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Are Tax Cuts Really Expansionary?

Standard economic models predict that tax cuts stimulate the demand for goods and services and thus lead to expanded production and employment. But a recent study by NBER researchers **N. Gregory Mankiw** and **Lawrence H. Summers** (*NBER Working Paper No. 1443*) suggests that in some cases—specifically under the circumstances that prevailed during the recession in 1982—tax cuts can be contractionary. In fact, the authors find that the 1981 tax cut may have contributed to the recession of the following year.

According to Mankiw and Summers, the economic effect of a tax cut depends critically on the monetary policy that accompanies it. Many economists point to the 1964 tax cut as evidence that tax cuts are expansionary. But to Mankiw and Summers, the rapid growth of the economy following the 1964 tax cut was equally the result of the Fed's expansionary monetary policy that prevented real interest rates from rising.

In 1982, on the other hand, the Federal Reserve was more committed to stabilizing the money supply than to stabilizing interest rates. Under such a monetary policy, the larger deficits that follow a tax cut may cause interest rates to rise as the government competes with private borrowers for credit. These higher interest rates discourage investment spending and thus tend to reduce production and employment.

Standard economic analysis implies that higher interest rates only partly mitigate the expansionary effect of a tax cut. Mankiw and Summers point out, however, that this conventional view is based on the assumption that a dollar of consumer spending generates no more money-holding than a dollar of investment spending. They argue that there is reason to doubt this standard assumption, that all forms of spending generate equal money-holding.

Firms that operate on a large scale can better economize on cash balances than can households, whose spending level is much lower. In fact, Federal Reserve data indicate that households hold about 90 percent of the money supply (M2). Using data going back to 1930, Mankiw and Summers look at the determinants of money-holding and find that it fluctuates more closely with consumer spending than with total spending.

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Thus, by tilting the composition of GNP toward consumer spending and away from investment spending, tax cuts increase the demand for money. With the Fed holding the supply of money fixed, this increase in demand causes the price of money-holding—the interest rate—to rise further. Mankiw and Summers therefore conclude that the effect of a tax cut

on interest rates may be so great as to render the tax cut contractionary.

They also find that their view of money demand can help to explain the 1982 recession. After the 1981 tax cut, the composition of GNP changed, with consumption increasing relative to investment. At the same time, the velocity of money (the ratio of GNP to the money supply) fell dramatically. Mankiw and Summers propose that this fall in velocity was partly attributable to the tax cut.

Their results have important implications for economic policy during a period of large budget deficits. They suggest that even large personal tax increases or reductions in transfer payments may not reduce the level of economic activity. Indeed, by causing interest rates to decline, large personal tax increases might even speed the recovery. In contrast, sharp reductions in government purchases might significantly reduce aggregate demand if a constant monetary policy were pursued.

LDC Debt and the Value of Bank Stocks

During the 1970s and early 1980s many large commercial banks in the United States made substantial loans to less developed countries (LDCs). These loans sometimes comprised a large share of the banks' total equity. For example, at the end of 1982 Citicorp's loans to Brazil alone amounted to 116 percent of the bank's equity. When the LDC debt crisis began in August 1982, the safety and value of many of these loans became unclear. Bonds from such high-debt countries as Mexico began to trade at substantial discounts, and the value of the stock of banks with sizable exposure in these countries quickly declined. In fact, a recent study by NBER Research Associate **Jeffrey D. Sachs** and **Steven C. Kyle** finds that in 1983 the stock market valued bank loans to Argentina, Brazil, Chile, Mexico, and Venezuela at around 90 cents on each dollar of face value.

In **Developing Country Debt and the Market Value of Large Commercial Banks** (*NBER Working Paper No. 1470*), Sachs and Kyle ask how the ratio of the market value of a bank's stock to the book value of its equity depends on its exposure to loans to these five countries. The most exposed banks in their sample of 62 large commercial banks had outstanding loans of at least twice their book value. The average bank's loans were 70 percent of book value, and the least exposed banks had no such loans. After adjusting market to book value for other factors, Sachs and Kyle find that exposure to LDC debt did indeed depress stock prices. Moreover, even though the banks' exposure, measured as a percentage of book value, declined after August 1982, the effect of this exposure continued to grow. Between the third quarter of 1982 and the third quarter of 1983, investors became more aware of the extent of the debt crisis and increased the implicit discount they applied to LDC debt held by the banks.

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The authors conclude that the stock market did penalize banks for making loans to certain LDCs, even though no debtor country had then, or has now, defaulted. While these market penalties did not prevent the current problems, they may foster increased caution in the future among lenders to LDCs.

Pensions and Inequality

Pensions worsen inequality between blacks and whites, according to a recent study by NBER Research Associates **Edward P. Lazear** and **Sherwin Rosen**. The difference in private pension benefits between typical black and white retired workers is even greater than the difference in their earnings just prior to retirement. For men versus women, however, the difference in pension benefits is about the

same as the earnings difference. Thus, pensions do not increase male-female inequality, Lazear and Rosen find.

In *NBER Working Paper No. 1477*, the authors report that the probability of receiving a private pension is 61 percent for retired white men in their sample, but 55 percent for retired black men. Moreover, for black men who receive pensions, benefits are a smaller percentage of their final earnings than for white men. Both factors—a lower probability of receiving a pension and a lower replacement (of earnings) rate—contribute to inequality between blacks and whites in average pension benefits that is greater than the inequality in preretirement earnings.

In contrast, the difference in average pension benefits of white men and women is smaller than the difference in their earnings just prior to retirement. Only 48 percent of retired white women in the sample receive private pensions, but they get a higher fraction of their salary in pension benefits than do the retired white men.

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Lazear and Rosen attribute the relatively high pensions of white women to two factors. First, both white men and women tend to have spent about 22 years with the firm from which they retire, versus 15 years for black men and 17 years for black women. Even though the average white woman works fewer total years than the average white man, her average stay at her last job is evidently the same.

Second, many women are in "pattern" pension plans, in which benefits depend on years of service but not on final salary. Since, on average, women have lower salaries than men but the same years of service at retirement, benefits from pattern plans are less unequal than final salaries.

Black women fare the worst in the Lazear-Rosen sample. Only 41 percent of retired black women receive private pension benefits. Black women also have substantially fewer years of service than white women when they retire, so their pension benefits are a lower percentage of their final salary than those of white women. Moreover, "black women are only about 75 percent as likely to receive pensions as black males." So, for black women relative to white women or to black men, differences in pension benefits are larger than differences in earnings.

Securitities Activities of U.S. Commercial Banks

The Glass-Steagall Act currently prevents commercial banks in the United States from offering investment banking services. What would happen if, as part of the trend toward deregulation in the banking industry, these restrictions were abolished? According to NBER Research Associate **Richard M. Levich,** writing in *NBER Working Paper No. 1428,* U.S. firms would probably benefit "with a minimal increase in risk to the safety and soundness of the banking system."

Levich reaches his conclusion after a thorough analysis of the Eurobond market in which affiliates of U.S. commercial banks have been freely participating for over 25 years. Eurobonds, first issued in 1957, are debt instruments underwritten by international syndicates and offered for sale in a number of countries simultaneously. They are denominated in a currency that is foreign to a number of their investors. The Eurobond market is largely unregulated and encompasses institutions that take on underwriting and investment banking duties in addition to their commercial banking functions.

Despite the lack of regulation, in the entire history of the Euromarkets, no bank has failed solely or even mainly because of Euromarket lending. Moreover, losses to investors through default amounted to only 0.24 percent of the total invested between 1963 and 1977. Finally, of the top ten firms issuing Eurobonds in 1982, five were American.

Levich concludes that: "By all standard measures —new issue volumes, secondary market volume, default ratios on bonds, underwriting concentration ratios—the Eurobond market must be labeled a success." Although little more than 25 years old, it is about the same size as the U.S. domestic bond market, and adaptation and innovation have accompanied its steady growth. Furthermore, Levich observes: "Firms in the market have behaved prudently and did not use the absence of regulation as an opportunity for taking excessive risks."

Levich also examines the European banking system, in which commercial banks may engage in investment banking activities. Among the potential areas of concern in such a system are the conflict of interest between investing (for example, for trusts) and underwriting activities, excessive links between banks and corporations, and concentration (a small number of powerful firms) in banking. Levich asserts that U.S. regulations (outside of Glass-Stea-

gall) on disclosure, fiduciary responsibility, and anticompetitive practices should prevent these from developing in the United States.

Without Glass-Steagall, there would indeed be increased risk to the U.S. banking system. Based on the Eurobond market experience, though, Levich suggests that the risk would be small and manageable. Any potential benefits of such deregulation, on the other hand, would derive from increased competition in the supply of investment banking services. While large corporations already have the benefits of access to the Euromarket, increased domestic competition might make such benefits more certain and more available to all interested firms.

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