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INTRODUCTION

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Despite the extensive tax policy debates that continued throughout President Reagan's term in office, possible changes in the structure of the tax system continue to command the attention of policymakers, the media, and the public. Issues relating to both the overall level of taxes and the choice of tax instruments played an important role in the recent presidential campaign and are certain to occupy the Congress in coming months. Some observers see the need to reduce certain taxes in order to increase incentives. Others see increased revenues for deficit reduction as the key priority. The only confident prediction one can make is that fiscal policy debates will be with us for many years to come.

Economic research can make an important contribution to tax policy debates. It can quantify the effects of potential tax changes on economic behavior, and it can isolate the many indirect effects of tax policies on both the distribution of income and the economy's overall level of output. All too often, however, the results of research by economists concerned with tax policy are not presented in a way that is accessible to policymakers, attorneys, businesspeople, and others involved in the formulation of tax policy.

In an effort to communicate research results, the NBER has sponsored a continuing series of conferences on tax policy and the economy. This volume is the third in the series. Like its predecessors, its content is nontechnical and directed not to academics only but to the much broader community concerned with tax policy. In keeping with the NBER's standard practice, the papers included here provide information and analysis that can enlighten tax policy debates but do not make specific policy recommendations. The papers in this volume provide some important new perspectives on issues that will be at the forefront of tax policy debates over the next several years. In the remainder of this introduction, I shall describe the primary conclusions of these papers.

The volume's first study, "Budget Deficits, Tax Incentives, and Inflation: A Surprising Lesson from the 1983–1984 Recovery," by Martin Feldstein and Douglas Elmendorf, assesses the 1983–1984 cyclical recovery. Many lessons have been drawn from the economy's impressive rebound from its deepest postwar recession. Feldstein and Elmendorf sort through the evidence and seek to determine which lessons are valid. They firmly reject the "supply side" explanation, which emphasizes the incentive effects of the 1981 tax cuts on labor supply, noting that there were no increases in the labor force participation rate as the economy recovered in 1983 and 1984. They also challenge the often-invoked Keynesian explanation for the recovery, arguing that the economy's turnaround can be entirely explained by monetary variables, without resort to fiscal deficits.

While Feldstein and Elmendorf find that the deficit had only very little effect on the growth of nominal gross national product (GNP), they argue that deficits did have very important effects on the composition of GNP. Large deficits and potent investment incentives raised American real interest rates, attracting foreign capital into the United States and causing the dollar to surge. This, in turn, reduced the inflation rate and led to a more favorable allocation of nominal GNP growth between real growth and inflation than would otherwise have been possible.

While Feldstein and Elmendorf focus on the effects of public dissaving through the budget deficit, the study by Daniel Feenberg and Jonathan Skinner, "Sources of IRA Saving," is concerned with personal saving behavior. In 1981, the Individual Retirement Account (IRA) program was greatly extended. The hope was that the extended program would encourage Americans to save more. While it is clear that the personal saving rate has not risen since 1981, considerable controversy continues as to whether IRAs were effective between 1981 and their partial repeal in 1986. Critics of the program allege that money put into IRAs was typically drawn from assets that would have been saved in any event. Proponents argue that while this may have been the case immediately following the introduction of IRAs, the program was becoming increasingly effective as asset holdings were drawn down.

Feenberg and Skinner use newly available data on individual taxpayers' capital income and IRA contributions over a several-year period to assess these arguments. They find that IRA contributors typically also significantly increased their asset holdings outside of IRAs. Feenberg and Skinner report that contributions of $2000 by couples who could legally contribute more were extremely common. They also note that taxpayers expecting to receive refunds were less likely, other things being equal, to make IRA contributions than taxpayers who owed the government money. Their conclusion is that "there is strong evidence that in fact IRA saving does represent new saving."

The study by James Poterba, "Venture Capital and Capital Gains Taxation," takes up one of the most controversial areas of tax policy—capital gains. Poterba is concerned in particular with the effects of capital gains taxes on investment in venture capital. The venture capital boom that followed the 1978 capital gains tax cut is often cited as a strong argument for capital gains tax reductions.

Poterba finds some evidence supporting this argument. The U.S. venture capital industry grew very quickly during the early 1980s compared with the venture capital industry in Canada and Britain, but its relative performance deteriorated sharply after the increase in capital gains taxes embodied in the 1986 Tax Reform Act. This evidence cannot be regarded as conclusive, however, because of the possibility that the venture capital industry matured more rapidly in the U.S. than in other nations. Nonetheless, it does suggest some role for tax policy in influencing the extent of venture activity.

Poterba goes on to examine various channels through which capital gains taxes influence venture capital. He is rather skeptical of claims that capital gains tax reductions raise the supply of funds to entrepreneurs. He finds that while funding for new ventures did increase sharply after the 1978 capital gains cut, much of the new money came from pension funds that were not affected by the tax reform. The continuing participation of tax-free entities in the venture capital market suggests that taxes were not the dominant factor driving venture funding. A more plausible link, in Poterba's view, connects capital gains taxes to entrepreneurs' decisions to start new companies. He notes that because such entrepreneurs often sell out after a few years, the gains from deferral of capital gains taxes are smaller than those from some other investments.

Poterba concludes his paper by stressing that capital gains tax reductions are a very blunt instrument for helping venture capital. Only about 30 percent of taxable capital gains occur on common stocks. The remainder occurs on real estate, partnerships, and other depreciable assets. Furthermore, venture capital represents only a small proportion of the capital gains realized on common stocks. Poterba estimates that in 1985 and 1986, venture-backed initial public offerings accounted for less than 1 percent of realized capital gains.

B. Douglas Bernheim's study, "Incentive Effects of the Corporate Alternative Minimum Tax," addresses the Alternative Minimum Tax (AMT) introduced in the 1986 Tax Reform Act. It has often been argued that this tax, by falling heavily on certain industries, undercuts tax neutrality and economic efficiency. Bernheim challenges this conclusion, arguing instead that the AMT dovetails well with the rest of the tax system by burdening industries that would otherwise largely escape taxation. A central point of his analysis is that the AMT offsets biases associated with financing investment by raising the tax burden on debt-financed investments and by lowering it on equity-financed investments. Hence, he finds that the AMT has relatively little effect on weighted average costs of capital.

An additional concern about the AMT is that it might distort the composition of economic activity by promoting otherwise unprofitable mergers or leasing arrangements. Although there has not been enough time since the introduction of AMT to fully evaluate this argument, Bernheim's preliminary analysis, using balance sheet data for a large number of industrial firms, finds no evidence of such distortion.

Tax reform debates have occurred around the world. John B. Shoven's paper, "The Japanese Tax Reform and the Effective Rate of Tax on Japanese Corporate Investments," offers a summary of recent tax reform developments in Japan, focusing attention on incentives for corporate investment. Shoven finds that the probable changes in the Japanese tax system are at least as significant as those contained in the 1986 Act in the U.S. His prediction is that the introduction of a value-added tax (VAT) and the elimination of individual saving incentives is likely to increase the perceived fairness of the system. Shoven also anticipates some increase in the tax burden on corporate investment, up to a level slightly lower than the one prevailing in the United States. This is especially likely if Japanese inflation rates remain negligible.

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