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Deficits, Taxes, and Inflation in the 1983-4 Recovery

In November 1982, the trough of the worst recession of the postwar period, the U.S. unemployment rate reached 10.6 percent. During the next 24 months, the unemployment rate fell to 7.1 percent and real GNP expanded by 11.9 percent. This stronger-than-normal expansion was accompanied by lower inflation than would have been expected on the basis of past recoveries: the GNP deflator was increasing at an annual rate of 3.6 percent in the fourth quarter of 1982, but at an annual rate of only 3 percent in the fourth quarter of 1984.

According to NBER President **Martin Feldstein** and **Douglas Elmendorf,** the driving force behind the recovery of nominal GNP was the shift to an expansionary monetary policy, not changes in fiscal and tax policy. This contradicts the popular view that the recovery was the result of a consumer boom financed by reductions in the personal income tax. In **Budget Deficits, Tax Incentives, and Inflation: A Surprising Lesson from the 1983-4 Recovery** (*NBER Working Paper No. 2819*), Feldstein and Elmendorf also find no support for the proposition that the recovery reflected an increase in the supply of labor induced by the reduction in marginal personal income tax rates.

Both the timing of the expansion and the composition of the changes in real output demonstrate the importance of monetary policy to the recovery. Short-term nominal interest rates fell throughout the period while nominal GNP rose, indicating that the supply of money was increasing faster than the demand for money. Further, during the 1983-4 recovery, business investment rose quite rapidly while consumer spending and federal government purchases of goods and services were not unusually strong. This pattern also points to the importance of monetary policy and of the enhanced investment incentives contained in the 1981 tax reform.

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Feldstein and Elmendorf also find that the growth of real GNP was more rapid than would have been expected on the basis of the rise in total nominal spending, and that the increase in the price level was correspondingly less. They conclude that the sharp rise in the value of the dollar during this period explains that phenomenon. Although the strong dollar depressed exports and induced a rise in imports, its net effect on total real output was favorable: it reduced the rate of inflation and thereby permitted

more of the rise in nominal GNP to be channeled into increased real GNP.

Part of the dollar's rise can be attributed to the Fed's successful anti-inflationary monetary policy. However, the dollar also increased in value because of the rise in real interest rates that resulted from the expansionary fiscal policy, the increase in anticipated budget deficits, and the enhanced tax incentives for investment in business equipment and structures. Because of the rise in real interest rates, U.S. securities became more attractive to foreign and domestic portfolio investors, driving up the value of the dollar.

While expansionary fiscal policy therefore did contribute to the greater-than-expected rise of real GNP in 1983-4, it was through the unusual channel of dollar appreciation. The fiscal expansion raised output because it caused a favorable supply shock to prices—not because it was a traditional stimulus to demand. The budget deficit and investment incentives were expansionary in the short run because, by causing the dollar to rise, they reduced inflation and thus permitted a faster growth of real GNP.

Investors and Initial Public Offerings

Initial public offerings (IPOs) of corporate stock typically are underpriced: those who purchase the new shares directly from underwriters subsequently are able to sell them for an extremely high average return on the stock market. In a new study for the NBER, Research Associate **Robert Shiller** suggests that underwriters may deliberately underprice initial offerings in order to enhance their reputations, create customer goodwill, and stir up enthusiasm among investors.

In **Initial Public Offerings: Investor Behavior and Underpricing** (*NBER Working Paper No. 2806*), Shiller reports on his survey of two groups of investors in initial public offerings, one drawn from a mailing list of active high-income investors, the other from a list of subscribers to a newsletter about new stock issues. Shiller also mailed surveys to a list of high-income individuals who were used as a control group. A total of 153 individuals from the first two groups indicated that they had recently purchased an initial public offering or had seriously considered investing in an IPO.

According to the survey, most purchasers of IPOs are repeat investors. They do not view their purchases as short-term investments: on average, they hold the stock purchased in IPOs for over a year, and rarely dispose of it within a matter of months. Most IPO investors deal with a single broker, despite the possibility of obtaining a larger share of oversubscribed issues by receiving allocations from several brokers. About three in five believe that their allocations of shares in IPOs, particularly in those likely to prove successful, are related to the amount of business they give their broker.

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In general, investors appear to select a given IPO because of the product or concept promoted by the offeror, without an explicit evaluation of the price or the expected return. IPO investors appear more likely to buy because of market psychology than investors in the control group. Conversely, fewer of them remember having a theory about the "fundamentals" of the stock before agreeing to the purchase. A majority of IPO investors recalled that prior to making their investment, they felt it was important to act right away to take advantage of a short-lived opportunity; only one-third of investors in the control group recalled feeling a similar sense of urgency.

These survey results, Shiller contends, lend support to what he calls the "impresario hypothesis." Just as impresarios may underprice tickets to specific concerts in hopes of generating long ticket lines and large crowds that will enhance the performer's reputation, underwriters may deliberately underprice IPOs in order to create a favorable impression among clients when the price later increases in the marketplace. "Many investors are viewing their past successes with IPO investments as related to their own information sources, substantially their knowledge of their broker and underwriter, and not as a return just for the fact of having invested in a random IPO. This in turn means that the high initial returns are likely to be enhancing the reputation of the underwriter of the issue," Shiller explains.

The "impresario hypothesis" may not be the sole explanation for the seeming success of IPO investments, he adds, noting that there are periodic IPO "fads" during which investors show particular enthusiasm. The high initial returns help generate those fads, he suggests, as successful investors encourage others to seek a piece of the action. This fits with empirical findings that the volume of new issues tends to be high six to 12 months after periods of high initial returns.

ML

Multinationals, Employment, and Earnings

The more a U.S. multinational firm produces abroad, the higher is the average skill level of its U.S. employees and the lower is its U.S. employment per dollar of output. In **The Effect of Multinational Firms' Foreign Operations on Their Domestic Employment** (*NBER Working Paper No. 2760*), NBER Research Associates **Irving Kravis** and **Robert Lipsey** suggest that the larger their foreign activity, the more multinationals have the opportunity to reallocate labor-intensive operations abroad, reducing demand for unskilled American workers. The firms tend to keep their skill-intensive operations at home, thus raising their average compensation levels. Even where no actual shift takes place, the growth of activity increases the demand for highly paid home office supervisors.

Using data for over 1200 manufacturing firms and almost 600 service industry firms from the Commerce Department's 1982 benchmark survey of U.S. direct investment, Kravis and Lipsey find a great deal of variation across industry lines. In general, however, manufacturing firms appear to be more able to shift labor-intensive and low-skill activities overseas. In services, apparently it is inherently more difficult to break up the production process to take advantage of labor cost differentials.

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In service industries, Kravis and Lipsey find some difference between majority-owned affiliates (that is, foreign companies of which a U.S. firm owns more than 50 percent) and those firms owned 50 percent or less. Every million dollar increase in sales by affiliates that are not majority-owned actually increases employment at the U.S. part of the multinational (parent employment) by 20 jobs. On the other hand, every million-dollar gain in sales by majority-owned service affiliates *reduces* parent employment by 10 jobs. The combined effect of foreign activity by service industry firms, as by manufacturing firms, is reduced U.S. employment for any given level of U.S. sales. In other words, more production abroad means less employment per dollar of sales at home.

Kravis and Lipsey also show that for services, as for manufacturing, foreign activity does not substitute for exports but in many cases encourages them. That is the case not only in wholesale trade, in which that relationship would be expected, but also in computer services, in which each dollar of sales by majority-owned affiliates is associated with 45 cents in parent exports, and engineering services, in which each dollar of such sales is associated with 14 cents in parent exports. Only in advertising are higher increased affiliate sales associated with lower exports by parents.

LB

The Impact of Government Transfers on Older Women's Work

Until recently, only a small percentage of women had worked and paid Social Security taxes long enough to be covered by Social Security Disability Insurance (SSDI). However, between 1960 and 1984 the number of women under age 64 receiving SSDI on the basis of their own earnings grew more than eightfold, from 99,000 to 849,000. Moreover, the average age of these disabled workers fell from 57 in 1960 to 53 in 1984.

In **Labor and Transfer Incomes and Older Women's Work: Estimates from the United States** (*NBER Working Paper No. 2728*), **Philip de Jong, Robert Haveman,** and **Barbara Wolfe** estimate the effects of available disability transfer income on the decisions of older women regarding whether or not to work. Clearly, higher potential benefits are likely to result in more women applying for and receiving benefits, and in lower labor force participation. However, the authors find that a 40 percent increase in the prospective level of total government disability transfer payments (including SSDI) would produce only a 5 percent decrease in the labor force participation of older married women and a 13 percent decrease for older female heads of households. Since they account for about 40 percent of these transfers, SSDI benefits would have to double to produce this same impact on the labor force participation of older women. Therefore, the authors conclude that the actual increases in SSDI benefits since the 1960s have only slightly decreased the number of older women who work outside the home.

De Jong, Haveman, and Wolfe project that in the 1990s substantially larger numbers of women will be

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eligible to choose between continuing to work or applying for disability transfers. Their choice will affect the future costs and caseloads of public disability transfer programs, as well as the proportion of older women that will remain in the work force. Thus, while the ratio of work reduction to increases in available disability benefits is not large now, the absolute magnitude of the work reduction could be substantial as the number of women covered by the program increases.

The authors also find that the work effort of women with low earnings capacities—for example, those with less education or with health problems—responds more to potential levels of benefits than the work effort of women with higher earnings capacities.

In a related study, **Michael Hurd** finds that husbands and wives tend to retire together. In **The Joint Retirement Decision of Husbands and Wives** (*NBER Working Paper No. 2803*), he reports that 8.5 percent of husbands and wives retire in the same month and 28 percent retire in the same year. Part of this behavior can be explained by the similarity in spouses' ages: Hurd estimates that an increase of one year in the age difference between husbands and wives increases the difference in their retirement dates by 3 to 5 months. However, age does not explain everything: husbands and wives may retire at the same time simply in order to spend more time together.

The study by de Jong, Haveman, and Wolfe uses data from the Michigan Panel Study of Income Dynamics on women aged 45–62 in 1968 who had worked full time for seven years or more. Hurd's data are from a survey of individuals who first received Social Security benefits between June 1980 and May 1981.

DRF

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