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## Public Opinion and the Balanced Budget

Americans favor some sort of balanced budget requirement, but "for a smorgasbord of reasons and at an unclear price," according to NBER Research Associate **Alan S. Blinder** and **Douglas Holtz-Eakin**. In *NBER Working Paper No. 1234, Public Opinion and the Balanced Budget*, the two economists further observe that political affiliation, ideology, and personal circumstances matter far less than economic rationales in determining one's opinion on the balanced budget.

Blinder and Holtz-Eakin's analysis is based on two public opinion polls conducted in 1980 when a proposed amendment to the Constitution calling for a balanced budget was in the news and the public was quite concerned about inflation. The Gallup poll, taken in March, asked whether the individual supported such an amendment and why (or why not). Sixty-seven percent favored the amendment, 13 percent were opposed, and the rest were undecided. In the sample of 1260 responses studied by the authors, there was a nearly equal division among three arguments for the amendment: (1) nations should "live within their means"; (2) balancing the budget is anti-inflationary; and (3) balancing the budget is a good way to cut wasteful government programs.

The most popular argument against the amendment (given by 20 percent of the respondents) was that it would tie the hands of policymakers. Fifteen percent of those in the sample worried that such an amendment would reduce necessary military and domestic programs; 13 percent feared that it would interfere with stabilization policies.

In a CBS/*New York Times* (NYT) poll taken in April 1980, the question was whether one favored a balanced budget requirement even if it would require

cutbacks in federal spending. Sixty-one percent were in favor, 32 percent were opposed, and the balance were undecided. The stronger opposition in this poll may reflect its different wording (from the Gallup poll) and the public's unwillingness to face the costs of balancing the budget.

Among the 1262 respondents to the CBS/NYT poll that Blinder and Holtz-Eakin observe, the most important determinant of answering "yes" was the belief that this amendment was the best way to fight inflation. That stands in contrast to the Gallup poll in which 77 percent of those observed in this study thought the amendment would have only a small effect on inflation (either up or down).

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In the CBS/NYT poll, those who had been laid off in the past year were more likely to support the amendment; those who were better off than a year earlier were less likely to support it. The race or sex of the respondent did matter in the CBS/NYT poll but did not in the Gallup. Also, in the Gallup sample, full-time students (3 percent) and those with some education beyond college (7 percent) were more opposed to the amendment than the others; in the CBS/NYT poll, education had the opposite effect on response. Finally, age, income, ideology and political affiliation, and geographical region did not matter in either sample.

## Food Stamps as Money and Income

The Food Stamp program in the United States is an automatic fiscal and monetary stabilizer, according to NBER Research Associate **Daniel S. Hamermesh** and **James M. Johannes**. In **Food Stamps as Money and Income**, *NBER Working Paper No. 1231*, the two economists reach this conclusion by analyzing the Food Stamp program and asking how closely the stamps substitute for money and how well they function as fiscal stabilizers.

The Food Stamp program is one of the nation's largest income maintenance programs; in 1982, nearly \$11 billion worth of stamps reached about 22 million individuals. Food Stamps are an additional source of income to their recipients and function somewhat like money, as a means of exchange for food purchases. Although Food Stamps held by banks (deposited by business) and deposited with the Federal Reserve may be counted as official reserves, Food Stamp money is not included in any published Federal Reserve money series.

Based on an analysis of 1959–81, Hamermesh and Johannes find that Food Stamps are perfect substitutes for money (M1). An important implication of that finding is that “when the amount of Food Stamps issued rises in a recession, the true money stock rises more rapidly than that published by the Federal Reserve.” Thus, Food Stamps are an automatic stabilizer of the money supply (increasing in bad economic times, decreasing in good times).

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Other studies of Food Stamps have shown that they add little to the amount of food consumed by their recipients and that they improve only slightly the nutritional value of the food purchased. If Food Stamps free up other income of recipients, that income is spent on other commodities or saved. To the extent that the freed income is spent, the program acts as a means of smoothing the lifetime consumption of recipients (allowing them to not change their consumption patterns very much, even when “times are tough”). In fact, Hamermesh and Johannes find, this is exactly what happens. Income from Food Stamps is spent in at least as great a proportion as other types of disposable personal income. Since Food Stamp payments are likely to increase during a recession, “the high propensity to spend them enables them to function as an effective automatic fiscal stabilizer of aggregate demand.”

Under the Food Stamp program, both the money stock and consumption are likely to increase during a recession. Thus, the program is a form of both fiscal and monetary policy.

## Years of Service and Probability of Promotion

The way to get ahead in business, according to the free enterprise enthusiast, is to work hard and to demonstrate high ability. Undoubtedly that won't hurt, but according to NBER Research Associate **James L. Medoff** and Research Fellow **Katharine G. Abraham**, perhaps 60 percent of all employees in the United States work in plants and offices where seniority also counts substantially in making promotions. That finding, in *NBER Working Paper No. 1191*, **Years of Service and Probability of Promotion**, is inconsistent with an economic view that the tendency for long tenure to be associated with high pay simply reflects greater productivity.

“For a substantial part of the U.S. work force,” the two write, “the earnings advantage enjoyed by longer-service employees because they hold higher-level jobs must be considered at least partly a return to seniority, independent of performance.”

Moreover, Abraham and Medoff find, seniority counts significantly for promotions in nonunion firms as well as in union companies. In other words, promotion in nonunion firms often is not awarded purely on merit. Although length of service does carry greater weight in the typical promotion decision for a union hourly worker than for a nonunion hourly worker, this difference is less pronounced than is popularly supposed or than one might expect based on an examination of written provisions for promotion covering the two groups. There may be no written policy requiring that seniority govern promotions in the nonunion company but, even in the absence of a union, managers are often not completely free to promote the candidate expected to perform best on the new job. And, even in the presence of a union, management most often can avoid making a promotion that would have very harmful effects on productivity.

To reach their conclusions, Abraham and Medoff surveyed a large sample of U.S. firms in the private sector. They mailed a questionnaire to 1025 randomly selected nonagricultural, nonconstruction firms from the 1981 edition of *Standard & Poor's Register*. Where possible, the survey was sent to the individual in charge of personnel at the firm. They received 429 responses, of which some were not usable because of various data problems.

The survey found that only 24 percent of nonunion hourly employees were covered by a written policy specifying seniority as having a role in promotion decisions, and only 13 percent of these policy statements say seniority is the most important factor. So only 3 percent of these nonunion employees are covered by a written provision making seniority the most important factor in promotion decisions. But in practice, over one-half (56 percent) of the responses covering nonunion hourly employees indicated that senior employees are afforded substantial preference in the promotions process. That means that a junior employee would never be promoted ahead of a senior employee (in 15 percent of the cases) or that a junior employee would be promoted ahead of a senior employee only if expected to perform *significantly* better (in 41 percent).

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In the case of salaried nonunion employees, no firm among those surveyed had a written policy specifying that seniority would be the most important factor in promotion decisions. Nonetheless, some 57 percent of the responses indicated that senior employees are given substantial preference despite the lack of written provisions. Of those responses, 12 percent indicated that the junior employee would never be promoted and 45 percent said the junior employee would be promoted ahead of a senior employee only if expected to perform significantly better.

Some 85 percent of the hourly union workers have contract provisions specifying a role for seniority in promotion decisions, of which 48 percent said seniority was the most important factor. Some 76 percent of those surveyed give senior employees substantial preference in promotions, and in 33 percent of the cases, senior employees would never lose to a junior competitor. Based on the survey, Abraham and Medoff conclude that among perhaps 80 percent of the nation's private-sector, nonagricultural, nonconstruction employees, senior individuals are afforded substantial preference in promotion decisions.

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## **Adaptability of Corporate Taxes**

The welfare cost of the U.S. corporate income tax system may be greater now than it was before the adoption of the accelerated cost recovery system (ACRS) in 1981, according to *NBER Working Paper*

*No. 1239, Uncertainty, Welfare Cost, and the “Adaptability” of U.S. Corporate Taxes.* The 1981 and 1982 changes in depreciation writeoffs and investment tax credits may stimulate investment. However, new work by NBER Research Associate **Don Fullerton**, **Andrew B. Lyon**, and **Richard J. Rosen** indicates that the distortions caused by the new system may result in a higher welfare loss than that caused by the old one. In addition, this welfare loss may be amplified by uncertain inflation. Moreover, the three authors find that the Auerbach–Jorgenson system of first-year cost recovery is not necessarily equivalent to indexing depreciation allowances, as is often claimed.

The design of a good tax system is limited by compromises among competing objectives. Often discussed are vertical and horizontal equity and economic efficiency. Fullerton, Lyon, and Rosen concentrate on a goal they call “adaptability.” Tax rules usually must be set for an indefinite period, in the presence of uncertainty about future rates of inflation. Ideally, a tax system would adapt automatically to changes in inflation so that the desired properties of equity and efficiency would remain constant. But the only way to obtain complete adaptability is with full indexation of the corporate tax system, and this would entail costly administrative complications.

In practice, tax systems are based on nominal income, fixed depreciation schedules, and historic costs. Because assets vary in the extent to which depreciation allowances differ from economic depreciation at replacement cost, these systems unavoidably distort investment incentives, misallocate capital among assets, and reduce overall welfare for any level of total corporate investment. Moreover, a given depreciation scheme may tax the returns on various assets similarly at one inflation rate and dissimilarly at another rate. The authors note that the shifting effect of inflation rates on a tax scheme complicates the task of choosing the most economically efficient system. Thus, policymakers may have to consider two concepts of welfare costs: the welfare cost of a tax system at the expected rate of inflation and the expected welfare cost given all the possible inflation outcomes.

Fullerton, Lyon, and Rosen estimate welfare costs for a given capital stock under both of these concepts for three tax systems. The first is the set of depreciation allowances that existed in 1980. The second is the current scheme: the ACRS of 1981 with the changes adopted in 1982. The third is the Auerbach–Jorgenson proposal for single, first-year writeoffs equal to the present value of economic depreciation. For each scheme, they use a formula to measure the cost of capital and the incentive to invest in each of 33 assets, and they model the demand for each type of capital in order to measure welfare costs. The authors assume the government must establish a tax policy before future inflation rates are known, while firms invest after the uncertainty in inflation is resolved.

The welfare cost for each tax system falls at a de-

creasing rate as the rate of inflation rises. As a consequence, the cost of capital for the expected inflation rate can be substantially less than the expected welfare cost. Fullerton, Lyon, and Rosen assume that policymakers face an array of possible inflation rates centered around a mean of 7 percent. For a simple example, they further assume that each rate between 1 percent and 13 percent is equally likely.

Welfare costs also vary with interest rates. Since the effect of inflation on interest rates is uncertain, the coauthors use two sets of calculations in the estimates of welfare costs. One assumes that nominal interest rates change with inflation in such a way that the real, aftertax rate of return is always 4 percent. In the second set, nominal rates are such that the real, aftertax return is 4 percent when inflation is 7 percent; nominal, pretax rates vary up and down, point for point, with the inflation rate. The welfare costs under each tax system are stated as a fraction of estimated tax revenues. This ratio is not limited to the price level of a particular year, and it provides a useful measure of the efficiency of each tax.

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The ACRS lumped diverse kinds of equipment into a single five-year writeoff category and many kinds of structures into a single 15-year category. It abandoned any pretense of basing writeoffs on economic depreciation and introduced new variance among the required pretax returns on different assets. As a result, welfare costs tend to be higher under ACRS than under the 1980 law, both because absolute welfare costs are higher and because long-run

revenues are lower. Under both ACRS and the 1980 system, welfare costs tend to fall as inflation increases.

The effect of varying inflation rates on welfare costs shows up strongly. At the mean expected inflation rate of 7 percent, the welfare cost of the 1980 tax system is 2.8 percent of long-run revenues. However, the average of the welfare costs under all the inflation rates from 1 percent to 13 percent is almost 4 percent of revenues (in the case where the real, aftertax rate of return is a constant 4 percent). Under ACRS, the welfare cost at 7 percent inflation is 3.8 percent of revenues; the expected welfare loss for all inflation rates is 4.8 percent of revenues.

The welfare cost under the Auerbach–Jorgenson system is zero under all inflation rates if the real, aftertax return is a constant 4 percent. In other words, the system is a neutral one that adapts perfectly to changing inflation. However, if nominal interest rates move point for point with inflation, inflation alters real, aftertax returns. Since policymakers must use a single, constant rate to discount writeoff allowances, changing inflation can alter the real value of the allowance. That in turn changes the tax rates on alternative investments and creates a welfare loss. Welfare costs at the expected 7 percent rate of inflation are still zero. But Fullerton, Lyon, and Rosen calculate that the expected welfare cost over all inflation rates is 0.5 percent of revenues. If inflation turns out to be 13 percent, the Auerbach–Jorgenson system will be the most distorting of the three.

The authors conclude that the only way to avoid welfare losses from distorting investment decisions is to use economic depreciation and full indexing. Short of that, the fewest distortions can be obtained by using Auerbach–Jorgenson and underestimating the real, aftertax rate of return used to discount depreciation allowances. Such a policy would minimize the chances that very high inflation would produce large welfare losses. At the extreme, this policy would imply full expensing of new investments in the first year. AE

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