The Trans-Atlantic Tax Divide

By Rupert Darwall

LONDON—Gordon Brown, the U.K. chancellor of the exchequer, today unveils his 10th budget, which many speculate could be his last before becoming prime minister. But the only budget that the opposition Tories want to discuss is the one that was passed 25 years ago this month.

It's become accepted fact among British Conservatives that the 1981 budget was a heroic turning point in the country's economic fortunes. At the time, the budget provoked a storm of outrage because it engineered a massive tax hike in the depths of a recession; 364 economists famously wrote a letter to the Times of London denouncing it. The lesson that today's Conservative Party and its new leader, David Cameron, have taken from that budget is that balancing the budget should take priority over all else. The problem, however, is that they're looking at the wrong budget.

On the other side of the Atlantic, in similar economic circumstances, a newly elected president was doing the exact opposite—pushing through the largest tax cut in American history. The uncomfortable logic is that in terms of economics, Sir Geoffrey Howe, Margaret Thatcher's first chancellor, who raised taxes in a recession, and Ronald Reagan, who cut taxes in a recession, can't both be right. Indeed, the two budgets of 1981 go a long way toward explaining why British Conservatives and American Republicans still do not see eye to eye on cutting taxes.

Although inflation fell during the first Thatcher government, the economy went into a deep recession and unemployment rose sharply; raising taxes on labor made the necessary structural adjustments more costly. It was not until her second term, starting in 1983, that the budget came into balance and Mrs. Thatcher made the progress in cutting tax rates that helped transform the performance of the British economy.

Geoffrey Howe recalls in his memoirs that when he first suggested to Mrs. Thatcher that he would have to raise taxes, she reacted angrily, exclaiming that she had not been elected to put up taxes. So how could a tax-cutting conviction politician of the caliber of Ms. Thatcher find herself being forced to raise taxes? In fact one of her government's first actions two years earlier had been to raise taxes, provoking Arthur Laffer in these pages to warn U.S. conservatives to learn the lessons from what he called "the impending U.K. economic failure." That budget had increased taxes by £400 million. The 1981 budget was designed to raise them by a whopping £4 billion, equivalent to nearly 2% of GDP or £24 billion in today's terms.

As suprising as it may seem, the Thatcherite ministers were the very ones pressing for tax increases. They thought previous governments had failed because they lacked the resolve to see their policies through. A fiscal crisis had led Britain to being bailed out by the International Monetary Fund, and they were determined to avoid risking a repeat at all costs. One of Mrs. Thatcher's top advisers urged Sir Geoffrey to raise taxes by as much as he thought necessary and "give the country a real shock, which would be good for the authority and credibility of the government."

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In retrospect, it is clear that the purely economic rationale for the tax hike was mistaken. By 1981, Treasury forecasts of the budget deficit were running £4 billon ahead of plan in part because of failure to control spending. To maintain future spending discipline, Thatcherite ministers felt that their colleagues had to be taught a lesson that excess public spending carried a penalty. But when the numbers came in, the actual borrowing overshoot was only £2 billion. Even in its own terms, half the tax rise—most of which came from higher income taxes—wasn't needed.

More importantly for the government's counterinflation strategy, it was believed that there was a link between government borrowing, inflation and interest rates. Squeezing the taxpayer to reduce government borrowing and the issuance of government debt, which in turn would help get interest rates down. This theory was widely accepted, but it happened not to fit the facts. In his memoirs, Nigel Lawson, then a junior minister in the Treasury and later the tax-cutting chancellor of Mrs. Thatcher's second term, wrote of this monetary justification of the tax hike, "I became skeptical of the link between budget deficits and interest rates in a world of free capital movements. Even in 1980, I had my doubts about how strong the link really was." In a recent defense of the 1981 budget one of Britain's leading monetary economists, Tim Congdon, found that during the 1980s and 1990s, changes in money supply and budget deficits could no longer be correlated. The theory that cutting taxes leads to monetary and economic instability, currently in vogue among British Conservatives, is not borne out by the evidence.

Under the Thatcher government's medium-term financial strategy, tax and spending would be adjusted to help meet monetary targets while the supply side of the economy would be strengthened by cutting taxes and improving incentives. But that didn't explain what might happen when these two came into conflict, as they did in 1981.

David Cameron

For the American supply-side economists at the side of Ronald Reagan, there was no conflict. As early as 1971, Art Laffer and Bob Mundell argued that what economies like Britain's and America's needed were policies to slow down monetary growth and tax cuts to restore incentives. With Paul Volcker at the Fed and Ronald Reagan in the White House, the tight money and tax cuts policy mix is precisely what America got, whereas Britain got tight money and tax increases. It remains the case to this day that, compared to their counterparts in Britain, U.S. policy makers have much greater clarity on the respective roles of monetary policy in keeping inflation low and of low taxes in driving higher growth.

The Reagan tax cut stimulated growth, which meant the revenue loss was much less than predicted by static analysis. Estimates by economist Lawrence Lindsey suggest that well over one-third of the direct cost of the tax cut flowed back in higher government revenues. According to Mr. Lindsey, "The Keynesians were right in claiming that such a substantial reduction in rates would powerfully boost demand.... On the other hand, the revenue results vindicate supply-siders' most important claim: The tax cut produced quite large changes in taxpayer behavior."

The pioneers of the 1980s on both sides of the Atlantic changed their countries vastly for the better. Being a pioneer means that sometimes mistakes are made; the optimal sequencing of economic policy exists only in theory. In the 1980s, the U.K. took its time to catch up with the American lead in cutting taxes. Yet for many Tories today, their favorite budget is one that raised taxes. Policy should be made on the basis of analysis, not legend, and that analysis clearly shows which of those two budgets 25 years ago was the true epoch-making event.

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The Washington Post / *By Jim Hoagland*

A Trap and Opportunity

Ask Bush administration hard-liners about Iran's sudden acceptance of the U.S. offer to talk about stability in Iraq and you hear this reaction: It's a booby trap. These

sions on the Iranian side. Thus the endless arguments over Iran's "moderates."

The Bush team must make the Baghdad talks one insulated part of a coordinated

step toward new U.N. negotiations over a resolution imposing sanctions on Iran. "The Europeans need to show their publics that they have jumped through all the

Give Bosnians A Visa

By Wolfgang Petritsch And Jakob Finci

Europe wants the Balkans to become "normal." The ultimate carrot, of course, is membership in the EU. But in the meantime the bloc could start by treating the citizens of Southeast Europe like "normal" people, and odds are they'll start behaving like it, too.

One obvious way is to relax the EU's stringent visa requirements for Bosnia and Herzegovina, Macedonia, Serbia and Montenegro, and Albania. The greatest resistance in the EU to lifting the visa regime seems to apply to Bosnia.

Concerns linger that fundamentalists of Middle Eastern origin found refuge in the country. They're unfair and outdated. During the 1992-95 war, foreign mercenaries came into the country. Some of them acquired Bosnian citizenship and a few were connected in 2001 to alleged terrorist plots. But Bosnia, with foreign law-enforcement agencies, vigorously scrutinizes suspicious activities of naturalized citizens—who are mostly law-abiding members of society and, by the way, constitute only 0.025% of the population. After 9/11, Bosnia unambiguously joined the fight against terrorism. In the years since there has been no reason to doubt the country's commitment to this fight, as numerous assessments by international bodies attest.

Bosnia used to be a state with porous borders and no competent central agency to prevent illegal migration. But thanks to the new State Border Service (SBS), a multiethnic force of some 2,000 agents, illegal border crossings have dropped significantly.

The overall crime rate and its number of resolved cases favorably compare with those in EU member states. What's more, the government already has signed readmission agreements with most EU countries to allay fears of massive economic migration from or through its territory once the visa regime has been liberalized.

An additional political consideration applies—the fact that many ethnic Croats and Serbs in Bosnia hold dual citizenship. Thus a significant segment of the Bosnian population, namely all those with Croatian passports, is already able to travel to the EU without a visa. It is entirely conceivable that the EU may soon reward Serbia with visa-free travel, too. This would leave Bosnian Muslims alone in the queue outside foreign embassies whenever they want to travel—a certain recipe for continued division and discrimination.

Relaxing its visa rules—by starting a "smart visa regime" for students, journalists and businesspeople and streamlining the procedures for others as a first step—is the best option for the EU to provide the sort of tangible benefit that will demonstrate to ordinary Bosnians that reform pays off for everyone.

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