The twenty-sixth annual Tax Policy and the Economy conference, which was held on October 6, 2011, at the National Press Club, continues the NBER’s tradition of disseminating high-quality research on topics that are directly relevant to fiscal policy. This year, NBER researchers presented work related to some of the major economic policy issues of our day, including Social Security, health care, and tax policy. These research presentations were well complemented by Congressional Budget Office Director Doug Elmendorf’s discussion of how the combination of population aging and rising health care costs means that past approaches to government budget policy simply will not be sustainable going forward.

It is well known that the aging of the population is poised to place substantial strain on our pay-as-you-go Social Security system and the federal budget as a whole. In addition to its role in the federal budget, Social Security is also of great interest to economists because of its impact on key economic activities, such as saving and labor supply. In the first paper in this volume, Jeffrey Liebman and Erzo Luttmer study an important determinant of the labor supply effects of Social Security—participants’ perceptions of labor supply incentives. One important area of disagreement in the Social Security reform debates of recent decades has been the extent to which the Social Security payroll tax distorts labor supply. To the extent that individuals perceive a tight link between marginal taxes paid and future benefits, economic theory suggests that any loss in efficiency arising from the payroll tax would be small. Conversely, if individuals perceive little linkage, such that the payroll tax is viewed as a pure tax on labor, then the level of the payroll tax could result in a sizable deadweight loss. Liebman and Luttmer conduct a survey of Americans aged 50–70 and find that respondents appear to believe the link between taxes and benefits is actually stronger than it is in reality. They also explore participant understanding of other Social Security
rules and find that some provisions (such as the effect of delayed benefit claiming) are reasonably well understood while others (such as spousal benefit rules) are poorly understood. Overall, the authors’ conclusion is summarized in the subtitle of their paper: “The Perception of Social Security Incentives for Labor Supply and Retirement: The Median Voter Knows More Than You’d Think.”

In addition to population aging, Elmendorf pointed to rising per capita health care spending as a major challenge for fiscal policy. The second paper in this volume, “Reforming the Tax Preference for Employer Health Insurance,” examines the budgetary and economic impact of changing the way in which employer health insurance is treated in the tax code. The authors, Joseph Bankman, John Cogan, Glenn Hubbard, and Daniel Kessler, explore the likely impact of switching from the current tax treatment of health care to a system in which individuals would be permitted to deduct expected out-of-pocket health care expenditures from their taxable income. This approach would remove the tax bias that favors health insurance over out-of-pocket payments, and the use of expected rather than actual spending would also eliminate any marginal distortions on the extensive margin. The authors show that such an approach has opposing effects on the demand for medical services but provide calculations suggesting that the net effect would be to reduce overall health care spending.

To the extent that population aging and health care cost growth are placing a strain on the spending side of the federal budget, it becomes all the more important to have an efficient tax system with which to raise revenue. The remaining three papers in this volume focus on issues related to tax policy.

Michael Devereux and Simon Loretz provide an analysis of how US investment in Europe might be affected by corporate tax reform in the European Union. Earlier this year, the European Union proposed a “common consolidated corporate tax base” designed to reduce the costs and burden associated with 27 different national tax systems, each with its own definition of taxable profits. This paper undertakes—at a high level—the complex task of examining how US investment in the European Union would be affected by this proposal. The authors estimate the effective tax rates of US multinationals and how they compare to those of European Union–based companies and the extent to which these firms would likely choose the new tax system (assuming that it was optional, as is currently proposed). They conclude that a crucial issue in determining the overall effect is the treatment of foreign passive income.

Leonard Burman and Marvin Phaup examine “tax expenditures,” a term used to describe a wide range of policies that show up on government
books as a reduction in taxes rather than as an increase in spending. They point to the observation of a former Tax Policy and the Economy organizer, the late David Bradford, who once noted that nearly any spending program can be creatively recast as a tax expenditure. Indeed, a substantial amount of policy in the United States is enacted this way (e.g., tax subsidies for employer-provided health care and retirement plans, charitable deductions, and so forth). In this paper, the authors provide a simple model in which a failure to account for tax expenditures in measures of total spending may distort budgeting decisions, leading to an inefficient allocation of resources. Specifically, the model shows that "fiscal illusion" arising from our accounting treatment of tax expenditures can lead to higher spending and higher (current or future) taxes.

Of course, all of these issues—the fiscal challenges facing Social Security, rising health care costs, and inefficiencies in our tax system—have been on the political radar screen for many years. Finding solutions that will place the United States back onto a balanced fiscal path is politically difficult, a fact that often leads to long delays in making the changes necessary to restore fiscal balance. One consequence of these delays is the creation of substantial uncertainty about future tax and spending policy. In the final paper in this volume, Francisco Gomes, Laurence Kotlikoff, and Luis Viceira show that in addition to the direct economic impact of the imbalance, the policy uncertainty about how it will be addressed imposes additional efficiency costs on the economy. The authors construct a life cycle model and use it to calculate the deadweight loss associated with delaying the resolution of uncertainty about the level of future Social Security benefits (or, alternatively, the level of future tax rates). They show how this uncertainty affects consumption, saving, labor supply, and portfolio decisions and, importantly, how it reduces individual welfare.

There is no question that the United States is facing significant fiscal challenges. While NBER research papers do not make specific policy recommendations for how to confront these challenges, the research makes valuable contributions to our understanding of the economic effects of alternative approaches. The NBER looks forward to continuing to share rigorous research with policy makers who are entrusted with the task of designing and implementing fiscal policy.