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U.S. Taxes and Foreign Investment

Tax policies to encourage domestic investment may significantly reduce foreign investment by U.S. firms, according to NBER Research Associate **David G. Hartman** in **Domestic Tax Policy and Foreign Investment: Some Evidence**, *NBER Working Paper No. 784*.

Foreign earnings of U.S. companies that are reinvested abroad account for nearly 90 percent of all U.S. direct foreign investment. The importance of foreign investment is often understated by comparing it with *gross* domestic investment, even though reinvested foreign earnings are *net* of depreciation allowance. In fact, U.S. foreign direct investment (that is, investment abroad by U.S. firms) has been between one-third and one-half as large as net domestic investment in recent years. As a share of GNP, foreign direct investment rose by over 45 percent between the late 1960s and the late 1970s, while net domestic investment fell by almost 40 percent.

U.S. taxes on foreign investment income are due only when the income is repatriated. A parent company can thus repatriate foreign dividends, pay the U.S. tax, and then earn the U.S. rate of return on the balance. Or, the company can defer the U.S. tax by reinvesting abroad, earn the foreign rate of return (net of foreign tax), and later pay U.S. taxes on the accumulated returns.

The U.S. tax on foreign source income is roughly neutral with regard to the choice between investing at home or abroad. That is, regardless of the U.S. tax, investment will occur abroad when there is an opportu-

nity to earn a higher net return there and as long as the U.S. tax is deferred. A reduction in U.S. taxes on both foreign and domestic investment returns is *not* neutral because it raises the relative attractiveness of investing repatriated earnings at home rather than reinvesting abroad.

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In Hartman's analysis, the investment of foreign retained earnings (as a share of U.S. GNP) depends on the alternative aftertax return in the United States as compared with the foreign rate of return, net of foreign tax. For 1965-79, the indication is that a higher domestic real net-of-tax rate of return would significantly reduce foreign investment.

Indeed, Hartman estimates that a tax incentive that raises net domestic investment by a dollar will reduce net foreign investment by at least twenty cents (so the net increase in total investment is eighty cents). Overlooking foreign investment, the total investment effect of the tax reduction is exaggerated by at least one-fourth.

Some critics of domestic investment incentives might find support in this result. But looking only at net total investment may be misleading. That is, if a U.S. firm invests abroad, American interests (that is,

the government and investors) receive only the net-of-foreign-tax return on the capital invested; if the investment were made in the United States, the government would receive its share of the *gross* return, and investors would receive the balance of that return.

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Union Effects on Wages, Turnover, and Training

Union pressure on wages results in the hiring of more productive workers, higher fringe benefits, reduced turnover rates, flatter age-wage profiles, and less job training, according to *NBER Working Paper No. 808* by Research Associate **Jacob Mincer**. In **Union Effects: Wages, Turnover, and Training**, Mincer first proves the existence of a wage premium in union firms and then shows how that premium affects other aspects of union jobs.

To determine whether unions in fact push wages above competitive levels, Mincer asks whether *the same worker* receives a higher wage in union than in nonunion employment. He observes a large sample of white men, ages 17 to 64, who were not full-time students and who changed their union status between 1968 and 1978. The findings show that union joiners under age 30 gained about 15 percent in wages; those over age 30 gained between 4 and 12 percent. Even if the gain from mobility (that is, simply changing jobs) is estimated and subtracted out, the younger men received a union premium of between 6 and 14 percent. According to Mincer, "The union premium is clear and significant mainly if union joiners quit the preceding job and moved between industries, as a majority of them did."

The union-nonunion wage differential between similar but not identical workers is over 20 percent. Some of this differential may be the result of selectivity, that is, unions accepting only the best workers in order to partially offset the increased labor costs imposed by the union. To test this theory, Mincer looks at wages over time and asks whether the union workers were more highly paid even before they joined a union. He finds that over one-half of the wage differential among union and nonunion workers is a net union gain; the balance is due to quality differences among workers.

If union wages include a premium, then workers are less likely to quit union jobs than nonunion jobs. Indeed, Mincer observes that "quit rates in the union sector are about half as large as in the nonunion sector for young workers . . . one-third . . . for men over 30 . . . and one-seventh for men over 48." The larger the wage gain from joining a union, the less likely the union joiner is to change jobs.

Perhaps unions attract workers who are less mobile than their nonunion counterparts, and this is why there is less turnover in union firms. To determine that, Mincer examines individual mobility of workers before and after they joined unions. He finds that young men who joined unions in 1969-71 were no less mobile than their nonunion peers, but by 1971-73, their "quit frequency" was 13 percent lower than their peers'. In sum, Mincer finds that union workers can gain from mobility within the union sector, but they will lose wages if they leave the sector. "They thus tend not to leave the firm unless there's a good chance of landing another union job."

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Fringe benefits under a union also exceed nonunion fringes, both in dollar value and as a percentage of the total wage package. In a large sample of firms in 70 industries, Mincer finds that, on average, union fringes are 70-80 percent higher, and wages 20-30 percent higher, than nonunion. Imposing higher fixed costs (of hiring and fringe benefits) benefits the union because it deters employers from reducing hours of work in response to higher wages. It also induces greater stability of employment in the face of fluctuating demand. Indeed, Mincer finds that average weekly hours per worker are almost the same in both union and nonunion firms, but overtime is more prominent, temporary layoffs more frequent, and total layoffs larger in the union sector. His evidence from 70 industries shows that the higher labor costs of unions (particularly, higher fringe benefits) lead to more stable employment during periods of fluctuating demand; union firms use overtime and temporary layoffs more than nonunion firms do. Mincer summarizes, "In this light, union pressure on fringe benefits is not merely (or at all) a trade-off for higher wages, but a policy which increases both earnings and job security for union workers."

Finally, Mincer analyzes the relationship between the age-wage profile in union firms and worker training. Although union wage differentials diminish with age, seniority rules ensure that wages rise as a union worker stays with his job. With wages linked to seniority, workers have reduced incentives for training. General (transferable) training is not adequately rewarded within the union firm and is not particularly important since union workers are less likely to change jobs. Whatever training takes place in union firms therefore tends to be specific to one's job, not general. Mincer's conclusions are supported by direct survey responses that indicate that union workers receive less training on the job than do nonunion workers.

Secular Patterns in Corporate Finance

Some analysts maintain that the current state of corporate finances is dangerous—that too many companies are highly leveraged through heavy issues of debt. But, according to a recent study by NBER Research Associate **Robert A. Taggart, Jr.**, today's corporate debt levels are not unprecedented when viewed in the context of the entire century. In *NBER Working Paper No. 810, Secular Patterns in Corporate Finance*, Taggart concedes that the corporate use of debt financing has increased considerably in the postwar period, particularly in the 1960s and 1970s. However, the use of internally generated funds for corporate financing was unusually high between 1930 and 1960. The recent surge in debt financing merely returns the level of corporate debt to roughly the levels experienced in the first decade of the century.

Taggart also finds that corporate short-term liabilities have increased in importance over time. This, though, has not been a unidirectional trend in the past. And, adds Taggart, "It is not clear if the recent surge represents a temporary phenomenon or the continuation of a trend."

Looking at the equity side of corporate finance, Taggart's study shows a long-term decline in the relative importance of both preferred and common stock. "Stock issues staged a modest comeback in the 1970s, compared with the 1960s, but they remain very low by prewar standards."

Using an amalgamation and development of prior theories to interpret the data he has gathered, Taggart concludes that there are four primary determinants in corporate financial structure.

The first determinant is corporate and personal tax rates. The rise in corporate tax rates should have encouraged corporate leverage (use of debt for financing), especially in the years between the 1920s and the early 1950s. However, the largest increases in corporate debt financing appear to have occurred during the 1970s when the tax incentives were relatively flat.

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A second important factor is perceived bankruptcy costs. It is possible that the fear of bankruptcy following the Great Depression overwhelmed the incentive for issuing debt from higher corporate tax rates in the late 1930s and 1940s. Perhaps the same thing occurred after the deep 1973-75 recession and during the increased economic instability that followed it. But Tag-

gart wonders why bankruptcy fears were not allayed sooner after the Depression.

Third, inflation makes the issue of debt more attractive since it alters the trade-off between tax savings and bankruptcy costs. It probably has contributed to increased debt usage in recent years, Taggart says.

Finally, there are supplies of substitute securities. That is, investors can choose state, local, or federal government securities as alternatives to corporate bonds or other debts. For instance, a large increase in federal debt could "crowd out" corporate debt. During the 1970s, when corporate debt increased rapidly, the relative supply of government securities was essentially flat. In the earlier decades of the century, corporate debt may have met a greater need for relatively safe, fixed-dollar claims not met sufficiently by either the government or other financial institutions. Today, other financial institutions—mutual funds, pension funds, and the like—are more available to offer such safe investments. DF

The OPEC Surplus and U.S.-LDC Trade

The United States and the "newly industrializing countries" are becoming more interdependent economically, according to **William Branson**, director of NBER's Program in International Studies, in *Working Paper No. 791, The OPEC Surplus and U.S.-LDC Trade*. In other words, Branson writes, during the 1970s the United States developed stronger trade and financial ties with such countries as South Korea, Taiwan, Hong Kong, Singapore, Brazil, Argentina, and Mexico—countries often known as "newly industrialized countries," or NICs.

U.S. exports of capital goods to these countries have grown rapidly. So have U.S. imports from them of consumer goods, except for food and automobiles. Thus, the structure of U.S. trade has been reoriented to become, as economists say, "complementary" with these rapidly growing, developing countries. These changes are important for the formulation of appropriate U.S. foreign economic policy.

Explaining this phenomenon, Branson notes that the rapid growth of these developing countries was not slowed by the recession in the industrial nations (1973-75 in the United States) that belong to the Organization for Economic Cooperation and Development (OECD). The NICs managed this by borrowing the surplus of the OPEC countries and using that money to maintain a high level of investment, and thus growth.

In the case of the United States, it exported nearly

enough more capital goods, chemicals, and agricultural products to finance its larger imports of petroleum. From 1975-80, U.S. total exports of capital goods grew at an annual rate of 11.2 percent in real terms, and growth of these exports was even faster to the developing countries. In 1970, 32 percent of U.S. capital goods exports went to the developing countries; by 1980, the fraction was 42 percent. Similarly, U.S. imports of consumer goods (nonfood, nonauto) grew at 11.7 percent annual rate in the same 1975-80 period, reaching \$31.6 billion in 1980.

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Branson explains that when OPEC quadrupled the price of its crude oil in 1973-74, some oil exporters won huge surpluses of funds that were placed in the international financial system. This money was borrowed by the NICs and other developing countries for use in their domestic development. That investment stimulated the demand for U.S. capital goods. In turn, as the U.S. economy devoted some of its resources to the production of capital goods, the extra income stimulated more demand for consumer goods. These were supplied in part by more imports. This means that the American and the NICs' economies complement each other better. On the other hand, the shift in the U.S. economy toward production of capital goods may make it more competitive with Europe and Japan. Another meaning of the rise of OPEC as a supplier of world saving is that growth in the developing countries is less dependent on the OECD countries.

In the second section of the paper, Branson looks at economic theories explaining the growing interdependence among the developing countries and the industrial nations, including the United States. One aspect reviewed is the “demand-side” links, theories

linking economies through trade flows. Branson then examines “supply-side” or financial market links. The latter, because of OPEC surpluses, have become more important in the 1970s and could be crucial in the 1980s and beyond, Branson figures. OPEC money has gone primarily into the Euromarkets, and from there to the developing countries. World savings have grown, become more mobile, and more internationalized.

The middle-income developing countries were best able to use this money to stabilize their growth in the 1970s. They were less sensitive to the declines in production in the industrial nations than in the 1960s. In the period from 1973 to 1981, the cumulative OPEC surplus reached \$453.8 billion. The cumulative international payments deficit of the developing countries was \$415.9 billion. Thus, in effect, the developing countries borrowed the OPEC surplus. In more than half of the NICs and another somewhat slower-growing group of developing countries known as the “next tier” (Indonesia, Pakistan, Malaysia, Philippines, Thailand, and Colombia), growth rates of real gross domestic product (GDP, the domestic output of goods and services) and real investment rose in the 1970s relative to the 1960s. In all cases, the ratio of investment to GDP was larger in 1979 than in 1960—showing they were investing the OPEC money.

Branson's paper shows these trends for the developing countries as well as changes in U.S. trade. By 1980, for instance, the U.S. surplus on trade in capital goods reached about \$45 billion. U.S. trade in automotive products switched from surplus to deficit in 1968. By 1980, the U.S. petroleum deficit was \$76 billion, but its agricultural surplus was \$24 billion and its manufactures surplus was \$30 billion. Within that manufacturing area, the United States had a large and growing surplus in capital goods and a smaller but significant deficit on consumer goods and autos. So the United States is shifting its production to areas where it has a “comparative advantage” relative to other nations. “The degree of adjustment is indeed quite remarkable,” finds Branson. DF

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