

The NBER Digest

NATIONAL BUREAU OF
ECONOMIC RESEARCH, INC.

August 1990

Takeovers Busted Up Conglomerates, Boosted Efficiency

Often overlooked in today's backlash against takeovers, buyouts, and bustups: the sorry state of much of American industry *before* the raiders came calling. For most of the 1970s, productivity languished, costs soared, and domestic producers' market share shrank. In the go-go 1980s, by contrast, factory productivity rocketed. Bloated payrolls and outsize wage gains went the way of Detroit's old gas guzzlers.

What accounted for the turnaround? The tendency, in many of the now-reviled "corporate control transactions" to transform fat conglomerate frogs into sleek princes—firms focused on just a few core businesses. That's the conclusion of a new study, **Industrial Dediversification and Its Consequences for Productivity** (*NBER Working Paper No. 3231*), by NBER Research Associate **Frank Lichtenberg**. His results are based on a detailed analysis of 1980 Bureau of Census data for 17,000 manufacturing plants and 1985 and 1989 company data culled from Standard and Poors's *Compustat* file.

For starters, a factory's efficiency rises with the propensity of its parent to stick to the company knitting. Using the 1980 factory-level data, Lichtenberg finds that the greater the number of industries in which the parent firm operates, the lower the level of productivity in its plants, and vice-versa. He includes in his measure of productivity—output per unit of total input—not just labor, but also capital and raw materials. Writes Lichtenberg, "The 1960s' conglomerate boom may have contributed to the slowdown in U.S. productivity growth that began at or slightly after that time."

The merger mania of the 1960s helped push the proportion of diversified firms in the *Fortune* 500 above 60 percent by 1974. Not long afterward, conglomerates began shedding recently acquired, unprofitable activities unrelated to their main lines of business. But the rush to get back to the basics didn't really pick up steam until the 1980s. Businesses began to change hands at a whirlwind pace, increasingly in response to hostile bids. Junk bonds, deregulation, and Washington's lack of antitrust enforcement helped grease the skids.

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What the 1960s brought together, the 1980s' takeover wave tore asunder. Between January 1985 and November 1989, when takeovers reached their zenith, single-industry companies grew from 16.5 to 25.4 percent of the total. At the other extreme, highly diversified firms with ventures in more than 20 different industries declined from 3.5 to 2.2 percent.

If conglomeration cast such a pall on productivity, why did so many 1960s' CEOs pursue that unprofitable strategy? The simplest explanation, writes Lichtenberg, is that the executives blew it, expecting syn-

ergies instead of unwieldy, unmanageable empires. Alternatively, managers may have wanted to keep control of excess corporate cash by using it to finance acquisitions rather than paying dividends to shareholders. Government also may have been an unwitting culprit. In contrast to the laissez-faire Justice Department officials of the Reagan administration, zealous 1960s' trustbusters wouldn't let managers buy companies in the same line of business—no matter how efficient or profitable the potential combination. SN

Have U.S. Unions Priced Themselves Out of Existence?

Union membership as a proportion of total employment outside of agriculture has dropped from 31 percent in 1970 to 17 percent in 1986-7. A new study by NBER Research Associates **David Blanchflower** and **Richard Freeman** suggests that U.S. trade unions simply have been too successful for their own good in winning large wage advantages for their members, and that this has given management an exceptional profit incentive to oppose unions.

In **Going Different Ways: Unionism in the United States and Other Advanced OECD Countries** (*NBER Working Paper No. 3342*), Blanchflower and Freeman observe that the large wage differentials gained by U.S. unions for their members from the 1950s through the 1960s "were probably economically justified as the United States was the clear world economic leader." But the differentials that developed in the 1970s and that were maintained in large measure in the 1980s have become "a major liability to the development of unionism in the country." In those two decades, the economic and political environment has changed in ways that placed union movements in the developed world under stress that is unprecedented since the Great Depression.

The slowdown in world economic growth and productivity advance, and the increased inflation that followed the OPEC oil shocks of 1973 and 1978, created high unemployment in virtually all western countries. In the United States, real wages fell for a large number of workers. Moreover, the composition of employment shifted from traditionally highly unionized sectors (for example, manufacturing) to traditionally nonunion sectors (such as services).

Finally, political ideas and power changed in most western countries in the 1980s. "Socialist ideologies

lost favor to more individualistic market ideologies," Blanchflower and Freeman write. President Reagan defeated the air traffic controllers; Prime Minister Margaret Thatcher in Britain defeated the miners' union in a protracted dispute; labor parties in Australia and New Zealand, and most governments in Western Europe, adopted more market-oriented policies. Further, the remarkable success of the Japanese economy challenged the traditional adversarial mode of plant-level labor relations in the United States, where management and union representatives fought almost constantly over various issues.

With such widespread challenges to trade unionism, it might be expected that trade unions would be in rapid retreat in most industrial democracies. Instead, the average proportion of unionized workers grew by 17 percentage points from 1970 to 1986-7 in 17 countries outside of the United States. In 1986-7, the proportion of unionized workers in the United States had fallen to 37 points below that average, compared to 17 points below in 1970. Further, trade union density in the United States moved from rough equality with Canada in 1970 to less than half the Canadian rate in 1986-7.

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Of the factors that might explain the different road taken by unionism in the United States from most developed countries, Blanchflower and Freeman find little difference among industrial countries. For instance, unions lower the dispersion of pay among union workers, and between white collar and blue collar workers, in several industrialized countries. Moreover, unions overseas have similar effects on employment, fringe benefits, job tenure and turnover, productivity, technical change, and profits as unions do in the United States.

The major difference between unions in the United States and in other industrial democracies is the magnitude of their effect on wages. Unionized firms pay some 20-25 percent above labor market rates for nonunionized workers in the United States. If that trend continues, and the world economic and political environment remains more or less the same, union density in the United States will drop below double digits by the early 1990s, Blanchflower and Freeman predict. "Unions will be relegated to a few aged industrial sectors and to public and some non-profit sectors, producing ghetto unionism similar to what the United States had prior to the spurt in unionization in the 1930s and 1940s," they write. DRF

How Social Security Reduces Savings in Japan

The savings rate in Japan, considerably higher than that of the United States, is gradually being pulled down by changes in the Japanese social security system, according to a recent NBER study. Those same changes have brought about a marked reduction in the Japanese labor force through earlier retirement.

In **Determinants of Saving and Labor Force Participation of the Elderly in Japan** (*NBER Working Paper No. 3292*), **Tetsuji Yamada, Tadashi Yamada, and Guoen Liu** find that for each percentage point of increase in social security benefits between 1973 and 1982, personal savings in Japan were reduced by as much as 3.7 percent. Meanwhile, a 1 percent rise in social security benefits reduced labor force participation by those over age 60 by about 0.4 percent.

In Japan, the main purpose of personal savings is to finance retirement. Therefore, the longer the expected period of retirement, the higher the savings rate must be. Thus, the ultimate impact of changes in the social security system is the net of two opposing forces: the "benefit effect," in which public financing of retirement substitutes for private saving; and the "retirement effect," in which the facilitating of earlier withdrawal from the labor force encourages additional saving.

Partly because of deliberate Japanese government policy, the benefit effect seems to have increased over time while the retirement effect has been diminishing. The enactment of the first postwar social security plan in 1951 actually led to an increase in the personal savings rate. But the direction was modestly reversed in 1965 by allowing collection of some on-the-job benefits, and even more so after 1973 by automatic price adjustment to pensions, which reduced the need for private saving to hedge against the risk of inflation.

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Currently, 10 percent of the Japanese population is 65 or older. By the 21st century, that figure is expected to rise to 17 percent. The combined employer-employee contribution to the public retirement fund would have to rise from 12.4 percent in 1985 to over 40 percent of wages in the 21st century to support these retirees. For that reason, the social security law was changed in 1986 to raise the normal age of

retirement from 60 to 65 for men and from 55 to 60 for women.

Another factor affecting Japanese saving is the long-term increase in life expectancy. This increase has not led to any change in the average retirement age. Rather, those who are retired are living longer. According to the NBER study, each 1 percent increase in life expectancy reduces the labor force participation rate of those over 60 years of age by about 1.7 percent. On the other hand, since many Japanese save as a precaution against the expenses of illness, each 1 percent increase in life expectancy reduces the personal savings rate by about 2 percent, according to the study. LB

1986 Tax Law Altered Mix of Foreign Investment to and from the United States

The Tax Reform Act of 1986 (TRA86) caused U.S. investment in low-tax countries to increase drastically, according to NBER Research Associate **Joel Slemrod**. TRA86 also contributed to an increase in debt outflows and a surge of Japanese and British investment in the United States.

In **The Impact of the Tax Reform Act of 1986 on Foreign Direct Investment to and from the United States** (*NBER Working Paper No. 3234*), Slemrod explains how three features of the U.S. tax law interacted to increase American companies' incentive to invest in low-tax countries. First, the U.S. government taxes income of foreign subsidiaries of U.S. multinational corporations only to the extent that dividends are repatriated. Second, a U.S. company can offset its U.S. tax liability dollar for dollar with taxes paid to foreign governments on its foreign income. If the U.S. company pays more to foreign governments than it owes in U.S. taxes, however, it receives no refund from the United States. Instead, the U.S. company gets an "excess credit" that can be carried forward for five years (or backward for two years), without interest. Finally, TRA86 lowered the tax rate on corporate income from 46 percent to 34 percent.

Prior to TRA86, a typical U.S. company had little reason to invest in a low-tax, rather than a high-tax, country. If a country's tax rate were 34 percent, then the U.S. company would have to pay 34 cents per dollar of income to that country's government and, upon repatriation of the income, 12 additional cents to the U.S. government, for a total of 46 cents. If the country's tax rate were 45 percent, then the U.S.

company paid 45 cents to the foreign government and 1 cent upon repatriation to the U.S. government, for the same total of 46 cents. Thus, regardless of where the U.S. company invested, its eventual tax liability was 46 cents per dollar of income.

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The drop in the U.S. tax rate to 34 percent changed this. Now, by investing in a country with a 34 percent tax, the U.S. company pays only 34 cents on the dollar; by investing in a country with a 45 percent tax, it pays 45 cents on the dollar and gets an 11 cent per dollar excess credit, which may be of little value. Not surprisingly, therefore, U.S. investment in low-tax European countries (Belgium, Ireland, Luxembourg, and Spain) increased by 122 percent between 1984 and 1989; it increased by only 45 percent in high-tax European countries (Denmark, France, Germany, Greece, Italy, the Netherlands, and Portugal).

TRA86 also caused net transfers of debt abroad to increase. Because the tax saving fell from 46 cents to 34 cents for every dollar of interest expense paid

out of U.S. income, U.S. multinationals had an incentive to shift debt—and therefore interest expenses—from the U.S. parent to foreign affiliates in high-tax countries. Between 1982 and 1985, U.S. companies had an average annual debt inflow of \$3 billion. From 1986–8, this switched to an average annual debt outflow of \$3 billion.

Even more striking than the increase in U.S. investment in low-tax countries was the surge in foreign investment in the United States. Foreign direct investment in the United States increased from an average of \$21 billion in 1980–6 to \$58 billion in 1988. About three-quarters of the recent surge was accounted for by just Japan and the United Kingdom. Slemrod reports that TRA86 reduced the tax rate on corporate income, but other provisions of the law more than offset this cut, increasing the effective rate of taxation on domestically located capital.

Japan and the United Kingdom, like the United States, tax their resident corporations on the basis of worldwide income and offer a tax credit for taxes paid to foreign governments. Thus the increase in U.S. taxation on investment by Japanese and British companies is offset by increased tax credits offered by the Japanese and British governments. When the effective tax rate on U.S. investors increased, the effective rate on Japanese and British investors in the United States stayed the same or increased less. The relative tax rates of Japanese and British investors fell, contributing to a shift in ownership of U.S.-located assets to Japanese and British corporations. DRH

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