

1986 Tax Reform Reduces Incentive to Invest in Housing

The Tax Reform Act of 1986 reduced investment in owner-occupied housing, especially for high-income taxpayers. At the same time, it shifted the remaining benefits of the mortgage deduction toward high-income households. The 1986 law also reduced the incentive to invest in rental housing, contributing to the decline in new multifamily housing starts from 500,000 in 1985 to less than 150,000 in 1991, according to a new study by NBER Research Associate **James Poterba**.

In **Taxation and Housing: Old Questions, New Answers** (*NBER Working Paper No. 3963*), Poterba explains that by reducing marginal tax rates for high-income taxpayers, the 1986 law reduced the incentive to invest in housing.

The 1986 tax law also increased the standard deduction, thus inducing millions of middle-income taxpayers to stop itemizing. By not itemizing, they could not deduct their interest payments on their mortgage. This reduced the total number of homeowners who deducted interest for home mortgages. Whereas in 1985, home mortgage interest deductions were claimed on 28.1 million returns, the Joint Tax Committee projected that only 24.1 million returns would claim such deductions for 1991, even though several million more taxpayers owned homes then than in 1985. Thus, for middle-income taxpayers also, the 1986 law reduced the incentive to consume housing.

As a result of the increase in the standard deduction, high-income households now get a slightly higher percentage of the tax deductions for mortgage interest. In 1986, the year before the Tax Reform Act

took effect, taxpayers with an income of \$50,000 or more (in 1988 dollars) got 62.3 percent of the total mortgage interest deductions taken. By 1988, they got 66.8 percent.

The 1986 tax law also substantially reduced the incentive to invest in rental housing. The law extended the depreciation lifetime for rental structures to 27.5 years, required straight-line depreciation rather than the more accelerated 175 percent declining-balance depreciation that had existed before 1986, limited the deduction of passive losses on rental housing, and removed the favorable treatment of capital gains income. All of these provisions made investment in housing less attractive. Not surprisingly, therefore, less investment occurred.

“The 1986 tax law . . . substantially reduced the incentive to invest in rental housing.”

Whereas multifamily housing starts were 300,000 to 400,000 annually prior to 1981 and peaked at 510,000 in 1985, they fell sharply after the 1986 tax law. Starts were down to 241,000 in 1990 and only 140,000 in 1991. Yet surprisingly, rents adjusted for inflation have increased by less than 2 percent since 1986, which is less than the 2 percent annual increase in rents in the four years before the 1986 law.

Social Security Distorts Marginal Tax Rates

The Social Security payroll tax is popularly thought of as a flat tax. Under the law, workers and their employers pay equal amounts totaling 11.2 percent of wages and salaries, plus additional fixed percentages for disability insurance and Medicare. In contrast to the federal personal income tax, which generally imposes higher rates on households with higher incomes, the Social Security rate is constant; the only exception is for individuals earning more than a maximum set by law (\$53,400 in 1991), who need pay no tax on earnings above that amount. But in a new NBER study, **Martin Feldstein** and **Andrew Samwick** point out that the seeming uniformity of the Social Security tax is deceptive. Although the payroll tax rate is uniform, the retirement benefits individuals can expect to receive from Social Security vary widely, creating widely differing net marginal tax rates among workers.

In **Social Security Rules and Marginal Tax Rates** (*NBER Working Paper No. 3962*), Feldstein and Samwick note that the full statutory 11.2 percent rate without any offsetting benefits applies to young workers, to women who will collect benefits as dependents, and to the very poor (who get Supplemental Security Income benefits rather than ordinary Social Security benefits). In contrast, those who earn benefits by paying taxes face substantially lower net marginal Social Security tax rates.

A typical 45-year-old man or woman who will collect benefits based on his or her own earnings faces a net marginal tax rate of only 5 percent. And, a typical married man whose wife will collect benefits based on his earnings record faces a *negative* marginal Social Security tax rate of 2.1 percent. If the couple has a marginal federal income tax rate of 15 percent, then the husband's combined marginal tax rate on earnings is reduced to 12.9 percent. In contrast, the wife in that couple pays the full 11.2 percent Social Security tax plus the 15 percent income tax for a combined marginal tax rate of 26.2 percent.

“The seeming uniformity of the Social Security tax is deceptive. Although the payroll tax rate is uniform, the retirement benefits individuals can expect to receive from Social Security vary widely, creating widely differing net marginal tax rates among workers.”

In general, the authors find, younger workers face much higher marginal tax rates than older workers: a

middle-income male planning to retire completely at age 65 faces a marginal Social Security tax rate of about 6.5 percent in his early 20s, but less than 3 percent in his mid-50s. Women who expect to collect benefits based on their own earnings have lower rates than men of the same age and income, and much lower rates than women who expect to collect benefits as dependents.

These differing marginal tax rates are inefficient, Feldstein and Samwick contend, because they distort labor supply decisions. The most serious distortions involve females: women whose earnings are so low that they would receive more as their husband's dependent than they would based on their own earnings record, pay the highest marginal rate, 11.2 percent, which discourages them from working altogether. “Reducing or eliminating the gap in tax rates within each married couple could be achieved by pooling the couple's Social Security earnings and taxes and dividing them equally between both members,” the authors suggest.

ML

Exports Help Eastern Europe

Since the opening of the Berlin Wall and the end of the Soviet empire, incomes in Eastern Europe have fallen sharply. During 1990–1, GDP fell 19 percent in Czechoslovakia, 11 percent in Hungary, and 20 percent in Poland. Now a new NBER study by **Dani Rodrik** estimates that the collapse of traditional export markets in the Soviet Union and of regional trading institutions in Eastern Europe can account for all of the decline in Hungarian income, about 60 percent of the decline in Czechoslovakia, and about 30 percent of the decline in Poland.

In **Making Sense of the Soviet Trade Shock in Eastern Europe: A Framework and Some Estimates** (*NBER Working Paper No. 4112*), Rodrik reports that sales to the Soviet Union constituted a large share of total manufacturing output in all three countries before 1990, particularly where capital goods were concerned. Rodrik estimates that the value of exports from these three countries to the Soviet Union and other formerly socialist economies fell by more than 75 percent in 1990–1. Moreover, their terms of trade with the Soviet Union deteriorated by 30–50 percent in 1991. These market-loss and terms-of-trade effects had a serious impact on output and employment.

In a related study, Rodrik writes that sales to Western Europe have boomed during the past two years.

For instance, Czechoslovak exports to Germany, Italy, and the Netherlands increased by about 20 percent from the first half of 1990 to the first half of 1991, and exports from Hungary and Poland to market economies increased even faster.

“The depreciation of Czech, Hungarian, and Polish currencies and the sharp fall in domestic demand are responsible for their exporting success.”

In **Foreign Trade in Eastern Europe’s Transition: Early Results** (*NBER Working Paper No. 4064*), Rodrik explains that the depreciation of Czech, Hungarian, and Polish currencies and the sharp fall in domestic demand are responsible for their exporting success. The elimination of most restrictions on trade also played a role in stimulating exports. Since 1990, these three Eastern European economies have become substantially open to trade, with low tariffs and few quantitative restrictions. However, the industries that have succeeded in increasing exports to the West are not the same ones that lost markets in the East—machinery and electro-engineering products. This suggests that considerable restructuring of the economies of Eastern Europe will be necessary to meet the new patterns of demand.

Japanese and U.S. Executives Face Risk of Job Loss

The top executives of large Japanese corporations receive considerably less cash compensation than their U.S. counterparts do, but they are just as likely to leave the company when their firms perform poorly, according to an NBER study by **Steven Kaplan**. He finds that the top three or four executives in Japanese firms have no guarantee of lifetime employment. In fact, executives just below the top level are more likely to be fired for poor performance in Japan than comparable executives in the United States are.

Further, contrary to what many had thought, there is no evidence that Japanese executives are compensated relatively more than U.S. executives for emphasizing market share or growth in sales over profits or stock prices. In both countries, Kaplan finds, rais-

ing profits and stock prices is rewarded more than boosting sales and market share.

In **Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States** (*NBER Working Paper No. 4065*), Kaplan examines the 149 largest U.S. companies and the 119 largest Japanese companies on *Fortune* magazine’s 1980 lists of the largest U.S. and foreign industrials. He reports that cash compensation, including salary and bonuses, for top Japanese executives averaged just under \$64,000 in 1981–4, compared with \$360,000 for top management in U.S. firms and \$286,000 for the average vice president in a U.S. firm. Changes in the yen/dollar exchange rate, and the faster growth of Japanese firms since then, have narrowed the difference between executive compensation in the two countries, but the gap undoubtedly remains large.

“There is no evidence that Japanese executives are compensated relatively more than U.S. executives for emphasizing market share or growth in sales over profits or stock prices.”

Another difference between the countries is that the Japanese top managers tend to be older than their U.S. counterparts. In 1980, the typical Japanese president was 66, while the typical U.S. president or CEO was 59. As a result, Japanese executives are more likely than Americans to die while in office or retire. However, in both the United States and Japan, a decline in the firm’s stock price, earnings, or sales growth significantly increases the likelihood that the president will leave the company.

While the relationship between reward and performance is generally similar in the United States and Japan, one difference emerges. Executive turnover and compensation in Japan are most sensitive to negative earnings, and more so than in the United States. In Japan, top executives of firms with negative earnings see their cash compensation decline by 15 percent and the likelihood of losing their positions increase by approximately 50 percent. Contrary to the view that Japanese managers can ignore current earnings, it appears that they are heavily penalized if their current and past investments do not generate positive earnings.

Kaplan concludes that, in Japan, a firm’s main bank is relatively inactive unless the firm performs poorly enough to jeopardize the bank’s loans. When the firm has difficulty meeting its financial obligations (that is, when earnings are negative or low), then the main bank intervenes.

New NBER Book

Tax Policy and the Economy, Volume 6

Tax Policy and the Economy, Volume 6, edited by James M. Poterba, is now available from the MIT Press. The price is \$28.95 for clothbound and \$14.95 for paperback.

This volume includes discussions of carbon and other energy taxes, corporate revenues since the tax reform of 1986, and government policy toward retire-

ment saving. It should interest economists, accountants, those involved in formulating tax policy, and the business community in general.

Poterba is a professor of economics at MIT and co-director of the NBER's Program in Public Economics.

Tax Policy and the Economy, Volume 6 may be ordered directly from the MIT Press, 55 Hayward Street, Cambridge, MA 02142; their toll-free telephone number is 800-356-0343.



The National Bureau of Economic Research is a private non-profit research organization founded in 1920 and devoted to objective quantitative analysis of the American economy. Its officers are:

Chairman—George T. Conklin, Jr.
Vice Chairman—Paul W. McCracken
Treasurer—Charles A. Walworth

President and Chief Executive Officer—Martin Feldstein
Executive Director—Geoffrey Carliner
Director of Finance and Administration—Sam Parker

Contributions to the National Bureau are tax deductible. Inquiries concerning the contributions may be addressed to Martin Feldstein, President, NBER, 1050 Massachusetts Avenue, Cambridge, MA 02138-5398.

The **NBER Digest** summarizes selected Working Papers recently produced as part of the Bureau's program of research. Working Papers are intended to make preliminary research results available to economists in the hope of encouraging discussion and suggestions for revision. The **Digest** is issued for similar informational purposes and to stimulate discussion of Working Papers before their final publication. Neither the Working Papers nor the **Digest** has been reviewed by the Board of Directors of the NBER.

The **Digest** is not copyrighted and may be reproduced freely with appropriate attribution of source. Please provide the NBER's Public Information Department with copies of anything reproduced.

Preparation of the **Digest** is under the supervision of Donna Zerwitz. The articles indicated by DRH and ML were prepared with the assistance of David R. Henderson and Marc Levinson, respectively.

Abstracts of all current NBER Working Papers appear in the **NBER Reporter**. Individual copies of the NBER Working Papers summarized here (and others) are available free of charge to Corporate Associates. **For all others, there is a charge of \$5.00 per paper requested. (Outside of the United States, add \$10.00 per order for postage and handling.) Advance payment is required on orders. Please do not send cash.** For further information, please contact: **Working Papers**, NBER, 1050 Massachusetts Avenue, Cambridge, MA 02138-5398; (617) 868-3900.

Requests for **Digest** subscriptions, changes of address, and cancellations should be sent to **Digest**, NBER, 1050 Massachusetts Avenue, Cambridge, MA 02138. Please include the current mailing label.