

# The NBER Digest

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## Political Parties and the Business Cycle

Since World War II, Democratic administrations have favored short-run economic expansion at the risk of higher inflation while Republican administrations have emphasized fighting inflation at the risk of short-run unemployment, according to NBER Research Associate **Jeffrey Sachs** and **Alberto Alesina**. Democratic presidents begin their terms by stimulating the economy, while Republican presidents begin by restraining inflation. During the second two years of the terms of either party, the effects of their different policies are weaker, and the difference in the performance of the economy is smaller.

In **Political Parties and the Business Cycle in the United States, 1948-1984** (*NBER Working Paper No. 1940*), Sachs and Alesina analyze the policies of the nine completed postwar presidential terms, from Truman to Reagan. During the second year of each Democratic term, when the new policies begin to take effect, there has been an economic expansion with real GNP growing 6.4 percent on average. In contrast, during the second year of each Republican term, there has been a recession, and real GNP has fallen 0.9 percent on average.

By the second half of each presidential term, there is very little difference in economic growth. Both

parties have averaged about 4 percent growth in real GNP, lower than growth during the first half of Democratic terms but higher than growth in the first half of Republican terms. Sachs and Alesina also find that

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Democratic monetary policy has been looser during the second two years of a term, while Republican monetary policy on average was unchanged during the entire four-year term. They note that the expansionary effect of Democratic policies and the contractionary effect of Republican policies work only in the short run. By the third year the economy has returned to its long-run trend regardless of which party occupies the White House.

## Bonuses and Employment in Japan

Twice a year most Japanese workers receive bonuses that total about one-quarter of their wages. But unlike wages, bonuses can vary with general business conditions and with the firm's profits. By adjusting bonuses over time, firms can share their good fortune when profits are high and reduce their labor costs when profits are down; in fact, bonuses theoretically could be eliminated entirely during severe recessions. This flexibility to cut bonuses, and thus to reduce labor costs, may help Japanese firms to avoid layoffs during slow periods and may be an important source of Japan's enviably low unemployment rate.

In a recent study for NBER, Research Associate **Richard Freeman** and **Martin Weitzman** confirm that Japanese bonuses indeed are more flexible than wages and help reduce unemployment. However, bonuses by themselves are not the prime cause of Japan's low unemployment rate.

In **Bonuses and Employment in Japan** (*NBER Working Paper No. 1878*), Freeman and Weitzman report that bonuses fall by 14 cents for every dollar of decline in profits. But since bonuses represent at most one-quarter of total compensation (which also includes wages and fringe benefits), labor costs will fall only about 3 cents when profits decline by a dollar. This sensitivity of labor costs to profits can be interpreted as reducing Japan's unemployment rate by 2-3 percentage points, thus contributing to the observed low rate.

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Freeman and Weitzman also find that wages are not sensitive to profits but that they respond to revenues, albeit less than bonuses do. Moreover, they find that large increases in wages tend to decrease employment, while bonuses are positively correlated with employment. This suggests that bonuses have different effects on employers' hiring decisions than wages do, which is consistent with the theory that the profit-sharing component of bonuses does not depress the demand for labor.

Freeman and Weitzman note, moreover, that in 1975 following the first rise in oil prices, Japanese labor unions exercised considerable wage restraint. It was this flexibility in wages, rather than any flexibility in bonuses, that allowed Japan to absorb the oil shock with surprisingly little unemployment and inflation.

Freeman and Weitzman use data on Japanese manufacturing and nonmanufacturing industries for 1958-83. They observe that bonuses, which range from 42-76 percent of operating profits before taxes, constitute roughly 10 percent of net domestic product.

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## Taxes and Corporate Investment

The effect that tax incentives have on corporations' decisions about investment depends in part on the timing of those incentives, according to NBER Research Associate **Lawrence Summers**. Policies that reduce tax liabilities immediately, such as the investment tax credit (ITC), encourage more corporate investment than provisions that raise the same total amount of revenue but require firms to pay more taxes now and less later. As a result, eliminating the ITC while lowering corporate income tax rates will tend to reduce corporate investment, even if total revenues from the corporate income tax remain unchanged.

In **Investment Incentives and the Discounting of Depreciation Allowances** (*NBER Working Paper No. 1941*), Summers reports that large corporations place more emphasis than might be expected on near-term tax incentives when they make their investment decisions. Summers surveyed the chief financial officers of 95 large corporations to find out what discount rate they used in deciding on new investment projects. He also asked if they applied different discount rates to relatively uncertain factors, such as operating profits, than to relatively certain factors, such as tax incentives. (Higher discount rates place more weight on what happens early on, while lower discount rates imply less emphasis on the early years of an investment project.)

Summers reports that over 90 percent of the firms in his sample place considerable importance on their estimates of discounted profits and taxes in making investment decisions. However, only 6 percent of the firms use different discount rates for riskier versus safer factors. Moreover, the discount rates used by these corporations range from 8 percent to 30 percent, with a median of 15 percent. Such discount rates on relatively certain items, such as tax credits and depreciation allowances, are surprisingly high at a time when nominal interest rates are under 10 percent.

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The fact that firms use very high discount rates in evaluating investment projects suggests that the ITC is a very potent tax incentive per dollar of government revenue foregone. According to Summers, that is because it provides an immediate reduction in tax liabilities. His findings imply that the current tax reform legislation will probably discourage corporate investment by eliminating the ITC and slowing down depreciation allowances even though corporate tax rates will also be reduced.

## **Poverty Among the Elderly**

Over the past 15 years, the elderly have made substantial economic gains, largely because of increases in real Social Security benefits and the indexing of those benefits to inflation. The incidence of poverty among the elderly even declined during the 1981–2 recession. Nonetheless, a significant fraction of the elderly has been left behind economically since the early 1970s, according to NBER Research Associates **Michael Boskin** and **John Shoven**. Elderly women, especially widows, are the most likely to fall through the safety net, they report in **Poverty and the Elderly: Where Are the Holes in the Safety Net?** (*NBER Working Paper No. 1923*).

In spite of substantial increases in the value of Social Security benefits, Boskin and Shoven find, a significant percentage of the retired are still poor. Some of the elderly were not poor during their working years but have suffered a large decline in income after retirement; this is especially true for widows.

In the sample of retired households that Boskin and Shoven analyze, 59 percent of widows from households that earned \$10,000–20,000 had retirement incomes under \$5000. Of the widows whose households earned \$5000–10,000 before retirement, 39 percent had incomes under \$3000. By far the most important factor associated with a sharp decrease in income is being widowed, separated, or divorced, they find.

Furthermore, over half of the elderly with low retirement incomes are widows. Social Security benefits and a small amount of earnings make up 78 percent of their income, but relatively little comes from private pensions.

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When Boskin and Shoven examine the ratio of pre-retirement to postretirement income (the replacement rate), they find that those with low replacement rates (less than 67 percent) receive less in pensions and continued earnings than they had expected. Those with high replacement rates receive more in pensions and earnings than they had anticipated. In fact, the “high-rate group” has Social Security benefits that average 55 percent of their career average earnings, adjusted for inflation. By contrast, the “low-rate group” gets only 15 percent of its career average earnings in Social Security benefits. Nonetheless, both groups receive more income from Social Security than they had expected three years earlier.

The authors also find that “. . . those who retired relatively early tended to be more likely to be poor and/or to have low replacement rates.” They believe that this is caused partly by the structure of the Social Security system and is also a product of the various factors that influence retirement. However, households with military or federal pensions tend to be relatively well off; these retirees also have more financial wealth than the typical retired family.

Boskin and Shoven conclude that a significant fraction of the elderly have very low incomes and/or lower resources than when they worked. However,

there is a wide distribution of replacement rates among the elderly. In fact, a nontrivial percentage of households in their survey had higher real income in retirement than they had during their working years.

This analysis is based on a survey conducted from

1969-79 by the Social Security Administration of households whose heads were born between 1905 and 1911. The authors use data on income and marital status from the 1977 survey and restrict their analysis to those who are retired.

## NBER

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