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SUPPLY-SIDE ECONOMICS

Leader: THOMAS M. MARRA
Speaker: ARTHUR B. LAFFER*

MR. THOMAS M. MARRA: It's my pleasure to introduce Dr. Arthur Laffer. He's a graduate in economics from Yale University. He received an MBA and a Ph.D. in economics from Stanford University. He had a distinguished career in academics as a professor at the University of Chicago, the University of Southern California, and Pepperdine University, where he was also a member of the board of directors. I personally remember his contributions back in the good old days, as he was a member of President Reagan's Economic Policy Advisory Board. He was also a member of the policy committee and board of directors of the American Council for Capital Formation, as well as a contributing editor of the *Conservative Digest.*

Dr. Laffer was listed in the *Los Angeles Times* on January 1, 1990 as being one of a dozen who shaped the 1980s. He is one of the greatest people who influenced our daily business according to *The Wall Street Journal* of June 23, 1989. (Of the 55 people mentioned, 11 are still living, and Dr. Laffer is the youngest member of the group.)

He currently serves on boards of directors of numerous corporations and is associated with numerous environmental business and economic groups. He is now chairman of A.B. Laffer, V.A. Canto & Associates, an economic research and financial consulting firm headquartered in LaJolla, California.

DR. ARTHUR B. LAFFER: Do all of you enjoy politics? If you take it seriously, it will kill you. But, if you enjoy it, you have to really get into it and enjoy it. Some of it is serious, but if you don't see the light side of it, it does really get to you.

I want to do a little bit of the overview of the economy from Bill Clinton's perspective. Bill Clinton is an interesting person. The one problem that he and all of us have – when events hit us – is that we have a hard time imagining it's just contingency or luck or just serendipity: things befall us. I remember a story one of my graduate students told me long ago. He was away for the summer. Where he was, there was a plane crash; 123 people were aboard and 122 were killed. The one guy came off the plane unscathed, not even a scratch or anything. The guy walked off the plane perfectly fine, and he believed that God had selected him to carry out some major mission on earth. The guy was so overburdened by this manifestation that within a year he killed himself. He believed that what had happened to him, as we all do, is not luck. What happens to you guys is luck, but what happens to me has some sort of purpose, some sort of meaning.

In light of that, Bill Clinton honestly believes he was elected President, and in fact, he wasn't. George Bush was defeated, and Bill Clinton happened to be the guy standing there at the time Bush was thrown out of office. Bill Clinton has this notion that

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people want him and want his policies. He got 43% of the vote, which is a little bit less than Dukakis got when he lost, and yet, Clinton comes in. Where Bill Clinton comes from and the perception of hubris that you get from Clinton with all these massive programs and everything like that, in my view, if it doesn't calm down very quickly, he has a chance of becoming a real tailspin very, very quickly.

It takes a Ph.D. in economics from Harvard to believe that if you raise taxes on workers and producers, and you increase the amount you pay to people who don't work and don't produce, you get more workers and producers. That is the sum and the substance of his tax policies. Clinton proposes to raise the highest marginal tax on the rich from 31% to 42%, counting the medical tax all the way out. In the 1980s, they cut taxes on the rich and the very upper income group, the top 1% of the tax payers, and the amount of taxes they paid as a share of total taxes increased. You all know the evidence there. The share paid by the top 1% increased dramatically during the 1980s, and if behavior stays the same, and if you raise those taxes, of course the share pay for the top 1% will actually decline if they behave the same way. A friend asked Joe Kennedy what he thought of that. He said that if the rich try to do that, we'll get them, and we will get the money from them if they try to cheat by doing that sort of stuff.

A different perception of how the world works -- let me take on health care. I don't want to spend too much time on health care because I don't know much about it. But, that's never stopped me from talking about a topic before. Let me try two propositions with you and see if you can agree with me on the two propositions. With the level of income we have in the United States and the successes that we've had over the last century or two, longevity and the quality of life have become increasingly important to Americans as consumers, and therefore, we will, under normal circumstances, spend an ever increasing share of our income on those things that lengthen our lives and increase the qualities of our lives, basically health care. Whether you say it's a luxury good or a superior good, I'm not really arguing that point, but we will increase the share of our total spending on health and health care and those things that increase the quality and longevity of American lives, number one.

The second thing is from Economics I. When the price of a product rises, two effects can be observed from that increased price. One, the higher-priced product makes it more costly to buy that good. Therefore, people will substitute for that good. They will buy other goods that are less costly and the high priced one rations demand. Two, a higher price signals to suppliers that there are more profits to be had in this industry and therefore, suppliers devote more resources to this industry. Are all of you with me on those two propositions? Do they make sense?

The last thing you ever want to do in health care is artificially lower the price of that product. You cause a squanderous consumption of the commodity, you encourage people to consume way beyond what the real underlying cost of the product would warrant, and you signal suppliers that this is not the industry you should produce goods in. You tell people not to go into medicine, don't become a doctor, don't do any pharmaceutical research, don't build a new wing to the hospital, don't get that MRI machine. It's a guaranteed prescription for causing major short-ages in the years ahead.

The last time we had this type of philosophy on a topic was in the 1970s on energy. We wanted to make sure that those oil companies did not gouge or make excessive profits, to any extent. So, we put on well-head price controls. Do any of you remember that in the oil industry, making it absolutely unprofitable to produce oil? We put an excess-profits tax on the oil companies to make sure that, if they did make one smidgen more than they should, we took it back. Then, to doubly make sure, we made sure that they weren't allowed to sell above a certain price at the gas station; we held the prices down. Of course, what happened is demand far exceeded supply at the going prices and there were long queues at the gas station. Remember the gas lines? Humor in serious situations – Herb Stein did a major paper on the maximum length of a gas line. He proved the maximum length of a gas line was the length of the line that it took a car with one full tank of gas to drive through.

Take a look at what happened during the gas situation. I mean, all of this is done in the sense of fairness, equity, fair play. I'll just give you a buy situation in southern California at that time. I am a typical, normal, everyday, average person in southern California. I thought Reagan was a little liberal, but not all that bad. Just so you know, I don't want to hide my political perspective from you. During the gas-line period, we had several cars in the family. We had four cars with many kids. I have six kids. I had a couple of teenagers who had girlfriends or boyfriends. So, for a couple of bucks, they had no problem waiting in line. They closed the window and the steam would be there. Whenever I ran out of gas in one car I always had the other cars to drive. I knew the owner of the gas station, and it was not too far from my home. He'd call me in the evening, just when he was ready to close up, and he'd say, "Art, if you need any gas, bring your cars down now, park them here, and I'll fill them up first thing in the morning." I never had a problem with the gas lines. In fact, I drove to the University of Southern California (USC) where I was a professor at the time. The Harbor Freeway usually is just a road full of people in traffic jams, but because of the gas lines and because of the difficulties of getting gas, all the riffraff was off the roads. So, I was able to drive in without any problems of congestion or traffic jams. My gas was really cheap. It didn't hurt me at all. In fact, it really made my life a little bit better.

Now, take a guy from east Los Angeles. The guy is driving a big old gas-guzzling clunker. He has to drive all the way across the city. He works in the hospital where he empties bed pans in the cancer ward, a really attractive job at the minimum wage. After finishing that job all day long he has to get back into his gas guzzler, drive back to east L.A. to his family, and wait four hours in the gas line. When you sit there and try to figure out what the equity is, rationing queues never help the poor, or the minorities, or the disenfranchised. It always helps the rich, who have influence and who can get it. When you start allocating medical services according to something other than price, you're going to find that the people who suffer the most are those who don't have the personal connections here. That's just the way the world works. When you're watching Clinton talk about the tax programs and the health care, my view is that these two are really serious detriments to Clinton. From the standpoint of the tax policies, I don't foresee a strong economy. I really don't foresee a tragedy occurring. The successes of the 1980s will stay with us, and we won't go back in time.

But, none of you mind me bragging about the real President, do you? Reagan? I have to tell you that in my professional capacity, I honestly believe that the man is a certifiable genius. There are a few people who disagree with my assessment. Some people thought he was lucky. You've got to admit, whether he was lucky or a genius, his one unique characteristic was his uncanny ability to select his four predecessors. Anyone following in the heels of Johnson, Nixon, Ford, and Carter just can't look bad.

I really perceive George Bush as being anti-Reagan; I voted for Bill Clinton and I guess I got a little press. I really thought it was important to get rid of Bush. Bush reminded me of a kamikaze pilot on his 43rd mission. No one questions that the guy was busy. Some people really wondered about his commitment, however. Bush was wallowing in a tub of hardening mush. He really had a hard time figuring out where the target was, who the enemy was, and who the friend was. Our side was disunited completely. With Clinton's victory in controlling the House and the Senate, you know who's in charge. They've got it, it's theirs, it's their turn. They've got the White House for the first time in 12 years. They've had the White House four out of the last 24 years. They really don't have much experience in the administration, and when you look at Bill Clinton, you have to remember that the world is point and counterpoint. I honestly do not believe that Ronald Reagan would have been elected in 1980 had Jerry Ford won in 1976. I think that Jimmy Carter made Ronald Reagan. My view is the concept of tall. To have the concept of tall, you must have also the concept of short. For the concept of fat, you have to have the concept of skinny. Good requires the concept of evil. There is no meaning to good if there isn't the counterpoint of evil. Whoever would Sherlock Holmes have been, had it not been for the evil genius of Professor Moriarity? Moriarity made Holmes what he is today, the genius. Saddam Hussein made Schwarzkopf.

When you look at Bill Clinton and analyze this politically and seriously, Bill Clinton will make a conservative comeback, period. This guy has the eminence from the antediluvian swamps of the inland empire. The dark force is coming. He is so clear, so articulate, so photogenic, so perfect, and everything he says is the antithesis of anything I've ever believed in my life. He makes it so perfectly clear that there is no ambiguity as to what he's saying. I jokingly say that the man is cloaked in the mantel of the serpent. He has the talisman of Beelzebub. He has the power to unite conservatives for the first time and really get a unified force. It's amazing what Bob Dole has done. He turns out to have a heart and a soul. It's just incredible. What you're seeing now is a unification of political forces, and my best guess is that you're going to see this unification come and that Bill Clinton will, in fact, become the symbol of everything that's wrong on that side. This is my one perception of the world. I'm wrong a lot, so forgive me. But, I really do think you're seeing a political coalescence there, and if you're from California and you can see what's going on in California, political response to all this is great.

The one that gets me, are all of you aware of this topic of the deficit? Have you followed this? Are any of you into this subject? Have any of you seen the Charles Kuralt show on Public Broadcasting System (PBS)? Can you imagine having Charles Kuralt standing up there? You know Charles Kuralt was not selected because of his rugged good looks. By the process of elimination, I came to the conclusion that this man must be cerebral. He has the two other worst ones in the world with him, Paul

Tsongas and Warren Rudman. Have you heard what this guy has been saying? He's standing by this clock in Washington, DC, the deficit clock, saying that the average indebtedness of the American family is $54,000. You get nervous, you want to start grabbing for your checkbook. They tell you about how big the numbers are; if you stack the dollar bills, it goes back and forth to the moon seven times, around Dolly Parton's body four times. Do all of you get the sense of the panic of this discussion?

Macroeconomics is to economics sort of what paleontology is to biology. They're very, very big numbers. But the basic laws still hold. Fiscal policy is to economics sort of what astrophysics is to physics. When you realize that there are two billion solar systems in this galaxy of Milky Way and there are a billion galaxies out there in the universe, these are huge numbers. They are mind-boggling. You can't let the brain function stop. The laws of economics still hold.

I want to mention two things about the deficit, because I think this is the biggest hoax I have ever seen in my life. Number one, on a conceptional matter, deficits don't matter. They really don't matter. Number two, we have no idea what the deficit is. We have not the slightest clue. I was chief economist at the Office of Management and Budget (OMB) from 1970 to 1972. George Schultz took me from the University of Chicago as his right hand economist and we set up the OMB at the end of 1970. The reason I tell you this is because at that time we had a political problem. At that time, Congress used to pass authorizing legislation, give the President obligational authority to spend money, and Nixon, at that time, just wouldn't spend it. He wouldn't write the check; he wouldn't give the okay to go ahead and spend it by the departments and agencies, and that was called the impounding of funds. Congress would authorize it and then he wouldn't spend it and that was called impounding of funds. Congress really couldn't stand him at the time. So, Congress passed additional legislation that required Nixon to spend all funds authorized by the Congress. So, the obligational authority had to turn into outlays and we had to figure a new way around it.

We figured out a very clever way at that time. It's called off-budget spending. Do all of you know what off-budget items are in the budget? Off-budget items are the same thing as on-budget items, with one simple exception – they are not counted in the totals. It's amazing, but if you count all your revenues and you don't count any of your expenditures, you could look like you've got really good books. The first thing we moved off budget was the Federal Financing Bank in 1971. Since that time, there has been a very rich and full tradition of on-budget, off-budget types of things. For example, you may be aware that Social Security is not counted in the totals today. It's an off-budget item, not a very important program. Do all of you realize that the bailout of savings and loans is off budget? It's not counted in the totals.

Now, from the standpoint of analyzing the budget, would you agree with me that we should include off-budget items in the overall budget? Is there anyone who disagrees with me on that? I'm going to take you through one example. I'm going to take you through the worst fiscal year ever in the history of the United States, fiscal year 1992. In that year, the budget deficit was $449,125,000,000 plus some change. Do remember that the OMB is the only place on earth where 0.1 stands for $100 million. Things are rounded off to zero if they're below $50 million. It's too small to even be considered. Now, that year the deficit was more than

$449 billion. If you include off-budget items in that total, the deficit drops to $400 billion. The off-budget items had a surplus of a little more than $49 billion. Interesting, isn't it? By the way, you all saw Ross Perot mention this in every speech he gave. He corrected this. He made it very clear to all the people that the numbers were really misleading, the deficit should be a little lower.

Are you aware that the federal government is the only entity in the world whose budget does not discriminate between capital expenditures and current expenditures? Every state government, every local government, everyone else has a capital account and a current account. Every company does. Every individual does. But the federal government does not. The federal government expenses capital purchases in the year of purchase, no matter what their useful lives are.

Now, I'm not going to argue with you about what I really believe. I believe that Ronald Reagan single-handedly defeated the Soviet Union. I believe that based on that perception, all of those defense expenditures throughout the 1980s should in fact be capitalized and should in fact be depreciated over the life of the asset, which is over the entire lives of our children and our grandchildren. Those expenditures should be depreciated over the group to whom the benefits inured. I believe that, but I'm not going to argue about that with you today.

I am going to take you to the appendix of the 1992 budget, where accountants go through and actually reconstruct the federal budget along the basis of capital accounts and current accounts. They historically capitalize and then depreciate all the assets and do the accounting. If you do that, according to the appendix items, you reduce the federal budget deficit from $400 billion to $200 billion. Do you think Ross Perot understood that when he did all these slide shows on television with little chickens chasing Clinton? Do you think he could have mentioned the fact that this had happened? Do you think he understands what a capital account is? Do you think he can read an Economics I textbook or an accounting textbook? Do you think he can hire an MBA from the University of Chicago to find it out? Bob Eisner is president of the American Economics Association and his presidential address goes though all these accounting anomalies.

Some of you may also be aware that the federal government has a slight amount of debt. In fact, in 1992, roughly speaking, it was about four trillion dollars, big numbers. Some of you may realize that in 1992 we had very low inflation. But, there was some inflation in 1992. In fact, inflation was about 3% in 1992. Now, when you have fixed liabilities, what happens to the real value of those liabilities during inflation? They decline and a true accounting system should capture the effect of a reduction in the real liabilities. Economists call it an inflation tax. If you don't like that you can call it involuntary principal repayment. But whether you count it as a revenue source or whether you count it as a reduction in the interest payments, because it's principal repayment, in some way, shape, or form, you've got to account for the inflation on fixed liabilities, and that would reduce the deficit 3% times four trillion. That would reduce the deficit by $120 billion. That takes you from $200 billion down to $80 billion. Do you think Ross Perot understands that?

In 1992, state and local governments had about the smallest surplus they ever had. In 1992, the surplus in state and local was about $25 billion. Usually it's between $50 billion and $75 billion surplus. That takes you down from $80 billion to $55 billion. State and local governments have one trillion dollars of fixed-liability debt. With 3% inflation that's another $30 billion decrease. You're down to a $25 billion deficit. Marty Felstein and I got our Ph.D.s at roughly the same time. We both had to take 25 courses in economics to get our Ph.D.s and Marty took 25 esoteric advanced, theoretical courses in economics and I took Economics I 25 times. I wanted to understand the basics just once.

Now, I am not trying to substitute my line for their line. I don't want you to believe the $25 billion is the right number, because it's not. But, I want you to realize that all these numbers are acres and acres of soap suds and horse manure. Those numbers have no meaning whatsoever, and the people who are professing this to you know better; or if they don't know better, they should. It's amazing that their noses don't grow right on TV. When Charles Kuralt tells you that the average American family has a liability of $54,000, why doesn't he also tell you that the average American family has fixed-income securities in its portfolio exactly equal to $54,000 as well, and that we do owe it to ourselves, and that for every dollar's worth of liability to the federal government, there's a dollar's worth of assets that we own because of the federal government?

When they talk about all this foreign ownership of the debt, no one mentions the fact that the percentage of our debt owned by foreigners since 1975 has declined dramatically. Warren Rudman says he resigned from the Senate when he realized the hypocrisy of it all; all of the interest payments going out there don't feed the hungry, don't house the homeless, don't do any AIDS research, and don't educate any of the illiterate. But they pay for all the pension funds, all the trust departments, all the retirement accounts. Can you imagine what would happen to this country if we stopped paying interest on the debt? When you hear a person complaining about his or her debt too much, what are they telling you? Ultimately they can't pay it and then they default.

If you think you've got a problem with the deficit and the national debt, just wait until they try to default on it. You'll see what real economic problems are going to be like. The U.S. did it from 1834 to 1837. We defaulted on all of our national debt. This is not a phenomenon. All of this focused the deficit. Number one, it shows the complete ignorance of the numbers. But, it's really a way of trying to panic the population into doing something that's crazy. It has no relationship to the real world. Now, I didn't include the change in the real value of the 2,500,000 square miles of land the government owns. I didn't talk about the change in the value of the gold stock or the unfunded liabilities of Social Security or civil service retirement or anything. All I'm telling you is that the numbers don't mean very much.

Now, conceptionally, it also doesn't mean very much. You sit there and you think of it in debt terms and somehow it's crazy. I'm just a professor from Southern California. I don't get this stuff. You tell me what the difference is if I tax the money from you or if I borrow it from you with a promise never to repay. It doesn't matter how they take the money from you. It matters whether they take the money from you. Deficits don't matter. Now, I crawl on my knees here to Boston, to Cambridge, to go to Harvard to learn from the citadel of intellectual thought. It is amazing up there. I crawl on my knees before Marty Feldstein. I said, "Marty, please explain this problem to me." He says, "Art, you've got to understand crowding out. Crowding out is the key here." I said, "Please explain it to me." "Okay, I'll try to explain it to you, Art. It's this way. If the government borrows money out of the capital markets, the private investors put their money in government bonds and don't invest in private capital formation. Private capital is being starved of the funds, and they won't get as much money as they need. They'll have to raise the interest rates to attract more capital, which they won't get. It'll slow down economic growth and cause higher interest rates. Do you understand that crowding-out argument? Let me make it even simpler for you, Art," says Marty. "If you have $100 and the government borrows that $100 from you, how much do you then have left over to invest in private capital formation?" Now, I was quick with math. "I have zero money." "Do you see how by taking that money away from you, private capitalists are crowded out of the capital market and they cause higher interest rates and slow growth? Do you follow the logic? So far it's right and then Marty says, "Do you see why we have to reduce the deficit? We've got to reduce that even if we do have to raise taxes some, do you understand that?" I said, "Well, can I ask you one question? Let's imagine, Marty, you have $100, and the government taxes that $100 away from you. How much do you then have left over to invest in private capital formation?" He said, "Excuse me, Art, I've got a class to teach, but I'll be back in a few hours."

Do all of you see? There is no difference between borrowing crowding-outs and taxing crowding-outs. In either case, the government takes the money from you and you don't have the money to invest in private capital formation. The issue is not how you finance government spending. The issue is exclusively government spending. It is not the deficit in any way, shape, or form. It is exclusively government spending, and when you misdefine the problem as being a deficit problem, as opposed to a spending problem, you get bad answers coming all the time. George Bush's tax increase in 1990 to balance the budget raised taxes by enough to reduce the deficit by $500 billion. Do all of you see how that deficit came way down? The only thing that came way down was the economy and his chances for reelection.

Do you see what Bill Clinton is doing with this energy tax and these other taxes? He believes there's a deficit problem, and there isn't a deficit problem. There's a spending problem, and it cannot be solved by taxes. Ross Perot's misleading everyone that there's a deficit problem, when in fact it's a spending problem. In ecstatic analysis deficits do not matter. Spending matters and spending is the only thing that matters. Do all of you follow where I'm coming from? Once you get the dynamics, there is a difference between deficits and taxes.

Let me show you this way. Let's imagine that you had $100. The government borrowed that $100 from you, and somehow you discovered you had a second $100. How much would you then have left over to invest in private capital formation? A full $100. Now, imagine for a moment that the government raised your tax rates enough to take your first full $100. What do you think it would do if it discovered yet a second $100? It would take that, too. By raising tax rates, you destroy the long-run rate of return on saving, investment, and capital formation? Once you get the dynamics, it is far better to run deficits than it is to raise taxes. By raising taxes you've not only destroyed the economy, but you don't get the money you thought you were going to get. George Bush never got the money he dreamed of in 1990. It didn't come. The deficits went up as a result of the tax increase.

In California in 1990, we had the big Proposition 11, the gas tax. By the way, mark my words at what a gas tax can do to your economy. We have the $.09-per-gallon gas tax, double the truck-weight tax. We got rid of, again, spending limits on highway spending. We destroyed the state of California relative to the rest of the nation, all by an energy tax. Then, of course, we had the problem when Pete Wilson raised taxes. We increased our taxes dramatically in the state of California and what happened to revenues? Revenues declined over the three-year period. But we lost 840,000 jobs. California went from being below the national unemployment rate to having the highest unemployment rate in the nation. Real estate values tumbled and we have a tremendously bad economy downgraded five times.

Raising tax rates destroys the economic base under which you're operating. The last argument I'm going to use here on a conceptional level is the old man. You don't mind me bragging about the real President again, do you? He had such a way of putting things. He was such a leader. He may not have been a rocket scientist, but he was a leader. Do any of you remember the 1984 convention when he gave his terrific speech? He said the problem was with that Congress. Congress, spends like drunken sailors. Then he leaned back and he got that little twinkle in his eye and he said that was unfair to drunken sailors for two reasons. One, drunken sailors spend their own money. Two, the next day when they wake up, drunken sailors are usually sober.

The truth of the matter is, Reagan's point is really substantive. How many of you honestly believe that if we raise taxes by $400 billion that the federal budget deficit would decline by $400 billion? If you give spendthrifts more money, they don't spend less, they spend more. Once you get the dynamics, it's far better to run deficits than it is to raise taxes. I'm the only one in the world who believes this, but those huge deficits are the godsend from the heavenly firmament of the 1980s. They were the only things that kept Congress from spending even more money than they did. If you want to stop them from spending, just don't give them the money, and sooner or later the checks bounce. That is the only way, ultimately, to do it, unless you're willing to put in personal incentives.

I've always disagreed with Jim Wright. Remember when he passed that legislation that increased congressional pay I opposed that personally. In fact, I wanted to propose alternative legislation. My view is that I think we should cut congressional pay. In fact, what I'd like to do is cut all congressional pay to zero and put them all on commission. Isn't that what we're all on? Let's put them on commission. Suppose every time a congressional representative or senator took office they were given a shadow portfolio of $2 million and were told they could keep all the capital gains, but they would be held personally liable for all the capital losses and that they should now go ahead and vote. Can you imagine what would happen if they had to bear the consequences of their own actions?

Do you want to control government spending quickly and easily? Imagine if you did it this way. For any department or agency that achieves its objectives and yet comes in under budget, we will take 35% of the savings and distribute them pro rata as bonuses to the employees of that department or agency. Can you imagine how long we'd have a spending crisis in this country? Ten minutes? The real problem is in America. If you want something, you have to pay for it. If you want good government, you have to be willing to reward good employees in government by writing them a check.

I don't know if you saw what Bill Weld did here with that lady. Remember the Betts lady? The Betts lady saved the state $174 million or something like that, and there was no provision in the state funds to reward this lady for the savings she accumulated for the people of Massachusetts. So, he had to go outside to find a fund. A group of people gave her a $10,000 reward for having saved the state some $174 million. It's incredible how we choose to ignore incentives in the government sector.

Well, taking it a step further, deficits are not your problem. If you focus on that problem, you will never come to a solution. The second stage of the Reagan revolution is now starting to bear fruit. Again, I hope you don't mind me bragging about the real President. I can remember the first meetings we had at the Beverly Wilshire in 1979. There were about eight or ten of us meeting together. Dick Allen was his prospective national security advisor. I don't know how you people see the world, but on a serious note, I personally believe that Ronald Reagan single-handedly defeated the Soviet Union, without the loss of any U.S. troops in the endeavor, and he did it by operating with normal, everyday, understandable incentives.

That has changed the world community dramatically. With the Soviet Union's influence out of the Eastern Bloc, a huge new group of people has been exposed to market capitalism and in my view, this will lead to enormous economic growth in Eastern Europe. But, from my perspective, I do not think that the U.S. is going to benefit much directly from that. The U.S. is at a major disadvantage in Europe. Germany has a lock on the Eastern Block. Take East Germany; that's the biggest leveraged buyout since Mike left us. Estonia, Latvia, and Lithuania were formally part of the Hanseatic trading league.

The break up of Czechoslovakia and the break up of the Soviet Union benefit Germany. They brought back the Volga. The Volga Germans, if you remember, were sent to Siberia. They were brought back by Yeltsin as a separate republic within the Republic. The ties that Germany has in the Eastern Bloc are extraordinary. In my view, Germany has a lock on the Eastern Bloc countries. It's not that we're not going to get some benefit out of it. We are. But that's not where the U.S. influence is going to be the strongest.

If you flip over to Asia, Japan is a country whose future is behind it. Japan does not have much of a future. It has never done things right. Every breath of air in Tokyo is eight calories. I do not believe in Japanese cars. I'm a Cadillac guy all the way. I do Cadillac advertisements in about half the country. Japan claims to make the best cars in the world. Some people may think that they do, and that's fine. But you can't drive a car in Japan. There are no roads. In the U.S., their cars don't park any better than any other countries' cars. Their pension funds are unfunded, as you know. Their population is aging tremendously. At $1 billion an acre in downtown

Tokyo, they have a serious long-run problem. When I look at Japan as sort of a caricature for us, Japan has sold us high-quality products below cost for the last 20 years. It's wonderful. They have then taken the proceeds from the sale of those products and they entrusted those proceeds to us to invest for them. We took all their money, we invested every single penny for them, we have proceeded to lose every single penny they gave us, we had them go bankrupt, and we have learned to hate them in the process. Japan is one of the true tragedies made up of pure politics.

Japan has been our best ally. We needed a big trade deficit and Japan provided us with the real resources during the 1980s to increase our output, employment, production and productivity. They gave us phenomenally good products at very low prices. They made it terrific for America and in return we've been very hostile to them. But, Japan is a country of the past, not the future, and we don't have the Eastern Block, Asia and Japan are pulling out. Where are we going from here?

Let me stop with one last story. Now, I want you to believe this story literally. But, I also want you to believe it figuratively, because the story is literally true, but it also is illustrative of a far more general phenomenon. The year is 1958. The U.S. has more money invested in this country than in any other certain country on the planet, with the single exception of Canada. Back in the 1920s, we had more money invested in this certain country than even Canada. The country is about the size of Pennsylvania, and it has 10.500 million people. It is a Hispanic country; in fact, it has the most educated population of any Hispanic country. In late 1958, a group of rebels came out of the mountains and took over the capital of this country on January 1, 1959. These rebels have been running this country now for 34 straight years.

The leader of the rebels is getting old. He turns 68 this next August 14. His speeches have decreased in length from five hours to two hours. His beard has a lot of gray. He doesn't smoke cigars anymore. He has lost all of his friends. All of his buddies are gone. Well, he thinks he has a successor. He thinks his brother, Raul Castro, is his successor. But, we all know better than that. See Cuba for what it really is. This is a dynamite place. My friends in California don't comprehend Cuba. They ask if it is a Mexican Hawaii. No, Cuba is Hungary right off the shores of the United States. This is a massive industrial nation. This is not just a vacation resort. My family owned a little place on the Isle of Pines at the turn of the century. You've never seen beaches like that in your life. By the way, the Communists renamed the Isle of Pines. It is now called the Isle of Youth.

Pan Am started as a commuter airline between Key West and Havana. It is a 90-mile flight. In 1958, Cuba supplied 30% of the domestic sugar consumption to the United States. I wouldn't go along beachfront property in Fort Lauderdale. If any of you think Donald Trump has problems with Cuomo and Dinkens and Florio and Marla, just wait until you see what happens to the value of Atlantic City casinos when we open up Havana. From the day Castro leaves office to five years thereafter, the U.S. will invest, in current prices, something between $65 billion and $70 billion net into Cuba. It is an incredible investment opportunity for America and will really bring up the rates of return on capital dramatically.

Cuba today has a GNP of a little more than $10 billion; the Soviets withdrew $4 billion in direct subsidies. They're moving from cars to cattle and horses. They're no longer fertilizing their fields with fertilizer but with animal droppings. They've closed down the 90% completed San Fuego nuclear power plant. They didn't have the money. What's going to happen to Cuba is incredible.

But I don't want you just to stick on Cuba. Have any of you been watching what's going on in Mexico with Salinas de Gortari? Have you seen it? He's got to be the smartest guy ever who was educated at Harvard, because he'll only hire University of Chicago Ph.D.s. Don't you wish you owned a little bit of the telephone company in Mexico? Have you seen what's going on in Argentina with Carlos Menem? Do any of you want to watch the Chicago boys at work in Chile? For the last 21 years, have you seen economics work? When all of us from Chicago were down in Chile in the early 1970s (I was down there a number of times with Milton Friedman and Al Harber and the others) the only ones who were against our changes were the U.S. government. Now you see Salinas and you see Carlos Menem. The model we want to follow is what happened in the economic reforms in Chile, only we want to do it faster.

When you look at this hemisphere, North and South America, the United States is number one, number two, number three, number four, number five, and number six. It's our hemisphere. You're seeing -- and let me bring you back to a little bit of an upbeat pattern -- the second stage of the Reagan revolution. The first stage was the U.S. in the 1980s and the boom you guys all got. The second stage is the Reagan revolution spreading to the rest of the world. You get the boom of freeing populations and lowering taxes and economic growth. As depressed as you may be about Bill Clinton or Jimmy Carter, put it in perspective.

Don't let yourself get too far gone in this. Deficits are not your problem. Government spendings are a real serious problem. Bill Clinton has a four-year term. I voted for Clinton, as I said. I tell everyone now I voted for Kemp in 1996 four years early. I honestly do not believe we could have had Reagan if Jerry Ford had been elected in 1976. I think it will take a Bill Clinton to really give us a good Jack Kemp administration for eight years. It's an interim period, and I just don't want you to get too depressed. There are many good things going on.

FROM THE FLOOR: I have a question about incentives. I've never really understood why the conservatives believe that rich people need incentives to invest. It seems to me that people with assets have three choices. They can spend it, they can invest it or they can burn it up in the backyard. I'd appreciate an analysis of why there is so much emphasis on creating incentives to invest money among the rich.

DR. LAFFER: Are you serious? I've learned that people don't work to pay taxes; people work to get paid after taxes. The very people who have demonstrated their incentive orientation are rich. I mean, if there's one group that has proven it likes to go after tax returns, it's rich people, is it not? They are the ones who have it. How did they get it? By going after it, obviously. To me, that's just natural human behavior. People like doing things they find attractive, and they're repelled by things they find unattractive. One of the things that makes something unattractive is a tax. If you tax something, you'll get less of it. One of the things that makes an activity attractive is a subsidy. If you subsidize an activity, people will do more of it.

At the beginning of the 1980s, the U.S. was doing two things. It was taxing work output and employment and subsidizing nonwork leisure and unemployment. It was no shock to us why we had so little work output and employment. Another thing that has always amazed me about Harvard people, it just amazed me how they think people save because their incomes are high. I have never understood how people save to go bankrupt. People save to augment their wealth, not to reduce their wealth. It's the after-tax rate expected rate of return that determines what you save. That's the key to the operation here. Businesses don't locate their plant facilities as a matter of social consciousness. They don't. They locate their plant facilities to make an after-tax rate of return on their investors' capital.

If you don't believe me, look at California in the last three years. We've made it unattractive to be in California. We're like a super nova sending off solar systems to the neighboring states. There are booms in Washington State, Oregon, Nevada, New Mexico, Montana, and Arizona. Have you ever been to New Mexico? How could anything locate anything in New Mexico? It takes a Pete Wilson to make New Mexico attractive. You can see what's happening here with your Massachusetts. Bill Weld is probably the best governor the United States has. He is blessed by being preceded by Dukakis. He is very good, but he also is preceded by someone who is really awful. If you look at Michigan, you see the same thing. John Ingler is about as good as they come, and he was preceded by Blanchard, who was really terrible. Fife Symington in Arizona probably has the best deal of all. Can you imagine having your predecessors be Babbit, Meakum, and Malford? You don't have to do anything and you're a winner. But Fife is also pretty good. I think he was a class behind Bill Weld at Harvard. Isn't it amazing how a couple of them make it through? I'm a fourth-generation Yalie by the way and Yalies have no record whatsoever. Can you imagine Bush, Weiker, Wilson and John Lindsay as your legacy? People do respond to incentives and you can see the results directly.

FROM THE FLOOR: I have two pet peeves. One is all these people who think it's good to have low interest rates. I'm not happy with low interest rates. Also, if government spending is so bad, why did we have so much spending in the 1980s? It's just as bad then as it is today. I don't think Governor Reagan defeated Russia at all. I think the cost of the cold war to both this country and to Russia is very bad, and this country is in as much trouble today. It knocked Russia off first because we were able to outspend them. But, it's just a fact, that the Russian standard of living was kept so low by the cold war. I think that's what got Russia down. Of course, we raced along with them on the cold war. But, we've also done a lot of damage to ourselves.

DR. LAFFER: I do agree government spending is very important and there are many great programs. But, you're totally wrong about Russia and Reagan. I can remember I made a bet with my father in 1950 about the north area allies of the United States. My dad checked over my list and thought I was right and he gave me a buck. Back then a buck was something serious. We started a tradition in my family, because it was so much fun. Every year on December 31, I presented my father with a list of all the political allies of the United States for 30 straight years. Can any of you guess what happened to the length of that list during those 30 years? It shrank to almost nothing. During the last years of Carter we lost three countries – Pakistan, Iran and Nicaragua – to the Soviet sphere.

Strobe Talbet said that when the history of mankind is finally completed democracy will be seen as but a blink. That was in 1978 or 1979. The only thing Shumpainter said that was good news was that he would not live long enough to ever have to personally experience the inevitability of socialism. Our joke in the White House in the 1970s was that Kissinger was negotiating the optimal terms of surrender. You forget what it was like back then.

Reagan did bring the Soviet Union to its knees in two senses. Number one, he made the west, for the first time, look attractive financially. See, do you remember what the stock market was like? Remember when we came in. Please try to remember. The prime interest rate in 1981 when Reagan took office was 21.5%, do you remember that? You liked those interest rates. Those were really good times. We had double-digit inflation, 14%, 15% inflation. The stock market at was 750. The stock market peaked in 1966 at 1,000. Fifteen years later it was down 25% in nominal terms, not counting the horrendous inflation we had.

There were long gas lines. There were air traffic controller strikes. Do any of you remember flying and they'd warm you up over LaGuardia all the time? Do you remember those days? Do you remember what was going on back then when the Soviet Union was a major threat? The high school kids would always list major fear in life as being the nuclear holocaust. Today drugs is their major fear. They don't talk about drugs because drugs have gotten more severe. They have not gotten more severe, and I can attest to that because I was a graduate student in the Bay Area of northern California during the 1960s. Drugs have not gotten more severe. The thing is we removed the threat of the nuclear holocaust and the next highest item popped up.

The reason you guys are all worried about deficits is because you have nothing else to worry about. If you want to stop worrying about the deficit, get a 21.5% prime. No one will talk about the deficit ever again. Give me a 14% unemployment rate and all that sort of stuff. No, I think you're forgetting where you were back then. Really, there was a major change.

FROM THE FLOOR: Spending is still a critical issue with a Democratic Congress. How are you going to do it?

DR. LAFFER: I am really a person who has always pushed for incentives all the way along the line, everywhere. I believe in merit pay for teachers. Frankly, I really do believe in the rewarding good behavior. I think every person has within himself or herself the potential of being a great teacher or a rotten teacher. The environment determines everything. I don't think there's a problem with the people in Congress this administration: the Democrats, Republicans, liberals, conservatives, left wing, right wing, etc. There's a problem with the structure of the way we do government today. The Grace Commission won't give it to you. The Grace Commission is wonderful. Everyone would like to pass a lockbox bill. Did any of you ever see it, the report? There are 42 volumes, 1,000 single-spaced pages per volume with no margins. There's not a congressional representative in America who can get through the introduction of the first set. You cannot get people to pass 42 volumes in law and walk away. They have to have a comprehension of it.

You have to set a structure up that allows good behavior to be rewarded and bad behavior to be penalized. That's just the way you do everything else in life. It's not the people who are at fault; the behavior is at fault. The reason the behavior doesn't come out correctly is because we don't have a structure of incentives that allows people to perform to the level as they should. That's why I jokingly talked about putting incentives in. But, you can go through from A to Z on incentives in the government and bring wonderful behavior out of these people. Government spending is really important.

Jack Kemp describes Cabrini Green. There is 90% unemployment. These people live in government-owned housing with subsidized rent. Give them the apartments. Bring in enterprise zones for goodness sakes, why not? You make the intercity, the high unemployment areas and low tax rate areas, you'll bring jobs to those areas. Get Dan Rostenkowski to stop blocking enterprise zone legislation in the House Ways and Means Committee. Reagan proposed it and then a west sider from Chicago blocked it because it might help the south side. If any of you know Chicago, you know exactly what I'm talking about.

Start using the incentives to really cure the problems. Jack Kennedy made it so perfectly clear. He said the best form of welfare is still a good, high-paying job. I am so sick and tired of people who profess to love the poor. They profess to love the poor so much that they would enact policies that would make all of us poor. The dream in America is not to make the rich poor, it's to make the poor rich. The dream is not to make Beverly Hills look like Watts, it's to make Watts look like Beverly Hills. It is perfectly fine and respectable and honorable to be propoor. It is absolutely offensive and antihuman to be antirich. The dream is to make the poor rich, not to make the rich poor.

Rice talks about me in every speech he makes. All these guys want to do is dismantle Reaganomics. They don't have any agenda of their own. They want to unReaganize America. They're negative all the way and are trying to get rid of the rich in the 1980s. If they want to get rid of the rich in the 1980, they should fire their entire cabinet. Those are the guys who made the bazillions during the 1980s and feel guilty about it. Here's what you've got going on here. You have to stop the negativism. You have to start building up from the base. You open your arms to all people. The Papikims are not the Republicans of my yoke. These are not the people you want. It's Ronald Reagan who says that it's not your oranges that matter, it's your destinations. We're here to be the inclusive party, to allow everyone to have an opportunity to make it.

FROM THE FLOOR: You pointed out that for every piece of national debt that the taxpayers are paying interest on, there's someone who is collecting the interest, and I agree. But isn't it true that the people who are collecting the interest own some kind of government securities and they are counting those among their personal assets, whereas nobody is counting among his or her personal liabilities the pieces of debt that we're all paying on? Doesn't that give us the illusion, collectively, that we're much better off than we really are in the aggregate? Should there be, perhaps, some way of keeping track of the liabilities that offset these assets? Is that what, perhaps, these people who talk about $54,000 of indebtedness are talking about?

DR. LAFFER: Yes, I hear where you're coming from, and I don't agree with you. But let me explain to you why. It's the Bob Barrell sort of notion of the Ricardian view of debt. Let me imagine for a moment that we were to just drop with a helicopter on the United States an additional four trillion dollars worth of debt and the implicit interest rate in all that debt and the implicit future tax liabilities that entails. Do you believe that the value of the capital stock of the United States would reflect those future tax payments and would drop in value? I do. The assets that currently exist that have implicit future tax liabilities that pay the interest of the debt. The discounted present value of those tax liabilities is exactly equal to the national debt and has already been incorporated in the value of those assets, company stocks, individual fortunes, etc. Now, that is an empirical question. I don't know how to answer it explicitly, except that unfunded liabilities of corporations show up in their stock prices. You can't have these unfunded liabilities and still expect your stock to be as if you didn't have an unfunded liability. The real master of Ricardian, probably the top economist in the United States, a guy named Bob Barrell over at Harvard. He is the master of the implications of all this stuff. But I think it's already implicit in the value of our capital stock. It's a debate. It's an empirical question now as to whether people in fact do correctly perceive the discounted present value of the future tax liabilities.

FROM THE FLOOR: You talk about the difficulty of measuring the debt. You talked about incentives. It seems to me that in order to have incentives you have to be able to measure what you're trying to give incentives for. Once you put incentives in place, you tend to create behavior that goes toward getting those incentives rather than accomplishing what you're trying to accomplish. Do you have any methods that you can offer to accomplish this?

DR. LAFFER: Yes, I know the cheapest one of all. Have you ever seen a hamburger in a kid's mouth? What is the probability that randomly a hamburger would end up inside a kid's mouth? Virtually zero. Yet all of them eat them and they eat them to the full extent, they go right down. Those are incentives. The key here is to recognize all of our levels of ignorance. The world is really complex. As bright and as intellectual as one may be, the earth is far more complex and far more complicated than we are capable of understanding. How do you get a drop of blood from your ankle through your heart up to your brain and down to your lungs? It is an amazing math problem, yet your body does it all the time, each day.

So, my view is, and it's a view that followed with Reagan: if it isn't broke, don't fix it. If a system is doing well, leave it alone. If you've got a problem, my best guess is that you're better off taking burdens off the situation, letting people solve the problem, rather than trying to have the government solve it. You allow natural market incentives to work by removing the burdens off the top of them. Our dream has always been to do what Jerry Brown proposed. Don't try to social engineer with taxes because you don't understand what the consequences are going to be and it always gives you unintended consequences. Our view has always been that Jerry Brown had the best single proposal in the country on fiscal policy: two single-rate flat taxes, one a flat-rate tax on business value added and one a flat-rate tax on personal unadjusted gross income. Jerry Brown had four deductions that I agree with totally: mortgage deductions, rent on your primary residence (basically to keep the parity between renters and homeowners), charitable contributions (because if you don't do it you'll lose) and any type of welfare payments from the federal government, (because you just have to mark them up to give them to the people anyway). But, those two taxes really remove all the discretionary effects of governments trying. There is no Howard Metzenbaum trying to figure out what tax-deductible schedule to use to reward his contributors and his campaign. There are no cranberry farmers in New Jersey in a transition rule. There are just two flat- rate taxes and that's it.

Let the market incentives do the rest. Removing burdens is the direction I'd like to see the government going. Rather than trying to impose new incentives, remove the disincentives that currently exist. At some stage, obviously, you have to reinstill incentives because no one is going to be willing to live with a society that has no intervention. I don't think any of us are willing to tolerate a society that lets people die, starve, or be homeless in the streets. We're just not willing to tolerate that. So our proposal with Jerry Brown is twofold. Number one, enterprise zones of the inner-cities, where there are tax havens. Jerry Brown proposed Jack Kemp's proposal. I guess I tried to write the first draft of that in the late 1960s at the University of Chicago, to make a tax haven in the innercities to bring jobs there.

Number two that Jerry Brown put forth that makes so much sense to me is the productive employment program. If a guy gets a job, welfare isn't lost the first day. He loses 20% of welfare the first year, 40% the second year, 60% the third year, 80% the fourth year, and the fifth year he is off welfare. But, don't make it so that the second a guy gets a job, he's worse off.

The amnesty program is the last thing that Jerry Brown had in his four-part proposal of the flat tax. I had worked on this with Tony Cuelho at great lengths. You know what it's like here in Massachusetts. We've had many state amnesty programs. Every state has a treaty with the IRS, whereby they are required by that treaty to transfer all the information they receive to the federal government. Now, if you violated state tax codes, if you have cheated on state tax codes, what do you think the chances are that you might have cheated on your federal taxes, too? It puts a real damper on it. So, our proposal to Tony Cuelho was that you have a combined federal, state, and local, national amnesty program. You have 90 days to confess to all your federal, state and local tax cheating. There are no criminal penalties. You pay your past taxes, plus interest, and you have 90 days to do it. After that, you're fair game. The estimates are that between $75 billion and $125 billion would be raised nationally.

That's the direction we're going. But you've got to put some incentives back in the system. You can't let people starve in the streets. You have to be moral on that. You aren't going to let people have private armies, Waco notwithstanding. I think they should stop those types of things. There should be some limited registration requirement for guns.

I had anticipated that someone would ask me a real practical question, so I applied the supply side of economic principal to the stock market. That's really practical. I analyzed those stocks for the last six weeks. It was incredible. The analysis came up with four stocks in those industries that I can guarantee you will quintuple in value in the next six months. But, no one asked.