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Program Report

Public Economics

James M. Poterba*

There have been major changes in U.S. tax policy, and much discussion of possible changes in expenditure programs, since my report three years ago on the Public Economics (PE) Program. The Economic Growth and Taxpayer Relief Reconciliation Act of 2001 is the most significant change in federal tax policy since the Tax Reform Act of 1986.

While there have been no comparably dramatic recent changes in government expenditure programs, the policy debate on two major programs has shifted quite sharply. Reforming Social Security and Medicare, long viewed as a political impossibility, has risen high on the policy agenda. While policy debate on these important issues has received little attention since the tragic events of September 11, a political dialogue on these programs started before that date, and it will surely continue in the future. Recent events also have generated new interest in old questions about the government's role in the private economy, with particular emphasis on insurance markets and the transportation sector.

The extraordinary level of policymaking activity with respect to both taxation and expenditure programs has been accompanied by a great deal of research activity by NBER affiliates in the field of public economics. In the last three years, more than 400 Working Papers were published in the PE Program. Program affiliates published four major books on topics involving taxation and public expenditure, along with three special issues of refereed journals and three new *Tax Policy and the Economy* volumes. The 81 program members participated in more than 20 research meetings ranging from small working group gatherings on narrow topics to full-scale Program Meetings and the biennial Trans-Atlantic Public Economics Seminar. The researchers in the PE Program currently are studying the economic effects of taxation, social insurance programs, and a host of other government policies. Their work provides critical input for policymakers who are considering reform options.

* Poterba is Director of the NBER's Program on Public Economics and the Mitsui Professor of Economics at MIT. NBER's website provides an online version of this report which contains links to the abstracts of the cited NBER Working Papers. These abstracts can be accessed by clicking on the Working Paper numbers provided in brackets throughout the report.

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Two new NBER initiatives, the Working Group on Environmental Economics and the Program on the Economics of Education, have been created under the direction of PE Program members Don Fullerton and Caroline M. Hoxby, respectively. These new organizational structures provide an important opportunity for researchers working on specific topics that are broadly within the purview of public economics to meet and discuss recent research developments. The NBER Program on the Well-Being of Children, directed by PE Program member Jonathan Gruber, is another example of such a specialized program.

In this report, I describe several components of the recent research by PE program members. The report is necessarily selective, and it excludes far more research than it includes. In light of the substantial recent policy interest and research activity on taxation and Social Security reform, I have focused most of this summary on new studies that bear on those topics. I also briefly describe new work on two emerging research areas.

Personal Income Taxes

Recent research by NBER affiliates provides new evidence on how taxes affect household decisions about labor supply, saving, charitable giving, and a range of other behaviors. The changes in the U.S. individual income tax that were enacted in 1993 and 1997 have provided an important opportunity to learn more about the impact of taxation. Researchers not only have analyzed these reforms, but also have developed new conceptual approaches for looking at a range of tax policy issues.

One of the most important empirical concerns about the individual income tax is the impact of changes in marginal tax rates on the amount of taxable income reported by taxpayers. Recent research provides substantial new insight on this issue [7512, 7367, 6584, 6582, 6576]. Other research finds new evidence on: the link between taxes and labor supply, as measured by hours of work [6759, 6621]; how tax rates affect taxpayer compliance [6575]; and how the differential tax treatment of different types of capital income affects the structure of household portfolios [8340, 8223, 7392]. Several studies have focused on the increasingly important Earned Income Tax Credit (EITC) [8078, 7363, 6856]. They suggest that tax code provisions have important effects on labor force participation and hours

of work. These findings, which apply primarily to young households with children, are mirrored in findings about the labor supply behavior of older households that face the Social Security earnings test [7923, 7200].

The recent decline in the personal saving rate as measured in the National Income and Product Accounts has drawn new attention to the possible impact of public policy, and in particular the individual income tax, on the level of household saving. Recent NBER studies address the broad impact of the income tax on rates of return and saving [7061], as well as the effect of specialized tax provisions, such as the 401(k) retirement saving program and Individual Retirement Accounts [8032, 7991, 7314, 7268, 7192, 7007]. Two questions that have attracted particular attention are what factors influence employee decisions about 401(k) contributions and participation [7735, 7682] and whether 401(k)-type accounts offer savers a higher rate of return than they could obtain elsewhere [8341, 8170]. Other recent work shows how dividend taxes affect share values [8486, 7445], thus informing the perennial debate about whether the corporate income tax should be integrated with investor-level taxes on corporate capital income.

The tax treatment of capital gains is a feature of the tax code that affects the return to saving and that has attracted significant attention recently. The capital gains tax can affect the overall level of saving, but it is particularly significant because it may affect risk taking and entrepreneurial activity [7976] and because changes in capital gains tax rules can affect the market value of risky assets [8011, 7893, 7644, 6885]. New research illuminates the link between capital gains taxation and the trading decisions of individual investors [7827, 7532, 6616]. Because the capital gains tax treatment of mutual fund investments has become increasingly important for many households, several recent papers explore this aspect of the tax [7669, 7595].

Recent policy debates concerning the estate and gift tax, and the changes to it that were enacted in 2001, have stimulated a very significant body of empirical research on the economic effects of this tax [8333, 8261, 8205, 8158, 7960, 7811, 7775, 7663, 7360, 6842]. These studies develop a conceptual framework for analyzing how the estate tax affects incentives for saving, charitable giving, and inter vivos giving. They also provide important input for the ongoing policy debate on the reform of taxes on intergenerational transfers.

Corporate Income Taxes

While corporate income tax rules were not changed as much during the 1990s as individual income tax rules were, the economic effects of the corporate income tax remain a subject of active investigation. Recent work focuses on the economic impact of investment incentives, including depreciation allowances and investment tax credits [6731, 6615], and on the links between tax policy and corporate financial behavior [8203, 7821, 7433]. There also has been new research on the ultimate incidence of the corporate income tax [8280], and on the effect of tax-induced changes in the cost of capital on business investment [7558].

The taxation of multinational firms is another area of ongoing interest. Researchers have considered the impact on firm dividend decisions of taxes that are triggered by the repatriation of foreign earnings [8507]. More generally, the researchers have looked at the effects that current tax rules have on firm investment and financing decisions [8440, 8144, 7929, 7920, 7903]. One of the most active areas of discussion on corporate tax policy during the 1990s has been the treatment of income earned by firms when they export products [8121, 8009]. Researchers have also considered the role of capital income taxes in inducing investors to hold more assets in their home country, rather than abroad, than a model of diversified investing would suggest [8193]. One

of the new books in the PE program, *International Taxation and Multinational Activity*, edited by Research Associate James R. Hines, Jr., is directly concerned with this broad set of issues.

A number of other issues involving corporate tax policy have also received attention from NBER researchers. These include: the impact of state insurance taxes on the financial behavior of multi-state insurance companies [6590]; the deadweight burdens associated with the taxation of wireless communication [7281]; and the tax treatment of executive compensation and its role in affecting the level and structure of corporate pay [7842, 7626, 7596]. On a broader scale, recent research has explored the potential design of “cash flow” taxes on business income [8122].

Social Security

As the Baby Boom generation grows older, both public and private sector retirement programs have attracted new scrutiny from applied economists. There has been a particular increase in research activity focused on the Social Security systems of the United States and other nations. The research includes historical and descriptive analyses of the evolution of the current U.S. system as well as a basic framework for analyzing retirement income [8488, 8451, 8258, 7362, 6603]. A new book by Research Associates Jonathan Gruber and David A. Wise on *Social Security and Retirement Around the World* provides important evidence on how the social security system may affect labor supply. There is also conceptual research on the appropriate framework to use in evaluating potential Social Security reforms [7119, 7118, 7117, 6719, 6610].

Recent empirical studies illustrate the distributional impact of both the current Social Security program and potential alternatives [8329, 7597, 7570, 7568, 7560, 7520, 6989]. Researchers also have considered the impact of the current system on household behavior, particularly on retirement [7830, 7651, 7339].

Further, new studies investigate the extent to which households understand their current Social Security benefits [7368], whether they recognize and act upon the consequences associated with claiming benefits at different ages [7318], and the interaction between Social Security and other programs that provide benefits to low-income elderly households [7574].

Risk sharing is an important feature of the current Social Security system, and it may become important in various alternatives as well. Several researchers have shown how the current system shares risk across households and generations [8270, 8064, 7861, 7031, 7030, 7016, 6839]. The investment behavior of the current Social Security trust fund also is related to concerns about risk. As policy attention on trust fund investment expanded in recent years, so too did research on the consequences of alternative investment policies [8259, 7739, 7015, 6991].

What are the potential consequences of replacing or supplementing the current Social Security program with systems of individual investment accounts? A number of studies consider the distributional, risk sharing, and other economic effects of such accounts [7767, 7492, 7065, 7050, 7049, 7005, 6970, 6918, 6540]. This line of inquiry helps to inform the ongoing national policy debate on Social Security reform. NBER Research Associate John Y. Campbell and NBER President Martin S. Feldstein edited a new NBER book, *Risk Aspects of Investment-Based Social Security Reforms*, that focuses attention on risk issues.

The current Social Security program also provides inflation-indexed annuities for retirees. A number of recent studies have explored the operation of private annuity markets, with an emphasis on understanding how they might be used in conjunction with a system of individual retirement accounts [8045, 7812].

NBER researchers have not limited their attention to the U.S. Social Security system. They also have considered the social security program in Germany [8503, 7304], in Europe

more generally [8487, 8103], in South Africa [8495], China [6794], and Singapore and Australia [8091].

Other Research Initiatives

While there has been a great deal of research activity on issues involving taxation and Social Security reform, there also has been much progress in studying other issues in public economics. These include the design of public policies toward the environment, the economic effects of public policies that bear on education and health care, and the incentive and distributional impact of expenditure programs designed to benefit children and the elderly. Since there are distinct NBER programs or projects concerned with each of these topics, I will not summarize recent work in these areas. Rather, I will describe some recent advances in two areas that fall broadly within the purview of public economics but are not the subject of separate programs: the political economy of public policy and the economics of public policy toward crime.

Political Economy

Public finance researchers traditionally have focused on the effect of government programs, and the effects of tax policies, with less attention to the question of why legislators and other elected officials enact particular programs. The rapidly expanding field of political economy tackles this aspect of public policy, and in recent years, an increasing volume of activity in public economics has focused on these issues. Recent work tries to explain the structure of welfare programs [8524, 8405, 8267, 6995, 6746, 5774], the nature of policies that transfer resources across generations [8394, 7518], the role of government in financial markets [7110], the difference between elected and appointed officials [7579], the factors that determine the size of government [6789, 6727, 6655], and more generally the impact of political institutions on policy outcomes [8214, 8154, 8036, 7342, 7097, 6848]. In collaboration with

Juergen von Hagen, I edited a new volume on *Fiscal Institutions and Fiscal Performance* that offers new insight on several of these issues.

Other political economy research focuses on issues that involve both political science and public finance, such as the factors that lead to electoral success [8441, 8252] and the nature of sorting across communities by income, preferences, and other factors [7859, 6977, 6822].

Public Policies Toward Crime

Providing for public safety is widely recognized as a central function of the government in modern market economies. This issue has attracted new attention in the last few months, although the particular types of criminal activity attracting attention are rather different than those studied in most academic research on the economics of crime.

Several researchers in the PE program are carrying out projects that will provide information on the impact of public expenditures, whether through prisons or through the provision of police services, on the level of crime. Some studies [8204, 6784] consider the determinants of crime and the impact of public policies. Other research considers the effect of prison sentences of various lengths, both on prospective criminal activity (through deterrence) and on the behavior of those who have been in prison [8489, 8004, 7967, 6786]. Some research considers the economics of criminal organizations [6592], the factors that determine punishments for various crimes [7676], and the impact of changing incarceration and prosecution costs on state and local government budgets [8382].

Government Service

Because public economics is concerned with the analysis of government policy, it is no surprise that many members of the PE Program have been called upon to serve in government agencies that address economic

policy. Program members also try to bring their research to the attention of the policymaking community through outlets such as the annual “Tax Policy and the Economy” conference, held in Washington, D.C., at which researchers present their latest policy-relevant findings.

During the last three years, program members have served in a number of distinguished capacities. Lawrence H. Summers, while a Research Associate (on leave) in the PE Program, served as Secretary of the Treasury. R. Glenn Hubbard is currently serving as the Chairman of

the Council of Economic Advisers (CEA), while Mark B. McClellan is one of the Council members. Douglas Holtz-Eakin is the Chief Economist at the CEA. Kathleen McGarry has served, and Jeffrey Brown is currently serving, as a senior staff economist at the CEA.

Research Summaries

Integrating Multinational Firms into International Economics

James R. Markusen*

As recently as the mid-1980s, research on multinational firms was almost entirely separate from research on international trade. The latter was dominated by general-equilibrium models using the twin assumptions of perfect competition and constant returns to scale. In this theory, there was little role for individual firms; indeed, theorists spoke only of industries, not firms. Multinational firms generally were approached from a case-study perspective, or at best in a partial-equilibrium setting.

To the extent that multinationals and foreign direct investment were treated at all in trade theory and open-economy macroeconomics, they were viewed as part of the theory of portfolio capital flows. The view was that capital, if unrestricted, flows from where it is abundant to where it is scarce. The treatment of direct investment as a capital flow was evidenced in data sources as well. There were lots of data on direct investment stocks and flows, but little on what multina-

tionals actually produced, where they produced it, and where they sold it.

It took little staring at available statistics to realize that viewing direct investment as a capital flow was largely a mistake. The overwhelming bulk of direct investment flows both from and to the high-income developed countries and there is a high degree of cross penetration by firms from these countries into each other's markets. It also appeared that the decision about whether and where to build a foreign plant is quite separate from how and where to raise the financing for that plant. Lastly, casual observation suggested that the crucial factor of production involved in multinational location decisions was skilled labor, not physical capital. By the late 1970s, I began to believe that location and production decisions should be the focus of a new microeconomic approach to direct investment while financial decisions should remain part of the traditional theory of capital flows.

Much of my work over the last two decades¹ has thus been to develop a microeconomic, general-equilibrium theory of the multinational firm. This theory should satisfy several conditions. First, it should be easily incorporated into general-equilibrium trade theory. Second, it should be consistent

with important stylized facts, such as the large volume of cross investment among the high-income countries. Third, it should generate testable predictions and survive more formal econometric testing.

One useful starting point for theory is a conceptual framework proposed by British economist John Dunning, who suggested that there are three conditions needed for a firm to become a multinational. First, the firm must have a product or a production process such that the firm enjoys some market power or cost advantage abroad (ownership advantage). Second, the firm must have a reason to want to locate production abroad rather than concentrate it in the home country (location advantage). Third, the firms must have a reason to want to own a foreign subsidiary rather than simply license to or sub-contract with a foreign firm (internalization advantage).

I have used these ideas as conceptual guides in building a formal theory. In my models with Horstmann and Venables², the ownership advantage is modeled by the existence of firm-level as opposed to plant-level scale economies. The general idea is that there are knowledge-based activities such as R and D, management, marketing, and finance that are at least

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