LAFFER ASSOCIATES
Supply-Side Investment Research
March 23, 2020

10-yr T-Note: 0.76% | DJIA: 18,591.93 | NASDAQ: 6,860.67 | S&P 500: 2,237.40 | S&P 500 Undervalued: 252.9%

EXPANDED COMMENTS ON THE CORONAVIRUS-INDUCED ECONOMIC CRISIS BASED UPON MY SIDE OF A CONVERSATION WITH THE PRESIDENT

By Arthur B. Laffer, Ph.D.

Summary

- Inherently solvent companies need temporary access to liquidity.
- The loss in output and employment induced by the Coronavirus can best be reversed by a temporary waiver of the payroll tax through December 31st, 2020.

On Thursday night, March 19th, 2020, after my bedtime, I missed three calls from the President. While I missed the last call, I did hear my phone ring (which was downstairs) and I tried to call the number back. Finally, at 9:18 CT (10:18 ET), the President called back and we were able to talk. We talked for about 20 minutes. The President directed me to call Larry Kudlow after our conversation and set up a conference call with both Larry and me and Steve Mnuchin. I did just that but to no avail. No one picked up their phone and the White House operator did not come online. On Friday, I also tried and tried to make contact. Finally, on Saturday, I received not one, but several calls from Larry and one from Steve.

I'd like in this note to give you my part of the conversation with the President. I'll leave it up to President Trump to tell you his thoughts and comments. That's not my job or my right. Before I start, let me just say that the President is amazing: even at that hour, he was alert, fresh and laser focused. And he "gets it" right away, if you know what I mean. My points:

A) I (Arthur Laffer) have experienced firsthand up close and personal any number of similar (but not identical) crises. I was in the White House as George Shultz' economist at the OMB during the 1971-72 economic crisis first resulting in the Camp David edicts: a.) devaluation of the dollar, b.) America going off gold, c.) the 10% import tax surcharge, d.) the Job Development Tax Credit (an ITC which excluded foreign made capital) and of course e.) wage and price controls. The catastrophe that ensued is the stuff of legend. The stock market fell by over 50% and people were running around and squealing like five-year-olds in a scary movie—except, of course, for George Shultz.

I was also heavily involved in the inner circles in the 1972-74 Watergate fiasco. I've always said (probably with some, but not too much, exaggeration) that 18 of the 25 staffers in the White House back then were convicted of some transgressions. My only excuse for not being one of the 18 was that my boss wouldn't let me join the others. George Shultz is the most honest, straight-shooting, ethical person I believe I've ever met. Someday I'll tell you all the anecdotes I have.

I was also in the mix with President Ford's Whip Inflation Now (WIN) set of policies that sank his presidency. My close friends and constant contacts were Don Rumsfeld and Dick Cheney (my classmate at Yale). In fact, it was with the two of them and Jude Wanniski that I drew "The Curve" on a cocktail napkin at dinner in the Washington Hotel. I worked closely with the Reagan campaign as an insider in 1976.

I was an active member of the "resistance" during the Carter debacle. In Reagan's 1980 campaign, I was a member (and the note taking secretary) of the Reagan Executive Advisory Committee (some 15 members at the outset) from 1979 through the election. I was also a member of President Reagan's Economic Policy Advisory Board (PEPAB) for both of Reagan's terms in office. In 1984's re-election campaign, I was one of 12 members of the executive committee of the Reagan/Bush Finance Committee.

I was intimately involved in the 1981 tax bill, the Crash of 1981-82 and in staving off the elimination of the third year of the tax cut attempted in the 1982 tax bill. It was lonely for me being an insider back then. But if you had the support of George Shultz, you knew you were right, and, in addition, if you had the support of Ronald Reagan, you knew you would ultimately prevail.

In 1987 with the market crash in November, as a member of the President's Economic Policy Advisory Board, I was part and parcel of all the inside discussions and brouhaha which ended in the correct decisions—"Don't just stand there. Undo something!" As a result, Reagan won his third term in office under the pseudonym George Herbert Walker Bush. One second after winning, President Bush 41 showed his true colors and four years later lost to Bill Clinton in 1992. Nonetheless, the decisions President Reagan *didn't* make in 1982 and 1987 led to a prolonged period of prosperity.

During the Clinton Administration, I was one of 25 members of the Congressional Policy Advisory Committee, most of whom were foreign policy experts: Wolfowitz, Rumsfeld, Cheney, etc. etc. We economists were few in number. I believe our presence was instrumental in how the Republican leadership (Gingrich et al.) handled President Clinton's economic agenda. A great period of prosperity was kept from being derailed by ill-conceived policy actions. When the economy has been doing well, doing nothing is a wise policy.

Lastly, I was a party to—unsuccessfully—the policies of Bush 43 at the onset of the Great Recession. This led to the weakest recovery in U.S. history under President Obama.

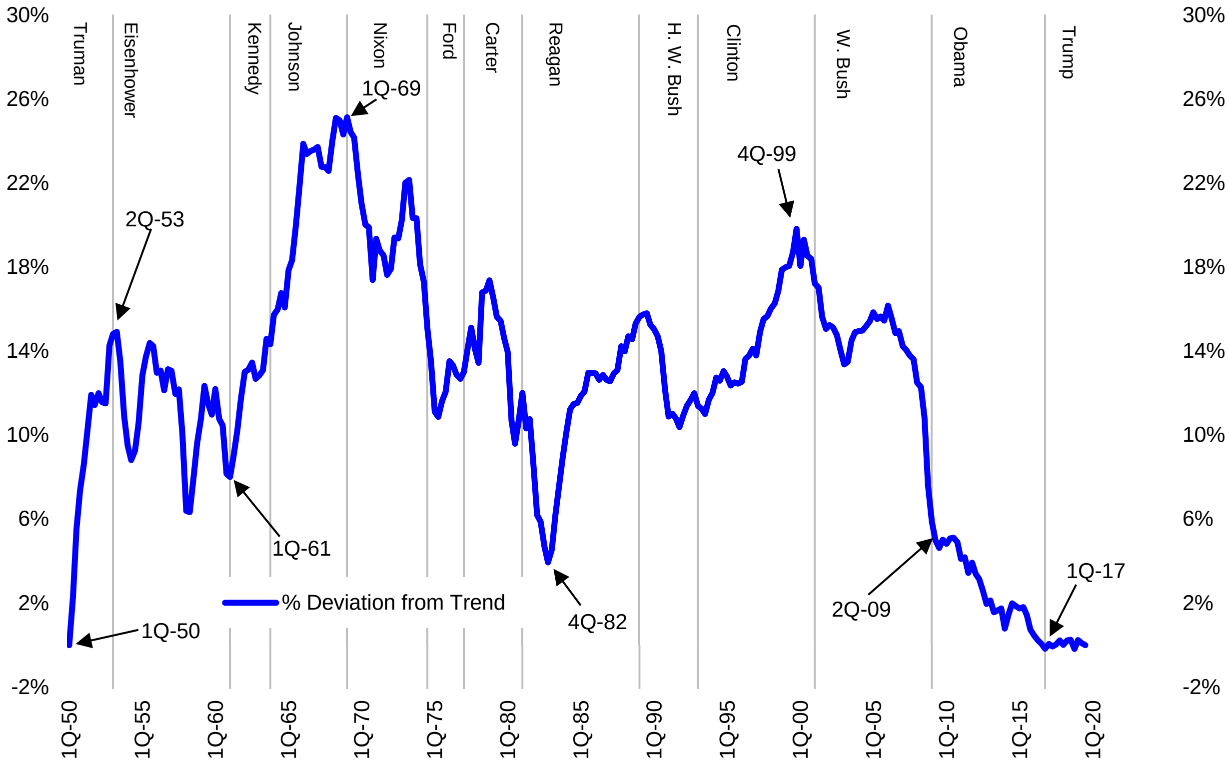
B) There is no one whom I know in the Trump inner circle who has any experience with or has any idea what it is like being a decision maker in times of crisis. This in no way is meant to be a put-down of President Trump's wonderful team. It's a fact. His people—who, I believe, are world-class professionals—are in way over their heads and, like previous crisis participants, are either too ashamed or too proud to ask for help. Having Secretary Mnuchin sell his plan is painful, pitiable and scary. It takes only five days of bad decisions to ruin a lifetime of success. Calling helicopter money a stimulus is like calling a nuclear bomb "the peacemaker." Government spending is taxation, as Milton Friedman repeatedly said. Platitudes and bromides are no substitute for good policies. It's easy being a top government official during peacetime prosperity, receiving accolades from adoring crowds. In times of crisis, being the point person sucks and no one admires or likes you. All that happens is that everyone yells at you and blames you.

This current crisis is deadly serious and has within it the wherewithal to wreak massive economic damage that could last for years and years. This current crisis also contains an essential opportunity for any leader who makes good decisions to become a legendary hero of biblical proportions. Just think of Winston Churchill, Thatcher, MacArthur, or Ronald Reagan. It's a choice between the tiger or the lady. The issue quite simply comes down to the experience, competence, knowledge and content of character of the decision making inner circle. I'm worried. It is a matter of great consequence who prevails in the internal debates. The House, Senate and President Trump need cool, calm and clearly thought-out advice.

Whenever politicians make decisions when they are either panicked (which today they are) or drunk (which I hope they aren't), the consequences are rarely attractive. We are still living with the disastrous consequences of bad policy from Nixon, Ford, Carter, Bush 41, Bush 43 and Obama. We need more Reagans, Kennedys and Clintons. Let's let Trump be Trump. He has what it takes.

It is clear that the response to the Coronavirus precipitated this ensuing crisis, which is now more economic than medical. But whatever its origins, the economy and our economic future are up-for-grabs. The near-term outlook is dark dark dark. What we now face is the question as to how we address the future which will determine the long-term prosperity of this great country and the political future of one of America's best presidents. Our "five days of decisions" are at hand. Just look at the chart below of U.S. Real GDP per adult detrended and you'll see what I mean.

Figure 1
Real GDP Per Adult Detrended
(quarterly, 1Q-50 to 3Q-19)



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Laffer Associates

C) One huge part of the crisis that faces the U.S. (and other countries) is the short-term need for liquidity faced by otherwise solvent industries and companies. These companies had the rug pulled out from under them with huge overnight shortfalls in revenues and what now looks like excess leverage on their balance sheets. Industries like cruise lines, airlines, hotels and healthcare, all of which had heretofore been highly profitable and comfortably solvent, now face a credit crunch of unimaginable proportions. If everything goes right, which it can and should, these industries and companies will be back on their feet in no time—within 12 months. If the government acts judiciously and carefully, those companies who were unprepared and vulnerable will have new owners. Those companies who were intrinsically solvent will get the liquidity they need and will prosper. It is not the role of government to pick winners and losers, especially not in a time of crisis. Free markets and the removal of government intervention is never more needed than it is in a time of crisis.

The worry is if these industries and companies don't get the liquidity they need and deserve, their liquidity crisis will morph into a solvency crisis and will spread to every nook and cranny of the U.S. economy. Inherently solvent companies need temporary access to liquidity.

Without the liquidity, these inherently solvent companies will terminate too many employees and will sell assets in a fire sale way below their replacement costs. Depression will permeate every aspect of the economy bar none. This happened in 2008-09 and 1930-31. You should have seen what happened in Chile in 1970 and the following two plus years when Salvador Allende replaced Eduardo Frei as president and before the Chicago Boys moved in. Unsuccessful companies with inherently insolvent businesses should not be bailed out. Who cares who owns Boeing? As long as someone owns it and runs it well, America is fine.

What needs to be done and can be done quickly by the Federal Reserve, the Treasury, the Small Business Administration, Housing and Urban Development, etc. is for the government to <u>lend</u> to these good companies or to provide loan <u>guarantees</u> to these good companies to tide them over these unforeseen hard times back to normalcy. The good airlines, cruise lines, hotel chains, restaurants, etc. should have ready access to liquidity.

Paraphrasing the words of Walter Bagehot, "In times of crisis, discount freely." No words are more true. These companies don't need bailouts, they need access to liquidity to tide them over this deep downturn. Already, some companies that see the writing on the wall are choosing bankruptcy. Remember that bankruptcy is not the destruction of capital, it is the reorganization of capital. Schumpeter said it best—this is creative destruction.

Extending credit to otherwise solvent firms is what the Fed and others should do right now. Banks that extend credit to small companies should be given backstops by our financial institutions, especially the Fed.

D) What shouldn't be done:

a.) Dumping liquidity into the overall economy by open market operations or interest rate cuts is not warranted. The U.S. banking system has plenty of excess reserves.

b.) Intervention in the foreign exchange markets to prevent the dollar from rising is also unwise and will disrupt much needed trade.

c.) Purchasing equity in private companies is always a bad idea. Once the government takes over, it doesn't leave easily.

Just help good companies with their liquidity needs. And, make sure that they pay the government back when they are back on their feet.

E) The equally large second part of a recovery process has to be making working more attractive and making employing workers more attractive. Today, there is only one policy that can achieve both of these objectives: a temporary payroll tax (Social Security and Medicare) waiver for both employers and employees through December of 2020. This policy also has the added benefit of providing widespread benefits across all segments of the population. No one is to blame for the Coronavirus and no one should be selected for special dispensation at the expense of others.

The payroll tax for employees is roughly 7.65% of the employee's gross wage and for employers, it is also 7.65%. Just think of it, virtually every worker or employee in America pays this tax. Likewise, every single employer in America also pays this tax. Nothing could be more broad-based than this tax. It is the perfect vehicle to recreate the prosperity we lost. We have a supply problem today, not too little demand. If you need more production, reward all producers—both employers and employees—more for producing. It ain't rocket surgery.

By waiving the employee contribution to the payroll tax, each and every employee will receive an increase of 7.65% in their after-tax wages. For a $50k per year employee, this is an after tax bonus of almost $4k annually.

Also, by waiving the employer contribution to the payroll tax, the cost of hiring or retaining an employee is reduced by 7.65%, as well. Again, for a $50k per year employee, the cost savings to the employer will be roughly $4k per year.

The second part of the crisis caused by the consequences of protecting Americans from the Coronavirus—the loss in output and employment—can best be reversed both in magnitude and timeliness by a temporary waiver of the payroll tax through December of 2020.

By making sure the waiver is only temporary, what happens is that both workers and employers know that these benefits won't last long, and, therefore, they will have an enormous incentive to put as much production as they can into the eight-month period when the payroll tax is waived. They will pull 2021 production forward and increase 2020 production as much as possible. This will make the bounce back as large and as fast as possible. Helicopter money such as $2,000 per family (needs-tested, of course) will reduce the bounce back. When Steve Mnuchin asked me "what harm" can helicopter money do, my response was "lots and lots." Just look at Europe and Japan over the post-World War II era to see the enormous damage done by helicopter money. The Treasury Secretary then blurted, "Let's agree to disagree." Huh?

Figure 2
Japan: 5 Year Real GDP Growth Annualized vs. Government Spending as a Share of GDP
(RGDP: 5-year Q4 to Q4 rolling growth rates, 4Q55-4Q60 to 4Q10-4Q15;
Expenditures: annual, historical 1960-2014, 2015 estimate)

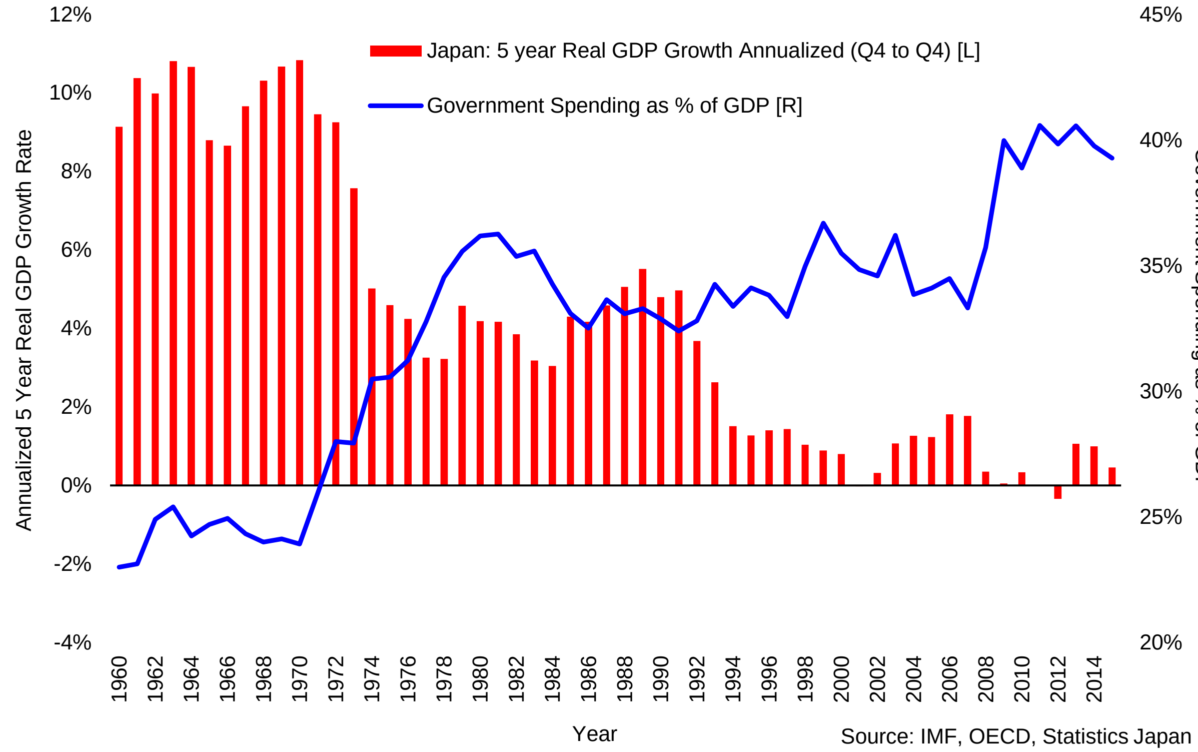
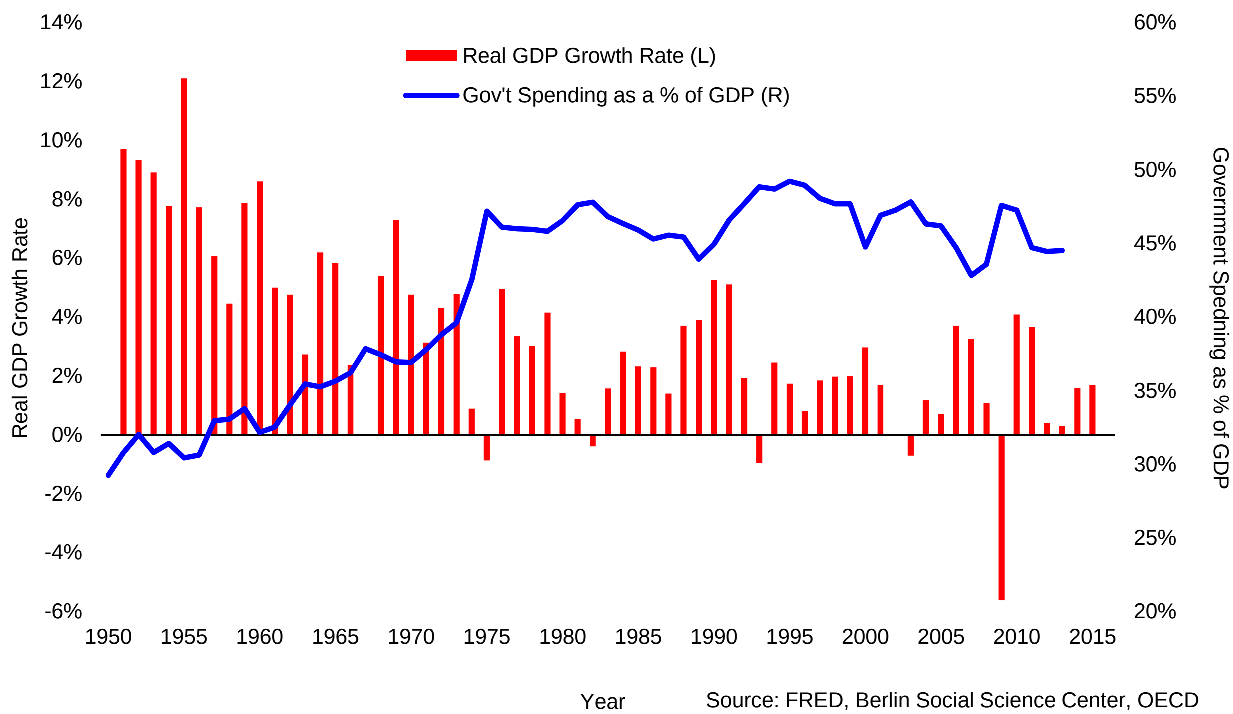


Figure 3
Germany: Real GDP Growth Rate vs. Government Spending as a Share of GDP
(annual, 1950-2015)



The total static cost of a plan to waive all payroll taxes through December 31st will be scored in budget terms at around $750 billion. But believe you me, in dynamic terms, the total cost will be a lot less than $750 billion. If one includes the costs of welfare payments and other tax revenue losses—federal and state and local—the feedback effects on the budget will be very large indeed. And if you only consider the human suffering that will be alleviated, I can't think of any policy more compassionate than the quick reversal of the economic downturn brought on by the health policies implemented to stop Coronavirus.

Spending other people's money indiscriminately is not compassion. It would be symbolic pandering if only it weren't so damned serious in damaging the economy.

F) In addition to the two policies listed above that we should do—1) discounting freely and loan guarantees for liquidity needs and 2) waiving the payroll tax to redress production losses—there is a much larger set of policies we shouldn't do. But these bad policies have been done time and time again in crises when panic freezes rational thought.

When panic (or alcohol) freezes rational thought, rash actions rarely have good consequences. Take, if you will, President Nixon's set of policy decisions made at Camp David in 1971. The damage they did to the economy and markets was immense. And yet, everyone at the time was screaming "we've got to do something!" The correct answer should have been to do nothing. Doing nothing is very hard, but it is often correct. In medical terms, i.e. Latin, it is called *primum non nocere*: first, do no harm. Also President Nixon's and his advisors' panicked policies around Watergate reverberate today as causing a terrible crisis for America, the likes of which we've never seen before. Wouldn't it have been better if President Nixon et al. had just told the truth right away and not tried to cover up the Watergate break-in?

We could add to the set of panic faux pas in policy President Ford's Whip Inflation Now, Jimmy Carter's wellhead price controls, excess profits tax and gasoline rationing. It doesn't get any worse (oh yes it does). Jimmy Carter's attempt to free the hostages was a panicked decision gone bad. Remember that? If you're going to use the military, think it through carefully. And the same goes for economic policies. Take your time and do it right.

With President Reagan, when confronted by panic situations, the response was very different. We had the huge market and economic crash in 1981 and 1982 brought about by our phase-in of the 1981 tax cuts. Everyone—except for a few of us—recommended eliminating the third year of the tax cuts and increasing social spending à la George McGovern. Reagan, to his credit, was well-aware of the problems created by mistaken, fear-driven policies and didn't succumb to the emotional stampede. The recovery, starting on August 14th, 1982 for the stock market and January 1st, 1983 for the economy was a wonder to behold.

Reagan (with Shultz at his side) also resisted the screams and hollers of panic-driven howler monkeys and uttered the phrase, "Don't just stand there. Undo something." A profound response to a panic situation. In medical terms, i.e. Latin, this response is called *vis medicatrix naturae*: the healing power of nature.

But then we had George H.W. Bush's panicked response to his situation in 1992 by raising corporate and personal income tax rates plus lots of other distasteful initiatives, and lo and behold the economy went in the dumpster and he lost the election to Clinton. Bad policies forged in panic have consequences, both political and economic. You cannot be warm-hearted if you aren't also clear-eyed. It's not compassionate to give away other people's money, and it doesn't do any good either. In fact, it does a lot of harm.

President Clinton, upon taking office in 1993, stupidly passed a tax increase. It's amazing how well he handled himself in economics after making that initial mistake. The 1993 tax increase caused the Democrats to lose the House, the Senate and governors' seats in 1994, but Clinton, like Reagan, learned an economic lesson. Unfortunately (for him), his panicked decisions to lie about sex hurt him badly. The lesson is simple: think things through carefully, be modest, recognize your own limitations and don't lie.

And then we come to "W" and Obama. Yikes! Just how bad decisions can be when people make them in a panicked state was sorely tested by these two losers. In five days, a panicked government can enact enough policies to ruin decades of prosperity. These two Presidents and their actions are sufficiently recent to not require recounting.

What one must remember, whether you make a panicked decision or not, a year from now all the buildings and people and computer code and trains and factories and airports etc. etc. will all still be there. They may be owned or reorganized in very different ways, but they will still all be there. The potential of the economy will barely be affected. When people say the economy will be destroyed, they are simply wrong. Who cares who owns Boeing a year from now as long as all the component parts of Boeing still exist? Unless they are solvent, why should we ever bail out the company's current owners? We shouldn't!

Remember that financial crises are just that—financial crises. Financial destruction and collapse does not affect a country's production capacity one iota. But once you try to help losers, whether their circumstances are their fault or not, by underwriting their losses, you set into motion a process that is destructive of growth. We live in a profit and loss economy where losses are just as important as profits. The financial system can be rebuilt quickly with only a pen and a ledger. That's not true of the real economy.

G) We should not give demogrants (George McGovern's phrase) or helicopter money à la Larry Summers' $600 per capita income-tested "tax rebate", cash for clunkers, $2,000 plus gifts to all families, $50 billion bailout for Boeing, special compensation for sick (Coronavirus) people etc. etc. etc.

We need only i.) protect solvent companies with extended lines of credit or loan guarantees to stave off a liquidity crisis and ii.) waive the payroll tax for both employees and employers until December 31st, 2020.

If either political party wants to block this bill, let them make that clear so we all know who is to blame. In the words of the political savant James Carville, "keep it simple…" (KISS). People do deserve the governments they get.

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