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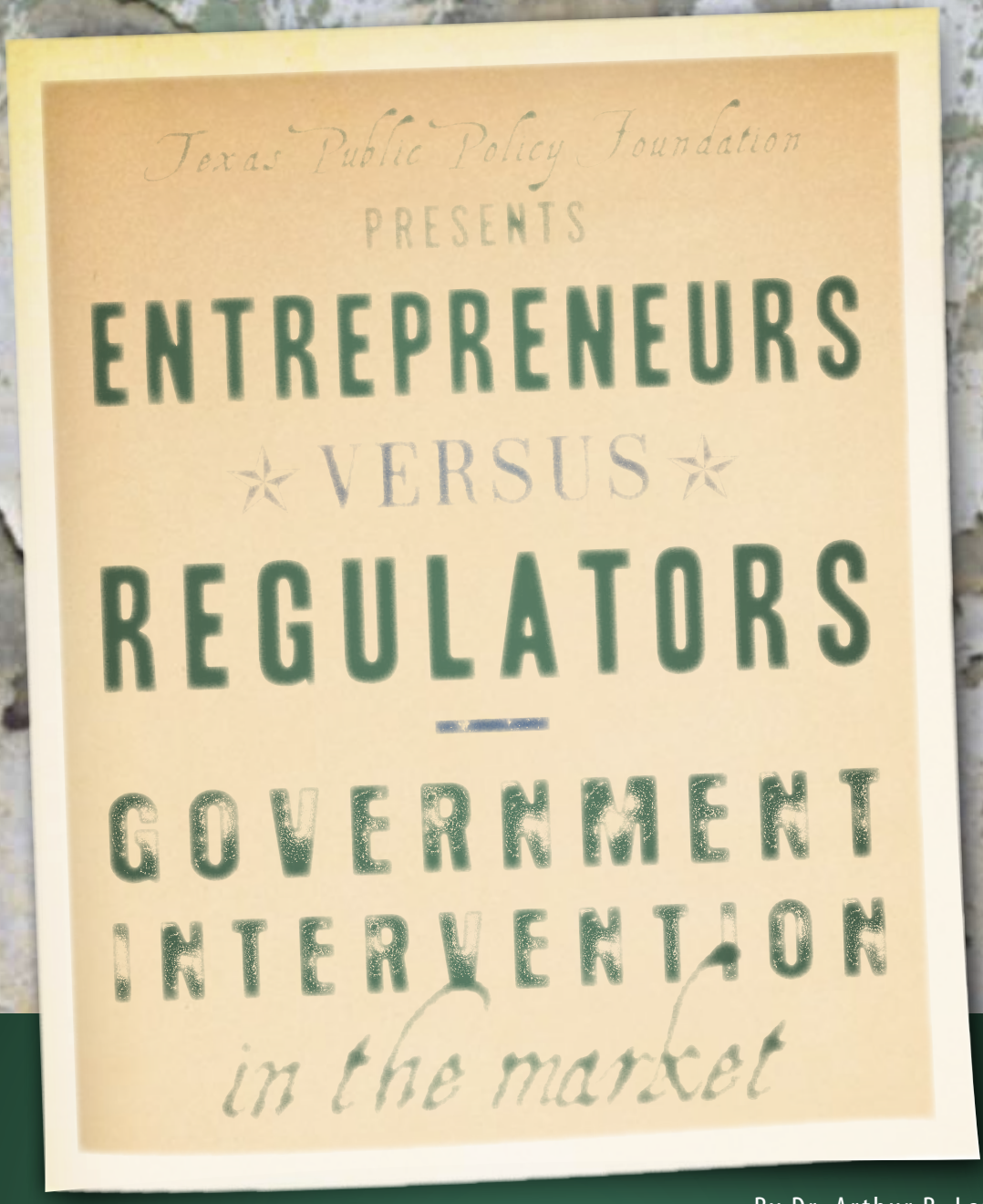

By Dr. Arthur B. Laffer

Thinking Economically

Lesson 8


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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

By now it has become a cliché: when you hear, "We're from the government, and we're here to help!" you know to grab your wallet and run for the hills. Whether it's cost overruns at the Pentagon, obsolete air traffic control equipment, or botched hurricane relief from FEMA, everybody knows that the government spends a whole lot more money doing the same job than the private sector would—and usually doesn't do as good a job.

This pattern isn't just a coincidence. There are straightforward reasons for the tendency of government interventions in the market to mess things up. In this lesson I'll briefly lay out the theory of government failure, and then follow up with several different examples of government in action.

Why Entrepreneurs Are More Successful Than Regulators

When trying to understand why private sector operations are cost-cutting and innovative, while public sector operations are over-budget and stagnant, one obvious difference is the incentives they face. An entrepreneur in the marketplace has to satisfy his customers, because they have to voluntarily give him their money in exchange for his goods or services. If his product is shoddy, or if his employees are surly, he will lose business. In contrast, a government agency gets its money from the legislature, and ultimately from the taxpayers. It's true that citizens direct government policy by periodically casting votes, but the connection between customer and provider is much more tenuous in the public sector. To give a flippant but accurate example: if you aren't happy with the service at the Department of Motor Vehicles, what are you going to do? Switch to a competitor? While one can certainly find poor service in the private sector and good service in the public sector, the different financial incentives explain why the distribution isn't purely random.

The different incentives also shed light on the relative frugality of the private sector. If an entrepreneur figures out a way to cut costs without sacrificing the quality of his product, he pockets the savings. Naturally this arrangement leads him to rack his brains, experimenting with different techniques in order to shave pennies here and there from his operation. Nothing of the kind happens in the public sector. Here, if a program manager comes in $10,000 under budget, he certainly can't buy his wife a diamond necklace—that would be embezzlement of public funds! So the incentive is for every manager to spend every last dime allocated by the legislature, lest his budget be reduced in the following year.

Many people often respond to the above facts by declaring, "We ought to run government like a business." But this is impossible due to the involuntary relationship between

customer and provider in the public sector. If a private entrepreneur cuts costs too much, and ends up reducing the quality of the product, consumers can always switch their loyalty to another brand; there is a built-in safety mechanism. But there is a much weaker safety mechanism in the public sector, and that's why it can never mirror the performance of the market. If, say, a police department were "run like a business," all sorts of havoc could occur. The chief could decide that patrol cars were an unnecessary expense, and sell off the department's vehicles to buy more computers for his detectives. If this decision meant longer response times to 911 calls, there would be no immediate backlash as in the private sector; taxpayers would still have to "pay" for their police services. To repeat, we don't need to worry about this type of thing in the private sector, because customers can always stop handing over their money if the firm cuts too many corners.

In the private sector, even large corporations can operate efficiently, because they can use profit and loss accounting to keep tabs on each sub-unit of the business. Individual managers can be entrusted with a budget, and then they can largely be left to their own devices; the corporation's accountants will closely monitor the performance to see which divisions are profitable and which aren't. But governments can't do the same with their operations, because the customers (i.e., the citizens) don't pay for each unit of product or service separately. That's why bureaucratic rules are necessary in the public sector, with their corresponding waste and stagnation.

Besides the incentive problem, government is also plagued by a "knowledge problem," stressed by Nobel laureate Friedrich Hayek. Even if we could trust government officials to be angels and act in the public interest, the reality is that they wouldn't know how to best serve the public. Yes, it's obvious that a police department needs patrol cars, but how many should it acquire? On the margin, maybe it would reduce crime rates to have fewer cars and better body armor, or a new computer system for that matter. And pushing the problem up a level, how does the city government know the best way to allocate funds between the police, fire department, school system, roads, and so forth? The market economy solves this problem through decentralized decision making, guided by the profit and loss test. But that ultimate check of profitability is lacking in the public sector, and so important decisions need to be made on the basis of imprecise proxies for the public welfare.

How does the city government know the best way to allocate funds between the police, fire department, school system, and roads? The market economy solves this problem through decentralized decision making, guided by the profit and loss test.

So we see that the private market and the government sector have very different institutional frameworks and incentives. This explains why government intervention in the market so often fails to achieve its ostensible goals. The voluntary private arrangement, where all parties benefit, is replaced with a coercive arrangement where a third party imposes its own rules

on the interactions. It's no wonder that government intervention leads to higher costs, lower quality, and often absurd outcomes. Let's look at some specific examples.

Price Controls: Minimum Wages and Maximum Rents

Two textbook examples of unintended consequences are government efforts to help poor people through minimum wage and rent controls. Minimum wage laws are examples of price floors. They don't require employers to hire anybody, they simply make it illegal to pay a worker less than a specified amount, currently $6.55 by federal law (and higher in some states). On top of that, employers must also pay their portion of Social Security and unemployment contributions, and are liable for lawsuits from their employees (for wrongful termination, unsafe working conditions, discriminatory promotional practices, etc.). All of these government measures—designed to help the defenseless poor—make it very costly to hire an additional worker. Now if a particular individual has few skills and no work experience, he might only add, say, $4.50 to the firm's bottom line for every hour he works. By implementing a minimum wage law, the government has guaranteed that this person will not find gainful employment. Like all price floors, minimum wage laws reduce competition. Employers using low-cost workers are placed at a competitive disadvantage by an ever-increasing minimum wage. This hurts their customers, and importantly, also hurts their employees and potential employees of that firm. Of course, minimum wage laws don't affect doctors and lawyers, whose market-clearing salaries far exceed the statutory level. The only people such laws affect are those who would make *less* than the legal threshold—and again, the law doesn't require that businesses actually hire these unskilled workers, but it rather makes it illegal to pay them what their services are worth. Now how exactly is rampant unemployment supposed to help the underprivileged?

In a similar manner, rent control laws—examples of price caps—hurt the very people they are supposed to help. By capping the amount landlords can charge tenants, one obvious effect is to reduce the supply of apartments. Developers are less likely to buy real estate and construct new rental units if the government arbitrarily reduces the amount they can charge per unit. And rent control laws don't just diminish the number of new units. At a low enough price, landlords might decide that it's no longer worth it to rent out a particular room to a boarder, and may instead take the unit off the market and use it as a guest room or for storage. Rent controls thus not only stifle new construction, but can even reduce the existing supply of housing on the market. This is why it's such a hassle to find a vacant apartment in a rent-controlled area: by mandating below-market prices, the government has ensured that demand exceeds supply. We saw the same thing when the government capped the price of oil in the 1970s—the long gas lines came about because more people wanted to buy gasoline at the regulated price than wanted to sell it.

Yet there are still other insidious effects of rent control. Because of the shortage, landlords are less responsive to the needs of their tenants. Why bother putting on a new coat of paint—let alone responding to a 2 a.m. problem with the furnace—when there is a long queue of potential tenants anxious to move in? And since the government makes it illegal to rent units to the highest bidder, landlords will use other criteria to ration the scarce supply. For example, they

might only rent to people they know through social circles, or to "good people" who match their ethnicity or social class. Once again it is the poor and minorities who suffer most from misguided rent control laws. The rich can pay brokers to find apartments and don't need to worry about unfair stereotypes.

Fiscal Follies: The Keynesian Illusion

Through the 1950s and 1960s, demand-side thinking guided the government's efforts to fine-tune the economy. Even though the stagflation of the 1970s discredited orthodox Keynesianism, and the supply-side revolution of the 1980s provided a successful alternative, policymakers are still mired in this way of thinking. When forecasting economic growth, even relatively savvy pundits on CNBC will talk about consumer confidence and spending, rather than incentives for production.

A perfect example of this mentality is the debate over the so-called stimulus bill for 2008. Both sides agreed that they needed to increase "spending" in order to forestall recession, and furthermore Democrats and Republicans alike believed that government checks could stimulate such spending. The only disagreement was over the proper recipients of the checks. And one of the arguments used by the Democrats to favor including the elderly and poorer citizens was that they were less likely to save the rebate!

There's no way to put it politely: the stimulus bill of 2008 was simple nonsense. Where does the government get the money to pay for these $600 rebate checks? It certainly isn't cutting back its *own* spending—why that would reduce "aggregate demand" and defeat the ostensible purpose. In the short term, the stimulus package will be paid for by increased government borrowing, which means ultimately U.S. taxpayers will be footing the bill for the spurt in sales of plasma screen TVs, iPhones, and other goodies. The federal government can't make total income go up by passing a law; nor do the resources going to the rebate recipients come from the Tooth Fairy. If the incomes of some people go up because of the rebate checks, it means the correctly calculated income (i.e., including future tax liabilities) of others must go down.

But wait, it gets worse. The stimulus bill isn't simply a wash. The rebate of $600 per man, woman, and child is transferred to people based upon some characteristic other than work effort. In fact, if you've worked too hard and earned too much, you won't get a rebate. So in some instances the rebate actually requires the absence of work effort. Now it's true that some of the people receiving the rebate may also be workers, but working is not the reason each person receives the rebate; it's simply because he or she is a human being. Thus rebate recipients are given command over real resources for doing something other than working.

I won't cover the same ground in this chapter as I do in the discussion of the Laffer Curve in the next lesson, but let's be clear: a recession occurs when total output stops growing. If the government gives yet another financial incentive to people who don't work, and pays for it with new burdens on people who do work, what effect will that have on total output? How will this stimulate the economy?

Interventions in the Oil & Gas Industry

Of particular interest to a Texan audience is the government's failed record in oil regulation.

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Because oil, as a commodity, is both fungible and durable, it is almost impossible to insulate any one economy from the ebbs and flows of the global oil market. Goodness knows, though, U.S. politicians of all stripes have never wavered in their quest for the silly notion of U.S. energy independence. Ironically, politicians who want to rid the U.S. of its "addiction" to foreign oil have traditionally offered up solutions that would have done at least as much damage to the U.S. economy as any foreign despot could have ever done—and sometimes even more. Yikes! Taxing oil production—whether it's U.S. oil production à la Jimmy Carter or California oil production à la California's proposed Proposition 87 (which, thankfully, was defeated)—hurts domestic oil producers and therefore makes U.S. oil independence and our ability to offset a foreign oil embargo even more difficult. Any rational plan to reduce U.S. dependence on foreign oil should encourage greater U.S. energy production, not less.

Politicians also go astray when they downplay the enormous benefits the U.S. receives from imported oil. Oil exporting countries sell oil to us at far lower prices than those at which we could produce that same amount of oil domestically. We take advantage of their cheap oil to increase our output, employment, and production. The plain and simple fact is that oil exporting countries make us a lot richer than we otherwise would be. Most proposals furthering the cause of U.S. energy independence would damage the U.S. economy if they were ever enacted. Not so surprisingly, those that were enacted historically did enormous damage.

For example, in 1959, in the never-ending quest for energy independence, President Dwight Eisenhower imposed strict oil import quotas which remained in force for years and years. As a result of those quotas and other targeted taxes, regulations, and restrictions, crude oil prices, as received by U.S. oil suppliers, deviated substantially from their rest-of-world counterparts even though wholesale prices of retail products were roughly similar. Oil producers in the U.S. were discriminated against.

Up to and including the early 1970s, the Texas Railroad Commission had enormous sway over the production of oil in Texas. When Ronald Reagan took office in 1981, the U.S. still had in place remnants of the Nixon/Ford wage and price controls in the form of wellhead price controls (in which Americans were forbidden from paying U.S. oil producers the same price that they were allowed to pay foreign oil producers), an excess profits tax on oil companies, gasoline rationing, and any amount of other claptrap that bureaucrats could conceive of. In hindsight, it is significant to quote from Reagan's July 17, 1980 acceptance speech at the Republican National Convention:

> *Large amounts of oil and natural gas lay beneath our land and off our shores, untouched because the present administration seems to believe the American people would*

rather see more regulation, taxes, and controls than more energy.

As so often happens, government intervention in the oil market achieved the exact opposite of its intentions. The price controls on crude oil paradoxically kept oil more expensive than it otherwise would have been. In the first place, we must understand that the controls only directly affected American oil producers—after all, if the U.S. government decreed that foreign producers received less than the prevailing world price when selling oil to Americans, the foreign producers would've simply shipped their oil exports elsewhere. What the price controls *did* achieve was a reduction in the profit earned by U.S. producers per barrel of oil. As with any industry, an artificial cap on prices stifled supply. Consequently, total world oil production was lower than it otherwise would have been, and the world price of oil was higher than it otherwise would have been.

As I predicted in an editorial (with Charles Kadlec) in *The New York Times* in 1979, removal of price controls on oil led to lower oil prices. This analysis seemed counterintuitive, and indeed many people thought I was nuts. (It's not the first time.) But the facts speak for themselves. In January 1981, one of President Reagan's first acts in office was to formally end federal price controls on crude oil, accelerating a phased decontrol set in motion by his predecessor. Critics considered it a huge giveaway to the oil companies, and predicted skyrocketing prices. But in December 1980 (one month before the full decontrol), average acquisition costs for imported crude were $35.63 per barrel. By December 1983 they had fallen to $29.30, and by December 1986 they had collapsed to $14.17 per barrel. Apparently, deregulated markets (along with big tax rate cuts) achieved what price controls could not. Incidentally, the supply-side response of oil producers would have even been more pronounced had President Carter not given us a windfall profits tax on oil as a counterbalance to his phased decontrol plan for crude prices (Reagan killed that too in 1988).

I'll close this section on energy interventions with a funny example of unintended consequences. Under the *Natural Gas Policy Act of 1978*, the federal government placed caps on domestic prices for natural gas. In a nod to economic realities, higher prices were allowed for newly discovered supplies, and for supplies that were more difficult to bring to market. In particular, natural gas from deep wells of more than 15,000 feet could be sold at market prices. One day, Amoco struck gas at a depth close to 15,000 feet—and then relocated the drilling rig to a nearby hill to qualify for the price control exemption. Encouraging this type of waste should be no part of a rational "energy policy."

Government Interventions in Texas

Sad to say, it is not only in the distant past that we find botched government measures that impact Texans. In 1999, the Texas Legislature passed a mandate that 50% of all electric generating capacity installed in the state after January 1, 2000 use natural gas. This seemed to be a responsible yet feasible goal, since natural gas is cleaner (and has a smaller carbon "footprint") than coal and because it was relatively inexpensive when the mandate was passed.

Due to the new mandate, the regulatory obstacles placed on new nuclear and coal-fired generation, and the cost structure of the situation at the time, by 2006 Texas' generation capacity was 49% natural gas. But by then, natu-

ral gas wasn't so cheap any more, and the utilities were forced to raise prices for electricity. Yet the public outcry was directed at the 2002 deregulation of the utilities, *not* at the natural gas mandate.

For another example of unintended consequences, we turn to the Texas homeowners' insurance industry, which in the early 2000s was wracked by large losses due to escalating claims of mold damage. From the first quarter of 2000 to the fourth quarter of 2001, total claims of mold damage rose from 1,050 to 14,706, and the average cost of mold claims per policyholder per year jumped from $24.32 in 1999 to $300.50 at the end of 2001. These trends contributed to insurers of Texas homes paying out more in claims than they collected in premiums in both 2001 and 2002. By 2003, the number of insurers underwriting Texas homes had dropped to 101 (down from 166 companies in 1997), and many of those remaining refused to write new policies. This refusal made it more difficult for Texans to sell their homes. But the biggest cost of the crisis was the extra $900 million in premium costs to policyholders over a five year period.

So what happened to put the Texas homeowners' insurance industry in such a precarious position? Undoubtedly much of the blame lies with aggressive trial lawyers (emulating their asbestos strategy) and a media all too eager to hype scare stories about the health risks from mold. But the underlying cause was government regulation. At the time, insurers were required to use the state's HO-B form, which was interpreted by a district court to include coverage for mold damage. Because of a $32 million judgment against an insurer for not paying a mold claim (later drastically reduced), all insurers started paying mold claims to fend off new

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lawsuits. This is significant, given the scant evidence of serious health risks from mold infestation. Without insurance companies footing the bill, would most homeowners have chosen to spend up to $30,000 removing mold from their residences? Or might they instead have opted for a cheaper method, such as using bleach and a few hours of scrubbing? Most likely the latter, because once the state allowed companies to use forms that specifically excluded mold coverage, the mold crisis in Texas disappeared.

Conclusion

Whether you focus on theory or history, or the federal level versus the state level, the lesson is clear: government intervention in the marketplace wastes resources, harms consumers, and often achieves the opposite from its intended goal. A deregulated and lightly taxed market is the best vehicle to achieve prosperity and a good life for all citizens. ◆

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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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