Business Economics (2020) 55:41–44
https://doi.org/10.1057/s11369-019-00150-7

NABE
National Association for Business Economics

SPEECH

Reflections on economic policy

Arthur B. Laffer[1]

Published online: 29 November 2019

Abstract

My dream of what the tax system should be is a complete flat tax. I think it's really wrong to have tariffs to protect domestic industries. I think the gains from trade are enormous, but when we use threats of trade barriers in negotiations it's not protectionist at all. I do think immigration for work has to be separated almost completely from immigration for citizenship. What really irritates me enormously is the discussion of income inequality. Whenever you redistribute income, you take from those who have a lot and you give to those who have less. The more you redistribute, the greater will be the loss in income. On monetary policy, if you put in the right price rule, you can stabilize the value of the dollar virtually for eternity. I don't really think we should have an independent Fed. On the long run, debt to GDP is an inappropriate measure; what you want to look at is debt to wealth, or debt service to GDP, and while there is some government investment spending that is really critical, government investment that tries to replace private investment is a mistake. In conclusion, there is nothing this economy can't do if you put the incentives correctly placed across the board.

Keywords Laffer curve · Flat tax · Deregulation · Trade · Incentives

1 The Laffer curve and Tax Reform

The Laffer curve is my profile. I do mathematical economics. I developed pedagogic devices to explain the math to my students. And one of them was the Laffer curve. At 100% tax rates, you know, you'll not work, and therefore, there'll be no revenue. At a zero tax rate, even though you work a lot and earn a lot, there'll be no revenues either. What you got is a curve shape, in a pedagogic form. And Marty Feldstein—I'm very sorry he passed—said it's something you can show a Congressman and then have that Congressman talk about it for 6 months.

The "Whip Inflation Now" program, if any of you remember, proposed a 5% tax surcharge. The budget had it raising 5% more revenues. I said, "Look, it will not raise 5% more revenues. It might raise 4% more, 3%, 2%. But it also might lose revenues." I was trying to explain it. I showed my little pedagogic device, the curve, to Don Rumsfeld and Dick Cheney, who were my classmates at Yale. And there was a reporter named Jude Wanniski there for the *Wall Street Journal*. And it was like it caught fire. And I don't know whether I actually drew it on a cloth napkin or not. My mom would be terribly offended if I did. But whatever, that's the story, and I'm stickin' to it. They've got a little copy of it, supposedly, at the Smithsonian. But just for us, I did that 2 years later.

Some people think that the audience might be a little surprised that I worked on the campaigns of Gary Hart and Jerry Brown. I designed Jerry Brown's flat tax, if any of you know the 1992 race. It's my ideal tax. I wrote this paper in 1981, I think it was, called "The Complete Flat Tax." It was the backing behind Kemp-Kasten. And it was also the backing behind Bradley-Gephardt and the Tax Reform Act of 1986, which was, I think, the best tax bill that's ever been done in America. But what we did was we got rid of all federal taxes, all of them, all federal taxes except sin taxes. The reason we kept sin taxes is because their purpose is not so much to raise revenues as it is to change behavior. I jokingly refer to it as we Americans don't like drunk people smoking while we shoot each other.

We proposed getting rid of all those taxes and put in two flat rate taxes, one on business net sales, if you're a Republican, and if you're a Democrat, on value added, and on personal unadjusted gross income from the first dollar to the last dollar. We made it static revenue neutral, which came out to a 12% rate. Jerry Brown bumped it to 13% because

✉ Arthur B. Laffer
ndrinkwater@laffer.com

1 Laffer Associates, Nashville, USA

he wanted a little more revenue. We went from eighth in the race to second in the race. We got the second most number of delegates in the Democratic primaries.

I still dream. My dream is to get a flat tax that's really a complete flat tax from the first dollar to the last dollar. You don't need an IRS. If a company owes you 100 bucks, they send you 87 and send 13 in to the government. If you buy something you have a 13% sales tax or whatever it would be on it, no individual tax filings or anything. Now, if you mow your neighbor's lawn for ten bucks, yeah, you do have to send in $1.30. But, 95% of all tax collections would be done at the business level, which is a very efficient way to collect taxes. That's my dream of what the tax system should look like.

I voted for Clinton twice. I just thought he was a great president. You know, he cut government spending as a share of GDP. You all know government spending is taxation. That was just amazing. He got rid of the retirement test on Social Security, and reformed welfare such that you actually have to look for a job to get welfare.

I started my career, at least in politics, in 1970. I was the first chief economist at the OMB when it was formed. I only talk about economics, just so you know. I think Trump and Reagan are very similar. If you look at economics, there are five pillars of prosperity: taxes, government spending, monetary policy, regulatory policy, and trade. And if you could look at the bill by Trump in the first term, my view was that the 2017 bill is probably the single best tax bill in the first term of any administration ever. I just think it's beautiful. President Trump said to me, "Why'd you say first term, Art?" And I said, "Well, because the '86 Tax Act was even better. But that was a second term." If you look at spending, this administration has done nothing on spending. Neither have the prior two. On monetary policy, I think Jerome Powell's doing a fine job as Chairman of the Fed. I think he's a lot better than Bernanke or Yellen was. As for deregulation, this administration is the best ever.

2 International trade

Trade is a work in progress. I can tell you very seriously that Trump is a free trader. He ran an international business. I've never seen an international businessman who's not a free trader, or a money manager who's not a free trader.

But he has a very tough time getting other nations to come to the table. Just a little anecdote: at the G7 in Ottawa, before he left to meet with Kim Jong Un in Singapore, President Trump looked at the other six members and said, "If you guys will agree today, the US will be committed to having no tariffs and no non-tariff barriers if you guys will agree to it as well."

They all just sort of looked at him blankly. I am not a negotiating type. Trump is. He's using his skills. And I hope it works out. I think it's a work in progress.

I think that's very similar to Reagan. We did NAFTA under Reagan. It didn't get passed until Clinton. We had the tax cuts under Reagan. We had really good monetary policy with Volcker. We did a lot of deregulation, if you remember Reagan dropping the books on the table there. Reagan and Trump are very similar in economics, and I think very similar to Jack Kennedy, as well. Kennedy was a great, great president.

Trade is my specialty. This is where I did my dissertation. If you've seen my *International Economics in an Integrated World* book, this is my specialty area. Trade is far more nuanced and complicated and confusing, and more mathematical, than probably any other field of economics. When you look at trade and someone says, "I'm a free trader," and the other one says, "I'm a tariff man," it's a silly, silly dichotomy. Tariffs were the primary source of revenue for the US government up until 1913. I think they were about 95% of all revenues for the US government for over a century. Tariffs are also a common use of policy to get other countries to do what we want. We have always used tariffs against countries who we don't like. I don't think anyone wants free trade with North Korea or Iran or any of these other bad actors. I think it's really wrong to have tariffs to protect domestic industries. I think the gains from trade, both the production and the consumption gains from trade, are enormous when it comes to domestic business competition with foreign business. I think any type of protective tariffs are extremely wrong, very debilitating, and very damaging. In May of 1930, as you all know, Hoover signed into law the Smoot-Hawley tariff. The consequence of that was a 90% drop in the market, no change in the US trade balance, a quartering of the volume of trade, and the Great Depression following with huge tax increases.

I was in the White House from 1970 to '72 when we had the second most protectionist administration, the Nixon administration. They put on the 10% import surcharge. They had the job development credit, which excluded foreign-made capital from getting the investment tax credit. And we also did currency manipulation in the Smithsonian Accord, if any of you remember that. We halved the stock market. It was the worst economy since the Great Depression.

Trade protectionism is a killer. It doesn't matter who puts it on, whether it's the other country or you. It kills both of you. Trade protectionism is something to really eliminate. Foreign tariff barriers hurt us and hurt them. Anything to move us closer to free trade, I think, is really positive for the US when it comes to industries and competitiveness there. We do not want to move towards free trade with North Korea or Iran, my view.

When we use threats of trade barriers to get Mexico to intercede with the caravans coming in, it's not protectionist at all. So trade is a very nuanced field. I want to make sure you realize how nuanced it is. I was with Bob Woodward, who was a couple classes behind me at Yale. You know, he has no sense of nuance on trade. He asked me, "You a free trade guy or are you a not free?" You know, that's not the right category.

3 Immigration

I think immigration has to be separated almost completely from citizenship. I think immigration for citizenship is one thing. Immigration for work and production is one other. And I jokingly say this, I loved illegal aliens when I lived in California. They provide high quality labor at low cost. You know, if you look at what county in California has been essentially ceded to Mexico, it's San Diego. You ask yourself which county in California is the best performing county, it's San Diego. These guys are wonderful, terrific people, as well as great workers. And I think for that reason, I'm very much in favor of immigration for work reasons. That's a very different thing than being in favor of immigration for citizenship reasons. But as long as these people want to come and work and do their job, I think it's wonderful. But I do want to separate immigration for work from immigration for citizenship.

4 Income inequality

Observing that income inequality has increased or decreased is an observation. It's an empirical assessment of what is or is not the truth. It is not a prescription for policies. What really irritates me enormously is the discussion of income inequality. Let's imagine you could make the rich poor faster than you make the poor poorer. I would think that would be horrible, even though it would lead to more equal income. Whenever you redistribute income, you take from those who have a lot and you give to those who have less. By taking from those who have a lot, you reduce their incentives to produce. And they will produce less. By giving to those who have less, you provide them with an alternative source of income. And they, too, will produce less. The theorem here–and it's math, not ideology or politics–is when you redistribute income, you reduce total income. That's the theorem. The lemma of this theorem is equally as important. The more you redistribute, the greater will be the loss in income. And the limit is the most powerful of all. If you were able to redistribute income completely, there would be no income. To redistribute income so that everyone had complete equality of income, what you'd have to do is tax everyone who makes above the average income 100% of the excess and subsidize those who make below the average income up to the average income. If you actually taxed everyone who made above the average income 100% of the excess, and you actually subsidized everyone below the average income up to the average income, I'll stipulate today, counselor, we'll all be equal at zero income. I beg all of you to read Kurt Vonnegut's short story called "Harrison Bergeron." If you do you will no longer work for income equality at all. Helping the poor is very different than seeking income equality. Income inequality is part of human nature. Our dream is to make the poor better off, not to make the rich worse off.

5 Monetary policy

I'll tell you what sound money is: guarantee the value of the US dollar. What we want to know with good monetary policy is what the value of a dollar will be in 10, 20, 30, 40, 50 years, so we can contract with each other with a numeraire that we know will be of stable value. I love the period of Bretton Woods. I loved the period earlier of the gold standard. I think a monetary standard where we fix the price, as Mundell and I worked on many years ago, is a price rule, not a quantity rule. If you put in the right price rule, you can stabilize the value of the dollar virtually for eternity rather than having a group of however many people work at the Fed.

There are a lot of different price rules. You can tie it to wages. You can peg it to consumer price index. One price rule is a fixed exchange rate. That's a price rule. An interest rate price rule is another price. Any one of these price rules has little pluses and minuses versus the others.

But they're all far better than quantity rules. And what you have to know with a price rule is to make sure that we realize that we're one nation in a sea of nations. When I look at the Fed today, and Jerome Powell, I don't want an independent defense department that makes up its own decisions of who to tax and who not to. I don't want an independent treasury independent of the administration. And I don't really think we should have an independent Fed. I think you want to align incentives so the person who gets credit or blame for the policies is also one the authorized to make the decisions. You want to align authority with responsibility. And that is not true in today's independent Federal Reserve. It's just not. Why? Are you telling me Princeton professors should handle monetary policy when they can't even handle their own classes? (I've got my Yale tie on today, by the way).

The thing I'd like to see that would really make a difference in America, is I'd like to see all politicians put on commission. If we have 3% growth, you get your pay. 4% growth, you get double your pay. 5% growth, you get triple your pay. 2% growth, no pay at all. 1% growth, you owe us the money. They'd never do the stupid stuff they do now if they were put on commission. It's like having a company that doesn't have the officers or directors have any stock options or own any stock. Of course you want skin in the game. I don't mind politicians making decisions, as long as they have skin in the game as well.

6 Debt

Let me talk about debt. Debt to GDP is an inappropriate measure. You should never use debt to GDP. You should never compare a stock with a flow. You should never compare an income item with a stock, with a balance sheet item. What you want to look at is debt to wealth, or debt service to GDP. If you look at debt service to GDP, it's a lot less than it was in 1982. If you look at debt to wealth, it's less than it was in 2008–2009 by a substantial amount. Remember, debt is a tool. How much would you borrow if I'd lend to you all you want at 1% and let you invest all you want at 12% with no risk? How much would you borrow? Everything you can get your hands on. Reverse those numbers. How much would you borrow? You can borrow all you want at 15% and invest all you want at 1%. You wouldn't borrow it all. It's the spread that matters. When we came into this country of ours in 1981, we found a country that had been run into the ground. Then we borrowed tons and tons of money. We cut tax rates like mad. We increased incentives. We stabilized the dollar. And then we prayed it would work. And it worked like you wouldn't believe it. Look at the growth of the '80s. Look at what happened to debt vs wealth. I mean, it was amazing growth and prosperity.

Then the county ran into the ground again in the first years of this century, and debt compared to wealth went way, way up. Now, with this administration, I think we've reversed that again. You know, you should handle debt on a federal level just the way you handle it on a personal level. Borrow when your returns are much higher than your costs. And pay it back when your returns are less than your costs. And that's how debt should be used on a federal level as well.

7 Investment and growth

There is some government investment spending that is really critical, really good, really needed: highways. You can think of all the ones there. I do. I think government investment that tries to replace private investment is a mistake. And I think looking at investment levels per se, is a mistake. How you get your output is not the government's job.

The government's job is to create an incentive structure across the top that makes output rewarded correctly, and then let the private sector determine whether they generate growth through investment or more employment or technology through tech companies, which obviously you know I don't understand. But all of that should be the private sector determining where the best returns are, not the government. So I don't really worry about these investment numbers not coming in as high as other people do. I look at GDP growth. And I'm really pleased. In all of 2018 and 2019 so far, this world is collapsing around us while the US is the best performing country because of our tax code, because of our deregulation.

We have 750 billion extra dollars produced at current rates today because of the tax bill. And the revenues are coming in very nicely as well, thank you very much.

In conclusion, if you'd let me do Jerry Brown's flat tax, my spending proposal, and then sound money, and then deregulation, we could send this economy to the moon. From January 1, 1983 to June 30, 1984, when our tax cuts finally took in, the skies opened. The sun shone forth on the fields. They turned green. The animals multiplied. The trees blossomed and bore fruit. And the children danced in the streets. And Ronnie Reagan was nominated and elected. From January 1, 1983 to June 30, 1984, the US economy in real terms, grew by 12%. We grew at an 8% per annum compound rate for a year and a half. There is nothing this economy can't do if you put the incentives correctly placed across the board. It would solve a lot of your poverty problems. It'll solve so many problems in this world.

Arthur B. Laffer is the founder and chairman of Laffer Associates, an economic research and consulting firm, and Laffer Investments, an investment management firm. Dr. Laffer's economic acumen and influence in triggering a worldwide tax-cutting movement in the 1980s have earned him the distinction in many publications as "The Father of Supply-Side Economics." One of his earliest successes in shaping public policy was his involvement in Proposition 13, the groundbreaking California initiative that drastically cut property taxes in the state in 1978. Dr. Laffer was a member of President Reagan's Economic Policy Advisory Board for both of his two terms (1981–1989) and was a founding member of the Reagan Executive Advisory Committee for the presidential race of 1980. He also advised Prime Minister Margaret Thatcher on fiscal policy in the UK during the 1980s. In June 2019 Dr. Laffer was awarded the Presidential Medal of Freedom by President Donald Trump.