NAForum

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Number 31, September 1998

On Voluntary Compliance, Voluntary Taxes, and Social Capital

Joel Slemrod
The University of Michigan

This article is based on Joel Slemrod's presentation to the NTA Spring Symposium, May 18, 1998.

For most Americans, when the topic of taxes comes up, IRS is the first thing they think about. But academics, and especially economist academics, have given the process of collecting and enforcing taxes very little attention. For awhile now in my own research and writing, I have been trying to rectify that lack of attention, with some very modest success.

Of course, in the past year, IRS has succeeded in attracting the attention of another group of folks interested in taxation—politicians—and out of that attention came a bill to restructure its operations. Although I like some of the directions the legislation takes, such as institutionalizing a concern for the enforceability and compliance costs of new legislation before it becomes law, other directions, like shifting the burden of proof, trouble me. My attempt to articulate what troubles me follows: some ruminations about voluntary compliance, voluntary taxes, and social capital.

Voluntary Compliance

Officially, the United States income tax system is based on voluntary compliance. From one perspective, that characterization is purely Orwellian. An elaborate system of employer withholding, matching of information reports, and audits with evasion penalties "encourages" compliance.[1] The fact that, by line item, there is a clear correlation between the voluntary compliance rate and the presence of these enforcement mechanisms confirms their importance.

From another perspective, though, voluntary compliance is not just Orwellian Newspeak. Given the probability of audit and the penalties typically assessed, evasion seems to be a winning proposition for many more people than actually do evade. From this perspective, the puzzle is not to explain why people evade, but rather why people pay taxes. In the context of the standard economic model, people who comply voluntarily are exhibiting nothing short of "pathological honesty."[2]

Whether we call this behavior pathological honesty or good citizenship, the cost of raising taxes and of running the government is lower because many taxpayers "volunteer" to comply. Think of there being a stock of goodwill, or social capital, the return to which is a more efficient operation of a given size of government. I want to argue that the social capital stock is at risk from any policy change that lowers the return to people investing in this capital by reducing the incentive to be a law-abiding citizen or by increasing the cost of not being one.

Voluntary Taxes

There also is a risk to social capital from conceptual cousins to voluntary compliance,

MEMBERS IN THE NEWS

Leonard E. Burman has assumed the position of Deputy Assistant Secretary–Tax Analysis in the U.S. Department of the Treasury. Len most recently was a senior research associate at The Urban Institute. Previously, he served as a senior analyst in the Tax Analysis Division of the Congressional Budget Office and as a financial economist in the Office of Tax Anslysis at Treasury. He has taught economics at Georgetown University, George Washington University, and Bates College.

W. Val Oveson has been named as national taxpayer advocate at the Internal Revenue Service. He has been chairman of the Utah State Tax Commission since 1993. He is currently serving as chairman of the Multistate Tax Commission. His previous public service includes the positions of Lieutenant Governor and Utah State Auditor. He also has been a consultant with KPMG Peat Marwick.

NTA Forum

Number 31, September 1998

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Douglas Holtz-Eakin Is NTJ Editor

NTA is very pleased to announce that Douglas Holtz-Eakin has been selected as editor of the *National Tax Journal*. His tenure began on June 1. He is Professor and Chairman of the Department of Economics and Associate Director of the Center for Policy Research at Syracuse University. He is a member of the Board of Economic Advisers for the New York State Assembly Ways and Means Committee, and a Faculty Research Fellow and Research Associate for the National Bureau of Economic Research.

He has held academic appointments at Columbia University and Princeton University, and was Senior Staff Economist for the Council of Economic Advisers. He also has been a consultant to the New Jersey State and Local Revenue and Expenditure Policy Committee, the Arizona Select Committee on State Revenues and Expenditures, and the New York State Office for the Aging.

He has a long-standing and broad interest in the economics of public policy. He has studied the role of federal taxes in home ownership, the contribution of inventories to the business cycle, and a wide variety of topics in state and local government finance. Recently, his research has centered on the productivity effects of public infrastructure; income mobility in the United States; and the role of families, capital markets, health

the so-called voluntary taxes,[3] defined by Cooper (1979) in a classic Brookings Institution book about estate tax avoidance as ones for which the tax base "could be entirely washed away if taxpayers put a strong effort into doing so" (page 4). The term has been applied not only to estate taxes but also to capital gains taxes (especially on houses), and state use taxes, among others. There is wide agreement that voluntary taxes are bad policy, although the proposed solutions offered bifurcate sharply: depending on the issue, some argue for closing the loopholes and tightening enforcement while others argue for abolishing the voluntary tax altogether.

Although this negative assessment of voluntary taxes comes naturally to most tax analysts, condemnation of matters voluntary goes against the grain of much of economics, in which the word voluntary generally has positive connotations, particularly in contrast to matters "involuntary." Consider, for example, the debate about the relative merits of the draft versus a volunteer army. Most economists accept that a volunteer army is more efficient in the sense that it mobilizes a given amount of resources at minimum economic cost because it would allow people with low opportunity costs to self-select into military service.

If a volunteer army is a good idea, why are voluntary taxes and compliance bad ideas? The answer is that compared to a draft a volunteer army reduces the total cost of operating the armed forces;[4] in contrast, both voluntary taxes and voluntary but less than universal compliance increase the cost of government because they encourage socially wasteful investments in avoidance and evasion. Moreover, they also cause horizontal inequity because some citizens end up paying more than others solely on the basis of personal characteristics, which should be irrelevant to tax burden, such as attitudes toward risk and attitudes toward civic responsibility.

Civic Duty and Social Capital

I have argued that the social capital derived from citizens' willingness to "voluntarily" pay taxes lowers the cost of operating government and of assigning its cost equitably to citizens. Notably, mention of the civic duty of citizens to pay what taxes they owe has been largely absent from the recent debate about restructuring, overhauling, or abolishing the Internal Revenue Service.

The notion of civic duty, though, has been a recent hot topic in political science, stimulated in part by the work of Robert Putnam (1993). Although economists have paid less attention to civic duty, they have recognized the critical role in economic performance of the related concept of "trust." The Nobel Laureate Kenneth Arrow (1972) has remarked that "virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can plausibly be argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence." In high-trust societies, individuals need to spend less to protect themselves from being exploited in economic transactions. Knack and Keefer (1997) argue that trusting societies tend to have stronger incentives to innovate and to accumulate both physical and human capital. Trust among citizens is, of course, not the same thing as forgoing pursuing short-term advantages vis-à-vis the state or other organizations—we might call it rule obedience—but they are related. Clague (1993) argues that, "A society with very low levels of rule obedience cannot...have a net of institutions that is conducive to economic progress" (page 412).

There is some fascinating new empirical evidence that trust and civic duty among a country's citizens contribute to prosperity and growth.[5] Knack and Keefer (1997) tested the impact of these attitudes on both growth and investment rates on a cross-section of 29 countries, using measures of trust and civic norms from the World Values Surveys of 1981 and 1990-1991. The question used to assess the level of trust in a society was: "Generally speaking, would you say that most people can be trusted, or that you can't be too careful in dealing with people." The strength of norms of civic cooperation were assessed from attitudes toward five particular actions. Notably, one of the five actions was "cheating on taxes if you have the chance." Tax rule obedience thus emerges as one dimension of civic cooperation.

Knack and Keefer find that social capital variables exhibit a strong and significant relationship to growth. As they note, the causality of this relationship could go in either direction: trust could be a product of optimism generated by high or growing incomes, as well as trust facilitating prosperity. However, they find that trust is more correlated with per capita income in later years than with income in earlier years, suggesting that the causation runs from trust to growth more than vice versa.

One possible channel through which trust might affect economic outcomes is its impact on the performance of government. To investigate this, Knack and Keefer construct an index of how much confidence people profess in various governmental and societal institutions and find that, controlling for per capita income and education enrollments, the only significant determinant of government performance is the trust variable: a trusting citizenry facilitates a successful government. It is conceivable, though, that the causation is reversed—that the behavior of governments influences levels of trust.

The economics branch of this literature is still in its infancy, and there is much that we don't yet understand about the role of social capital in economic growth. For example, certainly there are important distinctions between the concepts of trust, civic duty, and rule obedience, especially in this country, where rule obedience is a good thing only in concert with a vigilance about the wisdom of the rules themselves. Nevertheless, I am convinced of the importance of this kind of social capital. In fact, I suspect that it provides an important clue to explaining one of the most striking empirical regularities and puzzles in public finance—the positive association between a country's tax-to-GDP ratio and its level of affluence, as measured by per capita GDP.

Two classes of explanation have been offered to explain this association.[6] The first, called Wagner's Law, is a demand explanation. It posits that rising incomes and associated structural changes (such as urbanization) engender a demand for more government involvement. The alternative, supply-side, explanation is that affluence is associated with demographic characteristics (such as literacy and more non-agricultural market activity) that facilitate raising tax revenue, which in turn leads to expanded government activity. Of course, these explanations are not mutually exclusive, and the research challenge, as in many settings, is to disentangle the supply and demand explanations for government expenditure and taxation and their relations to the level of prosperity.[7]

The notion of social capital can help us do this. The idea is that a high level of social capital (or trust, or rule obedience, or civic duty) contributes to affluence and also facilitates a higher level of government activity. Thus, cross-country variations in social capital will generate a positive association between affluence and government activity that is not indicative of causation in either direction. It is not because affluence causes high taxes or because high taxes cause affluence, but rather that civic duty societies tend to exhibit both affluence and high taxes. Empirical testing of this hypothesis can proceed if there are reliable cross-country measures of aspects of social capital; in pursuing this idea, survey data such as is available in the World Values Surveys is likely to be crucial.

How Good a Tax System Do We Want?

Not everyone would agree that a large stock of social capital in the form of tax rule obedience is a good thing. Although this is undoubtedly part of a deep American distrust of rule obedience, mixed feelings on this issue also stem from the ambivalence of some people as to how good a tax system they really want. Other things equal, most people would like the tax system to be less burdensome and intrusive. However, to many conservatives, the attractiveness of an efficient tax system is diminished by the institutional bias toward big government. From that perspective, a painful, burdensome tax system acts as sand in the wheels of the political machine.

Witness the recent proposal from the Cato Institute to eliminate withholding on the income tax, echoed by Milton Friedman on the op-ed page of the *Wall Street Journal*.[8] The goal of this proposal is to increase the visibility and perceived "pain" of tax payments, yet certainly another impact would be to reduce the efficiency and equity of tax collection, as any tax administrator will attest to the crucial importance of withholding.

I have some painful, personal experience of this tension in the objective of tax policy. In 1984-85, I took leave from being an untenured assistant professor to be senior economist for tax policy at the Council of Economic Advisers. In November 1984, the Treasury Department had released its proposal for comprehensive tax reform, and the Reagan Administration was in the process of deciding of how much to embrace as its official proposal. In the midst of that deliberation, I was in charge of writing a chapter on tax policy for the Economic Report of the President, and I duly delivered a first draft in late 1984 to then acting Chairman William Niskanen, now head of the Cato Institute. The draft was a fairly standard recitation of what public finance economists believe about how to make the system efficient, simple, and fair. Soon after receiving my draft, Dr. Niskanen called me in for a meeting and proceeded to tell me that, in his opinion, given the absence of institutional restraints on the size of government, it would be good policy to make the tax system less rather than more efficient. Many, perhaps especially untenured professors, probably can relate to the sleepless nights I spent imagining how to write (and the impact on my professional reputation) a chapter on laying out in fine detail how to make the tax system worse than it already was.[9]

Policy Implications

The moral of this story is that, in formulating policy, we first need to come to agreement about whether the objective should be to obtain the fairest, most efficient tax system, or not. I think it should be. If we agree on that, then we must think seriously about how to preserve the social capital associated with paying taxes. What constitutes proper maintenance of this social capital becomes the $64,000 question. Surely, just because high-tax countries tend to have more social capital does not imply that increasing tax rates is social capital deepening! Ensuring fair and responsive service to taxpayers is more likely to be a good investment. Increasing the cost of civic duty by facilitating free-riding tax evasion and preserving voluntary taxes certainly is not a wise investment.

Preserving social capital requires a subtle balancing of the carrot and the stick aspects of IRS operations referred to by Prettyman (1955) as an "art of delicate shadings and impressions as well as stark lines" (page 51).[10] It does not require or justify, in the words of President Clinton, "citizens harassed and humiliated by what seemed to be an unaccountable, downright tone-deaf agency."[11] Neither does it justify creating an ethos that dismisses and devalues civic duty and destroys valuable social capital, which like all kinds of capital can be augmented by net investment and can dissipate if not maintained properly.

Notes

1 The IRS Mission Statement, as cited in Steuerle (1986, p. 1), lists as its first task to "encourage and achieve the highest degree of voluntary compliance in accordance with the tax laws and regulations." IRS measures of the level of tax compliance are all couched in this language, featuring concepts such as the "voluntary" reporting percentage and "voluntary" compliance level.

2 Psychologists and sociologists have pursued other explanations, reviewed in Roth, Scholz, and Witte (1989).

3 Emil Sunley reminds me that the presence of such taxes also has been referred to as "taxes on honesty."

4 And increases it for no one, depending on how the taxes to pay for the voluntary army are raised.

5 There also is an older literature of cross-country research on national develop-ment, which argued that nations whose people generally support government policies progress more rapidly than nations in which obedience must be coerced. See Almond and Verba (1963).

6 The same relationship holds for the U.S. and, I suspect, most countries, over time: the tax-GDP ratio has grown as the country has become richer.

7 See Slemrod (1995) for the problems involved in this enterprise.

8 The Cato proposal is outlined in Stansel (1998); Friedman's op-ed piece is in the *Wall Street Journal*, April 15, 1998.

9 If I recall correctly, a compromise was reached to include the standard chapter and, elsewhere in the report, a recommendation for institutional constraints on the size of government.

10 The art of preserving this social capital was described nicely by E. Barrett Prettyman, Circuit Judge, United States Court of Appeals for the District of Columbia, as follows:

> In the vast majority of these instances the public attitude toward a law, in the long run, springs from the nature of the enforce ment program….The mass attitude derives not only from the treatment given the mass itself but also in large measure from the treatment given small segments of the mass, i.e., the outlaws and venturesome. Mr. Average Citizen, who naturally would obey the law, derives his eventual attitude from his observation of the manner in which officialdom treats the outlaw and the venturesome and, of course, the way it treats him, Mr. Average Citizen.
>
> Mr. Average Citizen requires that outlaws be treated as outlaws and that intentional but merely venturesome violators be chastised. To gain and retain the respect of the mass of people, law enforcement must be drastic with the defiant law breaker….

11 President Bill Clinton's radio address, May 2, 1998.

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Preliminary Program
91st Annual Conference on Taxation

November 8-10, 1998
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Austin, Texas

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PRELIMINARY PROGRAM

SUNDAY, NOVEMBER 8

OPENING GENERAL SESSION
1:00 PM-3:00 PM

TRUST IN GOVERNMENT

Moderator: *Daphne Kenyon*, Simmons College, Boston

Presenters:

Peggy B. Musgrave, University of California at Santa Cruz

Richard A. Musgrave, H.H. Burbank Professor of Political Economy, Emeritus, Harvard University, and University of California at Santa Cruz

C. Eugene Steuerle, The Urban Institute

Gerald D. Bair, Iowa Department of Revenue & Finance

THREE CONCURRENT SESSIONS
3:15 PM-4:45 PM

CONSUMPTION TAX REFORM: THE EFFECT OF THE CONSUMPTION TAX ON HOUSING

Moderator: *George Zodrow*, Rice University

Presenters:

Patric Hendershott, Ohio State University; *Richard K. Green*, School of Business, University of Wisconsin-Madison; and *Dennis R. Capozza*, Business School, University of Michigan—"Taxes and House Prices"

Douglas Holtz-Eakin and *Donald J. Bruce*—"Consumption Tax Reform and Residential Housing Values"

George Zodrow and *John Diamond*, Baker Institute for Public Policy, Rice University—"Housing and Intergenerational Redistributions under a Consumption Tax Reform"

Discussant: *Jane Gravelle*, Congressional Research Service

THE DOUBLE DIVIDEND HYPOTHESIS: CAN POLLUTION TAXES HELP THE ENVIRONMENT AND REDUCE TAX DISTORTIONS?

Moderator: *Diane Lim Rogers*, Congressional Budget Office

Presenters:

Gilbert van Hagen and *A. Lans Bovenberg*, Tilburg University—"How Can We Determine the Truth about the Double Dividend?"

William Jaeger, Williams College—"Taxing Pollution Effectively: Support for the Double Dividend Hypothesis"

Ian W. H. Parry, Resources for the Future—"The Double Dividend: Where Do We Stand?"

Ronnie Schoeb, Erkki Koskela, and *Hans-Werner Sinn*, University of Munich—"Green Tax Reform and Competitiveness"

Peter Wilcoxen, University of Texas at Austin—"The Truth about the Double Dividend"

Roberton C. Williams III, Stanford University—"Second Best Environmental Taxation When Environmental Quality Affects Health or Productivity"

Gary Wolff, Stanford University—"Finding Double Dividends in a Sea of Data"

Don Fullerton, University of Texas at Austin; and *Jane Gravelle*, Congressional Research Service—"The Irrelevance of the Double Dividend"

Diane Lim Rogers—"Environmental Tax Reform: Economic Perspectives on the Double Dividend"

ECONOMIC IMPACT OF GAMING

Moderator: *J. Fred Giertz*, Institute of Government and Public Affairs, University of Illinois, Urbana (invited)

Presenters:

Ranjana Madhusudhan, New Jersey Division of Taxation—"What Do We Know about Casino Taxing in the United States?"

Donald Phares, Charles Leven, and *Claude Louishomme*, University of Missouri-St. Louis—"Impact of Gaming on the Economy of the Public Sector"

Francois Vaillancourt, University of Montreal—"Lotteries in Canada"

ANNUAL MEETING 5:00 PM

PRESIDENTIAL ADDRESS

Wayne G. Eggert, Lucent Technologies Inc.

RECEPTION 6:30 PM

MONDAY, NOVEMBER 9

GENERAL SESSION 8:30-10:00 AM

TAXATION OF HIGH-INCOME HOUSEHOLDS

Moderator: *Joel Slemrod*, University of Michigan

Presenters:

Joel Slemrod—"Why the Rich Are Getting Richer: What's Taxation Got to Do with It?"

Austan Goolsbee, University of Chicago—"Evidence on the High-Income Laffer Curve from Six Decades of Tax Reform"

Robert Carroll, Office of Tax Analysis, U.S. Treasury Department—"Tax Rates, Taxpayer Behavior, and the 1993 Tax Act"

THREE CONCURRENT SESSIONS
10:15-11:45 AM

STATE AND LOCAL FISCAL INSTITUTIONS

Moderator: *Dale K. Craymer*, Texas Taxpayers and Research Association

Presenters:

Therese J. McGuire, University of Illinois at Chicago, and *Kim S. Rueben*, Public Policy Institute of California—"The Effect of Statewide Limits and Local Referenda on the Level and Mix of Municipal Government Expenditures and Revenues"

Leslie Moscow, Federal Reserve Bank of Chicago—"State Debt Referenda and the Composition of State Indebtedness and Spending"

Katherine Baicker, Dartmouth College—"The Effect of Fiscal Institutions on State Responses to Federal Mandates"

Discussants:

Julie Cullen, University of Michigan

Sheila Murray, University of Kentucky

Brian Knight, University of Wisconsin-Madison

SITE VALUE TAXATION: IS THE TIME RIGHT?

Moderator: *Michael E. Bell*, MEB Associates

Presenters:

Michael E. Bell, and *John H. Bowman*, Virginia Commonwealth University—"Administering Site Value Taxation"

Robert M. Schwab and *Amy Rehder Harris*, University of Maryland—"Analysis of the Graded Property Tax"

Joan Youngman, Lincoln Institute of Land Policy—"Site Value Taxation: Current Practices in Central and Eastern Europe"

Discussant: *Walter Rybeck*, Center for Public Dialogue

ISSUES IN CANADIAN PUBLIC FINANCE

Moderator: *Michael Smart*, University of Toronto

Presenters:

Jack Mintz, University of Toronto—"Reform of International Business Taxation in Canada"

Michael Baker, Toronto—"Joint Retirement: Evidence from the Spouse's Allowance"

Michael Smart, University of Toronto—"The Empirical Effects of Matching Grants: Evidence from the 'Cap on Cap'"

Discussants:

Howard Chernick, Hunter College, CUNY

Joel Slemrod, University of Michigan

LUNCHEON Noon-1:30 PM

Speaker: *Hon. Jake Pickle*, Former Member, U.S. House of Representatives

THREE CONCURRENT SESSIONS 1:45-3:15 PM

ISSUES IN STATE AND LOCAL PUBLIC FINANCE

Organizer: *Wallace E. Oates*, University of Maryland

Presenters:

Timothy J. Goodspeed, Hunter College, CUNY—"Tax Structure in a Federation"

Wallace E. Oates—"Property Taxation and Local Public Spending: The Problem of Renter Illusion"

Robert M. Schwab, University of Maryland—"Education Finance Reform and the Demand for Private Education"

Discussants:

Shama Gamkhar, LBJ School of Public Affairs, University of Texas-Austin

William Oakland, Tulane University

George Zodrow, Rice University

CURRENT RESEARCH ON TAXATION OF INTERNATIONAL INCOME

Moderator: *Rosanne Altshuler*, Rutgers University

Presenters:

Harry Grubert, Office of Tax Analysis, U.S. Treasury Department—"Another Look at the Low Taxable Income of Foreign-Controlled Companies in the United States"

Jack Mintz, University of Toronto—"The Role of Allocation in a Globalized Corporate Income Tax"

Mihir Desai, Harvard University—"Mass Transit and Exodus: Multinational Responses to the Tax Reform Act of 1986"

Discussant: *William Randolph*, Office of Tax Analysis, U.S. Treasury Department

TAXATION OF LOW-INCOME HOUSEHOLDS

Moderator: *Janet Holtzblatt*, Office of Tax Analysis, U.S. Treasury Department

Presenters:

Bruce Meyer and *Dan T. Rosenbaum*, Northwestern University—"Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers"

Stacy Dickert-Conlin, Syracuse University; and *Scott Houser*, California State University, Fresno—"The Effect of the Earned Income Tax Credit on Living Arrangements"

Janet Holtzblatt, and *Jeffrey Liebman*, John F. Kennedy School of Government, Harvard University—"The EITC Abroad: Implications of the British Working Family Tax Credit"

Discussants:

Robert Triest, Federal Reserve Bank of Boston

Anne Alstott, Yale Law School

THREE CONCURRENT SESSIONS 3:30-5:00 PM

FRONTIERS OF PUBLIC FINANCE

Moderator: *William Oakland*, Tulane University

Presenter: NTA Outstanding Dissertation Winner

FEDERAL ISSUES AROUND THE GLOBE

Moderator: *Timothy J. Goodspeed*, Hunter College, CUNY

Presenters:

Guy Gilbert, Université de Paris—"Fiscal Harmonization in the EU"

Teresa Garcia-Mila, Universitat Pompeu Fabra; *Timothy J. Goodspeed*; and *Therese J. McGuire*, University of Illinois at Chicago—"Fiscal Decentralization Policies and Debt: The Case of Spain"

Joann Weiner, Office of Tax Analysis, U.S. Treasury Department—"Estimates of How the Unitary Tax Affects Business Investment"

ON THE USES OF THE CENSUS OF GOVERNMENTS TAXABLE PROPERTY VALUE DATA

Incorporates the program of the NTA Committee on Property Taxation

Moderator: *Elliott J. Dubin*, National Association of Home Builders

Presenters:

John O. Behrens—"Levels and Dispersion of Assessment Ratios in Taxable Property Values and in the Courts"

Dick Netzer, New York University—"Paradise Lost: The Many Uses of the Taxable Property Values Data in Policy Research"

Robert P. Strauss, Heinz School, Carnegie Mellon University—"How the Quality of Residential Assessments, as Shown by the Taxable Property Values Data, is Affected by State Laws Governing Right of Entry"

TEXAS BARBECUE 6:00-11:00 PM

TUESDAY, NOVEMBER 10

THREE CONCURRENT SESSIONS 8:30-10:00 AM

NEW RESEARCH ON FINANCING PUBLIC EDUCATION

Moderator: *Andrew Reschovsky*, University of Wisconsin-Madison

Presenters:

Amy Ellen Schwartz, New York University—"School Districts and Spending in the Schools"

Jennifer Imazeki and *Andrew Reschovsky*, University of Wisconsin-Madison—"Measuring the Costs of Providing an Adequate Public Education in Texas"

Shawna Grosskopf, Southern Illinois University; *Kathy Hayes*, Southern Methodist University; *Lori L. Taylor*, Federal Reserve Bank of Dallas; and *William L. Weber*, Southeast Missouri State University—"Allocative Inefficiency and School Competition"

Discussants:

Judy Temple, Northern Illinois University

David L. Sjoquist, Georgia State University

Cities and Policy Advice

Moderator: *Ronnie Lowenstein*, New York City Independent Budget Office

Presenters:

George Sweeting, New York City Independent Budget Office—"Issues in Local Taxation: Income Taxes and the Poor, Property Taxation and the Form of Housing Ownership"

Richard Dye, Institute of Government and Public Affairs, University of Illinois; and *David Merriman*, Loyola University—"Does Tax Increment Financing Stimulate Economic Development?"

Robert P. Strauss, Heinz School, Carnegie-Mellon University—"Central City Migration Flows: Evidence from Pennsylvania Cities"

Discussants:

Dick Netzer, New York University

Robert Wassmer, California State University, Sacramento

Kim S. Rueben, Public Policy Institute of California

Tax Reform and Financial Structure

Moderator: *Andrew Lyon*, University of Maryland and PricewaterhouseCoopers

Presenters:

John Graham, Fuqua School of Business, Duke University—"Valuing the Tax Benefits of Debt"

Andrew Lyon—"Stock Market Valuations under Fundamental Tax Reform"

Ken Wertz, PricewaterhouseCoopers, Washington DC—"Financial Statement Income as a Substitute for Taxable Income"

Discussants:

Jane G. Gravelle, Congressional Research Service

Calvin H. Johnson, School of Law, University of Texas, Austin

THREE CONCURRENT SESSIONS

10:15-11:45 AM

Individual Income Tax Measures

Moderator: *James R. Nunns*, Office of Tax Analysis, U.S. Treasury Department

Presenters:

Nicholas Bull, Janet Holtzblatt, James R. Nunns, and *Robert Rebelein*, Office of Tax Analysis, U.S. Treasury Department—"Assessing Marriage Penalties and Bonuses"

William G. Gale, The Brookings Institution; and *Janet Holtzblatt*—"Compliance Burdens and Fundamental Tax Reform"

Iris J. Lav, Center on Budget and Policy Priorities; and *John O'Hare*, The Urban Institute—"Cleaning the Code: Strategies for Simplifying the Individual Income Tax"

Private and Public Provision for Retirement: Past and Future

Moderator: *Leslie E. Papke*, Michigan State University

Presenters:

Michael Palumbo, University of Houston—"Have Working-Class American Families Always Been Low Savers? Saving and Accumulation before the Advent of Social Insurance."

Alan L. Gustman, Dartmouth College; and *Thomas L. Steinmeier*, Texas Tech University—"Changing Pensions in Cross-Section and Panel Data: Analysis with Employer-Provided Plan Description"

Leslie E. Papke—"The Wage-Benefits Trade-Off: Evidence from a Panel of Public Schools"

State Value Added Tax: Experience and New Proposals

LUNCH NOON-1:30 PM

Texas Tax Policy Panel

THREE CONCURRENT SESSIONS

1:45-3:15 PM

Tax Incentives and Social Policy

Moderator: *Eric J. Toder*, The Urban Institute

Presenters:

Bruce F. Davie, Office of Tax Analysis, U.S. Treasury Department, and Georgetown University—"Tax Credit Bonds for Education: New Financial Instruments and New Proposals"

Stacy Dickert-Conlin and *Douglas Holtz-Eakin*, Syracuse University—"Employee vs. Employer-Based Wage Subsidies"

Andrew Reschovsky and *Richard Green*, University of Wisconsin-Madison—"Increasing Home Ownership Rates by Replacing the Mortgage Interest Deduction with a Credit"

Eric J. Toder—"The Changing Composition of Tax Incentives, 1980-99"

Issues in Mexican Finance

Incorporates the program of the NTA Committee on International Finance

Moderator: *Charles Vehorn*, International Monetary Fund

Issues in Taxation and Equity

Moderator: *Michael Ettlinger*, Citizens for Tax Justice

Presenters:

Howard Chernick, Hunter College, CUNY—"State and Local Tax Incidence: Would There be a Race to the Bottom?"

Steve Fazzari, Washington University—"Tax on Investment and Economic Growth"

Michael Ettlinger—"Fundamental Tax Reform and Taxing Business"

Discussant:

Carol Ó'Cléireacáin, New York City

TRAVEL NOTE

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Devolution: The New Federalism

Editors Note: *The following is based on Robert Tannenwald's overview of the Proceedings of the Federal Reserve Bank of Boston-NTA Colloquium on Devolution: The New Federalism (New England Economic Review, May/June 1998; available from Research Library-D, Federal Reserve Bank of Boston, PO Box 2076, Boston MA 02106-2076).*

The only point that virtually all participants agreed on, Tannenwald says, was that the devolution movement has not proceeded very far. Most participants agreed that a mix of federal control and state and local autonomy was desirable, with the optimal arrangements varying from function to function. Participants tended to reject extreme centralization and decentralization, and disagreed over the movement's advantages and disadvantages, its probable success in achieving its goals, and the likely behavior of states and municipalities under a more devolutionary scenario.

The Devolutionary Tortoise

Speaker: *John Kincaid*, Meyner Professor of Government and Public Service, Lafayette College; former Executive Director, U.S. Advisory Commission on Intergovernmental Relations and Associate Professor, University of North Texas—"The Devolution Tortoise and the Centralization Hare."

Kincaid specifies six objectives of devolution: (1) more efficient provision and production of public services; (2) better alignment of the costs and benefits of government for a diverse citizenry; (3) better fits between public goods and their spatial characteristics; (4) increased competition, experimentation, and innovation in the public sector; (5) greater responsiveness to citizen preferences; and (6) more transparent accountability in policymaking. He concludes that what is currently referred to as devolution (a surrender of a function by a superior government to a subordinate government that is generally complete, permanent and of "constitutional magnitude") is more accurately called "restoration" or "rebalancing" of powers. He cites as the most significant immediate factor stirring interest in rebalancing the federal system the Republican majority in both houses of Congress following the 1994 midterm elections. He traces the roots of the movement back to the suburbanization of America, migration to the sunbelt, spreading disillusionment with the federal government and skepticism regarding its long-term fiscal capacity, increasing respect for and confidence in state and local governments, and a groundswell of support around the world for decentralization, deregulation, and free enterprise. A spreading disrespect for the federal government also has promoted sentiment for restoring state powers.

He concludes that the movement's progress has been extremely limited, summarizing the devolutionary trend as a "discernible crawl toward some rebalancing of the federal system" in the Congress (TANF, other categorical grant consolidations into block grants, the *Unfunded Mandates Act of 1995*), the Presidency ("performance partnerships," categorical grant consolidation proposals), and the Supreme Court (several recent rulings on federal-state power balancing that favor the states. Why has devolution proved to be a tortoise compared to the centralization hare? All devolutionary plans would create winners and losers. The potential losers have been sufficiently powerful and politically adept to thwart legislation calling for more extensive restoration of powers to the states. The predilection of the Congress to preempt state law reflects to some degree a desire to enhance nationwide economic efficiency and international economic competitiveness through interstate uniformity. Underlying the retention and expansion of federal powers in many areas, Kincaid notes a fundamental change in the way America views itself.

Opponents of devolution, he says, are concerned about the dangers of intensified interstate competition and the potential inability of the states to take on functions devolved from the federal government. He asserts that predictions of a "race to the bottom" (especially welfare and environmental programs) are premature and probably unfounded. He also argues that states can be as capable as citizens want them to be.

Kincaid finds compelling arguments in favor of decentralization but powerful political forces retarding its progress. The federal government will continue to preempt the states in many policy areas and to impose conditions on intergovernmental assistance. He sees the judiciary branch as most likely to further the devolutionary cause.

Panel:

David R. Beam (Associate Professor and Director, Graduate Program in Public Administration, Illinois Institute of Technology; former Senior Analyst, U.S. Advisory Commission on Intergovernmental Relations) saw disillusionment with all levels of government behind the devolution movement and argued that this cynicism reflects a fundamental misinterpretation of constitutional intent.

David T. Ellwood (Lucius N. Littauer Professor of Political Economy, John F. Kennedy School of Government, Harvard University; former Assistant Secretary for Planning and Evaluation, U.S. Department of Health and Human Services) noted that the welfare program no longer is just about redistribution; an important goal is to facilitate the transition from welfare to work. Some federal role is still appropriate given the wide disparities among the states.

William F. Fox (Professor and Head, Economics Department and Director, Center for Business and Economic Research, University of Tennessee) maintained that interstate disparities in service levels are appropriate if they reflect differences in preferences and that interjurisdictional competition can enhance efficiency in service delivery. He also noted that devolution will not occur or will be detrimental if state and local governments do not have the ability to control their own revenue sources.

William B. Modahl (Director of Tax Affairs, Digital Equipment Corporation) reminded participants that the authors of the constitution purposely imposed restraints on the power of the federal government, wary of the potential for all levels of government to misuse their "legal monopoly on coercion."

George Latimer (Distinguished Visiting Professor of Urban Studies, Maca-lsester College, and Chief Executive Officer, National Equity Fund; former Mayor of St. Paul) maintained that the nation's high degree of "spatial inequality" is a significant problem the solution of which demands considerable federal input.

Comes the Devolution

Speaker: *Robert Tannenwald*—Assistant Vice President and Economist, Federal Reserve Bank of Boston

Will the states be able to respond? Tannenwald investigates the following: How easily could state governments and their municipalities expand their fiscal domain should devolution proceed and should they choose to do so? Which states would have the most difficulty? How disparate would be states' response capacity? Would those least able to respond tend to prefer relatively low levels of state and local public services anyway? Some opponents of devolution fear certain states and municipalities lack the ability and the will to assume such responsibilities. The most often cited constraints are taxpayer resistance, a dearth of taxable resources, growing traditional subnational public problems, and interjurisdictional competition.

Tannenwald first looks for clues about states' likely fiscal response in the historical pattern of the aggregate state and local revenue burden (a measure of general state and local revenues, net of federal aid, as a percentage of nationwide personal income), which rose by 0.8 percentage point between FY77 and FY94 while the burden of state and local taxes declined by 0.7 percentage point. The two fastest growing categories of state and local revenue were non-tax sources (i.e., miscellaneous revenues and user fees and charges).

Tannenwald examines recent trends in state and local aggregate surplus, reasoning that they might be building up reserves as a contingency against potential reductions in federal assistance. He cites evidence that states have deeper reserves and higher ratios of surplus-to spending than local governments. This presents problems for devolution advocates in that local government are at the bottom of the "fiscal food chain."

Many are concerned about the potential inadequacy of government spending in "fiscally uncomfortable" states, those with low fiscal capacity relative to citizens' needs for public services, and that devolution would put the least fiscally comfortable states at a disadvantage in interstate competition, forcing them into a vicious circle of reduced public services, loss of labor and capital, intensification of their fiscal problems, and further tax increases and spending cuts. Tannenwald estimates the relative fiscal comfort of each state in FY94 (using the ACIR methodology). He uses these estimates to evaluate the degree of diversity among states in preferences for the level of state and local public spending. He finds that tax effort and fiscal comfort are uncorrelated, implying that as a whole fiscally stressed states have a preference for relatively low levels of spending. Both sides of the devolution debate, he says, can find encouragement in this finding. (See "Fiscal Capacity, Fiscal Need, and Fiscal Comfort: New Evidence and Its Relevance to Devolution," by Robert Tannenwald, *NTA Forum*, December 1997.)

Panel:

John D. Donahue (Associate Professor of Public Policy, John F. Kennedy School of Government, Harvard University; former Assistant Secretary and Counselor to the Secretary, U.S. Department of Labor) doubted that state and local expansion will offset federal shrinkage because of the intensive competitive economic pressures generated by increased business mobility.

Patricia McGovern (Partner, Goulston & Storrs; former Massachusetts State Senator) was confident that state governments have the creativity, independence, and expertise to respond effectively under any devolutionary scenario.

Isabel V. Sawhill (Johnson Fellow, The Urban Institute, and President, National Campaign to Prevent Teen Pregnancy; former Associate Director, U.S. Office of Management and Budget) noted that the substitution of block grants for matching grants will sever the relationship between state welfare spending and federal aid received and will accentuate interstate disparities.

John Shannon (Senior Fellow, The Urban Institute; former Executive Director, U.S. Advisory Commission on Intergovernmental Relations) said we are moving away from "lopsided federalism" toward a system in which each level of government does what it does best.

Helen F. Ladd (Professor of Public Policy Studies and Economics and Director of Graduate Studies in Public Policy, Duke University) raised the issue of whether local governments are likely to suffer the most fiscal stress in scenarios entailing more extensive devolution.

MTC Positions Available

The Multistate Tax Commission, a state government instrumentality, announces the following positions:

Director of Policy Research in state tax policy and economics—minimum qualifications: Masters in economics, business administration or public administration and 5 years public finance research experience. (Ph.D. in economics, may substitute for 3 years of experience). Salary $65,000-$70,500. Closes Friday, October 2, 1998. EOE.

Policy Research Project Manager in state tax policy and economics—minimum qualifications: Masters degree in economics, business administration or public administration and 4 years public finance research experience, including taxation of electric utilities or telecommunications industries (Ph.D. in economics may substitute for 3 years experience). Funding term is limited. Salary $55,000-$62,500. Closes Friday, October 9. EOE.

Tax Policy Research Associate in state tax policy and economics—qualifications: Masters degree in economics, business administration or public administration and 3 years public finance research experience with advanced knowledge of database or statistical analysis software (Ph.D. in economics may substitute for 3 years experience). Funding term is limited. Salary $45,000-$50,500. Closes Friday, October 16, 1998. EOE.

Applicants should submit a letter describing their education and experience, including a writing sample, preferably on a public finance topic, to William Six, 444 North Capitol Street NW, Suite 425, Washington DC 20001. Detailed position announcements, including the application process, are available at http://www.mtc.gov.

The Conference in Austin

Join your NTA colleagues for the Conference in Austin–the capital of Texas, the "Live Music Capital of the World," home to the University of Texas, gateway to the 32,000-square-mile Texas Hill Country, an arts and cultural center, and a fast-growing technological mecca!

Town Lake (one of many created from the Colorado River) is the site of the Conference hotel, the Hyatt Regency, a repository of local historical photos, maps and other documents, and western boots and hats, as well as home of "the best fajitas in Austin."

Austin has its own ballet, opera, and symphony, plus more than 30 art galleries and museums, several local dance companies, and 35 independent theater companies. The city's multicultural makeup and heritage are reflected in its architecture, ethnic foods, festivals, and musical styles. More than a hundred clubs and other venues (many close together on East 6th Street or the Warehouse District) offer country, blues, folk, rock, jazz, Latino, rap, and reggae.

Barbecue and Dance Party: The Local Arrangements Committee has planned a special evening on **Monday, November 9** at Austin's famous **Broken Spoke**, called by owners James and Annetta White "the best honky-tonk in Texas and the last of the true Texas dancehalls," a hang-out of most of the city's country musicians (not to mention some superstars like Willie Nelson), with real Texas country cooking. The music will be provided by the **Alvin Crow Band**. The Broken Spoke is a "must see" spot for visitors from all over the world (in July, when staff visited, there were people from England, the Netherlands, Australia, Belgium, and France). This will be very casual.

Also on Monday, November 9, there will be:

Spouse/Guest Breakfast: Spouses and Guests are invited to a Continental Breakfast.

Austin City Tour: Spouses and guests will visit the city's major points of interest. Highlights include the State Capitol, the Governor's Mansion, the French Legation, University of Texas, LBJ Presidential Library, and drives through the historic homes area and the historic district of Congress Avenue and Sixth Street.

PLEASE LET US KNOW IF YOU PLAN TO ATTEND THE SPECIAL FUNCTIONS.

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Name ______________________________

Spouse/Guest Name ______________________________

- ☐ Broken Spoke (_______ No. Attending)
- ☐ Spouse/Guest Breakfast (_______ No. Attending)
- ☐ Austin City Tour (_______ No. Attending)

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WARNING: INTERNET TAXES COULD UNDERMINE THE GLOBAL MARKETPLACE!

Update on NTA Electronic Commerce Tax Project to be Presented in Austin

As articles in various publications extol (properly) the merits of the new communications technologies and how they introduce the possibility of a truly global electronic marketplace, they often are accompanied by something like, "Warning! State and Local Taxation of the Internet Can Take All these Benefits Away." Or, "Danger: Internet Taxes Ahead!" Or, "The Internet: A Competitive Edge or Tax Trap?"

Are these "warnings" misleading? In most cases, the answer is yes.

At the same time, the scope and process of the taxation of electronic commerce and telecommunications pose important tax problems, both conceptual and administrative. The issues range from the public sector's concern over the viability of state and local revenue systems to equally important taxpayer (and tax administrator) concerns over risks to commerce posed by poorly developed legislation and/or regulations. For public finance economists, the issues go to the heart of "getting it right" in terms of horizontal equity, tax simplicity, and, to go to the point of the "warnings," efficiency.

Business, governments, and end-user taxpayers must cooperate to undertake an integrated approach to the interplay between the advances in telecommunications and electronic commerce and tax systems. Failure to do so will undermine the long-term legitimate interests of taxpayers and tax collectors alike.

Co-Chaired by NTA members Gary Cornia and Kendall Houghton, the National Tax Association Communications and Electronic Commerce Tax Project brings together key decisionmakers from all these segments to address how the new technologies will affect tax systems, commercial interests, and taxpayers. Based on a commitment among all the interested parties to work this out together, several policy and administrative issues have been placed on the project's agenda, including matters of tax base, tax rates, administrative simplification, and the development of model legislation. Public meetings have been held in Boston, Washington, DC, Chicago, La Jolla, Salt Lake City, and Las Vegas. The next meeting is scheduled for Washington in late November.

Progress is being made, and a complete (and technical) update will be provided at a special session at the Annual Conference in Austin.

SEE PAGES 5-8 AND 11 FOR IMPORTANT INFORMATION ABOUT THE 91ST ANNUAL CONFERENCE ON TAXATION