Chapter 4: Read This Case and Get a Guaranteed "A"

So, did that title get your attention? Actually, there are a few details for you to work out with your professor. But, what brings my title to mind is a little gem called the American Job Creation Act. Isn't that a beauty? One thing Congress has gotten really good at in the past few years is in naming their legislation. Let's hope that at least some of that legislation accomplishes its stated objective better than this turkey.

The AJCA, as reported by Steven Jones and Michael Rapoport for *The Wall Street Journal*, provided a nice tax holiday for American business doing significant business abroad. For one year, firms are allowed to bring profits earned and invested overseas back to the U.S. at a tax rate of 5.25 percent. Compared to the normal corporate tax rate of 35 percent, this is a very nice break. According to Jones and Rapoport, analysts projected that the AJCA would bring some $320 billion dollars back into the U.S. in its one-year lifetime. So, with a reduction in the tax rate of 29.75 percent, that's better than $95 billion that companies will get to keep instead of pay in taxes.

How did the American Jobs Creation Act propose to create American jobs, you may ask? The hope was that firms would use big chunks of cash to finance new investment projects in the U.S., and those projects would presumably have to employ labor previously not needed. However, the list of allowable uses of the money gives firms a great deal of discretion, with no direct link between planned expenditures and job creation.

According to the Treasury Department, companies can use the cash for advertising and marketing, certain acquisitions, capital investment, research and development and "financial stabilization" such as debt reduction and payment of legal liabilities. The Treasury's guidelines require only that companies attest that the spending "likely would have direct or indirect positive effects on employment in the United States."

And how is it working so far? Jones and Rapoport report on several companies simultaneously, or nearly so announcing the hundreds of millions they are bringing home and the number of people they are laying off. National Semiconductor is bringing back $500 million (tax savings: $148,750,000), and eliminating 550 jobs, 6 percent of its workforce. Sun is bringing in roughly $1.1 billion (tax savings: $327,250,000), and laying off (or had in the previous nine months) 3,600 people, about 10 percent of its workforce. Colgate-Palmolive announced plans to bring back $500 million (tax savings: $148,750,000) and close a third of its factories and eliminate 4,400 jobs over four years.

Maybe we should have raised the tax. Ok, just kidding. But a different structure to the tax break might have led to different results. How might this have been done differently to bring about a better result? One can look to the Hicks-Marshall laws of derived demand, as found in Chapter four in *Modern Labor Economics* for some clues.

The hope of the AJCA was to stimulate the supply side of the economy by allowing business to keep more of their profits after taxes. Without getting into the details of the debates that exist regarding the effectiveness of such policies, many economists would predict that their job creation effects tend to materialize in the long-term rather than short-term, so the jury may still be out on the ultimate effects of the policy.

Had Congress really been as serious about short-term job creation as the name on the legislation implies, they probably would have been better off focusing on the demand side of the labor market. One way to do this would have been to have more strings attached to the tremendous tax break businesses were getting. Given the fungibility of cash, that is more easily said than done. But if tax breaks had been contingent on expansion of a company's employment in the U.S., it would have lowered the relative price of labor and possibly resulted in scale effects and substitution effects.

The size of the scale effects would depend on the boost to derived demand from lower prices. As additional hires free up tax breaks, the marginal cost of hiring workers drops, reducing production costs. Lower production costs could then be passed on to consumers, whose response would depend on their price elasticity of demand for the goods. The greater the share of total costs going to labor, the greater the cost savings and consequent price reduction. The more elastic the consumer demand in response to the price cuts, the greater the increase in derived demand. Substitution effects would depend on the ability to replace other inputs with labor, and on the supply elasticities of labor and the replaced inputs. Some industries might not be able to replace
other inputs with labor, even with the cost savings. A spokesperson for National Semiconductor was quoted as saying, "...the nature of the technology business is that we tend to produce more with fewer people over time." Where substitution was possible, supply elasticities (and the number of qualified workers unemployed and available for hire) would determine how much upward pressure additional hiring put on wages, which if significant could choke off new hiring. But all of this is hypothetical, as the American Jobs Creation Act did nothing to effect the price of labor. As the spokesperson from National Semiconductor, who formerly worked on Capital Hill, said, the name for the law was marketing. "I would not trust the title of any law and what it really says." The same warning, of course, applies to the titles of case studies.


a. One element of many economic stimulus packages of the years has been an Investment Tax credit. Firms receive credits on their Federal Corporate Income taxes in some direct proportion to new capital investment. Analyze, using the Hicks-Marshall criteria, the job creation potential of investment tax credits.

b. The Targeted Jobs Tax Credit, discussed in Chapter three in Modern Labor Economics, offered firms similar credits if they increased their employment of individuals who were members of specifically identified, usually hard-to-employ groups. Those targeted varied over the years, but included youth, welfare recipients, offenders, and so on. Contrast the TJTC with investment tax credits.

c. There might be long-run concerns about the effectiveness of a jobs tax credit, when compared with an investment tax credit or the tax break under the AJCA discussed in the case? Describe what those concerns might be.