Tax Dividend Evaluation of Major Urban Renewal Projects

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April 2003

ABSTRACT

This paper aims at proposing a parsimonious methodology to evaluate the impact of large urban renewal projects on public revenues. The impact is largely endogenous, external to projects and may encompass a broad range of instruments, ranging from local to regional to central governments. We look at licence fees, user charges, piggyback levies, excise taxes, social security contributions, and taxation of property, corporate income, personal income, and value added or sales. All these revenues are labelled tax dividends for short. The evaluation of a project’s tax dividends may help governments on their licensing and, above all, on their co-financing decisions. However, the need for rigorous financial evaluations faces too many difficulties in practice, from modelling complexity to information shortages to time constraints to bureaucratic obstruction. The methodology in this paper will seek precisely at delivering feasible, fast and reasonably sound assessments that can be computed before or after the projects’ accomplishment.

Keywords: urban renewal; taxation; revenue forecasting; real estate; Expo’98.
JEL’s classification: B41; E27; E62; H71; R51; R52.

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1. Introduction

Economic performance within a city is not spatially homogeneous. Quite often, once prosperous districts lose the lead for new urban fronts and turn into economic blackspots decades later. These depressed areas typically raise a number of economic and social problems, like poverty, crime and pollution, which may also extend to neighbouring areas. Major renewal projects are development initiatives tailored to improve the urban standards in blackspots. However, these programmes are likely to generate a number of positive externalities. Co-ordination problems may jeopardise their private provision. Even the government may fail to deliver the project if all relevant benefits are not internalised.

As representatives of the public interest, local and upper-tier governments have an obvious interest on major renewal projects and developers turn to them for licensing and financing purposes. At the same time, the public budget constraint is always a key political concern at every government level. A renewal project can be self financed, in which case there is no need for public funding. Yet, the licence decision may well take the public revenue impact into consideration, along with other economic and political effects. More interestingly, there may be renewal proposals with net social benefits, but where private benefits fall below private costs. In this case, the government’s willingness to co-finance the project will certainly depend a lot on its public revenue impact. Thus, whatever the case, the assessment of the public revenue potential of a renewal project should appeal to public authorities.

1.1 The analytical approach

Most revenue consequences will depend upon the project’s impact on the economy; hence, the economic analysis should precede the financial evaluation. In general, the economic effects differ across space and time. Spatial effects are not restricted to the renewal site. Very often, they spill over to neighbouring city areas, and may also include region and nationwide outcomes. Most in-site effects are internalised by the developer but generate tax dividends too. The renewal project can also bring important benefits to adjacent city areas, because it either reduces a negative externality—traffic congestion, pollution or crime, for example—or creates a positive externality—such as widely appraised amenities—for agents located therein. In the case of really large renewal projects, there may also be non-local effects to account for. In fact, the project’s own expenditure is likely to leak into regional and national suppliers, triggering macro-economic consequences. Economic effects differ also on time, being permanent or temporary. The former increase the real value of capital in the economy forever and thus
have a lasting impact upon output. Real estate rents, in site and in adjacent areas, capitalise the social net benefits of the renewal project. Temporary effects change the economy during a limited time span. Most of them come out of resource acquisition by the developer, and may include expenditure on planning, compulsory purchases, decontamination, demolition, and construction.

We identify two mechanisms through which the projects affect the economy and thus public revenues: first, a permanent asset appreciation, usually restricted to an urban subspace; second, a temporary increase on expenditure. We propose to quantify the former mechanism by estimating differential rents; these, in turn, allow us to figure out the changes on the general government revenues. The expenditure mechanism triggers macroeconomic impacts and we propose using a tailored Mundell-Fleming approach combined with an adaptation of a cyclical budget balance framework that provides us with recent tax elasticity estimates.

The methodology is easily customisable to particular projects. As an example, we include an application to the large ongoing renewal project in Eastern Lisbon, Portugal, triggered by the 1998 world exhibition—Expo ’98. Frequently, major renewal projects are prompted by a highly visible event, such as this exhibition or the Olympics. The event itself is likely to cause temporary effects, for example through its impact on the tourism sector—which is likely to boost within the city and its region. Our application shows also how to plug event effects into the analysis.

1.2 Links to the literature

To the best of our knowledge, there is no available technique specially designed to suit the envisaged goal: assessment of the public revenue impact of a major urban renewal project. Yet, there are some methodological connections with the analytical tools which have been used in the literature to evaluate the economic effects of a large infrastructure programme. Among others, the list includes export-base approaches (Isserman, 1980; Norcliffe, 1983), input-output tables (Batey et al., 2000; Miller, 1998), shift-share analysis (Loveridge and Selting, 1998), macroeconometric frameworks (Bradley, 2000; Röger, 1996), and applied dynamic general equilibrium models (Pereira and Gaspar, 1999; Pereira, 1997). Richardson (1988) and Blakely (1989, Ch. 5) remain useful introductions to these and other tools. O’Sullivan (2003, Ch. 6) and McCann (2001, Ch. 4) grant fresh surveys on the subject. Such tools can be effective to capture the effects of a large-scale investment programme on the regional or the national economy, by looking at the investment expenditure links with the rest of the economy.
The export base and input-output models capture demand effects only and are popular in regional and interregional analysis. However, they are hardly tailorable for purposes of urban policy analysis. The export-base approach requires an ex ante definition of basic (or export) and non-basic sectors, which is not trivial in large, diversified cities. The computation of input-output tables requires data typically unavailable at the local level. The interest on shift-share techniques springs from their scarce data requirements but is limited by the mechanistic economic explanations these techniques offer.

Demand and supply effects can be provided by macroeconometric and general equilibrium frameworks. Usually, they work out the infrastructure investment as an externality to the production function and may untie short- and long-term economic outcomes. However, the size of the renewal project may be too micro to endorse the use of these macroeconomic models. Also, their complexity commands data typically unavailable at the local level and a degree of expertise perhaps incompatible with the time and budget constraints of the commissioning agency.

In our view, a major renewal project fuels expenditure into the economy, as explained above. Thus, those tools can help to quantify the demand and supply effects of the project’s expenditure. However, a renewal project is much more than an expenditure engine. We believe there are other effects to consider as well: they spring from the value society attaches to the project achievements. Suppose the project provides the city with museums, a marina, top-quality zoning restrictions, streetscape improvements, broad road infrastructures, and a new subway line. The social value of these facilities does not need to coincide with their construction cost; in fact, and in principle, the two should be different. We argue that the project’s net benefits are transmitted to the economy through the differential willingness to pay for real estate assets in the renewal site and in neighbouring areas. The existing toolbox does not seem effective to cope with these other economic effects. Moreover, even their use to assess the impact of the project’s expenditure may prove unfeasible in many actual exercises if their complexity renders the analysis too expensive or too long to accomplish.

The paper is organised as follows. Section 2 defines carefully the urban development project our methodology applies to. A synopsis of the economic and tax effects of a major urban renewal project is presented in Section 3; they follow from the asset appreciation and temporary expenditure transmission mechanisms. Sections 4 and 5 elaborate on the specific methodology to quantify the contribution of the former mechanism upon the economy and the tax dividends, respectively. Section 6 details our proposal to measure the economic and revenue effects triggered by the expenditure mecha-
nism. Finally, Section 7 exemplifies an application of the suggested framework—the Lisbon’s Expo’98 project.

2. A major urban renewal project

As a city grows, it experiences a slow but steady continuous shift in the patterns of land use, mainly due to the gradual suburbanisation of manufacturing activities, pulled out of the urban centre by cheaper land and better interurban road networks in the outskirts or pushed away by environmental protection zoning. At the same time, service activities move into the city centre and residential areas relocate within the urban area. These changes on land use patterns result in higher value added being generated at the urban centre and is likely to boost economic growth in its periphery as well.

2.1 The role of major renewal projects

This gradual process of tertiarisation of the urban area does not evolve homogeneously across space. Sometimes, spots of inertia resist in or close to the city centre, retaining increasingly degraded industrial or residential activity. Such blackspots arise because of the strong negative externalities generated either by the industrial activities themselves or by the vicinity of inaesthetic or polluting collective facilities.

An example is provided by the concentration of four or five chemical plants in a 4-km² land lot whose activity over several decades has contaminated the soils significantly and continues to spoil the air daily. In this situation, if one firm decides to move away before the others, it will incur on decontamination and transfer costs, but it will not capitalise the potential value of the land, as buyers will continue to suffer the negative externalities imposed by the adjacent firms. Therefore, each firm has the incentive to be the last one to move away, so as to receive the full land value. Another example is a neighbourhood crossed or bordered by a linear transportation infrastructure—railway, highway or a canal. The revaluation of this zone implies the elimination or the covering up of the whole infrastructure, a project normally surpassing the capacity of local landowners.

So, sometimes the only feasible option to operate the complete regeneration of a depressed urban spot is the renewal of the whole area through a single requalification project. This is the major renewal project our paper addresses.

2.2 Integrated regeneration policies

What are then the main features of the major renewal project we have in mind? First and foremost, the project must be an integrated package of land interventions
within the whole blackspot. The project needs to internalise most of the external effects above so as to circumvent the co-operation difficulties of individual landowners. The project is run by one special agent (the *master developer*) empowered to buy all land lots within the *intervention area* (IA), possibly through compulsory purchases. All land conversion operations, such as ground clearance and soil decontamination, are typically provided by the master developer. The developer is also responsible for the zoning policy in the IA, possibly with the co-operation of the local authorities, and guarantees the construction of a number of flagship collective facilities, such as cultural spaces, recreational zones, and accessibilities. The net proceeds from the resale of land lots, whose value will be capitalised by the project, should help the developer to finance the project, i.e. the land purchases, the conversion costs and the facility construction.

Second, and very often, the benefits from the renewal project extend well beyond the IA. In fact, real estate on neighbouring districts is depreciated because of its proximity to a depressed area. Hence, whilst the master developer is able to fully internalise the benefits in the IA, the same does not happen with the *spillovers generated in the neighbourhood*. These spillover gains can make a case for public co-funding, either by the local government and/or by upper-tier administrations. Calls for public financing can also arise simply because the works needed to renew the IA are only effective if their scale extends beyond the geographic boundaries of the IA; examples include water-line cleaning, cover-up of highways and railways, and provision of new accessibilities.

Third, the need to conclude the renewal intervention within a short period also pressures for an integrated operation. Note that the land lot resales are the major own revenue of the developer. The credibility of the project as perceived by market players influences substantially the land appreciation at the time those sales occur. There are indeed many cases where the speed of implementation is crucial for the success of the project. Consider, for example, an urban renewal project associated to the hosting of the Olympics or a Universal Exhibition. This event would certainly add a substantial visibility to the renewal project, thus enhancing its marketing prospects; at the same time, the event would certainly impose strict deadlines to the project implementation and there would be serious credibility penalties for the developer in case of default. An integrated management of most development interventions speeds up the project implementation.

3. **The Economic and Fiscal Effects at Glance**

A major urban renewal project impacts the economy via two channels: appreciation of real assets and expenditure on goods and services. Table 1 helps to sum up both
transmission mechanisms. We may realise the renewal project as a process through which the developer acquires a set of resources to transform into a set of results. Some results are tangible, and may include museums, marinas, recreational parks, exhibition centres, sports complexes, mass transport lines and road infrastructures. Intangible achievements may comprise the appreciation of the external image of the city, innovative urban development features pioneered in the country by the major urban renewal project and the self-esteem derived from the achievement capacity of local and national residents. Generally speaking, the set of results impacts the economy via the benefits the society at large derives from its fruition. If society feels wealthier with such achievements, it will possibly produce and consume more goods and services in the future. The problem the applied analyst faces is how to measure such benefits.

Table 1—Economic effects and possible tax dividends

<table>
<thead>
<tr>
<th>Effect</th>
<th>Length</th>
<th>Recipient government</th>
<th>Public revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset appreciation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock accumulation and rent increase in the IA</td>
<td>Permanent</td>
<td>Local, Central</td>
<td>Prop. Tax and others, etc.</td>
</tr>
<tr>
<td></td>
<td>Temporary</td>
<td>Local</td>
<td>Licences, Real-estate Sales Tax, and others</td>
</tr>
<tr>
<td>Rent increase in adjacent districts</td>
<td>Permanent</td>
<td>Local</td>
<td>Cap. Gains on local govern. property</td>
</tr>
<tr>
<td></td>
<td>Temporary</td>
<td>Local, Central</td>
<td>Cap. Gains on central govern. property</td>
</tr>
<tr>
<td>Expenditure</td>
<td>Temporary</td>
<td>Central</td>
<td>$T_{m}, T_{c}, T_{s}, and T_{ss}$</td>
</tr>
<tr>
<td>Master developer</td>
<td></td>
<td>Central</td>
<td>$T_{m}, T_{c}, T_{s}, and T_{ss}$</td>
</tr>
<tr>
<td>Private developers</td>
<td></td>
<td>Central</td>
<td>$T_{m}, T_{c}, T_{s}, and T_{ss}$</td>
</tr>
<tr>
<td>Tourists</td>
<td></td>
<td>Central</td>
<td>$T_{m}, T_{c}, T_{s}, and T_{ss}$</td>
</tr>
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In our view, the bulk of benefits society enjoys from the tangible project achievements are capitalised into urban rents. In the IA, this capitalisation proceeds mainly from the creation of new real assets, and secondarily from the appreciation of existing real assets. The former include new buildings and the latter include land and preserved old constructions. As explained above, a successful project is also likely to spill over social benefits to adjacent districts: these benefits are signalled via higher rents on the existing stock. In both places, there are permanent and temporary effects to take care of. Real estate appreciations are permanent effects in the sense that they will remain embodied in market values forever. They accrue tax dividends to both government tiers: the local authority benefits namely from higher property tax revenue whilst the central government gains from higher indirect tax ($T_{i}$) proceeds, among others. However, the addition of new buildings and facilities provides the local government also with temporarily higher revenues: the proceeds from construction licences (occurring during the construction phase only) and an eventual real-estate sales tax. Furthermore, some non-real-estate assets may appreciate as a consequence of the project. For
example, take the case of taxi permits in a city whose renewal project brings in a substantial increase on the number of passengers.\textsuperscript{3} It is also possible that government property on neighbouring districts becomes more valuable as a consequence of the project. This enables the public owners to reap \textit{capital gain} revenues once, which accounts for another kind of temporary local effect. The next section details this transmission mechanism.

The urban renewal project is expected to generate a different set of economic effects as well, with its own transmission mechanism. The project achievements require expenditure because resources must be used to produce those results. A fundamental expenditure source lies with the master developer: it buys multiple goods and services to transform the IA: land lots, multiple labour skills, cement, tar, transport vehicles, etc. The developer needs these goods and services to undertake land purchases, ground clearance and decontamination, land movements, business and household relocations and the construction of urban infrastructures, including flagship collective facilities, such as museums, multipurpose arenas and marinas. The construction costs on the IA of residential, office and commercial buildings, possibly by private developers, also adds to the aggregate expenditure on goods and services. If a flag event is associated to the renewal project, then the provision of specific goods and services to be used during the event (ticket offices, computers, national and international promotion initiatives, for instance) also stimulates aggregate expenditure. Often, such events peak the tourism demand in the city and other regions, again expanding aggregate expenditure. It is important to note that these several expenditure inflows are \textit{temporary}: they occur over a limited number of years, roughly encompassing the renewal project length. The temporary output expansion is likely to boost the base of the most important \textit{central government} taxes: \textit{direct taxes on households} ($T_h$), \textit{direct taxes on companies} ($T_c$), \textit{indirect taxes} ($T_i$), and \textit{social security contributions} ($T_{ss}$).

Note that the two kinds of effects do not overlap. In general, the social benefits from the project achievements do not coincide with the provision costs detailed in the second transmission mechanism. To make the case clear, we can imagine a project that spends the whole budget on digging and subsequently closing big holes in the IA ground. The macroeconomic expenditure effects described above would still exist but, naturally, there would be no lasting results from such project and so no social benefits to enjoy in the future.

Table 1 just makes explicit two administration tiers: local and central. However, for cases where a regional or state layer exists, the analyst should also take the respective tax dividends into consideration. Typically, regional tax dividends are a linear combination of central and local tax instruments. Finally, details may change from case
to case. For instance, in countries where regional and local governments charge indirect levies (e.g. retail sales taxation), asset appreciation may lead to higher permanent subnational indirect tax revenues. See further details in Subsection 5.2.

4. Asset Appreciation Effects on the Economy

The major urban development intervention is likely to renew real estate property substantially in the IA. New buildings and collective facilities take the place of industrial plants or deteriorated residential buildings. In principle, the property appreciation in the IA is easy to assess given the integrated business model of the master developer. The difference between the final value of capital goods (land, buildings and equipments) in site and its initial value represents an increase on the stock of capital. Hence, the corresponding incremental rental value measures the permanent increase on potential gross domestic product (GDP).

From a macroeconomic perspective, the additional market value of property in the IA, $dM^A$, increases the country’s stock of real wealth. In what follows, we assume that the marginal propensity to consume out of real wealth equals the adjusted real interest rate, $r$; this is the ordinary real interest rate plus the economic-depreciation rate necessary to preserve the economic value of real estate forever. So, the perspective is consistent with future-oriented consumption theories with bequests: households smooth out their wealth consumption over time by spending every year just the real interest on their wealth, thus being able to bequest the principal to the next generation. Note that assuming a stronger wealth effect without a sound foundation for doing so would run against our conservative approach of avoiding to overestimate revenue impacts.

A comparable macroeconomic effect happens with the asset appreciation in the adjacent districts. Here, the urban renewal project does not provide new real estate necessarily but it impacts upon the market value of the existing stock, $dM^A$, where the superscript stands for the locations adjacent to the IA. The annual increase on private consumption is therefore $r dM^A$.

4.1 Assessment of real estate appreciation

So, in order to quantify the impact of the urban renewal project on private consumption, we need to assess the real estate appreciation in the IA and adjacent districts. At this stage, there is a difference to bear in mind between ex ante and ex post exercises. We say the assessment exercise is ex ante when it is performed before the results of the project are observable. Indeed, most programmes include a projection of impacts and public authorities may be very sensitive to tax dividend projections before deciding to
license or to co-fund the project. It is also common to find requests for ex post evaluations, i.e. assessment exercises based on observed project outcomes.

In the former case, the applied analyst does not observe $dM^i, i = IA, A$. She thus needs to infer the expected market value appreciations. For property in the IA, there are normally professional property assessments available, both relating to existing (pre-project) property and to future property. Given the integrated business model, the master developer is self-interested on acquiring the most efficient price estimates and is aware of the construction potential. We assume the $dM^{IA}$ value is available to the analyst. A more serious difficulty lies with the projection of $dM^A$. Since most (if not all) asset appreciations in the adjacent districts are external to the project, there is no hands-on figure to proceed to the next stage. The analyst must therefore focus on the additional rents on the existing stock, ideally breaking down the stock by classes: residential, office, commercial and industrial.

One possible solution uses available databases on market values. In many cities, professional agents collect actual rents or ownership values per sq. ft. and these data are organised by urban districts and property classes. Naturally, the spillover effects of the renewal project tend to decrease as the distance to the IA increases. The definition of adjacent districts is a case-by-case decision requiring good wisdom to balance the available data zoning with the analyst’s perception of the spatial decay of spillovers. Once the adjacent area is identified, the analyst should look for a distant district (or collection of districts) with a property mix as close as possible to the one observed in the adjacent area. Let us denote such district as the benchmark district. The analyst needs to assume that there will be no project spillovers in the benchmark district.

One interesting feature of asset markets is their capacity of discounting future events with an impact on relevant prices. The more the urban renewal project is credible, the sooner the forward expectations about future prices are embodied on current prices. This seems to be a robust result in the case of projects with credible deadline commitments—which is typical of projects associated to flag events. It is perhaps appropriate to distinguish across two kinds of ex ante assessments. First, consider an assessment carried out after the credibility of the project is perceived by economic agents. As soon as the commitment to execute the project within the announced schedule is realised by agents, market prices jump to a higher level and the following evaluation method becomes feasible. Let $t_1$ be the year right before the project is announced and $\bar{t}$ be the latest year for which data are available. With no spillovers in the benchmark territory, its observed price growth rate between these two years, $\hat{p}^B$, can be used to produce counterfactual data for the adjacent districts. The counterfactual property price level in the adjacent districts at year $\bar{t}$ is simply $q^A_\bar{t} = p^A_\bar{t} \left(1 + \hat{p}^B\right)$; as the two zones
have approximately the same property features, we assume that the price level in \( A \) at time \( T \) would be \( q^4_T \) if there was no renewal project in the IA. Now, the difference at year \( T \) between the actual price and the counterfactual price, \( p^4_T - q^4_T \), is a proxy for the price appreciation due to the urban renewal project. The reliability of this method depends on the expectation formation speed, as noted before. A second kind of ex ante assessment comes out when the exercise has to be carried out before the credibility is acquired. In this case, the observed period is probably too short for the market players to anticipate almost in full the asset appreciation due to the project, and the analyst may need to postulate additional assumptions about the adjustment pattern.

Naturally, the assessment of real estate appreciations turns out much easier in the case of ex post exercises. Here, the available price data, computed by professional specialists, reflects for sure the capitalisation of the spillover effects. The applied analyst can thus apply the above counterfactual methodology to estimate the appreciation ascribable to the urban renewal project.

4.2 Agglomeration and other permanent effects

Besides the in-site and neighbourhoods effects just analysed, the achievements of the urban renewal project may engender other economic influences, spreading all over the city and contaminating the hinterland region as well. A more harmonious and cohesive urban centre boosts growth opportunities both in the city and in the region. To a large extent, these influences are capitalised into property values and Subsection 4.1 has shown how to quantify them in the case of the IA and adjacent districts. Outside these local areas, the positive effects are smaller and inherently diffuse over space and so we recommend to ignore their quantification.

It could be argued that a local urban renewal could improve the general productivity in the economy but we do not give much credit to this possibility. In general, the activities attracted to the IA are not technological upstarts, they are likely to resemble ordinary urban activities, such as offices, housing, retail, culture and leisure. It is true that some collective facilities may have an impact upon the respective industry’s productivity—for instance, covered multi-use arenas for large events, theatres, exhibition pavilions or hotels. However, most of that impact is taken up by the facility itself and embodied into its value, thus being already accounted for in Subsection 4.1.

Finally, we should note a number of intangible results of the urban renewal project. Successful large urban renewal projects may create marketable know-how to the master developer and other major actors and can also add self-esteem to the local and even national people. These results are hard to measure, and probably impossible to an-
5. Tax Dividends from Asset Appreciation

The discussion in the previous section identifies one transmission mechanism of the project economic impact: the appreciation of real estate in the IA and adjacent districts. This appreciation, in turn, affects the revenue of important taxes of all government tiers. We start with the central government tax dividends.

5.1 Central government tax dividends

Section 4 points at least to one major lasting effect of the urban renewal project on the economy: the expansion of private consumption. Private consumption is the largest determinant of indirect taxes revenue, \( T_i \), and so the wealth effect above triggers an increase on this revenue for sure. The next difficulty lies with the quantification of this causality. Typically, tax rates on goods and services are flat, causing the revenue elasticity with respect to the base to equal the unity. The asset appreciation impact on the proceeds of indirect taxation is therefore

\[
dT_i = \frac{T_i}{C} r \left( dM^{it} + dM^{it} \right)
\]

per year, where \( T_i \) and \( C \) are the initial values of indirect taxes revenue and private consumption, respectively. In reality, tax rates differ across goods and services. Actual elasticities estimated from available time series may differ slightly from unity if households change their expenditure composition over the sample period. However, our analysis is a long-term one; as nothing in it supports a change on expenditure mix out of the wealth effect, we consider the above equation a reasonable approximation to the true tax dividend.

The aggregate expenditure expansion triggered by the wealth effect is likely to stimulate output and the price level, possibly with different impacts over time. Hence, from a qualitative viewpoint, we cannot exclude the possibility of other central government tax dividends: taxes whose bases are positively correlated with domestic income, such as personal and corporate income taxes and social security contributions, will probably generate more cash to the government in subsequent years as a consequence of the urban renewal project. Yet, as explained in the introductory section, our pragmatic proposal does not comprise a customised macroeconometric model with a sound price-adjusting mechanism. In its absence, we cannot quantify these dynamic effects. Again,
we stick to the conservative option of minimising the chances of overestimated tax dividends.

5.2 Subnational tax dividends

A large urban renewal project is also likely to impact upon the revenues of sub-national governments. We focus on local proceeds first.

Typical local government revenues include property taxation, excise taxes, piggyback levies, user charges, and licence fees. Consider the (immovable) property taxation to begin with. As explained in Section 4, real estate rents are expected to increase permanently in the IA and adjacent districts and this information is essential though insufficient to estimate the project’s dividend over this tax. Let $dM_k^t \equiv dM_k^{IA} + dM_k^A$ denote the present value of the future differential-rent stream corresponding to asset class $k$ in the city. The number of classes to consider depends on the available information on real estate rents and may encompass broad classes such as housing, commercial, and industrial properties. So, $dM_k$ can be interpreted as the market-value appreciation of assets $k$ due to the renewal project. Property tax revenues, $T_k$, are likely to follow each year. Yet, the link is not straightforward because the actual tax base most countries use differs from market valuation. Typically, tax administrations rely on property assessments for this purpose and the nominal (statutory) tax rate, $t_k$, is a proportion of the assessed value $A_k$, $t_k \equiv T_k/A_k$. Hence, given $t_k$, the revenue estimation involves, for each asset class, the estimation of the assessed-value appreciation:

$$dT_k = t_k dA_k .$$

At most, $dA_k = dM_k$ but this is unrealistic as most administrations are unable (or unwilling) to tax the full market value. In order to derive a finer estimation, we can express the actual tax base as a function of the market value, $A_k \equiv a_k M_k$, where $a_k$—normally smaller than unity—denotes the assessment ratio for asset class $k$. So, the applied analyst must inquire about the assessment ratio in use at the envisaged locations. Knowledge on the rules in practice will generally enable a reasonable assumption with respect to $a_k$. With this parameter, the urban renewal project effect on the property tax proceeds from asset class $k$ can be finally estimated as

$$dT_k = t_k a_k dM_k .$$

Local governments also have access to excise taxes. The actual bases differ a lot from jurisdiction to jurisdiction, sometimes even within the same country. These bases tend to target economic activities with local relevance, such as hotel turnover in tourist spots, casino revenues on gambling locations, or taxi rides in large cities. A large urban renewal project may or may not have a sizeable impact upon the revenue of these taxes.
It is up to the applied analyst to trade the benefits of accounting for this impact against
the costs of performing the evaluation exercise. Given the fact that we are now discussing
a narrow tax base, the exercise may be worthwhile when the project impacts *directly*

on the base. For example, this is possibly the case of a project that includes a new gambling complex in a jurisdiction with an excise tax on gambling, and has indeed been the case of the new Boston’s *Convention & Exhibition Centre*.\(^6\) In many cases, the base estimates are easily available to the analyst because they are part of the project itself.

Piggyback levies are popular in many countries basically because they are an administratively simple method to make broad bases available to local governments. Examples of these bases include personal income, corporate income, retail sales and value added. The administration of these bases is complex and subject to substantial scale economies, which explain why their management tends to be a prerogative of central governments. A piggyback levy allows each local government to share the base apportioned within its jurisdiction. Let \(B_i\) be the broad base eligible in jurisdiction \(i\); the central government’s revenue raised within community \(i\) is \(W_i = wB_i\), where \(w\) denotes the central government’s tax rate.\(^7\) This jurisdiction’s piggyback levy is simply

\[
T_i = t_i wB_i
\]

with \(0 \leq t_i \leq 1\) standing for the local tax rate. Therefore, in order to estimate the impact of the urban renewal project on the piggyback levy \(T_i\), we simply have to assess the project’s effect upon the base \(B_i\). Since the base is controlled and taxed by the central government, that effect should be scrutinised according to the relevant methodology we propose for central tax dividends.\(^8\) The impact on this local tax follows straightforwardly.

Many local authorities are also entitled to licence fees. A licence allows the addressee the right to perform a given activity, such as mobile phone operation or taxi riding. Some licences are sold while others are granted for free. Urban renewal projects may allow the government to derive money from licensing and, in general, the analyst has simply to look into the project to identify the licence fee potential. The idea is to search for impacts on the base of *existing* fees and to find also provisions for *new* licence issues. As an example of the former, consider the construction volume induced by the project. Construction typically involves the temporary occupation of public space and many local governments only allow such occupation in return for a licence fee. The relevant dividend estimate is found by applying the predetermined fee structure to the projected construction volume. The Boston’s *Convention and Exhibition Centre* project provides an example of a new licence fee. The Centre costs were partially financed out of taxi medallion sales specially granted for the project’s purpose.
User charges are one more local revenue category the applied analyst should look at. However, contrary to all other categories we have examined in this section, user charges are a form or earmarked finance. Governments collect them in return for a flow of goods or services (water supply, sewerage, solid waste disposal, etc.) they provide to local agents and therefore correspond to a commodity price. Ideally then, we should evaluate the urban renewal project’s impact on net revenue because, by definition, no user charges are collected without provision costs being incurred. In an actual application, it only makes sense to care about user charges if the project is likely to affect the provision of those goods or services. Typically, the project contains the relevant information to figure out the empirical relevance of such effects. For example, the project may anticipate an increase on the number of households served by the piped-water infrastructure, broken down by income brackets. There are dedicated methodologies to estimate revenues and costs of network expansions and, if time and the budget allow, the evaluating team should go through one of these techniques. Anyway, some crude indicators can be drawn by comparing the projected expansion to an existent benchmarking district and this simpler procedure may be enough when the analysts are convinced that the impact on (net) user charges is just a minor dividend.

Finally, grants are an important revenue source to local governments in many countries. They are basically monetary transfers from one government unit to another government unit, whether in the same jurisdictional level (horizontal transfers) or in different jurisdictional levels (vertical transfers). The accomplishment of the renewal project may affect the size of future transfers to the jurisdiction where the project is being undertaken. For example, the betterment programme may attract additional residents to the local community, thus increasing future grants if they are proportional to resident population (as is often the case). Any way, as long as we want to evaluate the project’s impact upon the revenues of the general government, the potential influence of the renewal project on incoming transfers is uninteresting because it is fully cancelled out by a change on the outgoing transfers (expenditures) of another government unit.

One word of caution about potential spillover effects is worth mentioning. Some urban renewal projects may impact on the revenues of more than one local government. This is likely the case when the renewed district is close to jurisdictional borders. These interjurisdictional externalities are often a source of political conflict between adjacent communities when the project costs are concentrated in one jurisdiction and the benefits spread across multiple jurisdictions. This possibility may render the evaluation of local effects a very sensitive issue. The evaluation exercise should carefully disentangle the project’s impact upon the bases of the neighbouring jurisdictions and replicate the techniques above to all parties involved.
Last but not the least, we mention the case of regional or state governments. Generally speaking, their revenue portfolio is a combination of the central and local finance tools we have studied above. Hence, there is nothing specific to add. The applied analyst simply has to identify the regional or state revenues and apply the relevant evaluation methodology.

6. Expenditure effects

We now turn to the second transmission mechanism of the project’s economic effects. As noted in Table 1, the implementation of a large urban renewal project requires expenditure by the master developer, and possibly by partial (private) developers and event tourists as well. Typically these expenditure flows are concentrated on a restricted time horizon running up to the project conclusion and may change domestic output. From a qualitative viewpoint, the project expenditure can be realised as an expansionary demand shock.

As is well known, demand shocks normally affect central government’s revenues—and some expenditure items. The interest to identify business cycle effects on the public budget leads macroeconomic authorities to calculate cyclically-adjusted budget balances. The difference between the nominal, observed balance and the cyclically-adjusted equivalent is a proxy for the cyclical budgetary effects. National governments and international organisations as the IMF, the OECD, the European Commission and the European Central Bank are currently very active on this area.

As the autonomous expenditure inflow ascribed to the urban renewal project is temporary, we suggest estimating the resulting central tax dividends as cyclical revenue components. For this purpose, we borrow on the growing theory and practice on cyclical tax revenues. Here we will not look at the cyclical position of the economy but instead at the temporary output change ascribed only to the renewal project.

We propose a two-step approach. Firstly, we estimate the macroeconomic effect of the (autonomous) expenditure increase, including the reactions on output, consumption and other relevant variables. Secondly, we turn to tax elasticities (which measure the automatic reaction of public revenues to macroeconomic fluctuations) to determine the effect of those reactions on public revenues. The exposition follows with an explanation of each step, beginning with the latter.

6.1 Estimation of central tax dividends

The computation of the central tax dividends from the project expenditure makes use of tax elasticities. We build on the approach developed within the European Central
Bank, and presented on Bouthevillain et al. (2001) to obtain cyclically adjusted budget balances. This approach takes into account that different components of revenue react differently to output changes; instead of looking only at total output and its effect on total public revenue, the approach considers separately the main revenue categories. Broadly speaking, the cyclical component of a revenue category $j$ is the revenue change induced by the cycle, $dT_j^c$, and can be expressed as a proportion of the total observed revenue, $T_j$, as follows:

$$\frac{dT_j^c}{T_j} = \varepsilon_{T,b_j} \frac{db_j^c}{b_j},$$

where $\varepsilon_{T,b_j}$ is the elasticity of revenue category $T_j$ with respect to the base $b_j$ and $db_j^c$ is the cyclical component of the macroeconomic base—for output this would be the output gap.

We adapt this methodology to evaluate the impact of the urban renewal project on public revenue categories. The idea is to define the proportional impact on revenue category $j$ as simply the product of the relevant tax elasticity by the project’s induced relative change on the macroeconomic base,

$$\frac{dT_j^c}{T_j} = \varepsilon_{T,b_j} \frac{db_j}{b_j} \quad (1)$$

Bouthevillain et al. (2001) consider four broad revenue categories: direct taxes on households, direct taxes on companies, indirect taxes and social security contributions. They identify the appropriate macroeconomic bases for each of them and present values for the elasticity of each revenue category relative to the respective base for all EU countries—see their p. 18. The macroeconomic bases are as follows in Table 2.

<table>
<thead>
<tr>
<th>Revenue Category</th>
<th>Macroeconomic Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct taxes on households</td>
<td>Employment and compensation of private sector employees</td>
</tr>
<tr>
<td>Direct taxes on companies</td>
<td>Gross operating surplus</td>
</tr>
<tr>
<td>Indirect taxes</td>
<td>Private consumption</td>
</tr>
<tr>
<td>Social security contributions</td>
<td>Compensation of private sector employees</td>
</tr>
</tbody>
</table>

So, the four macroeconomic aggregates whose reaction to the project’s expenditure shock we need to estimate are private consumption, gross operating surplus, compensation of private sector employees and employment.

Our approach thus benefits from tax elasticity estimates available for national economies. The project recently led by the European Central Bank generated estimates of the relevant tax elasticities for all EU Member States. These elasticities were “either econometrically estimated or derived from tax or expenditure rules” (Bouthevillain et
al., 2001, p. 7). For other economies it is possible to use the OECD estimates that were also recently revised—see the Appendix of van den Noord (2000).13

6.2 The macroeconomic effects of the urban renewal project expenditure

We now describe the first step of our methodology. The ultimate goal is the estimation of the project’s impact upon the tax bases above.

Consider the macroeconomic modelling to begin with. The nationwide macroeconomic effects are temporary: potential output does not react to the increase on planned expenditure. To keep our methodology simple and parsimonious we do not try to model dynamic transitory effects. Instead, we assume that an expenditure increase at year $t$ changes output in the same year $t$ and only in this year. Following this reasoning, that considers short-run effects only, we assume constant prices. Once again this is justified by the need to keep the methodology simple and parsimonious. Thus, we look at temporary effects on output springing from expenditure expansions while ignoring prices upshots.

Capital markets are so integrated nowadays that most urban renewal projects are too small to affect the interest rate. For a small open economy the interest rate is determined abroad. In the case of a large economy, the expenditure increase triggered by carrying out the renewal project is probably not large enough to change the interest rate. Thus, we take the interest rate as given.

Next, we assume a constant exchange rate. This is actually the case of many economies, including many countries pegging their currency to the dollar and also the Euro-zone economies. If we want to apply the methodology to a flexible exchange rate economy, it is necessary to assume that the expenditure shock caused by the renewal project is small enough to affect the equilibrium value of the exchange rate. This will not be an implausible hypothesis in large national economies.

Thus we propose to use a Mundell-Fleming approach. With exogenous exchange and interest rate, the output change caused by a variation on autonomous expenditure is given by the simple keynesian multiplier, $\alpha = 1/(1-c+m)$, where $c$ is the estimated marginal propensity to consume out of total income and $m$ the estimated marginal propensity to import. Having determined the total expenditure in goods and services directly imputed in each year to the renewal project execution, we multiply these amounts by the keynesian multiplier to obtain the yearly estimated changes on total output.

This is only an intermediate step as total output is not the ultimate macroeconomic aggregate we are interested in. As explained above, our focus lies on the macro-
economic bases listed in Table 2 and their annual changes, $db_j$. The change on private consumption follows from the previously estimated consumption function. For the other three variables, we recommend the estimation of a relationship between them and total output, followed by the use of the parameter estimates to project the changes on these aggregates ascribable to the renewal project.

At last, we can go back to equation (1) to compute the central tax dividends of the urban renewal project expenditure. We just have to plug in the annual estimated base changes, $db_j$, and make use of the relevant elasticities to generate the annual tax dividends.

7. Application

The above methodology was applied to an ex-ante evaluation of the impact of the 1998 World Exhibition (Expo’98, for short) on public revenues—Baleiras et al. 2002. The credibility of the project was already earned when the study was undertaken. The flag event was held in Lisbon, Portugal, in an originally degraded area bordering the Tagus river. The site, a long strip between the river and a major railway, was the largest industrial area inside the city, including an oil-refinery, a large slaughterhouse, waste dump and treatment facilities, along with military and port warehouses. The refinery was obsolete, the port facilities were unusable and in general the equipments were degraded. The renewal operation, managed by a public-funded firm (Parque Expo 98, or PE), was linked to the Exhibition, implying the clearing and full treatment of soil prior to the event. Lisbon zoning restrictions were changed in order to reconvert the site for homes, offices and entertainment facilities. A (central) government decree defined clearly the geographical limits of the IA, granted public interest to it, and assigned PE with urban planning authority over the entire IA. The neighbourhood of the IA could be easily defined by us given the topology of the area. All figures quoted below are expressed at 2001 constant prices, unless otherwise noticed. Tax dividends are expressed as 2001 present values, using a 2.5 per cent discount rate.

Regarding asset appreciation effects, we considered three areas of local impact: (a) the IA, (b) nearby consolidated residential districts, and (c) nearby restructuring districts. In the IA, we used financial data from the master developer; disregarding its net profits, we considered (a present) value of 374.8 million euros (€374.8m) of local taxes—including some temporary licence revenue. In the adjacent consolidated residential districts, we searched for a benchmark, another Lisbon district with similar characteristics but not suffering the negative external effects. Then we applied the benchmark price growth rate to those districts, obtaining a €369.77 differential per square metre and a corresponding property appreciation of €737m, generating €296.0m local
property taxes, plus a wealth effect on central indirect taxes of €165.8m. In the adjacent restructuring districts, we analysed the (probable) changes in the zoning restrictions and computed the expected future built-up areas for residential, office and industrial uses, obtaining a real estate appreciation of €1,213.0m, generating €485.2m on local property taxes, indirect taxes of €272.9m, plus large (but not quantified) capital gains on government property. These additional tax revenues—most of them permanent effects, some temporary (licences)—amounted globally to €1,594.7m.

We now focus on expenditure effects. We estimated linear functions for consumption and imports using time series for the previous business cycle of the Portuguese economy (1985-1995), obtaining a value of 0.8 for the marginal propensity to consume, \(c\), and a value of 0.682 for the marginal propensity to import, \(m\), thus implying a keynesian multiplier \(\alpha = 1/(1-c+m) \approx 1.134\).\(^{15}\)

We had access to the master developer’s expenditure on the Expo’98 project, between 1993 and 2001, as certified by the national Court of Auditors. Table 3 presents the expenditure value and the respective effect on output, as determined by the multiplier: \(dGDP = \alpha \times d\bar{A}\). The autonomous expenditure increase, \(d\bar{A}\), corresponds to the expenditure of the project—the leftmost column. We present values for the proportional change on GDP, as we need them to apply the tax elasticities in equation (1); at the same time, these figures show the dimension of the project at a nationwide level.

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditure</th>
<th>(dGDP)</th>
<th>(dGDP/GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>29.62</td>
<td>33.59</td>
<td>0.05%</td>
</tr>
<tr>
<td>1994</td>
<td>208.76</td>
<td>236.68</td>
<td>0.32%</td>
</tr>
<tr>
<td>1995</td>
<td>195.89</td>
<td>222.10</td>
<td>0.29%</td>
</tr>
<tr>
<td>1996</td>
<td>320.98</td>
<td>363.92</td>
<td>0.44%</td>
</tr>
<tr>
<td>1997</td>
<td>501.54</td>
<td>568.64</td>
<td>0.64%</td>
</tr>
<tr>
<td>1998</td>
<td>802.05</td>
<td>909.34</td>
<td>0.89%</td>
</tr>
<tr>
<td>1999</td>
<td>255.72</td>
<td>289.93</td>
<td>0.27%</td>
</tr>
<tr>
<td>2000</td>
<td>137.83</td>
<td>156.27</td>
<td>0.14%</td>
</tr>
<tr>
<td>2001</td>
<td>113.34</td>
<td>128.50</td>
<td>0.10%</td>
</tr>
</tbody>
</table>

As mentioned in footnote 12, we used the tax elasticities computed by Neves and Sarmento (2001) for the Portuguese economy. To use these elasticities we need to compute the variations on the following tax bases: private consumption, gross operating surplus, compensation of private sector employees and employment. For private consumption, \(C\), we used the previously mentioned estimation of a linear consumption function. For gross operating surplus, \(S\), and for the compensation of private sector employees, \(W\), we considered that these aggregates changed proportionally with output. Finally, for employment, \(N\), we estimated a linear relationship between the logarithm of employment and the logarithm of output allowing us to estimate the elasticity of em-

\(\alpha = 1/(1-c+m) \approx 1.134\).
ployment with respect to output as 0.279. After obtaining the changes on the bases, we applied directly the expressions for the tax revenue changes presented in Neves and Sarmento (2001). The expressions are as follows:

\[
\hat{T}_H = 1.69(\hat{W} - \hat{N}) + \hat{N} = 1.69\hat{W} - 0.69\hat{N} \\
\hat{T}_I = 1.1\hat{C} \\
\hat{T}_{CI} = \min\{\hat{S}_{t-1}, \hat{S}_{t-2}\} + \max\{\hat{S}_{t-1} - \hat{S}_{t-2}, 0\} \\
\hat{T}_{SS} = \hat{W} .
\]

where \( \hat{x} \) stands for the rate of growth of variable \( x \), the \( T \)'s are the central government’s tax revenues identified in the legend of Table 1 and the subscript \( t \) refers to time period whenever this explicit temporal reference is necessary. The change on employment, \( \hat{N} \), matters in \( \hat{T}_H \) to allow for tax progressivity. As we want to be conservative about the expansion of public revenues induced by the project and we had no access to sound and reliable data on employment, we preferred to assume no progressivity effect on the households’ direct taxes; this implied \( \hat{T}_H = \hat{W} \).

The table below presents the final values obtained for the four revenue categories in each year. The progressivity effect on households’ direct taxes was ignored in these calculations. The 2001 present value of all these revenues is \( €1,531.2m \).

<table>
<thead>
<tr>
<th>Year</th>
<th>( \hat{T}_H )</th>
<th>( \hat{T}_I )</th>
<th>( \hat{T}_{CI} )</th>
<th>( \hat{T}_{SS} )</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>2.65</td>
<td>7.70</td>
<td>0.00</td>
<td>5.44</td>
<td>15.79</td>
</tr>
<tr>
<td>1994</td>
<td>17.76</td>
<td>55.11</td>
<td>1.75</td>
<td>36.63</td>
<td>111.26</td>
</tr>
<tr>
<td>1995</td>
<td>15.74</td>
<td>50.15</td>
<td>13.90</td>
<td>34.08</td>
<td>113.87</td>
</tr>
<tr>
<td>1996</td>
<td>25.85</td>
<td>82.30</td>
<td>9.99</td>
<td>55.31</td>
<td>173.45</td>
</tr>
<tr>
<td>1997</td>
<td>39.13</td>
<td>125.20</td>
<td>24.15</td>
<td>87.44</td>
<td>275.92</td>
</tr>
<tr>
<td>1998</td>
<td>58.93</td>
<td>198.63</td>
<td>36.12</td>
<td>131.36</td>
<td>425.04</td>
</tr>
<tr>
<td>1999</td>
<td>18.36</td>
<td>63.11</td>
<td>26.34</td>
<td>40.20</td>
<td>148.01</td>
</tr>
<tr>
<td>2000</td>
<td>10.11</td>
<td>32.46</td>
<td>7.17</td>
<td>23.77</td>
<td>73.52</td>
</tr>
<tr>
<td>2001</td>
<td>8.16</td>
<td>25.84</td>
<td>4.97</td>
<td>19.28</td>
<td>58.24</td>
</tr>
<tr>
<td>Total</td>
<td>196.67</td>
<td>640.50</td>
<td>124.40</td>
<td>433.52</td>
<td>1,395.09</td>
</tr>
</tbody>
</table>

Applying the same methodology to the forecasted private construction (a temporary increase on autonomous expenditure also ascribable to the project), we obtained a total of \( €556.7m \).

The Expo’98 World Exhibition was the flag event associated to the major urban renewal project. We also considered that Expo’98 could increase tourism—Basílio (2002). He shows a statistically significant effect, although only temporary, on the net inflow of tourists to the Portuguese economy. This may also be seen as an increase on autonomous expenditure and so implies an increase on total output. We applied again the steps described above and obtained a total of \( €344.3m \) for central tax dividends induced by additional tourists.
Summing up the effects of the increase on expenditure due to the master developer, private firms and additional tourists, the present value of the central government tax dividends is €2,432.2m, at 2001 prices.

Taken together, the public revenue effects springing from asset appreciation and expenditure inflows (€4,026.9m) are much higher than the public subsidy given to the project—Exhibition plus urban renewal. As the approach was very conservative and as there were several effects not quantified (for instance, the capital gains on local and central government property), the study confirmed the net social gain derived from the public endorsement of the Expo’98 project.

References


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1 These references are application examples. They focus on the macroeconomic impact of EU’s regional policy.

2 Also focusing on EU’s regional policy.

3 This is certainly the case of Boston’s Convention & Exhibition Centre (http://www.mccahome.com/MCCAHome.aspx). Special taxi medallions were sold to capture this benefit.

4 The applied analyst may wish to consider another property assessment method if she has access to a better one.

5 In general, the true market prices (either rents or ownership values) are unobservable and those databases just record proxies for such prices. For instance, CCIAAR (2001) reports professional value assessments for Rome city and province whereas Confidencial Imobiliário (2000) reports ask quotes (for values) for many Portuguese cities recorded by real estate agents.

6 State legislation enabled the imposition of the following excise taxes: 10-dollar levy on each vehicular rental transaction and an additional hotel room tax—actually, an increase up to 4.5 per cent of the original tax rate.

7 Indeed, \( w \) and \( B \) can be vectors of tax rates and base subtotals, respectively, depending on the actual tax structure.

8 See Subsection 5.1 for permanent effects and Subsection 6.1 for temporary effects.

9 To be fully coherent, the impact on social security revenue should also deduct the impact on future social security payments in countries where earmarking applies. This is more likely the case of fully-funded pension systems and definitely not the case of pay-as-you-go systems. Hence, the applied analyst may wish to evaluate the project’s impact on net social insurance revenues whenever she has access to studies allowing for an easy and sound projection of the future welfare costs out of a projected current revenue increase.

10 See the discussion and the references in Fisher (1996) and Bahl and Linn (1992).

11 For very large economies the appropriate dimension may be the region.

12 In our application to the Portuguese case (Section 7 below) we draw on the detailed presentation of all the relevant results by Neves and Sarmento (2001). Detailed studies for other EU countries are also available.

13 Bouthevillain et al. (2001, p. 41) present a comparison between their results and the OECD’s for the common set of countries.

14 As we were making an ex-ante analysis with access to data extending beyond the credibility acquisition, we confirmed that the rental rates in those districts actually converged to the benchmark values. This convergence was clear by 1998, at a time when the commitment of the Portuguese government and the financial sector with the Expo’98 urban renewal project was already guaranteed.

15 The choice of a small period for estimation minimizes the risk of structural breaks. Indeed, we obtained statistically significant structural breaks with longer time series.