



THE CONDITION OF OUR NATION

THE PRESS IS
ALWAYS WRONG

By Dr. Arthur B. Laffer

Thinking Economically

Lesson 4

Thinking Economically

Key economic concepts at the foundation of our market-based economy, such as value, entrepreneurship and competition, often get lost in today's complex policy debates. Too often this results in unforeseen consequences that no one involved intended to bring about.

Thinking Economically is a project of the Texas Public Policy Foundation designed to provide a basic economic education for policymakers, the media, and the general public. In this way, the Foundation hopes to highlight the intersection of economics and public policy, and the importance of "thinking economically" when making policy decisions. We are grateful to be able to undertake this project with the assistance of Dr. Arthur Laffer, who has throughout his distinguished career shaped the thinking of many world leaders by bringing sound economic thought into policy debates and the public's awareness.

Thinking Economically

It's a cliché that the media love to focus on the negative. If a loving wife cooks her husband dinner, it won't sell any newspapers. But if a bitter wife cooks her husband *for* dinner, now there's a story! The pattern holds true when it comes to economic reporting. It's always racier to get quotes from alleged experts saying the market will crash, the dollar will plummet, the manufacturing base will crumble, and so on down the list. Apparently it's very dull to listen to someone saying that our economy is just fine, and average Americans have never had it better.

Beyond their tendency toward negativity, reporters also suffer quite often from a poor understanding of economics. We can see this in their headlines and in the focus of their articles. This is very unfortunate, since it simply reinforces these ideas in the public mind, and leads to wrongheaded policies being enacted. Ironically, the press ends up benefiting since their reporting can actually end up causing the economic problems that sell papers!

In the current paper we'll briefly summarize why the condition of our nation is fantastic, and then we'll move on to expose and dissect the Keynesian fallacies underlying the press' mistaken reporting.

IT'S GETTING BETTER ALL THE TIME

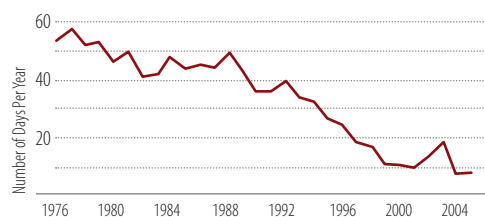
Contrary to the pervasive negativity in the media, the U.S. today is in the best shape it has ever been. This paper will focus narrowly on economic issues, and explain how today's fiscal, monetary, trade, and regulatory policies are far more pro-growth than they have been in a long time. But before we get into those technical details, we should step back and look at some other indicators of progress, just to remind ourselves how good we have it.



Air quality across the country, including big cities like Houston, has vastly improved.

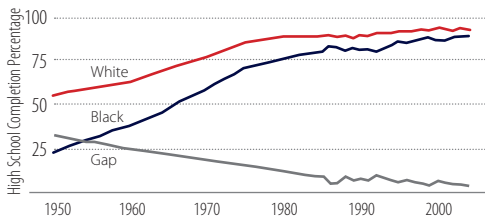
For example, pollution is way down. As a boy raised in the 1940s and 1950s on the shores of Lake Erie, it is truly a miracle to me that Lake Erie is now clean. The Cuyahoga River no longer catches on fire; even the Hudson River in New York is back to its pristine state. A running joke used to be a charcoal grey postcard entitled, "L.A. on a Clear Day." Over the past 30 years, the percentage of days per year in the Los Angeles area that have violated federal air quality standards has fallen from over 50 percent to less than 10 percent (Figure 1). In addition, the number of federal "health advisory" days per year in California has fallen from 166 to 11 over the same period.

Figure 1: Percentage of Days Per Year In Violation of Federal Air Quality Standards in the Los Angeles Area*



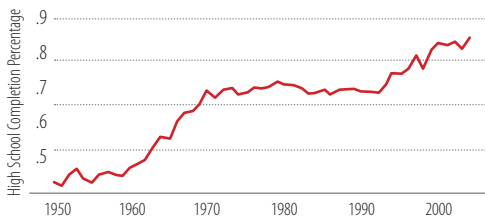
*The Los Angeles Area refers to the South Coast Air Basin.
Source: South Coast AQMD

Figure 2: Educational Attainment by Race: High School Completion Percentages, Ages 25-29, 1950-2004*



* Categories include persons of Hispanic origin prior to 1980. Prior to 1985, datapoints interpolated between survey periods by author.
Source: National Center for Education Statistics

Figure 3: Ratio of Black/White Median Incomes, 1950-2004



Source: U.S. Census Bureau, "Historical Income Tables—People"

Notably, even the gap between white and black educational attainment at the high school level has closed tremendously since 1950, as has the difference in median incomes (Figures 2 and 3).

In broad military terms, huge positive changes have also come to pass. When I was young, people had bomb shelters and we all feared a Soviet nuclear attack that could wipe out life on earth. And to think this cold war scenario was better than the World War that immediately preceded it. We won the Third World War without the long feared nuclear holocaust. And as bad as terrorists are today, they still are no match for the Soviet Union when it comes to producing fear. We've never been safer.

Even little stuff, like smoking and driving under the influence, have been on a long downhill slide. Crime and teenage pregnancies are receding. Yes, it's true, things could be a lot better, but they never have been. But enough of the fluff—let's get back to economics!

THE PRESS: "WE'RE ALL KEYNESIANS NOW."

Although they might not know it, most reporters on financial topics believe in a crude form of Keynesian economics. It was Richard Nixon who famously said, "We're all Keynesians now," but truth be told this economic theory—in which the government needs to manage aggregate demand in order to steer the course between unemployment and inflation—has been discredited among professional economists. The stagflation of the 1970s seriously shook the economic profession's faith in Keynesianism, because stagflation should have been impossible according to the prevailing orthodoxy. After that bitter experience, the supply-side successes of the 1980s were the final nail in the coffin for John Maynard's views. Most economists now understand the tremendous importance of incentives to work and produce. The old-school Keynesian thinks that if customers are willing to buy, that's enough to induce production—but not if the government taxes away all those revenues!

Even though professional economists have abandoned Keynesianism, the financial press hasn't caught on. The typical news story discusses consumer confidence and spending, as if this were the most important driver of economic growth and prosperity. The reader could be forgiven for wishing that it were Christmas all year round—then retail sales would always be terrific and we'd live in nirvana, right?

Obviously there's something missing from this picture. If all it took were loose monetary policies and profligate spending, the government would have "solved" the economic problem long ago. But grown-ups know that in the real world, you have to first *produce* goods and services before you can *consume* them. By narrowly focusing on the demand side and ignoring the supply side, the Keynesian press completely botch their stories and misinform the public.

WISDOM FROM THE ANCIENTS: SAY'S LAW

Jean-Baptiste Say (1767-1832) was one of the great French classical economists. In his treatise on political economy, Say had a fairly innocuous section detailing his "law of markets." Here he made the straightforward point that the use of money is just a detour, and *really* people ultimately demand products through supplying their own wares. For example, the butcher may buy his clothes by handing over silver coins, but he only got those coins because he spent the last week selling cuts of meat. In the grand scheme, the butcher acquires clothes and everything else through *providing* his own services in exchange. Money is simply an intermediary that greatly facilitates the underlying transactions.

"Say's Law," as it became known, thus showed that recessions aren't caused by "underconsumption" or a general "glut" of goods, where consumers don't want to buy all of the items that have been produced. According to Say, merchants can move their inventories by slashing prices. It's true, there could be mistakes and overproduction in a particular industry, but that would correspond to *under*production somewhere else. Say argued that it made

no sense to worry about overproduction in *every* sector. Indeed, when all industries produce more output than in the past, that's not a prescription for disaster—on the contrary, that's the epitome of progress! We *want* everyone in general to be more productive and churn out greater amounts for sale, year after year. That's the only way to increase consumption year after year.

The reason year-round Christmas wouldn't work is that the stores would quickly run out of goods, unless people started working a lot more hours. The simple act of handing over green pieces of paper is intrinsically useless. *Spending* doesn't create wealth, production does. The retail store manager, the dentist, the surgeon, and every other seller don't ultimately want their customers' money; what they really want is to get their hands on the goodies that their customers have made in *their* respective occupations. When the economy is in a slump, what we need is for people to get working again, producing things that others value. If it were simply a matter of spending money, recessions would be ancient history. Say's Law recognizes these simple truths, and yet the vast majority of financial reporters still don't get it.

ECONOMIC GROWTH DOESN'T CAUSE INFLATION! THE DISCREDITED PHILLIPS CURVE

Besides their general concern with spending and consumption, the press are wed to the so-called Phillips Curve, even though the typical reporter might not know the term. Whenever you read about strong economic growth and the consequent fears of upward "pressure" on prices, it is belief in the Phillips Curve at work. Judging from their articles, the press continue to believe that unemployment at least

keeps inflation at bay, and that booming output unfortunately causes prices to rise. As we'll see below, these beliefs—supported by the Phillips Curve—are exactly backwards.

The Phillips Curve concept originated with an empirical study published in the academic journal *Economica* by A.W. Phillips in 1958.⁷ Phillips analyzed U.K. wage changes and unemployment rates for the period 1861-1957 and found a negative relationship. Thus, during periods with large increases in nominal wages, according to Phillips' study, unemployment tended to be low. Periods of stable or falling wages generally had high unemployment. Although Phillips himself was quite circumspect about the policy implications of his findings, later economists such as Paul Samuelson and Robert Solow postulated a tradeoff between unemployment and inflation and used Phillips' study as empirical justification.

The postulated Phillips Curve tradeoff between inflation and unemployment would lead one to conclude that policies implemented to get an economy out of a slump will only do so by also causing prices to rise; policies implemented to rein in inflation will have the undesirable consequences of slowing growth and increasing unemployment. Sad but true: In this Phillips Curve world, "there is no free lunch."

Part of the appeal of the Phillips Curve is that it is perfectly intuitive on the micro level. From a businessman's perspective, to accommodate an increase in demand for his wares, a company can either increase quantity, increase price, or do some of each. The company's decision whether to increase quantity or increase price depends



Paul Samuelson popularized the now discredited Phillips Curve.

Photo source: Library of Congress Prints and Photographs Division

upon the current state of its business. If business has been slow and the company has excess capacity and an underutilized labor pool, it probably will satisfy the increase in demand primarily by increasing quantity. In fact, if business is slow enough, the company may well cut its prices to attract customers. Slow times warrant stable or even reduced prices. However, if business is really good and capacity is stretched and there's a shortage of labor, it's only logical that the company will ration demand and increase profits by raising prices.

To a businessman, it would seem a small step to extend his knowledge of his business to the economy at large. Aggregating over all businesses, the conclusions are simple: Growth is inflationary—especially when the economy is close to full employment, as the U.S. economy is today.

Despite the completely straightforward application of Phillips Curve logic to an individual business, there is a subtle flaw that creeps in whenever the principle is aggregated from an individual business to the whole economy. When a businessman talks about lowering prices because demand is weak, he's not talking about dollar prices so much as he is talking about lowering the prices of his products to attract business away from other products. To attract business away from other companies, the businessman lowers his product prices relative to the prices of other products, thus making his goods more competitive in a price sensitive

⁷ Phillips, A.W. (1958) "The relationship between unemployment and the rate of change of money wages in the United Kingdom, 1861-1957," *Economica*, Vol. 25, pp. 283-299.

marketplace. In turn, when a businessman talks about his company raising its product prices, he also means that the company raises those prices *relative* to the prices of other goods and services so that he can increase profits, pay workers more, and pay his suppliers more in order to increase output. Therefore, when a company raises prices, demanders of the company's products substitute away from the now higher-priced products into *relatively* less expensive substitutes—a movement along the demand curve. Likewise, higher *relative* prices of a company's products at full capacity provide incentives to the company to bid workers, capital, and raw materials away from other firms—a movement along the supply curve. So far so true.

Where the analogy between a company and the economy breaks down is in aggregation. While a company can raise the prices of its products relative to the prices of all other goods and services, an economy cannot raise the relative price of all goods and services relative to all goods and services. As intuitive as the analogy between a company and the whole economy may seem to even an astute businessman, it's still silly. Not everyone can be above average. What is true for a company is most definitely not true for an economy—it's impossible for *all* prices to rise relative to all prices. What, then, is true for an economy, given that we all know inflation exists?

EXCESS MONEY, NOT ECONOMIC GROWTH, CAUSES INFLATION

A price is nothing more or less than the ratio of two goods in exchange. In a barter exchange of apples for oranges, the price of an apple is so many oranges and vice versa for the price of an orange. Inflation, no matter the measuring rod we choose, is the rate of

increase of the exchange ratio. A businessman who talks in terms of dollars is really referring to the relative price of his products *vis-à-vis* other products.

The inflation we talk about for the economy as a whole is literally a general rise in the prices of all goods and services measured in units of money. Stated somewhat differently, inflation is the rate of decline of the purchasing power of money. For a business, prices are relative prices, while for an economy, prices are dollar prices. Therefore, it only makes sense that on an economy-wide scale, the money (dollar) price of a representative good will reflect the relative scarcity of money versus goods. The scarcer the money, the lower the price of goods measured in money; the more plentiful money, the higher the money price of goods. But to our point, the more plentiful goods are, holding money constant, the lower (not higher) the money price of a representative good will be; conversely, the scarcer goods are (as in a recession), the higher the money price. More goods mean lower prices; fewer goods mean higher prices. It's as simple as that.

Inflation is in part caused by recession and cured by growth. For an economy, inflation results from an oversupply of money (relative to goods) or an undersupply of goods (relative to money). Holding the quantity of money constant, an increase in the quantity of goods will lower prices and a reduction in the quantity of goods will increase prices.

Just as a bumper crop of apples lowers the price of apples, so too does a bumper crop in the production of goods and services—an increase in output, employment, and production—lower the price of goods and services.

Output growth—economic expansion—reduces inflation. Recession, contraction, and increased unemployment actually increase inflation. Ironically, the Phillips Curve, as used by its modern adherents, has it exactly backwards. Putting people back to work doesn't cause inflation. Period!

THE FOUR KILLERS OF A BULL MARKET

Although the press seems to think otherwise, recessions always happen for a reason. More than that, the reason is always something very concrete, not some *ex post* “explanation” such as, “People lost confidence.” In macroeconomics, there are four grand arenas or kingdoms, if you will, mapping the areas in which government policy can either be benign or malignant. When times are good and the bulls are roaring, the government must first tamper with one of these four areas in order for growth to falter. Below we'll review the four kingdoms of macroeconomics, and explain why Keynesian policies in each can kill a bull market. The four policy arenas are:

- *Fiscal policy* encompasses government spending and taxation.
- *Monetary policy* is more narrowly focused on Federal Reserve policies *in re* money supply, prices and those sorts of arcania.
- *Trade policy*, of course, has to do with imports, exports, tariffs, quotas and other impediments to the free flow of goods and services across national boundaries. And lastly,
- *Income policy* is generally a catchall category for anything missed in the first three categories. Income policies include all

sorts of government actions that indirectly impact the economy such as regulations, restrictions and requirements like the minimum wage, wage and price controls, government health care and so on and so forth.

There's a lot of overlap and ambiguity when it comes to the details of which policy goes in which category, but the broad boundaries should be fairly understandable.

As we've emphasized throughout, the Keynesian framework can lead to disastrous policies in each of these four kingdoms. (And that's why it's so crucial for the press to abandon this framework in their reporting!) Remember, the traditional Keynesian thinks the government's primary tasks are to boost aggregate demand during economic downturns (to prop up employment), and to reduce aggregate demand during boom periods (to mitigate inflationary pressures). This notion of the government's role as wise caretaker of the economy leads to definite policy conclusions.

In the fiscal arena, the Keynesian mindset provides justification for progressive income taxes and welfare relief programs, because these “automatically” provide the antidote to cyclical movements in the business cycle. (And since these automatic countermeasures are already in place, we don't need to wait around for Congress to debate them and the president to sign them into law.) When the economy is booming, the Keynesian thinks the government should soak up the “excess” income by raising taxes. But this is precisely what a progressive income tax code does—rising incomes push people into higher brackets, and thus raises their effective rates without an official change in the law. On the other hand, when the economy is in a slump,



The flattening of the income tax rate under Ronald Reagan helped produce one of the greatest periods of growth in U.S. history.

Photo source: Library of Congress Prints and Photographs Division

food stamps, unemployment insurance, and other relief measures kick in, thus allowing the government to increase its spending (and prop up demand), again without a formal change in policy. Of course, the tragedy is that progressive income taxes and generous low-income assistance programs reduce the incentives to work. If you wanted to wreck an economy, a good start would be to punish people who produce and reward people who don't. As a result of the Reagan Revolution, we today enjoy a top marginal tax rate of 35 percent, compared to a top marginal tax rate of 70 percent before President Reagan took office.

When it comes to monetary policy, the problem with Keynesianism is that it tries to use the money supply to solve problems for which it is inadequate. When unemployment is high, the Keynesian advocates a loose policy in order to increase spending and get people back to work. But when inflation becomes unacceptably high, the Keynesian recommends tightening in order to sop up aggregate demand and get price increases back under control. The problem here is that these policies will allow both unemployment *and* inflation to get out of hand—as the nation experienced all too well in the 1970s. When the public loses faith in the discipline of the Federal Reserve and the purchasing power of the dollar, these expectations allow for high unemployment even though the government might be pumping in new money. After all, if

workers expect prices to rise by 10 percent, to get a raise of 5 percent in their paychecks isn't a "stimulus." Once Paul Volcker took over the Fed in 1979 and made it his main priority to restore price stability and confidence in the U.S. dollar, the vicious circle was mercifully broken. (Chairman Volcker's "price rule" will be fully explained in Lesson 5 of this series.) During the 1980s, we enjoyed low unemployment *and* low inflation. The alleged Phillips Curve tradeoff was shown to be spurious. And getting inflation under wraps allowed interest rates to fall sharply, too.

In the arena of trade policy, as always the Keynesian focus on demand is dangerous. For example, the popular measure of Gross Domestic Product (GDP) can be calculated by summing up the expenditures by various sectors on U.S. output. As some readers may remember from their undergraduate days, $GDP = C + I + G + (X-M)$, which is to say that real income (often denoted by Y) equals the total of private consumption spending, investment spending, government spending, and net exports (i.e. how much foreigners spend on U.S. exports minus how much Americans spend on imports). With this framework, it is easy to slide into the mercantilist view that the way to national prosperity is to promote exports and discourage imports. This might include subsidies to domestic exporters, as well as tariffs, quotas, and other restrictions on imports. Such policies merely impede the efficient allocation of production across the globe, as the great free trade classical economists demonstrated over 200 hundred years ago. To put it bluntly, you don't make Americans richer by taxing them if they decide to buy a Toyota. Fortunately, trade barriers today are lower than they have ever been in this country.



Some economists are concerned about the return of 1970's era stagflation, caused by Keynesian monetary policy.

Photo source: Library of Congress Prints and Photographs Division

Finally we come to incomes policy, the catch-all for those government interventions not explicitly covered in the other three categories. Here the Keynesian distrust of the market economy, coupled with its unbridled confidence in the wisdom and efficacy of centralized solutions from D.C., lead to mounting dislocations which then in turn demand yet more political “solutions.” For example, the wage and price controls of World War II inaugurated the practice of employer-provided health insurance. (If it’s illegal to attract workers with higher wages, firms can offer other frills.) Confiscatory tax regimes paved the way for deductions and other loopholes on socially appealing items such as medical expenses, and the Great Society programs led to massive government spending on health care and welfare programs. The end result? The medical sector in modern day America is a far cry from a free market, where just about no one pays the actual sticker price for products and services or cares how much

things cost. This in turn reduces incentives for cost cutting and efficiency, so that health care expenses have exploded. And then of course you get every major Democratic presidential candidate calling for some version or another of government-guaranteed health coverage, as if *that* will hold down costs and improve the quality of care. On the contrary, what the medical sector needs is more free enterprise, not more red tape and regulations.

CONCLUSION

The Keynesian mindset pervades the modern financial press. The obsession with aggregate spending, and the belief that the federal government can fine-tune the situation, led to the disastrous policies of the mid-20th century. Fortunately, the supply-side successes of the 1980s turned the tide, with the result being the strongest economy in human history. We currently enjoy low flat(ish) tax rates, sound monetary policy, an economy open to foreign trade, and a fairly unregulated market where prices are free to reach their equilibrium levels. So long as we understand why the 1970s were so bleak, and why the 1980s and beyond have been so much better, we can continue to enjoy this unprecedented prosperity. ♦

Thinking Economically

ABOUT THE AUTHOR



Arthur B. Laffer is the founder and chairman of Laffer Associates, an economic research and consulting firm that provides global investment-research services to institutional asset managers, pension funds, financial institutions, and corporations. Since its inception in 1979, the firm's research has focused on the interconnecting macroeconomic, political, and demographic changes affecting global financial markets.

Dr. Laffer has been widely acknowledged for his economic achievements. His economic acumen and influence in triggering a world-wide tax-cutting movement in the 1980s have earned him the distinction as the "Father of Supply-Side Economics." He was also noted in *TIME*'s 1999 cover story on the "Century's Greatest Minds" for inventing the Laffer Curve, which it deemed one of "a few of the advances that powered this extraordinary century." His creation of the Laffer Curve was deemed a "memorable event" in financial history by the *Institutional Investor* in its July 1992 Silver Anniversary issue, "The Heroes, Villains, Triumphs, Failures and Other Memorable Events."

Dr. Laffer was a member of President Reagan's Economic Policy Advisory Board for both of his two terms (1981-1989).



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