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How Does Military Service Affect Civilian Earnings?

Veterans of World War II appear to earn 10 to 20 percent more than nonveterans their age, but Vietnam-era veterans earn less and have experienced more unemployment than comparable nonveterans in their age group.

Why this difference? Some have speculated that Vietnam-era veterans were discriminated against when they returned to the civilian labor market because the Vietnam War was unpopular, while World War II veterans and earlier generations of veterans were relatively successful in the civilian labor market because they returned home as heroes, and because their military training imparted valuable skills.

A new NBER study contradicts this view. In **Why Do World War II Veterans Earn More Than Nonveterans?** (*NBER Working Paper No. 2991*), **Joshua Angrist** and **Alan Krueger** find that the apparent labor market gains for World War II service are illusory—an artifact of the way individuals were selected into the armed forces in that era.

Nearly 80 percent of draft-age men served in the armed forces during World War II, and many of those who did not serve were deemed physically or otherwise unfit. Because of the government's selection and screening process, World War II veterans tend to possess more of the qualities that increase earnings. Thus, the men who served in the military during World War II would have earned more than nonveterans even if they had not served in the military. By ignoring the fact that selection into service was not random, simple comparisons of World War II veterans and nonveterans tend to overstate the effect of military service on earnings, On average, nonveterans of World War II are not comparable to veterans.

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Angrist and Krueger analyze the conscription process during World War II and observe that 10 million of the 16.4 million who served in that war were drafted. Because of the way the draft was conducted after 1942, men whose birthdays fell in the beginning of the year were more likely to be inducted than men born near the end of the year. Based on this feature of the draft, Angrist and Krueger use a new approach to estimate the true effect of military service on earnings. In essence, they overcome the fact that selection into military service was not random by linking differences in earnings to differences in the probability of serving in the military based on birthdate. Because the distribution of workers' skills and abilities is not likely to be correlated with their birthdays, this procedure compares veterans to otherwise comparable nonveterans.

Angrist and Krueger apply their technique to a

total sample of more than a quarter of a million men born between 1925 and 1928, drawn from the 1960, 1970, and 1980 Censuses. They conclude that World War II veterans certainly earn no more than comparable nonveterans, and probably earn 5 percent less than comparable nonveterans, on average. Thus, Angrist and Krueger's estimates suggest that after adjusting for differences in who was selected into the military, the effect of military service on civilian earnings is not very different for World War II veterans than for Vietnam-era veterans. DRF

Less Pain, More Gain in U.S. Business Cycles

Over the last century, the U.S. business cycle has changed considerably, according to NBER Research Associate **Victor Zarnowitz.** Downturns are less steep now, and expansions—including the current phase, which began in November 1982—last longer.

In **Facts and Factors in the Recent Evolution of the Business Cycle in the United States** (*NBER Working Paper No. 2865*), Zarnowitz examines U.S. business cycles over the last 100 years. Although some uncertainty about the early historical data is inevitable, certain findings are reasonably well established. For example, in the interwar years (1919–45) real GNP became more volatile, but its ups and downs have moderated since then. According to recent estimates, there was roughly half as much movement in real GNP around its average from 1946–83 as there was from 1875–1918, and only one-third as much as in 1919–45.

Zarnowitz finds that while the average length of a complete business cycle has not changed, the contractions (or recessions) have gotten shorter and the expansions longer. In the 70 years before 1945, contractions represented about two-fifths of the business cycle; since 1945, they have been only one-fifth of the cycle, while expansions accounted for four-fifths of the postwar period. The downswings also have become shallower, and there were proportionately more declines in output prior to 1945 than since.

Zarnowitz outlines a number of reasons for these changes. First, U.S. output and employment have been shifting from goods to services. In 1869, employment in trade, finance, insurance, and other service industries that are generally "noncyclical" was 19 percent of total U.S. employment; in 1979–81, the comparable figure was 45 percent. The demand for services that cannot be stored is much less sensitive to changes in income than the demand for goods: spending on services did not fall between 1948 and 1982. Thus, the shift to services has made GNP and employment less volatile.

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Government, another sector that does not shrink in recessions, also has grown much larger and more important to the economy over the century. Government employment was 4 percent of total U.S. employment 100 years ago and stands at 19 percent today.

Automatic fiscal stabilizers—including the progressive income tax and unemployment insurance —now help to cushion the economy in downturns. Government's active fiscal policies (for example changing the size of the budget deficit) had mixed effects but probably have been stabilizing on balance. The same is true of monetary policy.

Wages and prices have become less flexible downward in the last 50 years. In general, flexibility of relative prices and wages tends to moderate business cycles. However, before World War II, wages would fall during recessions, thus aggravating slumps in demand. Also, some of the most severe downturns were made worse by financial crashes. Nowadays, bank deposit insurance and central bank cooperation help to divert such financial panics.

Finally, consumers and businessmen learned from history to expect less cyclical instability in the future. Recessions became mild and short, in part because they are now expected to be so, which reduces the need for people to cut back their spending when times turn bad. To be sure, not all recent developments built confidence and promoted growth in this way: the rise of inflation in the 1970s and the subsequent disinflation in the early 1980s worked in the opposite direction for a time.

Capital Gains Tax Cut Would Cause Loss in Tax Revenues

Cutting the maximum federal tax rate on all capital gains from the current 33 percent to 15 percent is likely to reduce total federal tax revenues by $2 to $6 bil-

lion in the long run, according to an NBER study by **Patric Hendershott** and **Yunhi Won.** However, limiting the cut to capital gains on corporate equities probably would increase revenues, they conclude.

In **The Long-Run Impact on Federal Tax Revenues and Capital Allocation of a Cut in the Capital Gains Tax** (*NBER Working Paper No. 2962*), Hendershott and Won point out that decreasing the top tax rate on capital gains almost certainly would increase tax revenues in the short run by causing a onetime "unlocking" of existing capital gains. That is, people would respond to the lower tax rate by realizing gains that they had been postponing at the previous higher tax rates.

Even in the long run, the authors write, the lower tax rates would cause a large increase in realizations of capital gains, thus substantially reducing the federal government's loss in revenues. If a cut in the tax rate on capital gains did not cause people's behavior to change, then the federal government could lose $14.5 billion annually. But even a "moderate" increase in realizations in response to the cut—which is the most likely response—would bring the federal government's loss down to $3 billion annually.

"The reduction in tax rates on capital gains also would cause taxpayers to shift out of nontaxed assets—tax-exempt state and local bonds, for example—and into taxed assets."

If the top tax rate on capital gains were cut to 15 percent, corporations would respond by shifting their payout of corporate income away from dividends and toward capital gains, since capital gains would be taxed at a lower rate than dividends. The cut in the capital gains tax also would cause noncorporate enterprises to report some capital income and some labor income as capital gains rather than as current income. However, Hendershott and Won estimate that both of these effects together would cost the federal government only about $1.3 billion per year, bringing the government's total revenue loss to $4.3 billion.

On the other hand, the reduction in tax rates on capital gains also would cause taxpayers to shift out of nontaxed assets—tax-exempt state and local bonds, for example—and into taxed assets. This shift would increase federal tax revenues by about $0.9 billion, leaving the federal government with a net loss of only $3.4 billion.

Finally, Hendershott and Won estimate the revenue effect of a tax cut on capital gains on corporate equities. They find that with no change in investor behavior, federal revenues would fall by $6.3 billion. More realistically, with a moderate increase in realizations, federal revenues probably would increase by $0.3 billion. DRH

World Financial Markets After 1992

Fueled by onshore capital controls and credit restrictions, the Euromarkets have grown explosively since the early 1960s. Will the proposed unification of European financial markets after 1992 spark a decline in the role of Euromarkets? The answer depends on whether the 1992 initiatives result in lighter regulatory burdens in onshore markets, according to NBER Research Associate **Richard Levich** in **Euromarkets After 1992** (*NBER Working Paper No. 3003*). "The lasting stimulus to the Eurocurrency market has been differential regulation between onshore and offshore banking," he writes.

The Eurocurrency market—that is, the market for deposits denominated in a currency different from the indigenous currency of the financial center—has grown by about 20 percent annually over the past 15 years. In March 1988 total deposits in Eurocurrency markets, net of interbank deposits, were $2.2 trillion. Europe's share was 52 percent, U.S. banks had 13 percent, and Japan's share was 14 percent.

The European Commission's blueprint for 1992 calls for the abolition of all capital controls by members of the European Monetary System by July 1, 1990. The Commission also seeks "harmonization" of certain prudential regulations by the end of 1992, although it does not envision a uniform regulatory regime nor a supranational regulatory agency.

Unification will spur further deregulation within the European Community (EC), Levich predicts. As a rule, greater capital mobility creates competition among regulators. It is easier for financial institutions to avoid markets where regulatory burdens—reserve requirements, disclosure rules, and taxes on interest, dividends, and capital gains—are relatively heavy. To avoid a loss of competitiveness, regulators in those markets are forced to reduce these restrictions and burdens.

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Competition among EC money centers should lead to more homogeneous regulation. Right now, regulatory burdens vary sharply within the EC. Reserve requirements range from zero in the Nether-

lands to 15 percent and higher in Italy, Portugal, and Spain. Belgium and Greece levy no taxes on capital gains. England and Ireland have neither a withholding tax nor dividend disclosure. Banking authorities' freedom to adjust national policies to reflect market conditions will result in speedier adjustment and greater flexibility, Levich believes.

In some cases, authorities actually may reregulate. Markets that eschew regulation altogether do not snare all the business: despite having the freest financial markets in the world, Hong Kong and Singapore continue to have relatively small shares of the offshore market. According to Levich, money center banks still gravitate to the safe harbors. They value lenders of the last resort, deposit insurance, and enforceable contracts. So, for example, freewheeling Luxembourg might adopt minimal reserve requirements but still might fail to increase its share of financial activity.

European unification has two main implications for policymakers. The net regulatory burden of the EC must be commensurate with the burden in other industrial countries; otherwise there will be a migration of financial services offshore. Since the Europeans have benefited from excess regulation in the U.S. financial market, they can hardly question that this migration will occur. And, as capital continues to become more mobile, all countries must be prepared to lose some sovereignty. Monetary, fiscal, and banking policies will have to take into account the competitive consequences of regulation for financial markets. SN

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