

# **It Pays to Cut Taxes**

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## Preface

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At a time when much economic debate is devoted to the relative merits of tax cuts or increased spending, the Adam Smith Institute felt that some consideration should be given to the effectiveness of tax cuts, particularly at the upper levels, in achieving greater revenues. There is now an established and documented history of the effect which tax cuts can have in increasing both the revenue yielded, and the proportion of it which is paid by upper income earners.

There is a theoretical framework in terms of marginal incentives, and a massive weight of empirical evidence to show when the predictions of theory are achieved in practice. In order to put these ideas forward for consideration, the Adam Smith Institute, jointly with the US based Manhattan Institute, organized the London Conference on Taxes and Growth. A distinguished group of academic economists came over from the United States to confer with their opposite numbers in Britain, and with legislators and financial writers.

The conference attracted significant attention, with its ideas receiving extensive coverage in the *Times*, the *Sunday Times*, the *Wall Street Journal*, the *Financial Times*, and the *Guardian*. Even the popular press was intrigued by the notion that "soaking the rich" could be brought about by cutting their tax rates. The debate has continued since then, with those newspapers and others taking up positions and making calls for action.

The general consensus, even by those opposed to supply side tax cuts, has been that a new voice has been injected into the debate, and an argument which has to be answered has made itself heard. As Brian Walden put it in the *Times*, "Surely the time is ripe for trying a different system." That system is one which mobilizes resources by increasing incentives. By lowering the barriers to achievement and by raising the rewards it makes it worthwhile to achieve more. Although the tax rates are lowered, the tax base is broadened as a result, and revenues rise as the general wealth of society advances.

Even the barely reputable argument from envy is refuted. The lowering of tax rates at the upper levels can be done in such a way as to lower the proportion of tax paid by the poor, and to increase the percentage paid by the rich. The evidence is clear, and the following chapters lay it out in detail. Given that Britain's starting tax rate, at the time of the assembly of this report, was one percent above the new top rate in the United States, it is clearly time for the supply side case to merit urgent consideration.

# 1. Introductory Remarks

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Andrew Neil

I'd better own up to the fact that Bill Hammett is blaming me for this entire conference. Bill read an editorial which I wrote for the *Sunday Times* about supply-side economics, particularly about the Reagan tax reform bill in the United States. I had asked in the editorial if any political party in this country would have the courage to initiate the same kind of reform. That gave him the idea of holding this conference in London. I'm afraid the answer to my question, so far, is that no political party has mustered the courage to do the same. Maybe this conference will help to ease the path toward such a reform.

I'm delighted to see both the participants and the audience here today. There are more supply-siders in this room than there are in the rest of Britain. Maybe it's the start of a growing creed. I certainly hope so. One of the things that's been most disappointing for me in the Thatcher years has been that this conservative government has not proved to be a supply-side government. It is a fiscally conservative government, it is a strong government on defense, it is a strong government in reforming the trade unions, but it is not a supply-side government in the way that anybody here from the United States would understand that term. That is why I believe that the British economic revival is not as strong as it should or could be. Maybe some of the ideas that we're about to hear will help to put us on the right road.

## 2. Supply-Side Economics: Radicalism or Common Sense?

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By Tom Bethell

In England, there used to be a cricket match every year called the Gentlemen versus the Players. Most of the time, the professionals would win, but there were occasions, very rarely, when the amateurs would win. There are moments in history, as well, when the amateurs, as represented by journalists and others, do know more than the professionals, although that is not normally the case. The supply-side movement has been one of those moments. Supply-side economics has been a movement of amateurs invading a field of professionals, the field of economics, from which common sense has been fairly rigorously excluded for two or three decades. Supply-side economics is really just an elaboration of the notion that you shouldn't kill the goose that lays the golden eggs.

Socialists were almost immediately hostile to supply-side economics. That's because they are not interested in collecting the fruits of production. Socialists are interested in controlling the means of production. They don't want the eggs. They want the goose. If you explain to a socialist that lowering tax rates will generate more revenue for social programs, he's not interested, because he knows at the same time there will be some people who will be getting richer.

Socialists are also hostile to the whole notion of incentives in economic discourse. For socialists, the only morally proper incentive is working for the collective good. The idea is that you're supposed to be willing to work in a situation where the government takes most of your money and spends it for things that you know nothing about, on people that you've never met, for causes that you do not perhaps support. If you are opposed to this, then you are considered selfish. But in fact you are not being selfish, you are being rational. It is irrational to let someone take the money that you have worked hard to earn and allow them to spend it on things that you know nothing about.

In any event, we can understand why socialists oppose supply-side economics. Marx, in the Communist Manifesto, listed ten socialist commandments, the second of which was that the state should enact a steeply progressive income tax. Supply-side economics, after all, is really a proposal to sharply reduce the progressivity of the tax code. The conservative resistance to supply-side economics is somewhat more puzzling. If you lower the top tax rates, revenue does increase. There is just no doubt about that anymore. I was discussing this the other day with a friend of mine in Washington who is a senior Tory treasury official on loan to the IMF. I asked him, "Why don't you reduce the top tax rates in England? There's no point in trying to tax people at a 60 percent rate." He replied that "Everybody in the higher reaches of the Tory government knows that the top rates are not collecting revenue. They know there wouldn't be much of a decline in revenue if you reduced them. It's all political." The Tories are afraid of what the reaction would be if they were to reduce the top rates. They

are afraid of the outcry that Mrs. Thatcher is helping the rich. Essentially what we have is the appeasement of envy. There is a fear that the opposition will launch an envy-arousal campaign. It's true that in 1981 when the Reagan Administration cut the top tax rate, just such an envy-arousal campaign was immediately launched in the news media. The encouraging thing is that this year when the top rate was being reduced from 50 to 28 percent, a similar envy-arousal campaign didn't materialize. People in the news media have finally figured out that if you lower the marginal rates, the rich do pay more. Passage of the tax reform bill was much easier than everybody had expected. I think that you might find the same lack of resistance in England.

There is one other important point to raise about the Tories. I have often wondered about the continued persistence of the class system in England. There is no doubt that if you go and live in America, you become immediately conscious of the fact that the class system, such as it is found in England, doesn't exist there. It occurred to me that the tax structure might have something to do with this. There may be a kind of subconscious Tory class interest in the maintenance of the present tax structure.

If you or your ancestors had had the opportunity in an earlier period of history to convert your income into wealth — buying an estate in the country, buying a house in London, buying Chippendale furniture, or what have you — you would now be at a great competitive advantage over someone who has no wealth or land and who has 60 percent of his marginal income intercepted by the government. That person can never catch up with the individual who had the opportunity to convert his income into wealth at a time when the income tax didn't even exist.

High marginal tax rates tend to prevent upward mobility. They prevent the rotation of elites. If you perceive a society as a Ferris wheel of elites, then it is only natural for the people who are at the top to say, "Let's freeze it, right now. Let's not let the wheel rotate anymore." I am not saying that there are people in the Tory Party who have consciously worked out this idea, only that people often subconsciously have a way of figuring out what is in their class interest.

In summation, I would suggest to you that if you lower tax rates it will not benefit the rich but rather people who want to become rich. That is why it is extremely important to make this change.

### 3. Tax Competition in Europe

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Alan Reynolds

Just as private companies compete in the marketplace by cutting the prices of their products, so also do nations compete for scarce labour and capital by cutting tax rates. Since April of 1976, when supply-side economics was first given a name, there have been reductions in tax rates in a number of European countries as well as in the United States. In Europe, those reductions have been rather timid. Sweden reduced its top tax rate from 87 to 80 percent; in Portugal it went from 77 to 65; in Ireland from 72 to 62; in Italy from 72 to 60; Norway's went down about seven points. The only significant reduction in Europe was in Turkey, from 68 to 50 percent. Turkey happens to be the fastest growing economy on the continent. In the United Kingdom, the top rate went from 83 to 60 percent, a substantial reduction, but having started too high, you ended up too high. Only Belgium swam against this tide by increasing its tax rate from 60 to 72 percent. Belgium, of course, has experienced an economic growth rate of zero for the past five years.

Smaller economies have very recently enacted relatively bold tax reforms to lower the highest rates. Jamaica went from 58 to 33 percent. New Zealand is about to go from 65 to 48 percent. The Philippines under Aquino is going from 60 to 35 percent. India dropped its top tax rate down a year ago from 65 to 50 percent. The Indian stock market doubled in one year and revenues from the individual income tax increased by 40 percent. China, in effect, instituted a zero marginal tax rate on agriculture – a 15 percent average rate. They said, "If you make more than your quota, you can keep the rest and sell it in what used to be the black market." The economy boomed so fast that it frightened them, something like a 12 to 15 percent average rate. Real tax revenues rose by 50 percent in three years.

There are other reforms that are explicitly planned to reduce marginal tax rates, which are supply-side reforms, not Keynesian reforms. There are currently plans in Canada, France, Germany, Japan, and Singapore. The United Kingdom, which got on the bandwagon first, is now lagging behind. International tax competition affects many things including capital flows, exchange rates, interest rates, and labour costs. A country where the overall tax climate is getting relatively worse, because it's getting better elsewhere, will tend to experience a loss of both financial capital and human capital. This forces the central bank to keep interest rates higher than otherwise to prevent the capital outflow from causing an inflationary depreciation of the currency.

Taxes, tariffs and regulations, i.e. the cost of government, also affect production in terms of both labour and capital costs. Payroll taxes, consumption taxes and income taxes on labour income create what is called a "wedge" between what the employer pays for labour and what the employee ultimately receives. The

employer has to pay quite a lot. The employee looks at his after-tax take-home pay and sees nothing. A 5 percent pay increase in a 28 percent marginal bracket is just as desirable to an employee as a 9 percent pay increase in a country where the marginal tax rates are 60 percent. If labour is overtaxed relative to capital, as I believe is the case particularly in Ireland and the UK, it tends to foster the uneconomic substitution of machines for men and results in unemployment rates of 13 and 17 percent.

Taxes on capital such as property taxes, dividend taxes, and capital gains taxes introduce a wedge between the return of capital to the economy as a whole and the return to the individual capitalist. Among other things, high marginal rates on capital income add a tax premium analogous to the inflation premium in interest rates. People would have a higher demand for bonds if they got to keep a larger portion of the return. Thus a reduction in marginal tax rates, other things being equal, tends to lower interest rates.

High marginal rates don't yield high revenues. It is because of steep marginal tax rates, not despite them, that the individual income tax yields only 2 percent of GDP in Mexico. Steep marginal tax rates yield only 4 percent of GDP in Greece, 6 percent in France, 9 percent in Austria, and 10 percent in the UK, all lower than in the US, where it is 12 percent.

Belgium raised tax rates with unprecedented enthusiasm. Real tax revenues fell in that country by 9.1 percent from 1981 to 1984. As a result, Belgium's budget deficit is 13 percent of GDP. In the Netherlands, where tax rates reach 72 percent on \$99,000 and there is a VAT tax that goes up to 33 percent, real tax revenues fell by 3.2 percent between 1980 and 1984. In the United States, by contrast, real tax revenues rose at the federal level by 5.4 percent in 1984 alone. Oppressive tax rates are a luxury that Europe can no longer afford.

High marginal tax rates no longer just affect the wealthy. In the 1970s, inflation pushed ordinary working couples into tax brackets once reserved for the very affluent. This happened in both Europe and the United States. It actually steepened the progressivity of the tax code. I call this "greasing the rungs on the ladder of opportunity." These steep marginal tax rates did succeed in what they were intended to do. They succeeded in preventing people from earning high incomes. The result was that the tax burden had to be shifted down to lower incomes. We increased VAT and payroll taxes on people of modest means.

High taxes also affect the balance of trade. It is impossible for the whole world to export more than it imports. The growth of world trade requires growth in imports. Who are the laggards here? It turns out that the countries with the highest tax rates have reduced their imports for several years. From 1981 to 1985, the dollar value of imports fell in Germany, France, Austria, Belgium, Finland, Ireland, the Netherlands, Norway, Spain, Portugal, Sweden, Saudi Arabia, Yugoslavia, and Hungary, among others. In a world of poor countries who are desperately trying to earn dollars, this isn't much help. In the supply-side countries, by contrast, imports rose by 97 percent in China, 32 percent in the United States, 20 percent in Hong Kong and 19 percent in South

Korea. Tax systems that suffocate domestic income and sales are not just a national problem, they hinder world trade as well.

It has to be emphasized that the supply-side objective is to reduce high marginal tax rates on added income. That does not necessarily mean reducing the average tax rate. In the Netherlands, the average tax rate on an income of \$28,000 is 21 percent, which isn't that high. The marginal rate on the same income is 52 percent. You better be very careful before making \$28,100 because they will take more than half of the next one hundred dollars that you earn. This is one measure of the inefficiency of a tax system, the difference between average and marginal rates. Such a large gap creates the maximum disincentives and the minimum amount of revenue collected over time.

I have made some rather rough estimates of marginal tax rates for all of the major countries in Europe. The estimates are based on three major taxes — the income tax, the social security tax, and the VAT sales tax — and are applied to four levels of income ranging from \$28,000 to \$49,000 a year. The figures are for 1986, except for the United States which are for 1988, when the marginal tax rate will drop from an average of 49 percent to 35 percent on labour income.

In the UK, Ireland, Norway, Denmark, Finland and Greece, the total marginal tax rate on labour income ranges from 60 to 64 percent. On an even more extreme level, marginal tax rates run from 72 to 84 percent in Belgium, from 66 to 79 percent in Portugal, 66 to 76 percent in the Netherlands, and 87 to 92 percent in Sweden. A 1985 OECD study concluded that "the evidence for almost all countries suggests that the tax system overall has relatively minor effects on the income distribution." That's an understatement. The evidence suggests that there is no effect at all. Europe's high marginal tax rates are quite simply a barrier to upward mobility.

The lowest marginal tax rates on labour income are in Switzerland, the United States and Turkey. The highest rates are in Belgium, the Netherlands, Greece, and Portugal. The cumulative increase in real GNP from 1980 to 1985 was 27 percent in Turkey, 13 percent in the United States, and 9 percent in Switzerland. Among the overtaxed economies over those five years, total growth, not annual growth, was 2 percent in Belgium, 3 percent in the Netherlands, 4 percent in Greece, and 5 percent in Portugal.

Until marginal tax rates are reduced in Europe, along with an increase in the income level at which those thresholds take effect, Europe will continue to be plagued by chronic stagnation. Employment, real tax receipts, imports, and living standards will all continue moving steadily downward unless real supply-side reforms take place.

## 4. Anatomy of a Tax Revolt

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Warren Brookes

The best news that we've heard from Britain in a long time came out of the Bournemouth conference last week<sup>1</sup>. Mrs. Thatcher has apparently decided to focus her energies on policy issues at the townhall and council level. Issues like taxation and supply-side economics can and should be fought out in the local arena. In the United States, the supply-side movement drew much of its force and power not from Washington but rather from various state movements, particularly in 1978 with California's Proposition 13 and in 1980 with Massachusetts's Proposition 2 1/2. Unfortunately, the foreign press has chosen to ignore or trivialize the supply-side revolution on the state level.

Last July, a national news story in the American media reported that the fastest growing real estate market in the United States was the once totally moribund Boston metro area. At the same time, last summer, the Massachusetts State Department of Revenue announced that the state's total property market value, both commercial and residential, had risen more than 40 percent in the last two years, reaching an all-time high of \$217 billion. This was a 90 percent increase in real terms from the 1981 level of \$87 billion. That's the fastest growth in a state property tax base since the numbers have been compiled.

These numbers are no lucky accidents. They are the direct result of the decision of the people of Massachusetts to take power into their own hands through the voter referendum and slash their highest-in-the-nation property tax rates by 40 to 50 percent. They were warned in this referendum process by the leaders of both parties, and most of the corporate business community, that this was a dangerous and radical step because it would cut property tax income, destroy social services and drive the economy into the ground.

Fortunately, these warnings lacked credibility since they came from the leaders who had resided over the state's economic decline. The rest, shall we say, is history. The once-stagnant Massachusetts economy, the third slowest growing state economy in America in 1978, has become the third fastest growing one over the last three years. The current unemployment rate is 3.4 percent, down from 9.5 percent when Proposition 2 1/2 was passed. Companies have to bus in workers from neighbouring states to fill available jobs.

Those who opposed Proposition 2 1/2 referendum would have you believe that this transformation would have happened anyway because of the burgeoning high-tech boom or as the *Economist* reported "Governor Dukakis's industrial policy initiatives." The trouble with that explanation is that it's wrong. Massachusetts's manufacturing jobs since 1980 have actually fallen by 7 percent.

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<sup>1</sup> Conservative Party Conference held at Bournemouth on October 10.

What really turned Massachusetts around was the rejuvenation of its dying property tax base which had long been depressed by excessively high real estate tax rates.

Even the *Boston Globe*, which opposed Proposition 2 <sup>1</sup>/<sub>2</sub>, admitted in a lengthy article last June that the referendum's passage was largely responsible for turning that state's stalled economy around. In the article, Ralph Whitehead Jr., a liberal advisor to Governor Dukakis, was quoted as saying, "Massachusetts has a dirty little secret. Without Proposition 2 <sup>1</sup>/<sub>2</sub>, we would be on our way to becoming a banana republic." The *Globe* article admitted that "the worst political problem for businesses considering relocation or expansion [in the state] was the perception of the state as Taxachusetts."

From 1970 to 1979, Massachusetts's tax burden had risen steadily from about 3 percent below the national average to 11 percent above it. During that same period, the personal income of the state fell from 10 percent above the national average down to only 2 percent. The moment Proposition 2 <sup>1</sup>/<sub>2</sub> was passed, we began to see a reversal of the two curves. Personal income soared. This year, it rose to 19 percent above the national average, the highest in the state's history. The tax burden is now almost 5 percent below the national average. The effect of all this was to generate large and accumulating surpluses in the state's tax revenues. The state now has a surplus of \$1.1 billion accumulated over the last two years. Ten years ago, it had a \$1 billion deficit.

Why did such a simple reduction in property tax rates have so dramatic and immediate an effect on total economic growth? The answer is equally simple. Growth ultimately is the appreciation of value of a nation's capital stock and taxes have a direct effect on the value of that capital stock. The term used by public accountants to describe the phenomenon is tax capitalization.

If you have a piece of property worth \$100,000 and your taxes on it are \$2,000 and your mortgage payment rate is 10 percent, you wind up paying \$12,000 a year – \$2,000 in taxes and \$10,000 in mortgage loans. If for some reason your \$2,000 in tax payments were eliminated, you could then finance \$120,000 in property value with the same \$2,000 a year. Your \$12,000 a year—could now support a much higher value. What that means is that for every dollar you reduce the taxes on property, you increase the value of that property by ten dollars. For every dollar you raise property taxes, you decrease the value of that property by ten dollars. If you understand this principle of tax capitalization you understand Massachusetts's economic boom. The passage of Proposition 2 <sup>1</sup>/<sub>2</sub> increased the value of property in the state by \$12 billion because it involved a statutory property tax cut of \$1.2 billion.

What happened in Boston alone is even more dramatic. In 1980, the property tax rate in Boston was \$82.70 per thousand dollars, the highest in the nation. The tax base was stagnant at \$5.3 billion. Over the next five years, the tax rates came down dramatically to \$18.64 per thousand and the property value base shot up from \$5.2 billion to \$24.4 billion. That's an increase of 366 percent! What this amounted to was a \$19.2 billion infusion of wealth into one small city economy.

It helped take the unemployment rate of that city down from 10 percent to 3.5 percent. You don't have any cities in England with that low an unemployment rate. What happened in Boston is nothing more than tax capitalization.

This concept is not confined to property taxes. Look at what's happened with payroll taxes. It is no accident that since 1970 when American social security payroll taxes started to soar, that we also experienced the first decline in real wages in the nation's history. Over the last decade, social security taxes were increased 450 percent while wages only went up 226 percent. The extra increase had to come out of the wage packet. That's why more people have to work, sometimes two or three members in the average family. That hasn't happened in the United Kingdom because of the unions. Here the tax capitalization has taken the form of unemployment. You have taken more and more of the capital supporting employment and moved it into the tax base.

Once you realize that economic growth is nothing more than asset appreciation, you can understand why studies show much higher rates of economic growth in the countries that have lowered their tax rates. Since 1979, the United Kingdom has raised its tax burden by 17 percent. In that same period the unemployment rate rose from 6.5 percent to 13.5 percent. I suggest that there's a direct and immediate link between those two increases. Conversely, the two countries that have kept their taxes more or less at the lower end of the scale, Japan and the United States, have had infinitely faster rates of job growth and much lower rates of unemployment. What we're talking about is not a theory. We're talking about a law. It's also been proven in California.

Again, your own press is misleading or trivializing this issue. Last July 15, the *Financial Times* took a very sour look at California's Proposition 13 and argued that the taxcutting experiment in that state had "stifled rather than nurtured the pioneering spirit which set California apart from the rest of the United States." I have a few economic facts that I want to close with that were never reported in the *Financial Times*. Since 1978, while Britain's total employment has fallen by half a million jobs, California, with less than half the population, has created two million new jobs. California's unemployment rate is 6.5 percent in constant terms; yours is over 15 percent. Britain's total real GNP in the period from 1980 to 1985 rose by 8.7 percent. California's real GNP rose 32 percent, four times the British rate of growth. While you have created 30,000 new businesses since 1983, California is now creating 80,000 new businesses every single year, 300,000 since 1980. The reason for this wide disparity is quite clear.

Since 1978, California has cut its third highest in the nation tax burden from 19.2 percent of income down to 14.7 percent last year. That's a 23 percent drop in its total revenue burden. As I pointed out before, in the same period, Britain's burden went up 17 percent. By bringing down these rates, the new governor George Deukmejian has watched tax revenues boom. He's been able to increase government spending at the fastest rate of any major state in the nation. The Laffer Curve is working.

The *Financial Times* and the *Economist* have both been rather snide about these state experiences. Yet they can only dream of the kind of economic growth that is now going on in Massachusetts and California. So long as the press peers down its nose at America's supply-side ideas, the country will continue to stagnate.

## 5. The American Challenge

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George Gilder

I'd like to present a broader perspective on the supply-side developments which will be taking place in the coming years. The key to those developments is the emergence of new technologies. From George Orwell to John Kenneth Galbraith to Jean-Jacques Servan-Schreiber, the general conviction has always been that technology favoured the state over the individual and that we were moving toward 1984 and the triumph of Big Brother. 1984 did come, but there was no Big Brother. On the contrary, in the United States we experienced the fastest growth of small businesses in the history of the country. During the previous five years, there had been a doubling of small business starts from about 280,000 to 640,000. There was also a massive upsurge of venture capital, two hundred-fold above the average between 1970 and 1977. There was an incredible efflorescence of new companies on the stock market; new public issues rose some tenfold. Overall there was a massive surge of small business growth on the frontiers of high technology.

In Europe, however, the results were less positive. This is in no small part due to the fact that for the past twenty years Europe has been operating under the influence of the ideas of Jean-Jacques Servan-Schreiber as voiced in his book *The American Challenge*. Servan-Schreiber perceived a great competitive threat to Europe from America in the form of the military-industrial complex and the massive rise of government-subsidized research carried on by multinational corporations. Servan-Schreiber's book helped to persuade Europeans to rely on state-subsidized business efforts at the very point when new technologies were shifting the balance of power away from the state and toward the individual entrepreneur.

The first effect of these new technologies has been to create global capital markets. Many of our economic concepts are still based on an historical period when capital moved more slowly than goods. You brought gold down to a clipper ship and sent it across treacherous seas, exposed to pirates. Our mercantilistic preoccupation with the balance of trade is derived from this period. But today, entrepreneurs can bounce capital off satellites in microseconds or down fibre-optic cables at the speed of light. Capital now moves much faster than goods. A country that adheres to supply-side economics will tend to run a trade deficit if other countries don't follow suit. This is merely a reflection of its hospitality to capital.

The second major change has been the declining significance of natural resources. A car is comprised of about 50 percent natural resources. Oil technologies are 90 percent natural resources. A silicon chip is less than 2 percent natural resources, and much of that is sand. There's been a drastic

decline in the significance of natural resources in economic growth. Energy usage has steadily declined as a share of output.

Finally, the new technologies, particularly some upcoming changes in the computer industry, strongly favour individual entrepreneurs over big government projects and multinational corporations.

The three most fundamental changes in computer technology are related to artificial intelligence, the silicon compiler, and massively parallel processing.

Artificial intelligence allows computers to compute without using mathematical formulas. They can now deal with symbols and perform work requiring common sense in a variety of uncertain circumstances.

The second major breakthrough, the silicon compiler, allows individuals to design a microchip on a computer from beginning to end. To understand the significance of this breakthrough, imagine that in order to publish a book you had to own a printing press – in other words, a situation where the printers essentially sponsored all the writing of books. This is the way it's been in the computer industry up until now. In order to make a chip, you had to own a wafer-fabrication facility which cost \$100million. This restricted the design of chips to a few companies in the semiconductor industry. Now, anybody anywhere in the world with a \$50,000 workstation can design a chip. This is a major breakthrough which enhances the role of entrepreneurs in the semiconductor industry.

The third major development, with probably the greatest long-run impact, is parallel multiprocessing. This essentially allows a magnification of computing power by 10,000-fold, a massive increase in the efficiency of computer architecture.

To get an idea of what this means, imagine that all the work at General Motors took place in one room and that all the workers had to line up in front of that room and wait to carry out their work orders. Most of the corporation would be inert most of the time. This is the way it's been in computing ever since its conception. Now computers will be able to operate like a real General Motors with large numbers of individual processors.

The combination of these three developments will be explosive. It will result in an incredible variety of new technologies.

One example is the talkwriter which is soon to be launched by a small entrepreneurial company in the United States. You'll be able to talk to your typewriter at a pace of 150 words a minute with a device which will originally be priced at about \$20,000. Since it's made of silicon, however, once silicon compilers become prevalent, the price will drop to \$5,000. Eventually, the keyboard will vanish from most computer applications.

Another key area is strategic defense. Massively parallel processing is precisely the technology that's needed for the kind of pattern recognition of enemy warheads required by Star Wars. The defense industry can now enter the computer industry learning curve, creating defense technologies that are cheaper and more effective.

The overriding theme of these new technologies is that they favour the individual over the state. The individual can send his money across the ocean in microseconds. He can move his company without moving himself. The entrepreneur doesn't have to forgo all the joys of life in Britain. He can spend much of his time in Britain but also enjoy the tax rates in America. There are many British engineers, particularly in Silicon Valley, who are making vital contributions to American technology and yet who still retain British citizenship. They are not patriotic enough, however, to pay confiscatory tax rates.

The real promise of supply-side economics in the long term is the triumph of the individual entrepreneur. The state has no role in the new global economy. The state can send thousands of workers down into mines to dig out gold. It can even find oil with the help of international consultants. The state can have a functioning role in these natural resource-based industries. It is completely impotent and at bay, however, in confronting the proliferating opportunities found in the new information technology.

That is why the triumph of supply-side economics is inevitable. Any country that does not respond to the new "defi Americain", our 28 percent top marginal tax rate, will find itself losing its capital, its entrepreneurs and its future in the global economy.

Britain's initial tax cut led the world in supply-side economics. Since then, the rest of the world has moved ahead. Our newly emerging technologies make it absolutely mandatory that Britain continue to fulfil the supply-side promise.

## 6. Tax Rates versus Tax Revenues

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James Gwartney

When the tax legislation of 1981 was passed in the United States, the implicit assumption was that changes in the tax rates did not affect the tax base. If we had a 10 percent increase in tax rates, it was assumed that revenues would go up by 10 percent. Similarly, if we had a 10 percent decrease in the tax rate, the popular wisdom was that revenues would go down by the same percentage. Supply-side economics, however, has demonstrated that that view is incorrect, particularly for high marginal tax rates.

Consider the impact of an across-the-board 25 percent reduction in tax rates. The top rate in the United Kingdom is 60 percent. A 25 percent reduction would slice that top rate from 60 percent to 45 percent. When you have a 60 percent top rate, people in that tax bracket get to keep 40 cents of every additional dollar that they earn. When you slice that tax rate by 25 percent to a 45 percent top rate, people then get to keep 55 cents of each additional dollar. There is an increase from 40 cents to 55 cents in the amount of money each individual can keep for every additional dollar that they earn. That comes out to a 40 percent increase in take-home pay.

Let's try a lower base of 16 percent. Suppose the 16 percent rate was also cut by a 25 percent. The 16 percent rate would now be sliced to 12 percent. What impact would it have upon the incentive to earn additional income? The person originally got to keep 84 cents on each dollar that they earned. After the cut in the tax rate they would get to keep 88 cents, an increase of 5 percent in their take-home pay. This is far less than the increase in the higher bracket. The largest increases in the incentives to earn come in the higher brackets. As a result, if you cut tax rates across the board by 25 percent, you can expect that this will increase the tax base more in the upper brackets and thus you will gather a larger share of tax revenue from high-income individuals. Again, when the 1981 tax cut was passed, the popular view was that it would be a windfall for the rich. Some of us who had looked at previous historical tax rate reductions strongly questioned that view.

From the period between 1921 and 1926, the top marginal income tax rate in the United States was cut from 63 percent to 25 percent. The bottom rate was cut from 9 percent down to 4 percent. At that time, there was a lot of the same talk about how these cuts would be a windfall for the rich. The numbers tell a different story. You had a tremendous increase in the tax revenue that was collected from high-income people in 1926. Individuals making over \$100,000 in income paid 86.3 percent more in tax revenues in 1926 than they did in 1921, in constant dollar figures. In contrast, those with income of less than \$25,000 paid over 50 percent less in taxes in 1926 than they did in 1921.

The 1964 tax cuts show a similar picture. In 1964 we cut the top rate from 91 percent to 70 percent and cut the other rates proportionally, roughly a 20 percent reduction in each income bracket. The top 5 percent of taxpayers in the United States paid 7.7 percent more in taxes after their rates were reduced. In contrast, the bottom 50 percent of taxpayers paid 9.2 percent less in taxes in 1965 than they did in 1963. It was data like this that led Richard Stroup, an economist at Montana State University, and myself, to argue in an article that the 1981–84 tax rate reductions would more than likely increase the share of tax revenue derived from high-income individuals compared with that from taxpayers with lesser incomes. We made that prediction in late 1981. The data are now available to measure the impact of the tax cut legislation. Once again, if you look at the bottom 50 percent, you'll find that they paid 8.3 percent less in revenues in 1984 than they did in 1981. In contrast, the share for the top 5 percent of taxpayers increased. In 1981, they paid 35.3 percent of the total tax revenues collected. In 1984, they paid 38.9 percent. Five percent paid almost 40 percent of the total taxes collected, a thirty year high in terms of the share of revenues collected from upper-income taxpayers.

Far from the popular wisdom at that time, what the Reagan tax cut did was soak the rich by cutting the top rates. The implication of this is rather straightforward. Tax rates above a certain level are counterproductive. They result in the tax base shrinking. You would actually end up collecting more revenue from high-income people if you cut their tax rates.

I am not arguing that if you lower tax rates overall, you'll collect more revenue. The evidence will not support that argument. What you will do is expand the tax base, particularly at the top range.

This challenge to the conventional wisdom is beginning to sink in. One difference with respect to the most recent tax legislation passed in the United States and the legislation passed in 1981 is in the media's handling of the issue. In 1981, there was no discussion of the fact that the tax base would be affected by changes in the rates. In 1986, there was a widespread recognition that the base is affected by the level of marginal tax rates. The "windfall-to-the-rich" argument did not nearly carry the weight this time around that it did in previous debates. The implications for the United Kingdom are clear. The U.S. experience indicates that a 60 percent top marginal rate is too high. If you want to soak the rich, you have to cut that rate.

## 7. The Laffer Curve: A Look at the Evidence

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Lawrence Lindsey

In early 1984, I was senior staff economist for tax policy at the Council of Economic Advisors. The first tax data since the 1982 tax cuts were then coming out, and low and behold, the tax share paid by the rich had risen. This upset the establishment in Washington. They argued that the numbers were deceptive. Their objections were twofold. First, some of the early analyses looked just at the number of taxpayers. Obviously, with economic growth and rising income, there will be more people at the top. Needless to say, more people at the top will pay more taxes at the top. Their second objection was that 1982 was a peculiar year. Indeed it was. We were in the midst of the worst recession in post-war experience. They argued that the distribution of income in America had changed. We had record high nominal interest rates. Interest income is concentrated at the top of the income distribution, so when you see a rise in interest income, you should expect to see a rise in the share of income and taxes at the top of the distribution.

Since I was heading back to academia, I decided to accept these arguments as valid and run some regressions with those assumptions built in. I took all of the critics' arguments into account about changes in the distribution of income and the number of taxpayers and I plugged them into the National Bureau of Economic Research forecasting model to see what levels of revenues were predicted at different marginal rates. In 1982, the top rate was dropped from 70 percent to 50 percent. That rate applied to people with incomes of over \$200,000. Under the old 70 percent rate, they would have paid \$25.95 billion in taxes. Under the new 50 percent rate, assuming the base didn't broaden at all, we would have expected them to pay \$22.44 billion. When the tables came out, however, it was discovered that they had actually paid \$26.62 billion. In other words, the top 183,000 taxpayers paid more in taxes than we would have expected them to pay at the old 70 percent rate. Taking all of the critics' arguments into account, people at the top paid more taxes with lower rates than they would have paid with higher rates.

If you look at the figures for 1983, the situation persists. People in the top bracket paid \$31.7 billion instead of the \$29 billion predicted at the higher rates. In 1984, their actual tax payments were \$42 billion compared to the \$34 billion predicted using the old higher set of tax rates. Quite clearly, what we have is the Laffer Curve. Prior to the 1982 tax cut, we were at the negative end of that curve where higher rates produce diminishing revenue. 70 percent was too high a tax rate.

What is true at the top, however, is not necessarily true for everyone. In 1982, for all taxpayers, we expected to take in \$311 billion. We actually took in \$277 billion. The tax cuts did bring about a loss of revenues. Note, however, that if

we didn't have any revenue response, we would have only collected \$267 billion. In other words, we did yet a positive revenue response of about \$10 billion. We made up about a quarter of the total cost of the tax cuts.

In the final part of my study I tried to discover what a revenue-maximizing tax rate would be. I looked at the actual taxable income reported compared to what was predicted. My revenue-maximizing tax rate came out to be 33 percent. I talked to some anti-supply-siders about my findings and again I decided to stack the case against myself. I took all of their statistical ideas into consideration so as to make the revenue-maximizing tax rate as high as possible. My new maximum rate was 50 percent. I would call that an upper limit on the revenue-maximizing rate with the 33 percent rate as the lower limit. One could split the difference and say that a 41 percent marginal tax rate would be the point at which you would take in the most revenue. That's a lot better than your current 60 percent rate.

It's important to point out, however, that a hypothetical revenue-maximizing income tax rate is not an ideal which policymakers should shoot for. There's nothing wonderful about a tax system at the revenue-maximizing rate except that it produces the most revenue for the government. There is not a single economist who would tell you that that is optimal for society. A smart society will have a tax rate well below the revenue-maximizing level.

Yesterday I was having a talk with David Willets, a member of the Prime Minister's staff, about your experience here in England. You might find it reassuring to note that the British numbers on tax cuts and revenue collections among the wealthy parallel my own findings. In 1979-1980, prior to the 1979 tax cut which lowered Britain's top marginal income tax rate from 83 percent to 60 percent, the top 1 percent of taxpayers in Britain paid a 10.4 percent share of total revenues collected. In 1985-86, six years after lowering the rates, the top 1 percent of taxpayers paid 12 percent of total revenues. The same was true in the next highest bracket. The top 3 percent of taxpayers in 1979-80 paid 18 percent of total revenues. In 1985-86 they paid 20.7 percent.

The irony is that these numbers were requested from the Treasury Department by a Labour member of Parliament who wanted some evidence that the rich were getting a big break from the tax cuts. Obviously, he didn't run to the newspapers with these results.

Finally, I do not as an academic recommend that the results I obtained be directly applied to the British experience. My breakdown of taxpayer groups does suggest, however, which individuals will respond the most to changes in tax rates. The people you should expect the most response from are people who are entrepreneurs. They have the most discretion regarding their income and how they will arrange their compensation package. My figures show that business income exploded at the top end of the income distribution. If that's also true in England, if your top bracket earners are primarily entrepreneurs who control their own compensation packages, then I think your revenue-maximizing rate should be very similar.

## 8. Tax Avoidance at the Margin

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Roger Waud

I'm sure some of you have been sitting here wondering how it is that by cutting the tax rates of the rich they end up paying more money. Some have referred to this as soaking the rich. The rich are too clever to get soaked. The rich are winners and you have to do something which appeals to their incentives. Lower tax rates provide individuals with a greater incentive to work, save, and invest which in turn broadens the base of wealth that is taxed. The economic models currently being used measure these incentive effects. None of them, however, explicitly take into account the effect that different tax rates have on tax evasion and avoidance activities. As a result, they underestimate the revenue-raising potential of lower marginal rates. They don't take into account the evasion and avoidance activities that are spawned by high tax rates.

Estimates have been made for different countries regarding the extent of evasion activity. In Great Britain, the studies that have been done have tended to underestimate the amount of illegal activity that goes on. These studies, with the help of the British Treasury, attempt to measure tax evasion by reviewing family survey questions. What happens, as you might imagine, is that when they select a sample of people to put their questions to, often 30 percent or more of the sample will not respond. What they report, therefore, are estimates of evasion only on the basis of those people who do respond. These studies' authors admit that this underestimates the amount of evasion activity that's going on. They generally estimate unreported income in the United Kingdom to be in the range of 3 percent of GNP.

Other studies done by people outside of Great Britain, however, estimate a larger degree of evasion activity. They take into account all kinds of activities which the British can't get a handle on through family surveys. A summary of that outside research estimates that between 8 to 12 percent of GNP in the United Kingdom goes unreported. Thus there's a considerable amount of revenue that the government is not able to get its hands on. That is why the numbers that Lawrence Lindsey and James Gwartney have been reporting to you are totally plausible. When you cut high marginal tax rates, it becomes less worthwhile for you to hire accountants and attorneys to discover ways you can avoid and evade taxes. But even if you don't accept the argument that lowering tax rates will generate more tax revenue from the rich, you should still consider cutting rates as a way of getting your high unemployment rate down.

The United Kingdom currently has an unemployment rate of 14 percent. Both Keynesians and supply-siders will tell you that if you cut tax rates, you'll stimulate your economy and lower that rate. Of course, the argument is then raised, "Since it is unlikely that government spending will be reduced significantly, won't tax cuts increase the deficit?" I don't think cutting rates will

widen the deficit at all. I've done some revenue estimates based on a study in the United States by Charles Clotfelter of Duke University who looked at over 47,000 U.S. income tax returns. By examining those returns as well as audits of the returns, Clotfelter was able to estimate the effects of changing marginal tax rates on the amount of unreported income.

He found that if you lower the marginal tax rate by 10 percent, you will increase reported income by 5 percent. In some cases the increase in income reported was 15 percent. For the sake of argument, let's split the difference. That would mean if you cut British marginal tax rates by 10 percent, reported income should, likewise, go up 10 percent. In addition, the cuts in rates should stimulate production and income as well. If a 10 percent cut in rates stimulated income by an additional 8 percent, and this was coupled with a 10 percent increase in reported income, the British Treasury would pull in the same amount of revenue as it did at the higher rate. Would a 10 percent cut in rates stimulate income growth by 8 percent? You now have 14 percent unemployment. You certainly can't argue that you don't have excess capacity in your economy. You have little to lose. By cutting those rates, you'd probably get an increase in income, a reduction in unemployment, and little overall negative effect on tax revenues. Moreover, it would help to stop the so-called brain drain of British engineers who are flocking to the United States where marginal rates will soon be less than half as high as they are in Great Britain. I would urge those of you with influence to promote the idea of cutting marginal rates for those reasons.

## 9. A Dissenting View

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George von Furstenberg

It is fitting that we meet in the United Kingdom, a country whose prime minister, Margaret Thatcher, was the first among post-war democratic leaders to bring right-wing rhetoric out of the closet. She's had more time to succeed and time to waste than any of the other western conservative leaders. I suppose if she's not being called the "Iron Lady" much lately, it is because her promises to cut government spending and taxes in 1979 have somewhat rusted. But if the gap between promise and performance has become noticeable in Britain, it is a veritable chasm in the United States, especially with regard to government spending and the fiscal deficit. I think it is useful to review the relative performance of the United Kingdom and the United States with regard to spending, taxation, and deficits.

If you look at government expenditures as a percentage of GNP, you'll find that government spending in the United Kingdom rose from 42 percent in 1979 to 45 percent in 1981. Spending has stayed at that level partly because the United Kingdom never fully recovered from the worldwide recession of 1982. In addition, as an oil-exporting country, it was adversely affected by the decline in oil prices.

In the United States you have the same measure of government expenditure rise from 30 percent of GNP in 1979 to 35 percent in 1982. Again, spending has remained at the 35 percent level in spite of the fact that the United States has experienced a strong economic recovery. One might argue that the United Kingdom had a passably good excuse for not reducing its spending rate. The United States had none.

The story about fiscal deficits is a familiar one. In fiscal 1980, the United States had no fiscal deficit of any size worth speaking of. Since then, the deficit has reached astounding proportions. In the United Kingdom, on the other hand, the deficit as a percentage of GNP has slightly declined from 1979, in spite of the fact that the United Kingdom never fully recovered from the recession. How did this come about? In the United Kingdom, the tax rate was increased from under 40 percent of GNP in 1979 to just over 40 percent more recently. In the United States, a succession of phased tax reductions kept the aggregate tax rate flat at the level of 30 percent, at the same time that government expenditures were increasing, thus producing the enormous deficits.

We should perhaps not give Mrs. Thatcher too much credit for reducing her deficit through tax increases. It would have been more consistent with her own philosophy to approach that goal through spending reductions instead of tax increases. However, if you can't get spending down, the least you expect an honest government to do is to make the full cost of government explicit to its

citizens by relying on current taxes rather than deferred ones. In that sense, at least, Mrs. Thatcher deserves a great deal of credit.

In comparison to Britain, the United States' economic policy has been characterized by a great deal of pretence. The pretence has been most noticeable in the area of fiscal policy where we currently are running annual deficits in excess of \$200 billion. We have promised the world that the deficits will go away by magic by 1991. The magic I'm talking about is not the magic wand of Laffer, it is the magic of law. It is the magic of the Budget Control and Deficit Reduction Act passed in December 1985, an act known by its sponsors, Gramm, Rudman and Hollings, otherwise known as "Grrrrrrr!" Unfortunately, this dog doesn't bite anymore. It is now expected that the deficit in the current fiscal year will be between forty and fifty billion dollars above the target set in Gramm-Rudman, which allows a maximum leeway of only ten billion dollars. We can expect very little to be done to unmask this fraud-inducing act before the November elections. But even after the November elections, it will be very difficult to get spending down. There are always some new elections to prevent spending cuts.

Moreover, it's becoming increasingly difficult to reduce spending because the net interest paid on the debt is becoming a larger and more uncontrollable part of the budget. The Reagan Administration has raised the ratio of government debt as a percentage of GNP from a 1979 low of one-third to almost two-thirds. That kind of increase cannot go much farther without precipitating an external payments crisis which in turn will cause nominal interest rates to rise rapidly, and place pressure on the government to adopt austerity measures. At some point there will be a change in course. That change will most likely involve a tax increase and a freeze or a substantial reduction in defense spending. At that point, you will find the United States adopting the policy combination of tax increases and spending cuts that Prime Minister Thatcher tried to undo, very early in her term. When that has happened, what will we be left with? We will be left with Reagan's tax reform which is a solid economic achievement. On the other hand, we will also be saddled with a large addition to the national debt and a deterioration of the United States's external trade position. The net effect of these pluses and minuses on economic growth is difficult to determine.

The gentlemen on the right and the gentlemen on the left all have their spending favourites. The gentlemen on the left spend to make the poor poorer. The gentlemen on the right spend to make the defense industry richer. Between them, spending continues to rise. Given that fact, it is unlikely that we will soon see lasting tax reduction, meaning by that, a reduction in the ratio of taxes to GNP. What can be done and what has been done in the United States is tax reform. The lowering of marginal rates and the broadening of the tax base is an abiding achievement which will soon produce positive economic results. It is an accomplishment which I hope will be emulated by other countries, including the United Kingdom.

## General Discussion

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**Questioner** – Many of the speakers have mentioned that lowering tax rates increases the incentive to earn. Then, as Professor Waud pointed out, lower rates also increase the incentive to declare earnings. I would like to add a third factor. Lower tax rates also increase the incentive to take earnings as income. A company director, for example, might take less options on shares and opt for a bigger salary, or an individual will invest more in income-producing assets than in capital-gains producing assets. Have any of you seen these behavioural changes in your research of the American economy?

**Lawrence Lindsey** – The most responsive area of income was in capital gains. In 1983, \$43 billion in capital gains were declared. If you looked at the projections for that year, given household wealth, it should have been \$32 billion. That's a 30 percent increase over what was expected. The second most responsive area was business income. That's exactly what you're talking about with regard to earnings declared. In 1982, 88 percent more business income was declared than was expected by people earning over \$200,000. Business and entertainment deductions proved to be extremely responsive to changes in tax rates. The third responsive area was in wages and salaries for high-income earners. These are basketball players or corporate executives who make \$200,000 a year or more. They are the people who can choose to take money now or take it later. People who had control over their compensation package did take substantially more wages than they otherwise would have.

**James Gwartney** – In terms of businesses, it's often difficult to differentiate between valid business expenses and consumption perks. You get into all these issues about the thickness of rugs in offices, the kinds of equipment that you are working with, and whether you fly first class or not. A side effect of high marginal tax rates is that they make these kinds of expenses relatively cheap. The higher the marginal tax rate, the cheaper it is to consume something that shows up as a deductible business expense. Lower marginal rates, on the other hand, raise the real costs of these items.

**Questioner** – Is there any trend in fringe benefits over this time period?

**James Gwartney** – I don't have any aggregate data but I do know of individual instances where companies were setting up various kinds of retirement programs, but now with the lower tax rates, employees prefer to take their benefits in higher salaries.

**Richard Rahn** – The U.S. Chamber of Commerce does the only national survey in the United States of employee benefits. And we've witnessed huge increases in employees' fringe benefits as a percentage of total workers' compensation in the post-war period. But in the last few years that has slowed down. The growth

rate in benefits has declined since the tax cuts. We've been surveying our corporate people as to what impact the new tax reform is going to have. Many corporate executives say they will be much more sensitive now to the costs that Jim Gwartney mentioned – travel, entertainment, etc. Lowering the tax rates will increase the real cost of many of those items.

**Questioner** – I've reviewed reports by the Institute for Fiscal Studies which suggest that lowering tax rates does not broaden the tax base to the extent implied here today. Is there a conflict of evidence?

**Roger Waud** – I've read those reports from the Institute for Fiscal Studies. Those studies do not deal explicitly with social security cheating, financial offshore arrangements, or other kinds of activities that we typically associate with high-income tax avoidance. Those studies are looking at working household families. The other problem is that since the Institute is a government agency, if it asks questions that are too direct, the incidence of response starts going down and defeats the purpose of the inquiry. That's why I don't think their findings contradict the evidence presented here today. I would suggest the Institute pattern some research for the United Kingdom on the basis of the findings that we have reported.

**George von Furstenberg** – It seems to me that some people on the right have been used to living in opposition for so long that they can never understand when they've won, so they keep on fighting. The basic points presented by Professor Lindsey here today are part of American mainstream economic opinion. If you reduce tax rates across the board, irrespective of macroeconomic effects, you will recoup about a quarter, or maybe a third, of the lost revenue. The spectrum of respected opinion has shifted. Professor Lindsey's views are part of the economic mainstream.

**Questioner** – I've often heard it said that the supply-side movement in the United States has been discredited because when taxes were cut the deficit soared instead of falling. Fiscal conservatives say that kind of policy isn't for us.

**Stephen Entin** – We had a theoretical problem at the very beginning. The supply-siders argued that a non-monetized tax cut would not be inflationary. The Federal Reserve disagreed and tightened the money supply, driving the economy into a recession. The computer model which we used for spending sided with the Fed. It assumed a core inflation of 8 percent even though the price level plummeted from 13 percent to 4 percent in two years. Because the government was projecting 8 percent inflation for the foreseeable future, our spending appropriations included an inflation premium that wasn't needed. That's where the deficit came from. Tax revenues remained fairly constant all along at about 19 percent of GNP, the historical average. It's the outlays that soared. Moreover, the deficit as a percentage of GNP is not that large. At this point, the Congressional Budget Office projects that under current law, assuming 3 to 4 percent real growth, the deficit will continue to shrink as a percentage of GNP. We are over that hump.

**Bruce Bartlett** – One of the reasons why the deficit is a political issue is because it's the only thing on which the Left can make any inroads. Economic growth is up and unemployment and inflation are down. Basically, they don't care about the deficit at all. What they're interested in is using the deficit as an argument to raise taxes.

**Richard Rahn** – One of the great benefits of the deficit has been that it's put the Left in a bind. It's kept them from coming out with any new spending programs like national health care. I like to hear the Left talking about deficits because that plays into the hands of those who want to shrink government.

**Stephen Entin** – We heard earlier that the one great achievement of the Reagan Administration was the tax reform. I think there's another one that ought to be mentioned. In the last three years we've created eleven million jobs. The European community has had no job growth in the last ten years. I believe that America's supply-side, classical economic ideas can bring some new economic vigour to the nations which in fact gave them birth. If you do bring these ideas home again, you'll find that you've also recaptured the moral high ground. There's nothing more moral than putting people to work.

**Questioner** – George Gilder mentioned that the emergence of new technologies would greatly reduce capital requirements. Doesn't that open us up to a much wider international competition? What natural advantages are left for the older industrialized countries, including the United States? Aren't the individuals who really benefit from the new technology the individuals in developing and newly industrialized countries?

**George Gilder** – Yes, and I think that's wonderful. I don't think it's a zero-sum world. If they work harder and more creatively than us, they'll get richer than us. It won't be a tragedy. We'll get richer too. Any triumph of capitalism in the Third World is a triumph for us. Any advance of socialism in the world is a setback for us.

If the Chinese continue their course of economic liberalization, they will become one of the most important powers in the world economy. To the extent that any nation is willing to emancipate the creativity of its individuals, it will triumph. That doesn't disturb me at all. If Americans don't exploit these technologies as well as other countries do, they'll grow relatively poorer than other countries. But to the extent that the whole world turns toward capitalism, the whole world will be richer.

For the Third World and to an extent some European countries, natural resource wealth has been a curse in disguise. Their wealth in natural resources has allowed them to avoid freeing up their economies. Britain was directly hurt by North Sea oil in this respect. The Third World will actually be liberated by the declining importance of raw materials in their economies.

**Questioner** – You put the matter very much in terms of the American Challenge. All I'm trying to say is that America will be very much among the challenged.

**George Gilder** – The American Challenge is the 28 percent top marginal tax rate. That is the new "defi Americanain." To the extent that other countries follow our example, that means we'll be challenged too. Everybody benefits the more widely this challenge spreads.

**Questioner** – I think our commentators have been a little bit too optimistic about the impotence of the state. The governments of Europe, working through the OECD, have been actively working to block the ability of people to move their capital around. At this very moment, there is a tax treaty being pushed within the OECD which would enable one signatory government to ask for and demand the tax returns of individuals living in jurisdictions of other signatory governments, whether or not there is a criminal tax prosecution or investigation underway. The treaty is intended not only to thwart illegal tax evasion, but also perfectly legal tax avoidance activities. This is an ominous development which I think we should be aware of.

**Alan Reynolds** – I don't think George Gilder meant that the state was limited in its ability to do mischief. What he's saying is that governments are going to become increasingly limited in their ability to do things that are beneficial to their national economies, particularly at the expense of other economies.

Their strategy will be to prevent the escape of capital and people. I don't think they'll succeed. It's a big world out there. If the major countries were to get together to prevent capital flows or migration, I can assure you there will be other countries that will welcome their engineers and scientists with open arms. The high-tech industry will move to Brazil or some other unlikely place just as the textile industry is moving to Jamaica where the tax rates have suddenly been lowered.

**Warren Brookes** – It's another way of saying sanctions don't work. Sanctions ultimately fail. Massachusetts tried to keep companies from moving to New Hampshire. It was a fruitless cause. Companies physically stayed in Massachusetts, but they expanded elsewhere.

**Questioner** – One thing we have to take into consideration in this discussion is the election cycle. In 1982, in just three months, five European governments shifted over from fragmented left-centre coalitions to strong right-centre parties. In that honeymoon period, those governments implemented some important supply-side measures. I think the next cycle is critical, particularly with the new government coming into power in Germany in January. What they do will help to determine whether the supply-side revolution will go forward.

**Andrew Neil** – I'd like to know why you think that is true. So far, the Kohl government has shown itself to be even less of a supply-side government than the Thatcher government.

**Alan Reynolds** – This isn't really a partisan issue. One of the major architects of the latest tax reform in the United States was the senator from my own home

state of New Jersey, Dill Bradley, a Democrat. Some of the supply-side success stories that I mentioned are India and China, socialist countries. If one were to look at disappointments, I would point to the surtax in Canada under a conservative government. What the Tories should be concerned about is that the opposition might turn to supply-side economics. It is a very effective way to unseat the incumbent party.

**Questioner** – Governments could reduce taxation to nil and still control our entire lives through regulation. To me, the real issue is who owns assets and who has responsibility for their efficient use, not whether taxation is too high or too low. Unfortunately, these issues are not encapsulated in what we have talked about today.

**Bruce Bartlett** – Part of the supply-side agenda has always been deregulation. Supply-siders in the United States were very active, early on, in helping to deregulate transportation, communications and finance. It's not that we're oblivious to those problems. It's just that in the United States we've already fought and won many of those battles.

**Warren Brookes** – Indirectly, we have been talking about government control. We live in a global market. If tax rates are dropped in a few countries, the effect will be to drive them down everywhere else. Technology is helping to make market forces dominant over political forces. Governments have to conform to the realities of the marketplace.

Look at Africa. You don't find any love for capitalism among African potentates who once were very content with their corrupt socialist bureaucracies. They're making market reforms because they have no choice. Their people are starving. The new technology that George Gilder mentioned combined with the lowering of tax burdens is going to force a revolution on the rest of the world. You won't have any choice in this country. You'll have to lower your tax rates.

## Conference Participants

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### Speakers

<b>Bruce Bartlett,</b>	Heritage Foundation
<b>Tom Bethell,</b>	<i>American Spectator</i>
<b>Warren Brookes,</b>	<i>Detroit News</i>
<b>Stephen Entin,</b>	U.S. Treasury Department
<b>George Gilder,</b>	Manhattan Institute for Policy Research
<b>James Gwartney,</b>	Florida State University and Political Economy Research Center
<b>Lawrence Lindsey,</b>	Harvard University and National Bureau for Economic Research
<b>Richard Rahn,</b>	Chamber of Commerce of the United States
<b>Alan Reynolds,</b>	Polyconomics
<b>George von Furstenberg,</b>	Indiana University
<b>Roger Waud,</b>	University of North Carolina and National Bureau for Economic Research

### Session Chairman

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<b>Eamonn Butler,</b>	Adam Smith Institute
<b>David Howell,</b>	Member of Parliament
<b>Andrew Neil,</b>	<i>Sunday Times</i>

## Tax Payments by Taxpayer Groups U.S. 1980–1984

	<u>\$200,000 &amp; over</u>	<u>All Taxpayers</u>
<b><u>1982</u></b>		
Old Law	\$25.95	\$311.01
New	\$22.44	\$266.76
Actual Tax	\$26.62	\$277.60
<b><u>1983</u></b>		
Old Law	\$29.01	\$40.33
New Law	\$23.52	\$265.90
Actual Tax	\$1.73	\$274.18
<b><u>1984</u></b>		
Old Law	\$4.11	\$85.79
New Law	\$27.04	\$286.12
Actual Tax	\$42.11	\$303.97

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**Old Law** — Estimate of what would have been collected at the old higher tax rates.

**New Law** — Estimate of what would have been collected at the new lower tax rates, assuming there was no Laffer Curve effect.

**Actual Tax** — The actual revenues collected.

Dollar Figures in Billions

**Lawrence B. Lindsey**

Harvard University and National Bureau of Economic Research

## An Historical Look At Taxes in the U.S.

### 1920's Tax Cuts

<u>Taxpayer Group</u>	<u>Tax Revenue Collected</u> <u>(in millions of 1929 dollars)</u>		
	<u>1921</u>	<u>1926</u>	<u>Percent Change</u>
Over \$100,000	194.0	361.5	+86.3
Less than \$10,000	155.1	32.5	-79.3

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### 1960's Tax Cuts

<u>Taxpayer Group</u>	<u>Tax Revenue Collected</u> <u>(in millions of 1963 dollars)</u>		
	<u>1963</u>	<u>1965</u>	<u>Percent Change</u>
Top 5 percent	17.17	18.49	+7.7
Bottom 50 percent	5.01	4.55	-9.2

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### 1980's Tax Cuts

<u>Taxpayer Group</u>	<u>Tax Revenue Collected</u> <u>(in millions of 1981 dollars)</u>		
	<u>1981</u>	<u>1984</u>	<u>Percent Change</u>
Top 5 percent	100.4	103.6	+3.2
Bottom 50 percent	20.6	18.9	-8.3

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**Source:** *Internal Revenue Service*

Prepared by **Professor James Gwartney**

**Taxes Paid By Top Income Earners United Kingdom  
1978–79 versus 1985–86**

<u>Taxpayer Groups</u>	<u>Total Share of Taxes Paid</u>	
	<u>1978–1979</u>	<u>1985–1986</u>
Top 1 percent	11.2%	12.0%
Top 2 percent	15.4%	17.0%
Top 3 percent	18.8%	20.7%
Top 4 percent	21.6%	23.9%
Top 5 percent	24.0%	26.7%

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**Source:** *British Treasury*

### Tax Burdens as a Percentage of GNP Versus Jobs

	1979	1984	% Change	1980-85 Job Growth	1985 Unemployment
UK	32.88	38.51	17.10	-1.00	13.50
Germany	37.69	37.7	0.10	-1.90	9.30
France	41.08	45.49	10.70	-2.00	10.50
Canada	31.05	33.72	8.60	-2.50	10.40
Japan	24.43	27.38	12.10	+4.00	2.60
USA	29.91	28.99	-3.10	+8.20	7.10

**Source:** *O.E.C.D.*

Prepared by Warren Brookes

### Marginal Tax Rates and Economic Growth

	<u>Average Marginal Tax Rate (1986)</u>	<u>Cumulative Growth of GNP (1980–85) in 1980 dollars</u>
US <sup>°</sup>	35%	13%*
Switzerland	37%	9%
West Germany	50%	6%
Turkey	51%	27%*
France	52%	6%
Italy	53%	5%*
Finland	60%	7%
Norway	62%	14%*
United Kingdom	62%	9%*
Spain	63%	10%
Denmark	63%	11%
Greece	63%	4%
Austria	64%	8%
Netherlands	72%	3%
Portugal	74%	5%
Belgium	79%	2%
Sweden	90%	9%

**Source:** *OECD GDP Figures*,  
Prepared by Alan Reynolds

<sup>°</sup> — U.S. tax rates are the new projected lower rates for 1988

\* — Countries where marginal rates were reduced since 1975–79

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