

Harvard University
Department of Economics

Economics 2510b
Public Finance II

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Answer 4 questions

1. The government is considering whether to undertake a small public investment project, which would involve an initial cost, known with certainty, and uncertain benefit flows over time. Both costs and benefits would be distributed uniformly across the population. A survey of the population finds that the typical citizen would use a discount rate of 8 percent if he undertook the project himself. The risk-free rate of return is 5 percent, and there are no longer any taxes on capital income.
 - A) You are asked to provide the government with the proper discount rate to use in evaluating the project. What rate would you suggest?
 - B) Suppose (hypothetically) that you find 5 percent to be the appropriate government discount rate. A young government budget-cutter comes to you with the proposal that this project be undertaken instead by a private entrepreneur, with a 3 percent subsidy to insure the proper decision. Is this a good idea?
2. Two rival proposals for integrating personal and corporate income taxes differ primarily in their treatment of existing corporate equity. One would abolish the corporate tax on all corporate earnings, and pass all of these earnings through to the stockholders for tax purposes, as is done presently for unincorporated businesses. The alternative plan would provide this relief only for earnings generated by new equity issues. The treatment of earnings on pre-existing corporate equity under this plan would not be changed from current practice. Proponents of each plan argue that their approach would be appropriate to eliminate the distortionary double-taxation of corporate source income. Explain.
 3. Before 1979, individuals paid tax on 50 percent of realized capital gains. Since 1979, individuals have paid tax on 40 percent of realized capital gains. What would you expect to have happened as a result to: (1) the price per share of corporate stock; and (2) the fraction of a representative taxpayer's portfolio invested in common stock. Be explicit about the model that would support your conclusions.
 4. The President has proposed a proportional across-the-board tax cut to encourage increased labor supply. (1) On the basis of your knowledge of theory and econometric evidence, what impact would you expect this change to have on labor supply? (2) For any potential loss of tax revenue, what is the best way to change taxes to increase labor supply? (3) If tax change X increases labor supply more than

an equal-revenue-cost tax change Y, is X also a more efficient change? (4) Under existing law, there is a 50 percent maximum marginal tax rate on wage and salary income even though interest and dividends can be taxed at rates up to 70 percent. The across-the-board rate cuts would not reduce the 50 percent maximum rate on wage and salary income. With the help of an explicit model of individual behavior, comment on the possible effect of the across-the-board tax cut on the supply of labor of those who currently pay the 50 percent maximum rate on wage income and a higher rate on interest and dividend income.

5. Because utility functions are concave, capital markets are inefficient and some individuals are short-sighted, the unemployment insurance program provides a benefit that is worth more than the amount of money paid to unemployed persons. This benefit is acquired at the cost of distorting economic behavior. (1) How might the value of the benefits (i.e., the extent of protection) be increased at relatively low additional "cost" (in terms of distortion)? (2) How might the "cost" in distortion be reduced with only a small reduction in protection?