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IN THIS ISSUE

- Institutional Investors Drive Large Cap Prices
- More Efficient Tax Systems Encourage Bigger Government
- Lower Medicaid Fees Lead to Fewer Cesarean Births
- An Historical Analysis of Monetary Policy Rules

Institutional Investors Drive Large Cap Prices

In the early 1980s, economists discovered that—over the long run—small-cap stocks outperform large-cap stocks. Since then, however, the so-called small-cap premium has disappeared: from 1926 through 1979, the mean annualized return for small-cap stocks was 12.2 percent, compared with 8.2 percent for large caps; from 1980 to 1996, it was small caps 13.3 percent, large caps 15.9 percent.

The disappearance of the small cap premium has been the subject of much discussion among both investors and economists, but it hasn't been fully explained. In **Institutional Investors and Equity Prices** (NBER Working Paper No. 6723), NBER Faculty Research Fellows **Paul Gompers**

and **Andrew Metrick** offer one possible rationale. Put simply: Large institutional investors have come to own an ever-larger percentage of the country's equities, and large institutional investors prefer to buy large-cap stocks.

Using the "13F" disclosures that institutions with more than \$100

share held by the 100 largest institutions grew from 19 percent to 37 percent. Gompers and Metrick also find that these institutional investors show a strong, consistent preference for large, liquid stocks.

Together these two phenomena add up to an increase in

"Large institutional investors have come to own an ever-larger percentage of the country's equities, and large institutional investors prefer to buy large-cap stocks."

million of securities under management must file with the SEC, Gompers and Metrick find that the share of the U.S. equity market held by such institutions grew from 26.8 percent in March 1980 to 51.5 percent in December 1996. Over that same period, the

demand for large-cap stocks. And that increased demand helps explain the disappearance of the small-cap premium, Gompers and Metrick conclude.

—Justin Fox

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More Efficient Tax Systems Encourage Bigger Government

In addition to putting hours into record keeping and completing their tax returns, most people spend their incomes and assets in ways that would make little economic sense with a simpler tax structure. Complaints about the complexity and inefficiency of the federal tax code explain the support for a simpler, flatter, and broader tax, such as a proportional tax on consumption, or a fixed percentage tax on incomes above a given level. Unlike an income tax, a consumption

to consider their effects on government spending, according to a recent NBER Working Paper by **Gary Becker** and **Casey Mulligan**. In **Deadweight Costs and the Size of Government** (NBER Working Paper Number No. 6789), they conclude that flatter and broader taxes also tend to encourage bigger government because taxpayers offer less resistance to increases in flat tax rates than in rates of more onerous and less efficient forms of taxation. Any decline in the resistance of taxpayers leads to larger government budgets since an endless

increased 21 times to the present 15 percent combined rate on employees and employers. Social security taxes are even higher in some European and Latin American countries. As a result of such increases, countries that receive a larger fraction of their tax revenue from flat taxes tend to have considerably bigger governments. More generally, there is a close link observed by the authors between the ease of collecting tax revenue and the amount of government spending. For example, governments in oil producing nations tend to spend a lot more when the world price of oil is much higher.

“...taxpayers offer less resistance to increases in flat tax rates than in rates of more onerous and less efficient forms of taxation.”

In the past, economists have obscured major issues of political economy by neglecting the impact of tax reforms on government spending. Without effective controls over spending, a broader, flatter, and simpler income tax system may only transfer taxpayer pain from complexity and tax inefficiency to larger tax bills and bigger government budgets, the authors conclude.

tax does not double tax savings, while a relatively low flat income or consumption tax rate does not have the same distorting effects on hours worked and other decisions of the marginal income tax rates of 40 percent and higher in the current American tax system.

However, these advantages alone do not make the case for tax reforms because of the failure

number of groups agitate for greater government support.

Flat tax rates, such as the VAT and Social Security taxes on earnings, usually start at very low levels but invariably increase over time. The VAT is now 20 percent and higher in some countries. And payroll taxes began at a modest 2 percent in the 1930s in the United States, but have been

Lower Medicaid Fees Lead to Fewer Cesarean Births

Medicare expenditures have soared by 250 percent over the past decade to \$203 billion in 1996. Medicaid has grown by 400 percent to \$148 billion. These two giant programs accounted for nearly a third of the growth in the federal budget over that time span. No wonder policymakers

feel an intense pressure to reign in costs, especially with the aging of the population. So far, efforts to control both Medicare and Medicaid costs have centered largely on provider reimbursement, such as physician fees.

In the past, studies of Medicare have been concerned mostly with the effect of controlling fees on the quality of care. Studies of

Medicaid have focused more on the impact of curbing fees on patient access. Yet it would be a mistake to simply apply the findings of the Medicare studies—that doctors increase treatment intensity to compensate for lower fees—to Medicaid, according to NBER Research Associate **Jonathan Gruber** and his co-authors **Dina Mayzlin** and **John Kim**.

In **Physician Fees and Procedure Intensity: The Case of Cesarean Delivery** (NBER Working Paper No. 6744), they suggest that the opposite finding seems to hold true. Here's why: Some doctors tend to specialize in Medicare and, therefore, "income effects" dominate their reaction to lower fees: that is, they work more to make up for the lost income when fees decline. But Medicaid patients are a smaller part of a physician's patient pool than are Medicare patients. So, it is possible that "substitution effects" will dominate in the case of Medicaid fee changes. Thus lowering fees will lower treatment intensity, the authors write.

That's just what they find in their analysis of cesarean births under Medicaid. Cesarean births

offer two advantages for study: first, the underlying costs of the procedure measured in physician time and intensity are similar to those for vaginal delivery, but reimbursement is higher for cesareans. Second, there is state-by-state variation in how much

each 10 percent rise in the cesarean rate relative to the private vaginal delivery rate leads to an 8.4 percent increase in cesarean births.

Even more striking is the authors' calculation of the effect of fees on cesarean rates in Medi-

"The cesarean delivery rate rises by 3.9 percent for each \$100 increase in fees."

Medicaid programs will reimburse physicians for cesareans.

The researchers discover that, on net, fee differentials have a strong positive effect on the use of cesarean delivery. In absolute terms, they estimate that the cesarean delivery rate rises by 3.9 percent for each \$100 increase in fees; normalizing by private insurance fees, they find that

caid versus private health insurance coverage. Medicaid's lower fee differential between cesarean and vaginal childbirth compared to the differential in private insurance plans explains between one-half and three-quarters of the difference between Medicaid and private cesarean rates.

—Christopher Farrell

An Historical Analysis of Monetary Policy Rules

The recent decline in inflation in major industrial countries has led to a general reassessment of just what constitutes effective monetary policy. Government officials around the world are asking: should central banks respond to events on a case by case basis, better known as using discretionary policy? Or, should they agree in advance on how policy instruments will be used to respond to economic changes, known as adopting a monetary rule?

In **An Historical Analysis of Monetary Policy Rules** (NBER Working Paper No. 6768), NBER Research Associate **John Taylor** analyzes a century of U.S. monetary history with a simple mone-

tary policy rule as a "yardstick." The rule specifies how officials should adjust the short-term interest rate in response to changes in inflation-adjusted GDP and the inflation rate. Taylor concludes that if a monetary rule is used to set policy, the rule chosen should dictate relatively aggressive adjustments of the short-term interest rate in response to changes in inflation and real output. In fact, responsive short-term interest rates may help flatten economic fluctuations, he believes. After examining the responsiveness of short-term rate from 1879 to the present, Taylor concludes that the "dramatic" changes in U.S. monetary policy over the last 125 years have been associated with "equally dramatic changes in economic stability." The changes in mone-

tary policy are best described as "the result of an evolutionary learning process in which the Federal Reserve—from the day it began operations in 1914 to today—has searched for" a good procedure for adjusting the instruments of policy.

From 1879 to 1914, the United States was on the international gold standard, a regime that put an external constraint on long-run inflation. Short-term interest rates were relatively unresponsive to changes in output and inflation during this period, and recessions were both frequent and severe. The Federal Reserve System was founded in 1914, just as the classical gold standard was ending at the start of World War I. The Fed, as the lender of last resort, clearly was supposed to

provide money as necessary, but there was no agreement either on how quickly it should react to economic change or on how much money it should supply. According to Taylor, "that the Fed was unable throughout the inter-war period to find an effective

costs, the Fed resumed its search for an appropriate way to conduct monetary policy. During the 1960–1 recession, short-term rates were kept relatively high, and recovery was slow. When the Bretton Woods system failed in the early 1970s, the last external

the high costs of inflation.

The 1980s and the 1990s have been a time of much more stable inflation and relatively mild economic fluctuations. Comparing the results of a simple monetary policy rule with the actual changes in the Federal funds rate during this period shows that interest rates were within the range dictated by Taylor's simple monetary policy rule. Rates were outside this range during the periods when there was much less stability, including the period of the international gold standard and the period of the Great Inflation in the late 1960s and 1970s. In both periods, short-term interest rates responded too little and too late to changes in inflation and real output.

—Linda Gorman

"...if a monetary rule is used to set policy, the rule chosen should dictate relatively aggressive adjustments of the short-term interest rate in response to changes in inflation and real output."

policy rule for conducting monetary policy is evidenced by the disastrous economic performance during the Great Depression when money growth fell dramatically."

After a monetary policy hiatus during World War II, when the overriding objective was to minimize the Treasury's borrowing

constraint on inflation disappeared. Policymakers, concerned with maintaining low short-term interest rates, were reluctant to prevent accelerating rates of inflation. The result was the Great Inflation of the 1970s, and its 1982–4 aftermath, in which everyone learned painful lessons about

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