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### FCIC memo of staff interview with Arthur Laffer, Laffer Associates

Arthur B. Laffer

Matthew Cooper

Ron Borzekowski

Gary Cohen

Adam Paul

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## MEMORANDUM FOR THE RECORD

Event: Arthur Laffer, author of *The End of Prosperity* (2008) and owner of Laffer Associates. Laffer is best known for his work on tax policy and the Laffer Curve (a model that shows that cutting tax rates can raise revenues—to a point).

Type of Event: Interview

Date of Event: August 11, 2010 (10-11am)

Team Leader: Matthew Cooper

Location: FCIC, Phone Interview. FCIC participants used the large conference room.

Participants – Non-Commission: Arthur Laffer

Participants – Commission: Ron Borzekowski, Matthew Cooper, Gary Cohen, and Adam Paul

MFR Prepared By: Adam Paul

Date of MFR: Written August 11, 2010. Revised August 24, 2010 from audio record.

Resources submitted:

Following the interview Laffer provided two documents to the Commission:

“California—Who Are You?” Laffer Associates, February 17, 2006

“Money Matters,” By Arthur Laffer, Laffer Associates, May 4, 2007

Summary of the Interview:

**The following is a summary of the conversation. It should not be taken as a transcript.**

Key Points

- The Catalyst of the crisis: Monetary policy became too tight in 06-07
- The Precipitating Cause: The changes in American politics in the 2008 and 2010 elections. Laffer saw this reflected in stock markets.
- Fiscal policy turned a downturn into a Great Recession: “There is not stimulus in the stimulus bill”
- Housing prices should have been expected to rise during the early part of this decade and were a reaction to the lag in producing homes. Much of this lag is attributable to state/local regulations. This dynamic also facilitated the drop in prices as a lot of supply came online at once.

Summary

Cooper began by asking Laffer what he thought caused the crisis.

“Errors by the Fed in 2006 and 2007. They were too tight on monetary policy, which was the beginning catalyst if you will,” said Laffer. This change was a “catalyst” for the crisis. In particular, Chairman Bernanke did not allow the monetary base to expand quickly enough to meet rising demand for money.

Laffer described the financial crisis with the following metaphor:

“If you walk into a big building and there is a big broiler there and turning the heat all the way up. Now go to the safety valves and turn the safety valves off. Now tap the broiler ever fifteen minutes with a little brass tap hammer. By turning the heat on the boiler all the way up and turning the safety valves up, you guaranteed that the broiler will explode. By tapping it every fifteen minutes with a little brass hammer....The monetary policy was the tap hammer if you will.”

Laffer also attributed changes in “the politics of America” for the crisis. Laffer said that home prices were rightly high. In fact, in the early part of this decade, the economy remained strong. “We had an economy that was preconditioned for long-term prosperity,” said Laffer. “The elections of 2008, were the real preceptor of the crisis.”

Laffer compared the present crisis, not immediately to the Great Depression, but to the technology bubble that burst in 1999-2000.

“The financial crisis in 2000 was about as large as in 2009. The only difference was our responses,” said Laffer. In the tech bust, markets were allowed to correct with little government action. “Unfortunately in 2008-2009, we did not do it that way. We stepped in with fiscal policy.”

“We responded to a traditional financial crisis with massive fiscal redistribution. It turned a crisis into a catastrophe just the way it did in the 1930s...I think that answer should have been that we did nothing. We should have held our hands and said ‘I not listening, I’m not listening.’ Instead, whenever politicians make decisions when they are panicked or drunk the consequences are always ugly.”

Fiscal stimulus greatly troubled Laffer. Laffer who says there is no Keynesian Multiplier, or no free lunch, says that fiscal transfers do not stimulate: “There is not stimulus in the stimulus plans.” Laffer gave several examples of how a “stimulus” plan works. This included an economy made of fixed number of apples where government can only give one person more apples by taking them from another person; unemployment insurance was several times mentioned as a real world example.

“We responded to a traditional financial crisis with massive redistribution,” Laffer said. This mistake took what could have been a mild downturn into the Great Recession. Laffer said there

is nothing new about the desire of government to fix economic problems but that the execution was different this time. “Every administration looks for the tooth fairy, a free lunch, and Father Christmas, but this one really did it, and it was {George} W. {Bush} and Obama combined,” according to Laffer.

Laffer did not think that homes were overvalued, or at least not significantly so. Instead Laffer views the run up in home prices as consequential to the long lag between conceiving and finishing a new home. In particular, Laffer, who previously sat on the board of Lyon Homes, said that local regulation accounts for much of this lag. Thus while regions wait for supply to come online, only price can adjust demand, leading to rising prices. Once new homes are completed, Laffer predicted the home prices would have declined. “It wasn’t the housing market wasn’t the housing market was turning the heat up in the boiler a lot. It wasn’t what caused it but it surely compounded it.”

Borzekowski followed-up on housing asking Laffer how he envisioned the supply shift happening. “You’ve got to just let the markets adjust but they {polymakers} think they can manipulate the economy.” Asked by Cohen about the failures of institutions like Bear Stearns and Lehman Brothers, Laffer was clear, “Let them all go under.”

When Cooper followed up by asking about the role of financial innovation, Laffer said that innovation was not a cause of the systemic failures. Cohen then asked Laffer to distinguish between how financial markets tumbled and why it happened.

Laffer responded by explaining the political conditions that lead to shifting policy. Laffer noted the 2006 midterm elections and the change in congressional leadership as a starting point. To Laffer, policies such as the 2007 stimulus bill (which Laffer attributed both to Treasury Secretary Henry Paulson and to then-Harvard Professor Larry Summers), the 2007 Farm Bill were all important departures. Laffer was particularly critical of President Bush, saying “Bush wanted nothing more than to leave office as fast as he could. He didn’t know what to do. He was like a 5-year-old in a scary movie. The administration was panicked, terrified that something terrible was going to happen, so they did something. That was exactly what shouldn’t have happened.”

Cohen asked if government inaction would have prevented the crisis. “I think the crisis would have been much smaller. It would have been over much more quickly,” said Laffer. The crisis could have looked more like the 2000 crash and impacted mostly asset values but not productive capacity.

Cooper asked if policymakers could learn lessons from any previous crises. Laffer indicated that in both the East Asian crisis (1997) and the Long-Term Capital Management event that “Greenspan handled those perfectly.” Ron asked if Laffer supported the liquidity provisions used by the Fed in the current crisis. Laffer responded that liquidity early could have saved firms but that “by the time the Fed got involved it was already over.”

Laffer said that by failing to provide a liquidity provision early a solvency problem was allowed to develop. “What should have been done is that in early 2007, the Fed should have allowed the monetary base to grow much more quickly. They didn’t.”

Laffer reasserted that a housing price correction was likely under any policy conditions, saying “The housing *downturn* was going to happen anyways.” Yet a housing downturn would not have become an economic crisis without bad policy. This bad policy included items designed to help the poor, like the extension of unemployment insurance, which actually hurt everyone.