NTA Forum

Perspectives, Ideas and News from the National Tax Association Winter, 1993

From the Editor

The question raised by Donald W. Kiefer in the adjacent article has puzzled many observers of the federal budget dilemma. Not so many years ago economists thought (and taught) that by careful adjustment of tax rates and spending levels, federal fiscal policy could stimulate or restrain economic activity in such a way as to keep both inflation and unemployment within acceptable bounds.

Something clearly has gone wrong. Nobody in the new administration is urging major tax reductions as the way to "grow the economy". New spending initiatives such as infrastructure investment and job training are justified not on grounds of demand creation, as in the Keynesian model, but on their supposed addition to the nation's productivity. Major deficit reduction, not fiscal stimulus, is the guiding principle.

In suggesting four reason for the change in view, Kiefer cautions that he obviously is not offering a comprehensive and detailed analysis, but rather a brief overview for those who have not followed the scholarly literature in recent years.

This article is adapted from a paper Kiefer gave at the NTA Annual Conference last October in Salt Lake City. The views expressed are his alone and do not necessarily represent the position of the Congressional Research Service or the Library of Congress.

Comments on Kiefer's argument are welcome and should be addressed to the Editor at the NTA office. The *NTA Forum* also welcomes submissions of short articles on other topics of interest to the wide range of tax professionals represented in NTA membership.◆

Whatever Happened to Counter-cyclical Fiscal Policy?

by Donald W. Kiefer, Senior Specialist in Economic Policy, Congressional Research Service, Library of Congress

Washington is currently in the midst of preparing for the legislative push to enact the new President's economic program. The program is expected to include an investment tax credit and increased infrastructure investment among its primary elements. Whether it will involve an increase in the budget deficit in the first year is still under consideration at this writing. Mr. Clinton has said he is committed to substantial deficit reduction during his first term. While a fully developed economic program has yet to be articulated, the plan for fiscal policy apparently involves essentially no change — or perhaps a small increase — in the deficit in the first year (compared to baseline), followed by substantial reductions in the deficit during the next three years.

Thus, the fiscal program is focused primarily on long-term growth. Despite the program's conception in a presidential campaign that began during a recession, and despite Mr. Clinton's emphasis on job creation, the fiscal program is not an old-time Keynesian counter-cyclical economic stimulus. And while some economists called for an economic stimulus early in 1992, the recommended policy was long-term investment programs that would be deficit financed in the short-run. There have been no proposals for an across-the-board tax cut to stimulate the economy.

Why not? In the 1960s and 1970s several tax cuts were implemented to boost the economy out of periods of slow growth or recession, and a tax increase was adopted to restrain inflation. In the 1980s and 1990s fiscal policy has not been used for counter-cyclical purposes. What has changed?

(continued on page 2)

Fiscal Equalization: A Major Concern Facing State Legislators

NTA, in cooperation with the National Conference of State Legislatures, conducted a seminar on January 7 in Denver in which academic experts from NTA's ranks addressed legislators on various aspects of "The Challenge of Fiscal Equalization for State and Local Government Finance."

The seminar immediately preceded NCSL's annual conference of state fiscal chairs and was attended by more than 50 state legislators and members of legislative fiscal staffs.

Equalization can mean different things, but to legislatures in many states it means doing something to reduce disparities in fiscal resources among local school districts and, often, doing it soon. In a number of states court rulings have already forced fundamental

(continued on page 6)

NTA Forum

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In short, Murphy's Law struck with a vengeance; everything that could go wrong did. Four important factors are highlighted in this article (not necessarily in order of importance): 1) collapse of the theoretical underpinnings of counter-cyclical fiscal policy, 2) structural changes in the economy, 3) policy disappointments, and 4) the current policy setting.

Collapse of the Theoretical Underpinnings of Counter-Cyclical Fiscal Policy

The high confidence in counter-cyclical fiscal policy in the 1960s and early 1970s was based on Keynesian macroeconomics, the theoretical structure built on the writings of John Maynard Keynes. Two elements were crucial. The first was the notion that fiscal policy — primarily increases or decreases in the government deficit — could stimulate or restrain short-term economic growth. The second element was not actually derived from the writings of Keynes, but was appended later and became a key underpinning of both "Keynesian" fiscal policy and counter-cyclical monetary policy theory. This was the Phillips Curve, the notion that there was a stable tradeoff between inflation and unemployment.

The Phillips Curve implied that lower unemployment would result in higher inflation and vice versa. According to this relationship, for example, if unemployment were maintained at a low level, inflation would be higher than at higher unemployment rates but would remain at a relatively constant rate. The implication of this relationship was that policy makers could choose a point along the inflation/unemployment tradeoff that they believed to be optimal and adjust policy to achieve it. In the early 1960s, policy makers chose to strive for "full employment," which was typically defined as an unemployment rate of 4 percent. This was thought to be the level at which most unemployment would be frictional or structural.

In 1967, in his presidential address to the American Economic Association, Milton Friedman argued that the Phillips Curve relationship is incorrect. He posited a "natural unemployment rate" that would exist if the economy were in equilibrium. This natural rate is determined by real factors in the economy — the composition of the labor force, the nature of the unemployment compensation system, and the pace of technological change, for example — but not by the rate of inflation.

Friedman argued that any tradeoff between unemployment and inflation is strictly a short-term phenomenon. If policy attempted to keep unemployment below the natural rate, the inflation rate would rise. But soon the expected rate of inflation would rise to match the actual inflation rate, and as that happened equilibrium would be restored in the economy and unemployment would return to the natural rate. At the new equilibrium, unemployment would again be at the natural rate, but it would be paired with a higher rate of inflation. Attempting to keep unemployment permanently below the natural rate would require continuously increasing policy stimulus resulting in continuously increasing inflation. The implications were that macroeconomic policy actually could do rather little to affect the unemployment rate, at least in the long term, and that the inflationary effects of reducing unemployment were much greater than previously believed.

Friedman's interpretation and conclusions were not immediately accepted by the mainstream of the economics profession. During the 1970s, however, the advent of "stagflation" (simultaneous increases in unemployment and inflation) forced a broad re-examination of the unemployment/inflation relationship. Stagflation is inconsistent with the Phillips Curve, but it is not inconsistent with the natural rate of unemployment hypothesis. Today the natural rate hypothesis is the most widely held view, although there are significant competing theories. In general, the theory serves relatively well in providing an explanation of the observed relationship between unemployment and inflation over the post-war period. (As an aside, it can be noted that the estimated natural rate of unemployment in the early 1960s was between 5 and 5 percent, well above the "full employment" goal being pursued at the time.)

Friedman's theoretical contribution was notable not only because it introduced the concept of the natural rate of unemployment, but also because of its attention to expectations, how they are formed, and how they affect behavior. Prior to this time, most economic theory ignored expectations or relied on a simplistic view of how expectations are formed. Typically, expectations were assumed to be based on simple extrapolations of past trends; any new information — such as a policy change — that should affect the course of the economy was assumed to be ignored until its effects appeared in the trends of economic data. But during the last two decades a new branch of economic theory has been developed, based on the assumption that economic agents form their expectations rationally, that is, incorporate all relevant information. Some of the early contributions to this rational expectations school of thought did serious damage to the first element of Keynesian economics that provided the basis for counter-cyclical fiscal policy: the notion that such policy could stimulate or restrain short-term economic growth.

In one of the most provocative papers, Sargent and Wallace in 1975 developed the argument that in a world of rational expectations, systematic counter-cyclical policy has no real effects on the economy. In such a world, events that are known beforehand have no economic effect because they are already factored into expectations. Only events that come as complete surprises (or the aspects of events that are surprises) can have economic effects. This implies that systematic counter-cyclical policy can have no effect because it will be fully anticipated; people will adjust their behavior to offset the policy and still achieve their objectives.

Shortly thereafter, the empirical foundations of counter-cyclical policy were attacked, using a rational expectations framework. In what became known as the "Lucas Critique," Robert Lucas argued that the econometric evidence supporting the effectiveness of counter-cyclical policy was flawed because the models used to estimate the policy effects were misspecified. Specifically, the parameters in the models depend on the structure of the economy; they depend on behavioral patterns that are based, in part, on expectations. Prior procedure had been to estimate an econometric model based on historical data, and then use the estimates to simulate the effects of policy changes. Lucas pointed out that a policy change alters the structure of the economy and the expectations that underlie the model parameters. Hence, simulations based on the historical relationships are invalid.

The implications were that macroeconomic policy actually could do rather little to affect the unemployment rate, at least in the long term

These papers and others — together with applied research finding disappointing effects of the counter-cyclical fiscal policies enacted in the 1960s and 1970s (discussed in the third section below) — destroyed essential elements of Keynesian economics as understood in the 1960s. The Keynesians had no immediate response to the criticisms. An effort ensued to reexamine and rebuild macroeconomic theory from the ground up, paying closer attention to the optimizing behavior of economic agents that produces the hypothesized macroeconomic relationships. This effort has become known as building the "micro foundations of macro-economics." The process is still underway, but it is unlikely to yield a single general model of the economy that enjoys the support of a substantial majority of the economics profession, as the Keynesian model once did. Instead, several different paradigms are being developed.

While space does not permit reviewing these paradigms, their implications for the points developed here can be summarized. The natural rate of unemployment hypothesis, or some variant thereof, is consistent with most of the new models. While only one of the new paradigms fully incorporates rational expectations, virtually all serious economic modeling in the last two decades has incorporated expectations — how they are formed and how they affect behavior — in one form or another. (The rational expectationists got their comeuppance in the early 1980s when the recessions were far more severe than they predicted would result from a pre-announced tightening of monetary policy to squeeze the inflation out of the economy.) And while early in the process new models were developed within which counter-cyclical policy could affect short-term economic growth even with rational expectations, in none of the current models is counter-cyclical policy as strong or as efficacious as it was believed to be in the Keynesian models of the 1960s.

Structural Changes in the Economy

Important structural changes in the economy have occurred since the 1960s, some of which have weakened the effectiveness of counter-cyclical fiscal policy. More specifically, in 1971 flexible exchange rates replaced the earlier system of fixed rates of exchange between currencies. The international capital market also has developed very rapidly in the last few decades as a result of advances in telecommunications and computerization. These changes have resulted in more efficient capital markets, but they also have weakened the ability of fiscal policy to affect domestic economic activity.

A tax cut to stimulate the economy, for example, will increase the budget deficit and result in higher interest rates. The higher interest rates will attract capital in the international capital markets as investors in other countries shift assets to earn the higher rate of return. With flexible exchange rates, the greater inflow of foreign capital will drive up the value of the dollar in relation to other currencies. This will make foreign goods and services cheaper to Americans and U.S. goods and services more expensive to foreigners. Hence, U.S. net exports will decline, offsetting the initial effects of the fiscal stimulus. This effect is sometimes characterized as "exporting the stimulus" because the decrease in net exports (increase in imports) will create jobs in other countries. (Under fixed exchange rates, the greater demand for dollars in the foreign exchange markets would force an expansion of the money supply; this monetary expansion would reinforce the fiscal stimulus.)

The effects (of tax cuts or increases) grow slowly, peaking in the second or third year after implementation when economic stimulus or restraint may no longer be needed.

These effects can be seen in the U.S. experience during the 1980s. We incurred sustained, historically large Federal budget deficits, even during periods of fairly robust economic growth. These large deficits were accompanied by unusually high real interest rates. We changed from a capital exporting country into a capital importing country so quickly and dramatically that we now are a net debtor to the other nations of the world. As the dollar rose dramatically on the foreign exchange markets early in the decade, U.S. companies had difficulty selling exports and competing against imports, and "international competitiveness" became a policy issue. And despite the sustained unprecedented budget deficits, the, economy did not overheat and become inflationary.

Another important structural change affecting fiscal policy is the indexation of the Federal individual income tax. Until the mid-1980s, the individual income tax burden increased automatically each year as a result of inflation — the so-called "bracket creep" phenomenon. Periodic counter-cyclical tax cuts enacted during recessions or stagnant periods offset the bracket creep that occurred during the growth years. Unless inflation got really out of hand, tax increases to restrain the economy were not needed; in a politically convenient fashion they occurred automatically due to bracket creep.

Now, however, the income tax is indexed for inflation; bracket creep is largely a phenomenon of the past (though real income growth still results in bracket creep). In this setting, a counter-cyclical tax cut has to be followed by a counter-cyclical tax increase to avoid a long-term reduction in government revenues. Given the difficulty with which our political structure confronts a tax increase (or spending cut), counter-cyclical fiscal policy implies pro-cyclical legislative gridlock.

Policy Disappointments

The third factor affecting the use (or nonuse) of counter-cyclical fiscal policy is that we tried it and it didn't work, or at least it didn't work as well as expected. The three major counter-cyclical fiscal policies implemented during the 1960s and 1970s — the 1964 tax cut, the 1968 surtax, and the 1975 tax cut — were the subject of much economic research. While this research cannot be reviewed here in detail, three general conclusions from the research can be summarized.

First, the magnitude of the peak effect of a tax increase or decrease, in terms of the change in real GDP, is only about equal to or somewhat smaller than the size of the tax change itself. This contrasts to earlier beliefs that the tax change multiplier could be as high as 2 or 3.

Second, the effectiveness lags for tax changes are longer than had been expected. Tax cuts or increases had been expected to have rather immediate effects. Instead, the effects grow slowly, peaking in the second or third year after implementation when economic stimulus or restraint may no longer be needed (or appropriate).

Third, in the short-run period when the effect of a tax increase or decrease is desired, a permanent tax change has more effect than a temporary tax change (both the 1968 surtax and the 1975 tax cut were temporary). In the first year, a temporary tax change probably has no more than half the effect of a permanent tax change. This finding is consistent with the theoretical developments in the 1970s and 1980s concerning the role of expectations in determining the effects of policy changes. Earlier theory, however, did not distinguish between permanent and temporary tax changes in terms of their effectiveness.

Another lesson was learned from the enactment of the 1975 tax cut: it is frequently impossible to know the stage of the business cycle early enough, and to design and implement legislation quickly enough, to offset an economic fluctuation.

The state of the economy was debated throughout 1974 during the first episode of stagflation in the aftermath of the 1973 OPEC oil price increase. Some people maintained the economy was overheating and that policy should aim to slow it down. Others believed it was slipping into recession. In October 1974 President Ford, siding with the first group (which was probably the majority of observers at that point), proposed a surtax to curb inflationary pressures (this was part of the short-lived Whip Inflation Now program that spawned the infamous WIN buttons). It soon became clear, however, that the economy was, in fact, sliding into a deep recession. In January 1975, the President recommended a tax cut to stimulate the economy out of the recession. It was enacted with uncharacteristic speed; the President signed the tax cut legislation on March 29, 1975, only 10 weeks after recommending it.

Despite the speed with which the 1975 tax cut was enacted, its implementation came after the recession had ended. With the advantage of hindsight and data that were unavailable concurrently, the recession was eventually dated as lasting from November 1973 to March 1975. The initial implementation of the tax cuts under the legislation did not occur until May 1975. Hence, the recession ended before the tax cut was put into effect. (It is possible, however, that the tax cut contributed to the end of the recession by giving a boost to expectations.)

The Current Policy Setting

Because of the factors summarized above — revisions in economic theory, structural changes in the economy, and disappointing policy experiences —views about the efficacy of counter-cyclical fiscal policy have changed substantially since the 1960s. One way to discern the change is to contrast statements of the Council of Economic Advisors (CEA) in the 1960s and 1980s.

In the 1962 *Economic Report of the President*, the CEA — comprised of Walter Heller, Kermit Gordon, and James Tobin — made the following statements:

> To capitalize on the potential gains of stabilization requires skillful use of all economic policy, particularly budget and monetary policy. (p. 70)
>
> To be effective, discretionary budget policy should be flexible. In order to promote economic stability, the government should be able to change quickly tax rates or expenditure programs, and equally able to reverse its actions as circumstances change. (p. 72)

In the report, the President proposed that he be given stand-by authority to temporarily reduce individual income tax rates by as much as 5 percentage points and to initiate temporary capital improvement projects as counter-cyclical measures.

The views of the 1982 CEA — comprised of Murray Weidenbaum, Jerry Jordan, and William Niskanen — also expressed in the *Economic Report of the President*, are in sharp contrast:

> Although the Federal Government is the appropriate agent for stabilizing the economy, the limits of such action must be understood. This Administration believes that "fine tuning" of the economy — attempting to offset every fluctuation — is not possible. The information needed to do so is often simply not available, and when it becomes available it is quite likely that underlying conditions will already have changed. As a result, a policy of fine tuning the economy is as likely to be counterproductive as it is to be helpful. Though it is necessary for the government to have macroeconomic policies, including both monetary and fiscal policies designed to achieve some desired growth of income, such policies are not suitable for correcting small fluctuations in economic activity. (p. 36)

the relevant fiscal policy question is not how to design and implement a stimulative deficit increase, but rather when and by how much the deficit can be reduced without causing intolerable contractionary effects.

While these statements were written by different economists working for different Administrations representing different political parties, the most important reason for their differences is probably the broadly changed views regarding counter-cyclical policy. Despite their differences, the statements in the two reports probably reflected the mainstream view of economists at the time they were written.

During the 1980s there was almost no discussion of counter-cyclical fiscal policy in the U.S. In terms of major tax legislation, the 1980s were the most active decade in the post-war period, but none of the tax changes was aimed at short-term stimulus or restraint of the economy. The legislation was aimed primarily at encouraging economic growth, tax reform, or raising revenue to reduce the budget deficit.

The deficit has itself become an independent reason for the disuse of counter-cyclical fiscal policy, at least on the stimulative side. The deficit has grown to such enormous proportions that significantly increasing it to stimulate the economy is no longer a serious policy option. Given the size of the deficit, the relevant fiscal policy question is not how to design and implement a stimulative deficit increase, but rather when and by how much the deficit can be reduced without causing intolerable contractionary effects.

It should be noted, however, that even though *discretionary* counter-cyclical fiscal policy is no longer in vogue, the Federal budget still contains a number of *automatic* stabilizers. The progressive income tax, for example, automatically claims a larger portion of income as incomes rise and a smaller portion as incomes fall. Welfare programs and unemployment compensation automatically increase payments to individuals as the economy slows down and reduce the payments as the economy speeds up. These programs result in significant automatic increases or decreases in the size of the deficit at different points in the business cycle. Hence, fiscal policy does not remain neutral with regard to the business cycle even though new fiscal policy legislation may not be enacted specifically to counter a given economic turn.◆

New Book Examines State Taxation of Business

TAXATION OF BUSINESS PROPERTY: ISSUES AND POLICY OPTIONS is the title of a new book published in December by Praeger Publishers, in cooperation with the National Tax Association. Edited by Thomas F. Pogue, the 340-page volume contains papers presented at the 1991 Seminar on State Taxation of Business, under sponsorship of the Association's Committee on State Income and Business Taxation.

Organized in seven sections, the volume covers:

- DESCRIPTION AND RATIONALES FOR STATE BUSINESS TAXATION, in chapters by Steven Galginaitis, William H. Oakland, and Robert H. Aten.
- STATE TAXATION OF CORPORATE INCOME, in chapters by George N. Carlson, Gerald M. Godshaw, and Jeffrey L. Hyde; James Francis and Brian McGavin; Robert P. Strauss, and Robert N. Mattson.
- EXPORTING OF STATE TAXES, in chapters by William R. Brown, Burns Stanley, and Ferdinand P. Schoettle.
- STATE TAXATION OF TELECOMMUNICATIONS, in chapters by Walter Hellerstein and Patrick J. Nugent.
- STATE TAXATION OF MULTISTATE BANKING, in chapters by Thomas S. Neubig; and William Fox and Michael P. Kelsay.
- STATE TAXATION OF INSURANCE COMPANIES, in chapters by John W. Weber, Jr.; Thomas S. Neubig and Michael Vlaisavljevich; Martin F. Grace and Harold D. Skipper, Jr.; and James Barrese.
- ENVIRONMENTAL TAXES AND FEES, in chapters by Joseph J. Cordes; and Robert Bohm and Michael P. Kelsay.

An epilogue by Thomas F. Pogue discusses Goals and Strategies for Business Tax Reform.

NTA members (individuals only, please) can order copies at a special discount price of $44 (20% off list) by phoning 1-800-225-5800 and citing source code S-018. For quantity purchases phone Judy Martin at 203-226-3571 ext. 392.◆

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Fiscal Equalization, continued from page 1

revisions in school finance systems, and systems in many other states are currently under challenge as to their constitutionality.

Rather than addressing the immediate legal situation state-by-state, the seminar focused on the conceptual issues in fiscal equalization and evaluated the various fiscal policies states have adopted or might adopt to bring about greater fiscal equality.

Papers by Helen F. Ladd, of Duke University, and William H. Oakland, of Tulane, dealt with the concept of fiscal equalization and the major policy strategies for ameliorating them. Thomas F. Pogue, of the University of Iowa, and Thomas Downes, of Northwestern University, discussed alternative methods of taking fiscal capacity and need into account in designing school aid formulas, while Andrew Reschovsky and Michael Wiseman, of the University of Wisconsin, considered how states can most effectively meet their school finance responsibilities.

John Anderson, of the University of Nebraska, examined ways of reducing reliance on the property tax in school finance, and Fred Giertz and Richard Dye, of the Institute of Government and Public Affairs, University of Illinois, analyzed voter attitudes toward fiscal equalization. Michael Bell, of Johns Hopkins University, evaluated tax base sharing as a fiscal equalization device.

The papers are to be published later this year by Praeger Publishers in a volume edited by John Anderson, which will be available to NTA members at a discount price.◆

Spring Symposium, May 24–25, 1993
Arlington, VA
Crystal City Marriott

Stanley J. Bowers 1912-1992

Stanley J. Bowers died Friday, November 20, 1992, at the age of 80, following an illness of several months.

He was Executive Director of the National Tax Association - Tax Institute of America from 1967 to 1987. Prior to the merger of the two organizations in 1972, Stan served as President of the National Tax Association (1958-59) and as President of the Tax Institute of America (1962). In 1987 he was elected an honorary member of NTA-TIA. To many, Stan Bowers was known as "Mr. NTA-TIA."

Stanley Bowers had a long and notable career in the field of taxation. He went to work for the Ohio Department of Taxation in 1933 and served there for thirty years. He received his LL.B degree from Franklin University in 1939 and J.D. from Capital University in 1966. From 1954 to 1963 he served, under three governors, as Ohio Commissioner of Taxation, earning a well deserved reputation for effective and fair enforcement of the tax laws. In 1963 he was honored for outstanding service as a tax commissioner by the Tax Executives Institute. Active for many years in the National Association of Tax Administrators (now Federation of Tax Administrators), he served as president of that organization in 1956-57.

Following his retirement from the Ohio Department of Taxation, along with his duties as Executive Director of NTA-TIA Stan engaged in the private practice of tax law with the firm Caren & Bowers. He served also as tax counsel for the Ohio Manufacturers Association.

Stan is survived by his wife, Ruth, who resides at Friendship Village, 6000 Riverside Drive, Dublin, OH 43017, and by their daughters Judith Ann Nicely, of Akron, OH, and Mary Jo Py, of Boca Raton, FL, and by eight grandchildren and two great-grandchildren.◆

Papers Available on Public Finance Education

Two papers given in Salt Lake City at the meeting of the Committee on Education in Public Finance are now available. These papers will not be contained in the published *Proceedings* of the conference.

They are:

Public Choice Theory in the Undergraduate Public Finance Course, by Douglas Y. Thorson, of Bradley University

Summer Internships in a Graduate Public Policy Program, by Charles F. Adams, Jr., of Ohio State University

Copies may be obtained from the NTA office for $2.00 (each) to cover postage and handling.◆

Future NTA Annual Conferences

November 7–10, 1993
St. Paul, MN
Radisson St. Paul

November 13–16, 1994
Charleston, SC
Omni Hotel Charleston

October 8–11, 1995
San Diego, CA
Doubletree Hotel

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New Members

The Association is pleased to welcome the following new members who have joined between September 1 and December 31, 1992

NAME	STATE OR COUNTRY
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Marshall Blumenthal	Minnesota
Anthony Joseph Cataldo	Virginia
Robert Cline	Minnesota
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