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Book Review

The Emergence of Arthur Laffer: The Foundations of Supply-Side Economics in Chicago and Washington, 1966–1976

Brian Domitrovic
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Economic policy entrepreneurs operate at the intersection of academia, media and politics. The skills required to earn a Ph.D. in economics do not necessarily translate into the ability to make public policy at state or federal levels. One example is the ability to reach citizens on their own, non-academic terms.

Dr. Arthur Laffer is often associated with *supply-side* economics, i.e., the idea that low taxes and sound money foster economic growth. He could be seen as the best example of a late 20th century economist who reached policymakers. Laffer's means? An easy-to-understand tool: a graph on a napkin.

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Domitrovic, "a close friend," "contract worker," and Laffer Center employee does not make this point. But he has written a comprehensive account of Laffer's interactions with policymakers prior to meeting Ronald Reagan, the U.S. president most closely associated with the Laffer Curve. U.S. tax cuts (1978–86) reduced the capital gains rate by more than half in real terms, and lowered the top marginal income tax rate from 70 to 28 percent. The Laffer Curve was their "unmistakable emblem," though the supply-side era it underpinned failed to achieve another goal: a sound money regime with a commodity-backed U.S. dollar.

Ohio was an industrial powerhouse when Laffer was born in 1940 in Youngstown, a steel town. He grew up in Cleveland observing postwar American prosperity. Laffer's parents were Taft Republicans. His father was a manufacturing executive who preferred to negotiate with one union and opposed right-to-work legislation on the grounds it would reduce efficiency. After Arthur struggled with grades at Yale University, his father told him to shape up or leave college. They agreed Arthur would serve an office-clerk internship in West Germany. Returning to Yale, he took nine economics courses in his senior year, completing his bachelor's degree with high grades. Laffer earned an MBA at Stanford and pursued a Ph.D. at the school, completing his coursework and comprehensive exams and needing one more partial requirement to get the doctorate, a dissertation approved by Stanford authorities. He rejected a Morgan Stanley offer but took a summer job in the Cleveland Fed's research department. He authored a comment that appeared in the *American Economic Review*. Hired by the Univ. of Chicago, Laffer was A.B.D. ("All But Dissertation"). At Chicago, Laffer met Robert Mundell, a future Nobel winner. Both defended "the status quo of the international monetary regime," i.e., Bretton Woods with its pseudo-gold standard that fixed the dollar to gold at $35 per ounce. They stood in contrast to another Chicago economist, Milton Friedman, and his floating-rate system. Laffer argued fixed rates and gold convertibility—"19th century fossils"—delivered postwar prosperity, with no natural end in sight. He spent his first year at Chicago on leave at the Brookings Institution, a Washington think tank, later working during the Nixon administration as Office of Management and Budget economist under future Reagan Secretary of State George Schultz.

Laffer turned 31 the day before Republican Richard Nixon broke the dollar's last link to gold, effectively ending Bretton Woods.

Consider Laffer's resume at that point: undergraduate and graduate degrees from elite universities, a summer Fed stint, an *AER* citation, a tour at a national think tank, and agency service. He also worked at a university whose economics department later produced 13 Nobel Prize winners. In sum, Laffer was positioned for a brilliant academic career. Yet it was in the non-academic policy realm where he made his greatest mark. Austrians can learn a great deal from Laffer's life, especially the supply-side movement's ability "to take shrewd advantage of highly placed converts in the media and easy access to politicians and think tanks." (Rothbard 2006, 40–41) Domitrovic does not pursue this point but it is ripe for research as it relates to successful policymaking. To the soft-money establishment, the most dangerous economist is a credentialed dissident with the ability to communicate abstract ideas, using common sense, to influential media and policymakers after escaping an academic straightjacket.

Why did Laffer leave academia? Far from being big-hearted, academic conformists proved intolerant of dissent within the priesthood. To dissent in the 1970s was to suggest gold should not be subservient, fixed exchange rates were important, and blue-collar Americans bore the brunt of the worst decadal inflation in U.S. history. Domitrovic terms the 1970s "an acutely dispiriting economic time of troubles, that of stagflation, which befuddled and embarrassed professional economics." Tax cut critics focus on supply-side's fiscal policy, overlooking its *monetary* policy, which supports a gold-defined dollar. As inflation emerged, Laffer and Mundell challenged the flexible-rate consensus "increasingly furiously," arguing growth cannot produce problems in a classically arranged international monetary system. This belief had a corollary, one that would move to the center of supply-side economics. In sum, permitting a domestic economy to grow by natural processes was the paramount objective of policy and did not involve trade-offs in the international domain or courting of destabilization or disequilibrium. Stagnation, they reasoned together, came from inflation's interaction with the tax code, which was for the great part, "un-indexed."

Academic intolerance devolved into petty office politics. As of 1971, Laffer did not have a conferred Ph.D. MIT's Paul Samuelson revealed this fact, which Domitrovic terms "the origins of Laffer's turn from academic publication and careerism toward public policy." The pettiness at Chicago, after "the Ph.D. flap," included acts such as removing Laffer's access to the typing pool and long-distance calling. Stanford finally conferred in 1972. In a last farcical note, the calligraphy on Laffer's Ph.D. diploma spelled his name "Authur." Laffer's alienation from academia may have simmered for some time. In his senior year at Yale, Laffer found "something... off-putting in those such as (James) Tobin who exuded attitudes about the fundamental stodginess of businessmen (like his father) and the clear headedness of the right type of intellectuals." Chicago's frostiness, coupled with stagflation's seriousness, "and his certainty that his novel growing monetary and fiscal model was apt given the challenge, had all but decided for Laffer, by 1976, that he was going to get off the ladder of academic publication and prestige and concentrate, in greater part, on being a policy economist and advocate."

Laffer offered the genesis of a stagflation theory. The devolution from fixed to flexible rates sprouted domestic inflation in disproportionately devaluing nations. By late 1974, CPI grew at double-digit rates. Yet money was "tight" to monetarists because M1 expanded at an annual rate under 5 percent (February 1973 to June 1974). Domitrovic notes an unintended effect of the monetarist Shadow Open Market Committee's founding in 1973 was to "wash its hands" of the emerging problem—to provide monetarism with plausible deniability when the 1970s Great Inflation emerged. Top economists dismissed gold, using terms such as "hopelessly unworkable, outmoded, constricting, benighted...." But inflation exploded after Nixon broke the dollar-gold link in 1971. By 1980, CPI was 13.5 percent. To Mundell and Laffer, the 1973–74 oil shock was a consequence of currency devaluation, which made it impossible for trade terms to change in any meaningful way due to the efficient market operations of an integrated world economy.

Domitrovic notes that Laffer expressed his belief that "the function of monetarism within the development of economic thought was not so much to hold up fundamental new insights about money as simply to challenge Keynesianism. That was its central purpose and point of origin... (an anti-Keynesian) club."

Laffer found new platforms, such as the *Wall Street Journal*'s editorial page, private seminars for congressmen and executive officials, and legislative testimony. His first *Journal* column, "Do Devaluations Really Help Trade?" appeared in January 1973. A contraction began that November, lasting until March 1975 and creating an opportunity to challenge the Keynesian consensus. Laffer's next *Journal* piece, "The Bitter Fruits of Devaluation," appeared in January 1974, one of the few complete contraction years in U.S. history. Laffer advanced in policy circles throughout the 1970s, making presentations to Congress's Joint Economic Committee. He argued similar points in journals. One example: a fixed-rate monetary system democratizes the global supply of money and relieves the Fed of the impossible burden of being correct.

The relationship Laffer developed with *Journal* editorial page editor Robert Bartley and his staff arguably advanced supply-side economics more than any non-academic venue. The Laffer Curve suggests a relationship between tax rates and government revenues. *Journal* associate editor Jude Wanninski described it in a 1978 article for *The Public Interest* ("Taxes, Revenues, and the Laffer Curve"), though Domitrovic concludes the interpretation that Laffer "wrote it on a napkin at some point in the latter part of 1974 is probably correct." The napkin graph was simple enough for policymakers and citizens to understand, a key factor in its "going viral." Effective communication of economic ideas to a non-academic audience is a skill. In terms of CPI, a contemporary example would be before-and-after inflation grocery bills. Supporters of a market-based system would reach more Americans if they talked about "jobs and paychecks," though some supply-siders appear preoccupied with stock-market returns.

Laffer's influences were broader than caricatures drawn by his critics. As a student, he heard President John F. Kennedy speak of a fixed-rate policy mix: "monetary policy aimed at stabilizing the currency and fiscal policy at spurring domestic growth." At Stanford, his favorite professor was Marxist Paul Baran. He interacted with campus libertarians. Supply-siders and Austrians understand that inflation starts with the Fed. If Domitrovic authors a sequel, one hopes he asks why a sound money system has not been achieved. The answer may lie in the absence of symbols and images easily understood by citizens.

REFERENCES

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