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THE "LAFFER CURVE" IS NO JOKE -

THIS TAX REVOLT IS REAL

Speech by Bosworth Todd, Louisville Rotary Club

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Day before yesterday I heard a gentleman from the New York office of Daiwa Securities discuss the Japanese economic miracle. He said that while Japan's wholesale prices rose 20% last year their consumer price index rose only 7 1/2%. Why? Productivity rose 12%. Japan produces 40 cars a year per worker, we produce 10. Their steel production per worker is almost twice our level. They have successfully tested a combination diesel/electric car that averages 100 miles per gallon which can be mass produced at reasonable prices. Hitachi has developed lettuce that matures in only eight days.

In yesterday's "New York Times", an article on the semiconductor industry reports that the Japanese, even with a late start, were successful in gaining a 40% share in the 16,000 bit memory chip and are aiming to get a higher share in the next generation 64,000 bit computer memory chip. Last year, U.S. semiconductor companies had $2 bil. in foreign sales. The industry is growing 25% a year. This can be an extremely important export market for us in the 80's, yet Hewlett Packard shook up the semiconductor industry this spring when it reported that chips it bought from Japanese suppliers had a defect rate one-tenth that of American made chips. James Fallows, in an article on American industry in last month's "Atlantic Monthly" says that this difference is higher Japanese investment in automated assembly equipment.

What goes on here? The economist, Pierre Rinfret, says we risk becoming an industrial museum, like England.

Japanese capital investment, per capita, is twice our rate. Their savings rate is at least four times as much. We now have the lowest productivity rate in the industrialized world, near zero.

As our growth rate declines, demand for compensating public programs increases disproportionately. Pressure to finance these programs with inflationary deficits, already strong, becomes irresistible. As the tax base declines, inflation becomes self accelerating; and as the cost of public services rise, the quality falls.

The appearance of our economic maturity - or senility - is a policy induced illusion. The Dean of the Management School at the University of Rochester says that if we are reaching the end of the era of dramatic economic growth, it is "not because we are running short of energy; we are not. It is not because we are confronted with ecological disaster; we are not. It is because government is destroying the incentives which are the well-springs of economic growth."

Our economic difficulties are often described as stagflation. Federal tax revenue in the years since 1974 has grown steadily as a proportion of GNP. In fiscal 1981 they are projected to exceed 22%, the biggest since World War II. Legislated tax increases, including Social Security, are pushing people into higher brackets.

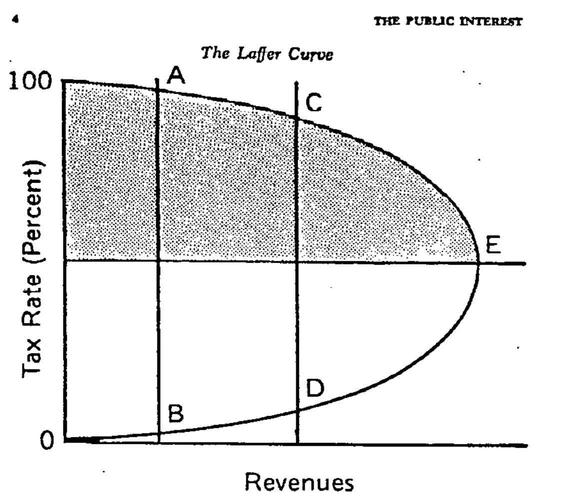
A family of four with one wage earner making $18,000 four years ago needs to make $27,000 next year just to keep pace with inflation. But with higher tax rates at the increased earnings level, such a family's real after tax income over the four year period would have shown a five percent decline. We need look no further to explain the changing orientation of the American voter and the tax revolt.

Happily, there is a gathering recognition of just how government can influence growth. Political dialogue in this election year has dramatically focused on the issue of tax cuts as a remedy to our economic ills.

In 1813 a British Member of Parliament made a mistake as he was drafting an extension of the heavy tax on tobacco imports and a fourth of the tax was allowed to lapse. Before the error could be rectified, the revenues from this tax - which had been declining for several years - shot up 700,000 pounds.

This is an example of the phenomenon best described by something called the Laffer Curve - which expresses a simple concept: lower tax rates, by increasing incentives, can <u>increase</u> tax revenues.

The Laffer Curve turns back on itself and looks like a snub-nosed bullet in flight. Arthur Laffer, an economist at U.S.C., whom we've had the opportunity to meet with on several occasions, explains that there are always two tax rates that yield the same tax revenues. A zero tax, for example, yields nothing because it takes nothing. A 100% tax also yields nothing because it seeks to take everything - and thus totally eliminates incentive. Somewhere between these two rates - at the tip of the snub nose of the Laffer Curve - increasing tax rates yield decreasing tax revenues because of decreased incentive.



The concept is far from new. In 1756, David Hume wrote that "exorbitant taxes, like extreme necessity, destroy industry by producing despair." Two hundred years ago Adam Smith, in the closing pages of the "Wealth of Nations" said: "...it might perhaps be more proper to lighten than to aggravate, the tax burden and to endeavor to draw revenue, not by imposing new taxes, but by preventing the embezzlement and misapplication of the greater part of those which they already pay."

Laffer's critics contend that his work is simplistic and unscientific. But Laffer has always conceded that he cannot quantify his concept - that he cannot predict precisely where the curve will turn, and where higher taxes will start producing lower revenues, or at what rate. The

Laffer Curve is a compelling concept, not because it is based on elaborate statistical evidence, but because it expresses common sense. You can't raise taxes indefinitely without sooner or later discouraging people from the activity - working or investing or consuming - that produces the tax revenues. Cutting prohibitively high tax rates can result in a surge in production without being inflationary. It can also do wonders for the stock market. Let's look at some examples.

At the conclusion of World War I the high tax rates were left in place by the Democrats with the idea that the revenues would go toward paying off the $24 billion public debt. Instead the U.S. slid into a recession. In the 1920 elections the Republican candidate, Harding, called for a return to normalcy on tax rates. He said: "I believe the tax burdens imposed for the war emergency must be revised to the needs of peace and in the interest of equity and distribution of the burden."

Harding won by the greatest landslide in the history of presidential elections. Coolidge, who succeeded Harding as president upon Harding's death in 1923 shortly thereafter gave a speech in New York which was a lucid discussion of the stifling impact of high tax rates. He said: "The first object of taxation is to secure revenue. When the taxation of large incomes is approached with that in view, the problem is to find a rate which will produce the largest returns. Experience does not show that the higher rate produces the larger revenue. Experience is all in the other way."

As it gradually became clear throughout the year 1924 that the Coolidge tax cut bill had sufficient support for passage, dramatically cutting the top personal income tax bracket to 25%, the Coolidge bull market got underway. The stock market then quadrupled in 5 1/2 years.

It is ironic that the current history of that era makes no mention of the relationship between the dramatic personal tax cuts and the Coolidge bull market.

Perhaps the most dramatic single contemporary example of the Laffer principle comes from Soviet Russia, where farm workers are allowed to keep only 10% of what they produce. In other words, the effective tax rate is 90%. But there is a loophole. Farmers are permitted to maintain one-acre private plots of their own and keep all they produce. So the tax rate on these plots is zero, and this tiny Soviet tax shelter - only 1% of all cultivated land - produces an incredible 27% of Russia's total agricultural output.

The miracle of post-war German recovery began in 1948 when Finance Minister Ludwig Erhard was finally able to reduce wartime tax rates. Japan delayed cutting its wartime taxes until 1950, and only then could its fantastic recovery begin.

In every year since 1950 Japan has cut tax rates at the margin on personal and business income either directly through rates or indirectly through tax preferences. Budget surpluses are thus given back to the private sector to spend. Economic growth has been spectacular, as mentioned earlier, with GNP rising from $16 billion in 1952 to $300 billion in 1972 and today is almost half our own. Japan has consistently stayed in the lower portion of the Laffer Curve.

The early 1960's have been called the golden economic age in our postwar years. It was due to the Kennedy-Johnson tax cuts of 1962-64, coincident with the Kennedy round of tariff reductions of 1964. The highest rates were slashed from 91% to 70% while the lowest rates went from 20% to 14%. In addition a variety of business tax rate reductions were made.

From 650 at the end of 1962 the Dow Jones Industrials rose to over 1000 by January, 1966. Inflation averaged between 1% - 2% throughout this period. Unemployment fell from 6.7% to 4%. Interest rates were 4 1/2% to 5%. Real GNP grew at a 5.5% rate. By 1965 we were spending 50% more on defense per dollar of output than we are today.

The U.S. was in marvelous condition in early 1966 but in March, 1966 restrictive tax changes were enacted at the President's request. Excise tax cuts were postponed, and income tax payments were accelerated. The U.S. economy was now heading up the Laffer Curve. Vietnam spending rose. Rather than cut back on the absolute level of domestic spending to accommodate it, Johnson pushed through his 10% surtax.

Jude Wanniski, in his book,"The Way the World Works", says it was probably this surtax that gave Richard Nixon his narrow victory over Hubert Humphrey in 1968. Nixon had steadfastly pledged to end the Johnson surtax and balance the budget. Humphrey, oblivious to the importance of this issue, remained firmly tied to Johnson, who insisted that continuation of the surtax was necessary.

After his election Nixon then changed his mind and extended the surtax. This was a mistake. The economy drifted into the 1969 recession, which of course meant a loss of tax revenue several times the expected gain in the surtax revenues Nixon was seeking to preserve. Even worse Nixon later repealed the investment tax credit and tightened the tax treatment of capital gains, which instantly halved the potential rewards from high risk entrepreneurial investments. The Treasury estimated that this reform would add $1.1 billion to revenues in 1970 and by 1975 increase revenues by $3.2 billion a year. Instead 1969 revenues of $7.1 billion fell to an average of $4 billion in the following four years.

In April, 1978, when the Dow was at 750, Representative William Steiger, a Republican from Wisconsin, introduced an amendment to a tax bill that would roll back the capital gains tax to its 1969 level, from roughly 50% at the top to 25%. According to one study, it would have produced, by 1983, a $98 bil. increase in GNP; a $46 bil. increase in capital; $33 bil. in Federal revenues, and 1/2 million new jobs. Steiger who was not widely known, determined that he had a majority of the House Ways and Means Committee favoring the amendment. The news totally upset the Administration's plans for the economy.

The stock market did the same calculation with almost no delay. The result was a 65 million share twenty point rise on April 14, and another 100 points in the subsequent three months. Shortly thereafter the peak capital gains tax rate was reduced to 29%.

Legislation currently proposed, if enacted, is quite bullish for the stock market. On July 2, 1980 Alan Cranston, Senate Majority Whip, introduced two bills in the Senate. One provides for reduction of the maximum capital gains tax rate from 28% to 21%. The other provides for establishment of an investment rollover account whereby taxes on long term gains and securities would be deferred if proceeds were invested in another security (much like the rollover provision available to home owners). Hallelujah! It's long overdue.

The effect of these proposals will be significant. Goldman Sachs recently estimated that the reduction in the long term capital gains tax rate alone could add 10% to the market value of stocks. Deferral of the capital gains taxes, which could result in a zero tax for many years, could add 18-20% to stock value, according to their study.

No wonder that the stock market rose almost 100 points on the Dow subsequent to this July 22nd proposal.

The legislative process virtually insures that Cranston's proposal will be moderated through amendment. However, the quantitative impact of these proposals, though considerable, is not as significant, in my view, as the fact that liberal politicians are now joining their conservative colleagues in accepting the idea that tax reform designed to stimulate investment is essential. Whether it be the Cranston proposal, the "10-5-3" package of accelerated depreciation, tax policy now seems geared to stimulating growth - a welcome change, indeed.

One of the most articulate spokesmen for an American Renaissance is Congressman Jack Kemp. The Kemp-Roth proposal would apply the Laffer principle massively by slashing the personal income tax rate a third in the next three years. Congressman Jack Kemp was reelected to Congress by a 95% margin in 1978 and his crusade for tax reduction has made him a force in national politics this summer. The pollsters are discovering that his proposal becomes even more popular with voters when linked to mandatory cuts in government spending, a proposal Senator Nunn introduced in 1978. Kemp picked up on one of President Kennedy's themes that "a rising tide lifts all boats". He asserts that the U.S. has been operating at only half its potential and the chief encumbrance has been the "wedge" inflation, and especially income taxes. These inhibitions have bred cheating and strife and the solution is a national commitment to dynamic growth. He asserts that his Kemp-Roth bill is anti-inflationary and that by narrowing the barrier between effort and reward you increase the willingness and ability of individuals to supply the marketplace.

The Republicans adopted it and it became the Reagan bill. On June 25 the Republicans in joint press conferences announced their proposal for a 10% across the board cut in income taxes and also endorsed the "10-5-3" proposal for faster write-offs of assets. The cuts total $39 bil.

In his press conference Reagan said: "A tax cut to restore investment, production and incentives - tied to a convincing reduction in the rate of increase in Federal spending - is the only means to achieve the magnitude of growth in the economy necessary to balance the Federal budget...the phased in tax cut approach is just the first installment of an overall program to get the country back on its feet and moving again - a program to steadily reduce today's stifling tax burdens on citizens and businesses, large and small."

Carter then lambasted it as totally irresponsible and nothing but a gift to the rich. Actually opponents have sprung up from all sides and it is not merely a partisan political debate. But for the first time in decades the Republicans, as Senator Moynihan recently noted, are becoming the new populists and the Democrats are being penned into a corner as the establishment and obstructionists. The Senator noted the inroads Reagan is making among blue collar workers, warning his party not to take this trend lightly.

President Carter responded. Three weeks ago he reversed his earlier position and proposed an economic revitalization plan which would reduce taxes $27 billion next year. Significantly, business would get more than half of the relief, but it would increase Federal spending $4 billion during the two years beginning October 1. As the "Wall Street Journal" editorialized, the main merit in the tax cut Mr. Carter has proposed is in liberalization of depreciation allowance for business which will make some new equipment purchases more attractive. This, however, is overshadowed by the futility of a very modest tax credit to offset part of the sharp increase in the Social Security wage tax due next year. His plan of giving cash, in the form of an investment credit, to money losing companies appears to me to be a stimulus to inefficiency.

Carter's reason for doing so little to reverse economic stagnation is that any genuine measure to slow the Federal spending and taxing increases might exacerbate inflation. But at least it's a beginning.

But you do not cure inflation by raising taxes. If that were the case it is unlikely the inflation rate could have tripled over the last three years when Federal tax receipts were rising 50%. Inflation can be cured by sound central bank money growth control along with Federal policies that do not discourage production and the efficient use of resources. It is not necessary to be dogmatic about the Laffer Curve to argue that on the record of the last three years arresting the rise in tax rates, particularly as it affects investment and incentive, it is more likely to reduce inflation than continuing to pile on additional taxes. Obviously Federal spending must also be brought under control.

Lower tax rates are essential if we are to improve our competitive position in world markets and reinstitute incentives for growth in our economy. The resulting higher stock prices could allow for increased capital formation, benefiting labor productivity and the current high rate of inflation. Tax relief is essential to achieve an improved investment environment. It is essential if financial assets are to once again provide real returns to investors after the impact of inflation and taxes. Over the last 10 years, sadly, neither stocks, bonds, nor Treasury bills, have provided investors total returns that even matched our 8.0% inflation rate, to say nothing of the tax impact.

So the Laffer Curve is an elementary idea: that public policy, moving uncritically in the direction of rapid spending increases, eventually reaches a point where it becomes counter-productive in its own terms. In taxation, in regulation, in every area of public policy, more tends to become less. It's time to change.