

Lloyd Greif

From: Swenson, Charles W. [Cswenson@marshall.usc.edu]
Sent: Sunday, April 15, 2012 10:41 PM
To: Lloyd Greif
Subject: reaction to Blue Sky Consulting report
Attachments: Comments on Blue Sky Report.pdf

Hello Lloyd.

I have had some time to look at Blue Sky's report and have written up some of my observations. Feel free to share this with appropriate city officials or BTAC members.

Sincerely,

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Date: 4/18/12
Submitted in JSB Committee
Council File No: 09-114-88
Item No.: 1
Deputy: BTAC

Comments on “Economic and Fiscal Effects of Eliminating the Los Angeles Business Tax” By Blue Sky Consulting Group (Report dated 3/22/12)

Prepared by Charles Swenson, PhD, CPA

April 15, 2012

Introductory Comments

Predicting the economic and fiscal impacts of a significant policy change, such as elimination of the Los Angeles Business Tax, is a very complex task. If this were an easy task, the City would not ask experts like me or Blue Sky to become involved. Because of this complexity, it is not surprising that there would be differences in the predictions by myself and Blue Sky.

Comments on Blue Sky’s Results

I am flattered that Blue Sky used as a starting point many of my report’s facts—same references, the regression methodology which I created to “parse out” business versus individual taxpayer components of certain taxes, etc. The major problem I find with their results is the low estimated economic impact. For example, Table 4 predicts that elimination of the tax would result in the creation of 7,640 jobs over the course of ten years. Given that there are about two million people working in Los Angeles, this is a very small number, considering it would be the outcome of eliminating a \$400 million tax per year over 10 years. To put some perspective on this, just three of the “Big Four” CPA offices in Los Angeles alone have more than 7,000 employees. So, the estimate of 7,640 jobs seems considerably too low.

This low job estimate suggests that their tax revenue impacts are too low as well. My understanding of the REMI model is that the formulae this program uses to estimate jobs are also used to estimate output effects. These output effects, in turn, are used to predict indirect tax revenue gains to the city. Since the job effects are too low, the estimated tax revenue effects of \$27 million will be understated as well.

It is useful to review the likely effects of a reduction in (including a repeal of) the tax. For some companies already in Los Angeles, the tax reduction would be a windfall, not causing any changes in their decisions to expand or not leave the City. The impact on Los Angeles for these firms is that some of the tax savings would be spent in the City, and through multiplier effects, would have a relatively modest effect. The larger impact would be for firms considering moving into the City, or firms considering leaving, or firms considering doing an expansion outside of the City (as opposed to inside it). Here, tax reductions will be the “tipping point” for some, resulting in very high elasticities (responses relative the tax reduction).

The Blue Sky analysis in fact assumes a very low elasticity--below 5%. Their analysis assumes that the 25% elasticity (or -.25) reported in Bartik (1991), which is based on firms' reactions to a combination of state and local taxes, should be reduced since we are examining only changes in a local tax. It is not clear their extremely low elasticity is correct, for two reasons. First, the Los Angeles business tax is larger than it may appear; although it is only about .5% of sales, if this were translated into an income tax rate, assuming a company has a 10% profit margin, this would be equivalent to a 5% income tax--which is actually almost as much as many states' corporate income tax rates. Second, there is actually a much higher elasticity reported in Bartik for the few *intra-metropolitan* studies which have been done. As pointed out in Bartik, when studies have examined firm responses to taxes in specific cities, firms are much more responsive than in state location decisions, since nearby cities are relatively homogeneous and tax differences are often decision-driving differentiators (which may be the case for Los Angeles versus nearby competing cities with lower tax rates).

Blue Sky's Critiques of My Study

Blue Sky suggested that because there was variability in the data I used, there is credibility issue relating to my estimates. First, it should be noted that rather than rely solely on published papers on state/local tax changes, I felt that because of the unique nature of the Los Angeles business tax, an actual empirical estimate of how firms had reacted to changes in this specific tax were called for. Yes, there was variability in the data I used; in fact, there is almost always variability in data (that is its nature). To try to "triangulate" and thus average out any variability, I used both LATAX and NETS data, and I examined two separate law changes. In the end I used a blend of results obtained from both of the data sources and tests.

Blue Sky suggests that I relied solely on a 2001 change in the business tax to predict how firms would react to other changes in the tax. In fact, I estimated a blended elasticity from 2001 and 2007 changes. And contrary to assertions, for both time periods, the comparison groups were not only other non-Los Angeles firms, but also Los Angeles firms which were unaffected by the tax changes (larger firms). Also, the assertion that the "tech wreck" of 2001 had a distortive effect on my results is not likely, since the comparison groups I used were firms from across the state, and not just the Bay Area (where the effects of the technology collapse was sharpest).

References

Bartik, T. 1991. *Who Benefits from State and Local Economic Development Policies?* Kalamazzo, Michigan: W.E. Upjohn Institute for Employment Research.