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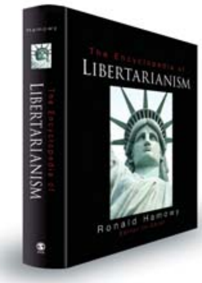

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Cato Policy Report

September/October 2008 **Vol. XXX No. 5**

Inequality and Taxes

BY ALAN REYNOLDS

Every contest for the presidency is also a contest among interest groups, think tanks, and journalists eager to gain attention and influence public policy by persuading candidates to adopt their agenda as a campaign theme.

Income inequality has long been a favorite rhetorical device to promote such disparate policies as tariffs, immigration restrictions, or subsidies to builders of low-income housing. In the current election cycle, the mantra of "rising inequality" is incessantly used as a rationale for punitive tax policies toward high-income taxpayers and even middle-income investors—proposals rarely defended on their economic merits. "Fairness" arguments often seem to drown out serious debate about the potential impact of higher marginal tax rates on economic efficiency, incentives, tax avoidance or economic growth. This campaign for higher tax rates on upper incomes invariably relies on measures of incomes among the "top 1%" as reported on individual income tax returns (a strange average of incomes ranging from about $350,000 to $3.5 billion).

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ALAN REYNOLDS is a senior fellow at the Cato Institute and the author of *Income and Wealth.*

In *D.C. v. Heller*, the Supreme Court clearly declared that the Second Amendment protects an individual right to keep and bear arms. Robert A. Levy, a Cato senior fellow and board member, may not own a gun, but he acted as "prime mover" of the case, financing it, assembling the original plaintiffs, and guiding the case through the lower courts. Pictured from left to right at the Court after the decision: Levy (wired for radio interviews), who acted as co-counsel throughout, plaintiff Dick Heller, and lead counsel Alan Gura talk to reporters following the historic decision.

BY WILLIAM A. NISKANEN

"A disciplined group that is prepared to endorse one or the other major party candidate in a close election can have a substantial effect on the issue positions of both major party candidates."

Chairman's Message

A Case for a *Different* Libertarian Party

All of this blog talk about which major party candidate is more likely to be receptive to libertarian policy positions, I suggest, is a waste of time unless the winning candidate of either major party is dependent on the votes of libertarians.

Increased outrage about the state of American politics and the prospect for a large number of close elections increase the potential effectiveness of a different "libertarian party"—one that sometimes endorses one or the other major party candidate but does not run a party candidate for that position.

The effectiveness of the Libertarian Party and almost all other third parties in U.S. history in promoting their policy positions has usually been counterproductive, because running a third-party candidate reduces the vote for the less undesirable of the major party candidates. A disciplined group that is prepared to endorse one or the other major party candidate in a close election, however, can have a substantial effect on the issue positions of both major party candidates. The following conditions must be met to achieve this:

1. An effective libertarian party must not run a separate candidate.
2. The size of the party must be larger than the expected vote difference between the major party candidates.
3. After the major party candidates are selected, the party leadership must have the opportunity to bargain with each of the major party candidates on the issue positions of highest priority for the libertarian party.
4. The party, as much as possible, must act in concert to support the major party candidate that is preferred by the members of the party in that district.

There is no reason for this libertarian party to be active in any district for which the party does not meet all four of the above conditions. Condition 2 illustrates why a different libertarian party could be far more effective than the current Libertarian Party; several polls indicate that about 20 percent of voters have general libertarian political preferences, but few Libertarian Party candidates win more than 1 percent of the popular vote. Condition 4, I suspect, is the most difficult of these conditions for libertarians to meet. In addition, the party should not emphasize the same issues in every district, because the choice of these issues should depend on those for which one or the other major party candidates is willing to bargain.

This is a strategy to increase the approval of libertarian policy positions rather than the usually counterproductive effort to increase the number of votes for Libertarian Party candidates. Maybe it would be better to term the organization that I have described as a libertarian political action committee or a liberty caucus rather than a libertarian party.

Supreme Court's Heller *ruling is clear*

Second Amendment Revived

Thanks in no small part to the work of Cato senior fellow Robert A. Levy, the long, heated debate over the meaning of the Second Amendment to the U.S. Constitution has been decided: Americans have the right to own firearms for self-defense.

On June 26, 2008, the Supreme Court decided 5-4 in *D.C. v. Heller* to strike down the District of Columbia's 32-year-old ban on handguns, the most restrictive in the nation. The decision unequivocally affirmed the right of individual American citizens to own firearms irrespective of service in a militia. Writing for the majority, Justice Antonin Scalia said the militia language was merely a "prefatory statement of purpose," while the "operative clause" was "the right to keep and bear arms."

According to a June 26 *New York Times* synopsis, *D.C. v. Heller* "reached the court as the result of an assumption by the Cato Institute, a libertarian policy organization here, that the time was right to test the prevailing interpretation of the Second Amendment."

Robert A. Levy, a Cato senior fellow, board member, and co-counsel to *D.C. v. Heller,* deserves most of the credit. As chronicled in past editions of *Cato Policy Report*, it was Levy, who was the "prime mover" behind the case, conceiving it and financing it as it traveled from the lower courts to the nation's highest court. He chose to challenge D.C.'s gun ban, as it was the most restrictive in the nation and, crucially, subject only to federal law. He recruited law-abiding District of Columbia residents to be plaintiffs, including Dick Heller, an armed security guard by day, barred by law from protecting his own family by night, and Cato vice president Tom G. Palmer, who once brandished a pistol to defend himself from potential attackers. Ultimately it was Levy who decided, against the active opposition of groups such as the National Rifle Association, to challenge the D.C. gun ban at the district, appeals, and finally, Supreme Court level.

It's difficult to overstate just how significant this decision is for libertarians. The Supreme Court had not conclusively interpreted the Second Amendment since its ratification in 1791. It had only attempted to do so once, in 1939, offering a murky ruling in *U.S. v. Miller* that led to fierce and often ideological battles among legal scholars and effectively allowed local legislators to ignore the Second Amendment in crafting gun regulations. In short, an entire amendment of the Bill of Rights was being trampled on, thanks to being essentially ignored by the Supreme Court, and Levy, along with Alan Gura of Gura & Possessky, as well as Clark Neily of the Institute for Justice, was able to overcome that.

The decision in *Heller* means a revitalized Second Amendment, one that clearly protects for the individual right to keep a firearm for self-defense. Just how much local gun regulation will change as a result of the decision is debatable. Randy E. Barnett, a senior fellow at the Cato Institute, predicted in a June 27 *Wall Street Journal* op-ed that the ruling would not merely stand in the District, but would "eventually be extended to the states." New York, San Francisco, and Chicago are all subject to extremely strict gun regulation bordering on outright bans, and expect to experience a flurry of litigation.

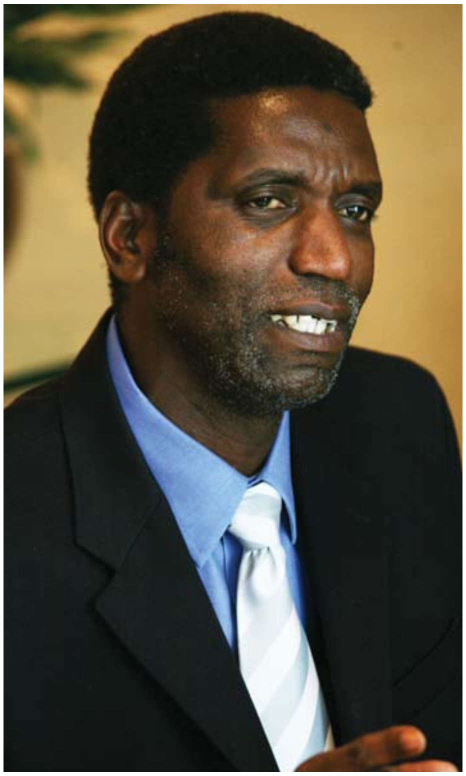
Cato has commissioned a book on the case and on the history of the controversy over the right to bear arms entitled *Gun Control on Trial*, by *Reason* magazine senior editor Brian Doherty. It will be out November 1. Also, be sure to check out www.cato.org/gunban, where you can learn more about *Heller*, read Cato commentaries on the case from throughout the news media, read the full text of the decision, and hear podcasts with Robert A. Levy.

NEWS NOTES

At long last, the Cato Institute is pleased to offer its own necktie. The men's silk tie is maroon and features Cato's logo imprinted in grey and red throughout. The *New York Times* liked the tie enough to say "the Cato Institute doesn't just set the libertarian intellectual agenda, it provides the libertarian intellectual wardrobe." We think you'll really like it, too. It's heavy and rich—not gimmicky like other company ties. Visit Cato's store at www.catostore.org to claim your own for the low price of $25. For the ladies, there's a matching scarf, also only $25.

JAMES A. DORN, vice president for academic affairs and editor of *Cato Journal*, contributed the entry on Peter Bauer in the second edition of the *New Palgrave Dictionary of Economics*, which has been called "the standard reference work on economics." Dorn reviews Bauer's pioneering work in development economics, which challenged the state-led development model that was in fashion when Bauer began writing, and notes Bauer's receipt of the first Milton Friedman Prize for Advancing Liberty just before his death in 2002.

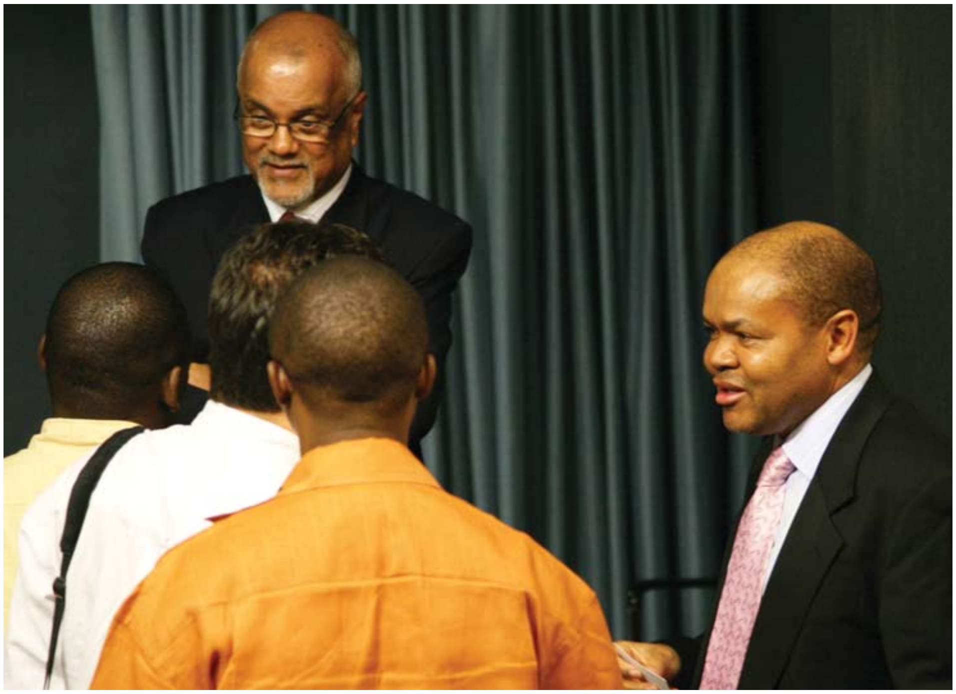
The Cato Institute is pleased to name GENE HEALY as vice president. From 1994 to 1996 he served as managing editor of *Regulation* magazine. After earning his J.D. from the University of Chicago and sampling private practice at Howrey Simon Arnold & White, he returned to Cato as senior editor in 2001, with responsibility for editing all Cato studies. As vice president, Gene will oversee Cato's foreign policy, constitutional, and civil liberties policy work, in addition to maintaining major editing responsibilities. He'll also continue to write. A recent George Will column described Healy's *The Cult of the Presidency* as "brilliant" and "the year's most pertinent and sobering public affairs book."



At a Capitol Hill Briefing, Zimbabwean activist Rejoice Ngwenya said hyperinflation, currently at 12.5 million percent, has gotten so out of hand that prices double every 22 days and a single tomato costs 5 million Zimbabwean dollars—for now.

At the Goldwater Institute on July 16, author Al Regnery (right) said that from a limited-government perspective the Bush administration is a glass half-full. Cato executive vice president David Boaz held up an empty glass to appreciative laughter from former congressman Mickey Edwards, author of *Reclaiming Conservatism*, and the audience of 200.

The world's largest democracy, India, is an emerging economic giant. Reforms that began in the 1980s and accelerated in the 1990s have led to high growth and have reduced poverty by fully one third. At a Cato Book Forum, Arvind Panagariya, the Jagdish Bhagwati professor of Indian political economy at Columbia University, said India's growth will continue, perhaps even overshadowing China's going forward. He cited an assortment of indicators: India is adding 8 million cell phones per month, its trade-to-GDP ratio has more than tripled in the last 15 years, and rapidly rising foreign direct investment indicates that world players are banking on India's continuing development.



On a continent scarred by political repression and economic underdevelopment, Botswana and Mauritius stand out. In 2007, Freedom House certified both countries as free, and the latest *Economic Freedom of the World* report found that Botswana and Mauritius had the two freest economies in Africa. According to the World Bank, the two also have—along with Seychelles—Africa's highest per capita incomes. Pictured: (left) Kailash Ruhee, ambassador of the Republic of Mauritius, and (right) Lapologang Caesar Lekoa, ambassador of the Republic of Botswana, field questions from reporters following a Cato Policy Forum on the African success stories.

Twelve million undocumented workers currently reside in the United States, and more are on the way. (Left) At a Cato Book Forum, Jason Riley, author of *Let Them In: The Case for Open Borders* and a member of the editorial board at the *Wall Street Journal,* said conservatives ought to rethink their opposition to immigration. He asked how they can criticize laws that prevent the free flow of goods and capital across borders, yet turn protectionist when it comes to people doing the same. (Right) Michael Barone of *U.S. News and World Report* pointed out that the greatest wave of immigration occurred not in the present day, nor in the 1920s, but in the 1850s, when predominantly German and Irish immigrants came in massive numbers to experience American opportunity. That wave, like all succeeding ones, was a major boon for the U.S. economy.

> "Bad statistics are never a good excuse for enacting bad policies."

Continued from page 1

Telling this story always involves picking two dates very carefully, as if that described an ongoing trend.

The Old Two-Year Ruse (start with 1979)

In June 2007, the Pew Charitable Trust's "Mobility Project" was launched with a pamphlet written by project director John E. Morton, former foreign policy adviser to Sen. John Kerry's presidential campaign, and Isabel Sawhill, associate director of the Office of Management and Budget under President Bill Clinton. The first sentence noted that "the convergence of a presidential election cycle" and "income inequalities last seen nearly a century ago" provide "a unique opportunity to refocus the debate."

The document claimed that the United States "is a society with rapidly growing income inequality," noting that "the Congressional Budget Office [CBO] finds that between 1979 and 2004, the real after-tax income of the poorest one-fifth of Americans rose by 9 percent, that of the richest one-fifth by 69 percent, and that of the top 1 percent by 176 percent." Yet "rapidly growing" surely implies inequality *is* growing rapidly *in the present*, not the past. Comparing 1979 and 2004 shows that something happened between those two dates, but not *what* happened or *when*. If we needed only two years to define a trend, then the same CBO estimates would show that the share of income for the top 1% was 12% in 1988 and 12.2% in 2003. It is no accident that the Mobility Project started with 1979.

One thing that happened between 1979 and 1988 is that marginal tax rates on individuals stopped being higher than tax rates on corporations. The textbook *Taxes and Business Strategy*, by Myron Scholes and others, shows that "pre-1981 . . . many doctors, lawyers and consultants incorporated to escape the high personal tax rate." After the highest individual tax rate fell from 70% to 28%, they added, "many of the corporations converted back" to partnerships, LLCs, and Subchapter-S corporations.

Shifting income from the corporate tax to the individual tax created an illusory increase in top incomes in studies by the CBO and by economists Thomas Piketty and Emmanuel Saez in their 2003 study "Income Inequality in the United States, 1913–1998," which is regularly updated on Saez's website. Business income was only 11.1% of the reported income of the top 1% in 1986, according to Piketty and Saez, but that fraction nearly doubled in only two years to 21.2%. The unusually rapid increase in *reported* top incomes between 1979 and 1988 largely reflects increased incentives to earn more income in taxable cash (rather than perks), and to report that income on *individual* (rather than corporate) tax returns. But it also reflects the fact that inflation fell from 13.3% at the end of 1979 to 4.4% by 1988, greatly increasing the value of bonds and stocks. That, in turn, added to capital gains and stock option payoffs in the CBO estimates of top incomes—particularly in 1986, when there were huge sales of appreciated assets to avoid a higher tax in 1987. To now look back on 1979 as an ideal example of low inequality is ironic, because the runaway inflation of 1979 and the subsequent three-year recession hurt rich and poor alike.

Conflicting Evidence

Using the same CBO figures, if the income gains are measured from 1988 instead of 1979, the increase in the income of the top 1% drops from 176% to 47%, the increase for the top fifth drops from 69% to 31%, and the increase among the bottom fifth rises from 9% to 16%. In other words, nearly all of the "rapidly rising" inequality happened between 1979 and 1988 —a period that ended 20 years ago. Some rise in inequality still remains in this particular set of data, to be sure, even after eliminating the exaggeration resulting from using 1979 as the base year. Yet other measures of income show a quite different pattern of gains, particularly for low-income households.

Table 1 shows two estimates of the changes in *before-tax* income gains for the poorest, richest, and middle fifths of households. The first column is from a May 2007 CBO study, "Changes in the Economic Resources of Low-Income Households with Children," and it begins with the 1991 recession and ends with 2005 (http://www.cbo.gov/ftpdocs/81xx/doc8113/05-16-LowIncome.pdf). This report was based on Census Bureau income plus transfer payments, notably the earned income tax credit (EITC). The second column covers all households, using the Federal Reserve's triennial Survey of Consumer Finances from the cyclical peak of 1989 to 2004 (https://www.federalreserve.gov/pubs/oss/oss2/2004/bulletin.tables.pub.xls). The SCF uses a broader measure of income than the usual Census Bureau definition, including realized capital gains, business income, and transfer payments.

TABLE 1
ESTIMATED GROWTH OF REAL INCOME

	CBO 1991-2005	SCF 1989-2004
Poorest Fifth	35.0%	23.4%
Middle Fifth	17.3%	14.1%
Top Fifth	53.2%	18.3%

Both surveys show relatively large increases in real, inflation-adjusted income among both the poorest and richest fifths, with smaller gains in the middle. The percentage gains for the top and bottom fifths appear much larger in the CBO figures partly because that study begins with the 1991 recession, which exaggerates cyclical change. In the SCF figures, the 1989–2004 income gains among the poorest fifth (23.4%) and second-poorest (20.9%) exceeded the gains among the top 10% (18.3%) , which does not meet any definition of rising inequality.

The Pew report, as well as sensational news stories this year in *The New York Times* (April 9) and the *Wall Street Journal* (April 19), suggested there was something unusually bad about the fact that real median household income in 2006 had not yet gotten back to the peak level of 2000. Yet in the last business cycle median income was also well below the 1989 peak in 1995, after six years, and only $34 higher in 1996 (despite cheap oil). Moreover, the relatively slow growth of middle income in CBO and SCF data shows why the similar measure of median income is *not* a reliable approximation of how real income in general has grown. In both studies, 80% of the population experience more rapid real income growth than the middle did.

A New Two-Year Ruse (start with 2002)

Those who cite rising inequality as the reason for undoing the most economically significant tax rate reductions of 2000–2003 must realize they need evidence about what happened since 2000, not since 1979. Lacking the required proof that the "Bush tax cuts" resulted in a dramatic increase in after-tax inequality since 2000 (and therefore should be repealed), proponents of higher tax rates resorted to misleading statements about before-tax incomes since 2002.

Writing in the May 1 issue of *Time*, Justin Fox said, "According to economists Thomas Piketty and Emmanuel Saez, 75% of all income gains from 2002 to '06 went to the top 1%—households making more than $382,600 a year." Noting with approval that "Obama in particular has been explicit about wanting to shift more of the income-tax burden . . . onto those making more than $200,000 a year," Fox blamed inequality on President Reagan's tax cuts and cited a recent poll showing 51% favor "heavy taxes on the rich." Yet his figures, from Piketty and Saez, refer to income *before taxes*.

Citing the same Piketty and Saez calculations, *Wall Street Journal* columnist David Wessel added "the trend didn't begin with President Bush's election, but he didn't do

> "It is clearly illogical to point to income *before taxes* to suggest that the rich do not pay enough taxes."

much to arrest it." What could he have done? Raising tax rates on the rich or transfers to the poor could not change these numbers, because Piketty and Saez *exclude* taxes and transfers. "There is significant disagreement among politicians and voters about . . . how much the tax code should redistribute income," wrote Wessel, noting that "Sen. Obama would wield the tax code more aggressively than Senator McCain." This alleged policy debate relies on statistics that exclude taxes in order to rationalize the use of higher tax rates to reduce high incomes. That makes no sense.

The statistics were lifted uncritically from a March 15 memo by Emmanuel Saez of the University of California at Berkeley, "Striking It Richer." Saez compares the 1993–2000 Clinton expansion with the Bush 2002–2006 expansion, concluding that "during both expansions, the incomes of the top 1% grew extremely quickly at an annual rate over 10.1 and 11.0% respectively." But that is only because he starts with 2002, after stock prices had collapsed, and includes capital gains. Realized capital gains fell from 6% of GDP

TABLE 2
AVERAGE BEFORE-TAX INCOME OF THE TOP 1% (IN 2006 DOLLARS, INCLUDING CAPITAL GAINS)

	INCOME ($)	SALARY SHARE (%)
1993	596,525	59.8
2000	1,185,533	56.9
2002	820,102	58.7
2006	1,242,595	48.4

Source: Thomas Piketty and Emmanuel Saez, "Updated Tables," Tables A6 and A7, http://elsa.berkeley.edu/~saez/TabFig2006.xls. Salary share adapted from Table A7 (which excludes capital gains) to define income to include capital gains.

in 2000 to 2.4% in 2002, and then recovered to 5.2% in 2006.

The first column of Table 2 shows the Piketty and Saez estimates of average (mean) income for the top 1%, measured in 2006 dollars and including capital gains. These figures supposedly show that real incomes of the top 1% have been growing very rapidly under Bush, just as they did during the tech stock boom of 1997-2000.. In reality, top incomes doubled from 1993 to 2000, but then fell 31% by 2002. For the remaining 99%, by contrast, real income fell by only 4% from 2000 to 2002. Saez claims incomes of the top 1% continued to rise "extremely quickly" after the Clinton years, both in absolute terms and also relative to other incomes. For the whole period from 2000 to 2006, however, his figures show that real income of the top 1% rose by 9% (from $1.185 trillion to $1.243 trillion), while the real income of everyone else rose by 9.8% (from $6.22 trillion to $6.83 trillion).

The second column shows the *declining share* of top incomes received from salary, bonuses, and stock options. Saez, however, says, "A significant fraction of the surge in top incomes since 1970 is due to an explosion of top wages and salaries." That was true from 1966 to 1988, and from 1994 to 2000, but not since then. His data show that real *labor* income of the top 1% was flat from 1988 to 1994, rose 65.7% from 1994 to 2000, and then *fell* 8.4% from 2000 to 2006.

The relatively small increase in top 1% incomes from 2000 to 2006 is mainly because of income shifting—the business share of the top 1% of income rose from 27.4% in 2002 to 30.1% in 2006, after individual and corporate tax rates became the same. Lower tax rates on dividends also raised taxable top incomes. Dividends accounted for only 4.2% of top percentile incomes in 2002 (aside from capital gains), but 7.4% in 2006. When capital gains were included, they accounted for 5.8% of the income of the top 1% in 2000, 2.3% in 2002, and 4.4% in 2006. It is not difficult to imagine why Saez chose to include capital gains and to measure top income gains from 2002 rather than from 2000.

"Telling a story about rising inequality always involves picking two dates very carefully."

Imagine There's No Taxes . . .

The Brookings Institution began a new policy program in 2006, the Hamilton Project—founded by former Treasury secretary Robert Rubin. The first director was Peter Orszag, now head of the Congressional Budget Office. The project's seminal statement on tax policy, "Achieving Progressive Tax Reform," was coauthored in June 2007 by former Treasury secretary Larry Summers; Jason Furman, now economic director for the Obama campaign; and Jason Bordoff, the new project director.

The paper acknowledged that "excessively high tax rates distort economic behavior by changing the incentives to work, save, and invest, which can harm economic performance." Yet the key theme was to assert that "rising inequality strengthens the case for progressivity." Proof of such rising inequality again relied on CBO estimates of income changes since 1979. Like Saez, Summers, Furman, and Bordoff emphasized *before-tax* data: "In 1979," they wrote, "the before-tax income of the most affluent 1 percent of the U.S. population already equaled that of the bottom 26 percent. That share has since risen nearly continuously, reaching 45 percent in 2004."

Even if those figures were credible, they are *irrelevant* to the policies being prescribed. It is clearly illogical to point to income *before taxes* to suggest that the rich do not pay enough taxes. It is also illogical to point to income *before transfer payments* to prove that the poor do not receive enough transfer payments. The before-tax CBO estimates exclude the refundable earned income tax credit (EITC). The authors' estimates also rely on Piketty and Saez, who exclude *all* transfer payments. If transfer payments are excluded, the Census Bureau calculates that incomes of the poorest fifth in 2006 averaged only $5,208 but their *disposable* income—including transfers—was $12,329. Similarly, the *before-tax* income of the richest fifth averaged $182,505, but their *disposable* income—after taxes—was $137,293.

The Hamilton Project paper claims that "the tax system itself has become considerably less progressive. Reductions in taxes have been particularly dramatic for very high income taxpayers." That comment cannot refer to individual income taxes, as presidential policy debates assume. CBO estimates the individual income tax rate among the top 1% fell modestly from 21.8% in 1979 (when the top tax rate was 70%) to 19.9% in 1989 (when the top tax rate was 28%) and 19.4% in 2005 (when the top tax rate was 35%).

By contrast, reductions in taxes *have* been "particularly dramatic" for the middle fifth, whose average tax was slashed from 7.5% in 1979 to 5% in 2000 and 3% in 2005. For the poorest fifth, the tax rate fell to *minus* 1.6% in 1989, *minus* 4.6% in 2000, and *minus* 6.5% in 2005—reflecting the expansion of refundable tax credits. In the same paper, Summers, Furman, and Bordoff argue that the progressive 1986–2003 reductions in income tax for the bottom 40% have now made it "regressive" to reduce anyone else's income tax: "The bottom 60 percent of households pay less than 1 percent of total income taxes," they write, so "any income tax cuts that do not include expansions in refundable credits such as the EITC are therefore necessarily regressive." Making that comment even more ironic, the authors *exclude* the EITC when adding-up incomes of the bottom 40%.

In reality, the authors' claim that taxes have become "less progressive" cannot and does not refer to the reduction in *individual* income tax rates. Instead, it mainly refers to a CBO estimate that the effective corporate rate on the top 1% fell from 13.8% in 1970 to 6.7% in 2000—before rising to 9.9% in 2005. That timing makes it difficult to blame the 2001–2003 tax cuts for making taxes "less progressive." Besides, the CBO's technique for distributing the corporate tax is seriously flawed.

Adding Two-Thirds of Corporate Tax to Top Incomes

Believe it or not, the CBO adds two-thirds of *corporate taxes* to the before-tax income of households of the top 1%. They do that to estimate what share of that tax is borne by the top 1%. Yet adding most corporate taxes to top incomes makes before-tax CBO figures a particularly untenable way to measure changes in top incomes. CBO economists reason that the corporate tax is borne by owners of capital in general. Unfortunately, they then make an indefensible leap by estimating the ownership of capital by looking at only the dwindling portion of capital gains, dividends, interest income and rent still reported on tax returns. As a result, the estimated share of corporate taxes added to top 1% incomes rose from 34% in 1979 to 66.4% in 2004. And that, in turns, accounts for a sizable portion of that 1979–2004 increase in top "incomes" (including corporate taxes) used to defend the Hamilton Project's uneasy case for steeper marginal tax rates on incomes well below the top 1%.

The top 1% could not possibly have received 66.4% of the nation's investment returns in 2004. Their share of wealth was 33.4% according to the SCF, and closer to 21% according a study co-authored by Saez. Neither study finds any upward trend in wealth inequality, so assigning 66.4% of capital income to the top 1% is literally unbelievable. The only reason the top 1% accounts for a rising share of *taxable* savings is that a rapidly increasing share of everyone else's savings is now sheltered in tax-free retirement plans. Returns on those investments will *never* be reported to the IRS as dividends, interest, or capital gains, because distributions from deferred plans are reported as ordinary income while capital gains or dividends from Roth IRAs are never reported. Most capital gains on home sales also vanished from tax returns since 1997.

The CBO's statistical blunder of using *taxable* investment returns to guess the share of corporate taxes for the top 1% resulted in

Continued on page 19

One Man's America

With America suffering from a host of economic ills, and a pending presidential election that offers little reason for hope, you can forgive Americans for wondering what the future holds. Perhaps no one is more qualified to weigh in on that future than George F. Will, the Pulitzer Prize–winning columnist for the *Washington Post* and *Newsweek*. At a July 24 Cato Book Forum for his latest book, *One Man's America: The Pleasures and Provocations of Our Singular Nation*, Will said he was nervous about the out-of-control growth of the entitlement state, but that he remained optimistic for other reasons. Read his presentation in full here, or watch the video at www.cato.org. Just click the "events" tab and then click "event archives."

It's a pleasure to be at Cato to talk about books, because in spite of all the hoo-ha about the Internet and new media, I continue to believe not just that ideas have consequences but that only ideas have large and lasting consequences, and that books remain the primary carriers of ideas.

The Cato Institute certainly exemplifies this. Mr. Samples's book *The Fallacy of Campaign Finance Reform* is a major contribution to rolling back the regulation of political free speech. Gene Healy's splendid book *The Cult of the Presidency* is a very timely reminder that we invest irrational and dangerous hopes in the presidency. And I'm very much indebted to Brink Lindsey's *The Age of Abundance* on affluence in America and the transformation of American culture as a result of this.

The book I've assembled, *One Man's America: The Pleasures and Provocations of Our Singular Nation*, is a little bit different because it's very light on controversies about the current political agenda. It's more about American history and culture and interesting people you meet around the country. My hope is that at a moment when there's considerable argument as to what constitutes conservatism, people can read this and say, "Ah, *that's* a conservative sensibility." I tend to believe sensibility precedes philosophy and ideology, and that there really are two fairly distinct sensibilities, a liberal sensibility and a conservative sensibility. I hope, after having read my book about Hugh Hefner and Bill Buckley and the Dust Bowl and the Bakersfield sound and country music and all the rest, people will close it and say, "Well, I got it. That's what one conservative's mind playing on a wide range of reality looks like." I leave it up to them to decide whether they are conservative or not.

It's a very strange moment for those of us who are conservatives. We are facing, as the housing rescue bill proceeds through Congress, what I think can be called another prescription drug entitlement moment, during which conservatives either will or will not stand up and be counted. I wouldn't hold my breath.

It's a moment in which the cognitive dissonance of the country—the gap between the rhetorical conservatism and the operational liberalism of the country—becomes so discordant as to get everyone's attention.

In the next hour, as happens every hour of every day, the center of the American population will move two feet farther south and west. It didn't cross the Mississippi river until the 1980 census; today it is southwest of St. Louis, heading for Clark County, Nevada—which is Las Vegas—and Maricopa County, Arizona—which is Phoenix. This shift of the political weight of the country largely explains why when George W. Bush leaves office at noon, January 20, 2009, all of the elected presidents for 45 years will have come from Georgia, Arkansas, Texas, or Southern California. And this tends to give some people the soothing feeling that demography must be destiny, and therefore the shift of the political weight of the country toward the more traditionally conservative and indeed libertarian parts of the country guarantees a conservative ascendancy. The problem with that is that also in the next hour the federal government will, as it does every hour of every day, spend another $193 million on entitlement programs.

There is a disjunction in the American mind without precedent in history. For more than two centuries the assumption has been that the very process that produces enhanced national wealth—the dynamic market capitalist economy—simultaneously would produce increased family and individual security. Today a great many Americans believe that the market economy undermines family security. This is producing an epidemic of quite irrational apprehension. Never have Americans been more prosperous than they are today, but rarely have they felt more precarious. And this is setting us up for what I would call the cultural contradiction of the welfare state.

About 45 years ago, Daniel Bell, distinguished sociologist at Harvard, published a book called *The Cultural Contradictions of Capitalism*. His argument, much bowdlerized, in simplicity was that capitalism depends on certain social capital of stern virtues—thrift, industriousness, deferral of gratification. The problem is that those stern virtues produce wealth, affluence, leisure, comfort, indolence, and self-indulgence, which in turn undermine thrift, industriousness, and the deferral of gratification. In other words, capitalism undermines its own moral prerequisites.

Something of the sort I think may be happening with the welfare state—particularly in the context of an aging population. Given the fact that a welfare state exists to transfer wealth from the working young and middle-aged to the retired elderly, a welfare state depends on a rapid rate of economic growth to throw off the revenues to pay the bills. But a welfare state, by whetting the appetite for security, and by giving people a sense of entitlement to protection against the risks of the churning of a market economy and the creative destruction of capitalism, produces a political backlash, a political drive to provide security that is incompatible with the economic dynamism that a welfare state presupposes. Hence the welfare state begins to undermine through its entitlement mentality its own prerequisites.

It also I think produces a kind of infantilism on the part of people, by insulating them from the real choices necessary for a responsible society of self-sufficient individuals. Just consider the American savings rate, or lack thereof. In the 1980s, the American people saved approximately 10 cents of every dollar of disposable income. In the 1990s, they saved about a nickel. In 2005, for the first time since the Great Depression, the American savings rate went negative.

Today, in this country, there are more than 105 billion credit cards, approximately 9 per cardholder. Although this is an unreliable figure because it is based on self-reporting, the estimate is that the average household is carrying $12,000 of credit card debt. It is a generally accepted figure, I think, that household debt is now at about 140 percent of household income. Small wonder then that the American people have, to keep the party going, turned their homes into ATMs. And small wonder when you democratize credit as we have done. When, with credit cards and internet purchases and catalog shopping, you so thoroughly separate the pleasure of purchasing and the pain of paying for it, you are setting a country up for a delusional life.

"A welfare state produces a political backlash, a political drive to provide security that is incompatible with the economic dynamism that a welfare state presupposes."

Now I used the phrase a moment ago about the welfare state in the context of an aging population. If we date the arrival of the welfare state—somewhat capriciously—at the enactment of the Social Security Act in 1935, it is fair to say that the welfare state today exists to subsidize two things that did not exist in 1935. One is protracted retirement and the other is competent medicine.

In 1935, retirement as we think of it—a prolonged period of subsidized leisure after work—was a luxury of a tiny, economically and physiologically blessed people in the country. The span of retirement in the 20th century increased from 2 years to almost 20 years. We simply didn't anticipate any of this happening.

And with regard to competent medicine, there was virtually no medicine in 1935. In 1924, Calvin Coolidge—the sainted Coolidge, the last president with whom I fully agreed—was living in the White House with access to the best medicine the country had to offer. His 16-year-old son played tennis without socks; he got a blister, it got infected, and he died. There was very little medicine could do at that point. It is estimated that at least a quarter of the medical treatments now in use—diagnostic, therapeutic, and pharmacological—did not exist in 1965 when Medicare was enacted.

We have put in place as a matter of right an entitlement. We have attached the most rapidly growing portion of the population—the elderly—to the most dynamic sector of American society—this scientifically intensive health care industry—as a matter of right. And we're going to pay a very steep price for this.

We also are poised to see in the coming year or two the most astonishing tax increase in American history imposed upon the country automatically with the expiration of the Bush tax cuts. Will Rogers famously said, "The only difference between death and taxes is that death doesn't get worse every time Congress meets." Taxes will get very much worse without Congress doing anything under this dispensation.

To listen to our politics, you have to listen with a third ear to hear what is not said. And it is encouraging to see that no one was actually calling for the repeal of the emblematic achievement of the 1980s, the Reagan tax cuts—going back to when we had 70 percent marginal tax rates. But if we revert to a 39.6 percent marginal tax rate, then add in increases in the Social Security and the Medicare taxes, and then add in the average top rate in the states, which is 6.5 percent, you're getting close to 60 percent marginal tax rates for the top income earners in the United States. It is politically incorrect, but correct, to note that those people are the most creative class in the country when it comes to wealth and job creation. Add to this stew of coming problems the fact that we now have a dangerous emphasis on widening inequality of income in the United States, and we are set up for some confusing responses to problems, some real and some not.

There is indeed a widening inequality in income in the United States. The cure for it as far as I can tell is for Americans to drop out of school sooner. Two centuries ago the great source of wealth in the Western world was land, a century ago the great source of wealth was fixed capital. Today the great source of growth is human capital—mind, learning, the capacity to handle information. The slogan "you earn what you learn" is a good one. What we've seen from the market is a widening, emphatic return on the yield to education. The market is saying at the top of its considerable lungs, "stay in school." The problem is—and I hate to break this news bulletin here—that half of America's children are of below average intelligence.

As I speak at the F. A. Hayek auditorium, let me say that we are set up for what Hayek called the Fatal Conceit. That is, the belief that government can know and plan the unfolding future and should do so. That is a recipe for what my good friend Patrick Moynihan used to call iatrogenic social problems. In medicine, an iatrogenic problem is a disease or problem caused by medicine. In social life, an iatrogenic social problem is a problem caused by government's attempt to solve a problem.

> "One thing you can do for your country is to reserve a spacious portion of your own life for which you—not your country—are responsible."

The good news is that while all of these indicators are for a recrudescence of misplaced government confidence, that contains the seeds of its own correction. Do remember the following: between 1938 and 1964, there was no liberal legislating majority in this town. In 1938 the country responded against Roosevelt and his court-packing plan, and brought the New Deal to heel. Between that and the anti-Goldwater landslide, conservative Southern Democrats and Republicans kept the government on a more or less even keel. For two years after Goldwater lost 44 states, liberalism had its way. And, four years later, in 1968, Republicans began the process of winning 7 of the next 10 presidential elections. The market in politics, as well as in economics, does seem to work, and there does seem to be a self-correcting mechanism.

I think the American people broadly remain wise. Broadly remain convinced that a benevolent government is not always a benefactor. Broadly remain convinced that capitalism does not just make us better off; it makes us in some senses better. They're broadly convinced that when Jack Kennedy said, "Ask not what your country can do for you. Ask what you can do for your country," one sensible response is that one thing you can do for your country is to reserve a spacious portion of your own life for which you—not your country—are responsible .

I think most Americans still understand what Milton Friedman meant when he said: Take any three letters from the alphabet, put them in any order you want, and you will have an acronym designating a federal agency we could do without. I think most Americans still understand what Robert Frost meant when he said "I'm against a homogenized society because I want the cream to rise." And most of all I think they understand what Ronald Reagan meant when he said, "I do not want to go back to the past; I want to go back to the past way of facing the future."

It is my understanding that the purpose of the Cato Institute is to do precisely that, and I thank them for having me here today to talk about my book. Thank you very much.

Vaclav Klaus, president of the Czech Republic, author of *Blue Planet in Green Shackles*, and an economist by training, analyzes the economics of global warming in a meeting with Pat Michaels, Jerry Taylor, and other Cato scholars in the Cato boardroom. He stressed that the worst approach to the threat of climate change is to slow economic growth and innovation.

Steve H. Hanke, professor of applied economics at Johns Hopkins University and a Cato senior fellow, testified before the House Budget Committee in July. He urged the Federal Reserve to show restraint, blaming loose monetary policy for the recent run-up in fuel and food prices.

Egyptian civil rights activist Dalia Ziada spoke to the Cato interns about her personal experience of genital mutilation and the ongoing struggle for women's rights, as well as human rights generally, in the Arab world.

JUNE 6: Globalization and the World's Rising Living Standards

JUNE 12: *The Psychology of Evil: The Lucifer Effect in Action*

JUNE 12: *America: Our Next Chapter* with Chuck Hagel

JUNE 17: *Smart Power: Toward a Prudent Foreign Policy for America*

JUNE 18: *Let Them In: The Case for Open Borders*

JUNE 19: Botswana and Mauritius: African Success Stories

JUNE 24: *The Dirty Dozen: How Twelve Supreme Court Cases Radically Expanded Government and Eroded Freedom*

JUNE 26: Trade Facilitation: The New Wave of International Trade Liberalization?

JULY 2: *India: The Emerging Giant*

JULY 11: Securing Economic Growth through Trade Facilitation

JULY 15: McCain and Obama: Comparing Their Economic Platforms

JULY 20-25: Cato University: Freedom's Campaign in the 21st Century

JULY 23: The FBI Turns 100

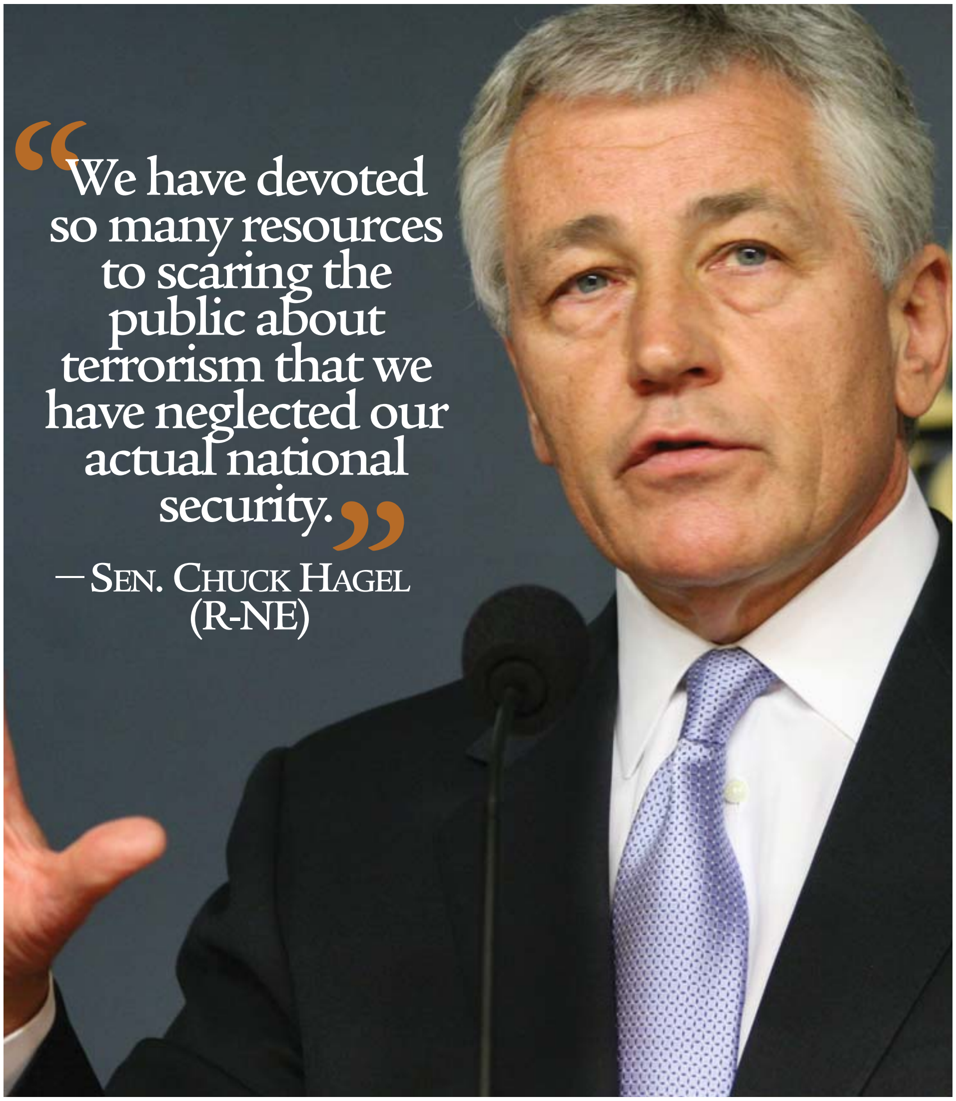
JULY 24: *One Man's America: The Pleasures and Provocations of Our Singular Nation* with George F. Will

JULY 25: Should Congress Lower Tariffs on Imported Shoes?

JULY 28: Escaping Poverty in Sub-Saharan Africa

JULY 31: *The Dirty Dozen:* Are They the Worst Supreme Court Cases in the Modern Era?

Find more information about events in Ed Crane's bimonthly memo for Cato Sponsors. Audio and video of most Cato events can be found on the Cato Institute website. Visit www.cato.org and click the Events tab at the top.



CATO CALENDAR

CATO CLUB 200 RETREAT
Kiawah Island, SC
The Sanctuary at Kiawah Island
September 18–21, 2008
Speakers include Gov. Mark Sanford and John Zogby.

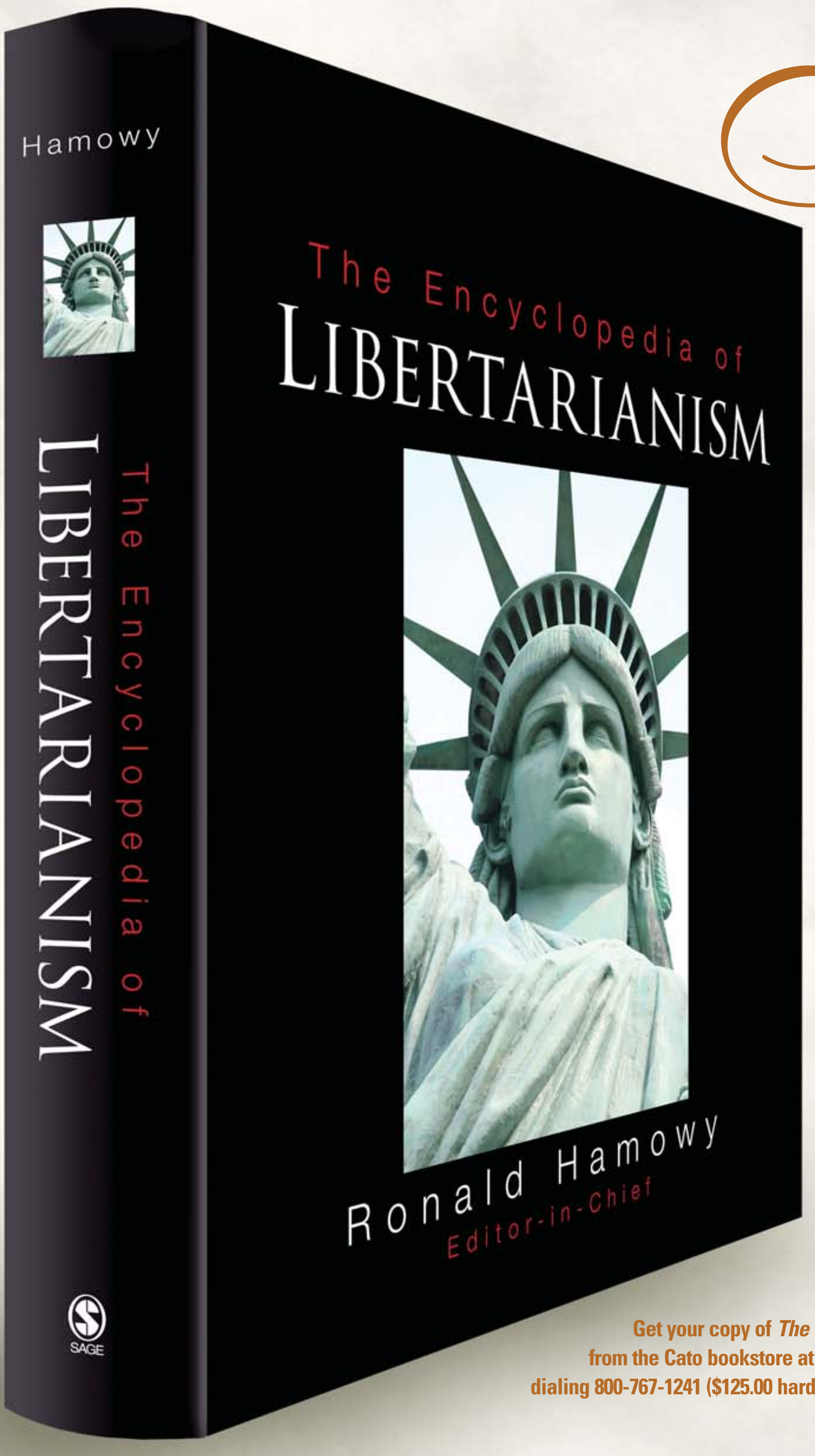
LESSONS FROM THE SUBPRIME CRISIS
26th ANNUAL MONETARY CONFERENCE
Washington • Cato Institute
November 19, 2008
Speakers include Donald Kohn, Anna J. Schwartz, William Poole, Brian Wesbury, and Wolfgang Munchau.

POLICY PERSPECTIVES 2008
New York • Waldorf-Astoria
November 21, 2008

POLICY PERSPECTIVES 2008
Chicago • The Drake
December 3, 2008

21ST ANNUAL BENEFACTOR SUMMIT
Riviera Maya, Mexico
Fairmont Mayakoba
March 4–8, 2009

THE ENCYCLOPEDIA OF LIBERTARIANISM



For the first time, the libertarian movement, which has excited voters and the news media; which has inspired presidents and prime ministers across the world; and whose ideas have swept across the Internet and become so "astonishingly widespread in American culture" that two elite professors wrote a book lamenting it, can claim a new mark of distinction: its own encyclopedia.

As the libertarianism movement has gained prominence, so has the need for a standard reference work. *The Encyclopedia of Libertarianism,* a project of the Cato Institute, serves as a useful introduction to and compendium of libertarian scholarship via a series of brief articles on the historical, sociological, and economic aspects of libertarianism within the broader context.

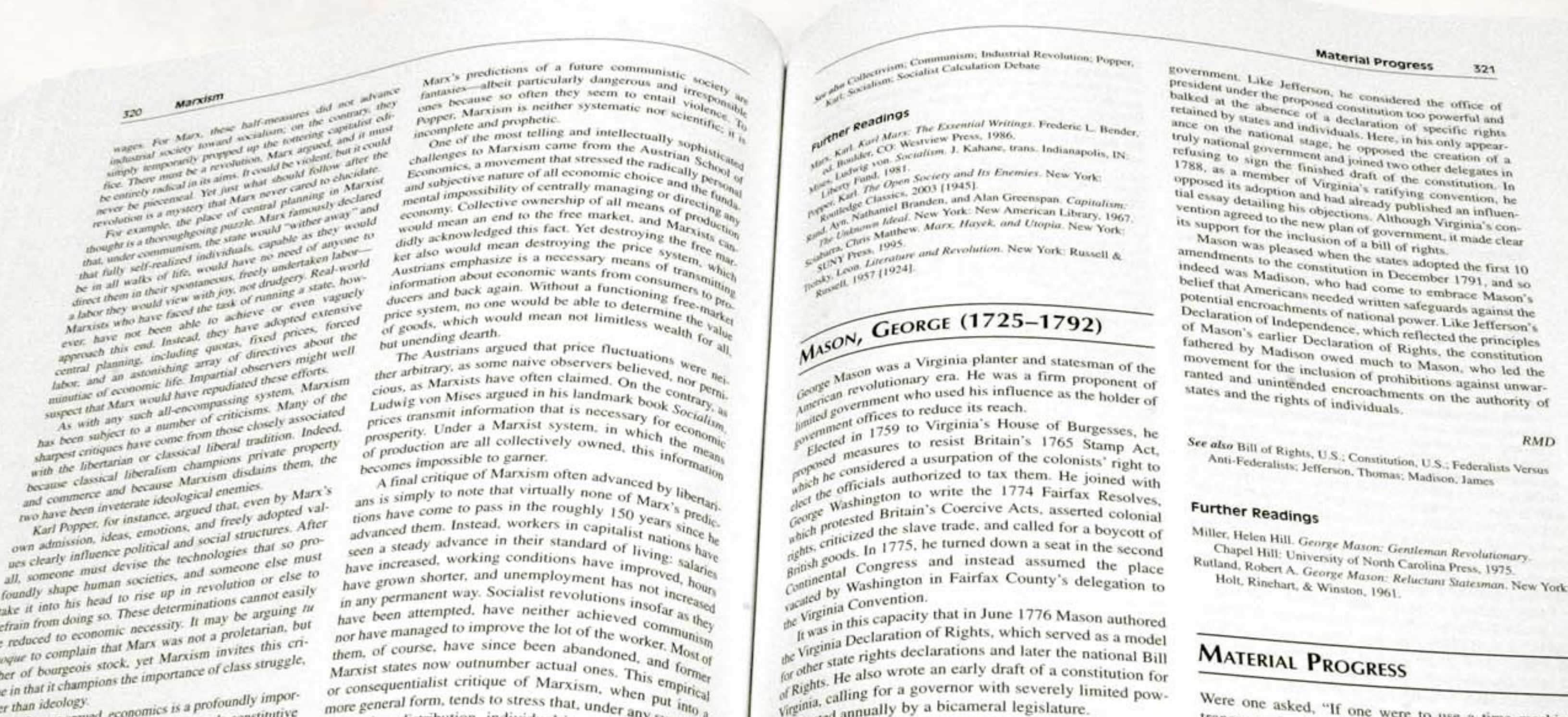
Get your copy of *The Encyclopedia of Libertarianism* from the Cato bookstore at www.catostore.org or by dialing 800-767-1241 ($125.00 hardback).

ABOLITIONISM, ABORTION, LORD ACTON, JOHN ADAMS, AFFIRMATIVE ACTION, AMERICAN REVOLUTION, ANARCHISM, ANARCHO-CAPITALISM, ANTI-CORN LAW LEAGUE, ANTITRUST, THOMAS AQUINAS, ARISTOTLE . . . PRICE CONTROLS, PRIVACY, PRIVATE PROPERTY, PRIVATIZATION, PROGRESS, PROGRESSIVE ERA . . . SOCIAL DARWINISM, SOCIALISM, SOCIALIST CALCULATION DEBATE, SOCIAL SECURITY, SOCIOLOGY AND LIBERTARIANISM, THOMAS SOWELL, HERBERT SPENCER . . .

Anthony de Jasay, Deirdre McCloskey, Richard Epstein, James Buchanan, Randy Barnett, Robert Higgs, Tyler Cowen, Gordon Tullock, Vernon L. Smith, and Israel Kirzner are among the impressive cast of contributors. Many Cato scholars contribute articles as well, including Chairman William A. Niskanen and Executive Vice President David Boaz. In fact, one of the stranger marketing challenges Cato has ever experienced was trying to find people to review the encyclopedia who hadn't already submitted entries!

The encyclopedia was edited by Ronald Hamowy, a distinguished historian who studied under Mises, Hayek, and Friedman and is now a Fellow in Social Thought at Cato, with the assistance of Jason Kuznicki and Aaron Steelman.

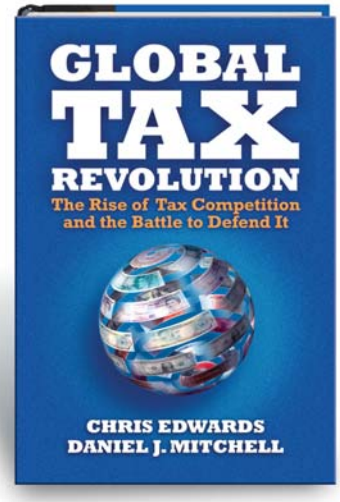
The encyclopedia begins with a substantial essay introducing the reader to libertarian ideas and history and continues with more than 300 original entries, from Aristotle to Whiggism. In between, you'll find entries on contemporary notables such as Ron Paul, and past great thinkers such as Robert Nozick and Ludwig von Mises. For those looking for a studied assessment of the economics of prohibition or privatization, just flip to the "P" section. And for those who want a broad overview of the libertarian movement, then *The Encyclopedia of Libertarianism*—which offers a sweeping overview from ancient times to the present, with an emphasis on the classical liberal tradition in Europe and its subsequent development in America—is for you. Meanwhile, contemporary policy issues from health care to transportation policy to worldwide economic development are also covered. And don't miss entries on Objectivism, Austrian Economics, Term Limits, Tax Competition, and Evolutionary Psychology. At 664 pages, *The Encyclopedia of Libertarianism* is large even for an encyclopedia.

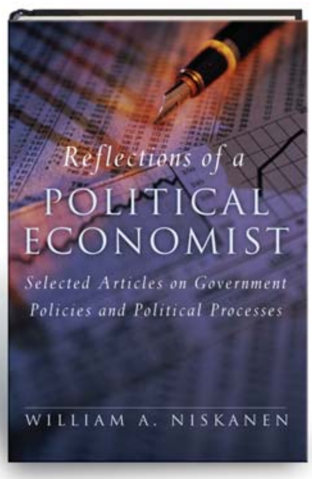


Bill Niskanen reflects on politics and policy

Global Taxes and Global Trade

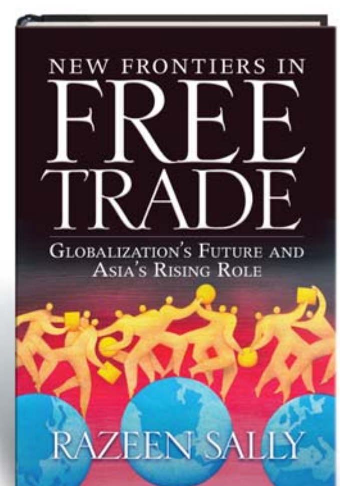
In an internationally best-selling book, *New York Times* columnist Thomas Friedman proclaimed that the world was becoming "flat." A new book from the Cato Institute, ***Global Tax Revolution,*** by director of tax policy studies Chris Edwards and senior fellow Daniel J. Mitchell, says the world is becoming even flatter than Friedman could convey. As the economic mobility of capital and labor has increased, tax rates have tumbled along with them. Since the 1990s alone, the average corporate tax rate in the European Union plunged from 38 percent to 24 percent. Individual income tax rates have also fallen sharply, with the average top rate in the 30-nation Organization for Economic Cooperation and Development having plummeted 26 percentage points since 1980. Meanwhile, a large and growing number of nations plugged into the "flat" world economy have adopted a "flat tax." Twenty-five nations have scrapped their multi-rate, growth-dampening, and economically distortionary tax regimes in favor of a simple, low "flat tax." "Tax competition," wherein nations compete with each other for capital and labor by offering more attractive tax and regulatory regimes, is the centerpiece of this story, a reminder that globalization is important not only for its immediate economic benefits but for its longer-run effects on institutions. **$21.95 hardback.**





Reflections of a Political Economist collects some of the most incisive and important policy analysis and public choice articles by Cato Institute chairman William A. Niskanen in the last 15 years. Niskanen covers many different areas of public policy, always with an eye toward rigorous economic thinking, fiscal conservatism, and finding shrewd, practical solutions to important problems. Taxation, health and retirement funding, terrorism, military preparedness, corporate governance, and global warming are among the subjects covered. Although Niskanen formerly served on President Ronald Reagan's Council of Economic Advisers, he doesn't put much faith in the Republican brand. Rather, he makes the case for divided government—where one house of Congress is controlled by a party other than the party of the president. The seemingly inevitable growth of government is historically much slower in such a situation, and American participation in every war involving more than a week of ground combat for the past 200 years was initiated by a unified government, a trend impossible to ignore. ***Reflections of a Political Economist*** also contains Niskanen's book reviews, in which he considers the works of other notable economists, including Paul Krugman, Mancur Olson, James M. Buchanan, and Alan Greenspan. The book concludes with Niskanen's personal reflections, each to some degree removed from economics, but all reflecting his thoughtful, understated approach to important issues, wherever he finds them. **$24.95 hardback.**

At 145 pages, ***New Frontiers in Free Trade: Globalization's Future and Asia's Rising Role*** offers a concise but comprehensive summary of the present state of affairs in international trade. Author Razeen Sally, senior lecturer at the London School of Economics and co-director of the European Centre for International Political Economy, tackles the economic case for free trade, the World Trade Organization's declining significance, whether bilateral trade agreements represent a good alternative, the emergence of trading giants China and India, and the future of globalization. With the collapse of the Doha round of WTO negotiations, and bilateral trade agreements not delivering significant trade expansion, Sally calls for nations to unilaterally liberalize their trade—that is, practice free trade regardless of whether their trading partners do. Sally's message to free trade proponents is to re-root the argument for free trade in the classical liberal framework. For Adam Smith, free trade was a way to tilt the balance away from rent-seeking producer interests—who are good at gaming the political process—and toward the mass of consumers. It was part of a wider constitutional package to keep government limited, transparent, and clean, enabling it to concentrate better on the public good. In the developing world especially, the argument needs to be made that free trade—including cross-border flows of capital and people—is linked to domestic institutions and growth, all on the canvas of the long-run progress of commercial society. **$18.95 hardback.**



Cato books are available at bookstores nationwide, online at www.catostore.org, or by calling toll-free 800-767-1241.

A one-man publishing house for liberty

Jim Powell Takes on the History of Freedom

If you haven't checked out Jim Powell yet, you're missing out. The former Laissez-Faire Books editor and current Cato senior fellow is an expert on the history of liberty. But don't take our word for it—read any number of his most recent books!

In *The Triumph of Liberty: A 2,000 Year History Told through the Lives of Freedom's Greatest Champions* (2000), Powell provides capsule biographies of 65 freedom fighters, tracing the struggle for freedom from oppression, equality under the law, sanctity of property rights, freedom of speech and thought, and peace. In addition to figures you might expect, like John Locke and Lysander Spooner, Powell also chronicles the lives of people like Hugo Grotius, a lesser-known Dutch antiwar philosopher who wrote, in 1625 (long before it was acceptable), that wars should be prosecuted only in self-defense.

After *The Triumph of Liberty* Powell embarked on an ambitious sequence of exposés of some of America's most revered presidents, offering contrarian analyses of Theodore Roosevelt, Woodrow Wilson, and Franklin Delano Roosevelt. Powell's best-known work is *FDR's Folly* (2003), in which he hammered home the notion that FDR's policies were not rehabilitative, but destructive, prolonging the Great Depression. As Powell points out, the median joblessness rate throughout the New Deal was 17.2 percent, and never dropped below 14 percent. Powell's easy-to-understand analysis of the unintended consequences of FDR's New Deal monetary policy was characterized as convincing "without a shadow of a doubt" by none other than Milton Friedman.

In *Wilson's War: How Woodrow Wilson's Great Blunder Led to Hitler, Lenin, Stalin and World War II* (2005), Powell shows that government intervention leads to unintended consequences not only in economic affairs but in foreign policy too. World War I, an elective war born of Wilson's liberal internationalism, did not bring the stable, peaceful world that Wilson imagined—instead, it brought on World War II, according to Powell.

The Republican nominee for president, John McCain, may like Teddy Roosevelt (because he "liberally interpreted the authority of the office" and "nourished the soul of a great nation," of all things), but Jim Powell is not a fan. In *Bully Boy: The Truth about Theodore Roosevelt's Legacy* (2006), Powell takes on Roosevelt's "trust busting" and the Pure Food and Drugs Act that was passed with his support, showing that even during Roosevelt's own time, those policies hurt the very consumers they were supposed to protect.

Powell's latest offering is arguably his most ambitious. In *Greatest Emancipations: How the West Abolished Slavery*, Powell asks why slavery, unchallenged in principle or practice for thousands of years, disappeared in a single century. It's an important question, and one rarely addressed head-on. In trying to answer this question, Powell looks at places like Haiti, the British Caribbean, Cuba, and Brazil—where slavery was particularly entrenched—asking why their political leaders were able to emancipate their slaves without the violence that occurred in America's Civil War. Turning to that war, Powell writes on the Abolitionist movement leading up to the Civil War, the war itself, and its aftermath in Reconstruction. His look at the big picture leads him to ultimately conclude that the greater the amount of violence that was involved in the emancipation process, the worse the outcomes were for the former slaves.

Jim Powell's *Greatest Emancipations: How the West Abolished Slavery* is available for $26.95 at www.catostore.org.

Boom, Bust, Rinse, Repeat

In the past, the federal government has introduced moral hazard in the banking system through deposit insurance. Banks underpriced risk because of the federal guarantee that backed deposits. After banking crises in the 1980s and 1990s, deposit insurance was put on a sound basis and that source of moral hazard was mitigated. But in its place, monetary policy has become a source of moral hazard, says Cato senior fellow Gerald P. O'Driscoll Jr. In **"Asset Bubbles and Their Consequences"** (Briefing Paper no. 103), he writes that in acting to counter the economic effects of declining asset prices, the Federal Reserve has come to be viewed as underwriting risky investments. Policy pronouncements by senior Fed officials have reinforced that perception. These actions and pronouncements are mutually reinforcing and destructive to the operation of financial markets. The current financial crisis began in the subprime housing market and then spread throughout credit markets. The new Fed policy fueled the housing boom. Refusing to accept responsibility for the housing bubble, the Fed's recent actions will likely fuel a new asset bubble.

Hyperinflation in Zimbabwe

The hallmark of Zimbabwe's economic collapse is hyperinflation—2.5 million percent a year at last tally. Zimbabwe's hyperinflation is destroying the economy, pushing more of its inhabitants into poverty, and forcing millions of Zimbabweans to emigrate. Steve H. Hanke, professor of applied economics at Johns Hopkins University, says that the source of Zimbabwe's hyperinflation is the Reserve Bank of Zimbabwe's money machine, and that it must be stopped. In **"Zimbabwe: From Hyperinflation to Growth"** (Development Policy Analysis no. 6), he suggests three options to rapidly slash inflation and restore stability and growth to the Zimbabwean economy: "Dollarization," which would replace the discredited Zimbabwe dollar with a foreign currency, such as the U.S. dollar or the South African rand; a currency board, which would mean the Zimbabwean currency would be fully backed by a foreign reserve currency and freely convertible into the reserve currency at a fixed rate on demand; or free banking, which would allow commercial banks to issue their own private notes and other liabilities with minimum government regulation.

McCain vs. Obama on Health care

In **"A Fork in the Road: Obama, McCain, and Health Care"** (Briefing Paper no. 104), Cato senior fellow Michael D. Tanner finds vast differences in the health care plans of the Republican and Democratic presidential contenders. Senator

Obama's approach relies heavily on government mandates, regulations, and subsidies. He would mandate that employers provide health care coverage for their workers and that parents purchase health insurance for their children. He would significantly increase regulation of the insurance industry, establishing a standard minimum benefits package and requiring insurers to accept all applicants regardless of their health. He would offer a variety of new and expanded subsidies to middle- and low-income Americans. In contrast, Senator McCain emphasizes consumer choice and greater competition in the health care industry. He would move away from our current employment-based insurance system by replacing the current tax exclusion for employer-provided insur-

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ance with a refundable tax credit for individuals. At the same time he would sharply deregulate the insurance industry to increase competition.

Trade After Doha

The bad news is that the Doha round of World Trade Organization negotiations collapsed without a new agreement being reached. The good news is that improving the international trading system does not

require a new, comprehensive multilateral agreement. In **"While Doha Sleeps: Securing Economic Growth through Trade Facilitation"** (Policy Analysis no. 37), Daniel J. Ikenson, associate director of Cato's Center for Trade Policy Studies, says countries can derive large gains by cutting bureaucratic red tape to the import and export of goods, a policy known as trade facilitation. Such reforms could do more to increase global trade flows than further reductions in tariff rates. For many developing countries—particularly those that receive preferential tariff treatment from rich countries—reducing transportation and logistics-related costs through trade facilitation reforms would be much more beneficial than further tariff cuts. With the assistance of Cato's media team and the International Policy Network, op-eds by Ikenson based on this study appeared in the *Wall Street Journal*, the *Jerusalem Post*, the *Straits Times* of Malaysia, the *Sunday China Post*, *Business Day* of South Africa, the *Daily News* of Egypt, the *Mint* of India, *El Universal* of Caracas, the *South China Morning Post*, the *Australian*, and many other papers.

A New Tool for School Choice Analysis

Education tax credits—programs that allow individuals to deduct education expenses from their tax liabilities or corporations to do the same for donations to scholarship funds—are a great way to put consumers back in charge of education. But according to **"The Fiscal Impact of a Large-Scale Education Tax Credit System"** (Policy Analysis no. 618), they would also save billions of dollars for state governments if enacted. Andrew Coulson, director of Cato's Center for Educational Freedom, and Ball State University economist Anca Cotet estimate the effect that model legislation for tax credits would have on the budgets of five different states. In its first 10 years of operation, savings from the model education tax credit bill would range from $1.1 billion for South Carolina to $15.9 billion for Texas. Illinois, Wisconsin, and New York would also see 10-year savings in that range. Accompanying the report is the Fiscal Impact Calculator, a generalized spreadsheet tool capable of calculating the fiscal impact of education tax credits on other states. This tool is available to state policymakers, pundits, and other interested parties at www.cato.org/pub_display.php?pub_id=9515.

Continued from page 8

nearly $150 *billion* being added to the "before-tax income of the most affluent 1 percent" in 2004. That huge miscalculation, in turn, was critical to the Hamilton Project's unexplained assertion that "rising inequality strengthens the case for progressivity."

The Brookings-Urban Tax Policy Center also uses the CBO's erroneous method to estimate how the corporate tax is distributed. As a result, they estimate that top 1% would receive two-thirds of the benefit from Senator McCain's proposal to cut the corporate income tax. Such estimates are not credible.

Unpaid Taxes Don't Pay Bills or Redistribute Income

The fundamental problem with trying to measure income from individual tax returns is that people try to minimize their taxes. Many studies find that an increase in marginal tax rates on capital gains or high incomes causes income reported from those sources to drop significantly. Economists call this "the elasticity of taxable income."

If the tax rate on dividends is increased, investors will shift many of their dividend-paying stocks into tax-exempt pension funds or sell them to tax-exempt domestic and foreign investors and hold more tax-exempt bonds. If the tax rate on capital gains is increased, investors will hold fewer shares in taxable accounts and avoid selling winning stocks unless they have offsetting losses. If the highest individual income is raised far above the corporate tax rate, thousands of professionals and businesses currently filing as partnerships, Subchapter S corporations, and LLCs will reincorporate to shelter income under the corporate income tax.

Because of such well-documented responses, income tax data provide incorrect information about income distribution when tax rates change. A large body of evidence finds large and sustained increases in *reported* income among high-income taxpayers in the wake of major reductions in tax rates on salaries (1988) or capital gains (1997) or both (2003). It follows that we could expect sustained *reductions* in reported income among high-income taxpayers if there were major increases in marginal tax rates on high individual incomes and/or capital gains. Such defensive moves by targeted taxpayers would *indeed* appear to reduce before-tax top incomes reported on individual tax returns. But it also means the higher tax rates would be largely or entirely *ineffective* in reducing after-tax income or in raising additional revenue.

Dubious estimates of relative income changes since 1979 or 2002, usually constructed from before-tax IRS data, are being widely cited as a sufficient justification for embracing tax policies that are undeniably harmful to economic progress and prosperity. Bad statistics are never a good excuse for advocating bad policies. ■

“To Be Governed...”

GO AHEAD WITH YOUR OWN LIFE, AND LEAVE ME ALONE

[Campaigning for Hillary Clinton, Bill Clinton offered] the succinct statement of the case: “You ought to be for her because she’s spent a lifetime making the only kind of change that matters: making changes in other people’s lives.”
—*Vanity Fair,* July 2008

GOOD NEWS FROM OBAMA

Barack Obama told House Democrats on Tuesday that as president he would order his attorney general to scour White House executive orders and expunge any that “trample on liberty.”
—**Associated Press,** July 29, 2008

ECON 101 ON CAPITOL HILL

In a pair of lengthy and sometimes testy closed-door sessions in the Senate last week, executives from Goldman Sachs and Morgan Stanley, two of Wall Street’s largest investment banks, made the case that their multibillion-dollar investments in energy contracts have not led to higher oil prices. Rather, they told Democratic staff members of the Energy and Natural Resources Committee that the trades allow international markets to operate efficiently and that the run-up in oil prices results not from speculation but from actual imbalances of supply and demand.

But the executives were met with skepticism and occasional hostility. “Spare us your lecture about supply and demand,” one of the Democratic aides said, abruptly cutting off one of the executives, according to a staff member in the room.
—*Washington Post,* June 19, 2008

THE WORLD’S WORST CENTRAL BANKER HAS A SENSE OF HUMOR

Of all the world’s central bankers, Zimbabwe’s gets the biggest—or at least the longest—salary. [Gideon] Gono won’t say how much he earns exactly as head of the Reserve Bank of Zimbabwe but does claim to have “more digits” on his pay slip that any of his peers. He earns trillions of Zimbabwe dollars. It now takes more than 16 billion of these to buy a single U.S. dollar. U.S. Federal Reserve Chairman Ben Bernanke earns only six figures, $191,300.
—*Wall Street Journal,* July 8, 2008

AUTHOR OF MCCAIN-FEINGOLD ACT THINKS SECOND AMENDMENT IS JUST AS SACRED AS FIRST AMENDMENT. GRAB YOUR GUNS.

Today’s ruling recognizes that gun ownership is a fundamental right—sacred, just as the right to free speech and assembly.
—**JohnMcCain.com,** June 27, 2008

COINCIDENTALLY, IT WOULD SAVE THE TAXPAYERS $300 MILLION

The [Louisiana] House is considering an income tax cut that would cost the state $300 million.
—*New York Times,* June 2, 2008

IN NEWSPEAK, “MORE OPTIONS” MEANS FEWER OPTIONS

A law that would bar fast-food restaurants from opening in South Los Angeles for at least a year sailed through the Los Angeles City Council on Tuesday. . .

Councilwoman Jan Perry, who has pushed for a moratorium for six years, said . . . “I believe this is a victory for the people of south and southeast Los Angeles, for them to have greater food options.”
—*Time,* March 27, 2008

FUN WITH NATION BUILDING

Are you a road engineer who speaks Urdu? A city planner fluent in Arabic? Maybe a former judge who happens to know Pashto and seeks foreign adventure?

There’s a job for you at the Civilian Response Corps, the State Department unit designed to deploy with or shortly after U.S. troops in world hot spots. The corps is designed to be a kind of international Federal Emergency Management Agency, U.S. officials said, an agency that would take charge of entities including local police, courts, the banking system and airports after states collapse or governments are defeated.
—*Los Angeles Times,* July 30, 2008

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