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INTRODUCTION

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Tax policy debates inevitably involve controversy about the efficiency and distributional effects of alternative means of raising revenue. They involve political compromise as well as detailed economic analyses by both academics and policy makers. To encourage interaction between these groups, for the last nine years the NBER has sponsored an annual Tax Policy and the Economy conference in Washington, D.C. The conference facilitates communication between academic researchers studying questions involving tax policy, and those in industry and government who are directly involved in the tax policy-making process. The conference is devoted to the presentation of new research findings of relevance for tax policy.

The five papers in this volume represent a cross section of some of the best applied research that bears on tax policy deliberations. Each paper provides new data and new insights about an important question in tax or expenditure policy. In several cases, the research papers were motivated by suggestions or questions at previous Tax Policy and the Economy meetings.

The first paper, by J. Karl Scholz, Stacy Dickert, and Scott Houser, investigates the determinants of transfer program participation. One of the long-standing questions in analyzing voluntary transfer programs, such as the earned income tax credit, is why some eligible households fail to take advantage of these programs. In "The EITC and Transfer Programs: A Study of Labor Market and Program Participation," the authors develop a new household-level data base for analyzing program participation decisions. In particular, they model the net benefits that different households would receive from participating in their state's Aid to Families with Dependent Children (AFDC) program, as well as their after-tax income from labor market activity. They find a consistent negative effect of prospective benefit levels on labor market activity, and a consistent positive effect of these benefits on the level of AFDC program participation. They also find that higher after-tax wages raise labor force activity and lower participation rates on AFDC. These empirical results lead the authors to predict that the changes in the earned income tax credit that were enacted in 1993 will ultimately lead to a substantial increase in labor force participation among single-parent households.

In "Cigarette Taxation and the Social Consequences of Smoking," W. Kip Viscusi presents new evidence on the social externalities associated with cigarette consumption. His analysis begins with a summary of changing trends in the tar and nicotine content of cigarettes sold during the last three decades. Because the average tar content of cigarettes has declined over time, Viscusi argues that applying estimates of the health damages from cigarettes consumed in the 1950s and 1960s to current cigarette consumption may overstate actual effects. He then develops an estimate of the total private as well as social cost of cigarette consumption, and concludes that such costs are no greater, and probably less than, the current federal and state excise tax levied on cigarettes.

Martin Feldstein and Jonathan Gruber explore the potential for changes in the structure of health insurance to alter the demand for medical care in their paper, "A Major Risk Approach to Health Insurance Reform." Their paper uses previous estimates of the price elasticity of demand for health care, along with detailed data from the National Medical Expenditure Survey, to estimate how changing the current health insurance system would affect total health care outlays. They consider in particular an insurance system that would limit an individual's out-of-pocket medical care spending in any year to 10 percent of income, but impose a substantial coinsurance rate, such as 50 percent, on medical costs below this level. They did find that for plausible values of the demand elasticity, such a policy could reduce total health care spending by approximately 20 percent, while still providing households with full insurance for catastrophic medical expenses. The authors also consider the net cost to the federal government of providing major risk insurance to all households. They conclude that the increase in income and payroll taxes that would result from eliminating the current tax exemption for employer-provided health insurance and the deduction for health care outlays above 7.5 percent of adjusted gross income, and reduced spending that would be associated with lower Medicaid outlays under such a plan, would finance more than 80 percent of the total cost of major risk insurance.

The effect of the investment tax credit, and investment incentives more generally, on investment behavior is one of the perennial controversies in applied public finance. Jason Cummins, Kevin Hassett, and R. Glenn Hubbard present new evidence on this issue in their paper, "Have Tax Reforms Affected Investment?" The authors argue that comparisons of the level of aggregate investment in years with and without the investment tax credit provide tainted evidence of the credit's effect, because the credit is enacted precisely when investment is expected to be weak. Instead of such time series comparisons, the authors rely on comparisons of investment growth across different assets that receive different treatment under the ITC. They find that investment in assets that qualify for the ITC tends to increase relative to investment in other assets when the credit takes effect, and that a reverse pattern is observed when the credit is eliminated. Their results provide some of the strongest evidence to date that investment incentives affect investment patterns.

In the final paper, "Taxation and Mutual Funds: An Investor Perspective," Joel Dickson and John Shoven explore how trading and capital gain realization decisions by mutual fund managers affect the after-tax returns to fund investors. If an individual purchases shares of common stock, he or she can decide when to sell these shares and realize any resulting capital gains or losses. If the individual invests in a mutual fund, however, decisions about when to sell the fund's underlying shares are made by the mutual fund manager, while investors pay taxes on capital gains or losses, and dividends, that are passed through the mutual fund. Dixon and Shoven demonstrate that mutual funds vary widely in the degree to which they realize capital gains, with corresponding differences in the tax liabilities of their investors. The authors estimate that taxes on mutual fund distributions currently amount to between $1.5 and $3 billion and observe that these revenues are highly dependent on what may be tax-inefficient behavior on the part of mutual fund managers. A number of new mutual funds have recently been established with the explicit intention of reducing investor tax liabilities associated with portfolio management decisions.

The need for interaction between academics and policy makers in the field of taxation is self-evident. Academic researchers often find research topics in the ongoing debates that take place in Washington, D.C., and state capitals. The recent expansion of academic research on health economics and insurance markets testifies to this link. In turn, many of the estimates of key parameters in tax policy debates, and to some degree even the vocabulary that guides policy debates, are derived from academic research. The papers in this volume represent a contribution to continuing, and improving, interaction between academics and policy makers concerned with tax policy.

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Many individuals played a key role in planning and organizing this year's Tax Policy and the Economy meeting. Martin Feldstein, president of the NBER, and Geoffrey Carliner, executive director, have been active supporters of this annual conference for the last nine years. Deborah Mankiw, the NBER's director of Corporate and Foundation Relations, and Liz Cary helped throughout the conference planning process. Candace Morrissey managed the daunting task of ensuring that the five conference papers were prepared on time and in a format that was acceptable for publication. The tireless efforts of the NBER Conference Department, particularly Conference Director Kirsten Davis, and Lauren Lariviere, ensured an outstanding level of efficiency at the Washington conference at which the papers were presented.

I am also grateful to each of the conference paper authors for striving to communicate their important research findings to a largely nonacademic audience. I appreciate their efforts and willingness to participate in this very important opportunity for interchange between academics and policy makers.