TAX FOUNDATION

TAX FEATURES

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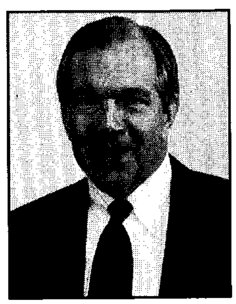
Foundation to Honor Gibbons, Corry at Annual Dinner

This Year's Conference Explores Pros, Cons of Consumption Taxes

Rep. Sam Gibbons (D-Fla.) and Charles A. Corry, Chairman of the Board and Chief Executive Officer of USX Corporation, will receive the Tax Foundation's Public Sector and Private Sector Distinguished Service Awards on November 17 at the 56th Annual Dinner in New York City, the Foundation has announced.

Rep. Sam Gibbons



Charles Corry

Messrs. Gibbons and Corry join an impressive list of previous award recipients that stretches back to 1941, and includes such notable statesmen as President Eisenhower, Senators Robert A. Taft and Everett M. Dirksen, and Federal Reserve Board Chairmen William McC. Martin, Paul Volcker, and Alan Greenspan (1992 Public Sector recipient).

Mr. Gibbons, who was first elected to Congress in 1962, is Vice Chairman of the powerful House Ways & Means Committee, and chairs its Subcommittee on Trade.

Mr. Corry began his USX career in 1959 as an attorney in the tax department of the former American Steel and Wire Division. He subsequently was named General Manager in the corporation's tax department (1975), Assistant Corporate Comptroller (1978), Vice President of Corporate Planning (1979), and Senior Vice President and Comptroller (1982). In 1987 Mr.

Annual Dinner continued on page 7

Witt to Step Down as Executive Director

Dan Witt, Executive Director of the Tax Foundation since 1989, has announced he will resign his post at the end of the year, to focus his full attention on the indepedent International Tax and Investment Center.

Mr. Witt will serve as President of the organization, which will oversee operations of the newly created N.I.S. Education and Training Centers. In October the organization opened offices in Moscow; Almaty, Kazakhstan; and Washington, D.C.

Dr. J.D. Foster, currently Chief Economist and Deputy Executive Director of the Foundation, will assume the title of Executive Director after the Annual Dinner on November 17.

FRONT & CENTER

An Alternative Health Care Reform Plan

Senator Phil Gramm (R-TX)

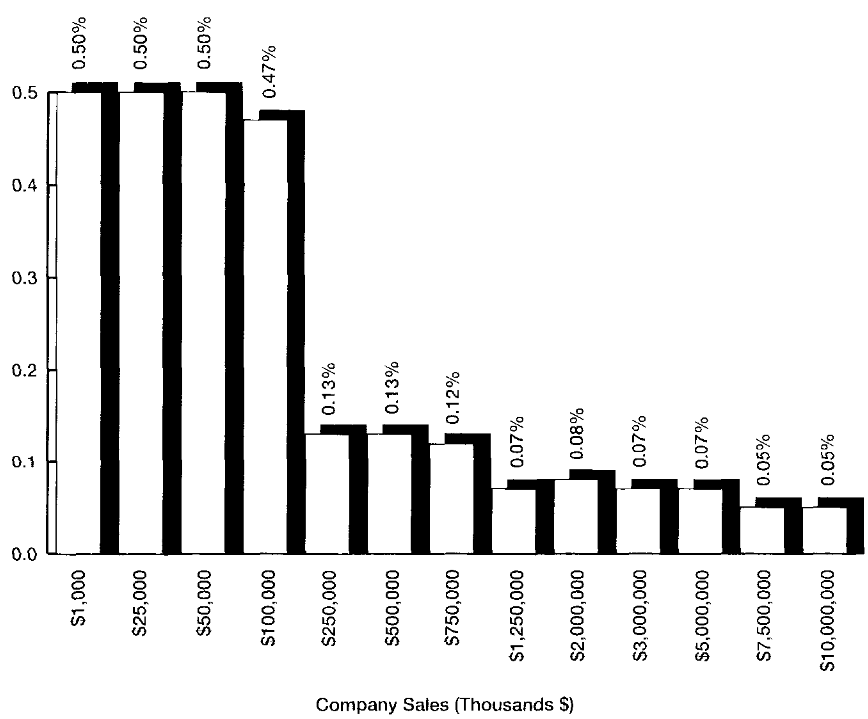
New Tax Foundation Studies Examine Cost of Income Tax Compliance for American Companies

Two new reports issued by the Tax Foundation this month examine the cost to business of complying with income taxes at all levels of government.

The first report, "The Income Tax Compliance Cost of Big Business," is a survey prepared by Dr. Joel Slemrod of the University of Michigan and Dr. Marsha Blumenthal of the University of St. Thomas. The Slemrod/Blumenthal study asked a select group of U.S. firms how much money they could save in compliance costs over the long run if the corporate income tax was eliminated. The 365 businesses responding to the survey came from the 1,329 firms active in the Coordinated Examination Program (CEP) of the Internal Revenue Service—a program that includes mostly large companies, often with an unusually complex income tax situation.

According to the survey, the estimated total annual cost of income tax compliance for businesses in the Fortune 500 amounts to $1.055 billion, or an average of $2.11 million per company. Of this, about 70 percent of the cost is due to the federal tax system. At least half the cost of complying with the federal corporate income tax is due to the rules on the taxation of foreign-source income and the alternative minimum tax (AMT), in particular the complex depreciation rules.

Compliance Cost-to-Sales Ratio by Firm's Annual Sales (Percent)



Source: Tax Foundation.

The survey results comport with the expectation that there are economies of scale in tax compliance. As companies get larger, their total cost of tax compliance increases, but it increases at a rate less than proportional to the increase in company size.

Most of the survey respondents strongly believe that the Tax Reform Act of 1986 increased the complexity of the federal tax code. Of those voicing an opinion, about 40 percent cited the AMT as the tax feature contributing most to compliance costs. Indeed, respondents estimated that the AMT adds 16.9 percent to incremental compliance costs.

The second newly published Foundation report on this topic is a *Special Report* authored by Senior Economist Arthur Hall. The study, titled "The High Cost of Tax Compliance for U.S. Business," places the Slemrod/Blumenthal study into the context of the cost of business tax compliance in general. Relying on Internal Revenue Service data published in a 1988 survey-based study by Arthur D. Little, Inc., Dr. Hall has estimated that the total cost of compliance for all businesses in 1993 will be $123.4 billion. This figure includes the cost of complying with federal income taxes, employment taxes, and their accompanying regulations.

Among Dr. Hall's key objectives was to compare the results of the Slemrod/Blumenthal study of big business with the compliance burden for small corporations. According to Hall's calculations, a conservative estimate of the 1992 average corporate income tax burden amounted to $5,025. In contrast to the Slemrod/Blumenthal study, that figure includes only corporations with assets of $1 million or less. Corporations in this size range accounted for 91 percent of the corporate respondents to the Arthur D. Little, Inc., survey.

To make his comparison, Hall derived compliance cost-to-sales ratios for small corporations—and used these ratios in conjunction with the ratios reported by Drs. Slemrod and Blumenthal—to estimate the compliance cost for a full range of different size corporations.

The above chart reports Hall's estimates. The cost-to-sales-ratio column clearly shows the existence of economies of scale in tax compliance, which helps explain the relatively low cost of compliance relative to company size reported in the Slemrod/Blumenthal study. The cost for corporations in general is much higher and gets relatively higher as companies get increasingly smaller. About 82 percent of all corporations have $1 million or less in annual sales. •

Typical American Family's Income Continues to Lag Behind High-Water Mark of 1980s

The typical American family's income, after taxes and inflation, still lags behind the level reached in 1989 as the economy continues to grow slowly, according to a new Tax Foundation *Special Report.* As Chart 1 shows, the strong growth in family income during the 1980s has slowed, due to an economic slowdown after 1989 and a rise in various federal, state, and local taxes .

In his analysis, Foundation Economist Chris Edwards used the income of the median (or typical) family with two income earners, as measured by the Census Bureau, as a starting point to study the change in tax burdens since 1980. This family will earn $51,883 in 1993, but will be left with only $33,807 to spend on food, housing, and all other items after all taxes are paid.

While the two-earner median family income has climbed to its current level from $26,879 in 1980, most of that gain has been eroded by inflation and taxes. The 93 percent rise in pre-tax income has nearly been matched by a 90 percent rise in total taxes and a 73 percent rise in the general price level. The result: the after-inflation, after-tax income of the typical family has only risen 15 percent since 1980 and has not risen at all since 1989.

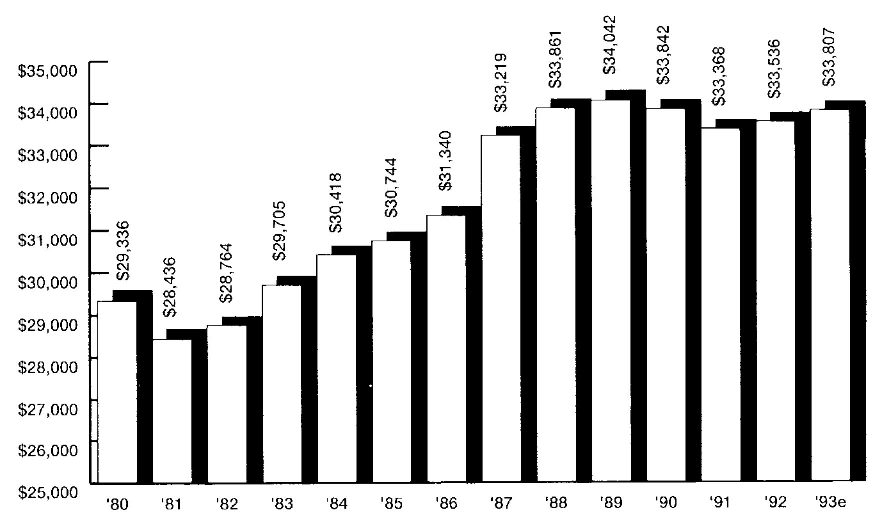
The overall average tax rate for the typical family has hovered around 40 percent each year since 1980, but the composition of the tax load has changed. Federal income tax rates have fallen from 15.0 percent in 1980 to 10.5 percent today, while federal payroll taxes for Social Security have risen from 12.3 percent of income to 15.3 percent, and state and local taxes have risen from 11.4 percent to 12.6 percent.

Federal Social Security payroll taxes have risen to the point where most American workers of lower and middle incomes now pay more in payroll taxes than in federal income taxes. In fact, the median two-earner family profiled pays 46 percent more in payroll taxes than in federal individual income taxes. A decade ago it was the opposite.

Chart 2 shows that taxes represent the largest component of a typical family's expenses. Federal, state, and local taxes represent 40.4 percent of a typical family's income in 1993—a larger bite out of the income pie than housing, food, and medical care combined.

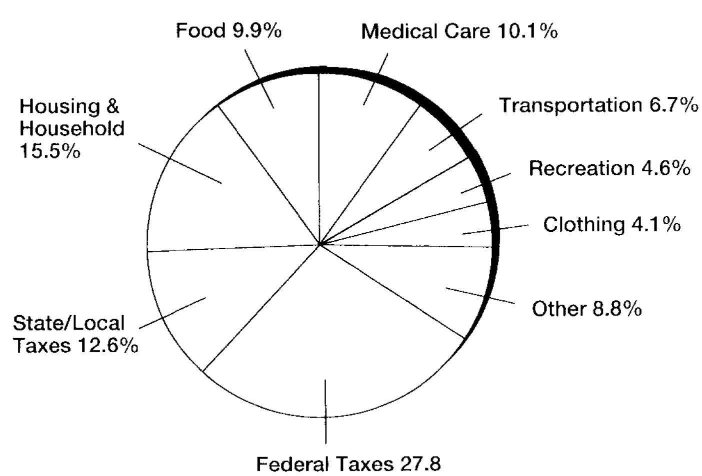
In the *Special Report,* Mr. Edwards notes the outlook for the typical family's income is uncertain. A sputtering economy and the potential for higher payroll taxes with health care reform could keep the lid on income growth. •

Chart 1
Real, After-Tax Median Family Income, 1980–1993



Source: Tax Foundation.

Chart 2
Typical American Family's Expenses, 1993



Source: Tax Foundation.

An Alternative Health Care Reform Plan

Senator Phil Gramm (R-TX)

What is the problem in health care? There are two fundamental problems. One is cost and the other is access, and the access problem exists because of cost.

What is the problem in the health care market? Why does the health care market work differently than our market for automobiles, food, or shelter? It works differently because, beginning about 65 years ago, we instituted a system of third-party payment through private health insurance. Third-party payment exploded during World War II because of the government—we were under wage and price controls and companies competed for labor by providing fringe benefits. We emerged from World War II with our major industries that had been engaged in war production heavily covered by third-party health insurance. It became a standard benefit for the private sector. When Medicare and Medicaid were introduced they at least pretended to model themselves after private health insurance.

If we look at the experience of the world, in every single case where government . . . dictates and controls the medical market, the ultimate mechanism for trying to control costs is rationing, wage controls, price controls, and limitation of services.

So we have reached the point today that when a person goes to the hospital, 95 percent of the hospital bill is paid by someone else. When someone goes to the doctor, 83 percent of the bill is paid for by someone else. Because of this third-party payment, the consumer of health care (unlike the consumer of food, housing, or automobiles) is paying a relatively small portion of the cost. Since consumers are not paying the bill, they are not cost-conscious and the natural incentives for a market system to control costs do not operate.

The administration is fond of asserting that free enterprise has failed in health and that now we should try collectivism. But the truth is that under the current system we do not have anything approaching price competition or free enterprise. If I bought groceries the way I buy health care, I would eat differently, and so would my dog.

Do we really believe that by having the government run the health care system it can hold down costs by being more efficient and reducing paperwork? No one can believe that. If we look at the experience of the world in which we live, in every single case where government becomes the only buyer of health care, where government dictates and controls the medical market, the ultimate mechanism for trying to control costs is rationing, wage controls, price controls, and limitation of services. Is that what we want?

What is the alternative? The alternative is to give people more choices, not fewer. How can we improve the health care system and save the things that we really like? My guess is that what the American people really want is for us to look at the parts of the system we love and leave them alone, and take the parts we don't love—the exploding costs, the lack of general access—and try to fix them.

Today, we literally have thousands of innovative systems evolving, systems where companies and employees, and groups of companies, have gotten together, come up

with new ways of providing health care coverage and new, innovative ways to control costs.

My proposal is to encourage innovation. Let me take a simple example: Let's take a small family-owned company in Mexia, Texas, called Flatt Stationers. It has about a dozen employees, and Tommy Flatt, brother of the famous Dicky Flatt, works for Flatt Stationers, Inc. The company's paying for part of his health care package, and he's paying part of it. Under the current system, he has only one choice and that's the plan Flatt Stationery helps him buy. Under the President's plan he'll have only one choice, and that's to buy from a government collective that will probably be run out of Austin or Waco.

Under my alternative he'll have several choices: First of all, he can keep the policy he wants. If he wants the current policy, and he's willing to pay the premiums, this is a free country and he ought to have the right to do it. Secondly, I would give him the right to take the share of the current policy that is being paid by his employer and take that to Waco and join an HMO. Alternatively, I would give him the right to take the share of the insurance policy that is now being bought by his company and take that money and set up a medical IRA with a private insurance company or with whoever would set up medical savings accounts. This is how the plan would work.

Tommy Flatt, about 45 years old, with two children and a spouse, pays about $4,500 a year for health insurance. He could buy a catastrophic policy that would pay everything over $3,000 for about $1,600 a year. He could then put the other $2,900 in a Medical Savings Account that could be used only for the purpose of paying deductibles on that catastrophic policy. But at the end of the year, if he hasn't spent the whole $2,900, he gets to keep it.

Now, under this Medical Savings Account, Tommy Flatt would have an incentive to look at alternatives. He would have an incentive to be cost-conscious. Ninety-two percent of all Americans don't spend $3,000 a year on health care. So for 92 percent of the people who opt for Medical IRAs, they're paying for their own health care and are becoming cost-conscious. The system begins to respond, and is not only directed at doing it better, but is also directed at doing it cheaper.

So innovations will occur in cost control. People who are working at Flatt Stationers, Inc., will look at what Tommy Flatt does. If the HMO turns out to be better, cheaper, then they move in that direction. If the Medical Savings Account turns out to be better, they move in that direction. If Tommy joins a *voluntary* health alliance, that provides the care he wants more cheaply, then they move in that direction. People are free to choose, the system changes, and we put the focus on price competition.

How do you deal with access to health insurance? The good news is that 85 percent of Americans have health insurance, either Medicare or Medicaid or private health insurance. The bad news is that 15 percent do not. Of those 15 percent, about 85 percent have had it at some point in the last two years. Here are the things we could do to deal with access immediately:

Number one, change the insurance policy to make it portable. Give people a grace period of 18 months during which, if they change jobs, as long as they pay the premium, they can keep their insurance until they can get into a position where they're covered.

Secondly, let's change the insurance policy to make it permanent so that once you have bought an insurance policy, as long as you pay the premium, even if you get sick, the company can't cancel the policy. That policy is going to be more expensive, but that's what insurance is all about.

We can set up a risk pool to help people with pre-existing conditions.

We can also set up a sliding-scale subsidy for people who are working, who don't qualify for Medicaid, and have a sliding-scale subsidy for people that are right above the level for Medicaid, but who make less than 200 percent of poverty. We can phase in these benefits as we reform the system and promote competition.

I'd like to give choices to Medicare recipients as well. They can keep what they have, and if they want to take the amount the government expects to spend on them and buy a private policy with it, the government ought to pay it.

We have a choice: To entrust American medicine—one-seventh of the economy, a critical part of what makes our life-style the best in the world—to the government, or to entrust it to a system which brings food into our house, which allows us to buy automobiles and shelter, which gives us the most efficient engine for economic development that the world has ever known and that is changing the health care system to provide incentives for people to be cost-conscious. •

The views expressed in Front & Center are not necessarily those of the Tax Foundation.

Danforth Promotes Permanent Research Credit

To spur research spending by the private sector, Congress should reenact the research tax credit on a permanent basis and make it more effective, Senator John Danforth (R-Mo.) stated in a recent Policymaker Interview published by the Tax Foundation.

"We are constantly telling our businesses not to look at the short-haul, but look at the long-haul instead, look at the future, and that is what the research and development (R&D) credit is all about," Senator Danforth told Foundation Chief Economist J.D. Foster and Economist Chris R. Edwards in their private meeting.

In conjunction with the interview, the Foundation issued a new *Background Paper* by Mr. Edwards, titled "The Research & Experimentation Tax Credit." The paper provides an overview of the purpose, legislative history, and effectiveness of the research tax credit, and summarizes recent proposals to reauthorize the credit.

In the study, Mr. Edwards notes that some policy makers have been concerned in recent years that the U.S. underinvests in technological research. While defense-related industries have provided a large stimulus to military research, concern has focused on a possible shortfall in civilian research spending.

Concerns over the competitiveness of American firms, along with studies showing low research spending by U.S. business, have prompted Congress to renew the research tax credit repeatedly since 1981. Initially enacted as part of the Economic Recovery Tax Act of 1981, the credit was extended and lowered from 25 percent to 20 percent in the Tax Reform Act of 1986, extended in 1988 and 1989, modified and extended in 1990, and extended in 1991. The credit expired temporarily on June 30, 1992.

Although President Clinton proposed reenacting the research credit on a permanent basis in his fiscal 1994 budget, Congress instead passed another temporary extension. The credit was extended, with no major changes, retroactive to July 1, 1992, and is set to expire on June 30, 1995.

However, led by Senators Danforth and Max Baucus (D-Mont.), many legislators are prepared to modify the credit and establish it on a permanent basis. To this end, the senators introduced S. 666 earlier this year.

"(Businesses) don't make decisions on the basis of quarter-by-quarter earnings results," Senator Danforth argued in the interview. "They make decisions on the basis of at least three years, five years, or more. So, for the sake of stability . . . it would be much better to get the certainty of having the credit permanently in the tax code."

In the report, Mr. Edwards says that, as a tax expenditure, the research tax credit has produced a revenue loss to the federal Treasury of between $700 million and $2 billion annually since being implemented. Though the concern for revenue loss in Congress is acute, there is also distress over the competitiveness of U.S. business. For this reason, a tax credit to encourage research has wide, bipartisan support in Congress.

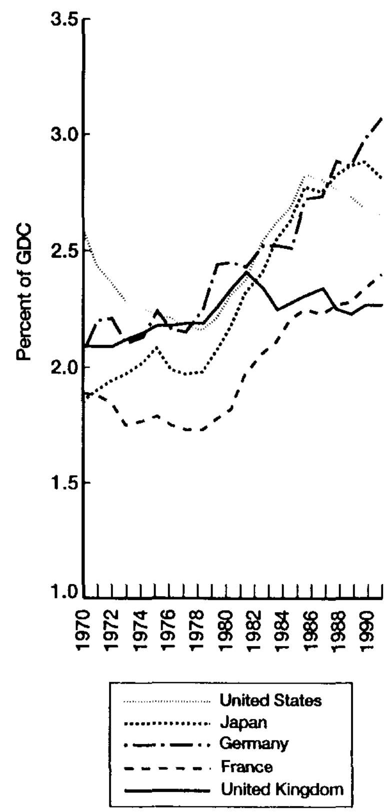
Aside from modifying and making permanent a research tax credit, the Danforth-Baucus bill also provides for:

- A liberalized method for calculating the fixed-base percentage.
- A flat 10 percent credit to small businesses with sales under $100 million, in the hopes of simplifying the credit calculation.
- Businesses paying the Alternative Minimum Tax (AMT) to offset 50 percent of their AMT liability with the research credit.
- A separate base calculation for civilian research by defense businesses so as to encourage the transition to civilian research in the economy.

"We need to encourage long-term investment in plant, equipment, and research and development," Senator Danforth explains in his interview. "This is a fundamental issue of tax policy and a lot of people are finding out that our tax code has just the opposite effect."

Still, in his paper, Mr. Edwards believes it is doubtful that such marginal changes in the tax code could make up the difference between U.S. levels of nondefense research spending compared to the level attained by the Japanese. Since the United States spends about two percent of GDP on nondefense research and Japan spends three percent, it would take a $63 billion research spending increase in this country to reach the Japanese level. This figure is an order of magnitude greater than the extra spending generated from the current research tax credit. Therefore, if increasing the level of private nondefense research spending to levels approaching those of our major competitors is to become a national priority, many additional measures will need to be taken, including expanding the research tax credit. •

Total R & D as a Percent of GDP



Source: National Science Foundation.

Annual Dinner

Continued from Page 1

Corry was appointed President of the U.S. Diversified Group, and in 1988 he was elected President of USX Corporation and a member of the board of directors. He was elected Chairman and Chief Executive Officer in 1989.

The annual dinner is scheduled to start at 7 p.m. at the Waldorf-Astoria Hotel.

The national conference, scheduled that day from 10 a.m. to 5 p.m. at the Waldorf, will focus on "Tax Policy and the Continuing Deficit Debate: Is There a Consumption Tax in our Future?"

The first session will examine "Fifteen Years of the Federal Budget, 1978-1993." Moderated by Paul Zagortz, Division Vice President of Taxes at Hallmark Cards, the panel will feature William Hoagland, Minority Staff Director of the Senate Budget Committee, and John Fund, Editorial Writer at the *Wall Street Journal*.

Session Two, titled "Budget Policy in the Future," will be moderated by Lawrence Kudlow, Chief Economist at Bear Stearns. Panelists will include Robert Reischauer, Director of the Congressional Budget Office; Stan Collender, Director of Federal Budget Policy at Price Waterhouse; and James C. Miller III, Co-chairman of the Tax Foundation and former Director of the Office of Management and Budget.

The afternoon sessions will focus on "Alternative Consumption Taxes" and "Advantages and Disadvantages of Consumption Taxes."

The former will be moderated by John Mills, Vice President of Taxes at USX Corporation, and will feature David Bradford of Princeton University, with comments by Tom Neubig, Director of Financial Economics at Price Waterhouse, and Mark Weinberger, Tax Counsel for Senator John Danforth (R-Mo.).

E. Noel Harwerth, Vice President & Chief Tax Counsel of Citibank/Citicorp USA, will moderate the final session of the day. Participants on the panel will include John Loffredo, Chief Tax Counsel at Chrysler Corporation, and Daniel J. Boyers, Associate Tax Counsel for Sears Roebuck & Co. •

FOUNDATION MESSAGE

Don't Watch 'em Making Sausage or Tax Policy

We should take this time between major tax bills and before health care reform reaches its full fury to consider the tax policy process itself.

It has been said that one should never watch either sausage or tax policy being made. The making of tax policy may be a little more palatable than the making of sausage. For example, many very talented people in and out of government are deeply involved in tax policy (no insult intended to sausage makers). Further, these individuals are deeply interested in finding the right answers to difficult questions. Finally, to the extent they understand the tax code Americans have an extraordinarily high degree of tax compliance.

However, as a recent example of tax policy's less savory side, consider the recent tax change prohibiting taxpayers from deducting the costs they incur to interact with tax policy officials in explaining the effects of existing or proposed tax policy.

It is bad enough that government can take from taxpayers property in the form of income, much of which is simply misspent and some of which is spent on regulatory pursuits contrary to taxpayers' interests.

Dr. J.D. Foster
Chief Economist and Director

It is bad enough that the tax collection system is wrought with uncertainty, that many areas of the tax code are complicated beyond the ability of mortal man to comprehend, and that the tax code robs the nation of the saving and investment needed to compete and prosper. Now taxpayers are denied the ability to write off the expenses of "lobbying" their elected and appointed officials to explain these bad things.

On another matter, it seems what once were vices now are habits. The recent tax bill adopted a major retroactive tax provision as much for expediency in raising revenue as anything. It matters not on whom the tax was levied; retroactive taxation is wrong. A democracy whose government knowingly does wrong to any segment of its population, without so much as a "pardon me", is shortening its days as a free society.

Finally, tax policy is driven by revenue estimates. Consequently, revenue estimators are called on to perform superhuman feats in answering requests for estimates by members. These estimators in both the Joint Tax Committee and in the Treasury are surely to be numbered among the many talented people involved in tax policy. The fact remains, however, that the revenue estimates are based on methodologies that are known to be flawed in predictable ways.

Imagine the unimaginable—a 100% tax rate on income above say, $100,000. Common sense tells you that the government would collect almost no revenue from this tax rate because few people are so public-spirited they are willing to have all the product of their labor (and their saving) go to the government. Yet the revenue estimate would show a revenue increase of hundreds of billions of dollars.

Or imagine a 10% tax levy imposed on all sales of new plant and equipment. Obviously, total capital formation would plummet, as would the rest of the economy. But not according to our government revenue estimates. Should such a tax be proposed, government models would say that there would be no net reduction in national investment, employment, or total economic growth.

Now, when no particular tax proposal dominates the debate, when there is no big tax bill on the horizon, and when health care is just building momentum, would probably be a good time to make some badly needed repairs to the tax policy process. A few good places to start would be to allow taxpayers forever more to deduct the cost of defending themselves and their property from the taxman in all his guises, including the legislature; to ban retroactive tax provisions that raise revenue; and to bring the revenue estimating process out of Jurassic Park.

Treasury Fills Out Tax Team

Former Foundation Counsel Moves to Legislative Office

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The Treasury Department has just about filled its political posts, including those that work directly on tax policies. Among the political appointees hired: Floyd L. Williams II, former Chief Tax Counsel at the Tax Foundation from 1991 through August 1993.

Former Chairman of the Senate Finance Committee **Lloyd Bentsen** (D-Texas) was confirmed as Treasury Secretary in January.

Following him was **Roger C. Altman**, Deputy Secretary of the Treasury, the second-highest ranking official at the department. Prior to joining the Treasury, Mr. Altman was Vice Chairman of The Blackstone Group, a private merchant banking firm. Before joining Blackstone he was Managing Director of Lehman Brothers and a member of its management committee and board of directors.

Frank N. Newman serves as Under Secretary of the Treasury for Domestic Finance. In this position, Mr. Newman oversees the development of policy and guides Treasury activities in areas of management of the public debt, financial institutions policy and regulation, and other domestic financial matters.

Mr. Newman comes to the Treasury following six years with the BankAmerica Corporation as Chief Financial Officer and Vice Chairman of the board of directors. Prior to joining BankAmerica, Mr. Newman spent 13 years at Wells Fargo, moving through the ranks tobe named Chief Financial Officer in 1980.

Leslie B. Samuels is Assistant Secretary of the Treasury for Tax Policy. Mr. Samuels serves as the chief representative and advisor to the Secretary of the Treasury in the formulation and execution of domestic and international tax policies and programs.

From 1968 until joining the Treasury, Mr. Samuels was an associate, then a partner, with the New York law firm Cleary, Gottlieb, Steen and Hamilton.

Samuel Y. Sessions serves as Deputy Assistant Secretary of the Treasury for Tax Policy. He was Chief Tax Counsel with the U.S. Senate Finance Committee from 1990 to 1993. From 1988 to 1990 he was Tax Counsel with the committee, and prior to that served as a Legislative Assistant to Senator Bentsen.

Cynthia Gibson Beerbower is the International Tax Counsel at the Treasury Department, serving under Assistant Secretary Samuels. Her office is responsible for negotiating and reviewing income tax and estate and gift tax treaties with foreign countries and coordinating tax treaty matters with the State Department and Congress.

Before joining Treasury, Mrs. Beerbower was an associate, and then a partner, in the New York law firm of Simpson, Thatcher and Bartlett.

Michael Levy is the Assistant Secretary of the Treasury for Legislative Affairs. Prior to joining the Treasury, Mr. Levy served as Administrative Assistant to Senator Lloyd Bentsen. Before that he was a Staff Economist on the Joint Economic Committee. Levy received a Ph.D. in political science from Rutgers University.

Floyd L. Williams II is Senior Tax Advisor for Public and Legislative Affairs in the Office of Legislative Affairs. In this position he serves as a key liaison between the administration and Congress on tax policy. Before joining the administration, Mr. Williams was Chief Tax Counsel at the Tax Foundation. Prior to that, he served as Staff Vice President and Legislative Counsel at the National Association of Home Builders, and also spent four years at the Internal Revenue Service and seven years at the Joint Tax Committee in Congress. •

Tax Foundation
1250 H Street, NW
Suite 750
Washington, DC 20005-3908

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