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Introduction

Martin Feldstein and James M. Poterba

Tax policy debates depend critically on estimates of how alternative tax rules would affect household and firm behavior. Studies suggesting that reductions in marginal tax rates would increase household labor supply and saving were key components of the case for tax reform that resulted in the 1981 Economic Recovery Tax Act. Research indicating that capital gain realizations were very sensitive to capital gains tax rates played a similar role in the 1978 capital gains tax reform. In the early 1990s, federal tax policy debates focused on a related question, the effect of raising marginal tax rates on household behavior and reported taxable income.

Despite decades of interest in the effect of tax policy on household behavior, there remains substantial controversy on key empirical links between tax rates, household behavior, and revenue collections. The papers in this volume are the product of an ongoing NBER study of the effects of tax policies on household behavior. They present new statistical findings on how taxes affect household behavior or new analytical results on the effects of different types of tax policy. All of this research relies on household-level data, either drawn from public-use tax return files provided by the U.S. Treasury or from large household-level surveys, to explore various aspects of the relationship between taxes and household behavior. Most of the studies employ the TAXSIM model, an NBER-supported computer program that facilitates study of how changing tax rates or tax rules would affect the tax liabilities of taxpayers in different circumstances.

The eight studies can be broadly classified into three groups. The first set

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considers the effect of tax policy on labor market activity. Nada Eissa's paper on "Labor Supply and the Economic Recovery Tax Act of 1981" utilizes the tax rate reductions associated with this major tax reform to explore how after-tax wages affect the labor supply of married women. Her results suggest that raising after-tax wages encourages labor force participation and increases the number of hours worked by women who participate, although the estimated effects are relatively small. There is some evidence (Eissa 1995) that labor supply responses by women who experienced large tax rate reductions in 1986 were larger than those associated with the 1981 tax reform, perhaps because the 1986 tax rate reductions were part of a revenue-neutral tax reform.

Martin Feldstein and Dan Feenberg's paper, "The Taxation of Two-Earner Families," investigates how changing the current tax rules associated with joint filers would affect the labor supply of married women and the efficiency cost of the tax code. Drawing on previous estimates of the labor supply behavior of married women, this paper uses the TAXSIM program along with data from the Current Population Survey to estimate how several potential tax reforms would affect the hours of work and labor force participation of married women. The paper shows that policies that reduce the marginal tax rate on such earners, even if they are enacted in a revenue-neutral way, might substantially reduce the efficiency cost of the current tax system.

The third paper, by Gilbert Metcalf, investigates "Labor Supply and Welfare Effects of a Switch from Income to Consumption Taxation." This paper uses data from the Consumer Expenditure Survey to explore the welfare gains associated with a shift from income to consumption taxation. The usual argument for such a switch is that an income tax creates an efficiency loss by taxing capital income; a consumption tax such as a value added tax (VAT) avoids this. Metcalf points out that in practice most VATs exclude a number of goods from taxation, which induces an efficiency cost. Exemptions and exclusions distort consumer choices between the taxed and untaxed goods. The paper illustrates the potential magnitude of these effects and suggests that the welfare gain from reduced intertemporal distortions is likely to exceed the welfare loss from distortions among consumer goods.

A second set of papers is concerned with the effect of special tax provisions on household behavior. William Gentry and Alison Hagy's paper, "The Distributional Effects of the Tax Treatment of Child Care Expenses," studies the tax reductions received by households in different income and family status categories as a result of current tax expenditures for child care expenses. The authors focus on the child care tax credit and the dependent care allowance. Gentry and Hagy use data from tax return filings as well as from the National Child Care Survey to estimate the distribution of child care expenses, as well as the extent of utilization of these tax-based subsidies by parents with children. The study concludes that contrary to some previous claims, once one focuses on taxpayers with children, the benefits from these programs decline as household income rises.

Jonathan Gruber and James Poterba develop a new framework for measuring the net tax subsidy to purchasing health insurance in their paper, "Tax Subsidies to Employer-Provided Health Insurance." They argue that the current income and payroll tax systems embody substantial subsidies to employer-provided insurance but that these are frequently overstated. Not all of the costs of employer-provided insurance are paid on a pretax basis, and not all medical costs that might be incurred if a household were not insured can be deducted from taxable income. The authors combine data from the TAXSIM program with survey data from the National Medical Expenditure Survey to estimate the distribution of employer-provided insurance spending across households. They use these data to analyze the effects of various tax reforms, such as capping the amount of employer provided insurance that can be excluded from taxable income, on the demand for such insurance.

A third set of studies focuses on the effect of recent tax reforms on reported taxable income and tax revenues. Joel Slemrod's paper, "High-Income Families and the Tax Changes of the 1980s: The Anatomy of Behavioral Response," explores the effect of marginal tax rate reductions in 1981 and 1986 on the distribution of taxable income across taxpayers in different income groups. His starting point is Feenberg and Poterba's (1993) observation that after the Tax Reform Act of 1986 (TRA86), the share of taxable income reported by very high income taxpayers, those in the top 0.5 percent of the income distribution, rose substantially. Slemrod shows that some of this increase is due not to the same households reporting higher income after TRA86 than before, but to a shift in the set of households with very high incomes. He then tries to relate the share of taxable income reported by high-income taxpayers to a variety of factors, such as interest rates and stock market appreciation, that might affect this distribution. The results of this analysis suggest that the rise in taxable income among the highest income group after TRA86 cannot simply be attributed to the continuation of underlying economic trends of the 1970s and 1980s.

A second paper on a related topic, Andrew Samwick's "Tax Shelters and Passive Losses after the Tax Reform Act of 1986," attempts to determine which part of the 1986 tax reform was responsible for the sharp decline in tax shelter activity in the late 1980s. TRA86 included a number of provisions designed to curb tax shelters, including a reduction in marginal tax rates on interest and dividend income, an increase in capital gains tax rates, and limitations on taxpayers' ability to use passive losses to offset income from nonpassive activities.

The last paper in the volume, James Alm, Brian Erard, and Jonathan Feinstein's paper on "The Relationship between State and Federal Tax Audits," is difficult to group with any of the other studies. It is an analysis of the potential efficiency gains from greater coordination in tax administration between state tax agencies and the Internal Revenue Service. The authors use a unique data set from Oregon to show that in many cases state and federal tax administrators audit the same taxpayer without sharing information from their audits, even though such sharing would substantially increase total revenue collections at very little incremental administrative cost.

The NBER's research project on the effects of taxation on household behavior is an ongoing effort. Researchers affiliated with the project are continuing to explore the effects of tax reforms on various dimensions of household behavior and the efficiency costs of current tax provisions and their alternatives. Findings from these studies will be reported in the future.

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