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WE'RE ALL KEYNESIANS NOW

The government can redistribute income but cannot create it out of thin air.

by Arthur Laffer

At times of great economic disturbances such as we are currently experiencing, rather than trying to micromanage the economy, it is beneficial to step back and evaluate where we stand in relation to the ideal economic policies. We do this by looking at what I like to call the four grand kingdoms of macroeconomics: fiscal policy, monetary policy, trade policy, and incomes policies.

Ideal fiscal policy would include fiscal restraint, spending controls, and low-rate flat taxes. That is the perfect world. The ideal monetary policy would be stable-valued money: stable currency now and forevermore. Markets need to know with a fair degree of certainty that a dollar bill 40, 30, 20, 10, and 5 years from now will be worth approximately what it is worth today, which allows us to lend and borrow in the capital markets.

The ideal trade policy would be to have minimal impediments to the free flow of goods, services, and people across national boundaries. With total free trade, each country can avail itself of the maximal gains from global trade and specialization. Impediments to the free flow of goods and services, such as tariffs, quotas, restrictions on trade, or restrictions on people, lead to a deviation from the ideal trade policies.

Incomes policies include all of the indirect effects government can have on business—regulations, restrictions, requirements, minimum wage, wage and price controls, universal healthcare, security measures at airports, environmental policy, union activities, and everything of that ilk. We do need regulations. No one would suggest that you wake up in the morning and decide whether you are going to drive on the left or the right side of the road. But the ideal incomes policies are those that don't go beyond their specific regulatory purpose and thus cause collateral damage to the economy. The minimal amount of regulation necessary to achieve order and structure in society, but not go beyond that, is the ideal.

Unfortunately, over the past few years, we have begun to stray farther and farther from these ideal policies, particularly in fiscal policy. To illustrate this, I want to go through the logic of the stimulus and how it works to better explain the theory behind the current administration's fiscal policy. Its leaders describe it this way: if you give a guy $600 that he otherwise would not have had, he is going to spend more than he otherwise would have spent. And that's true; he is going to go out and buy stuff. That in turn is going to create jobs for people who are now supplying him with the goods and services that he otherwise would not have bought. Those people in turn will have higher incomes and spend more money, and there will be this cascading effect through the economy. And that will lift the economy up by the bootstraps.

As far as that description goes, it is correct. But that's not the whole truth; it's only the first chap-

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ter of the story. The second chapter is that unfortunately, in this world we live in, the government does not have a tooth fairy. To give command over real resources to someone based upon any characteristic other than work effort, it must take those resources from someone else. It is a zero sum game. The government can redistribute income but cannot create it out of thin air. When resources are given to one group and taken from another, the taxpayers who lose the resources in turn will spend less. That will disemploy people who had heretofore been employed through supplying the goods and services people are no longer buying. The incomes of the newly disemployed will be down, they will in turn spend less, and there will be a cascading effect through the system on the other side that exactly offsets the multiplier effect on the stimulus recipients. For every dollar received there is a dollar lost; whenever you bail someone out of trouble, you put someone else into trouble. That's double-entry accounting.

But that isn't the end of the story; there is still one more chapter. Yes, the income effects net to zero—the transfer recipients spend more, the taxpayers or transfer losers spend less, and those effects exactly offset. But something else happens: the substitution effects accumulate across the whole process. Let me describe it this way. If you transfer real resources to people based upon some characteristic other than work effort, those real resources that are transferred can only come from workers and producers. Whenever you transfer resources, you drive a wedge between wages paid and wages received, and you provide less incentive to the workers and producers. They will withdraw their services from the labor force, and the substitution effects will accumulate. You find that, in fact, the stimulus package not only doesn't stimulate but actually hurts the economy.

If instead we could move fiscal policy back toward low, flat-rate taxes accompanied by fiscal restraint, you would see the economy and stock market respond much more positively. ■

Arthur Laffer served as a member of President Reagan's Economic Policy Advisory Board and is co-author of The End of Prosperity: How Higher Taxes Will Doom the Economy—If We Let It Happen.