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Volume Author/Editor: James M. Poterba, editor

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INTRODUCTION

The NBER Tax Policy and the Economy conference, which has been held each fall for the last twelve years, is a specialized conference that seeks to communicate new research findings in the areas of taxation and government spending to interested policymakers in industry, government, and academia. The last year witnessed a substantial federal tax reform and ongoing debate about shifting responsibilities for welfare and other programs from the federal government to the states. There is also an emerging interest in entitlement reform, with both near-term and long-term issues receiving significant policy analysis. All of these issues provide excellent opportunities to introduce current research results into the policy debate on taxation and government expenditures.

This year's *Tax Policy and the Economy* publication is unusual. It is nearly twice the size of past publications, and it includes nine papers rather than the usual five. The first five papers were presented at the usual Washington conference. The last four papers, which together constitute a symposium on the asset-price effects of fundamental tax reform, were presented at an informal NBER meeting in January 1997. Because these papers are directly related to one of the perennial issues in the economics of taxation, and because there is an ongoing policy debate on fundamental federal tax reform, it seemed natural to include these papers in this volume as well.

The nine papers gathered here exemplify research that combines a concern for central policy issues with an application of state-of-the-art research tools. Each paper addresses a concrete question in tax policy or the design of expenditure programs. Each paper presents empirical evidence or develops a theoretical model that is directly relevant to the issue at hand. Each paper provides an important set of background facts or models that will be of value to policy analysts and scholars alike.

The first paper, David Cutler's study of "Cost Shifting or Cost Cutting?: The Incidence of Reductions in Medicare Payments," explores a question that is likely to attract substantial attention in the gathering debate over entitlement reform. David observes that several budget resolutions in the last fifteen years have included substantial reductions in Medicare provider payments. He then asks how these payment reductions have affected the med-ical services provided to Medicare beneficiaries and the prices charged to non-Medicare patients. His empirical findings suggest that the effect of Medicare cuts in the 1980s was different from the effect of similar cuts in the 1990s. In the earlier time period, reductions in the amount that Medicare would pay for services were largely offset by increases in the prices charged to non-Medicare providers. But in the last few years, the period following the rise of managed care and the heightened price sensitivity of non-Medicare payers, there is much less evidence that hospitals have responded to Medicare cuts by passing on costs to other payers. The implication of this study is the future reductions in Medicare payments may have a substantial effect on the operation of hospitals and the incomes of medical care, because cost-shifting options are likely to be limited.

The second paper, by Jerry Hausman, addresses an important but under-studied issue in the regulation-based taxes on telecommunication services. "Taxation by Telecommunication Regulation" estimates the deadweight burden associated with the Federal Communications Commission's (FCC's) choice of how to raise funds for a program of improved Internet access in public libraries. The FCC decided to tax interstate telephone service to finance this program, rather than increasing the subscriber line charge for telephone service. The efficiency cost of raising long-distance telephone rates is greater than the efficiency cost of raising the subscriber line charge, because the price elasticity of demand for long-distance service is much greater than the price elasticity of demand for telephone connections, and because the ratio of price to marginal cost is greater in the long-distance market than in the telephone connection market. Hausman's estimates suggest that the efficiency cost of the long-distance tax is greater than the revenue raised by this tax.

The third paper, "Tax Incentives for Higher Education," addresses the very timely question of how federal tax expenditures affect the number of individuals who enroll in higher education. Caroline Hoxby, the study's author, begins by describing the education-related provisions of the Taxpayer Relief Act of 1997: HOPE and the Lifetime Learning Credit. She places these provisions in the context of existing federal education-subsidy programs. The paper then draws on existing empirical research on the price elasticity of demand for two- and four-year college education to describe the likely impact of the new tax provisions. One of the most important features of the analysis is the explicit consideration of the possibility that tax subsidies that reduce the student cost of higher education may induce colleges to raise tuition prices. Although it will be several years before it is possible to assess the actual effects of the recently-enacted education tax subsidies, this paper provides an important guide to the potential effects.

Jeffrey Liebman's paper on "The Impact of the Earned Income Tax Credit [EITC] on Incentives and Income Distribution," the fourth paper in the volume, delivers exactly what its title promises. Liebman provides a comprehensive summary of how the EITC has affected the distribution of post-tax incomes relative to pre-tax incomes. The paper provides a wealth of information on the identity of households that receive the EITC, and it summarizes how the EITC affects the after-tax budget set for these households. The paper also uses a unique data set matching tax returns to survey responses in the Current Population Survey to study the extent of noncompliance with the EITC. The expansion of the Earned Income Tax Credit has been one of the most striking changes in the federal tax code in the last two decades, and this paper provides a clear and readable summary of the impact of these expansions.

The fifth paper is Leora Friedberg's study of "The Social Security Earnings Test and Labor Supply of Older Men." The Social Security Earnings Test specifies the amount of labor income that a social security recipient can earn without any reduction in benefits. It also specifies the rate at which benefits are reduced for those individuals who do choose to continue working after they begin receiving social security. While a small previous literature has concluded that the earnings test has a very limited effect on the behavior of social security beneficiaries, Friedberg challenges this conclusion. She shows that a substantial number of social security beneficiaries earn slightly less labor income than the amount that would trigger the earnings test. Moreover, when the minimum threshold for the earnings test changes, there is clear evidence that the level of reported earnings also changes. Thus this paper concludes that the earnings test does in fact affect labor-supply decisions, and that it may have substantial efficiency costs.

The last four papers in the volume are directed at a common set of issues concerning the economic effects of replacing the current income-tax system with a consumption-based tax system. It is widely recognized that transitional issues are crucial in analyzing the distribution of "winners" and "losers" in any reform that shifts the tax base. Yet relatively few research studies have tried to describe the effect of fundamental tax reform on asset values, interest rates, and other variables that have a significant effect on the transitional effects of tax reform. The four papers included in this volume represent an important contribution to understanding this set of research questions.

David Bradford's paper, "Transition to and Tax Rate Flexibility in a Cash-Flow-Type Tax," explores the problem of double taxation of "old saving" when a consumption tax is adopted. The central difficulty is that individuals who have saved under the income tax, assuming that they would be able to consume their accumulated principal without paying any tax, would be taxed at the time of consumption under most consumption taxes. Bradford sketches two methods of avoiding this double taxation under a consumption tax regime, and he points out more generally that the double-tax problem arises in a consumption tax regime any time the *rate* of consumption tax changes. The proposals developed here represent important potential building blocks for "transition relief" in future consumption tax proposals.

The second paper on fundamental tax reform, Martin Feldstein's "Would a Consumption Tax Reduce Interest Rates?" addresses one of the most important issues that affect the incidence of tax reform. While a number of earlier studies have argued that nominal pre-tax interest rates would decline substantially if the income tax were replaced with a consumption tax, Feldstein shows that this is not a foregone conclusion. Rather, he demonstrates that depending on the way personal saving responds to changes in the after-tax rate of return, and the relationship between debt and equity yields, it is possible for fundamental tax reform to raise interest rates. This paper underscores the fragility of some previous conclusions regarding the potential effect of tax reform home values, the level of the stock market, and other asset prices.

William Gentry and Glenn Hubbard's paper, "Fundamental Tax Reform and Corporate Financial Policy," presents an in-depth discussion of how a switch to consumption taxation would affect the tax planning environment for corporations. The authors emphasize that many potential income-tax reforms, as well as a switch to consumption taxation, would equalize the tax treatment of different types of capital income and eliminate the double taxation of corporate capital income through the corporation and the individual income taxes. They focus on the impact of such changes on the incentives for firms to use debt as opposed to equity securities, and on the design of complex financial securities. The authors conclude that there would be substantial efficiency gains from the homogeneous treatment of different financial transactions under either income or consumption tax reform.

The final paper in the tax reform symposium, "Transitional Issues in Fundamental Tax Reform: a Financial-Accounting Perspective," focuses on the importance of transition rules for business assets in any fundamental tax reform. Mel Schwarz, Peter Merrill, and Chris Edwards show that reform proposals that extinguish the value of existing depreciation deductions for past purchases of capital goods, or that eliminate the tax deductibility of interest payments at the corporate level, could have large effects on the prospective tax liability of some firms. More importantly, they show that there are substantial disparities across firms in the impact of fundamental tax reform. Along with the other papers in the symposium, this study shows that it is extremely important to analyze the incidence effects of particular fundamental tax reform proposals, with fully articulated transition rules, rather than simply to analyze abstract proposals for tax reform.

The nine papers in this volume represent important contributions to the ongoing public-policy dialogue on the design of tax and expenditure programs. They testify to the ongoing intellectual exchange between academic public-finance researchers and the policy-making community, and they suggest the broad array of topics on which academic research in public economics bears on policy debate.

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I am also grateful to Lawrence Lindsey, a former NBER affiliate and Governor of the Federal Reserve Board, who delivered the luncheon address at our conference. His talk provided many important suggestions regarding potential directions for tax policymaking in the next few years, and it substantially enhanced this year's meeting.

Finally, I wish to thank each of the authors whose papers are included in this volume for striving to communicate their important research findings in a readable and clear fashion. I appreciate their efforts and willingness to participate in this very important opportunity for interchange between academics and policymakers.