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Changes in Tax Law Had Big Effect on U.S. Mergers and Acquisitions

The 1981 tax law increased mergers and acquisitions (M and A) activity while the 1986 law decreased it, according to a recent study by NBER Research Associates **Myron Scholes** and **Mark Wolfson.** The 1986 tax law also gave foreigners an added incentive to acquire firms in the United States.

In **The Effects of Changes in Tax Laws on Corporate Reorganization Activity** (*NBER Working Paper No. 3095*), Scholes and Wolfson explain that the Economic Recovery Tax Act of 1981 stimulated M and A by introducing very rapid depreciation and the sale of assets generally. The dollar value of M and A was no higher in the first quarter of 1981 than in the first quarter of 1980, but it doubled during the second quarter of 1981 and increased by an additional 40 percent in the third quarter. In all, the dollar volume of M and A, adjusted for inflation, increased by 70 percent in 1981.

The 1981 tax law also caused longer-term increases in M and A. Between January 1, 1981 and January 1, 1987, the effective dates of the two tax laws, the average annual dollar volume of M and A was $119 billion. Adjusted for inflation, this was 2.8 times as large as the average during the six years preceding 1981.

Scholes and Wolfson add that the 1981 tax law gave corporate managers an incentive to buy the firms or divisions they managed. Certain benefits, including large tax benefits, which are common to both inside incumbent management and to outside investors, favor acquisitions by insiders. They face lower transaction costs to structure arrangements because they have more detailed knowledge of the firm and its prospects than outsiders do. The fraction of divestitures in which the existing management was among the buyers increased from an average of only 6.9 percent between 1978 and 1980 to 12.2 percent between 1981 and 1986.

The 1986 tax law had the opposite effect. It introduced less generous depreciation schedules, increased the capital gains tax rate for individuals and for corporations, reduced the ability to use installment sales to postpone capital gains taxes, and discouraged M and A in other ways. Although the law was passed early in the fourth quarter of 1986, its main provisions did not take effect until January 1, 1987. Thus M and A in the fourth quarter of 1986 fell under the old, more liberal rules.

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Not surprisingly, "The dollar volume of mergers and acquisitions during the fourth quarter of 1986 of $65 billion represents a record, in both nominal and

real terms, over at least the past 50 years," Scholes and Wolfson report. Also, as they expected, M and A activity declined after 1986: in the four quarters preceding the 1986 act, the dollar volume of M and A transactions among U.S. companies was $155 billion, while it fell by $31 billion in 1987.

Even more dramatic was the increase in purchases of U.S. companies by foreign companies that the 1986 law caused. In 1987, foreign companies bought $44 billion worth of U.S. companies, versus only $12 billion in the four quarters preceding the 1986 tax law. Why such a big increase? Scholes and Wolfson point out that the 1986 law, by increasing taxes on U.S. companies, increased the pretax rate of return required by U.S. investors. Because foreign companies receive tax credits for most explicit taxes paid in the United States, foreign companies could benefit by owning U.S. companies, receiving the higher pretax returns, and then getting credits for the higher taxes. Also, foreign investors often pay much less tax on their capital gains than the 1986 law forces American investors to pay. For both reasons, the 1986 tax law made many U.S. companies more valuable to potential foreign buyers than to American ones.

How did the 1986 tax law affect small corporations? Scholes and Wolfson report that the 1986 law increased "double taxation" of corporate income. Small corporations could avoid this double taxation by becoming S corporations, and they did. In 1985, about 75,000 S corporations were formed, but in only five weeks at the end of 1986 and the beginning of 1987, there were three times as many. DRH

The Cost of Social Security Reform

Current Social Security rules reduce the benefits of older workers who earn more than a specified amount. As of 1990, individuals aged 65 to 69 will lose $1 in Social Security benefits for every $3 they earn over the "annual exempt amount" of $9360. Prior to this year, they lost $1 for every $2 in excess earnings.

This provision exists because Social Security benefits were designed for workers who are retired, not for those who are still working. Indeed, the original rules eliminated all benefits for anyone with earnings, until age 70. However, the earnings test is a sore point among the elderly. Older workers charge that it amounts to a high tax that discourages work.

Recently, several proposals have been drafted to eliminate the earnings test outright. The most visible of these would make three changes in the law, starting either in 1990 or phased in over a short time. First, it would eliminate the earnings test; individuals could receive full benefits as soon as they registered regardless of any wage earnings they might have. Second, it would accelerate the scheduled increase in the delayed retirement credit, a Social Security provision that increases future benefits for every year that benefits are forgone. Finally, for those who have applied for benefits, the formula for calculating them would be altered to disallow the practice of replacing the low year of earnings with current earnings, if higher.

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In **Changing the Social Security Rules for Workers over 65: Proposed Policies and Their Effects** (*NBER Working Paper No. 3087*), NBER Research Associate **Alan Gustman** and **Thomas Steinmeier** calculate that for 65-to-69-year-old males, the proposed changes would raise full-time work over the next two decades by about 5 percent, or 40,000 workers per year. The changes would increase benefit payments to this group and their spouses by 1.6 percent, at a net cost after taxes of around $30 billion. The top one-quarter of earners would have 2 percent higher benefits on average, while the lowest one-quarter would see their benefits rise by 1 percent.

In the first decade, the change would generate a surplus of about $8 billion. This short-run surplus accrues largely because many workers would find it advantageous to delay registering for benefits. In later years, however, outlays from the Social Security Trust Fund would rise by over $40 billion, as workers who postpone registering initially receive their reward in the form of higher benefits.

Gustman and Steinmeier note that the acceleration of the existing delayed retirement credit boosts the long-run costs of the proposal. Without acceleration, however, eliminating the retirement earnings test could have high short-run costs. Workers would have no incentive to delay seeking Social Security benefits and often would find it advantageous to collect them as soon as possible. Over the long run, though, benefit costs would be reduced by not accelerating the delayed retirement credit.

Regulations cutting Social Security benefits for work beyond normal retirement age are expensive

and may be unfair, Gustman and Steinmeier write. However, they find that the increase in the costs of benefits arising from the proposed changes will not be offset by the induced increases in taxes for those who continue to work. "Labor supply changes will be modest at best," they conclude. DRF

Workers' Compensation and the Duration of Workplace Injuries

Work-related injuries and illnesses are responsible for 50 times as many workdays lost in a typical year as labor strikes, and one-third as many days lost as unemployment. Nearly half of those who are absent because of work-related disabilities receive workers' compensation benefits. A study for the NBER by **Alan Krueger** finds that the level of workers' compensation benefits affects the number of days that these injured workers are out of work.

In **Workers' Compensation Insurance and the Duration of Workplace Injuries** (*NBER Working Paper No. 3253*), Krueger estimates that a 10 percent increase in workers' compensation benefits results in about a one-week increase in days missed. Krueger's findings are based on a study of over 30,000 workers' compensation claims in Minnesota in 1986. In Minnesota, as in most other states, the workers' compensation benefit equals two-thirds of the workers' wage, subject to a minimum and maximum. Minnesota increases its minimum and maximum workers' compensation benefits on October 1 of each year. Workers who suffer injuries before that date receive the old benefits, and workers injured after that date receive higher benefits.

Increased benefits tend to have more of an effect on workers who miss only a few days, and only affect workers in firms that buy workers' compensation insurance from private carriers. Increases in benefits have little or no effect on the number of workdays lost by injured employees of firms that are self-insured and pay benefits directly. In Krueger's study, approximately 70 percent of the compensated injuries occurred in privately insured firms; 20 percent were in self-insured firms. The remainder were covered by the state insurance fund or the assigned-risk pool.

Krueger estimates that, for a given type of industry, workers in self-insured firms lose 9 percent fewer days than workers in firms with private insurance. Krueger infers from this evidence that firms encourage their workers to return to work faster when those firms bear the full cost of the workers' compensation benefits than when part of that cost is borne by their insurance companies.

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According to Krueger, more than half of all absences from work caused by work-related injuries last less than one month, and nearly three-quarters end within two months. Seventy percent of the injured workers are men, 57 percent of whom are married. Over half of Krueger's sample is under the age of 35. He estimates that the duration of an injury is 10 percent less for men than for women, and rises significantly with age. In addition, white collar workers return to work sooner than blue collar workers, full-time workers return more quickly than part-time workers, and employees in large firms go back to work earlier than employees in small firms.

Health Insurance Affects Labor Supply

Medicaid is the federal government's medical insurance plan for the poor. In 1988 about 92 percent of all Medicaid recipients who were neither elderly nor disabled were women who also received AFDC (Aid to Families with Dependent Children). For these women, finding a job usually means leaving AFDC. But since many low-skilled jobs provide little or no medical insurance, in the current scenario, welfare, Medicaid, and private health insurance come together to create a large disincentive to working for many welfare recipients.

A recent study by NBER Research Associates **Robert Moffitt** and **Barbara Wolfe** examines the effect of an expansion of private health insurance on the employment and AFDC participation of women 18 to 64 who head families with a child under 18. Slightly over half of these women work; about one-third of them receive AFDC; and 10 percent of the AFDC recipients also work. Thirty-seven percent of the

women in this study and 27 percent of the working women did not have private health insurance.

"Extending private health insurance to all working women would increase employment of these mothers by almost eight percentage points, and cut AFDC caseloads by nearly 11 percent."

In **The Effect of the Medicaid Program on Welfare Participation and Labor Supply** (*NBER Working Paper No. 3286*), Moffitt and Wolfe estimate that extending private health insurance to all working women would increase employment of these mothers by almost eight percentage points, and cut AFDC caseloads by nearly 11 percent. Private insurance benefits for working women usually are less generous than Medicaid benefits. If private benefits were raised to Medicaid levels, but coverage were not extended to all working women, the employment rate would rise by 13 percentage points and AFDC caseloads would fall by 18 percent. If all working women had private health insurance that was as generous as Medicaid, employment would increase by 18 percentage points and the AFDC caseload would fall by 24 percent.

Moffitt and Wolfe also examine the effect of increasing Medicaid benefits while not changing private insurance benefits or coverage. They estimate that by increasing the value of Medicaid coverage by one-third ($50 in 1984), employment would fall by nearly six percentage points and AFDC caseloads would rise by about 6 percent.

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