

TAX FEATURES

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New Tax Foundation Study Confirms Regressivity of Excise Taxes, Suggests Reform

Goals of Fundamental Tax Reform Helped by Integrating Excises

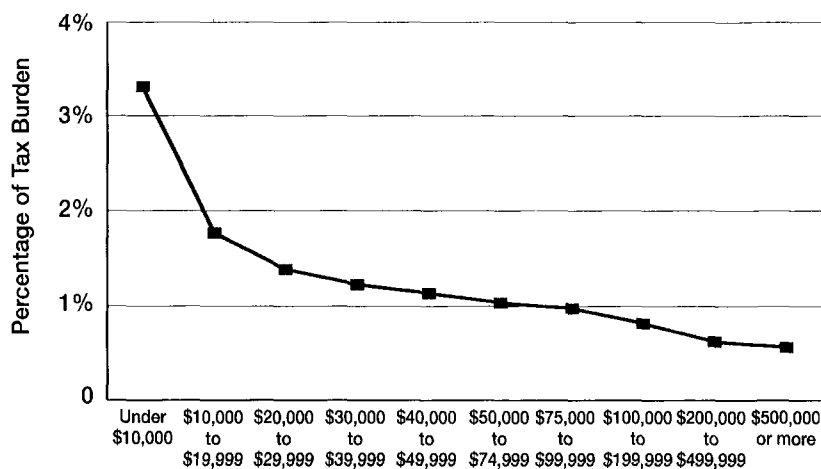
A new study by Tax Foundation economist J. Scott Moody, *Background Paper #29: Federal Excise Taxes and the Distribution of Taxes Under Tax Reform*, finds that taxpayers who report less than \$10,000 in adjusted gross

income pay 3.3 percent of their total tax burden in federal excise taxes. In contrast, individuals and families with incomes over \$500,000 face an effective excise tax rate of only 0.6 percent (see chart at left).

The study was unveiled Friday, January 15, at a three-day conference in Amelia Island, Florida, the same day that stories appeared in the nation's newspapers confirming that the President would propose a 55¢ per pack hike in the federal tobacco excise in his State of the Union address. The results of the study corroborate recent Congressional Budget Office research. CBO found that in 1995 individuals and families with less than \$10,000 in cash income faced an effective excise tax rate of 3.9 percent, while people making over \$200,000 paid only 0.3 percent.

Among federal excise taxes, the tobacco tax currently trails only transportation excises in its impact on the poor. Today's federal tobacco excise tax rate is 24¢ per pack and is already scheduled to rise to 39¢ per pack by 2002. President Clinton's proposed hike of 55¢ would therefore raise the federal tobacco excise to 94¢ per pack, triple what predominantly low-income smokers face today.

Distribution of Federal Excise Tax Burden by Income Class
Fiscal Year 1998

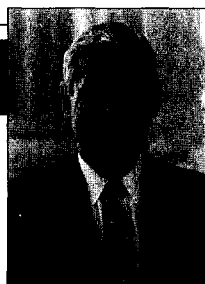


Source: Tax Foundation.

Adjusted Gross Income

Excise Taxes continued on p. 8

FRONT & CENTER



Tax Neutrality and Fairness to Small Business Should Be Watchwords of Internet Taxation Policy

U.S. Senator Bob Graham (D-FL)

National Conference Addresses New Challenges in Taxation Posed by Electronic Commerce

The Tax Foundation's 61st annual conference held November 19th at the Four Seasons Hotel in Washington, DC, addressed one of tax policy's new frontiers: electronic commerce.

The Foundation's executive director and chief economist, J.D. Foster, Ph.D., led off the conference by explaining that existing tax policy was written for a world in which most commerce was in

by Senior Economist Claire M. Hintz. It gives a snapshot of electronic commerce, pointing out that its largest component is business-to-business trade, then raises a number of issues in the application of tax policy:

- ◆ Services are a growing fraction of consumer expenditures, and the growth of electronic commerce will only increase the fraction of commerce that escapes sales and use taxation as more consumers go online to purchase services and intangible products. Should services and intangibles (digital goods) be included in the sales tax base? How?

- ◆ Because states are prohibited from compelling mail order vendors who operate only out of state to collect sales and use taxes, local merchants are at a competitive disadvantage. The Internet will certainly exacerbate this problem for conventional in-state vendors. Should remote commerce be subject to sales and use tax collection requirements?

- ◆ The Internet blurs the links between economic activity and location. In the borderless world of the Internet, where does a transaction take place? Is it at the customer's computer? At the company's website? The server that houses the website? The seller's computer?

Foster then introduced the afternoon's keynote speaker, Harris Miller, president of the Information Technology Association of America, who gave a brief history of computers and electronic communication.

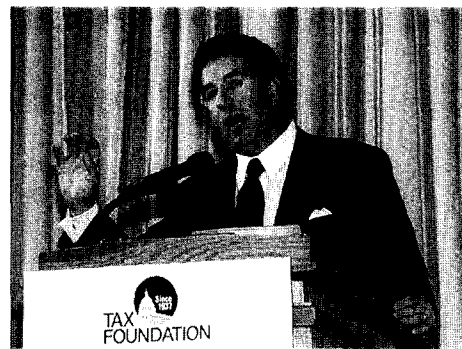
Miller and the ITAA have recently published a study that showed global information technology expenditures have reached \$1.8 trillion, or 6 percent of the world's GDP. It was even higher in the U.S., at 8 percent, and although it is thought of as an industry exclusive to developed nations, information technology's top ten customers include Brazil and China.

Miller quoted Mike Maples, one of the leaders of electronic commerce, as saying that e-commerce is a way of life. Because it has fundamentally transformed business, Miller doesn't see this an in-

stance of internet hype, but just a bold statement of what's really happening.

He called the taxation of e-commerce one of the thorniest public policy issues of the era.

"Our message as an industry is fairly



Keynote speaker Harris Miller, president of the Information Technology Association of America.

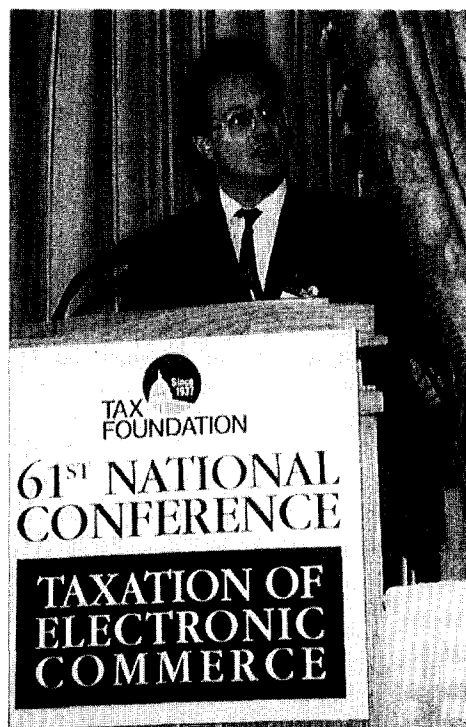
simple," said Miller. "Governments should be patient and avoid premature regulation. In general, regulation should be avoided, but premature regulation can be even worse. And they need to clearly

"Our message as an industry is fairly simple. Governments should be patient and avoid premature regulation."

***—Harris Miller,
President, ITAA***

articulate the policy issues they think are a priority to serve the citizens which is, of course, their major task."

Andrew Sernovitz, President & CEO of the Association for Interactive Media, followed with insights on the future of electronic commerce, urging the audience to focus on the changes that the internet and e-commerce would bring to



The Tax Foundation's executive director and chief economist, J.D. Foster, Ph.D., introduces the theme and the speakers at the annual conference.

sales of manufactured goods, and governments are not yet comfortable with any one approach to taxing it. Therefore, this conference would attend to the basics: describing what electronic commerce is, how it is being taxed now, and how it might be taxed in the future.

He described a new study that the Tax Foundation released at the conference, *Background Paper #28: A Primer on the Taxation of Electronic Commerce*

the lives of "normal people," that is, people who aren't particularly concerned with the internet right now.

Omnipresence. The internet will soon be everywhere, providing maps in cars and restaurant reviews on pocket gadgets, not just on computers—what people want, where they want it, when they want it.

Timely Information. Research and shopping will become dramatically easier as the internet starts providing not just mountains of miscellaneous information but information people need to support their lives.

Breaking Down Communications Barriers. After a few years of almost

York to buy a sweater from Land's End, but I do it through an online shopping mall that's based in Florida."

"The geographical basis for taxing sales has been blown out the window," Sernovitz declared. "The tax community has to figure out the simple, unobtrusive, fair way to collect taxes online."

Two panel

discussions followed. The first panel focused on the government perspective the taxation of electronic commerce. Because electronic commerce by its nature can cross both global and interstate boundaries, international, state and local governments are actively seeking agreement on how to apportion the income generated by these transactions and the sales and use taxes among taxing jurisdictions to avoid subjecting electronic commerce to onerous multiple layers of taxation. Speaking to this were Michael Hardy, Senior Advisor on Fiscal Affairs and Electronic Commerce from the Organization for Economic Cooperation and Development; Joann Weiner, Ph. D., Economist at the Office of Tax Analysis, Department of the Treasury; and



John Harrington, Majority Tax Counsel, Committee on Ways & Means; and Brigitta Pari, Majority Tax Counsel, Senate Finance Committee.

Harley Duncan, Executive Director, Federation of Tax Administrators.

Finally, on the last panel, representatives of industry imparted the business perspective on the evolution of tax law as it applies to electronic commerce. In particular, they spoke to the issues of complexity and compliance with the law as it exists and as it is evolving. Speakers were Dina S. Shapiro, Vice President, Citicorp; Carla Howard, Tax Counsel, Electronic Data Systems; and Pat Nugent, Director of Tax Legislative Affairs, MCI WorldCom. The conference wound up with a Capitol Hill update from two congressional staffers, Brigitta Pari, Tax Counsel, Senate Finance Committee; and John Harrington, Tax Counsel, House Ways & Means Committee. ●



At left, panelist Michael Hardy, Senior Advisor on Fiscal Affairs and Electronic Commerce at the OECD, talks with Tax Foundation Senior Economist Claire M. Hintz, author of a new primer on the taxation of e-commerce.

meaningless blather about telecommunications competition, we're starting to hear phrases like "free long distance" that mean something to regular people. Also, online communities are huge, with millions of people at any one second talking to each other over the Internet.

Sernovitz finished with a comment on one particular method of taxing electronic commerce that he is convinced can not work.

"I'm a D.C. resident with an E-mail account provided by a California company that also has an office in Virginia, which is my customer service office. I use my laptop when traveling to New



Center back, Dr. J.D. Foster and Bloomsburg University Professor George Agbango are surrounded by the professor's students. They were able to travel from Pennsylvania and join many other students attending the conference thanks to corporations who supported them through the Tax Foundation's College Classroom Project.

Tax Neutrality, Fairness to Small Business, and Internet Taxation Policy

U.S. Senator Bob Graham (D-FL)

For decades, state and local governments have been frustrated by their inability to establish a level playing field for the collection of state and local sales taxes on out-of-state sales, especially catalog sales. The advent of the internet and electronic commerce is transforming this issue from a major nuisance into a huge tax compliance and policy problem.

The recent passage of the Internet Tax Freedom Act provided a three-year moratorium on new state and

"The Advisory Commission on Electronic Commerce is supposed to publish a report within 18 months, but the composition of the commission is troubling, and the problem the commissioners are supposed to be resolving is getting bigger every month."

local internet taxes so that a newly created advisory commission could sort out the best solutions. The Advisory Commission on Electronic Com-

merce is supposed to publish a report within 18 months, but the composition of the commission is troubling, and the problem the commissioners are supposed to be resolving is getting bigger every month. Online retail sales hit \$3.2 billion for the Christmas season just past, and the three-year moratorium on internet taxes is looking more like a three-year tax-free shopping spree.

The Need for Fair, Reliable State and Local Taxes

When sales and use taxes go uncollected, state and local governments lose important revenues and local retailers suffer a competitive disadvantage. And when the states attempt to enforce use tax collection through "nexus" lawsuits, an inordinate amount of time and resources are expended by both the states and the remote sellers involved.

We have today in this country a situation in which if Main Street were divided north and south, all of the stores along the northern part of Main Street are meeting their obligation to collect the appropriate state and local taxes. But the stores on the south side of the same street are treated differently because they are in another jurisdiction. However, the stores on the south side of the street are exempt from the obligation to collect state and local taxes because their sales take place over the Internet or telephone.

This is fundamentally unfair. It is not only unfair to the retail seller on the north side of the street. It is also unfair in that it deprives the community of the resources necessary to pay for police, fire, health, and particularly educational services, the most expensive service that most communities provide to their citizens.

The issue is inexorably linked to internet tax policy. The internet is a form of remote sales; it differs from other forms only in its means of reaching its audience. Although unfair, discriminatory taxation on the internet is what the Internet Tax

FRONT & CENTER

Freedom Act attempted to avoid, it is instead providing the internet with preferential treatment, much to the detriment of state and local governments and conventional businesses.

Don't Tread on the States

This uneven application of sales and use taxes is not only an issue of tax fairness. It is also an infringement on the rights of the states. In this era of devolution of responsibility and federal reticence to provide assistance to states carrying out their most important responsibilities, such as the education of their children, we should not act to prevent them from collecting the revenue they need to fulfill those responsibilities.

The loophole that exists in today's law that leaves most remote sellers free from the responsibility of collecting state and local taxes is

"The loophole that exists in today's law that leaves most remote sellers free from the responsibility of collecting state and local taxes is making tax evaders out of millions of Americans."

making tax evaders out of millions of Americans. These are out-of-state customers who either don't understand that they are supposed to report their purchases and pay the tax, or who realize that the state has no enforcement mechanism whatsoever and therefore have decided not to report the purchases. Either way, the situation is costing states and localities an amount in lost revenue that is



already large enough to begin renovating their schools and meeting other critical needs if they were allowed to collect it.

As electronic commerce grows, especially if it grows at the expense of conventional commerce, the current lack of neutrality and basic fairness in taxation will become more painfully obvious. Our current economic boom is masking the problem by filling the coffers of states and localities. During moderate growth or lean times, we will certainly regret it if we have let this problem fester instead of righting the situation now.

Uncertainty Over the Advisory Commission

My position that the state sales tax collection problem urgently needed resolution was strongly supported as the Internet Tax Freedom Act was being debated. The House, which passed the legislation in June, included not only a directive for the commission to consider the remote sales issue, but also a requirement for the commission to produce a legislative recommendation on that point. In fact, the consideration of remote sales was the condition under which the National Governors' Association and other state and local government groups agreed to negotiate with Congressman Cox in the first place.

Without their agreement to come to the table, it is unlikely that there would have been any chance of passing it last year, and it therefore seems very unfair to disregard this issue of fundamental importance to state and local governments after they negotiated in good faith.

After the House acted, the Finance Committee also recognized the importance of the remote sales issue in its consideration of the Internet Tax Freedom Act by including it among the commission's duties in reporting the bill on a vote of 19-1. In view of all this commitment to resolve the matter, I believe it would be a grievous error to allow the commission to focus mostly on what is good and efficient for the internet industry, without making the resolution of tax collection problems a top priority.

That is why I have acted with a bipartisan group of senators to call upon the Senate leadership to review the appointments to the Advisory Commission on Electronic Commerce to ensure that the composition com-

"Although unfair, discriminatory taxation on the internet is what the Internet Tax Freedom Act attempted to avoid, it is instead providing the internet with preferential treatment, much to the detriment of state and local governments and conventional businesses."

plies with the intent of Congress's original statute.

When Congress passed the composition guidelines for the commission, the new panel was meant to represent all stakeholders involved. This equal representation, established

by the Internet Tax Freedom Act, was to be achieved by including eight representatives from state and local government. The commission was also meant to possess representatives

"If its recommendations are to be seriously considered by Congress, the commission must forge a consensus among all the stakeholders in the taxation of interstate commerce."

from the small business and local retail communities. These requirements have not been met. Only six state and local government appointees were named by the congressional leadership and no main street business representatives were included.

The Council of State Governments and the U.S. Conference of Mayors have sent a letter to President Clinton and members of Congress urging them to realign the membership of the commission to comply with the statute. The state advocates want to ensure that the committee "does not serve as a mechanism to harm or create a bias against local retailers" or "serve as a tax haven to drain vital resources critical to education, health care and public safety."

If the commission's recommendations are to be seriously considered by Congress, the commission must forge a consensus among all the stakeholders in the taxation of interstate commerce. This includes state and local government, companies providing internet access, main street business, and taxpayers. ●

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. The views expressed are not necessarily those of the Tax Foundation.

61st Annual Dinner Reunites Old Friends As Tax Foundation Honors Archer and Snow

When Rep. Bill Archer (R-TX) and CSX Chairman, President & CEO John Snow received the Tax Foundation's Public and Private Sector Distinguished Service Awards at the Foundation's annual dinner in Washington last November, they joined a long and distinguished list of American



At left, John Snow, Chairman, President and CEO of CSX Corporation, is pleased to receive the Foundation's Distinguished Service Award for the Private Sector from 1997's winner, Charles R. Lee, Chairman and CEO, GTE Corp.

business and political leaders that the Tax Foundation has honored.

Two U.S. Presidents have been honored: Herbert Hoover in 1948 (for his role as head of the Commission on Organization of the Executive Branch) and Dwight Eisenhower in 1960. Numerous Secretaries of Treasury have been honored, including Henry Fowler (1966), George Shultz (1974), William Simon (1975), and James Baker III (1985). Some of the most notable congressional leaders to accept the Tax Foundation award include Senator Robert Taft (1949), Chairman of the House Ways & Means Committee Wilbur Mills (1958, 1968), Senator Everett Dirksen (1965), and the father-son team of Senator Harry F. Byrd (1941, 1955) and Senator Harry F. Byrd, Jr. (1973).

In addition, four chairmen of the Federal Reserve System have been honored by the Tax Foundation at its annual dinner: William McChesney Martin, Jr. (1961), Paul McCracken (1971), Paul Volcker (1980), and Alan Greenspan (1992).

Many members of the private sector have also taken leadership positions in promoting sound tax policies, thereby earning the esteem of the Tax Foundation. AT&T Chairman Frederick Kappell (1967), GM Chairman Richard



At left, having received the Tax Foundation's Distinguished Service Award for the Public Sector, Rep. Bill Archer is congratulated by former Senator Harry Byrd, Jr.

Gerstenberg (1972), and GE Chairman Reginald Jones (1977) have been recognized at the annual dinner. In recent years, such distinguished business leaders as Alcoa Chairman Paul O'Neill (1991), Mobil Chairman Alan Murray (1992) and Hewlett-Packard Chairman John Young (1994) have been honored for their contributions to the national fiscal policy discussion. In 1996, the Tax Foundation chose to honor Dr. Norman Ture, long one of the nation's most respected public policy analysts, and a driving force behind the 1981 tax cut. ●

Tax Foundation Distinguished Service Award Winners Selected Years

1941	U.S. Senator Harry F. Byrd	1976	U.S. Senator Russell B. Long	1992	Mobil Chairman Allen E. Murray
1948	President Herbert C. Hoover	1977	GE Chairman Reginald H. Jones		Fed Chairman Alan Greenspan
1949	U.S. Senator Robert A. Taft	1980	Fed Chairman Paul Volcker	1993	USX Chairman Charles A. Corry
1954	Sec. of Agriculture Ezra Taft Benson	1981	Sec. of Defense Caspar W. Weinberger		U.S. Rep. Sam M. Gibbons
1956	White House Chief of Staff Sherman Adams	1982	U.S. Rep. James R. Jones	1994	Hewlett-Packard Chairman John Young
1960	President Dwight D. Eisenhower	1983	CEA Chairman Martin Feldstein		U.S. Senator William Roth
1961	Fed Chairman William McChesney Martin, Jr.	1985	Sec. of Treasury James A. Baker III	1995	Texaco Chairman Alfred C. DeCrane, Jr.
1962	Gov. Nelson A. Rockefeller	1987	U.S. Senator Daniel Patrick Moynihan		U.S. Senator Sam Nunn
1965	U.S. Senator Everett M. Dirksen	1988	U.S. Rep. Bill Archer	1996	Dr. Norman Ture
1968	U.S. Rep. Wilbur Mills	1989	USX Chairman David Roderick		U.S. Rep. Phil Crane
1971	CEA Chairman Paul W. McCracken		U.S. Senator Lloyd Bentsen	1997	GTE Chairman Charles R. Lee
1973	U.S. Senator Harry F. Byrd, Jr.	1990	Young & Co. Chairman William S. Kanaga		U.S. Senator John Breaux
1974	Sec. of Treasury George P. Schultz		U.S. Senator Bob Packwood	1998	CSX Chairman John Snow
1975	Sec. of Treasury William E. Simon	1991	Alcoa CEO Paul H. O'Neill		U.S. Rep. Bill Archer
			U.S. Senator Max Baucus		

FOUNDATION MESSAGE

Welfare to Wealth-fair: The Case for Social Security Reform

President Clinton's State of the Union Address confirmed that Social Security reform is the issue of the year. The Republicans ought to have applauded more because the President has again adopted the better part of a Republican proposal to prevent the Social Security Trust Funds from going broke.

The President's support signals an effective consensus that some of Social Security's current surplus should be invested in private markets. The next step is to decide who will "own" and manage these assets. A consensus may be developing here as well that reform should personalize the pension part of the program so that individuals own and manage some of their current payroll tax contributions.

Today's payroll tax receipts cover current benefits and the excess is used for other government spending. None of the payroll tax receipts collected today are invested in real assets to pay future benefits. Under Social Security reform, initially two or three percentage points of the current 12.6 percent payroll tax would be directed into an account at a regulated financial service company such as a bank or brokerage house. These accounts are sometimes called "Personal Security Accounts," or PSAs. Individuals would invest their PSA money in real assets like corporate equities, corporate bonds, government bonds, and money-market instruments. In effect, worker's payroll tax "contributions" would build a real pension as opposed to contributing to other government spending priorities.

To be sure, the idea of giving individuals ownership and control of more of their retirement income is frightening to some. Many Americans save little or nothing at all outside their company-managed pensions. Unaccustomed to the process, they are concerned about the safety of their investments and their own ability to invest prudently.

Most reform proposals have a long list of safeguards to address these concerns. For example, PSA owners could

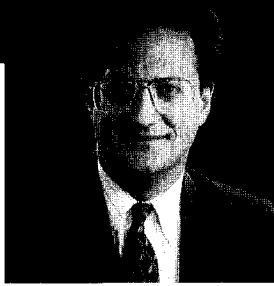
not make premature withdrawals from their accounts. PSA owners would be required to

diversify their investments. They would not be permitted, for example, to make investments in obviously high-risk and speculative instruments like derivatives and options, nor could they invest most of their PSA funds in any one company or industry. And the financial institutions that maintain the PSA accounts would be subject to strict regulation, similar to those on deposit-taking banks today. The government may even set up a special agency to invest PSA savings solely in government bonds for individuals who so desire.

For those concerned about the level of retirement benefits, both current and promised, reform would likely leave the existing benefit structure unchanged. In effect, reform would change the source of the benefit from taxes on workers to personally controlled assets, but would not change the level of benefits.

The political right quickly trumpeted Social Security personalization because it would reduce the level of taxes and government spending and the role of government. The political center is slowing coming around to favor personalization because we have learned that a regulated private sector generally outperforms government. Only the political left has been slow to embrace the principles of personalization. They, too, should soon come around because Social Security reform directly addresses the core goal of the left — elevating the economic status and dignity of workers, including the poor and disadvantaged.

Over the next 10, 20, 30, 40 years shareholders and bondholders will receive hundreds of billions of dollars in dividends, interest, and capital gains. Who are these lucky people? They are



*J.D. Foster, Ph.D.
Executive Director &
Chief Economist
Tax Foundation*

the people who have wealth — people who save or who have inherited the savings of their parents and grandparents. The wonderful thing is that anyone can get a piece of this action by saving and investing prudently. Unfortunately, if you don't save and you don't inherit a chunk of capital from Aunt Bessie's estate, you're left out of the money. In short, the wealthy will get this wealth. The old saw is true — it takes money to make money.

When President Clinton said, "I want every American to have a savings account and have a part of this country's wealth," he was referring to his proposed Universal Savings Accounts, which he wants to enact along with Social Security reform. But a personalized Social Security program can accomplish the same goal. When everyone with wage and salary income is saving and investing in the private sector through PSAs, low- and middle-income workers will own more of America and have a legitimate claim on the economic gains in America's future.

The left should champion Social Security reform because it is a positive and effective means of creating a more level distribution of the wealth in America. The current system condemns payroll tax payers to an abysmally low rate of return on their investment, generally far below that paid even by Treasury bonds. And, because the payroll tax is so high, particularly when added to federal and state income taxes, workers have little extra income to save and invest more wisely.

As a pension system Social Security guarantees workers a minimum benefit, and then virtually condemns them to doing no better. Reform would break this cycle. And the more fully reform returns payroll taxes to the workers to invest on their own behalf, the more completely the cycle will be broken. When Social Security is personalized, the American worker will see his wealth grow over time. He will see manifested in his own Personal Security Account the advance of his economic status and the dignity and security of owning wealth. ●

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Excise Taxes from p. 1**Fundamental Tax Reform and Federal Excises**

Moody suggests in his study that the goals of fundamental tax reform—simpler administration and permanently faster economic growth—would be helped by including excise taxes in the reform. Most tax reform proposals would replace the federal income tax with some form of consumption tax. Since saving is tax exempt under a consumption tax, replacing an income tax with a consumption tax tends to reduce the progressivity of the tax system, everything else held constant.

Since social policy considerations have historically dictated a progressive tax system, a partial solution to the progressivity problem for consumption taxes may be found by expanding the scope of tax reform to include excises. This would help economic growth by promoting neutrality, and it would simplify the tax code because each of these excises imposes its own administration and compliance costs.

The Tax Foundation's excise tax conference

examined the history and policy rationale of various excise taxes, including the telephone excise, the air transportation excise, the federal gasoline excise, and the "sin" taxes.

Tax Foundation Senior Economist Patrick Fleenor presented preliminary results from an upcoming study of the excise tax on beer, and numerous experts from government and industry gave insights about specific excise taxes.

The conference is part of a continuing program of excise tax research and activity at the Tax Foundation. An earlier conference focused on more elementary issues, and several other studies have been published: *The Use and Abuse of Excise Taxes* by Dwight Lee, Ph.D.; *Excise Taxes and Sound Tax Policy* by John McGowan, Ph.D.; *The Regressivity of Sin Taxes* by Andrew Lyon, Ph.D. and Robert Schwab, Ph.D.; *Burning Issues in the Tobacco Settlement: An Economic Perspective* by Jane Gravelle, Ph.D.; and *How Excise Tax Differentials Affect the Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States* by Patrick Fleenor. ●

Tax Foundation Co-Hosts Tax Policy Conference with Baker & Hostetler and PricewaterhouseCoopers

On February 25, 1999, the Tax Foundation will co-host the tenth annual Tax and Budget Policy Seminar with Baker & Hostetler LLP and PricewaterhouseCoopers LLP. A sophisticated analysis of the regulatory, budgetary, and legislative forces that will shape federal tax and budget policy in the coming years, the seminar will once again take place at the Hyatt Regency Capitol Hill, 400 New Jersey Avenue, N.W. The

program will run from 8:00 a.m. to 5:00 p.m., and the cost including continental breakfast and lunch is \$285.

To register or get more information, please contact Pamela Copeland at (202) 861-1679, or print the registration form located on the web at www.taxfoundation.org/bhformfax.html and fax it to Ms. Copeland at 202/861-1783. ●



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