Introduction

Jeffrey R. Brown, University of Illinois at Urbana-Champaign and NBER

The 2012 Tax Policy and Economy conference, which convened less than 7 weeks before the US presidential election, brought empirical clarity to a number of important economic issues that featured prominently in the national political discussion. At the time of the conference, the US economy was still in “weak recovery” mode following the Great Recession, publicly held US government debt as a fraction of GDP was at a many-decades high, and policy makers, pundits and business leaders were beginning to seriously consider the possibility that our elected officials might lead us over the so-called fiscal cliff. It is precisely at such times, when the economic consequences of fiscal policy are so important, that rigorous empirical economic research on the effects of taxation and government expenditure are vital.

For more than a quarter century, the NBER has used the annual TPE conference to facilitate a two-way conversation between academic researchers and the Washington, DC, policy community to evaluate and analyze tax and spending policy. This year’s conference featured six papers by leading scholars who brought their considerable expertise to bear on issues related to education funding, labor supply, taxation, fiscal adjustments, and the overall US fiscal outlook. In keeping with the policy and practices of the NBER, the papers in this volume provide analysis that can inform policy debates but do not offer specific policy recommendations.

The first two papers in this volume go directly at the heart of the discussion about the overall fiscal situation facing the United States and other developed nations. Jeffrey Liebman’s paper, “The Deterioration of the US Fiscal Outlook,” traces the United States’ shift over the past dozen years from running surpluses equal to 2% of GDP to projections of persistent deficits exceeding 5% of GDP even after recovery from the Great Recession. He notes that more than half of this decline occurred prior to the recession as a result of an increase in discretionary outlays (primarily defense and
homeland security), increased Medicare spending due to rising health
care costs and the introduction of Medicare Part D, an expansion of re-
fundable tax credits, and revenue declines from the tax cuts of 2001 and
2003. Looking to the future, he reports that rising Medicare, Medicaid,
and Social Security costs and rising interest payments on debt are the
primary contributors of continued high deficits relative to GDP. He also
examines the longer-run fiscal pressure that results from continued demo-
graphic change and rising health care costs and discusses the political
economy of reform. Overall, this paper underscores the economic and
political difficulties associated with stabilizing the debt-to-GDP ratio in
the coming decades.

Stabilizing a nation’s fiscal stance can be done through revenue in-
creases, spending reductions, or a combination of the two. In their paper,
“The Design of Fiscal Adjustments,” Alberto Alesina and Silvia Ardagna
provide new empirical evidence on the mix of tax increases and spending
cuts that, historically, have had the most long-lasting effect on reducing
the debt-to-GDP ratio. Using data on 21 OECD countries from 1970 to
2010, they find that fiscal adjustments more heavily weighted toward
spending reductions are less likely to be subsequently reversed than fis-
cal adjustments that rely on tax increases. Importantly, they also examine
the output and employment effects of fiscal adjustments and find that
spending-based fiscal adjustments are associated with smaller recessions
than tax-based adjustments. Indeed, their estimates suggest that it is pos-
sible for spending reductions to be expansionary, that is, to be associated
with economic growth rather than a recession. This evidence is especially
salient in light of ongoing policy discussions in the United States and
elsewhere about the economic impact of fiscal adjustments at a time of
overall economic fragility.

Labor markets were especially hard hit during the 2008–9 recession
and the subsequent slow recovery: indeed, as of late 2012, labor market
activity is still well below prerecession levels. In the third paper in this
volume, “Recent Marginal Labor Income Tax Rate Changes by Skill
and Marital Status,” Casey Mulligan provides evidence that much of
the decline in employment and work hours—especially the dispropor-
tionate decline among the less skilled and the unmarried—is driven by
implicit tax rates on labor supply. Specifically, he calculates the effective
marginal tax rates that are implicit in the design of several government
programs, such as unemployment insurance, SNAP (previously known
as food stamps), and Medicaid. He examines the change in the tax rates
associated with expansions in these programs over the 2007–9 period and
notes that large shares of the skill distribution saw their marginal tax
rates on labor income increase by more than 5 percentage points in this short time period. He documents that the pattern of changes in implicit taxes of these programs exhibit important cross-sectional variation due to differing eligibility rules. Most importantly, he then shows a striking correspondence between the 2007–12 changes in worker hours per capita and the changes to work incentives that result from these programs, patterns that are hard to reconcile with alternative explanations. An implication of these findings is that the labor market is unlikely to recover as long as there remain important disincentives to work.

The estate tax has been an important part of fiscal policy discussions over at least the past decade. One of the incentives created by the presence of an estate tax is for wealthy families to transfer resources to distant generations in order to avoid having the wealth become subject to multiple rounds of estate taxation. In “How Important Are Perpetual Tax Savings,” Jim Hines examines the economic, legal, and policy issues surrounding the ability of wealthy families to effectively create perpetual trusts. He notes that, until recently, it was not possible to create perpetual trusts because of legal restrictions inherited from English common law. However, he notes that the rules against perpetuities are established by state, not federal, law and that a number of states have repealed or relaxed these restrictions in recent years. He uses this variation to study whether there has been an increase in the creation of perpetual trusts. Although he documents modest tax benefits of creating such vehicles, the effect of repeal of laws against perpetuities is statistically insignificant as a predictor. He does find that state population and income have very large and significant effects, which is consistent with a hypothesis that most trusts are formed where settlors live rather than in other states with more attractive tax and/or legal environments.

The final two papers in this volume are focused on tax incentives for education. Andrew Samwick, in “Donating the Voucher: An Alternative Tax Treatment of Private School Enrollment,” examines the tax cost of allowing families who send their children to private schools to take a tax deduction equal to the per-pupil expenditure in their public school district. Using the NBER Taxsim model and the Public Use Microdata Sample of the American Community Survey, he calculates that treating the decision to forgo public schooling as the equivalent of a charitable contribution would cost the federal government an average of $7.75 billion per year over the 2006–10 period. Because rates of private school attendance are higher among higher-income families, the distributional effects of such a policy would be concentrated among higher-income households.
Susan Dynarski, Judith Scott-Clayton, and Mark Wiederspan’s paper, “Simplifying Tax Incentives and Aid for College: Progress and Prospects,” shifts the focus to federal aid for college. One way to view this paper is as a retrospective of what has occurred with regard to financial aid simplification in the 5 years since two of these authors wrote a prior TPE paper analyzing the complexity of the aid process. The authors note that, since their initial paper, the aid process has been simplified (as measured by a reduction in the number of questions on FAFSA, the federal application form), but only modestly. They note that the application still contains 116 questions, making it longer than the tax return filed by most US households. After reviewing the array of government programs targeted at college financial aid and the existing evidence on program effectiveness, the authors examine the prospects for further simplification of the aid process. They document that the vast majority of questions on the financial aid form have little impact on eligibility, suggesting that the distribution of aid would not be significantly affected if these questions were removed. For example, they find that if assets were dropped from the calculation of eligibility for Pell Grants, the share of FAFSA applications eligible for a Pell would be unchanged at 52%. They also find that such a change would leave the amount of aid unchanged for 95% of recipients. This work is important for helping to quantify both the costs and benefits of potential simplification of the aid application process.

As our nation moves forward in its effort to reduce the long-term gap between revenues and expenditures, rigorous research on the effects of fiscal policy on behavior is critical to the policy making process. The papers in this volume are important contributions to this effort.