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INTRODUCTION

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The 1980s have already witnessed four major tax reform bills. Tax reform has commanded the attention of policymakers, the media, and the public. Although the 1986 Tax Reform Act will not take full effect for some time, attention is already turning to further efforts to alter the tax system. Many observers see the need for revenue increases in light of continuing federal deficits. Others use the need for reforms to address the adverse incentive effects of existing provisions or to introduce new incentives into the tax system. The only confident prediction one can make is that tax policy debates will be with us for years to come.

Economic research can make an important contribution to tax policy debates. It can quantify the effect of potential tax changes on economic behavior, and it can isolate the many indirect effects of tax policies on economic efficiency and on the distribution of income. All too often, however, the results of research by economists on tax policy issues are not presented in a way that is accessible to policymakers, attorneys, business people, and others involved in the formulation of tax policy.

In an effort to communicate research results, the NBER has initiated a series of conferences and publications on "Tax Policy and the Economy." This volume is the second in the series. Like its predecessor, its content is nontechnical and directed not only toward academics but also toward the much broader tax policy community. 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. In the remainder of this introduction, I will describe and draw some connections between the six studies presented in this volume.

Traditionally, international taxation has been an arcane subspecialty among tax lawyers, and international considerations have played only a subsidiary role in shaping American tax policies. This is changing in light of the increasing internationalization of the world economy. Some $200 billion of foreign exchange are traded each day. Multinational corporations account for more than two-thirds of American trade. Close to one-third of

American exports pass between American multinationals and their subsidiaries. This volume contains two studies directed at international issues: Douglas Bernheim's "Budget Deficits and the Balance of Trade" examines the impact of changes in the overall level of taxation on the trade balance, and James R. Hines's "Taxation and U.S. Multinational Investment" examines the impact of specific tax provisions on the foreign direct investment decisions of U.S. companies.

Bernheim's chapter uses information on budget and trade deficits for the United States and its five leading trading partners—Japan, West Germany, Canada, the United Kingdom, and Mexico—to evaluate the impact of changes in budget deficits on trade deficits. He examines both the effects of changes in budget deficits within individual countries and of differences across countries in budget deficits. Bernheim concludes that "the evidence corroborates the view that fiscal deficits significantly contribute to the deterioration of the current account. Indeed, it appears that U.S. budget deficits have been responsible for roughly one-third of the U.S. trade deficit in recent years."

As I have already stressed, U.S. trade patterns are shaped to a significant extent by the behavior of multinational corporations. Hines's study seeks to assess the impact of the 1986 Tax Reform Act on the incentives faced by multinational corporations. Hines begins by reviewing historical information on the effects of taxes on multinational corporations as a prelude to considering the effects of the 1986 Act. He finds that particularly in the case of countries with substantial investment incentives, U.S. taxes have generally worked to discourage investment. He argues, however, that the 1986 Act "all but relieves most U.S. multinationals of U.S. tax obligations on their foreign income." He suggests that this will make foreign investment decisions of U.S. companies much more dependent on foreign tax rules and much less dependent on American tax policies.

Discussions of the need to "level the playing field" by designing a more neutral tax system played an important part in debates surrounding the 1986 Tax Reform Act. Supporters of the Act stressed the importance of eliminating incentives that allegedly favored certain types of investment at the expense of others, and the potential desirability of reducing statutory corporate and individual tax rates. The chapter by Don Fullerton and Andrew Lyon on "Tax Neutrality and Intangible Capital" and that by Roger Gordon and Joel Slemrod "Do We Collect Any Revenue From Taxing Capital Income" contribute to our understanding of the distorting effects of various tax provisions.

Fullerton and Lyon note that previous analyses have concentrated on the effects of taxes on physical investments in new plants and equipment. They argue that intangible investments in research and development, advertising, marketing, or worker training are also of substantial importance, and so it is necessary to consider neutrality toward these investments in evaluating tax policies. They note that since firms are permitted to "expense" outlays for intangibles, the tax system is biased in favor of the firms, and the authors attempt to evaluate the magnitude of this bias. After painstakingly deriving estimates of the stock of intangible capital, Fullerton and Lyon reconsider the effects of the 1986 Act on economic efficiency. They find that the Act increases production efficiency, but they note that the efficiency effects of eliminating the investment tax credit are reduced or possibly eliminated once intangible capital is taken into consideration.

Gordon and Slemrod focus on the problem of "tax arbitrage" in connection with the taxation of interest income. Tax arbitrage arises when interest deductions are taken at a higher tax rate than the rate at which interest income is taxed. For example, tax arbitrage occurs when an untaxed pension fund buys the bonds of a profitable corporation that deducts interest. They find that because of the importance of tax arbitrage, "taxing real rather than nominal interest would have raised tax revenues by $25.7 billion in 1983." A further finding is that exempting financial assets and liabilities from taxes and taxing only cash flows from real capital would have raised tax revenues by $9.1 billion. However, Gordon and Slemrod note that such a hypothetical reform would benefit high-bracket taxpayers at the expense of those in lower tax brackets.

The final two chapters explore aspects of the taxation of individual income. Lawrence Lindsey's "Did ERTA Raise the Share of Taxes Paid by Upper-Income Taxpayers? Will TRA86 be a Repeat?" examines the impact of changes in tax rates on tax collections. Among his other findings, Lindsey highlights the fact that the amount of wage and salary income showing up on the returns of high-bracket taxpayers rose sharply following the implementation of ERTA. Partially as a result of this change, tax collections from top-bracket taxpayers actually rose following the reduction in the top rate from 70 to 50 percent. Lindsey suggests that the increase in wages and salaries probably resulted from some combination of a shift in compensation away from fringe benefits and deferred payments toward wages and salaries, and some increase in labor supply. Lindsey's analysis suggests that reduced top rates contained in the 1986 Act will result in a significant increase in the wage and salary income of top-bracket taxpayers. However, he believes that this effect is likely to be more than offset by decreases in capital gains tax collections due to increased capital gains tax rates.

The chapter by Laurence Kotlikoff and David Wise, "Pension Backloading, Implicit Wage Taxes, and Work Disincentives," examines aspects of the impact of private pensions on the behavior of older workers. Because pension arrangements are substantially influenced by tax rules, this is a subject of some importance for tax policy design. Kotlikoff and Wise find that despite ERISA regulations appearing to mandate that benefit accruals occur smoothly over time, many private pension plans cause workers' benefits to be very sensitive to the length of their working life. Kotlikoff and Wise find that many pension plans give very substantial incentives for early retirements, that these incentives are much greater than those created by Social Security, and that they have an important impact in inducing earlier retirement by the workers who are affected.

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