

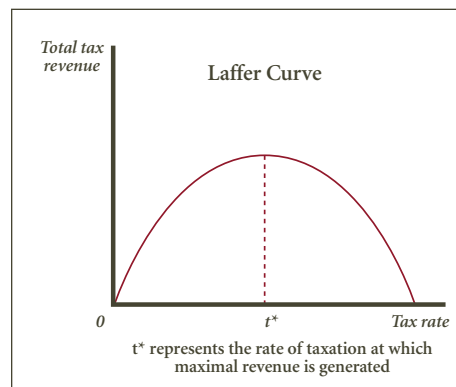
FOCUS

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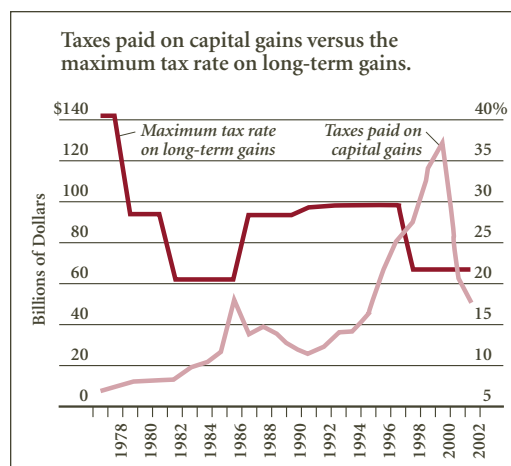
It is a Laffing matter

You may recall the Laffer Curve, developed by economics Professor Art Laffer who was an advisor to President Ronald Reagan in the early 1980s.

Stated simply, if tax rates were zero, then tax revenues would obviously be zero. At the other extreme, if tax rates were 100%, then again tax revenues would be zero, because no one would have an incentive to work to produce revenues that would be completely swallowed by taxes. Therefore, somewhere between 0% and 100%, there exists one rate that will maximize tax revenues under the economic conditions prevailing at that time. That tax rate is at the top of the Laffer Curve as represented on the graph to the right.



A recent *Wall Street Journal* article applied the Laffer Curve concept to capital gains tax rates over a twenty-five year period. As you can see from the next graph, taxes paid on capital gains increased every time there was a reduction in capital gains tax rates: 1978 (the Steiger tax cut), 1981 (the Reagan tax cut) and 1997 (the Clinton-Gingrich



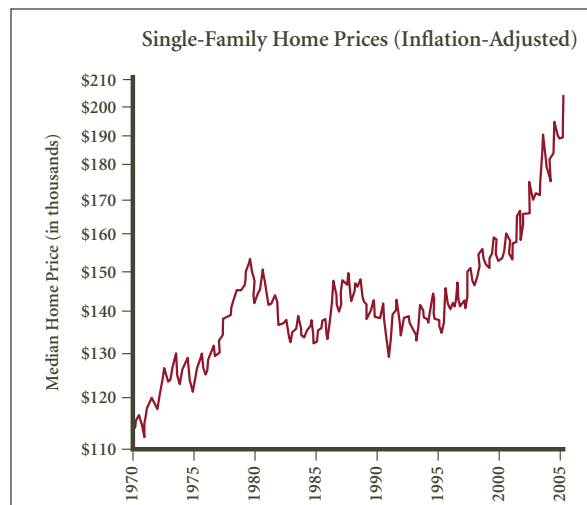
balanced budget deal). Conversely, tax revenues fell significantly after the 1986 capital gains tax rate increase. After that, capital gains taxes continued to rise during the dot.com bubble until it burst in 2001.

Although factors other than capital gains tax rates impact capital gains tax revenues, such as general economic conditions, stock market bubbles, and other phenomena, it has become fairly obvious that capital gains tax revenues will increase when capital gains tax rates are lowered if those rates were too high to maximize revenues to begin with. As further evidence, we expect the Treasury to report a surge in capital gains tax revenues for 2004 as a result of President Bush's 2003 reduction in capital gains rates to 15%.

Interestingly, the *Journal* article also reports that in each of the three rate change episodes cited above, Congress's Joint Tax Committee predicted results that were more or less the opposite of what eventually occurred. The implications of the Laffer Curve must be counter-intuitive to that committee.

Bubble, bubble...

Is there a housing bubble? We don't know for sure, and there are lots of arguments on both sides. However, we do recognize charts that show unsustainable growth. On the chart below, the vertical axis is logarithmic, so that steady growth over time would plot as a straight line. A line on such a plot that curves up represents a process that is accelerating. Logic tells us that if this trend continues, in the not-too-distant future our homes



will be worth a billion or more.


We like living where we do and have no plans to sell. However, two of our industry colleagues have just sold their homes (one in Atherton, the other in Napa) and are moving. Both say it was a financial decision—they wanted to get out while the getting was good. One will rent, expecting to buy back after the crash. The other is moving to Santa Fe, NM, where his new 6BR, 5BA home (he has lots of grandchildren as well as out-of-town guests) with an attached 2-car garage, a guest house, and a detached 2-car garage, cost him 1/5 of the sale proceeds of his home here.

A bubble? You be the judge.

**Storm
warnings?**

Ever heard of the Baltic Dry Index? No, it's not a weather forecasting term. Rather, it refers to the cost of shipping dry bulk cargo (wheat, steel etc., as opposed to liquid cargo) by ship. Over the last several months, this rate has dropped over 50%, reflecting at least in part a softening in demand for industrial commodities, especially for steel, the price for which has also been dropping.

Much of the demand for industrial commodities and thus for shipping tonnage during the past several years has originated in China. Thus, many analysts point to this decline as evidence that China's economic juggernaut is beginning to slow, implying that the world economy won't be far behind.

Like any economic growth process, China's economy is subject to ebbs and flows in spite of its government's attempts to mitigate them. We've never believed all the hype, nor have we accepted on face value the economic numbers that government produces. Therefore, what we may be seeing is simply a reversion to a more sustainable pace, which would be healthy for all. On the other hand, the situation does bear watching. 

What were they thinking?

The recent Supreme Court ruling on eminent domain has raised howls of disbelief across the country. Our colleague, Jim Anderson, Chief Investment Officer at SVB Asset Management, just published what we think is an outstanding summary of the issue. His article follows in its entirety.

FREEDOM'S BURDEN

“A society of sheep must in time beget a government of wolves.”
—Bertrand de Jouvenal (1987)

In an age when most believe the “intellectual and political pathologies”^{*} of the last century are in remission, we are on occasion reminded of the darker side of political power that lurks in some remote corner of human nature. Judging by the grass roots, mostly bi-partisan revulsion at the Supreme Court’s recent holding in *Kelo v. New London*, we may be witnessing one of those occasions. You may recall the basic facts of the case: the city of New London, Conn., wanted to seize and demolish a number of private homes to make way for a private development project that would increase the city’s tax base. In their decision, the court was obliged to reference the Takings Clause of the Fifth Amendment, which permits the eminent domain seizure of private property for public use. Reading the majority’s decision, one gets the sense that the jurists themselves felt they were on shaky ground. It must make even the Supremes queasy to trample on 200-odd years of precedent. Thus, in their wisdom the court included in the opinion an open invitation to our somnolent public representatives to take action to define “public good.”

The risk of debating public good is obvious. Good for whom? One man’s economic “blight” is another man’s refuge. Should it really be left up to a few minor public officials? In 1954, in the case *Berman v. Parker*,

the high court stated, “The role of the judiciary in determining whether that power is being exercised for a public purpose is an extremely narrow one.” In *Berman*, “blighted” property in a slum was seized for the purpose of urban renewal. It was the public burden of the “blight” in neighborhoods of Washington, D.C., as a source of crime and disease that drew the court’s attention not the possible economic consequences for the city. In truth, if increasing the financial resources available to public officials is the only criteria for seizing private property, then we are all at risk.

The broad-based reaction to the *Kelo* decision is easy to understand. We all looked at Susette Kelo and—but for a different set of circumstances—saw ourselves. It reaches deep. It’s the simple tautology of liberty that if you are not free, then I cannot be. And let’s make no mistake about the fundamental importance of the issue. Private property rights are at the core of human freedom and dignity. In societies where property rights are not respected, neither are the citizens. The erosion of private property rights goes hand-in-hand with the reduction in political freedom. It is a slippery slope that impinges gradually and inexorably on basic democratic principles. History has shown that when governments can take property with impunity, they will take other rights as easily. No need to look to the antique Communist or Fascist ideologies. There are plenty of modern examples from Zimbabwe to Venezuela to the current backsliding in Russia. And it runs both ways. The shifts in China and Mexico toward market economies produced, as a direct result, demands for democracy. It’s been written that “capitalism is a necessary and sufficient condition for democracy to exist.”

As we write this missive on a quiet Monday morning, July 4, legislative bodies around the country

are responding to swelling public concern and answering Justice Stevens's invitation to properly define "public good." They will, no doubt, seek to put some limits on the emergence of this questionable alliance between big business and local governments. The public response gives us comfort that, in fact, we are not yet a "society of sheep."

**Daniel J. Mahoney, Bertrand De Jouvenel: Conservative Liberal and the Illusions of Modernity (Intercollegiate Studies Institute), p. viii*

The paper mill

In a recent issue, we wrote about the ever-expanding complexity of the tax code. That may turn out to be the tip of a paperwork iceberg. As reported recently in *The Business Online* (www.thebusinessonline.com), "Red tape, including environmental, health and safety, and economic regulations is costing the U.S. economy \$877 billion a year, says the Competitive Enterprise Institute in Washington." The article goes on to report that the number of pages in the Federal Register, listing U.S. regulations, increased in 2004 to 75,676 pages or 6.2%, and that regulatory costs of \$877B are equivalent to 7.6% of Gross Domestic Product (GDP). Moreover, agencies of the government spent \$36.3B to administer and police all these regulations, bringing the burden on the economy to \$913B. Rules set by the Treasury, Homeland Security, Transportation, and Interior departments plus the Environmental Protection Agency accounted for 45% of the total regulatory pile.

These costs exceeded both all pretax corporate profits (\$745B) as well as all personal income taxes (\$765B). Adding these costs to all other federal spending brings the government share of GDP to 27%.

Think of the economic growth that is being diverted by this overregulation and bureaucratic meddling. As the report concludes, "At the very least, future federal budgets need to acknowledge and document the 'off-budget' costs

of regulation. Only then will Americans have the real truth about the federal government's reach in their lives."

**Keeping
perspective**

Wise words from Will Rogers:

Never slap a man who's chewing tobacco.

Never kick a cow chip on a hot day.

There are 2 theories to arguing with a woman. Neither works.

Never miss a good chance to shut up.

Always drink upstream from the herd.

If you find yourself in a hole, stop digging.

The quickest way to double your money is to fold it and put it back in your pocket.

There are three kinds of men: The ones that learn by reading. The few who learn by observation. The rest of them have to pee on the electric fence and find out for themselves.


Good judgment comes from experience, and a lot of that comes from bad judgment.

If you're riding' ahead of the herd, take a look back every now and then to make sure it's still there.

Letting the cat out of the bag is a whole lot easier than putting it back.

After eating an entire bull, a mountain lion felt so good he started roaring. He kept it up until a hunter came along and shot him. The moral: When you're full of bull, keep your mouth shut. ❗

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