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Program Report

Public Economics

James M. Poterba*

Researchers in the NBER Public Economics Program study many of the core issues that have been at the center of recent national policy debates. While the Public Economics Program is broadly concerned with the economic role of government, an expansive definition that includes some research in virtually every sub-field of economics, two of its most important research themes are the economics of taxation and the analysis of social insurance programs.

Since the last Public Economics Program Report in 2001, the United States has undergone substantial tax reform in the form of the 2003 and 2004 tax bills. Because many of the tax reform provisions that were enacted in 2001 and 2003 are scheduled to expire later this decade, further tax reforms have already been enacted in a sense. Policy debate about the extension of these tax provisions, and about the structure of the tax system more generally, seems very likely to continue through the next few years.

Tax reform has been widely discussed and there have been substantial changes in the last five years. In contrast, Social Security reform has also been widely discussed, but there have been no significant changes in the program's structure. Public programs for retirement income support have been active topics of discussion in many industrialized nations. In the United States, the earnest discussion of Social Security reform began when a Presidential commission suggested several reform proposals in 2001. Since then, various policy analysts and legislators have advanced a range of different proposals for reform. They differ in the role that they envision for the government in providing retirement income, and in their potential effects on the long-run fiscal balance of the Social Security system. Medicare, which portends to become an even more costly entitlement pro-

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gram over the long-term future, has attracted less policy attention than Social Security.

The NBER Public Economics Program includes a very diverse group of researchers. Nearly 120 Faculty Research Fellows and Research Associates claim affiliation with the program, although only half of those researchers cite Public Economics as their primary affiliation. Program affiliates have a long tradition of analyzing tax policies and of studying social insurance programs such as Social Security. They also study a very wide range of other topics, including environmental economics, political economy, and health economics. Program members meet twice each year at program meetings, and again for a variety of workshops during the NBER Summer Institute. In the last four years, there have been eight program meetings and more than twenty Summer Institute group meetings. Since late 2001, program affiliates have disseminated 605 working papers, or more than one sixth of all NBER papers, and published six books and a number of special issues of academic journals.

One recent innovation in the Public Economics group is the creation of several working groups that tackle specific research issues related to various topics in public policy. One such group, which Martin Feldstein and I have co-directed, focuses on the Behavioral Responses to Taxation. Its members are drawn from the U.S. Treasury Department, the Congressional Budget Office, and the Joint Committee on Taxation, as well as from NBER's ranks. This group has met to discuss completed research about, and the research agenda for, the link between tax rates and various dimensions of taxpayer behavior such as labor supply, capital gain realizations, and the reporting of aggregate taxable income. The Working Group has scheduled meetings just before or just after Program Meetings, or during the NBER's Summer Institute, to maximize participation by the NBER affiliates. A second such group directed by NBER Research Associate Douglas Shackelford of the University of North Carolina focuses on Financial Accounting and Taxation. It includes researchers in the fields of accounting, finance, and public finance. Its agenda includes issues at the intersection of public

finance and accounting, for example explaining the growing disparities between book and tax income for U.S. corporations and evaluating the impact of various tax reform proposals on accounting earnings and corporate balance sheets.

A brief report such as this cannot do justice to the breadth of research that is carried out by Public Economics Program members while also explaining the substantive contributions of this research. I have therefore decided to focus here on four broad areas: taxation, social insurance programs, political economy, and the economics of the state and local government sector. Because taxation issues are studied exclusively by researchers in the Public Economics group, while Aging, Economic Fluctuations and Growth, and Well-Being of Children Program researchers study some of the other issues (and their research is described in other Program Reports), I will devote more than equal time to the issues related to taxation. I will describe how Program members have approached a variety of topics, and I will briefly summarize their key research findings. This report unfortunately excludes far more research than it includes, and I apologize to the researchers whose work is not mentioned in this summary.

The Economic Effects of Tax Reform

There have been three important federal tax changes in the last five years. The 2001 Economic Growth and Tax Relief Reconciliation Act reduced marginal tax rates under the federal income tax, although budgetary pressures necessitated temporary rather than permanent tax reductions. The 2003 Job Growth and Taxpayer Relief Reconciliation Act reduced marginal tax burdens on dividend income by as much as 20 percentage points for some households, thereby

significantly reducing the relative tax burden on dividends relative to corporate retained earnings that generate capital gains. The 2004 tax bill introduced a transitory tax holiday for firms repatriating earnings from foreign subsidiaries, and it created a range of specialized provisions to encourage specific business activities. Researchers in the NBER Public Economics Program have analyzed the economic effects of tax changes similar to those embodied in each of these tax bills. As data on taxpayer response to the tax reforms has become available, they have also provided a rapid evaluation of actual behavioral changes in response to tax rules.

The tax changes of 2001, which were temporary, phased-in gradually, and included an immediate tax rebate as a means of stimulating economic activity, have generated several lines of research on tax policy and household behavior. A number of studies have explored how consumers responded to the increase in aftertax income that resulted from the immediate tax rebate (10784, 9308). These studies suggest that most households spent between half and three quarters of their tax rebate within six months of receiving the rebate, and that the spending effects were greatest for households with low levels of financial wealth. Other research has examined how the changes in investment incentives affected corporate investment activity (10415), and how the reduction in individual income tax liabilities raised the importance of the Alternative Minimum Tax for many individual taxpayers (10072). One of the central issues in analyzing any tax reform that changes marginal tax rates is how it will affect the amount of taxable income reported on tax returns, since this determines the revenue effects of the tax reform. NBER researchers have played a central role in developing estimates of the elasticity of taxable income with respect to marginal tax rates, and recent work supports earlier findings

of a substantial reporting response to changes in tax rates (10273, 10044).

Taxable income is the sum of many components, each of which may be affected to different degrees by changes in marginal tax rates and in the structure of the tax base. Not surprisingly, a substantial body of research has examined the components of taxable income and their sensitivity to the tax system. One item that has attracted attention is the mortgage interest deduction. It has been actively discussed of late because the President's Advisory Panel on Tax Reform suggested tightening current limits. Several recent studies have explored the economic effects of the current deduction rules and the distribution of the resulting tax deductions across income groups and geographic locations (10322, 9284). Because house prices differ widely, there are large differences in the average value of mortgage interest deductions across states, with much higher values on the East and West Coast than in Mid-western states. Other research has considered the effect of changes in the home mortgage interest deduction in other nations, with particular emphasis on the United Kingdom (11489, 9207).

Another active topic of research on the individual income tax is the link between current tax rules and incentives for entrepreneurial activity. Two studies have explored how the progressive structure of the individual income tax, and the interplay between the individual and the corporate income tax, affect entrepreneurial activity (9226, 9015). The important role that start-up businesses play in supporting research and development and encouraging job growth makes it important to understand how tax incentives affect the creation of new enterprises. Other topics that have attracted attention are the influence of tax incentives on purchases of health insurance and health care (10977, 9567, 8657, 9855), the link between taxation and labor supply

(10316, 10935, 10139, 9429, 8774), the sensitivity of capital gain realizations to marginal income tax rates (10275, 9674, 8745), the economic effects of excise taxes on goods such as cigarettes (8872, 8777) and alcohol (8562), and the impact of tax incentives on charitable giving (10374). The Earned Income Tax Credit and its effect on the labor supply of low-income households has been widely studied (11768, 11454, 11729). While many of these studies emphasize specific issues of income tax policy, NBER researchers are still examining the broad issues raised by fundamental tax reform, such as the economic effects of shifting toward a consumption tax (9492, 9596), the fundamental determinants of tax evasion (8551), the theory of optimal taxation (10490, 10407, 10119, 10099, 9415, 9046), and the accurate measurement of the distribution of tax burdens across households (8978, 8829).

Discussions of consumption taxation and of fundamental tax reform focus attention on the current tax rules that affect saving, and in particular on opportunities for earning before-tax returns in a variety of specialized accounts such as Individual Retirement Accounts and 401(k) plans. The analysis of retirement saving programs has been a very active area of research in Public Economics, and the ongoing research has drawn insights from behavioral economics (11518), financial economics, and many other sub-fields. In addition to studying how the availability of these saving programs affects wealth accumulation (11680, 9096, 8610), a number of studies have shown that participants in employer-provided saving programs are very sensitive to default options, peer behavior, and other considerations that are usually outside the neoclassical economics analysis of saving choices (11554, 11726, 9131, 8885, 8655). Research has explored the potential use of plan default provisions to encourage saving (11074) as well as the role that employer matching

of participant contributions may play in raising participation rates (10419). Another strand of research has considered how assets held in tax-deferred accounts should be valued from the perspective of a household trying to compute a balance sheet that includes both taxable and tax-deferred assets (10395). Related work has studied the asset allocation choices that households make when they participate in tax-deferred accounts, and it has contrasted these choices with the predictions of simple models of tax-efficient asset location (9268).

The tax changes of 2003 focused on the taxation of corporate capital income. By reducing the maximum individual income tax rate on dividend income to 15 percent, instead of the top rate of more than 35 percent that prevailed in previous years, the 2003 reform substantially reduced the tax incentive for firms to retain earnings or repurchase shares rather than to distribute cash dividends. NBER Public Economics researchers have been studying the link between tax rules and corporate financial policy since the program was created, as the "Business Taxation and Finance" group, nearly thirty years ago. Not surprisingly, the dramatic change in dividend tax burdens stimulated many new research projects. These include new studies of the responsiveness of dividend payout with respect to tax rates (10321, 10391, 10572, 10841, 11449), and of the impact of the 2003 tax reform on the market value of firms with different payout policies (11452). The empirical findings suggest that in the months following the dividend tax reduction, firms increased dividend payouts at a rate that had not been seen for several decades. The tax change was a catalyst that reversed a decades-long decline in corporate dividend payout. Many firms that were paying dividends increased their payouts, and many other firms initiated cash dividends. Research on dividend policy has moved beyond the simple documentation of higher pay-

out rates to study how firm characteristics, such as stock option holdings of top managers, affected the change in payout in the aftermath of the tax change. Dividend increases were smaller at firms where managers have substantial holdings of options that would decline in value if the firm paid out earnings as dividends than at firms without such executive option holdings (11002).

While the tax treatment of dividends has attracted particular attention in the last two years, NBER researchers have also studied many other aspects of corporate income taxation. The decline in corporate tax payments during a period of high profitability, and the popular claim that U.S. corporations were moving operations offshore to reduce their tax burden, have attracted an expanding set of researchers to issues of corporate taxation. Two recent studies have explored the source of the decline in corporate tax revenues (9477, 9535), and a substantial body of research has investigated the effect of international tax rules on the behavior of multinational firms (11717, 11196, 10806, 10936, 8854). These studies generally find that large disparities in effective tax burdens across nations have the effect of shifting the geographical pattern of reported income and of some corporate activities, although international tax considerations do not appear to fully account for changes in corporate tax receipts over time. Other studies have analyzed the determinants of corporate tax avoidance and tax planning (11241, 11341, 10858, 10690, 10471, 11504) and the interplay between tax avoidance and financial fraud (10978). Researchers have investigated the differences between taxable income and book income, and the potential consequences of moving toward a tax system that relied to a greater extent on book income for the computation of tax liability (11067, 8866), as well as the role of new and sophisticated financial products in affecting corporate income tax liabilities (9243).

Much of the recent research on corporate income taxation has focused on emerging issues in the corporate sector, and a number of studies have linked this work back to long-standing concerns such as the economic incidence of the corporate income tax (11686, 9916, 9374). Other studies have also explored potential reforms of the current corporate tax structure by analyzing the design of cash-flow corporate taxes in open economies (10676, 9843) and the way that the General Agreement on Tariffs and Trade (GATT) might treat various changes in the apportionment rules that are applied to the worldwide income of multinational firms (9060).

The individual and the corporate income taxes are the focus of most Public Economics research on tax policy, but there is always some research on other tax instruments. Several recent studies have examined the estate tax and tried to summarize its incentive effects, both in theoretical models (11408) and in practice (9456, 11025, 9661, 11767). One explanation for the substantial flow of wealth from one generation to the next is that elderly households hold wealth to prepare for the possibility of late-life medical needs or other costs. This suggests that the impact of the tax code on household behavior may be affected by the structure of insurance markets. An emerging literature is beginning to explore this interaction (11185).

Most of the research described above focuses on the detailed provisions of the tax rules affecting individuals or firms. But the unusual nature of the 2001 tax changes, in particular their temporary character and the role of budgetary rules in leading Congress to enact such tax policies, has stimulated new research on the broad subject of budget rules and the link between such rules and policy outcomes such as the budget deficit. Researchers have studied the effect of sunset provisions on budget outcomes (10694), the potential impact on federal

taxes and spending of unifying the budgets of the Medicare and Social Security trust funds with the rest of the budget (10953), and the link among anti-deficit rules such as limits on government borrowing and fiscal policy outcomes (10788, 11065). More generally, recent policy debates concerning federal deficits have led to renewed interest in the evolution of fiscal policy in the United States and elsewhere (11630, 11600, 10788, 10023, 9012), and to new analyses of how budget deficits and government debt levels affect interest rates (10681). Recent research on this issue has moved beyond earlier studies that considered only the contemporaneous correlation between asset markets and deficits, and begun to model expected future fiscal policy and its impact on interest rates.

Social Security and Other Social Insurance Programs

One of the reasons that long-term fiscal policy projections have attracted so much interest is the impending growth of Social Security and Medicare, programs that provide retirement income and health insurance to elderly households. These programs represent the federal government's largest long-term commitments. It is therefore no surprise that these programs have been the focus of an active research agenda by scholars affiliated with the Public Economics Program. Much of this research is also part of the NBER Programs on Aging and on Health Care, and is consequently summarized in other Program Reports. Because the issues in Social Security reform are particularly central to public economics, I will describe several components of this research, and then discuss social insurance research more generally.

A number of studies have considered the long-term fiscal health of the Social Security program and computed the present discounted value of promised payouts less projected taxes, as well

as the sensitivity of such calculations to various assumptions (11060, 10969, 10085, 9845). Other work has examined popular perceptions of future Social Security benefits (9798); these perceptions can have an important effect on current saving decisions.

The projected shortfall of Social Security payroll taxes relative to benefit payments has stimulated numerous proposals for Social Security reform in the United States (8592, 11098). Some researchers have explored the aggregate efficiency effects of adopting a "private accounts" Social Security program (11622, 11101). Others have focused on specific design features of "private accounts" programs, such as alternative asset allocation restrictions and return guarantee programs for such accounts (11300, 11084, 9195, 8906, 8732, 8731). The experience of Chile, a nation that adopted a privatized account system in the early 1980s, has been carefully chronicled (8924), and researchers have tried to predict the labor market effects of a private accounts system (10305). An important strand of research has considered the labor market effects of existing Social Security programs either by exploiting international differences in Social Security programs to generate differences in retirement incentives (11290, 9407) or by examining the incentives created by the Social Security program in the United States (10905, 9183, 10030). Social Security redistributes resources within cohorts as well as across generations, and recent research has examined how the Social Security program has affected the economic status of the elderly and its distribution (10466, 8911, 8625).

While a substantial group of NBER researchers studies issues related to Social Security, an even larger group investigates the wide array of other social insurance programs that currently operate in the United States and other developed nations. This research touches on many

different programs and topics. Some work offers theoretical guidelines for the design of social insurance programs (11386, 11250, 10792). Two central issues that arise in evaluating any social insurance program are: the extent to which the program alleviates the problem that it is designed to address and the extent to which it causes unintended distortions in the behavior of recipients (8730). Many studies have examined one or both of these issues in the context of specific social insurance programs, such as unemployment insurance (11760, 10500, 10443, 10043), the Supplemental Security Income program (11568), Medicaid (9058), Temporary Assistance for Needy Families (TANF) (8749), disability insurance (9155, 9148, 10219), housing assistance programs (8709), and child care subsidy programs (9693). Other studies focus on various aspects of behavioral response that arise in a number of different social insurance programs. These include the effect of such programs on household saving (10487), the decision of households with regard to benefit take-up (10488, 9818), the impact of social insurance and transfer programs on labor supply (9168), and the link between social insurance programs and living arrangements (8774). As a result of empirical studies such as these, policymakers have a much better description of the key inputs to social insurance program design.

Researchers in public economics have long recognized that it is important to study government-provided social insurance programs in a broad context that recognizes the many other ways in which resources may be transferred to households that experience adverse economic shocks of various kinds. Transfers within families are one such alternative mechanism. Recent research has emphasized two others: private insurance markets and transfers from religious organizations. Some research has considered how imperfections in private insurance markets can provide a rationale for the

creation of government-provided social insurance programs, while other work recognizes that the provision of social insurance may alter the operation of private insurance markets (11039, 10989, 9714, 9031). The welfare effects of public programs can be very sensitive to the private market response. Studies of charitable work by religious organizations, and how such work is affected by the provision of government transfer programs, represent a new direction for public economics researchers. Analysis of transfers during the New Deal suggests that as public spending on anti-poverty efforts increased, private spending through church-based relief efforts declined. This suggests a novel channel of crowd-out that has not been documented heretofore. Future research on social insurance will undoubtedly continue to explore both the way that potential beneficiaries respond to public programs, and the effect of public programs on other components of the economic support network.

Political Economy, Legislative Structure, and Policy Outcomes

Much of public economics is concerned with the consequences of various government policies. Research on the incidence of various taxes and on the behavioral effects of various transfer programs fits this description. An important and growing strand of research, however, seeks to understand the link between political institutions and policy outcomes. This work asks why certain policies are enacted, not how such policies would affect economic activity. This research on “political economy” crosses several NBER Programs, including Economic Fluctuations and Growth, Industrial Organization, and Public Economics.

There are many different elements of political economy research within the

Public Economics Program, but many of them are united by a central focus on the determinants of electoral or legislative rules, and the consequences of different rules. Some work offers an explanation for the political factors that underpin the choice of different electoral rules in different U.S. cities (11236). Another strand of research examines the factors that influence bargaining power within legislatures (10530, 8973) and the link between such power and legislative outcomes (10385, 9748). A third group of studies examine an even more general set of issues about the links between electoral rules, the structure of political parties, and the choice of economic policies (10176, 10040). Political institutions are increasingly recognized as affected by the underlying tastes of voters, the power of various interest groups, and the history of political jurisdictions (9006).

The recognition that political institutions matter for policy outcomes raises the related question of whether one set of institutions may be more efficient in responding to some types of economic problems than another institutional structure. One specific context in which researchers have explored this question concerns the choice between an appointed regulator and an elected politician as the decisionmaker in particular settings (10241). The findings suggest that politicians will be more likely to outperform regulators in settings that require compensating the losers from a policy action, that do not involve specialized technical expertise, and that do not feature small but powerful vested interests that benefit from or lose from the policy choice.

Another broad issue of interest in political economy concerns “election mechanics.” This area is concerned with the factors that affect voting, campaign spending, candidate selection, and electoral outcomes. One example of such research is the attempt to understand and explain the apparent electoral advantage of incumbent officeholders (10748).

Another is the analysis of voter participation. Several studies have explored economic and other factors that influence voter turnout (9896, 8720, 10797, 11794), as well as the likelihood that an election is close enough for an individual voter to rationally believe that she might have a significant chance of affecting the outcome (8590). Other work explores the effect of campaign finance rules on the influence of interest groups and on policy outcomes (9601, 8693), and the broad question of what determines the total amount of campaign contributions and campaign spending (9409).

One intriguing line of research explores how the identity of elected officials, which may be affected by electoral rules, influences policy outcomes. This work evaluates an Indian electoral reform that reserved a significant share of elected positions on local councils for women candidates (8615). After this electoral reform, the set of policies chosen by the local councils shifted toward support for public programs that would be particularly beneficial for women rather than men. These findings reinforce other studies that suggest the important role played by electoral institutions that affect the characteristics of winning candidates.

State and Local Public Finance

While much of the tax policy debate in recent years has centered on the federal government, many important and ongoing tax policy issues affect state and local governments. Recent research by Public Economics Program affiliates has examined a number of these issues. There are wide disparities in fiscal structure across states and localities. This provides much wider variation in tax policies than at the federal level, and also results in large differences across locations in fiscal balance (11203).

A key issue in state and local public

economics, as in its federal counterpart, is the behavioral response of taxpayers confronting the tax system. An example of research related to this issue is a study of how property tax measures that grandfather a taxpayer's taxable property value affect homeowner mobility (11108). School finance also provides many opportunities for analyzing taxpayer response. Recent work has analyzed school finance reform programs in specific states, such as Texas (10722), and looked at the effect of state-level aid programs on the tax and spending decisions of local school districts (10701). A feature that distinguishes state tax analysis from its federal counterpart is the possibility of taxpayer mobility across jurisdictions. One study (10645) explores the effect of such mobility in the context of state estate taxes, and finds some evidence suggesting that older taxpayers with substantial estates migrate to states with low estate taxes. Another study examines the impact on local finances of winning a multi-jurisdiction battle for a new plant (9844). A third study explores how the ease of inter-jurisdictional mobility affects the relationship between tax rates and revenue collections (9686).

Other Directions for Research

The research summarized in the four foregoing topic areas represents only a fraction of the work carried out by Public Economics researchers. Several other studies, not mentioned above, illustrate this range. Program affiliates have studied the design of terrorism insurance (10179, 9271), the detection of teacher cheating on behalf of students taking standardized tests (9413, 9414), and the effects of differential tax treatment of different sized families on fertility behavior (8845). Because the public sector is involved in some way with virtually every aspect of modern life in industrial democracies, researchers interested in this field have

found, and, I expect, will continue to find, an astonishing array of research topics to study.

Government Service

In part because members of the Public Economics Program devote their energies to studying government policies, they are frequently invited to serve in various governmental roles. A substantial fraction of the Research Associates in the Program have devoted part of their careers to high-level policy advisory roles. This historical pattern has continued in recent years, as many program affiliates have taken a break from their academic research and spent time in policymaking roles in Washington. Research Associate R. Glenn Hubbard served as the Chairman of the Council of Economic Advisers (CEA), while Harvey Rosen, Mark McClellan, and Katherine Baicker have served, or are serving, as members of the CEA. In addition to his role at CEA, Mark McClellan has also served as Commissioner of the Food and Drug Administration and as Director of the Centers for Medicare and Medicaid Statistics. Jeffrey R. Brown has been nominated to the Social Security Advisory Board. I served on the President's Advisory Panel on Federal Tax Reform in 2005. Douglas Holtz-Eakin served as the Chief Economist of the Council on Economic Advisors, and then as Director of the Congressional Budget Office. Mervyn A. King was appointed Governor of the Bank of England in 2003. While some members of the Public Economics Program make lifetime commitments to participate directly in the policy process, and they serve in a variety of policy roles, many other members have taken only a single job in Washington and then returned to their academic careers.