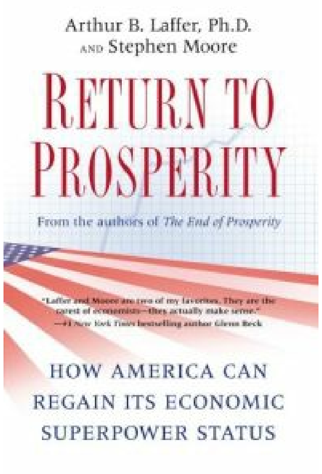

Book Return to Prosperity

How America Can Regain Its Economic Superpower Status

Arthur B. Laffer and Stephen Moore
Threshold Editions, 2010

Recommendation

Prominent economist Arthur Laffer is a contrarian's contrarian. He urges trade with North Korea and Cuba, dislikes unions, despises stimulus packages, loves the flat tax and espouses offshore drilling in the Gulf of Mexico (note, though, that the book predates the oil spill catastrophe there). The inventor of the Laffer curve (which says, not without debate, that cutting tax rates for rich people ultimately produces more government revenue) offers evidence for each of his zingers, though he meanders at times, and his points are sure to raise hackles. He issues economic warnings with the intent that "you should be scared," yet this isn't a partisan book – Laffer's informed insights, criticism and praise extend to both sides of the political aisle. He productively draws upon his own professional and personal experiences. When he writes that Americans are leaving high-tax states to move to low-tax states, he notes his own shift from California to Tennessee. Laffer is a supply-side conservative, but he voted for Bill Clinton, and he explains why. *BooksInShort*, which recommends books but takes no political stands (the opinions in the Abstract are the author's), suggests this analysis to policy makers and students of economics who welcome a curmudgeonly but deeply experienced perspective.

Take-Aways

- Weighed down by trillions in unfunded liabilities, the U.S. economy faces collapse.
- Profligate spending under Presidents George W. Bush and Barack Obama has caused the nation's debt to balloon.
- Both presidents responded to crises in exactly the wrong way – with costly, misguided stimulus packages.
- Governments can boost revenues not by raising capital gains tax rates or income tax rates for the rich, but by lowering them.
- Americans pay tax preparers billions to meet the hopelessly confusing, complex tax code.
- The middle class is not being squeezed out of existence; it is growing ever wealthier.
- Prices of consumer goods have fallen steadily over the past three decades.
- A flat tax, which is simple, easy to comply with and void of misguided disincentives, is the sanest system.
- The U.S. government foolishly imposes trade embargoes on North Korea and Cuba, sanctions that only help prop up dictators.
- The U.S. should encourage offshore drilling if it is strictly regulated.

Summary

Warning: Financial Train Wreck Ahead

The U.S. economy is in the midst of a "disastrous trend" of overspending and overtaxing that threatens the nation's prosperity. After a period of fiscal sanity under President Bill Clinton, Presidents George W. Bush and Barack Obama ratcheted up spending to unsustainable levels. In 2001, the interest on the national debt cost about 6.5% of federal tax receipts. By 2010, it soared to 25%. With presidents and legislators unwilling to show fiscal discipline, unfunded liabilities soared to $65 trillion in 2008. Social Security ($18.7 trillion) and Medicare ($33.2 trillion) accounted for much of that amount, and pensions for military personnel and civilian government employees totaled $2.7 trillion. With federal tax collections at $2.2 trillion a year, a looming liability of $65 trillion is staggering. To put those numbers in perspective, $65 trillion in liabilities equates to $557,745 per U.S. household. These liabilities represent a stone wall, and the locomotive is headed straight for it.

> "If economics is about anything, it's about the use of incentives to maximize our collective welfare."

Even though the U.S. economy is facing such a train wreck, governmental leaders seem oblivious to the realities of basic economics. The Bush and Obama administrations spent about $3.6 trillion on stimulus packages. If, instead, they had declared an 18-month federal tax holiday, U.S. unemployment now would be 3%, not 10%. Elected officials continue to push farfetched stimulus programs. Consider the "sparkle-headed" Cash for Clunkers program that rewarded taxpayers for purchasing new cars and trading-in old ones, which – according to the program's rules – had to be destroyed. This manipulation of demand boosted General Motors and Chrysler, which had run themselves aground by overpaying unionized workers, but it defied common sense. If giving car buyers $4,500 each to stimulate auto sales was good, why not more? To really grease the auto industry, Washington could have parked all cars older than three months. That would have sparked a car-building frenzy. Seriously, any stimulus designed to help a specific industry, be it autos or housing, does little to strengthen the overall economy.

> "This book is all about the political economy in the old sense of the phrase – a melding of economics and politics. Economics...has little meaning unless applied, and when applied by government it's always political."

Ignorance of economic basics can extend to both sides of the political aisle. Obama and Bush pursued foolish policies such as bailouts and trade embargoes. In contrast, Clinton pushed wise economic policies. He advocated for the passage of the North American Free Trade Agreement (Nafta) despite strong opposition from labor unions and the Democratic Party. He cut government spending, reined in Social Security benefits, pared welfare rolls and reduced the capital gains tax rate. And, he kept Federal Reserve Chairman Alan Greenspan, originally a Reagan appointee.

> "What we have today in the United States is an economic policy, and most specifically a tax policy, that has gone far off course."

Clinton's successor gets lower marks for economic acumen. The 2008 Bush stimulus package gave $600 to everyone who filed a tax return. This sent the wrong message. It didn't give an incentive for working or for taking risks; it rewarded taxpayers who didn't work. If governments truly could stimulate the economy by paying citizens to do nothing, stopping at $600 per person seems shortsighted. Why not give every taxpayer $6,000, or $600,000? Such pointless stimulus packages only take money from one part of the economy and shift it to another. Washington, D.C. could curb its addiction to spending by taking three simple measures:

- **No more sweet benefits for public employees** – End public pensions. Give politicians and government workers health benefits similar to those available in the private sector.
- **No more "earmarks" or "last-minute votes"** – Ban sneaky spending on earmarks. Require legislators to finalize their bills two weeks before a dispositive vote.
- **Give the president line-item veto power** – Allow the president to reject individual budget items and give the Senate power to overrule his veto with a 60% vote.

> "The government cannot give anybody anything that the government does not first take from somebody else."

Raising the capital gains tax rate and boosting rich people's income taxes are not the best ways for government to raise more money. The best strategies are the opposite. Cutting tax rates on the rich and on capital gains spurs tax collections. President John F. Kennedy proved this when he cut tax rates on capital gains, dividends, corporate incomes and the incomes of rich Americans. The trend has stayed strong. In the early 1980s, when top tax rates were higher, the richest 1% of taxpayers carried less than a fifth of the tax burden. By 2007, "the top 1% paid over 40% of all income taxes" in the U.S. To continue this trend, the U.S. should make President George W. Bush's tax cuts permanent and end the alternative minimum tax.

> "Not only is it impossible for a poor person to spend himself into prosperity, it's also impossible for a country to borrow itself into prosperity."

At the opposite end of the spectrum, the minimum wage rose 41% from $5.15 an hour in 2007 to $7.25 an hour in 2009. While this increase is politically popular, it hurts those it intends to help. If employers must pay more for unskilled workers than these laborers contribute to the bottom line, employers won't hire. Unions supported raising the minimum wage, but unions themselves have become a corrosive force in the economy. They push for unjustified pay increases and benefits. Unions are disappearing from the U.S. private sector, but they're thriving in the public sector, one reason many public entities face huge pension deficits. Unions, which wield huge political clout, need to be revamped. The U.S. should not let teachers, cops, firefighters and public employees strike or engage in partisan politics.

> "The poor actually spend less money now than 20 years ago on such necessities as food and clothing, meaning they have more disposable income for other purchases – call it the Wal-Mart effect."

The president and legislators often pursue misguided protectionist policies under the guise of self-sufficiency. Take the refrain that the U.S. must curb its dependence on foreign oil. This "silly" notion somehow has persisted since the 1950s. Oil is produced and traded in a global market; no protectionism will change that. The U.S. needs oil; other nations – Saudi Arabia, Venezuela, Nigeria and others – have more oil than they can use. By buying oil from them, the U.S. gets a commodity it needs and oil-producing nations earn money they can spend on other products. By the same token, the U.S. should pursue offshore oil drilling under stringent environmental rules. Opponents argue that a spill would cause environmental damage. By discouraging offshore drilling in the U.S., American authorities shift it to areas such as Indonesia, where environmental regulations are far looser. Opposition to nuclear power is another example of Washington's energy cluelessness. Americans consider nuclear power too dangerous, yet France generates most of its power from nuclear plants, and has clean air and an admirable safety record.

> "Americans are not made poorer because Bill Gates, Warren Buffett, Tiger Woods and the Walton family have gotten fabulously wealthy."

Washington has another foolish notion – that trade embargoes can transform nasty leaders into benevolent ones. The 60-year trade blockade against North Korea has done nothing to make it a prosperous democracy. The decades long Cuban embargo has not weakened Fidel and Raul Castro. To the contrary, it provides a convenient enemy, and prolongs their popularity and power.

The $4 Trillion Burden

The United States' tax system is crippling the country. Federal, state and local tax collectors take in $4 trillion a year, nearly a third of gross domestic product. In addition, citizens pay accountants and attorneys billions to tell them how much they owe and to help them comply with the ridiculously confusing federal tax code. The code is so complex and befuddling that many professionals can't make sense of it. In 2007, *USA Today* reported that five different tax preparers gave one particular family five different tax-bill estimates. The tax preparation industry has ballooned, employing more people than the top five *Fortune* 500 companies combined and taking in some $65 billion in revenue. A number of Obama's top advisers, including Rahm Emanuel, Tim Geithner and Hilda L. Solis, have had tax problems – not because they're tax evaders but because the rules confound even astute, sophisticated people.

> "If you want to get more tax revenue from the rich, you've got to make the rich richer, and to make the rich richer, you've got to lower tax rates."

Taxes skew investor behavior. Tax-exempt bonds, for instance, pay far lower yields than taxable bonds, but investors accept lower returns to gain tax protection. In another example of the hidden costs of taxes, migration patterns show that people are moving from high-tax states such as New York, New Jersey and Ohio to low-tax climes such as Florida, Nevada and Texas.

Easing the Capital Gains Tax

Capital gains taxes are not indexed for inflation, so they unfairly tax more than they should. When people hold investments for years, some of their taxed gains are "illusory" because inflation consumes them when inflationary cycles occur. The capital gains assessment is a double tax, because people must pay on an investment's value and its yield. In a final injustice, taxpayers must pay all capital gains, but they can write off only a portion of capital losses. In tough times, governments often raise capital gains tax rates, but that, too, is counterproductive. Cutting the rate boosts collections, while raising it causes capital gains tax revenue to wither. This happens because people adapt to higher capital gains taxes by choosing when to cash in their gains. If rates are prohibitive, investors don't sell assets. They benefit from flexibility that those who earn income on a regular schedule do not enjoy.

> "The fundamental problem with plans to redistribute income is that they don't take actual human behavior into account."

The estate tax is also counterproductive. Proponents say it helps distribute wealth by preventing rich families from passing their money from one generation to the next. Estate taxes, which can reach confiscatory levels of as much as 55%, give well-off taxpayers little incentive to leave money to their children or grandchildren. Instead, the government is encouraging people to spend their money before they die. State-by-state differences in estate taxes encourage the wealthy to move away from states with estate taxes, such as Ohio, to states without the tax, such as Florida. Estate tax supporters note that only 2% of Americans will ever pay it; in fact, no one should have to pay it. Ineffective and unfair, the estate tax should disappear.

> "Far from disappearing, the middle class has been getting steadily richer over time."

While capital gains taxes, estate taxes and high income tax rates on the wealthy are counterproductive, populist rhetoric claims otherwise. Those who would raise taxes on the wealthy commonly cry that while the rich get richer, the middle class gets squeezed. To prove it, they point to data showing that the wealthiest 1% of Americans earned only 8% of the nation's income in 1980 but 22% of the nation's income in 2006. These figures are correct, but they ignore the reality that everyone in America is prospering. Instead of being pushed out, the middle class is growing ever wealthier. For instance, the middle 20% of Americans saw their household incomes rise from $38,600 in 1983 to $42,500 in 1993 and $50,200 in 2005.

> "One generalization, in my opinion, is critical to understanding policy-making [anywhere]: Whenever people make hasty decisions when panic stricken or drunk, the consequences are almost always ugly."

The prices of many consumer goods have plummeted even as their quality has increased. Thus, the poor spend a lower percentage of their income on consumer goods. A mobile phone cost $4,600 in 1987; now it costs $46 – and comes with better service and more features. A Sears "side-by-side fridge-freezer" cost the equivalent of 140 hours of pay in 1975, but only 80 hours by 2006. A table saw that cost 52 hours of work in 1975 cost only seven hours of work in 2006. This economywide "Wal-Mart effect" eases the burden on the poor.

> "Treasury Secretary (Henry) Paulson's [stimulus package] decision was a classic panic decision and the consequences have been ugly."

Incomes for the rich have accelerated faster. For the top 20% of households, income jumped 47% from 1993 to 2005, but it rose just 9% for the bottom 20%. With any luck, a family didn't stay in the bottom quintile for that entire period. Racial and gender gaps in income are fading. A Pew Charitable Trusts study found that two-thirds of children from poor households grow up to make more money than their parents did. While deplorable inner-city public schools pose an obstacle for the poor, these statistics show that income mobility remains alive and well in America. Wealthier households make more, not only because of their huge paychecks but also because more people in the household work. The top fifth of households by income had 2.1 workers per home, compared to the bottom fifth's 0.5 workers.

> "It's my belief that good economics always turns out, ultimately, to be good politics."

The rich pay the most taxes, so tax policy that helps them become richer is the surest way to earn more tax revenue. The wealthiest 1% of Americans paid a bit more than $100,000 per filer in taxes in 1981 (adjusted to 2005 dollars); that soared to $288,000 in 2005. While lowering their marginal tax rates would be good, a flat tax that killed progressive tax rates would be even wiser. All citizens would pay the same percentage of their incomes, the rich wouldn't face a disincentive to work and people could prepare their own tax returns. Governments would adapt to stable revenue streams and end the current cycle of gorging during booms and starving during busts.

About the Authors

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