Martin Feldstein

Inflation, Tax Rules, and Capital Formation

National Bureau of Economic Research

Chicago

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Inflation, Tax Rules, and Capital Formation brings together fourteen papers that show the importance of the interaction between tax rules and monetary policy. Based on theoretical and empirical research, these papers emphasize the importance of including explicit specifications of the tax system in such study.

Feldstein begins with a brief overview of the research and principal conclusions. Then, in the volume's first section, he extends the traditional neoclassical models of monetary growth by including specific tax and debt-management policies. This first section is the most technical part of the volume; Feldstein offers, in the second, a less formal discussion of these models and their implications.

Subsequent sections of the book present both theoretical and empirical investigations of the interaction between inflation in the United States in the 1960s and 1970s and the concurrent tax rules. Specific chapters analyze the impact of this interaction on effective tax rates, on the market rate of interest, on the prices of common stock and other portfolio assets, and on business investments in plant and equipment.

Martin Feldstein is professor of economics at Harvard University (on leave) and chairman of the Council of Economic Advisers.

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(Resolution adopted October 25, 1926, as revised through September 30, 1974)

Contents

Preface

The research presented in this volume combines the traditional subjects of macroeconomics and public finance. From macroeconomics comes a concern with the rate of interest, the capital intensity of production, and the impact of monetary policy. From public finance comes an emphasis on the significance of the distortionary tax rules that have generally been ignored in macroeconomic analysis and a concern with the effects of tax rules and monetary policy on the distribution of income and on the value of assets. The results of this research show the importance of the interaction between tax rules and monetary policy and the importance of including explicit specifications of the tax system in the study of macroeconomic equilibrium.

The book brings together fourteen papers on the subject of inflation, tax rules, and capital formation that I wrote between 1975 and 1981. The volume begins with a brief overview of the research and of the principal conclusions. The first section of the volume then extends the traditional neoclassical models of monetary growth by including specific tax and debt-management policies. Since this is the most technical part of the volume, I have provided in chapter 2 a less formal discussion of these models and their implications. Subsequent sections of the book present both theoretical and empirical investigations of the interaction between the inflation in the United States in the 1960s and 1970s and the concurrent tax rules. The specific chapters analyze the impact of this interaction on effective tax rates, on the market rate of interest, on the prices of common stock and other portfolio assets, and on business investment in plant and equipment.

The research presented here is part of the NBER's Special Study of Capital Formation. The work was supported by the NBER and the National Science Foundation. I am grateful for this financial support and

also for the comments and suggestions of my colleagues and students at the NBER and at Harvard University, especially the members of the NBER Taxation Program and the Harvard Public Finance Seminar.

Four of the chapters were originally written with coauthors: chapter 4 with Jerry Green and Eytan Sheshinski and an appendix by Alan Auerbach, chapter 7 with Joel Slemrod, and chapters 8 and 9 with Lawrence Summers. I am grateful to them for their collaboration in the original research and for their permission to include our joint papers in this volume. Charles Horioka and James Poterba provided valuable research assistance and Douglas Bernheim and George Sofianos rechecked all of the equations in the volume. Judy Frink prepared the manuscript and the bibliography for publication.

The papers in this volume reflect the evolution of my thinking over six years. Not surprisingly, I now understand things about this subject that I did not understand when some of these papers were written. Although there is a temptation therefore to write a completely new and more explicitly integrated volume, I do not believe that the improvement in the final product would justify the delays and the extra work involved. Since I believe that the analysis and conclusions of all of the papers are still basically correct, I have decided not to alter any of the articles.

Although I believe that the research presented here has significant implications for fiscal and monetary policies, in the National Bureau's tradition I have refrained in this volume from making any specific policy proposals. I hope that the papers in the present volume will contribute to a wider understanding of the fundamental aspects of these issues and, more generally, to an appreciation of the important effects of an economy's fiscal structure on its macroeconomic performance.