

Laffer Associates

August 15, 2006

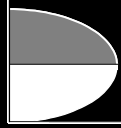
Re: Reaganomics at 25

This past weekend, Steve Moore and our friends over at the *The Wall Street Journal* published a very nice article noting the passing of the 25th anniversary of the beginning of the Reagan Revolution. Given that it ran in the Weekend Edition, I thought I'd call your attention to it in case you were out enjoying the sunshine and missed it.

The past 25 years have been a non-stop thrill ride, and I hope the next 25 are just as fun and exciting!

Warmest Personal Regards,

ABL



REAGANOMICS AT 25

The Wall Street Journal

August 12, 2006

Page A8

Twenty-five years ago this weekend, Ronald Reagan signed the Economic Recovery Tax Act. The bill cut personal income tax rates by 25% across the board, indexed tax brackets for inflation and reduced the corporate income tax rate. The anniversary is worth commemorating as a seminal moment that continues to influence policy for the better in the U.S., and around the globe.

The achievement of Reaganomics can only be fully understood by recalling the miserable state of affairs a quarter-century ago. *Newsweek* summarized the national mood when it wrote in 1981 that Reagan "inherits the most dangerous economic crisis since Franklin Roosevelt took office 48 years ago."

That was no exaggeration. The economy was enduring a cycle of rising inflation with growing levels of unemployment. Remember 20% mortgage interest rates? Terms like "stagflation" and "misery index" entered the popular vocabulary, and declinists of various kinds were in the saddle. The perception of American economic weakness encouraged the Soviet empire to ever bolder adventures, as reflected by Soviet tanks in Kabul and Communists on the march in Nicaragua and Africa.

The reigning Keynesian policy consensus had no answer for this predicament, and so a new group of economic ideas came to the fore. Actually, they were old, classical economic ideas that were rediscovered via the likes of Milton Friedman and the Chicago School, Arthur Laffer, Robert Mundell, and such policy activists in Washington as Norman Ture and Jack Kemp, among others. These humble columns under our late editor, Robert Bartley, led the parade.

For every policy goal, you need a policy lever, Mr. Mundell likes to say. Monetary restraint was needed to break inflation, while cuts in marginal tax rates would restore the incentives to save and invest. With Paul Volcker at the Federal Reserve and Reagan at the White House, those two levers became the essence of the "supply-side" policy mix.

The results have been better than even some of its supporters hoped. The Dow Jones Industrial Average first broke 1,000 in 1972, but a decade later it was barely above 800 -- one of the worst and most enduring bear markets in history. In the 25 years since Reaganomics, however, the Dow has climbed to about 11,000, accounting for an increase in national wealth on the order of \$25 trillion. To match that increase in percentage terms, the Dow would have to rise to some 150,000 in the next quarter century. American living standards have risen steadily, and U.S. businesses have created entire industries that didn't exist a generation ago.

Obviously, the economic policy path from 1981 to the present day has not been a straight line. The biggest detour occurred from 1990 through 1994, when George H. W. Bush and Bill Clinton forgot the Gipper's lesson and raised marginal income-tax rates; they suffered for it in the elections of 1992 and 1994. The arrival of the Gingrich Republicans in Congress stopped this slow-motion repeal of Reaganomics, however, and even helped to extend it at the margin with a cut in the capital-gains tax rate to 20% in 1997.

Adherents of Rubinomics -- after Clinton Treasury Secretary Robert Rubin -- are still not converts, arguing that tax increases are virtuous if they reduce the deficit. We've addressed that argument many times and will again. But even the Rubinites haven't dared to repeal indexing for inflation (which pushed taxpayers via "bracket creep" into ever-higher tax rates), and even the most ardent liberals don't propose to return to the top pre-Reagan income tax rate of 70%. They also now understand that, at some point along the Laffer Curve, high rates begin to yield less tax revenue. The bipartisan consensus in favor of sound money has also held.

Thus today, the top marginal personal and corporate tax rates are 35%, compared with 70% and 48% in 1981. In the late 1970s the tax on dividends was 70% and the capital gains rate was 50%; now they're both 15%. These reductions have increased the rate of return on capital, and hence some \$3 trillion more was invested by foreigners in the U.S. between 1981

and 2005 than was invested by Americans abroad. One result: 40 million new jobs, more than the rest of the industrialized world combined.

The rest of the world, meanwhile, has followed the Gipper down the tax-cut curve. Daniel Mitchell of the Heritage Foundation finds that the average personal income tax rate in the industrialized world is now 43%, versus 67% in 1980. The average top corporate tax rate has fallen to 29% from 48%. This decline in global tax rates has been the economic counterpart to the fall of the Berlin Wall. Most of Eastern Europe has adopted flat tax rates of 25% or lower, and the Russians now have a flat income tax of 13%. In Old Europe, Ireland's corporate and personal income tax rate cuts have helped generate the swiftest economic growth in the EU.

Not bad for a President dismissed as a dreamy former actor. In his 1989 farewell address, Reagan said that "People say that I was a great communicator. It would be more accurate to say that I communicated great ideas." He was right, and a remarkable global prosperity has followed in his wake. The challenge for current and future political leaders is not to forget it.

Down the Laffer Curve

Top income tax rate

	1980	2004
Australia	63%	47%
Canada	60	39
France	60	48
Germany	65	46
Ireland	60	42
Italy	72	47
Japan	75	50
Korea	89	40
Spain	66	35
Sweden	87	54
Switzerland	31	26
U.K.	83	40
U.S.	70	35
OECD Average	67	43

Sources: OECD and The Heritage Foundation