Part V

Supply Side for the World: An Interview with Arthur Laffer

Arthur Laffer, Charles B. Thornton Professor of Economics at USC and president of Laffer Associates, rose to prominence in the United States amidst the supply side economic furor which swept President Reagan to power. Formerly chief economist at the Office of Management and Budget (OMB) under Nixon, Laffer provides the definitive word on supply side economic policies as they relate to tax cuts, the gold standard, the world economy and Reagan. Professor Laffer was interviewed by Co-editors-in-chief Tod Loofbourrow and Erik Brynjolfsson and Senior Economics Editor Menzie Chinn.

IR: In the November issue of the *International Review*, economist Lester Thurow asserted that President Reagan's foreign economic policy is essentially exporting supply-side economics to the rest of the world. He claims that Reagan is telling the French, "...cut taxes, cut expenditures, just do what we're doing and you'll be fine." Is this your conception of supply-side economics, and if so, should the French adopt it?
Laffer: There's two different questions here. I don't know if Reagan is exporting [supply-side economics] or not. However, if the question is whether the French should use supply-side economics and if it would help the French people I think the answer is yes, very definitely.

IR: What then is your definition of supply-side economics?
Laffer: It's just looking at incentives. It's been coined "supply side," but the idea is just that when you change incentives, people change their behavior. If you make some activity more attractive people do more of it, not less. If you make something less attractive, they do less of it, not more of it. This applies to taxes, spending, monetary policy and regulations. So, whenever you change tax rates, you change the relative value of taxes and alternative activities and people alter their activity in that regard.

Let me give you what I refer to as the Thurow/Trudeau fallacy. You know Gary Trudeau is a good man, but do you remember the comic strip that came out shortly after the tax bill passed? Zonker was asked, "Hey, what are you going to do with your $150 [tax cut]?" He answered, "Maybe buy some pizza, some beer for my friends, maybe go on vacation for a week." "No, no," he was told, "you're going to invest in steel mills and cement plants."

The notion that economists like Thurow have is that somehow a tax cut is giving people money. That's a common demand-side approach to the question, and may well be right. But from my perspective, it's not the relevant point. The way Lester Thurow puts it, is if I get $100 tax cut, and the marginal propensity to save in the U.S. economy is five percent, I go out and consume $95 worth of goods, and the government has a $100 deficit. There may be some feedback, but basically net savings is reduced, as private spending will go up $5 but government savings go down $100. You have the neo-Keynesian model. I don't believe the model. It's not because I don't understand it—I've been trained in it all my life.

The way I look at it, you've got relative prices between leisure, current consumption and future consumption. You've got three alternative activities, and people allocate amongst those by relative prices. That's classical economics, it's not Keynesian, it's not monetarist, it's just general equilibrium economics, old line simple stuff.

IR: The mainstream analysis of the supply-side scenario is that with the tax cut, investment goes up, along with a shift in the supply curve as more jobs are created. But isn't it true that in the short run, aggregate demand will be stimulated, and inflationary pressures will build, which, if not accommodated by the Federal Reserve, will manifest themselves in higher interest rates and depressed investment?
Laffer: In the argument you just gave me, you gave a scenario of logical steps and came up with a conclusion. You can do that, or you can look at the facts. I am an empiricist. Did interest rates go up in previous periods of tax cuts such as Kennedy's or didn't they? Was savings cut?

IR: But the Kennedy era was a radically different time.
Laffer: If you preclude all previous experience from my body of knowledge, I know nothing. I am an empiricist. If in fact you say all my analogs in location forecasting and various time series analyses, that is, all my assumptions and techniques, are useless, then of course I know nothing...But I think classical economics has a lot more to offer than those [other] models.

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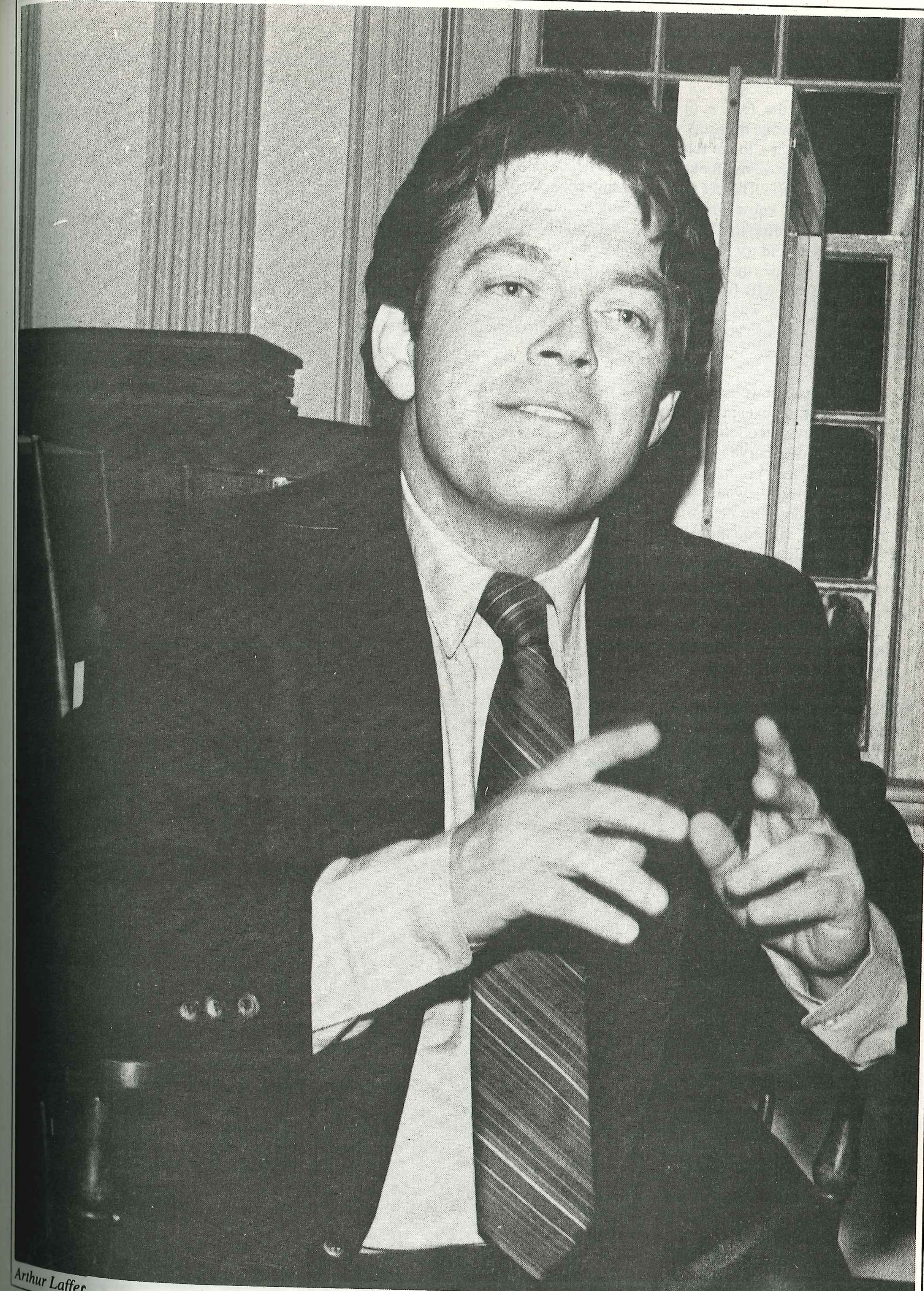
IR: Would you like to see a cut in government spending along with tax cuts, or should government spending be maintained at about present levels?
Laffer: What I'd like to do is cut government spending where it's not needed. We did not pass welfare programs so that the one time we need them we throw them out. That's immoral. I don't believe in cutting out people who are in need. The one thing I want to do is to reduce the number of people who are in need. As Jack Kennedy, my hero, put it, "The best form of welfare is a high-paying job."

IR: Doesn't such a policy lead to the huge projected deficits we've discussed?


Arthur Laffer

Laffer: Yes, it leads to those huge *projected* deficits, but it leads to *actual* balances, if not surpluses. What Stockman (the Director of the Office of Management and Budget (OMB)) is doing is one thing. When you use a static accounting model to project into the future, you're going to get silly numbers. Have you ever looked at the projections versus what actually occurs? There's no relationship between them. We not only don't know what the numbers mean, we don't know what they refer to. You take a standard Keynesian C+I+G model, and try to find anything that even approximates any one of those three conceptual terms. I was the chief economist at the OMB for two years, so I know what I'm talking about. That was the game—you want a balanced budget? Give me those accounting sheets and a sharp pencil and I'll give you one.

IR: You assume that we're on the far side of the Laffer curve, and that by cutting taxes, tax revenues will increase from the resultive increased economic activity.
Laffer: The Laffer curve is purely and simply a pedagogical device to illustrate a point. It's nothing more...If I lower tax rates on an activity, what would you expect to happen? Would people do more or less of that activity? You can go check the facts. They do more of it. You may collect less per unit, but there are more units. Moreover, if you have more of that factor employed...returns to other factors will go up! If you have any taxes on those factors, you'll collect more revenue per unit.

IR: Why do you advocate a return to the gold standard?
Laffer: Gold has worked very well, historically, to guarantee the liabilities of the monetary authority in terms of a commodity...something of real value.

IR: But we had a gold standard in this country before the turn of the century, and yet we had severe business cycles?
Laffer: Of course, nobody wants any gold standard that circulates gold per se. But we know an unhinged money doesn't work well, as we know pure gold standard doesn't work well, either. The post-war period was very successful, inflation was stable; let's have Bretton Woods again...and when gold leads to instability in the economy, I want to break with gold.

IR: In your interview in *Barron's*, you speak not only about lowering tax rates but about replacing income taxes with a value added tax (VAT). What is your argument here?
Laffer: The incidence of taxes has no correspondence to the burden, at all...We know the burden of taxation is based upon individual factor characteristics, period. Those factors with inelastic supply facing elastic demand bear the burden of any tax no matter where you place it.

IR: How closely would you say the Reagan or Stockman economic models compare with supply-side policies?
Laffer: I think Stockman is the antithesis of what I believe in. I think Stockman is the enemy, if you will. He is the anti-Jack Kennedy, and I am basically a Kennedy Democrat of the 1960's, because I do believe in low personal income taxes across the board.

IR: Is current U.S. economic policy supply-side?
Laffer: Compared to what? Compared to what Jimmy Carter was doing? Yes. Compared to what Kennedy was doing? Not close.

IR: What is Stockman doing wrong?
Laffer: He thinks tax revenue is the answer. Let me ask you this question: What country in Western Europe has the lowest tax rates? Switzerland. What country has the only balanced budget in Western Europe? Switzerland. Britain and Sweden have high tax rates. And Sweden's deficit is huge, and it's growing.

Have you ever looked at the projections versus what actually occurs? There's no relationship between them. We not only don't know what the numbers mean, we don't know what they refer to.

IR: Now what do you do in a country like Great Britain? Supposedly they're following what they call supply-side economics.
Laffer: Nuts! Look at Margaret Thatcher's tax increase. She promised tax cuts, but she's cut taxes where they've never been paid, and raised them where they can't be avoided. It forced the economy to collapse.

IR: Do you see any foreign countries' policies as coming close to what you advocate?
Laffer: I can think of a lot of them—Hong Kong and Sri Lanka, for example. Look at what they've done—it's just wonderful! And take Puerto Rico under Carlos Romero Barcelo.

IR: What about developed countries?
Laffer: In the developed countries...I suppose Kennedy would be the last real example. I can't think of many European countries that have done it—there was a period under [Chancellor] Erhard in Germany.

IR: Do you think there comes a time when society should concentrate less on producing goods and maybe worry more about guaranteeing a minimum level of income?
Laffer: Yes, sure.

IR: But if you remove the risks don't you remove also incentives?
Laffer: But of course! If the risks are global someone bears them. The issue is how to allocate the bearing of risk...you want to allocate that according to people getting rewards for their risks. Simple as that.

IR: Don't progressive income taxes lessen the risks of failing economically and therefore remove part of the incentives?
Laffer: But you don't take it to an extreme. No! We have a risk factor and you have an incentive factor and you need balance.

IR: In the current economic environment, where is the balance between the two?
Laffer: I think right now, frankly, what we've done is we've gotten it to the point where we've increased the risks and we've hurt the returns. I think we're way outside the frontier. I don't think we're close to Pareto Optimality.

IR: Why? What's caused this?
Laffer: Well, we're producing way below what we could have produced, and the poor are a lot worse off because of that. The tax structure is extraordinarily poor...if you reduce the taxes and disincentives throughout the entire system, the poor will benefit enormously.

IR: But isn't that the trickle-down theory?
Laffer: No, trickle-down has always been a demand-side concept to me...trickle-down as I was taught by Keynesians was that you put so much money in the hands of the rich—you know, they tip their taxi drivers more, and so on—that's trickle-down. My model is not that; I'm changing relative prices. I don't think the truck driver will do very well when there are no trucks to drive...Labor and capital are not enemies in the production process—without machines there are no workers. There are no wages. Without workers there are no profits. Machines and labor are complements, not substitutes. Anyone who confuses capital and labor as being enemies has got his proverbial economics head wedged.

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IR: A lot of the things that you're talking about, like unemployment insurance, and these various programs, are quite expensive.
Laffer: Not if they were actuarially sound—you paid your actuarial value for being unemployed. There is no disassociation between effort and reward. It was not a socialist state that sent us to redistribution of income. It is now, and it isn't working.

IR: In the sense of having more equality of income?
Laffer: Yes, but at what level? I would like to make everyone richer. I do not want equality at zero.

IR: What if that means that some have to be starving so that the overall average is higher?
Laffer: No! I want everyone better off.

IR: Who doesn't?
Laffer: A lot of people don't. In Britain they literally said, with their marginal tax rate at 98 percent, one of the things they find repulsive to see are millionaires. I like millionaires. I like poor people too, and I want to see both rich and poor grow richer, and I don't want to see any of them worse off.