

# Tax Policy And Economic Development: What Is A Legislator To Do?

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For Presentation to the  
Women In Government  
Custer, South Dakota  
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\* Standard Caveat

# Take-Aways

- Disappointments
  - No Solution To Short-Run Fiscal Imbalances
  - No Definitive Answers From The Academic Literature
- But, There Exists A Usable Framework To Guide Legislators/Tax Analysts In Formulating Policies
- Your Assumptions Guide Your Tax Policy
- Mind The “Opportunity Costs” Of Policies

# A Disappointing Start

- Short-Run Fiscal Imbalances Are Not Correctable With Economic Development Oriented Tax Policy Because The Impacts Are Not Realized Quickly
- Here We Focus On Long-Run Economic Development

# More Disappointment

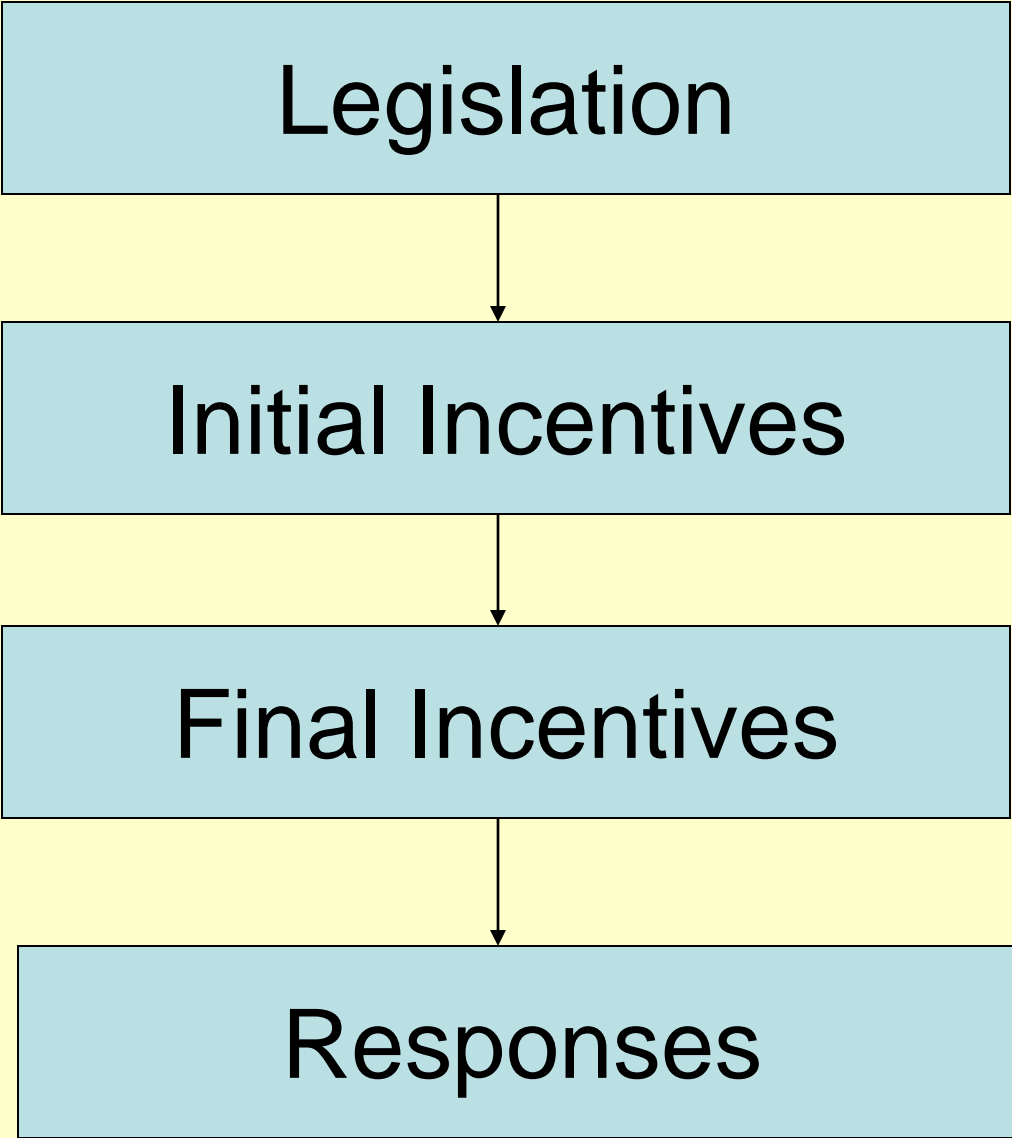
- "Do Taxes Matter? Yes, No, Maybe So."  
Therese McGuire (2003),  
Past President, NTA
- Bartik (1994)
- Wasylenko (1997)
- Bradbury, Kodrzycki, and Tannenwald  
(1997)
- Bogart and Anderson (2005)

# Why Can't These Folks Figure This Out?

- Some Limitations
  - Data
  - Statistical Inference
- The Major Limitation –
  - Lack of Critical “Experiments”
  - The Infamous “Ceteris Paribus” Phrase
  - Evaluating A Tax Program During The Recession
- The Mystery of Growth

# What A Legislator Can Do

- Useable Framework For Decision-Making
- Need To Impose State-Specific Judgments



\*\*\* Legislation \*\*\*

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graph TD; A["*** Legislation ***"] --> B["*** Initial Incentives ***"]; B --> C["Final Incentives"]; C --> D["Responses"];
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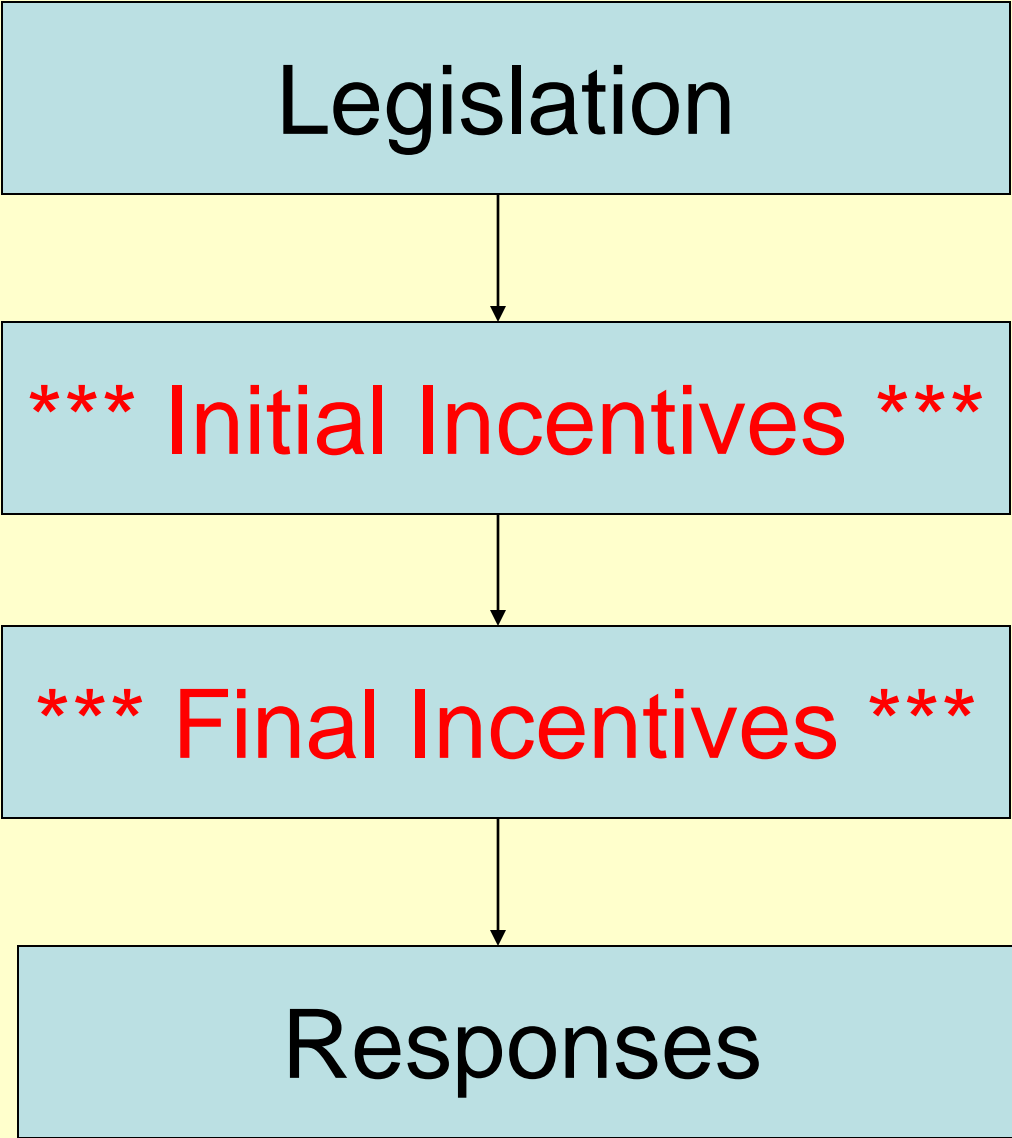
\*\*\* Initial Incentives \*\*\*

Final Incentives

Responses

# Legislation → Initial Incentives

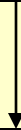
- Key Concept: User Cost Of Capital
- Salience
  - Federal Job Credits
  - EZ Pass And Toll Increases
- Policy Design
  - Perverse Anticipation Effects
  - Retroactivity



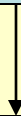
# Initial Incentives → Final Incentives

- You Are Not Fully In Control
- Tax Competition
  - Zero Sum Game?
  - Borders Matter (Chirinko and Wilson, 2008)
  - Harmful or Helpful?
    - Unrestrained Competition
    - Regional Coordination May Be Useful
    - Whither the Commerce Clause? (National Tax Association, 2007; Stark and Wilson, 2006)

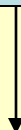
Legislation



Initial Incentives



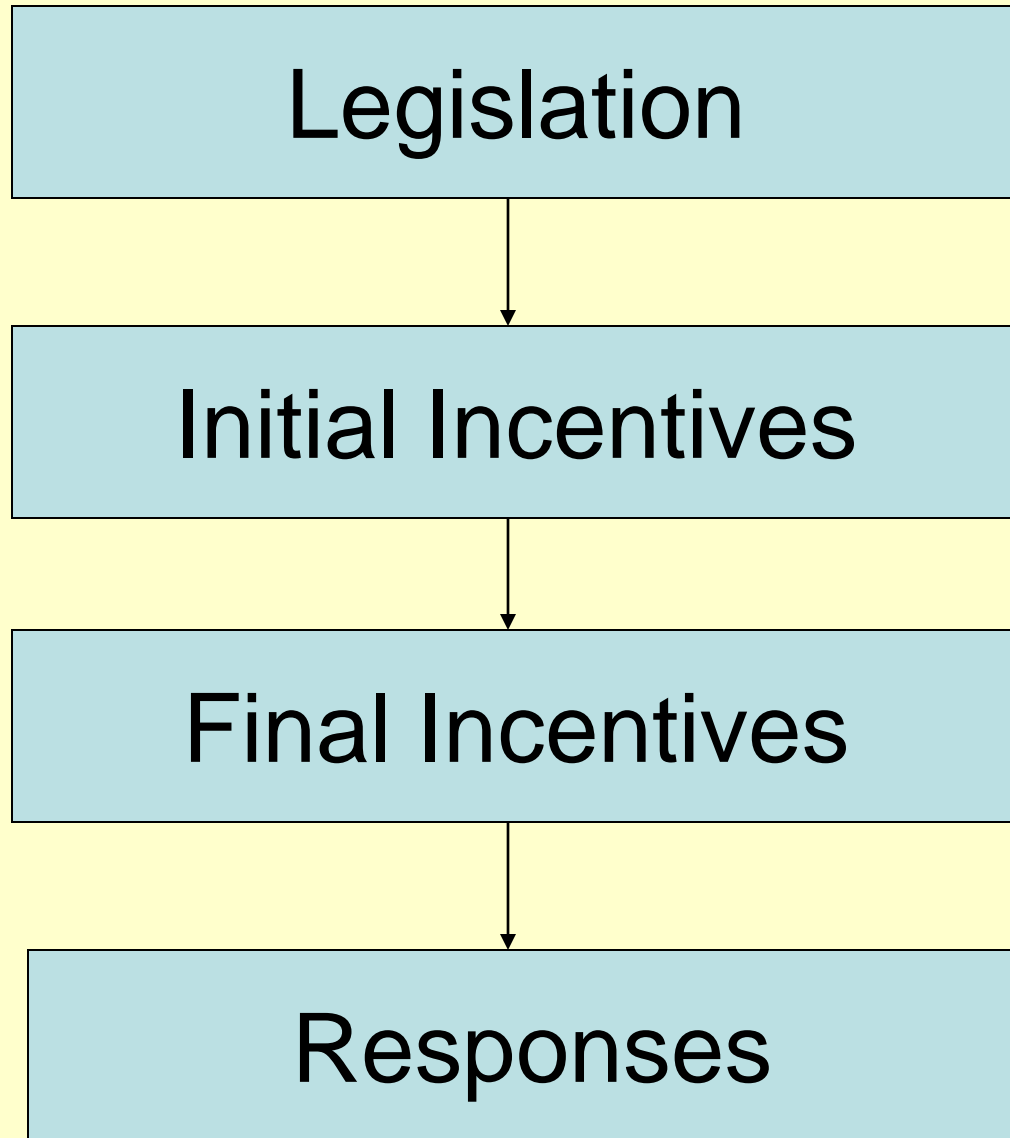
\*\*\* Final Incentives \*\*\*



\*\*\* Responses \*\*\*

# Final Incentives → Responses

- What Is The Response To Incentives?
  - Large
  - Small
- Traps:
  - Self-Financing Tax Policies
  - Multipliers: Short-Run vs. Long-Run



# Tax Simulations

- The Above Framework Has Been Discussed in Chirinko and Wilson (2010):
  - Impact of Legislation on Initial Incentives,
  - Tax Competition and Final Incentives
  - Response to Incentives
  - Other Factors
- And Can Be Analyzed Via <http://www.frbsf.org/csip/taxapp.php>

# Tax Simulations, Part 1

http://www.frbsf.org/csip/taxapp.php - Windows Internet Explorer

File Edit View Favorites Tools Help

http://www.frbsf.org/csip/taxapp.php

## Tax Policy Simulator

Illinois Corporate income tax Reset

Change in rate (percentage points)... -1 p.p.

Capital's factor share in production - E&S... 30%

Capital's factor share in production - R&D... 5%

Price Elasticity of demand for output... -3

Elasticity of substitution between Capital and other factors of production, E&S... -0.76

Elasticity of substitution between Capital and other factors of production, R&D... -2.5

Slope of the Tax Reaction Function - CIT... -0.077

Multiplier effect on output... 1

**Predicted Effects**

User Cost — Equipment and Structures:	-0.68%
User Cost — Research and Development:	0.48%
Equipment and Structures Capital Stock:	1.05%
Research and Development Capital Stock:	-1.30%
Real State Output (GDP):	0.58%

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# Tax Simulations

- For A 1% Cut in the Corporate Tax Rate in Illinois
- Focus on Bottom Panel, Bottom 3 Entries:
  - Equipment and Structures Capital Stock:  
1.05%
  - Research and Development Capital Stock:  
-1.30%
  - Real State Output:  
0.58%

# Tax Simulations, Part 2

http://www.frbsf.org/csip/taxapp.php - Windows Internet Explorer

File Edit View Favorites Tools Help

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## Tax Policy Simulator

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Slope of the Tax Reaction Function - CIT...	1
Multiplier effect on output...	1

**Predicted Effects**

User Cost — Equipment and Structures:	-0.68%
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Equipment and Structures Capital Stock:	0.00%
Research and Development Capital Stock:	0.00%
Real State Output (GDP):	0.00%

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# Tax Simulations – Zero-Sum

- A 1% Cut in the Corporate Tax Rate in Illinois  
BUT
- This Policy Change Exactly Matched by Neighboring States (Tax Competition)
- Focus on Bottom Panel, Bottom 3 Entries:
  - Equipment and Structures Capital Stock:  
0.0%
  - Research and Development Capital Stock:  
0.0%
  - Real State Output:  
0.0%

# A Key Remaining Issue

## How To Spend \$5 Million

### “Opportunity Cost”

- ↑ Investment Tax Credit Rate

vs.

↑ Spending On Education, Infrastructure, ....

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# A Key Remaining Issue

## How To Spend \$5 Million

### “Opportunity Cost”

- ↑ Investment Tax Credit Rate  
vs.  
↑ Spending On Education, Infrastructure, ....
- ↑ Investment Tax Credit Rate  
vs.  
↓ Corporate Income Tax Rate
- ↓ Corporate Income Tax Rate  
vs.  
↓ Personal Tax Rates

# Frustrated?

When discussing economic policy issues with President Harry Truman, Dr. Edwin Nourse (the first chairman of the U.S. Council of Economic Advisers) remarked

**"On the one hand...but then  
on the other hand.."**

After Dr. Nourse left the office, a somewhat frustrated Truman supposedly asked his assistant, John Steelman, **"John, do you think you could find me a one-armed economist?"**

# Hopefully Not.....

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(Beware of Multipliers)
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# The End