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Economic Reform Program, An  
11/1/74

Memorandum to: The Honorable William Simon  
Secretary of the Treasury

Subject: An Economic Reform Program

The enclosed program is uniquely mine in that I have tried to capture fully my own views as to what must or should be done to halt inflation, thwart the recession and preserve the gains once obtained. While I feel sure that you and I see eye to eye on the bulk of this program I'm equally as sure you'll have several questions on parts of it.

Also I have not been fully explicit in developing parts of the proposal. I can, if you wish, describe those parts in far more exacting detail if it ever were to get to that stage. The form of the fixed rate system, the intervention criteria, the method of euro-currency regulation, criteria for world open market operations, the specifics of tax reduction and detailed programmatic budget cuts I have worked out elsewhere. Inclusions of such details would have only detracted from the function of this memorandum.

In my own naive way I feel that this program also has some political appeal. In the first place it is both bold and will work. Given the way Republicans have fared a bold workable program is definitely needed. The program is also right in line with the traditional philosophy of the Republican Party.

The program as I see it is also potentially salable abroad. Many foreign governments are tired of floating rates and non-useable gold reserves. They are also becoming more and more aware of the potential dangers inherent in the Euro-currency market.

As a concluding point I do feel this program is simultaneously fully consistent with your position on the economy and Arthur Burn's position. I know of no program that could really succeed without receiving



simultaneously both your and his approval.

My warmest regards to you and your family for the holiday.

Arthur B. Laffer

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AN ECONOMIC REFORM PROGRAM

By Arthur B. Laffer

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An Economic Reform Program

By Arthur B. Laffer

The proposal contained in this paper utilizes basic and simple propositions that are missing from the current set of programs instituted to stop inflation and maintain production. Inflation, which is the decline in the good's value of the monetary standard, concerns us most when denominated in the U.S. monetary standard -- the dollar. While we may find it interesting and in some sense sympathize with others to find out what is happening to prices measured in Lire, Pounds, Marks, or Francs, I take it for granted that we are concerned principally with the rate of change of dollar prices.

Inflation results primarily from increases in the supply of money relative to the supply of goods. In a cliché form, inflation is too much money chasing too few goods. As such, cures for inflation have to focus on either the supply of money or the supply of goods, or both. Contrary to popular belief, an increase in unemployment per se does not help control inflation. Increases in unemployment and reductions in real output only increase the pressures for inflation and not the reverse. The reduction in employment that accompanies recessions reduces the supply of goods, and is inflationary.

A complete proposal to combat inflation will attempt to both reduce the rate of growth of the money supply and increase the rate of growth of real output. At a bare minimum, real output should be kept from declining.



Just as we know there is little chance of controlling the relevant money supply of, say, some county within the United States, so we presently know in this highly interdependent world economy there is no way of controlling one country's relevant money supply independent of other countries' money supplies. Today's supply of money is worldwide in scope, and highly fungible. To date, all attempts at regulating, stopping, or hindering international monetary flows have been recognized as complete failures.

With regard specifically to U.S. dollar prices, we must be concerned with the world's supply of money valued in U.S. dollars. In brief, the world's supply of money, as measured in dollars, consists of three main components. First, there is the U.S. money supply itself which is denominated in dollars. Then there are foreign money supplies denominated in foreign currency units which must be converted into dollars by multiplying them by the dollar foreign currency exchange rates. The third major component of the world's money supply is non-local currency denominated monies. This component consists primarily of eurodollars and other eurocurrencies.

Increases in the world's dollar equivalent money supply can result from changes in foreign money supplies, changes in exchange rates, and changes in eurocurrency deposits, in addition to changes in the money supply of the United States. Even the most optimistic of the monetarists would argue that we control only one component out of four of the dollar value



of the world's money supply. Over the past five years, the U.S. money supply component has not only become smaller relative to other countries money supplies, but the money authorities have also both unintentionally and deliberately relinquished their prerogative to control the growth of the world's money supply. The rapid growth of eurocurrencies has made this component a major force in the world's inflation picture. These deposits are virtually unregulated.

As a deliberate policy stance, the U.S. actively sought greater flexibility in exchange rates. While the arguments are by now well known, greater exchange rate flexibility removes control of the world's money supply from the hands of the monetary authorities. Any depreciation of the dollar leads directly to an augmentation of the world's dollar equivalent money supply. Given the same amount of foreign currencies, a depreciation of the dollar means that in dollar terms these foreign currencies are worth more.

Looking at dollar inflation from a worldwide standpoint presents an interesting juxtaposition with the more traditional monetarist view. Using fifteen of the largest freeworld countries as a basis, the world's money supply as measured in U.S. dollars is equal to the dollar equivalent of each of the fifteen countries M-1 money supplies plus eurodollar deposits. Worldwide income equals the dollar equivalent of each of the fifteen countries nominal GNPs. And, finally, worldwide dollar inflation is the dollar GNP weighted average of the



dollar rates of inflation in each of the fifteen countries consumer price indexes. To obtain a dollar rate of inflation for a country other than the United States, the foreign consumer price index is converted into a dollar equivalent by multiplying by the appropriate dollar foreign currency exchange rate.

In the charts below rates of growth of the world's money supply and rates of growth of world GNP have been plotted for the period 1959 through 1973 on an annual basis. These same series have been plotted for the U.S. alone.

As is readily apparent, the relationships on a worldwide basis are quite close. The rate of growth of the world's dollar money supply is closely associated with the growth of the world's dollar GNP.

Moving on to the plots of U.S. data alone, one finds that while the relationships are still close, they are not as close as those for the world as a whole. This divergence for the U.S. relationships is especially apparent in the most recent years, and does not appear on a worldwide basis. During the past five or so years, two factors have contributed to the very rapid growth of the world's dollar money supply which have not had a corresponding effect on the U.S. M-1 growth.

For the years 1959 through 1968, increases in eurodollar deposits added about two-thirds of one percent to the average annual rate of growth of the world's money supply. Since 1968, however, the effect of eurodollars on the world's rate of



monetary expansion increased markedly. For the 1969-1972 period, eurodollars alone accounted for over 2 1/2 percent annual increase in the world's money supply, and in the latest year for which we have data, 1973, eurodollar expansion caused the world's money supply to grow at additional five plus percent.

The other major factor which accounts for the differences between the U.S. and world results are changes in the dollar/foreign currency exchange rates. For the period 1958-1969, exchange rate changes actually tended to reduce the world's rate of dollar monetary expansion by about one-fifth of one percent annually. This reduction was due to an overall appreciation of the dollar relative to other currencies. From 1970 on, however, this effect has been reversed. The repeated devaluations of the dollar have caused the world's money supply to grow an additional two percent annually.

When considered in conjunction, increases in eurodollar deposits and devaluations of the U.S. dollar have provided a major impetus to the monetary expansion of the world as measured in U.S. dollars. Not only are these sources of world dollar monetary expansion outside the control of U.S. monetary authorities, they are also quantitatively quite significant. From the standpoint of dollar rates of inflation they just cannot be ignored.



The final point that should be made here is that holders of money balances are far more capable today of switching those balances across national boundaries. Large international firms can hold money balances denominated in any number of currencies. If one money market becomes relatively tight, they can increase their holdings elsewhere, and vice versa. Thus, even if monetary authorities could control the supply of their own currency, shifts in the location of deposits can offset in part the inflationary consequences of monetary policies.

In total, our current world dollar supply situation is clearly far outside the control of the U.S. Federal Reserve Board, and probably is currently outside the control of all the monetary authorities combined. To control inflation and manage rates of change of prices, the monetary authorities must regain control over the world's supply of money. To regain control of monetary policy, the following steps should be taken:

1. Fix exchange rates. This probably should be accomplished using an SDR intervention mechanism.
2. Regulate the size and growth of eurocurrency liabilities. A relatively straight-forward method of doing this would be to make all non-local currency denominated deposits subject to the same regulations as local currency denominated deposits.



3. Maintain an international synchronization and harmonization of different countries' monetary policies. Balance of payments criteria could and should be used.

The second part of the inflation program is also closely related to the maintenance of full employment objectives. As noted earlier, the best program to combat inflation simultaneously reduces money growth and increases real output growth. In order to increase real output growth, it is first necessary to focus on why people, machines, land, and other factors of production choose to be employed. Secondly, it is necessary to focus on why firms choose to employ these productive factors.

It is taken here as a simple truth that in part productive factors' choice to work is based upon their ability to earn after-tax income. It is likewise taken as a virtually obvious proposition that the more an employer has to pay his factors of production, the less he will want.

Marginal taxes of all sorts stand as wedges between what an employer pays his factors of production and what they ultimately receive in after-tax income. In the case of payroll taxes, for example, if an employer pays an employee \$100, he must also pay his share of the social security contribution of about \$5 1/2. Thus the use of the employee's services costs the employer \$105 1/2. The employee, on the other hand, has \$5 1/2 deducted from his pay for his share of the contri-



butions and therefore only receives \$94 1/2. With regard to social security taxes alone an employee's services will cost the employer \$105 1/2 and yet the employee will only receive \$94 1/2. The \$11 wedge is only the social security taxes. In addition to these taxes, there are also income taxes, sales taxes, property taxes, State and local taxes of all sorts, etc. At our current levels these wedge effects are very significant.

In order to increase total output, policy measures must have the effect of both increasing firms' demand for productive factors and increasing the productive factors' desires to be employed. Taxes of all sorts must be reduced. These reductions will have the greatest output effects where they lower marginal tax rates the most. Any reduction in marginal tax rates means that employers will pay less and yet employees will receive more. Both from the employer and employee point of view more employment will be desired and more output will be forthcoming. Obviously the more elastic the supply and the demand curves are, the greater the increase in output. The elasticity of these curves will increase with time.

Perhaps the single most extreme case of prohibitive taxes is the case of taxes on productive capital. In order to have an increase in the supply of output, more productive capital must be used. To get more capital into productive uses, capital must be allowed to earn reasonable returns after all taxes. The most striking example of the sensitivity of capital supplies to taxes is the recent juxtaposition of the policies



of Canada and the United Kingdom. In Canada tax rates on capital have been reduced substantially. Business taxes have not only been indexed against inflation, but tax rates have also been reduced. As a result, Canadian output has been faring far better than in other countries. In Britain, on the other hand, taxes are prohibitively high and have been increasing. As a result, the United Kingdom has experienced one of the poorest records on growth in real output.

Tax reductions, while necessary, are not sufficient to prevent the massive redistribution of output from private hands into the hands of the government. Tax reductions must be accompanied by reductions in the government's command over real resources as represented by budget outlays. A reduction in taxes by itself, if not accompanied by a reduction in outlays, only means that the government will absorb in debt issue each dollar it releases by lower taxes. The net effect will be a wash. There will, however, be distributional effects which may not be inconsequential.

One can distinguish, therefore, three possible effects from a tax reduction. The first occurs when the reduction is accompanied by an expenditure reduction. In this case, the sum of all factor net after tax returns is increased. Factors receive more of what they earn, and the aggregate supply of productive factors should increase.



The second effect of a tax reduction concerns the distribution of incentives to different factors. Output is optimized in a world where externalities don't exist when marginal tax rates are the same on all productive factors. When the tax burden is highly unequal, resources are not used efficiently. Any move toward more equal tax burdens should improve aggregate efficiency.

The third oft-mentioned impact of a tax reduction is that it forces the government to weigh more carefully any commitments it might make for future expenditures. Tax reductions, therefore, impose some form of a budget constraint on the government to keep the government's encroachment on private prerogatives from growing too rapidly.

Therefore, to have the fully desired effect on work incentives, a program of tax reduction should be combined with a concerted effort to reduce budget outlays. Specifically, taxes should be reduced on the most heavily taxed factors of production, and especially on their marginal tax rates. The income tax rate structure should, if possible, be made less progressive, perhaps by indexing tax collections as is currently done in Canada. The corporate profits tax also should be reduced. Similarly, reduction in payroll tax rates would be helpful. Budget cuts should occur primarily in the transfer area although cuts in any area will aid in the fight against inflation.



In summary, to keep output from falling further, the following steps should be taken:

4. As an initial step, reduce Federal taxes by 30 to 50 billion dollars through reductions in marginal tax rates on personal income, corporate profits and payrolls. This can be accomplished by indexing as well as changing the current tax schedules. Encourage State and local governments to follow suit in tax reductions.
5. Again, as a first step, reduce Federal outlays from their projected levels by 15 billion dollars. Budget cuts should be largest in the area of transfers. Here the disincentive work effects are the greatest. As with tax reductions, State and local governments should be encouraged to reduce outlays along with their tax reductions.

The third and final part of this economic reform program is aimed principally at the maintenance of the gains achieved by the first five steps. Traditionally, reductions in the rate of inflation have been followed by even more severe reductions in official ardor to maintain low rates of inflation. As a result, excessively expansionary monetary policies have ensued leading to even more virile bouts of inflation. In a similar vein, reductions in the rate of unemployment have led to policies less conducive to the productive use of our



economic resources. More unemployment and slower growth have often resulted.

This type of behavior is typical of discretionary policies in democracies of the sort we have in Western countries. Policy officials are generally in office for relatively short periods of time, and thereby discount the future at unwarrantedly high rates. The effects of this behavioral response is most noted in the steady rise in inflation rates throughout the postwar period. Not only have monetary aggregates tended to grow at ever-increasing rates, but one can also make a case that productivity, broadly defined, is growing at ever-decreasing rates. Both increasing monetary expansion and decreasing productivity have contributed to the unmistakable progression found in the inflation series.

Policy officials can, if they so choose, control either the growth rate of money or the rate of inflation. In general, they cannot simultaneously control both. There is, over the long run, only one rate of growth of the money supply consistent with any specific rate of inflation. Therefore, if one rate of growth of money is selected, the pattern of inflation is predetermined. Likewise, if one rate of inflation is selected, then the pattern of monetary expansion is predetermined.

The principal reason economists and government officials are so preoccupied with the rate of growth of the money supply



is because of the effects monetary growth rates have on the rate of inflation. But, because of the complicated relationship that in reality exists between monetary growth rates and inflation, at different periods in time the same growth rate of the money supply will be associated with widely divergent rates of inflation. Shifts in the demand for money, misspecifications of the correct monetary aggregate, as well as changes in the growth rate of real output, all can contribute to changes in the relationship between money growth and inflation.

In addition to the highly complex and arcane relationship between money growth and inflation, there is also the bureaucratic difficulty of having the public weal correctly followed by inherently short-lived politically expedient policies. In all, be it for purely technical reasons or for political reasons, it is mere wishful thinking to believe that discretionary control of the money supply will lead to the appropriate rate of inflation. Fortunately, an alternative exists whereby the monetary authorities can either fix or determine the temporal pattern of one commodity's price.

To fix the price of a single commodity means that the monetary authorities must alter the quantity of money continuously so as to perpetuate that single price. This policy directive forces the monetary authorities continuously to maintain the correct monetary policy. Their directive is stated



in terms of that result that most directly concerns the populace. Historically, the most successful tack taken in this direction has been to fix the price of gold in terms of the domestic monetary standard. While the U.S. supposedly did this during the Bretton Woods period, nothing could be farther from fact. Huge inventories of gold had been obtained and instead of varying the quantity of money they varied the quantity of gold so as to elicit a fall in the relative price of gold. Britain, on the other hand, between 1714 and 1914 maintained a fixed price of gold while keeping quite small reserves of gold. They were able to keep the price fixed by varying the quantity of money not by buying and selling huge quantities of gold.

Therefore, in order to maintain price stability over the horizon and effectively remove the temptation associated with discretionary monetary policy, a dollar price of gold should be reestablished. The price at which gold should be set should be the free market price after the United States and other countries have sold all the gold they consider excessive. In the case of the U.S., perhaps some 1,000 tons should be retained for intervention and emergency uses of some sort. The price should be set for all buyers and sellers irrespective of their official or private status or their nationality. American citizens as well as foreigners should be allowed the full rights of gold ownership.



The final step in the economic reform program is:

6. After an initial sale of official gold, the monetary authorities should establish an official price of gold and support that price for all buyers and sellers. The price of gold should be controlled not by maintaining vast inventories which fluctuate, but by regulating the world's quantity of money so as to stabilize the dollar price of gold. By doing this, monetary policy is assured of neither being excessively expansive or contractionary.