

Payroll Taxes, Capital Grants and Irish Unemployment: A Comment

FRANCES RUANE

Trinity College, Dublin

In this paper Frank Berry examines the issue of the appropriateness of capital versus labour subsidies in the Irish economy, in the context of three different models, namely a neo-classical small-open-economy model, a demand-constrained Keynesian model and a structuralist model, in which output is constrained by informational-type barriers-to-entry in export markets. Drawing on a series of earlier papers which consider each of these models in greater depth, Frank Berry analyses the effects of both capital and labour subsidies in terms of output and substitution effects and shows that in the case of *all* models a labour subsidy will be *more* effective than a capital subsidy in generating employment. He argues that “a strong case can be made for at least partial replacement of the current IDA capital-grants scheme by a policy of payroll-tax reductions for newly-created jobs”, i.e., replacing the grants to new capital investment installed with grants to new labour employed. I agree completely with the general tenor of the argument and analysis in the paper, and confine my comments to making three points, namely, a qualification to the interpretation of what is meant by a capital or labour subsidy in the Irish policy context, a caveat on the justification of using either type of subsidy in the barriers-to-entry export framework, and a recommendation for an extension of the neo-classical model used in this analysis.

I IDA GRANT: CAPITAL OR LABOUR SUBSIDY?

In the analysis it is presumed that the payment of a labour subsidy does not result in an increase in the wage demanded on the subsidised projects, and does not create a negative signal to employers about the quality of Irish labour. This latter argument has been used to justify the policy of subsidising capital rather than labour by the IDA, as has the argument that, for foreign investors in particular, a lump-sum payment up-front is more valuable than an on-going payment, because it guarantees that the government cannot renege on its agreement. Such arguments have resulted in the type of policy suggested in this paper not being given serious consideration by policy makers, despite there having been a widespread, although not unanimous, consensus on this issue among economists for more than a decade.¹

However, the basis for calculating the grant and the method of payment of the grant need not be identical, although this is often presumed. It is, for example, possible to relate the payment of a grant, calculated on the basis of a percentage of fixed-asset capital, to the employment of labour, and vice versa. What matters for efficiency and factor choice is the basis on which the size of the grant is determined. As long as the investor is aware of how a particular grant is determined, there is no reason why payment of the grant cannot be related to capital purchases or labour employed, if this is administratively more convenient. Indeed, it is often claimed by IDA personnel that since the IDA "capital" grant depends on expected employment, it actually operates as a labour subsidy. The validity of this argument can be demonstrated² in a simple one-period, two-factor model where the cost of production of net output (C) is defined simply as the sum of the cost of labour (wL) and the cost of capital (rK):

$$C = wL + rK \quad (1)$$

If the grant were strictly paid as a capital grant (g), then the expression for the cost of capital would be

$$C' = wL + r(1-g)K \quad (2)$$

Comparison of Equations (1) and (2) shows the output effect [$C' < C$] and the substitution effects [$w/r < w/r(1-g)$] of a capital subsidy, as noted by

1. See, for example, Geary, Walsh and Copeland (1975), Flynn and Honohan (1984) and Ruane and John (1984).

2. This simple method of demonstrating the equivalence of the "capital" grant and the labour subsidy is due to Peter Neary.

Frank Barry. However, suppose that the IDA actually determines the grant by saying that the grant to capital per unit labour employed must not exceed some fixed amount (m), then the grant constraint facing the firm is

$$[rgK/L] \leq m \quad (3)$$

If this constraint binds, i.e., $rgK = mL$, then Equation (2) can be rewritten:

$$\begin{aligned} C' &= wL + rK - rgK \\ &= wL + rK - mL \\ &= (w - m)L + rK \end{aligned} \quad (4)$$

Thus, if the IDA operates at the fixed maximum per job for all of its projects, and if it insists on a repayment of the grant if the employment projections on which the grant is calculated are not realised,³ then the policy proposals in this paper could be being realised by the existing grant system. However, it would be essential that the policy be advertised in such a way as to make it clear to the potential investor that the size of the grant which would be paid depends on the *actual* employment generated. Failure to do this would mean that the policy would not have the desired incentive effects, as what matters here is the perspective of the investor and not the IDA personnel.⁴ To achieve this effect would of course mean that there would be no reason to attempt to operate a discretionary system. Indeed, the difficulties encountered by government agencies worldwide in operating discretionary policies effectively when dealing with both foreign and domestic investors, suggest that such policies may be in practice inoperable, as negotiators are inevitably bid up to their maxima.

II BARRIER-TO-ENTRY IN EXPORT MARKET: EXPORT SUPPORT FOR ALL?

Frank Barry notes in his discussion of factor subsidies under imperfect competition that informational barrier-to-entry can be used to justify financial support from the government for new firms, and he recommends labour rather than capital subsidies as described above. The only caveat I would make here is that the justification for a general subsidy to exporting firms

3. It is claimed by IDA personnel that this is current policy though it has not been so for most of the period in which IDA grants have been available.

4. In other words, in incentive terms, if the investors believe that the grant system operates as a capital subsidy, the effect will be that of a capital subsidy, irrespective of whether or not the IDA operates the system as a labour subsidy.

depends on the argument that (a) consumers judge quality by country rather than firm quality, and (b) quality is uniform. Hence any export subsidy which increases Irish exports convinces the foreign consumer that all Irish products are good, and hence this subsidy is justified in terms of enhancing the sales potential of all future exports.⁵ However, if firms produce products of different quality, and consumers judge country quality on the basis of any individual product, then an indiscriminate subsidy to all firms may result in poor products being exported, which would be detrimental to the country's reputation. This would suggest that the argument for supporting firms because they face informational barriers-to-entry would only be justified if the quality of such exports could be assured. Such assurance would probably require the firm's proving some initial success in exporting, before assistance could be justified on economic grounds.⁶

III TWO-SECTOR NEO-CLASSICAL MODEL: AN EXTENSION WITH POTENTIAL

The paper could be extended in a number of ways, one of which would be to develop the small open economy model to incorporate a second sector. This would permit an analysis of the effects of factor subsidies on the relative factor intensities in different sectors and of the impact of relative sectoral promotion.

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5. This is the type of argument made by Mayer (1984).

6. An analogous argument is made by Grossman and Horn (1988) in an import-substitution framework.