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IRAs Can Raise Revenue and Saving

The revenue loss associated with Individual Retirement Accounts (IRAs) is either much smaller than generally has been estimated or is actually a revenue gain.

That's the key finding of **The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving** (NBER Working Paper No. 4021), by Martin Feldstein.

One of the key legislative and economic objections to IRAs has been that the tax advantage they give individuals reduces federal tax revenues more than it increases personal savings, thus adding to the national debt and reducing national savings. Feldstein notes that the low rate of saving and investment in the United States is a major impediment to national economic growth and rising real wages. "Study after study confirms that the primary explanation of inter-country differences in economic growth is the share of GNP devoted to investment," he writes. "Moreover, despite the increasing integration of the world capital markets, the rates of investment in the major industrial countries are closely related to their rates of saving."

During the 1980s, Feldstein continues, gross saving in the United States averaged 16.3 percent of GNP while gross investment averaged 18.3 percent of GNP. The gap was financed by a capital inflow from abroad. In contrast, Japan's 31.6 percent saving rate financed investment equivalent to 29.4 percent of GNP with the excess used to finance overseas investment.

IRAs are the primary incentive provided by the government for saving at the personal level, and thus are important. Earlier analyses indicate that deductible IRAs have been quite effective in raising national saving. An incremental dollar of IRA contributions has been financed by about a 45- to 55-cent reduction in consumption, a 35-cent reduction in taxes, and reduction of other saving of 20 cents or less, according to an earlier NBER study by Steven Venti and David Wise.

"Previous analyses of IRA-type plans have miscalculated their effect on tax revenue, and therefore on national saving, by focusing exclusively on their negative impact on personal tax payments and ignoring their positive impact on corporate tax payments. By taking into account the corporate side, and depending on the time horizon and other key parameters, the revenue loss from traditional IRAs either shrinks or is actually a revenue gain."

Feldstein maintains that previous analyses of IRA-type plans have miscalculated their effect on tax revenue, and therefore on national saving, by focusing exclusively on their negative impact on personal tax payments and ignoring their positive impact on corporate tax payments. By taking into account the corporate side, and depending on the time horizon and other key parameters, he calculates that the revenue loss from traditional IRAs either shrinks or is actually a revenue gain.

Feldstein states that the increase in personal savings resulting from IRAs increases the capital stock; the return on this additional capital increases corporate tax payments, thus offsetting the loss of personal income tax revenue. Recognizing the effect of the IRA on corporate tax receipts has a number of implications.

For example, with the most likely parameter values, the corporate tax revenue offsets 34 percent of the decline in personal tax revenue during the first five years of the introduction of a deductible IRA program and 67 percent of the decline in ten years.

Further, over a longer period, the IRA program actually increases total tax revenue. This implies that the national debt eventually is permanently lower than it would have been without the IRA program. Although each individual eventually withdraws all he has accumulated in the IRA, the national capital stock is permanently higher because the increased government receipts have reduced the national debt permanently.

Finally, it is possible to construct a nontaxable IRA in which contributions are not deductible, but no subsequent tax is levied on earnings or withdrawals. In this case, for the most plausible parameter values, the net revenue effect is positive every year. DRF

Foreign Direct Investment in the United States Grew Dramatically in the 1980s

During the 1960s, the outflow of foreign direct investment (FDI) from the United States was more than half of the world's total, while the flow of FDI into the United States was only about 10 percent of the total. But a recent NBER study by **Robert Lipsey** shows that this pattern has changed dramatically. In the last half of the 1980s, the United States received almost half of the world's inflow, but supplied only 17 percent of the outflow. As a result, the accumulated stock of other countries' direct investments in the United States, which had been one-fourth or less of U.S. FDI abroad, is now three-fourths of U.S. FDI.

In **Foreign Direct Investment in the United States: Changes Over Three Decades** (NBER Working Paper No. 4124), Lipsey notes that, even after the surge of FDI into the United States during the 1980s, foreigners control a relatively small share of the U.S. economy. Foreign firms now own about 5 percent of the assets of U.S. nonfinancial corporations and employ about 5 percent of private sector workers. However, the importance of FDI varies considerably by sector. In mining, foreign-owned firms employ 26 percent of U.S. workers, while in manufacturing the figure is 11 percent, and in trade and services it is only 3 percent. Still, the foreign firms' share

in employment has quadrupled in manufacturing and tripled in trade and services over the last 15 years.

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Lipsey also reports that the sources of FDI in the United States have shifted considerably over time. In 1960, British firms represented 33 percent, Canadians 28 percent, the Dutch 14 percent, and countries outside Europe and Canada only 4 percent of the FDI in the United States. By 1990, the Japanese share had grown to 21 percent, and the British, Canadian, and Dutch shares had fallen to 25 percent, 10 percent, and 11 percent, respectively.

In earlier periods, FDI in the United States was financed primarily from the retained earnings on existing investments. During 1984–90, though, 80 to 90 percent of the inflows of FDI were used to acquire existing U.S. firms and were financed by new capital raised abroad. Lipsey contrasts this pattern with U.S. direct investment in other countries, which “seems to have entered an era of mature self-financing, with few new firms entering the list of overseas investors.”

Experience Rating Unemployment Insurance Taxes Can Lower Layoffs

In many industries, orders slow down in the winter but pick up in the spring, or fluctuate with the business cycle. In response, firms in these industries may temporarily lay off employees, who then collect unemployment insurance (UI) benefits. UI benefits are financed by a payroll tax that varies with past lay-off experiences. In some states the taxes increase one-for-one with the UI benefits drawn—a practice known as “complete experience rating.” In other states, UI taxes are linked only partially to past benefits.

In a recent NBER study, **David Card** and **Phillip Levine** find that the lack of complete experience rating for UI taxes effectively subsidizes high-layoff firms to increase their layoffs. Complete experience rating would reduce the number of temporary layoffs. They estimate that it would lower the national unemployment rate by about one percentage point in the trough of a recession, and reduce the unemployment rate in an industry's months of lowest output by about the same amount.

In **Unemployment Insurance Taxes and the Cyclical and Seasonal Properties of Unemployment** (*NBER Working Paper No. 4030*), the authors document how the degree of experience rating varies from state to state. Washington, for example, has no experience rating. Florida is at the other extreme: in that state, firms with more layoffs pay taxes that more than cover the higher UI benefits drawn by their employees.

Card and Levine use the variation in states' policies to estimate the effect of the degree of experience rating on layoff rates. They find that layoff rates in states with the lowest experience rating are higher than in states with the highest experience rating. For example, in the construction industry in the first quarter of the year, Florida and Texas, with high experience ratings, had temporary layoff rates of about 2 percent. Georgia, North Carolina, and Tennessee, with medium experience ratings, had layoff rates of about 4.5 percent. Other southeastern states—Arkansas, Kentucky, Louisiana, Maryland, Mississippi, and South Carolina—where construction companies' UI tax rates did not rise at all when they laid off employees, had first-quarter temporary layoff rates of about 6 percent.

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Card and Levine write: “. . . a move to complete experience rating would reduce temporary layoff unemployment rates by 1.7 points (or 45 percent) in construction, 0.6 points (or 23 percent) in durable manufacturing, 0.4 points (or 22 percent) in nondurable manufacturing, 0.3 points (or 43 percent) in trade, and 0.3 points (or 50 percent) in services.”

The authors' study is based on data on 187,598 individuals in five industry groups in 36 states. The data were compiled from the Census Bureau's Current Population Survey for the years 1979 to 1987. DRH

Japanese Companies Do Better When Banks Are Stockholders

Japanese manufacturing firms whose equity is owned mainly by financial institutions perform better than similar firms whose shares are owned by individuals or by nonfinancial companies, according to an NBER study by **Frank Lichtenberg** and **George Pushner**. Firms whose directors and managers hold

a substantial fraction of shares also perform better than average, they find.

In **Ownership Structure and Corporate Performance in Japan** (*NBER Working Paper No. 4092*), Lichtenberg and Pushner examine a sample of 1241 large Japanese manufacturing firms during 1976 to 1989. These firms accounted for about 40 percent of total sales by Japanese manufacturers. The authors report that, on average, the fraction of stock held by financial institutions rose from 22 to 30 percent from 1975 to 1989, while ownership by individuals declined from 43 to 30 percent during that period. The fraction of stock held by nonfinancial corporations remained relatively constant at about 32 percent, while the fraction held by the top ten shareholders was also stable at around 50 percent.

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Lichtenberg and Pushner use two measures to evaluate the effect of ownership structure on corporate performance: total factor productivity, which measures the efficiency of a firm after taking the inputs of labor and capital into account, and return on assets. They estimate that transferring all of the shares currently held by individuals to financial institutions would increase productivity by 13 percent. On the other hand, transferring individuals' shares to nonfinancial corporations would lower productivity by 4 percent. The negative effect on productivity of ownership by nonfinancial corporations is especially large when financial institutions hold relatively little of the firm's stock.

The authors also find that ownership by financial institutions seems to keep firms out of trouble. Only 1.7 percent of firms with a large proportion of high financial shareholders had negative profits, compared with more than 8 percent of firms with a small proportion of financial shareholders.

Equity ownership by nonfinancial corporations has a strong negative effect on profits, though, and may even reduce the ability of financial institutions to keep profits high. “Interlocking” corporate shareholding, a managerial entrenchment device that was adopted for the specific purpose of preventing hostile takeovers by foreign firms, appears to free managers from discipline by the stock market.

Lichtenberg and Pushner suggest that Japanese financial institutions, especially the lead bank in a financial group, may monitor a firm's performance and intervene when management is performing poorly. Managers who own a substantial fraction of the firm's

stock also may have stronger incentives to keep profits and productivity high than managers with little stock ownership. By contrast, nonfinancial companies

who own stock in the firm may insulate poor managers from the pressures to improve performance exerted by other stockholders. RN

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