PEOPLE IN ECONOMICS

Getting There First

An economist's lifelong study of the effects of taxes and social insurance

Prakash Loungani profiles Professor ***Martin Feldstein***

MARTIN FELDSTEIN graduated in 1961 with a bachelor's degree from Harvard College and secured admission to Harvard Medical School. But, desiring to see a bit of the world, he headed instead to Oxford University and asked the medical school to defer his admission by a year. He asked for two more deferments before deciding he wasn't going to medical school after all: "It took me three years to work up the courage," Feldstein says, "but I finally had to tell them I was going to be an economist."

Good call. One doesn't know what contributions Feldstein would have made to medicine had he traveled down that road, but his contributions have made all the difference to many fields within economics.

Feldstein ended up staying six years at Oxford, attracted "by the sense that you were at the frontiers of economic research, with data and techniques that nobody had used before." But he allows that economics may not have been the only lure at Oxford. "I also got married in England, to an American." His wife, Kathleen, later got a Ph.D. in economics from MIT. "Getting that degree was an act of self-defense on her part," Feldstein says with a smile. "With all the technical talk swirling around her, she felt she had to arm herself." While not partners in academic work, the two collaborate on op-ed pieces for the *Boston Globe*.

Some of Feldstein's academic work from his Oxford days helped launch the new field of health economics. His doctoral thesis dealt with ways in which hospital costs could be reduced in a government-run health system. His focus on efficiency in provision of health care was very much against the spirit of those times—expressed memorably in an influential book by Archie Cochrane as "all medical care that's effective should be free for all"—but is mainstream today.

Some of Feldstein's other work at Oxford laid the foundations for his bigger claim to fame: his many contributions to the fields of public finance and macroeconomics. Here, Feldstein made breakthroughs in understanding the effects of social insurance programs, such as Social Security and unemployment insurance (UI), and revitalized the study of the effects of taxation. Summarizing the impact of Feldstein's work, Jonathan Gruber, an MIT economist and a treasury official in the Clinton administration, told the *New York Times* quite simply: "Marty showed that taxes matter."

By 1968, his intellectual achievements had won him tenure in Harvard's economics department at the age of 29 and, in 1977, the John Bates Clark award, given to the economist under the age of 40 who has made the most significant contributions to the discipline. That same year, he became president of the National Bureau of Economic Research (NBER), an economic think tank based in Cambridge, Massachusetts, that has flourished under his stewardship. Michael Bordo, an economic historian at Rutgers, told *F&D*: "Marty transformed the NBER into an umbrella organization of the highest caliber, one that could oversee empirical research without getting in the way of it. He pulled it off so well that people underestimate the skill involved."

Outside of a two-year stint in Washington in the 1980s as chair of the U.S. Council of Economic Advisers (CEA), Feldstein has been rooted in Cambridge, dividing his time between Harvard and the NBER. At "the Bureau"—as the NBER is generally referred to among economists—Feldstein's office is too cluttered with books and papers to offer a hospitable environment for an interview; instead he shepherds visitors into a small adjacent conference room whose walls are festooned with political cartoons lampooning him from his days as CEA chair.

The duck will move

Economists often get tongue-tied when asked to explain their award-winning contributions in lay-

man's terms. Not Feldstein. The essence of much of his work is captured, he says, in words once uttered by the late U.S. Senator Russell Long. Feldstein was testifying before the U.S. Senate Finance Committee in 1978 on his controversial view that a cut in the capital gains tax would *raise* the revenues collected from the tax. He explained that if you cut the tax rate, investors would have a greater incentive to sell assets and realize their capital gains. Indeed, his new statistical work—"the ink was hardly dry on my NBER paper reporting these findings"—suggested that they would do so to such an extent that the revenue collected from the tax would be higher despite the cut in the tax rate.

The senators were puzzled. Economists on the U.S. treasury and congressional staffs had told them the exact opposite: a cut in the capital gains tax would lead to lower revenues. Feldstein told the senators that was because congressional staffers took the more traditional view that tax changes would bring about no change in investor behavior: cut taxes by a third, and tax revenues would fall by a third. The traditional view made no sense to Senator Long. Feldstein assumes a Southern drawl to repeat what Senator Long said next: "Professor Feldstein, where I come from in Louisiana, when we shoot at a duck, we expect the duck will move."

Feldstein was overjoyed. He could not have explained the shortcoming of the traditional view any better than Senator Long had. In the event, the capital gains tax was cut in 1978, and Feldstein's analysis that investors would respond to it strongly was vindicated. Today, the procedures followed by the staffs of the U.S. Treasury and the Joint Tax Committee take into account the likely behavioral response of investors in estimating the revenue consequences of capital gains tax changes.

To Feldstein, the story illustrates a common thread in much of his academic work: "People respond to incentives." When economic policies—such as taxes or social insurance programs—are changed, the incentives for people change, and they alter their behavior. People will not sit still "like sitting ducks when you change policy on them. You have to factor in the strong possibility that, as Senator Long said, the duck will move."

Supply side "lite"

While the work on the capital gains tax drew the most attention in policy circles, there were few taxes that escaped Feldstein's scrutiny in the work he did in the 1970s and early 1980s. He illustrated "bracket creep," the phenomenon through which high inflation interacts with an unindexed tax system to push middle-income individuals into sharply higher tax brackets. A family earning the median income saw its marginal tax rate double to well over 40 percent between 1965 and 1980, he calculated. Inflation had also caused a sharp rise in the effective tax rates on the investment incomes of individuals, Feldstein showed. Popularized through his op-eds in the *Wall Street Journal* and elsewhere, Feldstein's work contributed to the growing sentiment during the 1970s that high taxes were, as he once put it, "unfair, unjustified, and unnecessary."

Feldstein showed how social insurance programs could also adversely affect incentives. He suggested that the Social Security system displaced private saving by households. Unfortunately for Feldstein, a programming error in one of his papers undermined some of his argument: "I am embarrassed by the error," he acknowledged forthrightly in the *Journal of Political Economy*, where the original research had appeared. But it did not dim his ardor for continuing to work intensively on the disincentive effects of the Social Security system and lobby hard for its reform, including by changing the system to include private investment accounts.

In a study carried out at the behest of the U.S. Congress's Joint Economic Committee, Feldstein showed how the UI program was acting as a disincentive to work and, thereby, keeping the unemployment rate high. "Economists had misjudged the extent to which the UI program could serve as a disincentive to work," Feldstein told *F&D*. "They would tell me it couldn't be a significant factor because UI benefits were only about 20 percent of average wages. But I countered that you had to look at the effect on people who were on the margin between accepting a job and remaining unemployed." For those who were the secondary earners in their families, for instance, the value of their unemployment benefits was often as high as 70 or 80 percent of what they could earn after tax in a job. For such workers, Feldstein argued, the provision of unemployment insurance could prolong the amount of time they remained unemployed, thereby boosting the unemployment rate.

Feldstein's claim was proved right, most notably in a 1979 study by Kim Clark, now Dean of Harvard Business School, and Larry Summers, former U.S. Treasury Secretary and currently president of Harvard. They estimated at the time that "if unemployment insurance were eliminated, the unemployment rate would drop by more than half a percentage point, which means that the number of unemployed people would fall by over 600,000." Feldstein is quick to emphasize that the message of the Clark and Summers study is *not* that the unemployment insurance program should be eliminated. "The point is that the provision of protection through social insurance programs also distorts incentives. To the extent that we can, we should design insurance programs in a way that minimizes the distortions."

Feldstein's advocacy of a capital gains tax cut, and his emphasis on supply-side incentives to keep the economy humming, made him an early supply sider, he has written, "probably before the term had been coined by former CEA chairman Herb Stein and certainly before I had heard the term."

At the Council

Given the tenor of Feldstein's work, it came as no surprise that he was invited by U.S. President Ronald Reagan to become the chairman of his Council of Economic Advisers when the position became vacant in 1982. Though a supporter of the Reagan tax cuts, Feldstein did not buy into the claims of many of the president's advisers that the cuts would be self-financing. Feldstein says he had "no doubt that certain tax cuts, such as in the capital gains tax or in the very highest income tax brackets, would generate increased revenue. But by stretching the idea to suggest that every tax would be self-financing, the supply-side extremists were giving supply-side arguments in general a bad name."

Feldstein's tenure as CEA chair was therefore marked by his frequent warnings of the need to control the growing U.S. budget deficit. In March 1984, *Time* magazine carried a picture of Feldstein on its cover under a headline that read: "That Monster Deficit: America's Economic Black Hole." Coming in an election year, Feldstein's warnings apparently got under the skin of some Reagan administration officials, and they made their displeasure publicly known.

So when Feldstein stepped down from the CEA post in the summer of 1984, the media were primed to attribute his departure to differences with the administration on fiscal policies. "There were certainly people in the administration who were annoyed and unhappy that I kept harping on the need to control the budget deficit," Feldstein admits. But he brushes off the suggestion that he was pushed out of Washington; more important, he told *F&D*, were the "two pull factors," the reasons drawing him back to Cambridge. The first was Harvard's "firm policy" of giving its professors leave for two years only. The other was that he was keen to resume his position as head of the NBER, where the changes he had launched since taking over in 1977 were just starting to bear fruit.

Feldstein emphasizes that his disputes in Washington were not with President Reagan. "The president had strong views, but he was always very pleasant to work for. I had been through my view on the budget deficit with him. In fact, I had given him a copy of my standard speech on the subject and gotten his blessings, so it wasn't really an issue with the president." Feldstein also points out that, "although Reagan's rhetoric always emphasized his opposition to increased taxes, he agreed grudgingly to some tax increases" between 1982 and 1984 "because he did not like the looming budget deficits."

Feldstein says he also admired President Reagan's ability to stay on message and get the big things right. On the fight against inflation, for instance, Feldstein credits Reagan with "the good judgment to reappoint Paul Volcker" as chairman of the Federal Reserve. "Reagan had a great ability to get the short-answer questions right," Feldstein concludes with the air of a lifelong professor assigning a student a grade (see box).

At the Bureau

The NBER has had a glorious history. Started in the 1920s, it has always attracted the superstars of the profession, such as Simon Kuznets, Milton Friedman, and Wesley Mitchell. But by the time Feldstein inherited the job as its president, it was

Teaching Ec10

The course Feldstein is most associated with at Harvard is called "Ec10." An introductory economics course spread over two semesters, it draws over 600 students and is one of Harvard's best attended courses. It is required for anyone planning to major in economics, the most popular concentration at Harvard.

Last March, Ec10 attracted controversy when members of a group billing itself Students for Humane and Responsible Economics organized a petition saying that the course failed to present a diversity of perspectives within the discipline. Others, including many students, rose to his defense. While it is no secret that Feldstein's views are firmly right of center, he is known to allow other voices to be heard. "He's very supportive of people who disagree with him ideologically, of people who are to the left of him. Basically he's an honest intellectual," says Robert Reich, Secretary of Labor under U.S. President Bill Clinton.

Responding to the controversy, Harvard's Core Office allowed one of Feldstein's colleagues, Stephen Marglin, to offer a new one-semester introductory economics course. Enrollment in Feldstein's Ec10 class last fall was about 85 students short of the previous year's number, almost exactly matching the number of students who signed up for Marglin's course. For now, Feldstein appears unperturbed by the decline in enrollment in Ec10; some of it, he reckons, is due to the desire of students to get their economics over and done with in a single term.

clear that the institution had seen better days. Feldstein revitalized it by bringing together economists who worked in the same field of empirical research under the auspices of an NBER program through which they could interact regularly two or three times a year. "Researchers are notoriously independent-minded people; as one myself, I should have known," Feldstein says with a chuckle. So he had to reassure them that "no one is going to order you to do anything. . . . All we're doing is inviting you to meetings where you listen to other people's work and get feedback on your own." But once he had recruited "a core of very good people" to head the five NBER programs he initially set up, it became easier to persuade economists to join the Bureau.

Today, the NBER is an elite and nonpartisan group of about 500 economists who issue much of their work in the form of NBER working papers. Feldstein says it was to ensure nonpartisanship that one of his "early actions was to close the NBER's office in Washington. I wanted the Bureau to be a little more detached than the average think tank, working on policy-relevant issues but not advocating particular policies." The result, Feldstein says, is that "seasoned NBER researchers have come to play key roles in Washington regardless of which party is in power. I don't think any other think tank can say that."

Asked to summarize what the NBER has achieved under his tenure, Feldstein modestly offers that he thinks "it has encouraged people to do more empirical research than they otherwise would have." Others are far more complimentary. Alan Krueger, a Princeton professor and onetime Clinton administration official, remarks: "There's been enormous speculation about the post-Greenspan Fed. Of more importance to the economics profession is the post-Feldstein NBER."

"When I'm 64 . . ."

Not that Feldstein is showing any signs of retiring or slowing down. As he approaches his 65th birthday, Feldstein continues to work on many of the issues, among them the effects of Social Security and health care programs, that have engaged his attention since his early days as a researcher at Oxford and Harvard. While U.S. domestic policy issues are clearly where his heart lies, he has, over the years, emerged as a pundit on international issues as well. During the Asian financial crisis of 1997–98, he was a severe critic of the performance of the IMF. He accused the IMF of applying to the Asian case "old policies designed for different problems." The IMF's traditional "devalue and deflate" prescription was not suitable for countries that had substantial debt denominated in foreign currencies, Feldstein argued. The devaluation automatically deflated demand by raising the value of the international debt; to deflate demand further through tight monetary and fiscal policies caused, in his view, "unnecessary pain and damage in the early stage of the crisis." Feldstein also disapproved of the IMF's insistence on structural reforms as a condition for its loans. He regarded such reforms as not central to the resolution of the crisis and an intrusion on national sovereignty.

Feldstein has also caused a stir with his views on the prospects for the euro, whose creation he has characterized as "at best an act of uncertain merit" and a "costly device to achieve political union." Speaking at an event to mark the first anniversary of the new currency in early 2000, he predicted that the euro would have adverse effects on employment and inflation in Europe and would exacerbate political conflicts within Europe and between Europe and the United States. Quizzed by *F&D* on whether four years on, and in light of the euro's appreciation, he had changed his mind about the European currency, Feldstein said: "On the contrary. The problems that I had thought would begin at the periphery of the system, say, in Spain or Portugal, have emerged at the core, in Germany and France."

Is he working on anything new? Befitting one whose research has always tackled the public policy issues of the day, Feldstein says: "I've been thinking about the economics of national security." He adds that while getting his bachelor's degree at Harvard, he had worked with noted economist Thomas Schelling, one of the few who have written extensively on the economics of peace and defense. "Now I get to go back to all that with new ideas, new data, new techniques . . .," he says, gesturing for perhaps the first time in the interview, his face beaming with anticipation. ■

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