

October 27, 2008:

The Age of Prosperity Is Over

This administration and Congress will be remembered like Herbert Hoover.

By [ARTHUR B. LAFFER](#)

About a year ago Stephen Moore, Peter Tanous and I set about writing a book about our vision for the future entitled "The End of Prosperity." Little did we know then how appropriate its release would be earlier this month.

Financial panics, if left alone, rarely cause much damage to the real economy, output, employment or production. Asset values fall sharply and wipe out those who borrowed and lent too much, thereby redistributing wealth from the foolish to the prudent. This process is the topic of Nassim Nicholas Taleb's book "Fooled by Randomness."



David Gothard

When markets are free, asset values are supposed to go up and down, and competition opens up opportunities for profits and losses. Profits and stock appreciation are not rights, but rewards for insight mixed with a willingness to take risk. People who buy homes and the banks who give them mortgages are no different, in principle, than investors in the stock market, commodity speculators or shop owners. Good decisions should be rewarded and bad decisions should be punished. The market does just that with its profits and losses.

No one likes to see people lose their homes when housing prices fall and they can't afford to pay their mortgages; nor does any one of us enjoy watching banks go belly-up for making subprime loans without enough equity. But the taxpayers had nothing to do with either side of the mortgage transaction. If the house's value had appreciated, believe you me the overleveraged homeowner and the overly aggressive bank would never have shared their gain with taxpayers. Housing price declines and their consequences are signals to the market to stop building so many houses, pure and simple.

But here's the rub. Now enter the government and the prospects of a kinder and gentler economy. To alleviate the obvious hardships to both homeowners and banks, the government commits to buy mortgages and inject capital into banks, which on the face of it seems like a very nice thing to do. But unfortunately in this world there is no tooth fairy. And the government doesn't create anything; it just redistributes. Whenever the government bails someone out of trouble, they always put someone into trouble, plus of course a toll for the troll. Every \$100 billion in bailout requires at least \$130 billion in taxes, where the \$30 billion extra is the cost of getting government involved.

If you don't believe me, just watch how Congress and Barney Frank run the banks. If you thought they did a bad job running the post office, Amtrak, Fannie Mae, Freddie Mac and the military, just wait till you see what they'll do with Wall Street.

Some 14 months ago, the projected deficit for the 2008 fiscal year was about 0.6% of GDP. With the \$170 billion stimulus package last March, the add-ons to housing and agriculture bills, and the slowdown in tax receipts, the deficit for 2008 actually came in at 3.2% of GDP, with the 2009 deficit projected at 3.8% of GDP. And this is just the beginning.

The net national debt in 2001 was at a 20-year low of about 35% of GDP, and today it stands at 50% of GDP. But this 50% number makes no allowance for anything resulting from the over \$5.2 trillion guarantee of Fannie Mae and Freddie

Mac assets, or the \$700 billion Troubled Assets Relief Program (TARP). Nor does the 50% number include any of the asset swaps done by the Federal Reserve when they bailed out Bear Stearns, AIG and others.

But the government isn't finished. House Speaker Nancy Pelosi and Senate Majority Leader Harry Reid -- and yes, even Fed Chairman Ben Bernanke -- are preparing for a new \$300 billion stimulus package in the next Congress. Each of these actions separately increases the tax burden on the economy and does nothing to encourage economic growth. Giving more money to people when they fail and taking more money away from people when they work doesn't increase work. And the stock market knows it.

The stock market is forward looking, reflecting the current value of future expected after-tax profits. An improving economy carries with it the prospects of enhanced profitability as well as higher employment, higher wages, more productivity and more output. Just look at the era beginning with President Reagan's tax cuts, Paul Volcker's sound money, and all the other pro-growth, supply-side policies.

Bill Clinton and Alan Greenspan added their efforts to strengthen what had begun under President Reagan. President Clinton signed into law welfare reform, so people actually have to look for a job before being eligible for welfare. He ended the "retirement test" for Social Security benefits (a huge tax cut for elderly workers), pushed the North American Free Trade Agreement through Congress against his union supporters and many of his own party members, signed the largest capital gains tax cut ever (which exempted owner-occupied homes from capital gains taxes), and finally reduced government spending as a share of GDP by an amazing three percentage points (more than the next four best presidents combined). The stock market loved Mr. Clinton as it had loved Reagan, and for good reasons.

The stock market is obviously no fan of second-term George W. Bush, Nancy Pelosi, Harry Reid, Ben Bernanke, Barack Obama or John McCain, and again for good reasons.

These issues aren't Republican or Democrat, left or right, liberal or conservative. They are simply economics, and wish as you might, bad economics will sink any economy no matter how much they believe this time things are different. They aren't.

I was on the White House staff as George Shultz's economist in the Office of Management and Budget when Richard Nixon imposed wage and price controls,

the dollar was taken off gold, import surcharges were implemented, and other similar measures were enacted from a panicked decision made in August of 1971 at Camp David.

I witnessed, like everyone else, the consequences of another panicked decision to cover up the Watergate break-in. I saw up close and personal Presidents Gerald Ford and George H.W. Bush succumb to panicked decisions to raise taxes, as well as Jimmy Carter's emergency energy plan, which included wellhead price controls, excess profits taxes on oil companies, and gasoline price controls at the pump.

The consequences of these actions were disastrous. Just look at the stock market from the post-Kennedy high in early 1966 to the pre-Reagan low in August of 1982. The average annual real return for U.S. assets compounded annually was -6% per year for 16 years. That, ladies and gentlemen, is a bear market. And it is something that you may well experience again. Yikes!

Then we have this administration's panicked Sarbanes-Oxley legislation, and of course the deer-in-the-headlights Mr. Bernanke in his bungling of monetary policy.

There are many more examples, but none hold a candle to what's happening right now. Twenty-five years down the line, what this administration and Congress have done will be viewed in much the same light as what Herbert Hoover did in the years 1929 through 1932. Whenever people make decisions when they are panicked, the consequences are rarely pretty. We are now witnessing the end of prosperity.

Mr. Laffer is chairman of Laffer Associates and co-author of "The End of Prosperity: How Higher Taxes Will Doom the Economy -- If We Let it Happen," just out by Threshold.