Investment Insight

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ARIA | CAPITAL

United States of Europe: *The Federal Reserve Bank of San Francisco (FRBSF) published interesting research on the conflict between State and local governments offering tax incentives to attract businesses to locate in their area. Proponents view these incentives as a valuable tool to encourage economic development. Critics, however, say their benefits come at the expense of reduced economic activity in other areas. A key element in this debate is distinguishing what is best from a local versus a national perspective.*

While the FRBSF was considering the issue in a US context, there are obvious parallels with the European situation: how does a local government protect its electorate in the face of federal policy-making? In ***The Inside Track*** *we take a look at the US debate.*

Semi-D or S&P? *We noticed a recent ad for a semi-d in Howth Road, on the market at just £925. The catch? It was a reproduction from 1940. But, it prompted us to think....if we could go back in time and buy the house, would it have been a good investment, or would our money have been better left in the stock market?*

In ***Pic of the Week****, we reveal the analysis.*

The Inside Track

Does local tax policy actually have an important effect, or do businesses base their decisions of where to locate primarily on nontax factors? Do the potential benefits to the local area exceed the cost of the tax revenue that is lost? Are these policies a zero-sum game at a federal level, such that economic activity simply shifts from high-tax/low-incentive areas to low-tax/high-incentive areas? These were some of the questions examined in the FRBSF's recent research on these issues as they pertain to the US....but the principles apply to Europe too. The following are some extracts.

Does local tax policy actually affect business decisions about the location of economic activity? Research to date has consistently found that it does. In addition to the findings regarding investment and R&D tax credits in Wilson (2009) and Chirinko and Wilson (2008), many studies have also found strong effects for corporate and individual income taxes, property taxes, job creation tax credits, film production tax credits, and other tax policies.

Do the benefits of a low-tax/high-incentive local policy exceed the cost from lost tax revenue? This is far more difficult to answer and the evidence is much less clear. Foregone tax revenue is inherently unobservable, and it is very difficult to estimate what economic activity and tax revenue would have been had the local government adopted different tax policies. The benefits are even harder to measure because they require policymakers to impartially estimate the monetary value of the jobs created directly or indirectly, as well as any less-quantifiable benefits to the local area.

Are local tax policies a zero-sum game? Empirical studies tend to focus on the effects of policies within a jurisdiction and not on whether they adversely affect other jurisdictions. However, when Chirinko and Wilson (2008) and Wilson (2009) addressed this question, they found the answer was roughly yes.

Would the (US) nation as a whole be better off if competition among local governments using taxes or incentives were banned? Local government policymakers are expected to set tax and spending policies to maximize the welfare of their own constituents, without regard necessarily for the ramifications for people or businesses in other places. Thus, according to this theory, it would be better for the central government to set all tax policies. However, an opposing view posits that people and businesses "vote with their feet" by moving to jurisdictions with the mix of taxes, spending, and regulation that best matches their preferences. Forcing all jurisdictions to have the same tax policies would shut off this channel for allowing individuals to maximize their welfare. In sum, there is a trade-off between the benefits of tax harmonization – eliminating the negative impact one jurisdiction's tax policy has on other areas – and its costs – eliminating the positive effects of competition between different jurisdictions.

Pic of the Week

The semi-d on Howth Road, advertised in 1940 at a price of £925, is selling today for €750,000. This represents a compound annual return of 9%. Over the same period, the S&P, as shown in the chart below, has generated a price return of 7% per annum. So the property wins out as the better investment. While 2% per annum may not seem like a huge difference, over a 75 year period the house has increased 639-fold compared to a comparatively paltry 173-fold increase for the S&P. So that's it then, property all the way!

Market View

	Last 7 days	YTD	5Y Ann.
Global equities	+1.0%	+5.1%	+9.7%
US equities	+0.6%	+2.5%	+13.8%
European equities	+2.2%	+13.9%	+9.3%
Emerging market equities	+1.0%	+3.9%	+1.2%
Irish equities	+2.2%	+12.9%	+15.5%
Commodities	-0.2%	-1.7%	-5.2%
Hedge funds	+0.4%	+1.5%	+1.3%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+0.9%	-0.6%	+3.5%
Germany	+0.3%	-0.4%	+1.4%
USA	+2.0%	-0.1%	+2.5%
China	+3.4%	+0.8%	+7.3%

Currencies	*Current*	*YTD Δ*
EUR:USD	1.12	-7.3%
EUR:GBP	0.73	-6.5%
EUR:CNY	7.03	-6.8%
GBP:USD	1.54	-0.9%
Bitcoin	250.38	-21.1%

Commodities	*Current*	*YTD Δ*
Gold	1,209.29	+2.1%
Copper	5,917.50	-7.1%
Oil	61.09	+3.2%
Wheat	500.00	-15.9%

Week ahead: Key events

02/03 Eurozone Manufacturing PMI
02/03 EU Unemployment & UK House Prices
03/03 EU PPI
04/03 Ireland & EU Composite PMI
04/03 Ireland & US Unemployment
05/03 US Initial Jobless Claims
06/03 EU GDP
06/03 US Non-Farm Payrolls & Consumer Credit

Central Bank rates	*Current*
Eurozone	0.05%
USA	0.25%
UK	0.50%

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