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## Temporary Tax Cuts

Temporary income tax changes are not an effective way to influence economic activity and might actually be counterproductive, according to the results of new research by **Alan S. Blinder** of Princeton University. The efficacy of the income tax surcharge enacted by Congress in 1968 to cool excess demand and the \$32 billion rebates and temporary tax cuts used to stimulate the economy in 1975 and 1976 has been a matter of some contention among economists. Blinder's study, **Temporary Taxes and Consumer Spending**, *Working Paper No. 283*, sheds new light on the controversy and suggests strongly that the same amount of stimulus or restraint could have been achieved with much smaller permanent tax changes.

The assumption that temporary income tax changes might not be effective is based on the permanent income hypothesis that holds that individuals base their spending and saving decisions on expectations about their lifetime incomes. Therefore, transitory changes in income, such as an inheritance or a one-time tax rebate, will affect spending less than a permanent change in income of the same magnitude. That is, a person will spend more of a \$1,000 raise than of a \$1,000 windfall during the year in which they are received. If the theory is correct, it means that temporary tax changes will have less immediate impact on aggregate demand than permanent tax changes of the same magnitude.

In his analysis of the 1968 and 1975-76 measures Blinder raises several important qualifications of the theory. For one thing, the question of the effectiveness of a temporary change has to be considered over some relevant time frame, since all income—both windfall and permanent—is fully expended over the long run.

Also, there are four reasons why temporary taxes might affect spending rather more than the pure theory would suggest. Part of a rebate might be "saved" in the form of durable goods purchases. In that case it would meet the policy goal of stimulating aggregate demand even though individuals would be behaving in accord with the theory. In addition, some households may face liquidity constraints that are ignored by the theory and may have to reduce spending in response to a temporary tax increase. Third, whether people treat a tax change as a windfall or an alteration in their permanent income really depends on how they perceive the change, and not on whether the government describes it as temporary or permanent. Finally, households

may discount the value of future consumption more heavily than envisioned in the theory. If people are short-sighted, temporary tax changes could have substantial effects on spending.

The results of prior tests of the efficacy of temporary tax measures have varied widely. Some have found that individuals treat surcharges and temporary reductions the same way that they treat changes in permanent income, so that temporary measures are fully effective policy tools. Other tests have found that temporary tax changes have little effect on aggregate demand and that people apparently save most of a rebate or make up most of a surcharge by drawing on savings. Blinder's finding lies between those two extremes; he concludes that individuals react to temporary income tax changes as though they were made up of a mixture of windfall and permanent income change.

Blinder's analysis differs from earlier ones in that he distinguishes temporary taxes from other changes in income on the grounds that the taxes are more transitory. This modification enables Blinder to segregate the effect of temporary taxes on spending. His study uses three income breakdowns: one includes only temporary taxes and all other changes in income; another consists of temporary taxes, permanent taxes, and personal income; and the third divides personal income into factor income and transfer payments.

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The first breakdown estimates that temporary taxes are treated as 75 percent windfall and 25 percent permanent income change. The second and third analyses estimate that people react to temporary taxes as though they were a fifty-fifty mixture of windfall and permanent change. Although these may not be precisely accurate, Blinder is able to conclude with confidence that temporary taxes do not affect spending as much as normal changes in income do.

The most important implication of Blinder's study is that temporary tax changes have only 20 to 60 percent, and re-

bates only 10 to 50 percent, as much impact on spending over the first year as do permanent tax changes. Viewed another way, a permanent tax cut of between \$2.5 billion and \$10 billion would have had as much impact on 1975 economic activity as that year's \$17 billion of rebates and temporary reductions.

The temporary tax savings do eventually get spent of course. Blinder's data suggest that much of the spending comes in the two years after a temporary cut (i.e., a 1975 rebate will have its greatest impact on spending in 1976 and 1977). Blinder believes that the delayed-spending response to temporary tax changes explains why the savings rate jumped to an incredibly high 9.7 percent in the second quarter of 1975 and then plummeted to its lowest level since the Korean War in the first quarter of 1977.

The delayed-spending response also is the reason that temporary tax changes can prove counter-productive if the goal of economic stimulus or restraint is very short run—the greatest impact of a temporary tax change may not come until it is no longer desired. Blinder concludes that smaller, permanent tax changes would be more effective policy tools, in terms of both timing and impact, provided that consumers believe the changes are truly permanent. AE

## Double Tax on Dividends

**Charles E. McLure, Jr.**, Vice President of NBER, in *Working Paper No. 298, A Status Report on Tax Integration in the United States*, considers how provisions such as the investment tax credit (ITC) and accelerated depreciation fit into a system for relieving the double taxation of dividends. In contrast, most earlier discussions of the economic advantages and disadvantages of "integrating" the corporate and personal income taxes have been conducted, at least implicitly, under the assumption that there are no such tax incentives. McLure concludes that the treatment of provisions such as the investment tax credit and accelerated depreciation can significantly affect both the administrative feasibility and the economic effects of any scheme for reducing the double taxation of corporate income.

The general cases for and against integrating the income taxes are by now well known. The separate tax on corporate income, besides favoring noncorporate businesses, creates a corporate preference for retained earnings over distributions and for debt in lieu of equity finance. While on balance the corporate tax adds to the progressivity of the tax system, it generates aggregate corporate and personal tax burdens on corporate and personal tax burdens on corporate income that diverge widely from statutory rates. Integrating the income taxes would eliminate these anomalies. Whether integration would also spur capital formation depends on whether, and by what means, lost revenue would be made up.

Total integration, in which the separate corporate income tax is abolished and retained earnings are attributed to shareholders for tax purposes, would be administratively difficult. Even if problems caused by requirements for data transmittal and record keeping and by amended returns and

audit adjustments could be handled satisfactorily, it is far from clear how corporate losses and multiple classes of stock should be treated. Although both Canada and Germany have toyed with the idea, no major country has attempted total integration of its income taxes.

European experience suggests that while total integration might be difficult to implement, providing relief from double taxation of dividends is feasible. Dividend relief could be provided either by allowing the corporation a deduction for dividends paid or, as in most European schemes, by allowing the shareholder a credit for that part of the corporate tax that is attributed to dividends. Germany now uses a hybrid system that, in effect, combines the two approaches.

Firms would have substantial incentives to distribute earnings if dividend relief were allowed. To the extent that corporate income is distributed, dividend relief would resemble integration. In most countries that provide dividend relief, only about one-half of the double taxation of dividends is eliminated, so the incentive for distribution—and the resemblance to integration—is correspondingly less.

The logic of total integration suggests that any special provisions that are available to noncorporate business should be passed through to shareholders. Under this view shareholders would receive ITCs for qualifying investments made by firms whose shares they own. Although the logic is equally compelling for dividend relief, its interpretation is not as obvious.

Dollars used to pay dividends do not carry convenient identifying tags. Therefore, it is necessary to assume arbitrarily either that dividends are paid first from fully taxed income, with any residual coming from so-called preference income (income benefiting from tax incentives such as the ITC, accelerated depreciation, and so on), that they came first from preference income, or that they are paid in proportionate amounts from preference and fully taxed income. While a proportionate assignment might seem to be the most reasonable, European experience suggests that it is virtually imperative for administrative reasons that dividends be assumed to come first from fully taxed income. This is the assumption implicit in the Ullman proposal made to the Congress a year ago; it is also inherent in European systems of dividend relief.

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Common European practice—and the Ullman proposal—differs in yet another way from what might seem to be inherent in the logic of integration. In Europe a special tax on corporations equal to the rate of shareholder credit is levied on any distributions paid from income that has not been fully taxed. Thus the benefits of provisions such as accelerated depreciation, the ITC, and so on, rather than being passed through to shareholders, are nullified any time dividends are deemed to be paid from income that has not been fully taxed at the corporate level. An alternative and economically equivalent approach that has sometimes been

mentioned in the United States, in which the shareholder credit would be based on the corporation's effective tax rate, would probably not be administratively feasible.

For many firms dividends would be no greater than net income on which the full corporate tax had been paid; for these firms the benefits of the ITC and other special provisions would be preserved. But firms with high dividend payout rates and substantial tax deductions and credits intended to provide incentives for specified activities—most notably public utilities and banks—could pay dividends in excess of their net taxable income and would, to that extent, find the benefits of the special tax provisions nullified. Thus dividend relief could affect various industries quite differently, if European experience is any guide. Moreover, incentives to distribute income would hold only so long as dividends could be paid from fully taxed corporate net income. Beyond that point, there could be a substantial disincentive to paying dividends.

## Union Power and Wages

The proportion of the production workers in an industry who are union members is an important determinant of union power, a new NBER study has found. The study shows that the ability of unions to win higher wages is closely related to the percentage of workers in a product market who are unionized. For instance, after all other factors are taken into account, union wages rise by 6 to 10 percent as the proportion of union members in an industry rises from 20 to 80 percent. The wages of nonunion workers in a market sometimes rise as union coverage increases, but by a much smaller amount, and sometimes they are totally unaffected. As a result, the differential between union and nonunion wages also increases with the extent of unionization.

The findings of **Richard B. Freeman** and **James L. Medoff** of the National Bureau of Economic Research are reported in **The Percent Organized Wage (POW) Relationship for Union and for Nonunion Workers**, *Working Paper No. 305*. This study is the first to demonstrate the relationship between union power and the extent of union coverage in an industry. Earlier studies related wages to individual union membership, but not to the percentage of workers covered, or related average wages in an industry to the extent of unionization, but did not focus on the union-nonunion differential.

There are several reasons to believe that union wages will rise as the extent of unionization increases. The first reason is that the opportunities for customers to shift to nonunion companies decreases as the extent of union coverage increases. Rising union coverage thus reduces the elasticity of demand for the products of union companies and, in turn, the elasticity of demand for union labor. Therefore, it makes sense for unions in high coverage industries to press for higher wages because the cost of a wage increase—in the form of lost union jobs—is lower. Alternatively, it could be that unions have concentrated on, and prospered in, industries with inherently low elasticities of demand for labor. That is, low elasticity of demand for labor may be a cause,

rather than a result, of high union coverage in an industry. A third reason for expecting a relationship between union wages and the extent of unionization is that unions in high coverage industries may be able to limit substitution between nonlabor and labor inputs. In other words, they may be able to reduce the elasticity of demand for labor by limiting the ability of employers to substitute other inputs for high-wage workers.

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Freeman and Medoff estimate the actual effect of union coverage by relating the difference between union and non-union wages to the percentage of union coverage in eighty manufacturing industries. For some other industries, including construction, they link wages to union coverage within geographic areas. In order to isolate the effect of the extent of union coverage, Freeman and Medoff control statistically for the effects of other potentially important factors. For example, they adjust for the effect of company size because large companies tend to pay higher wages and because there is also a correlation between company size and unionization.

While it is likely that high union coverage will give rise to high union wages, it is unclear what the effect will be on nonunion wages. On the one hand, there will be a wage-boosting demand effect on nonunion labor as customers shift from union products to lower priced nonunion ones. In addition, the threat of unionization is likely to rise with union wages, inducing nonunion employers to pay more in order to dissuade their workers from organizing. On the other hand, there will be a wage-reducing supply effect on nonunion wages. As union wages rise, employment in unionized companies will fall, and the supply of workers to non-union firms will increase.

In addition to their finding that the extent of union coverage has a strong effect on *union* wages in manufacturing, Freeman and Medoff find that nonunion wages in a sector are unaffected or rise slightly as the extent of union coverage in an industry increases. The results for the construction and nonmanufacturing industries are similar with some greater indication of increases in nonunion wages as coverage rises.

The Freeman-Medoff findings have another implication. Past studies of union-nonunion wage differentials in manufacturing have been interpreted as providing information only about the impact of unions on relative wages. It now appears that they provide information about the impact on absolute wages as well. Since higher union coverage does not cause nonunion wages to fall, and probably causes them to rise slightly, the past studies indicate the minimum total impact of unions on wages. That is, unions raise the wages of their members by at least as much as the union-nonunion differential, and they might raise all wages in an industry as well.

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