Public Finance Doctoral Examination June 10, 2011

You may use the notes you have brought with you in answering these examination questions. However, you may not use any other materials (articles, books, etc.) or the internet during the examination. You are not to discuss the questions with your colleagues as you prepare your answers. Your answers are to be turned in by 5:00 PM.

You should have sufficient time for the examination. Before you begin to write, it would be helpful for you to spend some time on reflection and on organizing your thoughts. Quantity is not a substitute for quality in answering these questions. Your score will depend on the quality of your answers, and high quality answers will include citations to the literature.

Answer one of the following two questions:

a. States are concerned about the impact of internet commerce on their sales tax revenues. Explain the nature of this concern, the estimation of how much revenue might be at stake, the legal, economic, and political constraints on state actions to deal with the problem, and remedial actions that have been taken and that are in discussion. Make sure that your answer reflects both the literature on the problem and recent policy developments.

b. The Russian tax reform on January 1, 2001 replaced Russia's graduated personal income tax (PIT) with a linear PIT and strengthened its tax administration (particularly enforcement). All the empirical evidence shows a dramatic increase in PIT revenues in the years following the reform. This success is said to be the catalyst behind the dramatic increase in linear PIT adoption since 2001 particularly among developing countries.

   Given the current fiscal crisis facing the United States of America, would you advise the current administration to adopt a linear PIT? Your discussion should be structured around the canons of a good tax. Be sure to highlight any similarities/differences between developing countries in general (especially Eastern European countries) and the US that would make a linear PIT suitable for one but not the other or suitable for both.

Answer one of the following two questions:

c. In 2010, the Simpson-Bowles Fiscal Commission suggested the elimination of most tax expenditures as a means to reduce the deficit. Define tax expenditure, and identify several of the largest federal income tax expenditures, along with their rough magnitudes. For one of these, describe the impact of eliminating the tax expenditure on efficiency, equity, and simplicity. Finally, describe the likely effects of eliminating that expenditure on individual and/or firm behavior, using appropriate cites to the literature.

d. Passed in April 2011, Indiana Senate Bill 589 included provisions which are intended to reduce or eliminate Indiana's personal property taxes (PPTs). In Indiana, PPTs are levied against "equipment used in the production of income or held as an investment; billboards; foundations for the equipment; and all other tangible property other than real property." In other words, by and large the PPT is a tax on capital inputs to production. Answer the following with appropriate cites to the literature:

   1) Does eliminating or reducing the PPT make sense from an economic efficiency perspective? Would optimal tax theory provide any insight on why a retail sales tax might be a better or worse replacement for PPT revenue? Explain your answer.

   2) Let's assume that prior to eliminating the PPT, we were in a long-run equilibrium where the post-tax rate of return was equal between Indiana and Non-Indiana capital. Describe the short-run and the new long-run equilibriums from eliminating the Indiana personal property tax in terms of how both the stock of capital and the rate of return on capital will adjust between Indiana and Non-Indiana sectors. Keep this description simple by assuming that the total capital supply is fixed with no capital taxes in the Non-Indiana sector. Do not introduce labor into your discussion (i.e. keep this to a partial equilibrium answer).

   3) Let's modify the problem in #2 by introducing labor, and making it a general equilibrium discussion in the Harberger tradition. In other words: closed national economy, fixed income, 2-sectors (Indiana and Non-Indiana), with 2 inputs (Labor and Kapital) that are fixed in total supply. Under what conditions will the *economic incidence* of the tax on Indiana capital be borne by capital? You can use equations to help explain your answer (provided you define the meaning of any symbols), but you <u>should not</u> mathematically derive the full Harberger model and you <u>should</u> explain your answer in as jargon-free language as possible.

Answer one of the following two questions:

e. Would you recommend the following changes in the federal budgetary process (why or why not)?
   1) Balanced budget amendment to the constitution.

   2) Biannual budget rather than an annual budget

f. The recent fiscal crisis has had a significant impact on the budget outlays at the federal level and budget revenues at the state and local level. Discuss how budget theories may apply in explaining the current status of budgeting at both the federal and state level (focus particularly on predicting budget outlays).

DEBT: Answer one of the following two questions:

i. Some market observers argue that the Build America Bonds (BAB) program has established a new paradigm for the debt financing of state and local governments. Discuss the pro's and con's of the BABs program. Also, from a financial economic perspective, discuss the history of the "exemption" of municipal bonds in terms of efficiency, equity and effectiveness.

j. S&P recently lowered its outlook for America's long-term credit rating from "stable" to "negative." Simultaneously, a municipal bond crisis appears to be brewing in several municipalities and states. Please comment on this recent turmoil in U.S. public debt market, and give your opinion on whether or not credit ratings are more important for buyers of municipal bonds than for federal bonds. Be detailed and comprehensive in giving your answer.