

NTA Forum

Perspectives, Ideas and News from the National Tax Association

Number 32, March 1999

TRUST IN GOVERNMENT

Opening Panel: 91st Annual Conference on Taxation
November 8, 1998

Trust in Government 1
Richard Musgrave

Trust in Government 5
Peggy Musgrave

Will People Trust a Government That Must Constantly Renege on Its Promises? 7
C. Eugene Steuerle

Also in this Issue
1999 Spring Symposium Program (Insert)

What's on My Mind 3
Wayne G. Eggert

Richard Musgrave Prize 4

Lowell Harriss Receives the Daniel M. Holland Medal 5

Wayne Eggert's "Benevolent Dictator Project" 11

New Members 12

PLAN NOW

1999 Spring Symposium
Hyatt Regency Crystal City
Arlington, Virginia
May 10-11, 1999

92nd Annual Conference on Taxation
Sheraton Colony Square
Atlanta
October 24-26, 1999

Trust in Government

Richard A. Musgrave
Harvard University and University of California, Santa Cruz

This is not the most inviting of times to discuss trust in government, but that only renders our theme the more important. Why does trust matter? Trust, we all agree, is a basic value in personal relations, such as friendship, family, and neighborhood; and though it cannot be taken for granted, it widely holds. But trust is needed also as we step outside personal relations and into the functioning of social institutions. A pastoral world where all could be settled by a handshake would be lovely to behold, but hardly realistic. Not all promises are kept, and formal arrangements are required to economize the need for trust and to lighten the burden that is placed on it. This is done more readily for the micro-trust required by the market than for the more demanding macro-trust that is needed by the public sector. The reason for this is not that its agents are less trustworthy than their counterparts in the market but that the public sector, by its very nature, involves joint concerns that have to be met by collective choice. As a result, a heavier burden has to be placed on trust. That places government at a disadvantage, but also adds to its charm. Let me explain why.

Private Exchange and Public Trust

Exchanges in the market are agreed upon voluntarily by the parties, and both act as their own agents. The two parties may not trust each other, but this does not matter because both can rely on a legal framework which assures that contractual obligations must be met. Whether the parties trust each other or not, penalties render breach of promise costly and thereby reduce the need to rely on promise keeping as a virtue. Trust, to be sure, remains helpful in oiling the machinery, but if my trust in one brand is severed, I am free to choose another the next time around.

The market, in dealing with the provision of private goods, thus operates through contracts between A and B, entered into voluntarily to meet their own interests and without concern for C. Government, in turn, enters where common concerns are to be met, and that separation of interests breaks down. This arises in the provision of public goods that are consumed jointly, so that a political process is needed by which A, B, and C can agree on what is to be provided and who is to pay. It also arises when society addresses issues of distribution, based on its view of distributive justice. In either case, the individual voter is still the base of the decision chain, but must submit to the jointly determined outcome, whether or not the outcome is to his or her liking. For democratic society to function, this requires that the inherent fairness of the process be trusted, a form of macro-trust more demanding than the micro-trust called for by the private contract. This, I think, is the crux of the problem that trust in government poses, not whether here and there the public is cheated by an incompetent or corrupt public official.

Trust in government is not a recent problem, nor are divergent views about it. Immanuel Kant, one of the great philosophers of the Enlightenment, viewed it to be the good sovereign's duty to conduct affairs of government in the public interest, leaving it the duty of the citizen to trust and obey his laws—a fine rule, provided the sovereign is

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Expressions of opinion in *NTA Forum* are solely those of the authors and do not necessarily reflect those of the Association, its officers, directors, or other members.

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indeed "good," but what assurance is there that that will be the case? David Hume's contrary counsel, voiced in the same age, warned that in constraining any system of government everyone must be supposed a knave and to have no other end in all his actions than private interest—a good protection from governmental abuse, but hardly a way to assure the public interest. In today's world of democratic institutions, the sovereign is replaced by elected officials, but the basic question remains. In a system of representative democracy such as ours, can we trust ourselves to choose representatives wisely, and can we trust them to serve us in our (i.e., the public) interest? For democracy to function, a threshold of trust on both these counts—trust in both us and them—is required. The view of government as consisting of them (the Washington establishment) and us (their helpless pawns) is a fiction. Government in the end is the voters. The voters are us, and we get what deserve.

Trust in Political Institutions

Each citizen is entitled to participate in deciding what governments should or should not do, but must then accept what has been decided. Nevertheless, it is important that the institutions and rules by which this process functions should be designed so as to deserve the citizen's trust. Madison (*Federalist* No. 51) nicely put it as follows:

But what is the government itself but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls of government would be necessary. In forming a government which is administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.

The Constitution accordingly provides for a system of representative, not direct, democracy—a fact much appreciated by someone who confronts California's practice of proposition voting. Representation is needed to permit leadership, to render political discourse man-

ageable, and to reach intelligent decisions on complex problems. Representatives have to be elected, and just how that process should be designed is not obvious, as illustrated by the recent debate over election reform in the United Kingdom. A balance between stability and responsiveness of outcomes must be found. What is clear, however, is that the role of campaign finance, which now dominates our elections, does not meet the test of fairness. Elections in this media age can be bought by those best financed. Their interests are passed on to the candidates, and the political process is distorted before decisionmaking even begins. Trust in government, more than anything else, calls for reform of campaign finance.

Next, there is the choice of voting rules by which delegates decide on policy issues. In line with the principle of equal worth and one person, one vote, majority rule has intrinsic appeal, and so does its outcome, which lets the median voter win. Outcomes may not be optimal since intensity of preferences is overlooked, but there need be no systemic bias toward excessive budgets. Nor need this be the case as coalitions are formed. Two parties may agree to outvote a third, be it to pass an additional program or to strike an existing one. Voting systems are defective, but there is no inherent reason why the resulting size of the public sector should be excessive or deficient. Either may result, and legislators, to stay in office, must meet the test of the next election.

Turning to the executive branch, much has been made of the proposition that officials and bureaucrats, to use that now pejoratively applied term, have a personal stake in expanding the budget and with it their status and power. Such may be the case, especially when public sentiment favors rising budgets. But at other times, self-promotion may be served by advocating program shrinkage, as we should be well aware at this time. Nor should we assume that civil servants, my preferred term, are incapable of serving the public sector. Their services are needed for government to function, and the spirit of the market

(continued on page 4)

From the 1998 Presidential Address 91st Annual Conference on Taxation

What's on My Mind

Wayne G. Eggert
Lucent Technologies Inc.

Four things are on my mind as we recognize 91 years of contributions to the field of public finance by the National Tax Association.

Your Organization and Its Mission

First, it is important to remind ourselves of NTA's mission:

- Educate and benefit its members
- Interest and inform the general public by:
 - promoting study of taxation and public policy
 - carrying on and encouraging research
 - conducting conferences and symposiums
 - bringing together various communities of interest for discussion
 - providing an information clearinghouse
 - publishing and distributing reports

NTA's richly diverse membership is its greatest strength. *The way for members to mind the store is to participate actively in setting the agenda for the conferences and seminars, participate in the Spring Symposium and the Conference on Taxation, and contribute to publications.* In other words, exercise your minds on behalf of your organization.

Attracting the Best Minds

The heart of any successful organization is a membership of great people with expertise, initiative, and imagination, who have been unleashed to use all of these attributes. They will (1) develop the best ideas and the most effective follow-ups, and the right policies and optimal application; (2) figure out how to use available resources to connect with each other; and (3) develop thought-provoking tax ideas, administrative simplifications, and persuasive reasons to adopt both. The National Tax Association has prestige and tradition and is highly member driven, with every opportunity for unleashing the best minds.

Members should expect something that fits their interests, but should also be part of programs outside their areas of interest. Staff and program and session chairs should take some responsibility to expand participation, but *the most important catalyst is members putting ourselves in the idea-pitching business.* We have to bring business members and state policy staffers to the table more often. And we need full inclusion.

Using the Best Minds

Taxation and public policy come out in real terms in tax legislation and regulations. Are the best minds given independence and held accountable in the legislative process? Are staffers given room to roam? Are taxpayers and government officials encouraged to team toward stretch goals? Are political expediency and policy framework at least equally balanced in the process? If revenue impact and cost assessments implement discipline in political expediency, are there other assessments for a good tax review? How about the fit to the policy framework and objectives of a good tax system?

I am dissatisfied that there is a good balance in examination of results (e.g., current tax law). Policy framework is too often given short shrift while political expediency is alive and well. There also are insufficient policy resources for state tax policy deliberations. Pooling of resources and cross-state team efforts can bolster the uniqueness of the U.S. system, wherein each state can be a laboratory of policy experimentation and yet uniformity can be introduced where it is important. In fact, in the electronic age, it is conceivable for more collaboration to happen without staffers working in the same place.

In any event, more attention to make every tax proposal fit a policy framework and an intentional examination of bolstering state policy deliberations are two thrusts to use tax policy minds more often and more efficiently.

Processing Improvements

When I speak of balancing policy fit with political fit, I am including an area that is often neglected, that is, process improvements and administrative ease or simplification. It is talked about, but proper resources are not typically devoted to it.

Delving into the process by which the tax authority and the taxpayer intersect can have some unanticipated and positive side benefits. It takes a team of revenue agency personnel and taxpayers working together to make progress in this area. The side benefit, two groups coming together to achieve a common goal, enhances relationships, appreciation for the role each group plays, and respect for the openness to improve.

What if something as mundane as processing W-9 forms was reviewed by a business/ IRS team? If they hung around an accounts payable department, they would be shocked at the amount of resources devoted to ensuring that a W-9 is on file for each new customer. It might cast doubt on the benefits outweighing the cost. Bringing in the tools of electronic commerce would no doubt produce enormous process improvements.

There is something that I happen to have a passion about—sales tax simplification. Two examples of breakthroughs include:

- **Exemption Processing.** Each state has a web site that (1) lists all exempt customers, with registration numbers; (2) includes Direct Pay Permit holders; and (3) once established, eliminates the need for all businesses having nonprofit exemption certificates and eases verification.
- **Sales Tax Registration.** Provide a nationwide multiple registration process that includes forms and ability to file one stream of information and select all or particular states.

The first of these would be accomplished by each state taking individual action. The second would require a cooperative interstate effort. Both types of changes should be possible if simplification was given attention and uniformity issues had a framework for accomplishment.

Richard Musgrave
(continued from page 2)

need not hold in that setting. Their conduct should be accountable and transparent so that the public can monitor their performance, thereby reducing the burden to be placed on trust. At the same time, a presumption of knavery, notwithstanding Hume's counsel, is inadmissible.

What Services to Provide?

I now turn to a brief look at how trust enters into some of the fiscal functions that need to be performed, and with it into the field of public finance. To begin with, how should public services be chosen so that budgets can be trusted to provide what people want? Why not simply ask them what they are willing to pay and then charge them for services rendered? Such a fee-for-service system (i.e., benefit taxation) would indeed be the safest way, but by the nature of public goods it is largely impracticable. Benefits are shared and individuals would act as free riders. Collective choice by voting is needed to determine what should be provided and who should pay.

That outcome can be only second-best, but prevailing practice might nevertheless be improved. Legislatures vote on expenditures independently of taxation, and the tax system is set without reference to what the outlays will be. While the two sides of the budget are linked when it comes to reconciling their totals, there is little allowance for differences in how particular taxpayers value the various services. I do not suggest that this be remedied by earmarking the revenue from particular taxes to finance particular services, but a closer linkage between tax and expenditure choices would render the process more transparent and trustworthy.

To budget efficiently, the cost of services must be allowed for when anticipating benefits. Deficit finance may interfere with that awareness, so that balancing the budget makes sense as a rule of fiscal discipline and in support of trust in its conduct. But that rule must be understood properly. Current tax finance, as a matter of fiscal discipline, is called for in the provision of services that offer current

NTA announces creation of the Richard Musgrave Prize, to be presented each year to the author or authors of the most outstanding paper published in the *National Tax Journal*.

During his luminous career, the work of Richard Musgrave has been characterized by a powerful blend of analytic clarity, insight drawn from the historical record around the globe, and respect for the importance of administration. With this new award, the National Tax Association wishes to recognize his contributions to public policy theory, research, and practice.

Winners will be selected based on the degree to which their research exemplifies the attributes of Professor Musgrave's work. That is, papers will be evaluated on the basis of their analytic underpinnings, the degree to which rigorous argument is buttressed by empirical evidence, respect for the historical and institutional factors, and their policy relevance.

The author of the winning paper will receive an award of \$3,000 (split if there is more than one author). Every refereed article published in *National Tax Journal* is automatically nominated. The winner will be selected by the Editor in consultation with the NTJ Editorial Advisory Board. The Musgrave Prize winner for each year will be announced in the subsequent June issue of the *National Tax Journal*.

benefits, while loan finance is appropriate for the finance of capital outlays, followed by debt amortization over the life of the asset. Moreover, allowance must also be made for the macro effects of budget policy. Deficit finance may be needed to sustain demand and surplus finance to restrain it when called for by economic conditions. Notwithstanding the Ricardian conjecture, this Keynesian insight now appears to have reemerged in the context of international stabilization (e.g., the International Monetary Fund's current call for fiscal expansion in Japan). The balanced budget rule, though helpful to support trust in fiscal prudence, may then have to yield to macro considerations.

Trusting Taxation

Taxation, that part of the problem of most direct concern here, is even more demanding of trust. "Taxes are what we pay for civilized society," as Oliver Wendell Holmes put it so well, and we ought to do so willingly, as we pay our other bills. But taxpayers also are entitled to trust that they are charged their fair share only, that they are not saddled with undue compliance costs, and that they can make their contribution in the least burdensome fashion. These requirements unhappily may conflict with each other, leaving trust difficult to achieve.

Lump-sum taxation, with the tax bill divided equally among all taxpayers, minimizes compliance cost and dead-weight loss, but is unacceptable on fair-

ness grounds. Fairness calls for relating tax payments to ability-to-pay and with it to the taxpayer's economic characteristics. Moreover, ability-to-pay varies with the size of the taxpayer's base. Fair taxation therefore calls for personal taxation; and whether the tax base can be measured in income or consumption terms, fair taxation cannot be gained by post-card returns. Moreover, fair taxation, by relating liabilities to the size of the base, involves a societal judgment regarding the shape of the social welfare function, agreement on which is one of the most difficult tests of social cooperation. Fair taxation, like all good things in life, is not simple and has its cost, but one that must be paid if the system is to be trusted.

These issues have been at the heart of recent debates over tax reform, featuring flat tax proposals and various ways of shifting from income to consumption as the tax base. This is not the place to deal with its details, but I would enter these two observations:

- (1) Without retaining a personal exemption, the flat tax would drastically shift the burden from the top and middle to the low end of the income scale; and even if the exemption is kept, there would be a shift from the top to the middle range.
- (2) Shifting from consumption to income as base would simplify matters in some important respects, but unless personal taxation is aban-

done, the consumption base also has its problems. Consumption is not readily defined, and loopholes would soon reappear.

There is no easy road to fair taxation, and leading the public to believe otherwise only invites future distrust.

Financing Social Security

The financing of Social Security, in particular, has raised issues of trust. With an aging population, an actuarial retirement system calls for accumulation of reserves to pay for future benefits.¹ But can those now contributing in the labor force be sure that the reserve will be available later on when benefits need to be paid? Critics of the system have doubted their availability and thus created distrust. Two issues are involved.

First, there is the question of whether the actuarial calculations have been based on correct demographic and economic assumptions. Uncertainties are involved, but based on conservative values they now show that current contributions and benefit levels will sustain the system for over two decades and that modest adjustments will suffice to maintain its solvency thereafter. Alarmist warnings that the system is about to go bankrupt or the claim that heroic acts are needed to save it are thus false.

Second, there is the question of how the reserve funds are used and whether they will be available later when benefits are paid. When received, the surplus on Social Security account is traded for Treasury debt, which will be redeemed later when the account is drawn down. Availability is thus assured. There is, however, a more subtle reason for concern. If the fund surplus is used to shift publicly held debt into the reserve, its later repayment by borrowing in the public market will leave publicly held debt unchanged. But if the initial use is to spend more, later repayment financed by new borrowing adds to publicly held debt and the burden of debt service. Excluding the surplus on Social Security account from the state of balance in the unified budget is thus called for since it will reduce that possibility. Investment of reserve funds in private securities would eliminate it, but would involve an unacceptably high market risk.

Devolution

Finally, I note how trust bears on the issue of devolution. Is it the central government in particular that should be distrusted, so that decentralization and devolution offer appropriate remedies? Residents of a small town know their mayor and will understand their local problems better than does the Beltway, but not all public issues are local in nature. City councils should decide where to put street lights and governors should be allowed to address regional issues, but central government is needed to deal with programs such as national defense and the Social Security system. The nature of the public service that has to be rendered largely sets the level at which it should be provided. Intergovernmental grants then offer a flexible instrument by which to separate finance from outlays and permit decentralized decisionmaking.

While there is much to be said for local choice, it also should be realized that measures of redistribution, such as progressive taxation and low-income transfers, cannot be handled effectively in a decentralized fashion. The debate over decentralization therefore contains, whether implicitly or openly, a debate over the scale at which such policies should be conducted. Trust requires that the cards be on the table.

Conclusion

In concluding, I return to my initial observation on how the role of micro-

trust in the private sector differs from that of macro-trust in the public sector. In the private sector, abuse of trust can be countered unilaterally by the victim, and trust is supported by a legal framework of guarantees. Trust in the public sector involves communal action, and this renders trusting more difficult. But government nevertheless is needed, and trust in government is a social capital without which a democratic society cannot function. A challenge, yes, but also a good thing. Individuals exist not only by themselves but also as members of their community, thereby rendering liberty meaningful and adding to their personal worth. Democracy in the United States, after all, has not done too badly over the years, and trust in government, including even trust in our fiscal system, should not be beyond our reach. Distrust when leading to correction of policy faults is a good thing, but implanting distrust to shrink government is a different matter.

Note

¹ An alternative approach, not dependent on demographic forecast, might be found in a flexible pay-as-you-go system, setting average benefits not in absolute terms but equal to a fraction, say 40 percent, of average working income net of retirement contribution. Adjusting that fraction, say every five years, to changing levels of income, the scheme adapts automatically to changes in productivity and population growth. Richard A. Musgrave, "Reappraisal of Financing Social Security," in F. Skidmore, ed., *Social Security Financing* (Cambridge, MA: MIT Press, 1981).

Dr. C. Lowell Harriss Receives Holland Medal

C. Lowell Harriss, Professor Emeritus of Economics, Columbia University, received NTA's Daniel M. Holland Medal at the 91st Annual Conference on Taxation in Austin. Eleanor Craig of the University of Delaware made the presentation. In accepting the medal, Professor Harriss noted, "My very first publication was around 1937 in the predecessor of the *National Tax Journal*, and my first National Tax Association conference was in 1938 in Detroit. That year, Daniel Holland was taking his first course in economics in my class at Columbia University.

"Since then, taxes have grown in relation to the size of the economy. And in complexity! Such changes have led to the creation and expansion of organizations concerned with one or another specific aspects—law, accounting, assessment, business and trade, international aspects, individual taxes and others you can add. Once, the National Tax Association...embraced everything. We still constitute the 'big tent.' That reality, the breadth and sweep of our interests, makes this organization unique.... NTA can serve, uniquely I believe, in broadening and deepening our knowledge and enabling us to have contact with persons who have common interests and responsibilities but who work on other aspects of public finance.

"A closing point: The quality of research can affect human well-being. In public affairs—especially but not limited to government spending and taxation—the need for high quality and the danger of poor quality present endless challenges. The National Tax Association presents a forum for presentation and criticism. It offers opportunities to enlarge personal associations. NTA presents the fruits of scholarly research. I thank you for the opportunity to have participated for six decades."

Trust in Government

Peggy A. Musgrave
University of California, Santa Cruz

In these days of "ML" and the aftermath of the recent election, I will resist the temptation to relate trust in government to the private behavior of our leaders. Suffice it to say that subjection of wrongdoing to the law and to constitutional procedures (even though perhaps somewhat overzealously) distinguishes a democracy such as ours from authoritarian regimes which lack that most precious of safeguards, namely accountability, and should fortify trust.

It is clear that trust in government is a bedrock requirement for the efficient and equitable conduct of the public sector. To paraphrase Abraham Lincoln, if I have the trust of the people I can do anything, but if there is no trust, I can do nothing. Distrust of government and the cynicism that usually accompanies it undermines willingness to abide by the rules (such as tax compliance). Lack of confidence in the ability or willingness of governments to meet future contractual obligations will result in behavior and political choices that weaken the social contract (as in the case of Social Security).

Distrust can undermine other aspects of civic morality, such as participation in the political process, leaving the field open to extremist groups to determine the course of government. Distrust of the government's resolve to stabilize the economy results in spending behavior that adds to the government's difficulties in this regard. Distrust of the motivation and conduct of public employees will have a corrosive effect on the relationships between the public and those who serve them in the public sector, with inadequate compensation for services rendered and declining quality of those services.

An essential ingredient of a well functioning public sector is therefore a high degree of trust on the part of the citizenry. Policies that instill distrust will be further corrupted by that distrust in a downward spiraling process. A just and stable society is surely one where there is

confidence that a democratically determined social contract will be adhered to by all members of society and their elected government.

Sources of Distrust

Several sources of distrust can be distinguished. While in some situations there maybe good reason for distrust, in others the inculcation of distrust can be used as a political or ideological weapon. In the last 25 years, we have seen in this country just such a use. Government has been portrayed as a predator and its agents as "bureaucrats" (in the pejorative use of that term) motivated solely by considerations of personal aggrandizement and prone to corruption. Public sector modeling by economists and public choice theorists has contributed to this view, transferring from private to public agents the assumption of personal utility maximization, while excluding concern for the public interest.

More generally, trust in government is reduced by implanting in the public's mind that government expenditures (with the possible exception of defense expenditures and protection of private property) are inherently wasteful and should be cut back, with savings transferred to individuals via tax reduction where they can be better spent. Historical forces also may play a part in explaining deep-seated distrust of government. This is evident in many western states in the United States where frontier traditions have contributed to a generally distrustful attitude toward government, which is seen as an obstacle to freedom in lifestyle. Nor can history be disposed of. In countries where tyrannical government has prevailed in the past, distrust of government dies hard, even after democratic regimes take over. Two hundred and thirty-six years later, memories of a tea party give some impetus to tax evasion.

Some displeasure with government is inevitable. Dissatisfied groups that are in a voting minority will dislike policies followed by a government in which they are outnumbered. The less homogeneous are preferences, the higher the degree of such dissatisfaction. Moreover, dissatisfaction with central government is likely to exceed that with local government where there is a higher degree of cohe-

sion. But a distinction needs to be drawn between dissatisfaction and distrust of government. A democratic system based on a form of majority rule is bound to leave some voters dissatisfied with particular programs; yet at the same time there must be trust in the fairness of the process by which decisions are reached. That process, by the nature of public goods, involves joint choices and therefore must be based on a democratic process.

Policies to Strengthen Trust

It is important, therefore, to conduct that process in a way which invites trust. Although I will focus on certain *fiscal* areas where trust in government plays both a cause and effect role in a well functioning government, it goes without saying that political and government leaders should operate within a framework of accountability and should not be beholden to those who finance their campaigns.

Taxation

In no policy area is trust more important than in the realm of taxation. As mentioned earlier, a high degree of taxpayer compliance depends on taxpayers' confidence in the quality of the tax system; this is of essential importance in the case of the income tax, which depends on self-assessment. What are some of the essential elements that contribute to confidence? First, there should be the highest degree of transparency in taxation, consistent with other objectives. Frequent complaints are heard that our income tax has become too complicated and obscure for the average taxpayer and that in consequence taxpayers distrust its fairness. While some complexity of the tax is inevitable if the tax is to be equitable and is applied in a highly complex modern economy, there are areas where preferences for special interests contribute to the intricacies of its provisions. The tax reforms introduced in 1986 did much to correct these deficiencies, but unfortunately there has been some backsliding since then.

Trust in the fairness of the tax system also depends crucially on the standards of **enforcement** that are applied. Taxpayers must have confidence that tax

Tax Policy in a Time of Surplus

Monday, May 10, 1999

8:45-9:00 A.M.

WELCOME AND INTRODUCTION

Diane Lim Rogers, Congressional Budget Office/The Urban Institute (April 1999), Program Chair

9:00-10:30 A.M.

FORECASTING THE SURPLUS: ISSUES IN PROJECTING RECEIPTS

Moderator:

Thomas A. Barthold, Joint Committee on Taxation

Presenters:

Ann D. Parcell, Office of Tax Analysis, U.S. Department of the Treasury—"Problems and Uncertainties in Forecasting Federal Income Tax Receipts"

Richard A. Kasten, *David J. Weiner*, and *G. Thomas Woodward*, Congressional Budget Office—"What Made Receipts Boom and When Will They Go Bust?"

Richard Kaluzny, New Jersey Office of Revenue and Economic Analysis—"Forecasting Receipts in the States: Lessons from New Jersey"

Brad Williams, California Legislative Analyst Office—"Forecasting Receipts in the States: Lessons from California"

10:45 A.M.-12:15 P.M.

CHALLENGES IN BUSINESS TAX POLICY

Moderator:

William C. Randolph, Office of Tax Analysis, U.S. Department of the Treasury

Presenters:

Moshe Schuldinger, O'Connor & Hannon, LLP; and *Dennis Zimmerman*, Congressional Research Service—"Taxing State and Local Government Enterprises: Economic and Legal Ramifications"

James R. Hines, Jr., University of Michigan—"Tax Deferral for Foreign Source Income: Limits and Alternatives"

Paul Crispino, Office of Tax Policy, U.S. Department of the Treasury—"Defining Corporate Tax Shelters"

Discussants:

Mitchell Rappaport, Nixon, Hargrave, Devans & Doyle, LLP
William M. Gentry, Columbia University

12:30-2:00 P.M.

SYMPOSIUM LUNCHEON

Presiding:

Billy C. Hamilton, Deputy Comptroller of Public Accounts, State of Texas; President, National Tax Association

Speaker:

Leonard E. Burman, Deputy Assistant Secretary for Tax Analysis, U.S. Treasury Department—"Surplus Tax Policy?"

2:00-3:30 P.M.

SALES TAXES IN THEORY AND PRACTICE

Moderator:

William G. Gale, The Brookings Institution

Presenters:

Austan Goolsbee, University of Chicago; and *Jon Zittrain*, Harvard University—"How Should Internet Commerce Be Taxed?"

George Zodrow and *Peter Mieszkowski*, Rice University—"The Sales Tax, the VAT, and Taxes in Between"

William G. Gale—"Estimates of the Required Tax Rate in a National Retail Sales Tax"

3:45-5:15 P.M.

BOOM OR BUST: THE ROLE OF STATE GOVERNMENTS IN THE NEW ECONOMY

Moderator:

Julia Lynn Coronado, Federal Reserve Board

Presenters:

Gloria Timmer, National Association of State Budget Officers—"State Surpluses: What to Do? What to Do?"

Arik Levinson and *Brian Knight*, University of Wisconsin—"Rainy Day Funds and State Government Savings"

Julia Lynn Coronado—"Does Tax Exemption Subsidize Capital Investment?"

Discussants:

Daphne A. Kenyon, Simmons College

Leslie McGranahan, Federal Reserve Bank of Chicago

Tuesday, May 11, 1999

9:00-10:30 A.M.

PAYING FOR THE RETIREMENT OF THE BABY BOOMERS

Moderator:

Eric J. Toder, The Urban Institute

Presenters:

Melissa Favreault, *Caroline Ratcliffe*, and *Eric J. Toder*, The Urban Institute—"Labor Force Participation of Older Workers: Prospective Changes and Potential Policy Responses"

Richard Johnson, The Urban Institute—"Distributional Implications of Social Security Reform: The Impact of Revising Spousal Benefits, COLAs, and Retirement Ages on Elderly Beneficiaries"

Kent Smetters, University of Pennsylvania—"Investing the Trust Fund in Equities: The 'Free Money' is a Hidden Tax"

Jan Walliser, International Monetary Fund—"Would Saving Social Security Raise National Saving?"

10:45 A.M.-12:15 P.M.

TAXPAYER RESPONSES TO LUMP-SUM

PENSION DISTRIBUTIONS

Moderator:

John Sabelhaus, Congressional Budget Office

Presenters:

Leonard E. Burman and *Norma Coe*, Office of Tax Analysis, U.S. Department of the Treasury; and *William G. Gale*, The Brookings Institution—"Lump-Sum Distributions: Recent Trends and Policy Issues"

Jeffrey Brown, Massachusetts Institute of Technology; *Olivia Mitchell*, Wharton School and National Bureau of Economic Research; *James Poterba*, Massachusetts Institute of Technology and National Bureau of Economic Research; and *Mark Warshawsky*, TIAA-CREF—"Taxation of Annuities and Retirement Plan Buyouts"

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administration is evenhanded and fair. Recent horror stories of arbitrary and punitive actions by IRS do great damage in this regard. Although fairness in enforcement procedures and close oversight of practices are warranted, the general impression of malfeasance on the part of IRS has been exaggerated and perhaps aimed at eventual demise of the progressive income tax. Criticism of IRS practices hopefully will contribute to standards of fairness rather than encourage lax enforcement, followed by further evasion and distrust in the tax system. No company will reward its accountants for minimizing recovery of unpaid bills, nor should IRS.

Predictability is also a feature that inspires trust in the tax system. Unforeseen results not only are injurious to business confidence but also encourage perceptions of arbitrariness among taxpayers.

Above all, it goes without saying that tax **fairness** is vital to taxpayer confidence. I expect a good many of you can remember a certain presidential pronouncement that the U.S. tax system is a "disgrace to the human race." That was a gross exaggeration, and in my view somewhat irresponsible, because the U.S. income tax for all its flaws compares favorably with many others in industrialized countries in terms of the fairness of its rules and its standards of compliance and enforcement.

Social Security

Perhaps the most extensive area of distrust in government exists in the Social Security system. The pay-as-you-go regime that is a feature of the system depends crucially on the trust contributors place in it. It represents a form of contract between the working and contributing generation on one side and the recipients of benefits on the other. For this to work, working-age people must have confidence that when they retire they will receive those benefits that are stipulated in the contract. It has been a favorite ploy by those opposed to social insurance to break that bond of trust by asserting that the benefits will not be there for future retirees. It is quite true, of course, that demographic and economic changes over time will cause

imbalances between outgoings and incomings of the Social Security trust fund. But rather than allowing such future developments to shake confidence in the system, a way can and should be found to build the necessary adjustments into the contractual rules to preserve equity between generations.

Budgeting

On the expenditure side of the government's ledger, the public's trust in the worthwhileness of government-financed projects and programs is a major component of the public's general trust in government. The public needs to know something about the worthwhileness of government-financed projects, with cost-benefit analysis helpful in this regard, and again transparency is required.

Conclusion

What can one say about the degree of trust in government in the United States as things stand? For one thing, it would seem that much depends on the state of the economy. The public opinion polls seem to show the level of confidence and satisfaction with government to be much higher than it was, say, ten years ago, this notwithstanding concern over trust at the top. No country has more opportunities for citizens to register their political choices than does the United States, yet it has a shamefully low voter participation compared with that of other industrialized countries. But this is hard to read, for it could bespeak either distrust and cynicism or an easy acceptance of the status quo.

The same can be said of the trend at the state level toward bypassing legislatures by the use of instruments of direct democracy (i.e., referenda, propositions, and voter initiatives). Is this development evidence of rising distrust in delegating decisionmaking to elected officials or is it a loophole in the polity that gives special interests undue influence? Legislators do not seem to be entirely averse to these end runs, as they thereby can avoid dealing with some contentious issues. Perhaps there is no greater need in the United States today to boost trust in government than campaign finance reform. This is not a new problem, but its urgency has risen greatly in

the TV age. The cost of campaigning has multiplied and with it the dependence of office seekers on contributor interests. Greater reliance on public financing with limited private contributions is urgently called for. But let me stay closer to home and conclude with a word on how we as teachers of public finance bear on the problem.

With, say, 60 percent of young people moving through college and, say 10 percent of those touching on economics, perhaps one out of 20 will be impacted by what we have to say. The fraction is small, but its influence after graduation may be much larger. Transmitting an understanding of fiscal institutions to students lays a necessary foundation on which to build trust, but whether it is earned depends on (1) how well desired outcomes are chosen and (2) the ability to reach them. Principles of public choice as well as economics are involved, and by teaching both we are in a very real sense the trustees of public trust. How well are we doing in that role? I wonder, as perhaps we all do.

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Will People Trust a Government that Must Constantly Renege on its Promises?

C. Eugene Steuerle
The Urban Institute*

From the beginnings of American politics, democracy and distrust have gone hand in hand. The Declaration of Independence began with a list of complaints about too little government—the King's obstruction of good legislation and administration—and ended with complaints about the royal government abusing its powers by doing too much.

This venerable love-hate relationship with government continues. But it seems to have taken a new debilitating turn. The good news is that Americans remain deeply attached to the symbols of their constitutional regime. There is little evidence that they have withdrawn patriotic feelings toward the basic form of government and its founding values. The bad news is that a long-term downward trend in political trust reflects not simply a skepticism toward authority but a much more negative cynicism toward anything that happens in politics. To doubt and to question public authority in America is a time-honored tradition. Always to expect the worst is not.

While Americans continue to express hope for their nation and communities, a large majority has become alienated and cynical about the entire political process, no matter who is in charge and in which directions policy changes are made. From the late 1950s onward, Americans have expressed a mammoth loss of faith in politics and government. A further reflection of dissatisfaction is the decline in voter participation. After long economic expansions in the 1980s and 1990s, Americans have been more content with their own representatives and more hopeful for the economic future. By self-report, they remain angrier at government and the political process than at any period in recent memory. What underlies this current period of political alienation? Three interrelated developments have fueled this sense of loss of ownership:

- First, Americans feel that government is not responding to their current needs. They find it busy, even meddlesome, but at the same time removed from their condition and concerns.
- Second, Americans no longer consider the information they receive from either the media or elected officials reliable. Although they ostensibly live in a society more openly and inclusively democratic than ever before, they sense they are being manipulated, pandered to, and seldom presented with the facts needed to come to their own informed conclusions.
- Third, for the tenure of most federal legislators and the voting life of most people under 35, it must look as though the federal government's main function is managing the deficit. In fact, the deficit, or surplus, is just what is left after public expenditures are subtracted from public revenues. Making and implementing these spending and tax policies is the main business of government.

Imagine for the sake of argument that there is some new purpose toward which government should turn its attention. The first step must be to ensure that proposed action is realistically tied to the actual economic and family circumstances of Americans. Otherwise there is little chance that resources will be matched to needs even if the resources are available for government to respond. Whether resources are available for the chosen purpose will depend to a large extent on the level of commitments we have already made. It turns out that our government has made so many commitments—to programs with literally eternal growth rates—that it can do very little that is new without renegeing on promises it has already made. This restraint holds even if no deficit is projected for the future based on current law. In other words, we will never be able to rethink our opportunities unless we rethink our commitments at the same time. None of this rethinking, however, gets us very far unless we have a political process that accommodates legitimate expectations for change and reform—some way to

build goodwill and trust, to distinguish fact from fiction, need from want, priority from possibility.

Restoring citizen-owned government, therefore, is like rebuilding a three-legged stool. No single leg or pair of legs is enough. The carpentry work will take years, if not decades, requiring much private initiative as well as legislation. Because our current dilemmas of self-government are interdependent, we must develop simultaneously (1) ways to compare relative needs and opportunities, (2) a political process for making informed decisions, and (3) budget flexibility through reasonable limits on growth in prior commitments.

Our current budgetary process does not allow the building of the last of these legs, that is, budget flexibility. This nation has lived through a long and arduous cycle of deficit reduction and budget cutting that stretches back almost a generation. The deficit reduction agreements in 1982, 1984, 1987, 1990, 1993, and 1997 were only the principal budgetary actions among many taken to get the nation's fiscal house in order. For the tenure of most members of today's Congress and for the voting lives of the generation of voters in their 20s and early 30s, it must appear as if deficit reduction is the primary legislative function of the federal government.

Think about it, however. The government doesn't exist to reduce its own deficit. The deficit is merely the residual from all of the other spending and tax actions that are taken. Despite higher levels of confidence in public officials, as is often associated with an economic expansion, the public simultaneously expresses both distrust and alienation from government. This alienation, I believe, reflects in part a reaction to the continual legislative preoccupation with cutting back, through net tax increases and net expenditure decreases, on excessive promises that could not be met in the first place.

From this last remark, it may appear that increasing spending or reducing taxes would be our next order of business. Appetites recently have been whetted toward spending budget surpluses anticipated for the next few years. Unfortunately, however, the nation's fiscal house is not yet in order. Despite the partial suc-

cess of past budget agreements, they all shared the fatal flaw of focusing on short-run deficits, not long-run policy. Short-run deficits were continually reined in, sometimes more, sometimes less. But most long-run issues were left to another day. Strong budget policy, however, would center its focus first on the long run. Get the long-run budget in order and the short run will come around. As long as we continue to look ahead only a short distance, long-run problems will almost inevitably continue to plague us.

Three fundamental problems confront us as a nation because of this unwillingness to deal with the long run:

- First, we are sitting in the eye of a fiscal storm. Hit by large deficits of the past, we are soon to be buffeted by gale force winds. Engaging in a bit of free spending today would be equivalent to dumping what little sand we have in our sandbags onto the beach just before the back part of the storm is about to hit us. And the gale force of an aging population is not scheduled to dissipate.
- Second, even if projected deficits were zero forever, we would not have gained control of our budget. Even if current policy were sustainable in the sense of avoiding mounting public debt, there would still be no fiscal slack. *Never before in the history of our nation have so many commitments and so much growth been scheduled in our laws literally for an eternity.* Our laws assert to all future generations that we know better today how to spend ALL of the revenues they will have 10, 50, 100, or 200 years from today. By way of comparison, imagine that if at the time the Constitution was ratified in 1789 our ancestors had put into law provisions and promises for how to spend all the revenues that the government collects today.
- Third, our budget priorities are now upside down relative to our true societal problems. This relates to the first cause of distrust I noted earlier—an inability to assess wants and needs appropriately. We are scheduled to spend ever rising amounts as a

response not to problems but to advances in well-being due to gains in life spans and improvements in health care. Our laws grant us a sixteenth, a seventeenth, an eighteenth year in retirement and require ever rising shares of national income and government revenues to be spent on health services. Under these laws, most people have already become primarily dependent on the government for combined retirement and health support for almost the last third of their adult lives. Where we have problems as a society—children unattended by adults, failures of our educational system, areas with too high crime rates—we are scheduled to spend ever smaller shares of our revenues, offset only with occasional attempts to engage in what are primarily symbolic efforts when we are not decrying that we have more will than wallet.

The Eye of the Storm

It is not hard to understand why we are sitting in the eye of the storm. Under almost any reasonable projection for discretionary expenditures, federal deficits will rise dramatically in the near future. For budget analysts, the last decade of the 20th century and the first decade of the 21st have always been viewed as a time of very modest reprieve and preparation for the future.

Budget cash flows now largely follow a demographic cycle. The baby-bust population of the 1920s, the Depression, and World War II is now retiring. Soon, however, they will be followed by the baby boomers, who will swell the numbers of adults dependent on government while simultaneously leaving the ranks of working taxpayers. Meanwhile, they are succeeded in the working population by another, more permanent, baby-bust population. Within a generation—a revolutionarily short period of time by demographic standards—the proportion of the population that is elderly will rise dramatically and the worker-to-retiree ratio will plummet. Within a few decades, according to different projections, the pension and health demands of retiring baby boomers, combined with the rising costs of other health care and

interest on debt, will eat up close to 100 percent of projected revenues at current tax rates.

When the impacts of the net interest implied by these projections are factored in and realistic assumptions are made with respect to discretionary spending, the overall federal deficit is projected to rise by as much as 10 percent of GDP within about five decades even before taking into account possible economic feedback effects. Social Security, Medicare, and Medicaid (including nursing home care) will cause expenditures to rise by as much as 7 percent of GDP within about three decades, while interest on the debt potentially adds several percentage points more. These are the strictly programmatic effects with which the Congress must deal. Declining national saving due to rising deficits would magnify these problems significantly.

Let me be clear. Partly because of the drastic impact on national saving and growth, policymakers will not allow these levels of deficits to happen. The projections, however, do warn us of the extraordinary level of commitment now in the law. They also reflect that some of the increase in demand to support rising numbers of truly old people will be unavoidable. Finally, they reveal the importance of compounding. Saving surpluses now, as well as avoiding future deficits, can yield very large additional gains in terms of lower interest costs on the nation's debt. Put another way, an additional dollar per year saved in an entitlement program now, at an interest rate of 6 percent, starts reducing the projected annual deficit by two dollars and more annually within a little more than a decade. The magic of compounding can help work wonders on government debt.

Program Growth for an Unknown Future

Never before in our history has the law preordained so much of our future spending patterns. Never before have dead and retired policymakers so dominated officials elected today. And never before has so much of policy bypassed the traditional set of breaks applied through normal democratic decisionmaking. When the nation has dramatically increased its financial obligations in the

past—through wars, such enormous land acquisitions as the Louisiana Purchase, assistance to workers and the unemployed in depressions—the accompanying budgetary commitments were temporary no matter how large their initial impact. It is the permanence of our newer obligations that is so different and so inappropriate. It makes no more sense to commit today almost all of the future economic resources that will be available to government than it would be to decide today where to station all of our troops until the next millennium.

How did we reach this state of affairs? The answer involves several factors. Societal expectations were built around a higher rate of growth in the third quarter of the 20th century than were sustained in the last couple of decades. Rapid growth in domestic spending as a percentage of gross domestic product was also made possible through peace dividends and corresponding reductions in defense spending. Indeed, most of the domestic spending growth in this nation's history took place under Presidents such as Nixon, Eisenhower, Bush, and Truman, who presided over the spending of Vietnam, Korea, Cold War, and World War II peace dividends.

But the drying up of peace dividends and slower rates of growth still do not explain our fiscal straightjacket. Even if the slower economic growth environment of the post-1973 period continues, future government revenues per capita, after adjusting for inflation, will still double within another half-century, or an even shorter period if we are lucky and engage in good economic policy. Under normal circumstances, this increase of more than one trillion dollars in annual revenues (in today's dollars) would yield significant fiscal slack and projections of surpluses under current law.

The truth is that past policymakers essentially spent more than all the growth in government revenues by building more and more automatic growth into public programs. It would be one thing if they merely bought too many goods and services in a current year. Instead, they bought larger and larger levels of goods and services for decades and more decades to come.

Two areas have dominated the built-in growth picture in the United States and other industrial nations: health care and retirement security. The demand for health care is virtually unlimited if we do not recognize any costs when we go to the doctor or the hospital, or when we buy insurance. Not that the costs aren't borne, they are simply shifted to other insurance buyers and taxpayers. Although most policymakers and individuals define \$1,000 or \$2,000 of health expenses as catastrophic, average household expenses on all health care goods and services is now around \$12,000. Again, that's the average. Most government insurance, and until recently most private insurance, hid these costs. This insurance has yet to impose adequate incentives, or constraints on prices and use, to slow down the extraordinary growth in health costs, including growth in payments to doctors and other health care providers.

Social Security and other retirement payments by government, in turn, have grown faster than the economy largely because of improvements in health and longevity. A larger share of the population is living to retirement and individuals are spending more of their lives in retirement, almost a decade more than early Social Security retirees. For a typical couple retiring today, Social Security benefits for the longer living of the two will last about 25 years. Thus, the cost of the program has risen significantly because there are so many more years of payment. More years of retirement also reduce the number of taxpayers for both Social Security and other purposes, thus raising tax rates on those still working.

These longevity cost increases are added to programs already scheduled to grow significantly, because annual benefits to new retirees are indexed to grow as fast as average wages in the economy. This indexing system not only protects retirees against inflation—a worthy goal, in my view—but promises each successive generation a higher standard of living. If benefits were held to a more modest rate of growth, it could much more easily finance the retirement of the baby boomers.

One consequence of so much built-in growth is that it takes ownership of government away from current voters and

their elected representatives. This debate is sometimes framed in the language of mandatory or entitlement spending. In the early 1960s, over 2/3 of spending was discretionary; today, it is less than 1/3, and the fraction would continue to decline under both Republican and Democratic budget proposals.

Depending on this type of decline in discretionary spending to continue is quite corrosive to the democratic process. In effect, it has no theoretical or empirical justification, but simply builds up false expectations. One can assume the result only through a mechanical calculation that has no relationship to foreign threats, educational opportunities, transportation demands, the needs of the impaired and disabled, or other future domestic concerns. In the fiscal 1999 budget, for instance, the Administration showed how continual declines in discretionary spending could pay for some of this growth in mandatory spending, but the assumption required to pay for huge mandatory spending growth was that discretionary spending would continue to fall toward zero relative to the size of the economy.

An Uneven Playing Field for Setting Priorities

There are those who would argue that automatic growth in programs doesn't matter and has no effect over trust in government. From one camp come concerns over protecting growth in social programs, from another it is the growth in tax breaks for businesses and savers that is sacrosanct. The plea made is that we established them and we can get rid of them as well. The claim is that making excessive promises or committing the wealth of future generations is not corrosive simply because we can renege along the way.

Backing up crystal ball predetermination of future needs with the force of the state, however, is not costless. These extra costs arise inevitably because of the uneven playing field among programs, between entitlement (including entitlement to permanent tax breaks) and discretionary spending, and among entitlements with different built-in growth rates. The impact of the vast differences in the way these two types of spending are currently treated can hardly

be overestimated. To *restrain* the automatic growth of entitlement spending requires what is really a supermajority—the combination of a simple majority in the House, a simple majority in the Senate, plus the President's support (i.e., no presidential veto), or the combination of two-thirds majorities in both Houses. A supermajority is now required to *expand* discretionary spending. Thus, new needs, which must be funded out of new legislation, are put at a dramatic disadvantage relative to old needs, prefunded out of old legislation. This has been and continues to be a practical recipe for stultifying the responsiveness of government to change.

Summary

In summary, one reason for higher levels of distrust these days is simply that government budget policy has lost its flexibility in ways that are unprecedented in the history of this country. The federal government promises more than it can deliver, sets eternal growth rates in programs regardless of societal needs or legislative review, and then goes through round after round of renegeing on those promises. Automatic growth in government has become so large that it has removed much discretion from current

Wayne Eggert's Benevolent Dictator Project

For NTA members, I propose a project that I will call the *Benevolent Dictator Project*. I ask that each member propose an improvement, addition, or change to current tax law, or an idea that should be adopted or at least debated in a public policy forum. It should be something you are passionate about.

You are a dictator, so go ahead and tell me what should happen and how. Because you are benevolent, the idea or change will improve something and it will also have benefited by your generous willingness to socialize the change in working with the two other constituencies.

If you are an academic, that means a taxpayer/business person and a government official. If you are a business taxpayer, find an academic and government representative who will provide constructive criticism that you will take into account as you report the final shape of your law change or idea. The same goes for government officials.

I solicit your pontifications as a benevolent dictator and will report on any such law change recommendations and ideas in various forms of NTA communications. (An edict from a benevolent dictator should carry the names of the dictator and one person from each of the other communities of interest willing to put their name on the recommendation.)

Communiques should be forwarded to weggert@lucent.com.

voters and their representatives. At the same time, it has favored the old over the new and set an unlevel playing field that makes government increasingly unresponsive to current assessments of needs. Restoring budget flexibility is among the most important steps required to restore trust in government and a sense of ownership among voters.

* Much of this paper is taken from C. Eugene Steuerle, Edward Gramlich, Hugh Hecla, and Demetra Nightingale, *The Government We Deserve* (Washington DC: Urban Institute Press, 1998); and C. Eugene Steuerle, "Long-Term Budget Projections and Issues," Testimony before the Committee on the Budget, U.S. Senate, February 25, 1998.

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