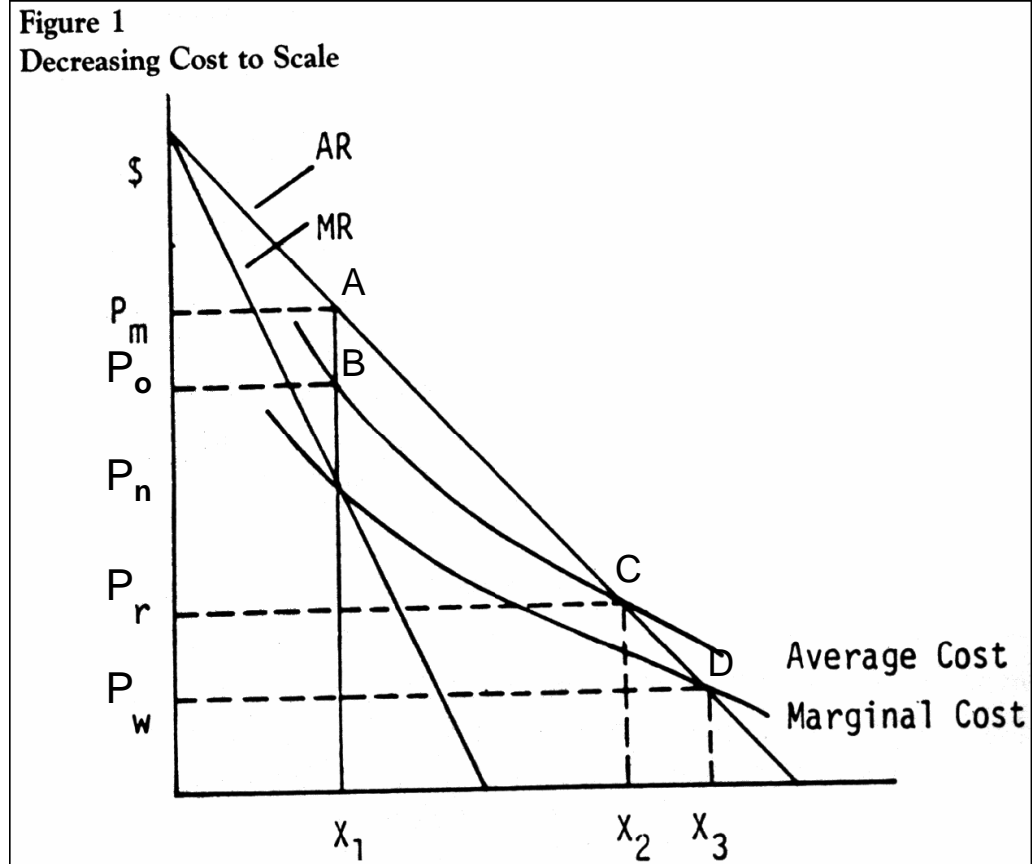
Outcome: **business wins**

- P_r is the avg. price that covers both fixed & variable costs of X.

Outcome: **draw**

- $P_m ABP_o$ is the monopoly rent sought by the gov't for X_1 Outcome: **government wins**

- Rent seeking strategies for a public service (X) with extraordinary economies of scale (firm = industry)



A. Allan Schmid, **Property, Power, and Public Choice**,
1987, p. 70

Business Location Game 1: Two Options

Prisoner's dilemma 1	Government (G) cooperates	Government defects (rent seeking behavior)
Business (B) cooperates	1. P_r good deal for all G: jobs & tax base B: site & public services	2. n.a.
Business defects (rent seeking behavior)	3. n.a.	4. no deal for G & B Lost social welfare esp. to distressed communities

Business Location Game 2: Four Options

Prisoner's dilemma 2	Government (G) cooperates	Government defects (rent seeking behavior)
Business (B) cooperates	1. P_r good deal for G&B G: jobs & tax base B: site & public services	2. P_m bad deal for B G: jobs & tax base B: poor site, no new services
Business defects (rent seeking behavior)	3. P_w bad deal for G G: no jobs, no new taxes B: site & public services	4. no deal for G & B Lost social welfare esp. to distressed communities

Business Location Game 3: More Options, More Players

Prisoner's dilemma 3	Government (G) cooperates	Government defects (rent seeking behavior)
Business (B) cooperates	1. $P_r > P > P_w$ good deal for all G: jobs & some tax base B: site & public services	2. P_m bad deal for B G: jobs & tax base B: site, no new services H: lower taxes
Business defects (rent seeking behavior)	3. no deal P_w bad deal for G & B subsidize G: no jobs & no new taxes	4. no deal G, B, & H Lost social welfare esp. to distressed communities

households (H)

B: site & public services

H: unwillingly cross

subsidize

Business Location Game 4: Even More Players

Prisoner's dilemma 4	Government (G) cooperates	Government defects (rent seeking behavior)
Business (B) cooperates	1. $P_r > P > P_w$ good deal for all G: jobs & some tax base B: site & public services	2. P_m bad deal for B G: jobs & tax base B: site, no new services H: lower taxes
Business defects (rent seeking behavior)	3. no deal bad deal for G & B: will not cross subsidize G: no jobs & no new taxes	4. no deal G, B, & H Lost social welfare esp. to distressed communities

~~B+: site & public services~~
 + Perverse incentives for Business (B), Politicians (p), Site consultants (S), and Chamber of Commerce (C) → "making the Programs"
~~H: unwillingly cross~~
 subsidize

Portrait of a high transaction cost location decision 2

- CI's cost more than the revenue generated
- redirects money from infrastructure & education
- poison inter-jurisdictional relations
- contributes to sprawl
- favors large over small business
- strains local planning capacity (p. 141)
- subj. to worst kinds of cronyism and abuse

A Firm 's Production Function for Output (Q)

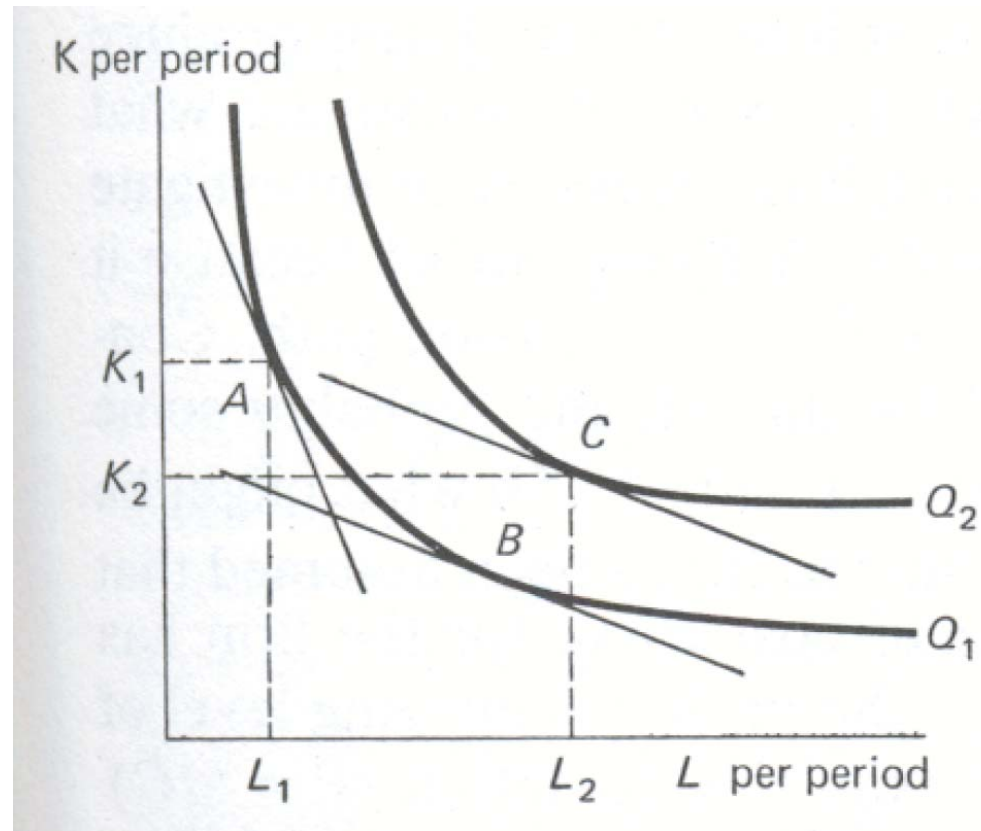
Inputs and Output of the Firm

- Capital (K) and labor (L) can be combined in various proportions to produce output levels Q_1 and Q_2

Input prices

- The ratios of alternative prices of capital to labor are the tangents to the labor and capital input combinations. These tangents determine the minimum cost of producing Q

- Capital – Labor Substitution and Output Effects from a Reduction in Wages



A Firm 's Production Function for Output (Q)

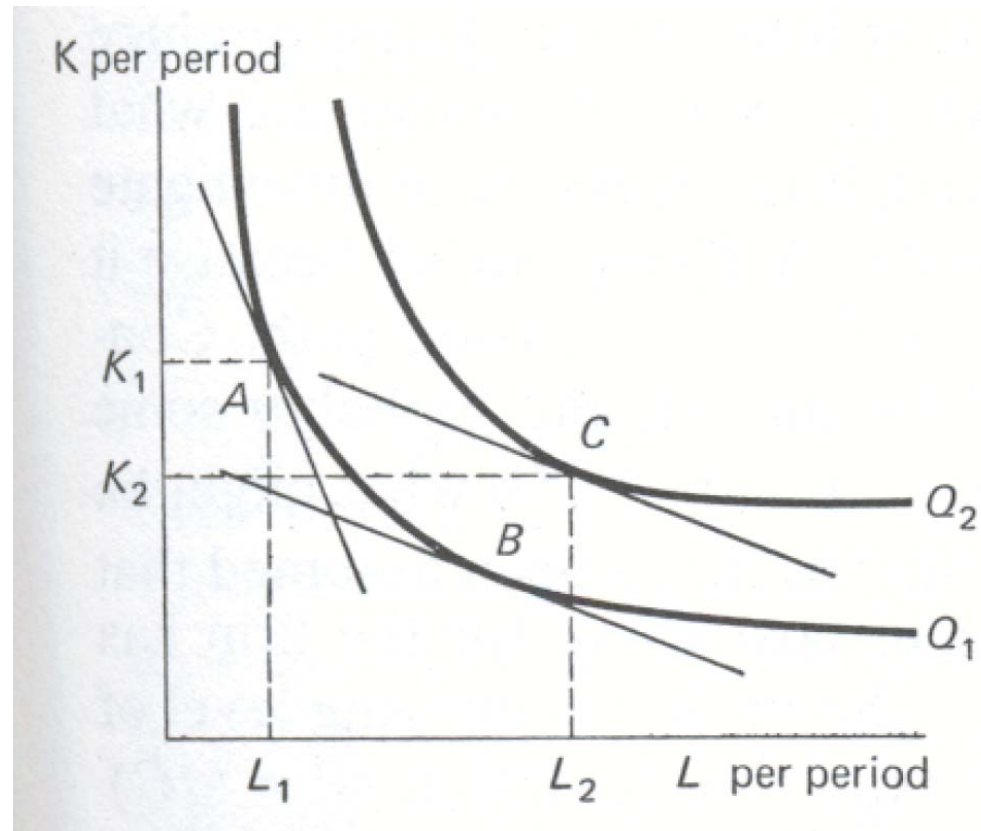
Decrease in the price of labor

- If the price of labor decreases relative to that of capital, then producers will substitute the cheaper labor for the more expensive capital.
- A to B: substitution effect*
- B to C: output effect
- >Capital decreases from K_1 to K_2
- >Labor increases from L_1 to L_2

The moral of the story

- If an input price decreases, more of it is used in production.
- *What happens to labor if the price of capital decreases?

- Capital – Labor Substitution and Output Effects from a Reduction in Wages



Walter Nicholson, **Microeconomic Theory: Principles and Extensions**, 1972 p. 339

Gabe & Kraybill (2002)

J. of Regional Science 42(4):703-730,

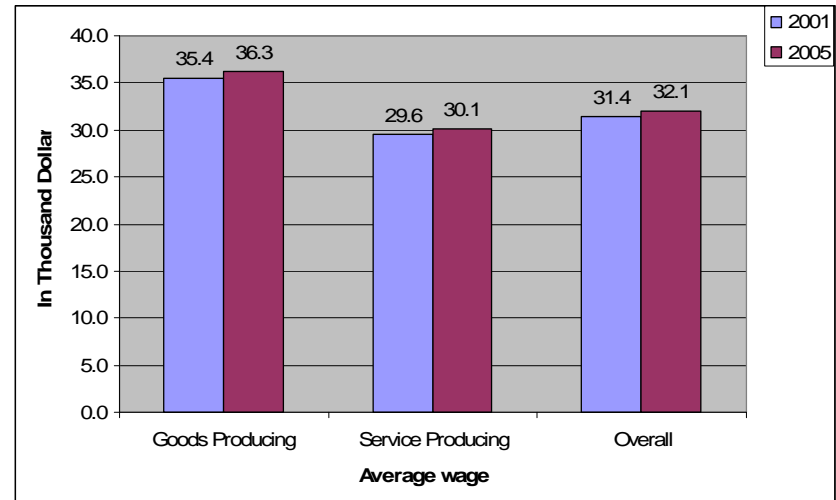
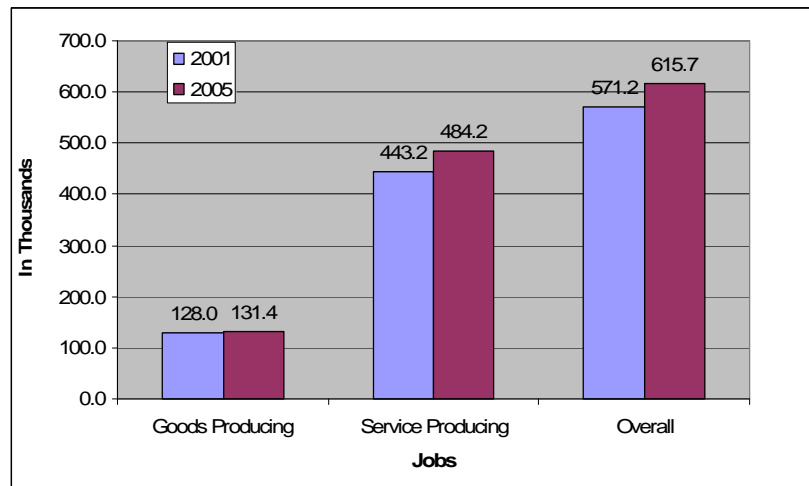
In a study of 366 Ohio firm expansions from 1993 to 1995

- To increase their capital incentives, firms have a reason to over announce # jobs.
- Firms that received capital incentive over-announced jobs but actually created no new jobs (see Markusen & Nesse, p. 21).
- In fact, capital incentive to firms led to fewer jobs.
- Ironically, firms with no capital incentives expanded and created new jobs.
- Reason: firm resources moved from production to seeking subsidies (farming the programs).
- Described by Krueger (1974) as rent seeking behavior.
- [Consistent w/ the substitution effect]

A third way?

- Positive sum gains
- Focused
 - Distressed areas
 - Unemployed, underemployed local labor
- Selective subsidies w/
 - Wide spillover-overs
 - Shared public benefits

Employment in Idaho: 2001 and 2005



Bharathkumar A. Kulandaisamy DECOMPOSITION OF SOURCES OF CHANGES IN IDAHO WAGE STRUCTURE: 2001-2005, (August 2007)

Towards a Unified Development Budget: Tax Expenditure per Job with a Narrow Sales Tax Base in Idaho: 2002

- To raise sales tax revenue \$150 million
 - Either expand the base
 - w/ 800 jobs lost in service sector
 - Or increase the rate 1 cent
 - w/ 150 jobs lost in goods sector
- Tax expenditure of a narrow sales tax base
 - Sales tax revenue forgone \$150 million
 - Net jobs saved 650
 - Sales tax revenue foregone/ job saved \$231,000 / job

S. Cooke, L. Stodick, & D. Holland, *Idaho Sales Tax: Increasing the Rate vs. Expanding the Base*, (February, 2006)

Towards a Unified development budget: HB306 Corporate Headquarters Incentive Act

- Min: 500 employees
- Income tax credit for capital investments
\$5 million max.
- Real property improvement tax credit
\$0.5 million max.
- Income tax credit for new jobs
\$1.5 million max.
- Property tax incentives
\$2.0 million max.
- Total incentives
\$9.0 million max.
- Incentives / job
\$18,000 / job max.

Sales tax revenue forgone:
\$150 million for 650 jobs

Revealed preference for
wage subsidization from
HB306

\$18,000 / job

Gross jobs subsidized w/
\$150 million

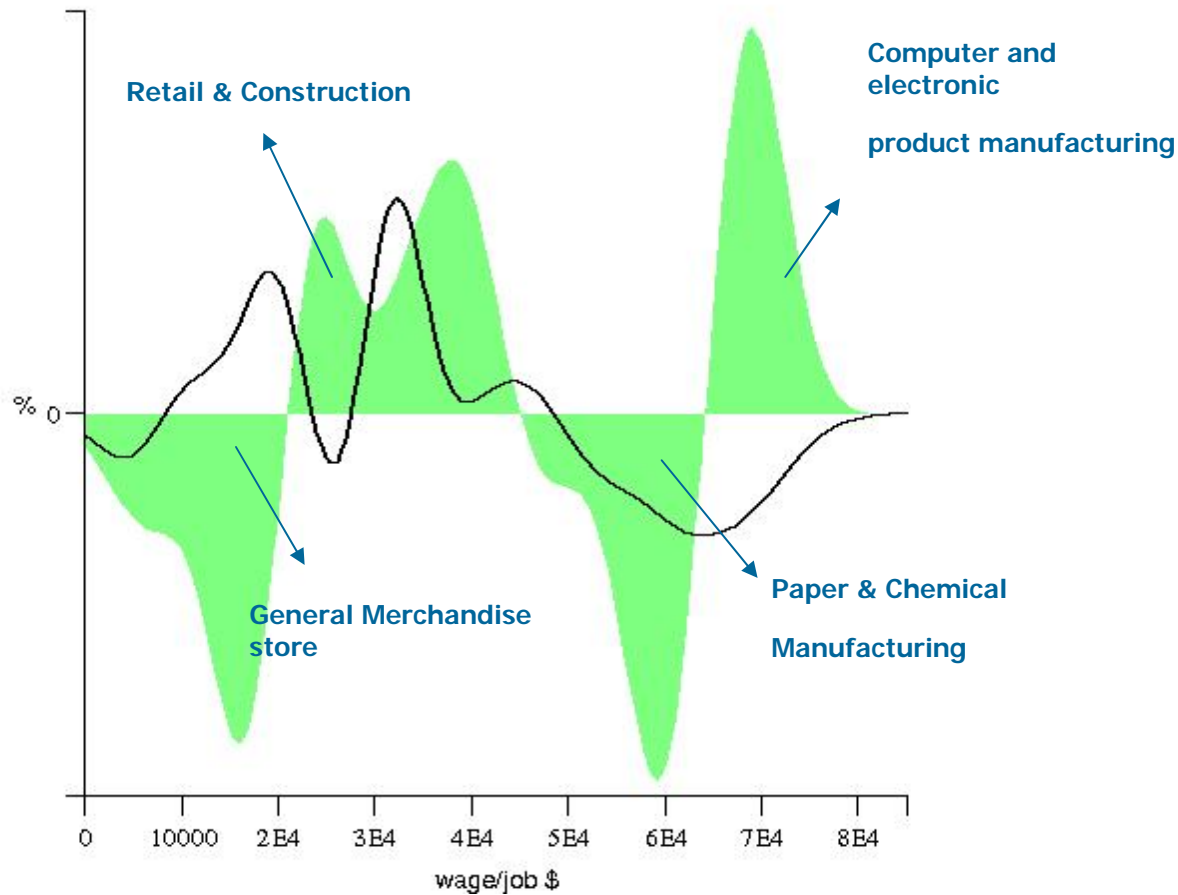
8,300 jobs / year

Net jobs subsidized

7,650 jobs / year

1200% increase

Key Sectors Responsible for the Wage (shaded) and Industry Changes In Idaho's Economy: 2001 - 2005



Bharathkumar A. Kulandaisamy DECOMPOSITION OF SOURCES OF CHANGES IN IDAHO WAGE STRUCTURE: 2001-2005, (August 2007)

“Where all the Difficult Contracting Issues Reside”

Theory of contracting	Bounded rationality absent	Bounded rationality admitted
Opportunism absent	Bliss	General clause contracting
Opportunism admitted	Comprehensive contracting	Trilateral governance [bureaucracy]

Williamson, O. E. *The economic institutions of capitalism : firms, markets, relational contracting*. 1985, p. 67.

Principles of Good Contracting

1

- Written contract w/ third party enforcement
- Accountability: clear, reasonable, obvious, reduces uncertainty, reduces opportunism
- Avoid rigidity and gullibility
- Ironically, cities with the best leverage make the best deal and need them the least. (151)
- CI incentives most needed where **business is least likely to want to go** (152)

Weber, R. (2007) Negotiating the Ideal Deal: Which Local Governments Have the Most Bargaining Leverage? ed. A. R. Markusen

Principles of Good Contracting

2

- Be flexible (p. 150)
- Make investments in place and not by firm
- Performance incentives are easier to enforce and allow for more flexibility
- Devise monitoring requirements including public inspections and audits
- Performance incentives negate the need for penalties

Principles of Good Contracting

3

- TIF on a pay as you go basis (cost are reimbursed)
- High income cities may prefer slow growth policies w/ exactions, and job quality requirements
- Better deals come from repeated experience
(state- level negotiator for disadvantaged cities to offset site consultants experience)

Weber, R. (2007) Negotiating the Ideal Deal: Which Local Governments Have the Most Bargaining Leverage? ed. A. R. Markusen

Targeted Job Creation Grant Program (NC & MN) (p. 170)

- State provides private employers \$8 / hr wage supplement for 6 months to hire local workers in distressed areas (\$8,300/job)
- Workforce Investment Board awards grants to firms that hire workers from disadvantaged groups
- Worker eligibility: resident of state, unemployed, exhausted unemployment insurance; or displaced by layoffs
- Job eligibility: new jobs only
- Firm eligibility: preference for firms w/ training programs and commitment to permanent jobs w/ prospect of advancement
- **Clawback (70%)** if an employee is hired less than 18

Schweke, W. (2007) Do Better Job Creation Subsidies Hold Real Promise for Business Incentive Reformers? ed. A. R. Markusen.