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1986 Tax Reform Will Reduce U.S. Housing Stock

The Tax Reform Act (TRA) of 1986 will raise investment in housing by 2.2 percent in the short term compared to what it would have been. In the long run, however, TRA will make housing investment 5.6 percent lower, according to the NBER's **Lawrence Goulder.**

In **Tax Policy, Housing Prices, and Housing Investment** (*NBER Working Paper No. 2814*), Goulder explains that TRA boosts short-run investment in housing by increasing the incentive to invest in housing relative to other industries. For one thing, TRA eliminated the investment tax credit that used to exist for purchases of equipment. Because housing consists mainly of structures, and because nearly all structures were not eligible for the tax credit, removal of the credit makes investment in housing more attractive than investment in other industries.

The scaling back of allowances for tax depreciation also favors investment in housing. A large fraction of houses are owned by their occupants, who were unable to deduct depreciation prior to or after the 1986 Act. Therefore, the changes in depreciation rules have a bigger negative impact on other industries, making investment in housing relatively more attractive.

On the other hand, the drop in the corporate income tax rate, from 46 percent to 34 percent, hurts investment in housing. Because less than 3 percent of residential capital is owned by corporations, the cut in rates is a far greater spur to investment in other industries, making housing investment less favorable by comparison.

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The net short-run effect of these two incentives and one disincentive is an increase in housing investment, according to Goulder. However, the 1986 Tax Reform Act's disincentives for all types of investment eventually will lead to a lower capital stock overall, which will cause lower output and incomes and reduced demands for housing services. This in turn implies lowered housing investment and a reduction in the stock of housing capital.

Associated with the long-run reduction in the housing capital stock is a long-run decline of about 3 percent in the total market value of housing. Goulder indicates that "the long-run decline in the total value of housing reflects a decline in housing quantities, not prices," since the long-run price per house should be about 1.1 percent higher than otherwise because of the new tax law.

DRH

How Can Latin American Nations Expand Trade?

Greater economic integration within Latin America has been a long-standing aim of many of the region's leaders. Although there were a number of integration schemes from the 1950s to the 1970s—the Latin American Free Trade Area, the Central American Common Market, the Caribbean Community, and the Andean Pact, among others—all have achieved limited success. At a time when most Latin American countries had few manufactures to export and sought to discourage imports to promote domestic industrialization, increasing foreign trade was not viewed as an important goal.

Servicing large foreign debts, and the spread of free trade arrangements in Europe, North America, and the South Pacific, have led Latin American counries to again consider ways of boosting trade among themselves. In many countries, regional economic integration is now perceived as a component of an overall outward-oriented strategy designed to enhance export growth. But NBER Research Associate **Sebastian Edwards** and **Miguel Savistano** find that integration is not likely to lead to a substantial increase in Latin American trade for many years. If exports are to grow, they suggest, that growth will have to come primarily from industrial country markets.

In **Latin America's Intraregional Trade: Evolution and Future Prospects** (*NBER Working Paper No. 2738*), Edwards and Savastano find that the opportunities for a substantial increase in trade among countries of the region are limited. In fact, the trend is in the other direction: after peaking at 13 percent in 1979, the share of Latin American exports destined for other Latin American countries fell to 9 percent by 1986. Over the same period, the share of exports shipped to the United States grew from 31 to 40 percent.

In the machinery, chemicals, and other manufactured goods sectors, in which the efforts at regional integration have been concentrated, Latin American countries are already drawing a growing share of their imports from other Latin American countries. For instance, between 1975 and 1984, manufactured imports from other Latin American and Caribbean countries as a percentage of all manufactured imports rose from 12 to 25 percent for Argentina, from 4 to 11 percent for Brazil, from 8 to 12 percent for Colombia, and from 5 to 9 percent for Venezuela. Given the decline in the dollar value of imports for almost every country in the region, however, this suggests less a surge in intraregional trade than a decline in the region's ability to finance imports from industrialized countries. In the agricultural sector, on the other hand, the share of imports originating within the region has declined precipitously since 1970, as a greater share of imported feeds and foodstuffs have been drawn from the United States.

Edwards and Savastano also report that the Latin American countries became more open to foreign trade during the 1970s. For example, between 1970 and 1980, the ratio of imports plus exports to gross domestic product grew from 14 to 21 percent in Brazil, from 29 to 36 percent in Chile, from 24 to 27 percent in Colombia, from 11 to 19 percent in Mexico, and from 38 to 52 percent in Venezuela. Since 1980 and the beginning of the debt crisis, this measure of openness has fallen in most Latin American countries. Between 1980 and 1985 the level of real imports declined by 45 percent in the 14 largest Latin American countries.

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Given these facts, Edwards and Savastano suggest, it is unrealistic to expect a large increase in the share of Latin American nations' trade that is conducted with other nations in the region. Preferential reductions in tariffs, alternatives to dollar-denominated payments, and other discriminatory measures are not likely to bring about substantial growth in trade, since most of that growth probably will be absorbed by the largest countries of the region, particularly the industrialized countries.

"There does not seem to exist any solid basis for advocating the return to a more regulatory approach to commercial integration in Latin America," Edwards and Savastano conclude. "The resumption of growth within the region will depend mainly on the design of a satisfactory solution to the debt problem, on the eradication of trade discriminatory practices in industrialized nations, and on the extent to which each Latin American country decides to implement profound structural reforms aimed at avoiding macroeconomic instability and at achieving a less biased and intricate trade regime." ML

Saving Rates and the Fear of World War

Countries tend to save less when a large fraction of their population think that a world war is likely during the next ten years, according to NBER Research Associate **Joel Slemrod**. The country that most expects another world war is the United States, he finds.

In **Fear of Nuclear War and Intercountry Differences in the Rate of Saving** (*NBER Working Paper No. 2801*), Slemrod reports the results of a Gallup Poll that asked respondents in 34 countries their opinion of the chances that a world war would break out during the next ten years. In the United States, 49 percent of those surveyed in 1986 thought that the chance of world war was 50 percent or greater. By contrast, only 14 percent of the respondents in the Netherlands thought that war was that likely, compared with 15 percent of the Japanese, 18 percent of the West Germans, 20 percent of the Britons, and 24 percent of the French respondents.

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Slemrod estimates that an increase of 10 percentage points in the fraction of the population that thinks the chance of world war is 50 percent or greater is associated with a decrease of about 4 percent in the net private saving rate. He also finds that the rate of recent economic growth and the age distribution of the population influence the saving rate.

Slemrod suggests that glasnost, by lowering expectations of world war, may contribute to higher saving rates around the world.

OSHA's Impact on Workplace Injuries

Increasing the number of OSHA inspections and the penalties imposed during those inspections would lead to reductions in workplace injuries, according to a new study by NBER Research Economist **Wayne Gray** and **John Scholz.** Gray and Scholz find that the annual number of injuries in an establishment declines for two or three years after it is inspected. Also, the larger the penalties imposed during the inspection, the more the injuries decline. Inspections without penalties have a relatively small impact on injuries.

In **A Behavioral Approach to Compliance: OSHA Enforcement's Impact on Workplace Accidents** (*NBER Working Paper No. 2813*), Gray and Scholz estimate that a 10 percent increase in the number of OSHA inspections done each year would reduce total annual injuries by 1.6 percent. A 10 percent increase in the average penalty per inspection would reduce total annual injuries by 0.9 percent.

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Manufacturing establishments suffered 1.2 million injuries that resulted in 19 million lost workdays in 1979, Gray and Scholz report. The average manufacturing worker lost slightly over a day of work that year. That same year, OSHA performed 28,389 inspections of manufacturing establishments, levying a total of $7.5 million in penalties.

Gray and Scholz suggest that OSHA inspections and penalties are effective in reducing workplace accidents because they draw management's attention to safety issues. An inspection without a penalty may encourage management simply to maintain existing safety procedures.

This study is based on annual data on injury rates and OSHA inspections for 6842 manufacturing plants from 1979 to 1985. Gray and Scholz note that these plants are larger than the typical manufacturing plant (averaging 523 employees in 1979, versus 87 employees for all manufacturing plants), and are more likely to be inspected by OSHA (27 percent were inspected in 1979, versus 8.1 percent of all manufacturing plants), so that it may not be possible to generalize the results of the study in order to predict OSHA's impact on injuries throughout the economy.

Managing Exchange Rates

Since the 1985 Plaza Accord, the U.S., German, and Japanese central banks have intervened massively in foreign exchange markets. But NBER Research Associate **Maurice Obstfeld** argues that intervention has played only a minor role in the dramatic realignment of exchange rates since 1985. In **The Effectiveness of Foreign Exchange Intervention: Recent Experience** (*NBER Working Paper No. 2796*), he concludes that "monetary and fiscal policies and not intervention per se have been the main policy determinants of exchange rates in recent years."

Obstfeld finds that intervention has been a weak instrument at best. For starters, the major currency

trends since 1985 can be traced largely to shifts in fiscal and monetary policy. Take the dollar's two-year tumble from its February 1985 peak. Obstfeld finds that the decline was triggered by the Fed's abrupt shift to an easier monetary policy in 1984 and was sustained by falling U.S. short-term interest rates. A reversal of the fiscal trends of the early 1980s in the United States and Germany was also key. By 1986, the ratio of government deficits to GNP had stopped rising in the United States and leveled off in Germany, a development that was widely anticipated in 1985.

Intervention frequently has failed, Obstfeld points out. Over 1987, the dollar declined despite heavy central bank intervention. More recently, the dollar rose by nearly 8 percent in the summer of 1988 even though Germany, Japan, and the United States were intervening against the dollar on a large scale. In both of these cases, governments were unable to maintain previously established target ranges for currency values.

"Intervention has been a weak instrument at best."

Intervention has been effective on some occasions, though. These involve the coordinated effort to drive the dollar down immediately after the Plaza Accord in Fall 1985 as well as an operation by the Fed, the Bundesbank, and several other European central banks in mid-1987 to counter pressure on the mark.

But, successful intervention does not really work independently of fiscal and monetary policy. Obstfeld finds that intervention is effective only when markets interpret the action as a credible signal of government intentions. Immediately after the Plaza meeting, for example, intervention signaled that the Fed was not going to slam on the brakes despite rapid growth of the money supply. Obstfeld points out that signaling is most likely to work when intervention is coordinated and, more importantly, when it is followed promptly by definite monetary or fiscal policy actions.

In related research, NBER associates **Francesco Giavazzi** and **Alberto Giovannini** investigate how the European Monetary System of fixed exchange rates works. Their study, **Can the European Monetary System Be Copied Outside Europe?** (*NBER Working Paper No. 2786*), concludes that the EMS could not be duplicated easily, say, by the United States, Germany, and Japan. For one thing, the EMS is just one strand in a larger movement toward economic integration. EMS targets are extremely credible because institutions within the European Economic Community are unusually dependent on stable exchange rates. Further, central banks within the EMS do not operate as equals. Indeed, Giavazzi and Giovannini find that the system functions as a de facto Deutsche mark zone in which Germany sets the monetary policies and France, Italy, and the other EMS member countries follow along. SN

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