Fiscal Policy and the 1982 Recession

Many economists have credited the 1981 tax cut with lifting the U.S. economy out of recession at the end of 1982. Although Congress passed the tax cut in August 1981, most of the fiscal stimulus from the phased-in tax reductions did not come until more than a year later. Now, NBER Research Associate William Branson, Arminio Fraga, and Robert Johnson report that the announcement of the tax program in the spring of 1981 helped push the economy into recession late that year.

In Expected Fiscal Policy and the Recession of 1982 (NBER Working Paper No. 1784), the authors make a case for the possibility of a purely “anticipatory” recession. They explain how an announcement of a future fiscal stimulus could depress economic activity in the short run if several conditions prevail.

If consumers and investors are unable to borrow to increase their current spending until the tax cuts actually occur, then the announcement of a tax cut will not have an immediate stimulative effect on the economy. The financial markets can look ahead to the stimulus, the increased budget deficit that the tax cuts will bring, and the effect on real interest rates. If investors expect real interest rates to rise in reaction to the tax cuts, then interest rates should go up immediately. The rise in interest rates, in turn, will boost the exchange value of the dollar. Higher interest rates depress investment, the higher exchange value of the dollar depresses exports, and the economy could move into recession until the fiscal stimulus actually begins.

Branson, Fraga, and Johnson claim that this is precisely what happened in 1981. In March of that year the Reagan administration proposed a three-stage tax cut to begin in 1982, with some cuts in non-defense spending. The package as a whole implied a growing structural budget deficit that would reach about $180 billion by the end of 1984. At about the same time, the Federal Reserve shifted to an anti-inflationary monetary policy. M1 grew at an annual rate of 5.4 percent from the second quarter of 1981 to the third quarter of 1982, down from a rate of 8.3 percent from the third quarter of 1976 to the third quarter of 1979.

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Nominal short-term interest rates rose about 5 percentage points from mid-1980 to mid-1981 and long-term rates rose about 3.5 percentage points. The dollar began rising on foreign exchange markets almost simultaneously with the announcement of the fiscal package. The recession began in the third quarter of 1981 and short-term rates promptly dropped.
Long rates, however, remained high. Branson, Fraga, and Johnson argue that short-term rates would have stayed above long-term rates if tight money were the sole cause of the recession. However, short rates dropped below long rates in the fourth quarter of 1981 and remained lower thereafter. The authors contend that this is consistent with tight money and the expectation of coming fiscal ease. In sum, Branson, Fraga, and Johnson maintain that the severity of the recession, the inversion of the term structure of interest rates, and the appreciation of the dollar at a time of falling output are a puzzle that can best be explained by the expectations dynamics of future fiscal policy at a time of tight monetary policy.

Tax Reform and Housing

Last year the Reagan administration proposed a tax reform package that included lower tax rates for all income classes and the elimination of deductibility of state and local taxes. A recent study by NBER Research Associate Patric Hendershot and David Ling estimates that the Reagan plan would increase apartment rents by 7 percent and raise homeownership rates by 1 to 2 percent. The cost of owning homes would fall for households with incomes below $40,000 and rise for households with incomes above $60,000.

Hendershot and Ling explain their findings in The Administration Tax Reform Proposal and Housing (NER Working Paper No. 1740). They assume that overall the administration's proposal would lower interest rates by one percentage point, which would tend to lower the cost of all types of housing. However, the proposal would also decrease the generosity of depreciation allowances for rental housing and increase the taxation of capital gains on such housing. Hendershot and Ling estimate that the net effect of these changes would be an increase of 7 percent in market rents.

“"The Reagan plan would increase apartment rents by 7 percent.""

The cost of homeownership would also tend to fall because of lower interest rates. However, eliminating deductibility of state and local taxes tends to raise the cost of homeownership. Lowering marginal tax rates also tends to discourage homeownership by raising the aftertax cost of mortgage payments. For a typical low-income household whose marginal tax rate is low and that often does not itemize deductions, the effect of the lower interest rates outweighs the costs of the tax reforms, and owning a home becomes less expensive. For a typical high-income household, the benefits of lower interest rates are more than offset by the loss of deductibility and the higher aftertax cost of mortgage payments.

Reform the International Monetary System?

The dollar's ups and downs in foreign exchange markets over the past several years have created serious problems for certain U.S. industries, foreign lenders, and tourists. As a result, there have been numerous calls for reform of the international monetary system; even the Reagan administration is dissatisfied with the current system of floating rates. Some economists and policymakers favor keeping exchange rates within ranges set cooperatively among the major countries. Others propose a return to completely fixed exchange rates.

Now, a recent NBER study by Research Associate Jeffrey Sachs and Warwick McKibbin concludes that these changes may not solve any problems. The authors show that different exchange rate systems encourage different types of international cooperation. Changing the current exchange rate system may lead to greater international coordination on some policies but less cooperation on others. Consequently, the worldwide costs (that is, less output than would be produced through policy coordination) may not decline. Sachs and McKibbin also find that the desirability of one type of exchange rate system over another depends on the nature of the shocks that hit the world economy.

In Coordination of Monetary and Fiscal Policies in the OECD (NER Working Paper No. 1800), Sachs and McKibbin trace the effects on the world economy of unanticipated changes in inflation, fiscal policy, and monetary policy under different types of exchange rate systems. They find that under the current system of floating exchange rates, an increase in the U.S. government's budget deficit of 1 percent causes GNP to rise 0.9 percent in the first year. The exchange rate appreciates 3.3 percent
and nominal interest rates rise by two percentage points after five years. GNP in other major industrial countries increases too, by more than 0.5 percent in the first year. However, rising interest rates and inflation quickly offset the short-term gains in GNP. An increase in budget deficits in other industrial countries would be transmitted in similar fashion to the U.S. economy.

Under a fixed exchange rate regime with a fixed stock of world money, in contrast, international transmission of fiscal policy is dramatically different. Sachs and McKibbin calculate that under such a system, a U.S. fiscal expansion would have a much larger impact on U.S. GNP than under flexible exchange rates. Moreover, the stimulus in the United States would be negatively transmitted to the rest of the world and GNP abroad would decline. Similarly, under a fixed system, a fiscal expansion in the rest of the industrialized countries would cause GNP in the United States to decline.

Discussing transmission alone, however, ignores the reactions of government officials in other countries to policies undertaken in the United States. Under flexible exchange rates, noncooperative macroeconomic policymaking is likely to have undesirable side effects, as countries fail to take into account the external effects of their policies on their trading partners. More rigid rules, as in a managed exchange rate system, may reduce the incentive to follow policies that harm other countries and thus lead to an undesirable outcome for the world economy.

Greater cooperation among countries may be achieved in a number of ways, though. It might range from bargaining at economic summit meetings to the implicit cooperation of adherence to exchange rate targets. The exchange rate alternative may be easier to follow, since it reduces the need for continual face-to-face bargaining. Moreover, it allows policymakers to act independently (noncooperatively) within the confines of the international agreement. Tighter margins for exchange rate fluctuations might also eliminate the most noxious forms of international competition. However, the authors conclude that each form of monetary arrangement is associated with its own incentives for following policies that have undesirable effects on the world economy.

In a recent study for NBER, Research Associate Michael Boskin, Marc Robinson, and John Roberts observe that "... the federal government's capital is large and growing, and federal government investment is an important part of national capital formation." Still, they estimate that federal, state, and local capital together total slightly more than half of private nonresidential capital in the United States.

Indeed, in 1984 the federal government owned almost $800 billion worth of nonresidential structures and equipment. Of the total federal capital stock, though, over 43 percent was military equipment and an additional 16 percent was military structures. Nonmilitary equipment and structures accounted for only 6 percent and 34 percent of the federal capital stock, respectively. The total federal capital stock, the authors estimate, was about one-quarter as large as private nonresidential capital in 1984.

In New Estimates of Federal Government Tangible Capital and Net Investment (NBER Working Paper No. 1774), Boskin, Robinson, and Roberts go on to report that net federal investment in 1984 was $20 billion: $17 billion for military capital and $3 billion for nonmilitary capital. In contrast, the private nonfarm sector alone accounted for $107 billion in net nonresidential fixed investment during 1984.

Between 1960 and 1966, Boskin, Robinson, and Roberts calculate, net federal investment averaged $12.2 billion (in 1984 dollars). It fell substantially in the decade 1967–77. But in 1978, net federal investment increased sharply and it continued to grow, accelerating still further in President Reagan's first term, 1981–84. As late as 1979, in fact, net federal investment was as large as the federal budget deficit.

Furthermore, in 1977 and 1978, nonmilitary net investment exceeded military net investment. By 1979, though, the two were roughly equal. Since 1980, net nonmilitary investment has fallen substantially, down to just $3 billion in 1984. Military investment, on the other hand, began to increase in 1978 and more than doubled in 1982–84 relative to 1978–81, from an average of about $8 billion to almost $20 billion.
Boskin, Robinson, and Roberts's estimates of federal investment and capital are all in 1984 dollars for 1927 to 1984. Their estimate of the federal capital stock is more than 20 percent larger than the official estimate of the U.S. Bureau of Economic Analysis because they use alternative methods of measuring depreciation.

**Some Effects of Part-Time Work on College Students**

If college students stay in school, then working during the academic year has little or no effect on their grades or their future earnings, according to NBER Research Associate Ronald Ehrenberg and Daniel Sherman. However, part-time work increases the likelihood that a college student will drop out of school. Students who work 20 hours a week have dropout rates about 25 percent higher than similar students who do not work.

In Employment While in College, Academic Achievement, and Post-College Outcomes: A Summary of Results (NBER Working Paper No. 1742), Ehrenberg and Sherman report that almost half of the students in their sample held jobs during the school year. Among those who worked, the average workweek was 20 to 25 hours.

The dropout rate among all first-year students enrolled in four-year colleges in the sample was 12 percent. The authors estimate for this group that working 20 hours per week increases by three percentage points the probability of dropping out of school. Moreover, they find similar effects among students in the upper classes and larger effects for students enrolled in two-year colleges. Ehrenberg and Sherman speculate that the decreased availability of financial aid coupled with increased college costs has probably forced more students to work in recent years and has tended to increase the dropout rate.

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Although Ehrenberg and Sherman find that work during the academic year has no effect on post-college earnings, if a student stays in college, they estimate that the student's grade point average and the quality of the college do influence later earnings.

The authors' analysis uses a national sample of 2700 male students who graduated from high school in 1972. These young men were first interviewed in 1972 and then reinterviewed about their employment and studies in 1973, 1974, 1976, and 1979.