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Arthur Laffer



Robert K. Dornan

A California Review Conversation

Dr. Arthur Laffer is Charles B. Thornton Professor of Business Economics at the University of Southern California. He earned his B.A. degree in economics at Yale and went on to earn his M.A. and Ph.D. at Stanford. From 1967 to 1970 Dr. Laffer taught economics at the University of Chicago. He served as economist at the Office of Management and Budget from 1970 to 1974 and, after a brief return to the University of Chicago, joined the faculty of U.S.C. in 1976.

Arthur Laffer is most famous for his "Laffer Curve" which illustrates the theory that when tax rates rise above a certain level tax revenues decrease. A leading proponent of supply-side economics, he travels some 8,000 miles a week and delivers about 40 lectures a year. But he has not let his busy schedule interfere with his teaching and was awarded the 1980 University of Southern California Associates Award for teaching excellence. Among the recipients of Arthur Laffer's advice have been Ronald Reagan, Margaret Thatcher and former California Governor Edmund G. Brown, Jr.. Dr. Laffer also maintains a collection of tropical birds, turtles, ferrets, weasels and over 300 varieties of cacti. Dr. Laffer graciously took time out of his schedule to talk with CR's Optimo Princeps, C. Brandon Crocker.

CR: Would you explain when and why lowering tax rates would lead to an increase in tax revenue?

LAFFER: The question of when is a difficult question, but I'll tell you why. There are two effects that tax rates have on total revenues. One effect which we call the arithmetic effect is that when you raise the tax rate it is unambiguously true that you raise more revenue per dollar of tax base and when you lower the tax rate you raise less revenue per dollar of tax base. But there is also an economic effect which is if you raise tax rates you reduce the incentive for people to do the activities that create the tax base, thus reducing it. When you lower the tax rates you increase the incentive to do those activities, which increases the tax base. These two effects always work in the opposite direction. But the economic effect, more often than not, will outweigh the arithmetic effect and that's why you get an increase in revenue. With regards to the timing, if you announce

tax cuts ahead of time people can prepare for them. So what happens is they will try to shift income out of the current high tax period and into the future tax period. Intuitively, how much would you shop at a store a week before that store has a big discount sale? Not very much. So what you would expect to see is a major shortfall in revenues in the years preceding the tax cut but once the tax cut takes place a huge resurgence of economic activity causing an increase in revenues.

CR: What makes you think we have reached that level of taxation where tax reductions would increase the incentive to produce?

LAFFER: It depends what kind of tax you are talking about. There are certain taxes that if we cut them we would lose revenue and taxes that if we cut we would clearly gain revenue. It all depends on the sensitivity of the factors of production. Now let me ask your next question. How can I be so sure that an across-the-board income tax reduction will increase revenue? Is that your next one?

CR: That's it.

LAFFER: No one can be sure that it will increase tax revenues. The one thing we have in research on previous periods when tax rates were reduced in a similar fashion. For example, the Kennedy tax cuts in the 1960's. Take a look at the Mellon tax cuts in the 1920's. What you'll find in both of those cases are very sharp increases in revenue. I'd like to refer you to a study by professors Canto, Joyce and Webb. They did a very thorough study on the Kennedy tax cuts using multi-varying time series analysis and they found an enormous increase in tax revenues in the 1960's from the tax cuts themselves. Michael Evans also did a study on the effects of tax rate cuts on upper income people in both the 1920's and 1960's. He found that the amount collected from the upper income groups went way, way up. There is also a study by Manny Johnson of the Treasury which shows the revenue effect of the capital gains tax cut showing that revenues went up enormously just from the capital gains tax cut itself, not even considering all the side effects which would all also increase tax revenues. Looking at all this evidence has led me to believe that after a few years

CR: Has lowering the top tax bracket from 70% to 50% led to the rich paying more taxes?

LAFFER: That's what they say. Manny Johnson shows that the revenues collected from that category have increased quite sharply when they were expected to go way down. In 1982 the 70% to 50% bracket is one of the few brackets in which tax payments went way up.

CR: Milton Friedman says that if lower tax rates increase tax payments then taxes should be lowered again until tax payments drop. How do you feel about this.

LAFFER: He's right. You should never be taxing at a rate where a lowering of taxes would increase tax revenue. Therefore you should keep lowering taxes until tax revenues start falling.

CR: Do you think that reducing tax revenues is the only way to cut government spending?

"In 1982 the 70% to 50% bracket is one of the few brackets in which tax payments went way up."

LAFFER: No I don't. Now that's where Milton Friedman and I would disagree. Not that it might not lower government spending, but that's not why I support tax cuts. Government spending is very important. Too much government spending can be a real drag on the economy. There is no question that

Free To Choose
by Milton & Rose Friedman
Avon Books
330 pp., \$2.95

promote democratic governments, as the Friedmans assert that "voluntary exchange is a necessary condition for both prosperity and freedom"—an assertion that is bolstered by the historical record. Free trade, as opposed to free-aid, is a mode of self-help for underdeveloped nations.

Sharp increases in our national income, accompanied by an increased standard of living, have rendered poor areas proportionately more visible. Public assistance programs now in effect were drafted, presumably, with good intentions. But as we are advised, "sincerity is a much overrated virtue." The use of poor means to achieve beneficent objectives has come to be an integral element in social planning. Current welfare programs hurt the poor by putting a cost on finding employment; subsidized urban renewal programs have replaced slums with middle class housing that the slum dwellers cannot afford. But what makes it so difficult to change these well intentioned but desultory policies is that they do benefit some people; bureaucrats employed to administer welfare programs; construction firms and people seeking middle class housing. These and like consequences of government do-gooding have induced the Friedmans to offer a companion to Adam Smith's famous axiom: "An individual who intends only to serve the public interest by fostering government intervention is 'led by an invisible hand to promote' private interests, 'which was no part of his intention.'"

Cures for the Republic's economic ills are proffered frequently. They reiterate constitutional truisms—limited governmental power with an emphasis on individual and states' rights. The so-called "public interest" is revealed to be a doublespeak nonentity.

The Republic's over-eager faith in New Deal liberalism has created. We must now elect either the "deadening effects of government control on private ingenuity or the dependence on collaboration among private individuals to realize a growth in productivity." The solution is self-evident. And for those in doubt, a perusal of *Free To Choose* should be convincing.

Victoria Sellers is a junior at UCSD.

Marketing the Free Market

by Victoria Sellers

In the cloistered world of liberal academia, self-righteousness is exceeded only by naivete. Many in such a community have been blessed with a vague, yet unerring, sense of good and evil, which they rarely hesitate to express. Miraculously, these individuals are able to observe the bounty of resources and opportunities in this nation, yet still penetrate this veneer and publicly disclose the capitalist hell in which we exist. To each of these insightful prophets I offer my most sincere sympathy and timidly recommend that they slither off their soap boxes and into the library. A panacea awaits in the form of Milton and Rose Friedmans' volume entitled *Free To Choose*.

Published almost two decades after their first book *Capitalism and Freedom*, *Free To Choose* is a landmark work. While extending the theoretical and ideological credenda proposed in their earlier book, *Free To Choose* concentrates on economic, political, and social dilemmas in a more concrete manner. Written in layman's terms and free of economists' jargon, the work is intellectually accessible to many.

The Friedmans' basic concepts are hardly novel, dating from the doctrines of Adam Smith and Thomas Jefferson. A free market system is the foundation of a healthy national economy. Permitting untrammelled interaction between economic spheres lessens the call for political intervention and its ubiquitous social programs.

As Adam Smith wryly observes, "I have never known much good done by those who affected to trade for the public good." The present applicability of this notable dictum is undeniably substantiated through references to such imbroglions as the state of Social Security and the public assistance programs. The notion held by our nation's founders, that "government's role is to serve as a referee to prevent individuals from coercing one another has been replaced by the view that government's role is to serve as a parent, charged with the duty of coercing some to aid others." This convoluted Robin Hood interpretation of equality and justice is not only irremissible, it has led to an increasingly centralized government

—stuffed with a veritable plethora of bureaucrats and the accompanying charms of a hierarchical power. Half-baked liberal rhetoric aside, cooperation is infinitely preferable to governmental coercion.



Government intervention has increased approximately tenfold during the past half century. Such expansion has resulted, oddly, in both public dissatisfaction with burgeoning welfare activity, and a push for more of the same. The number of governmental agencies serving special interest groups is so unmanageable that frequently, the taxpayers support both sides of an issue, for instance, subsidies to tobacco farmers and federally funded anti-smoking campaigns. While the effects of such implemented programs often cancel one another out, the costs do not.

Free To Choose systematically invalidates traditional economic myths favoring protectionist policies. The Friedmans extol the virtues of an economic order emerging from the free market. Unilateral fee trade is preferable to the throng of programs which allegedly protect the nation's workforce, but which instead serve only to increase unemployment and international bad feelings as did the Smoot-Hawley tariff in 1930. On the international level, such a policy of free trade would

with Arthur Laffer

Milton Friedman's focus on that is totally correct. But independent of government spending, the constellation of taxes matter. How you collect your tax receipts is as equally important as the total volume of government spending. And what I try to do with these tax reforms is look exclusively at the constellation of the tax rate as opposed to looking at the total volume of government spending. I would like to see people deal with government spending in a direct fashion. If you want to cut government spending go in there and cut government spending. But don't surreptitiously cut tax rates hoping to starve the government of tax revenues. My view is that you want to have an efficient tax collection system and you want to have an efficient spending system. And that should be done thru a democratic process.

CR: Dr. Robert Russell has said that the 1981 changes in the depreciation allowances have created a distortion in the investment market. Do you agree?

LAFFER: It sure did. Especially if you take the safe harbor provision. Companies that have losses can sell their investment tax credit to profitable companies. What this means is that a company with tax liabilities would be willing to pay a company with no tax liability up to the full amount of the tax credit. So they pay these companies that have losses, and the government loses the revenue. All it's doing is subsidizing losing corporations. From my point of view, this is nothing more than a corporate welfare bailout. I think it changes the structure of investments in America very much for the worse.

CR: Do you see trouble in the future with structural deficits, that is, deficits we would incur at full employment?

LAFFER: No. Not at all. Our deficit right now and all the projected deficits I see are all due exclusively to the depth of the recession. Whenever you have high unemployment people don't pay much taxes because they don't have income and people receive a lot of welfare, food stamps and unemployment compensation. Unemployment and inflation are the biggest spenders of them all. My view is if we lowered the unemployment rate to the 4% or 5% level, reduced inflation and interest rates, then we would have a balanced budget in no time.

CR: Would you describe the policies of President Reagan as "supply-side economics?"

LAFFER: Sure. It's obviously not pure supply-side economics, but what politician is pure anything? What you've got with Ronald Reagan is a lot of good focus on supply-side issues. He's a heck of a lot more supply-side than Jimmy Carter, Gerald Ford, Richard Nixon or Lyndon Johnson. I would have never delayed the tax cuts. He delayed them so we finally got our tax cut this year. But he's dealing with Congress and he's under a lot of political pressure. But over all you have to give Ronald Reagan awfully good marks.

CR: Would you advocate an additional tax cut right now?

LAFFER: Oh yes. In fact what I think we should do right now, all things considered, is get rid of three federal taxes. The payroll tax is a terribly regressive, unfair tax. The personal income tax is, of course, a farse. I mean it's the lawyers' and accountants' employment act. The corporate profits tax is a disaster. It bails out bad companies and taxes good ones, which makes no sense. I'd get rid of all three of those taxes and in their stead put two flat-rate taxes. A flat-rate value-added tax and a flat-rate personal unadjusted gross income tax. If you did that you could have a rate of about 11% and still collect as much revenue as we do from those three taxes. Those three taxes currently constitute over 90% of current federal receipts.

CR: Do you think there is any realistic possibility that we could get a flat-rate tax?

LAFFER: Sure. People deserve the governments they have. If people want one bad enough they will get it. We wanted that tax cut bad enough and we got it. And here in California we wanted to get rid of our inheritance tax and we got rid of it. We had Proposition 13 for property tax and we took care of that too.

CR: Do you believe protecting U.S. industries from foreign competition through tariffs, quotas, subsidies, etc., to be beneficial to our economy?

LAFFER: It's a disaster. It prevents Americans from getting higher wages. Americans work to buy Toyotas, Mazdas, Volkswagens, BMWs, and so on. By increasing the price Americans have to pay for these products you are literally lowering the income of people who are working. So it's the equivalent of an across-the-board tax increase with no corresponding spending. It's a tax you pay with no one getting the money.

CR: Do you think a significant slow-down in money supply growth was necessary to bring down inflation?

"We used to call the minimum wage the black teenage unemployment act."

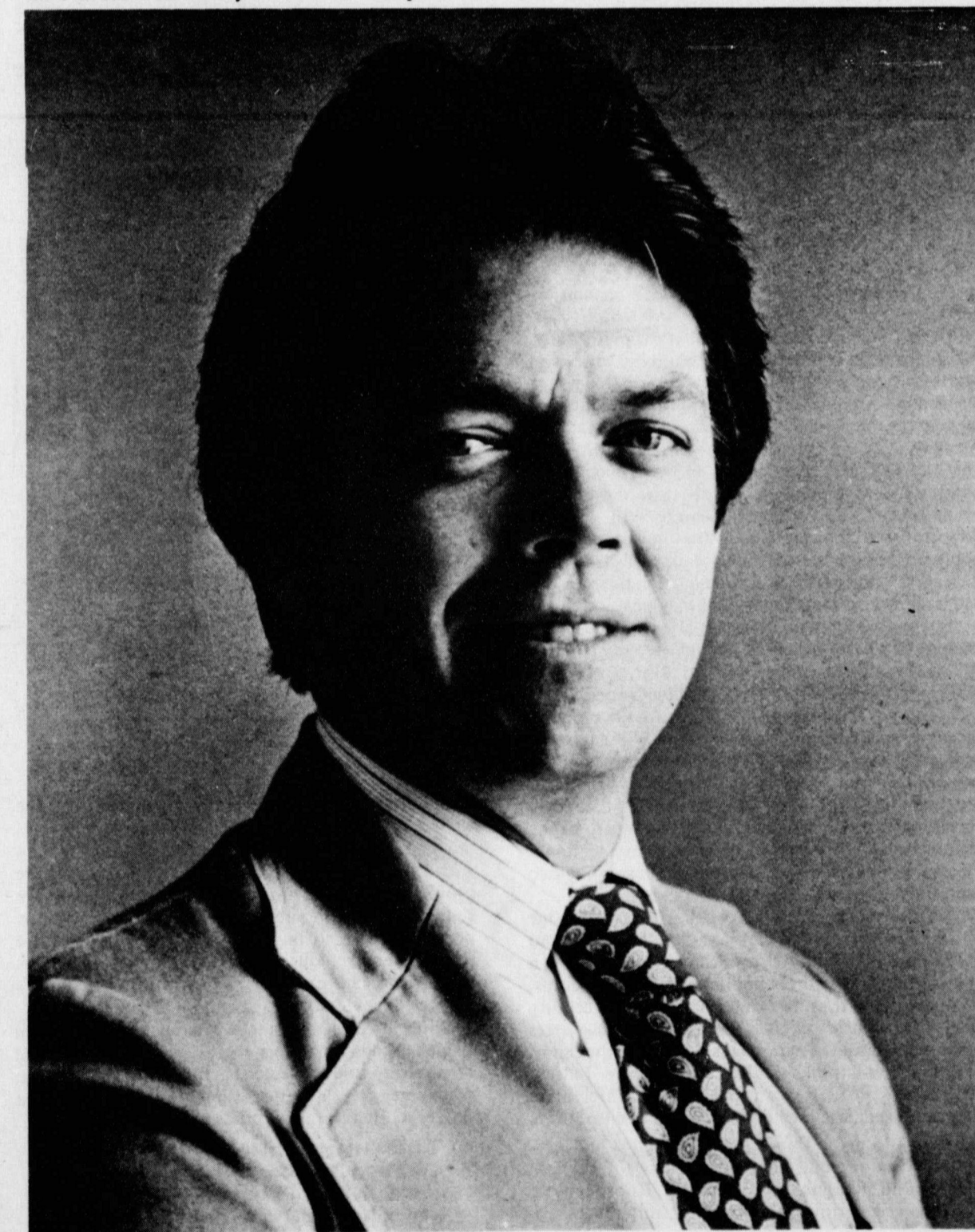
LAFFER: No. In fact it didn't. Take a look at last year when inflation went way down. The money supply went way up and velocity tumbled.

CR: Then what brought down the inflation rate?

LAFFER: The change in the Fed's policy to go back to the price rule. They're starting to make a quality money again by intervening in the foreign exchanges, stabilizing interest rates, stabilizing spot commodity prices and gold prices. When you make a good dollar people are willing to hold more of it. I think they've shifted the demand for money way up.

CR: Since the recovery has started, the savings rate in the U.S. has fallen to very low levels. Is this a problem?

(continued next page)



San Diego Symphony
Up Coming Concerts

Date	Program
November 3,4,5	Rimsky-Korsakov: Russian Easter Festival Overture Tchaikovsky: Piano Concerto No. 1 Rachmaninov: Symphonic Dances
November 10,11,12	Berlioz: Overture: The Corsair Debussy: Danse Sacree et Danse Profane Varese: Deserts Dvorak: Cello Concerto
November 17, 18, 19, 20	Ravel: Overture: Scheherazade Ravel: Piano Concerto for Left Hand Ravel: La Valse Ravel: Ballet: Mother Goose Ravel: Bolero

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