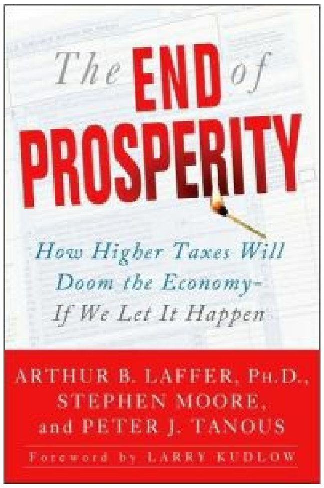

Book The End of Prosperity

How Higher Taxes Will Doom the Economy – if We Let It Happen

Arthur B. Laffer, Stephen Moore and Peter Tanous
Threshold Editions, 2008

Recommendation

Arthur B. Laffer, Stephen Moore and Peter J. Tanous give Ronald Reagan full credit for laying the foundation for decades of U.S. prosperity. They see today's government programs as a return to the worst of Franklin D. Roosevelt's New Deal and Lyndon B. Johnson's Great Society. The authors find it strange that the U.S. is adopting a more European model just as many European countries are moving more toward Reaganomics. They suggest a different path to good fortune: Get government out of the way of individual, entrepreneurial opportunity. If this reasoning persuades you, pay particular attention to their chapter describing how California, once the most prosperous U.S. state, became an economic basket case – a decline that the authors blame on the expansion of government spending, regulations and taxes. Laffer's advocates, including those who also favor a flat tax, see this book as an instant classic; his opponents have already dismissed it. *BooksInShort* suggests it to those seeking a conservative take on current economic policy.

Take-Aways

- America's economic policies will kill the prosperity begun by Ronald Reagan.
- The "Laffer Curve" says that people respond to incentives; in particular, reduced tax rates motivate people to earn and invest and, thus, pay more taxes.
- When John F. Kennedy proposed income tax cuts, some Republicans voted against them.
- Reagan's policies led to lower interest rates and less inflation, a tripling of the Dow Jones Industrial Average and economic improvement at every level.
- Bill Clinton deserves credit for reforming welfare and getting people to work.
- George W. Bush's tax cuts caused the rich to pay more taxes, not less.
- California's fall into fiscal and regulatory hell is a cautionary tale for America.
- European nations that are cutting taxes are enjoying new and greater prosperity.
- Estate taxes are unfair and wasteful. The government taxes earnings and then taxes them again upon death.
- Tariff and trade barrier advocates should examine how the Smoot-Hawley Act contributed to the Great Depression. Its hoped-for benefits never materialized.

Summary

Darkening Clouds Descend on the U.S. Economy

Those who predicted a U.S. economic collapse in the past were wrong. Americans are incomparably richer than they were a century ago. If owning microwaves, color TVs, air conditioners and the like indicates material well-being, they have made substantial gains since 1970. The current generation doesn't remember the Great Depression, the deprivations of World War II or even the 1970s stagflation. They've forgotten President Ronald Reagan's economic transformation. Now, leaders who learned all the wrong lessons from history are advocating policies that will undercut the U.S. economy. Since they don't understand prosperity, they will kill it with mistaken "trade protectionism," "tax increases," "profligate government spending," "new regulations," increased "government intervention in the economy" and bad "monetary policy."

What the "Laffer Curve" Really Says

Dr. Arthur Laffer famously drew the Laffer Curve on a paper napkin at the Hotel Washington in December 1974 as he explained it to Donald Rumsfeld, Dick Cheney and Jude Wanniski, then of *The Wall Street Journal*. These men, later prominent thought leaders under Reagan, cited the Laffer Curve as the reason to cut marginal tax rates. Laffer said reducing income tax payments gives people an incentive to work, invest and earn. When they earn more, they pay more taxes and government revenues increase. He was right and still is. The Laffer Curve has four principles:

1. "When you tax something you get less of it; when you tax something less you get more of it."
2. "The best tax system helps make poor people rich, not rich people poor."
3. "The higher the tax rate, the more damage to the economy and the greater the economic gain from reducing the tax rate."
4. "If tax rates get too high, they may lead to a reduction in tax receipts."

Tracking Taxes

In 1945, Congress cut the top tax rate from 94% to 85%, but, in 1950, Harry Truman raised it to 92%. Senator Robert Taft passed a bill to cut top rates, but Dwight D. Eisenhower vetoed it because he believed taxes had to be high to balance the budget. In the early '60s, John F. Kennedy fought to lower the top marginal income tax from 91% to 70%. While 70% seems high now, lowering it did what JFK wanted and predicted. Tax receipts accelerated and the economy grew. Republicans Barry Goldwater and Bob Dole voted against those rate cuts, but JFK showed that tax payments grow when Congress cuts marginal rates and creates economic incentives.

> "Reaganomics was a wholesale repudiation of the orthodox governing philosophy of the 1970s...a dismissal of Keynesian economics...a frontal assault against big government."

The 1970s were awful for the U.S. economy, from Lyndon B. Johnson's Great Society and Vietnam war costs, to Richard Nixon's foray into wage and price controls, to Gerald Ford's "WIN" buttons and Jimmy Carter's perverse creation of stagflation. Carter thought he could micromanage the economy, but his policies proved catastrophic and unpopular. Californians fought runaway taxes by passing citizen-initiated property tax reform, a movement that swept the U.S. Misunderstanding the national mood, Carter enacted oil price control policies that created shortages. A barrel of oil soared from the mid-$40s to nearly $100. Reagan deregulated oil and the price fell below $40 within a few years. Carter's fecklessness peaked with his depressing 1979 "malaise" speech, which opened the way for Reagan's optimism in 1980.

Reagan's Boost, Bush's Taxes and Clinton's Good Deeds

The U.S. faced double-digit inflation and 21% mortgage interest rates when Reagan cut taxes in 1981. As the recession deepened and the Dow sank below 800, even some of Reagan's advisors lost heart. He held his course and, in 1983, the economy rebounded. By tightening the money supply, the Federal Reserve brought inflation from 14.5% to 4% within two years. Interest rates dropped and U.S. drew capital investment from around the world. The prime interest rate, 21.5% in early 1981, fell to 8.2% by 1987. During the Reagan years, the Dow more than tripled and passed 3,000. The 1980s saw economic gains for all classes and movement of people among classes.

> "The economy will continue to grow. Political leaders who promote harmful economic policies will eventually be replaced and better policies will follow. But in the meantime it makes sense to protect one's assets."

George H.W. Bush promised "No New Taxes," but broke his word under intense media and Congressional pressure. Congress assured him it would use the new revenue to reduce the deficit rather, but promptly spent it all and more. In the 1992 campaign, Bill Clinton reminded the public about that broken vow and promised sound government. Popular memory says Clinton set out to balance the budget, but his proposed budgets still included deficits. The budget came into balance only after a Republican Congress pushed Clinton. Still, his approach to taxes was more moderate than that of previous Democrats and his spending was more restrained. The economy accelerated. Despite warnings of upheaval, Clinton reformed federal welfare, got people off the dole and let them become part of the economic boom. Barack Obama would benefit by heeding the lessons learned by Clinton as he seemingly prepares to return to high taxes and spending.

> "To spur economic growth...enact a flat rate tax."

Criticism of George W. Bush for cutting taxes for the rich confuses marginal rates with actual tax payments. A marginal rate is the tax rate on the last dollar of income earned by a taxpayer. In a progressive taxing system, higher taxes are paid on dollars earned beyond certain stepped thresholds. If you raise a rich person's marginal tax rate so high that earning more money becomes meaningless, the government gets less revenue since the rich person gets no economic reward for investing or earning more income. Instead, lowering marginal rates gives productive people incentives to produce more. This makes them richer, but it also creates jobs and, thus, new taxpayers. Democrats tried soaking the rich to fund social programs, but making one group pay higher taxes usually results in less revenue and growth than they project. Each time the government lowered tax rates, the economy grew more than the dire warnings foretold. Under George W. Bush, the wealthiest people paid more into the treasury and carried a greater share of the tax burden.

California as a Foretaste of Economic Hell

After World War II, California grew rapidly as the land of the American Dream. Its population swelled from 20 million in 1970 to 36 million-plus today. But the state added government spending and regulations faster than population, and now its budget is a mess. Arnold Schwarzenegger was elected governor as a fiscal conservative, but his desire to stay in office led him to permit the legislature to spend huge amounts on unaffordable programs. The state has a deficit of billions. And, the federal trend toward taxation, spending and regulation resembles the state's destructive ways. Californians must recapture the spirit that led to property tax reform in 1978. Until then, the state's economy will fall. The U.S. should not elect Congressional representatives who want to follow its path.

Why Is Europe Cutting Taxes?

Progressive-minded Americans have long pointed to Europe as a model for the transformations they want to make in the U.S. Unfortunately for them, but fortunately for Europeans, the trend in country after country has been to cut income taxes, flatten tax rates, diminish bureaucratic power and peel back regulations that strangle business. Even France has elected its most conservative president in decades because the citizenry knows that its economy cannot afford more socialism. In the mid-1980s, Ireland suffered nearly 18% unemployment. When it cut personal income tax rates, corporate rates and capital gains taxes, it underwent an "economic miracle." By 2000, its unemployment was about 4%. Other nations, especially former U.S.S.R. countries, are adopting supply side economics, a view that the economy will grow if people have incentives to produce, just as America is turning away from this model for prosperity.

Capital Gains and the Laffer Curve

As the past 50 years show, the U.S. Treasury receives less revenue when the capital gains rate is more than 20% than when capital gains are taxed at a lower rate. From 2002 to 2006, capital gains taxes were low and the Treasury received more revenue than expected. Capital gains taxes freeze capital in certain investments. Why buy stocks if taxes take away a chunk of your earnings, even after you pay tax on the income? This blind insistence on extracting every cent from taxpayers yields less money, prevents growth and stunts the tax base. Raising the capital gains tax would be harmful. Instead, cut the tax, preferably to zero, to unleash the nation's economic energy.

Why the Death Tax is Worse than Useless

Oprah Winfrey griped that after paying 50% of earned income in taxes, the feds want 55% of her estate when she dies. The death tax provides little revenue and costs a great deal to enforce. It encourages spending, not saving, and discourages the formation of capital. It defies traditional U.S. values of work, thrift and the pursuit of happiness. While the Republicans passed temporary reductions in the death tax, it is slated to return after 2010.

Why Protectionism Is the Wrong Answer

While experts posit a variety of root causes for the Great Depression, nearly everyone admits that the 1930 Smoot-Hawley Tariff exacerbated global contraction by cutting off world trade. It was meant to protect American businesses, but the retaliation it provoked from many other countries hit U.S. companies very hard. Some say it actually magnified a normal recession into the Great Depression. Closed borders and protectionist policies make countries poorer. Dynamic economies undergo creative destruction, as economist Joseph Schumpeter said, but they also experience compensating growth and they gain the flexibility to adapt to changing conditions. Trade barriers export jobs. They impede economic opportunity far more than free trade ever does.

Why the U.S. Needs a Flat Tax

Governments collect taxes to raise revenue, redistribute income and conduct social engineering. But why do government bureaucrats get to decide who gets what? And when did changing society become Washington's domain? The left favors progressive taxation. They say it is fair to tax more of your earnings as you earn more, so the government can give your money to those they decide should have it. In contrast, a flat tax treats every dollar the same without regard for the earner's wealth. The flat tax is more fair and efficient, and will spur faster economic growth. It eliminates the need for tax avoidance schemes, and costs less for taxpayers and government administrators alike.

Because It Feels So Good When I Stop

The Congress and President have lost control of the budget. They are spending stupendous amounts that the country does not have and are increasing the deficit. Their solution: Raise taxes on the rich. However, the wealthy do not have enough money to solve this problem even if they were taxed 100%. Congressional fiction writers, also known as budget planners, will try to get around this by declaring more people rich and raising their taxes. Furthermore, they want to provide healthcare for all Americans, at a lower cost. How? When federal taxes under Obama's plan are combined with state taxes, they will exceed 57% in New York, California, New Jersey, Iowa and Ohio. Instead, Congress should lower taxes, free up investment capital, smooth global trade, and permit more nuclear power and more oil drilling. Put on your rain slicker – a big, unnecessary, economic storm is coming.

Your Assets During the Storm

Don't bury your money in the backyard. You still need a solid portfolio that exposes you to balanced, systematic risk without overemphasizing one economic sector. Index funds still tend to outperform actively managed mutual funds, and no-load funds tend to be better buys than load funds. This is not the time for mutual funds. If you worry about inflation, consider Treasury Inflation Protected Securities (TIPS). Gold is not as sure an investment or inflation hedge as you might be led to believe. Market demand has distorted its price, and oil's price. Take the long view, be patient, be conservative. Work to restore Reagan's prosperity. Reclaim America as the land of opportunity, freedom and prosperity.

About the Authors

Arthur B. Laffer, Ph.D., "father" of the tax-cut movement, chairs Laffer Associates. **Stephen Moore** covers economics for *The Wall Street Journal* and contributes to CNBC. **Peter J. Tanous,** author of *Investment Gurus,* writes finance books and is CEO of an investment firm.