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Supply-Side Investment Research
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10-yr T-Note: 2.99%	DJIA: 12,124.36	NASDAQ: 2,684.87	S&P 500: 1,289.00	S&P 500 Undervalued: 126.6%

CONFERENCE CALL SUMMARY: THE U.S. FISCAL AND MONETARY DILEMMA

By Arthur B. Laffer

Summary

- Employment will not increase substantially without a significant decrease in the government wedge—we are looking at a continued slow growth recovery.
- Government transfer payments and a dependency on the top 1% of earners have trended up in the last half century.
- The Fed, handcuffed by the fiscal deficit, will need to continue buying treasuries following the end of QEII, setting up the U.S. for serious inflation.
- The current political atmosphere is hampering the U.S. economy and will continue to do so at least until the 2012 elections.

Thank you everybody for being on the call. This call is going to be a long look at the economy, rather than a quick, short look. I'm going to cover a couple of things today: what causes output and employment, U.S. policies today, and finally the fiscal dilemma that we're facing.

The Tax and Expenditure Wedge

I know I've gone through this with you before, but it's really important that people look at employment correctly, because once you look at the framework correctly, the answers just automatically flow from the inputs.

A firm looks at the total cost to that firm for employing that worker – gross wages paid – when deciding whether or not to hire a worker. The firm takes that number – gross wages paid – and compares it with the worker's marginal value product, which comes from the production function. If gross wages paid exceed the marginal value product, the firm will not hire the worker. If gross wages paid are less than the marginal value product, with a little bit in there for profit and running the business, the firm will hire the worker.

Now remember, gross wages paid include all costs to the firm from hiring that worker. The costs may include insurance costs, or workers' comp, or anything else, even expanding the parking lot to adding food in the cafeteria. It's simply the total cost to the firm for employing that worker. The demand for work effort is downward sloping to the right, with respect to gross wages paid. The lower gross wages paid are, the more firms will employ. The higher gross wages paid are, the less firms will employ. The location of the demand curve depends exclusively on the production function, the marginal value product of each worker.

Now, you may want to consider the marginal value product as being dependent upon several production functions, sort of a whole family of them. If you think of employment that way, let's say a farmer in Kentucky versus a nuclear physicist at Lawrence Livermore Labs, then you have a whole family of these production functions. But the demand for labor is downward sloping with respect to gross wages paid, and the location on the two dimensional axes, with the vertical axis as gross wages paid, and the horizontal axis as employment. It's downward sloping, and it's fixed by the production function.

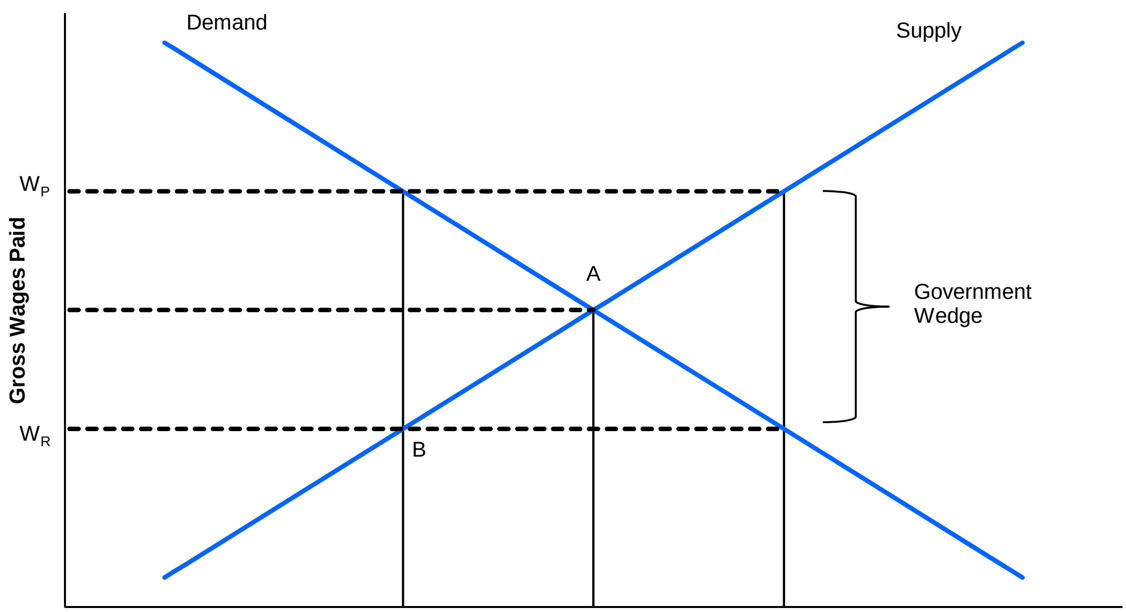
Moving to employment from the standpoint of the worker, the worker could care less how much it costs the firm to employ him or her. What the worker cares about is how much he or she receives net for giving up eight hours a day. Workers look at the foreign products they can buy, the domestic products they can buy, and the future products they can buy. What they care about is how much do they get net after deducting all expenses, all taxes, tariffs, quotas, restrictions, everything. They look at the net wages received (W_R).

The more a worker receives net, the more willing the worker is to work. The less that worker receives net, the less willing that worker is to work. The supply of work effort is thus upward sloping with respect to net wages received. When a worker gets a net wages received number, what that worker does is he or she then compares that number with what the total compensation would be if that worker were not employed: the total amount of social benefits the worker could receive, the pleasure to the worker of not being employed, of playing golf, of playing with family, maybe even of some black market activity of being paid cash, and certainly unemployment benefits paid to the worker. What the worker does is he looks at net wages received and he compares those numbers with the amount that worker would receive if that worker were unemployed. If net wages received exceed what the worker would get for being unemployed, the worker will work. If net wages received are less than what the worker would received for not being employed, the worker won't work. The supply of labor is upward sloping with respect to net wages received. And it is located on the wage-employment diagram by the amount of compensation that worker would receive for not working, period.

So therefore, you have a demand curve for labor that is based upon gross wages paid, and it's downward sloping to the right. And you have a supply curve of labor services offered to the marketplace, which is upward sloping to the right with respect to net wages received, and both of those curves are locked in place: the first by the production function, and the second by the compensation for not being employed.

Holding the compensation for not being employed and the production function constant, the difference between what it costs to employ a worker (W_P) and what that worker receives net (W_R) is what we call the "tax/expenditure wedge." It's a government wedge driven between wages paid and wages received. Obviously it includes a lot more than just government expenditures and taxes, but it does include those. In figure 1, A represents the equilibrium point in the labor market if wages paid is equal to wages received. B represents the new employment level due to the government wedge.

Figure 1
Labor Market



Let me just say, right at the outset, you are *never* going to get a substantial increase in employment, never, unless that wedge is reduced. I don't care if you like QE1, QE2, QEN, I don't care if you like stimulus spending, or any of these other things, or magic, or confidence – that wedge has to be reduced to be able to increase employment. If you reduce the wedge, you lower the cost to firms of employing workers, and therefore they'll hire more workers. If you reduce that wedge, you'll increase net wages received, making workers more willing to work. By lowering the wedge, you thus increase the demand for and the supply of work effort, thereby increasing work and employment.

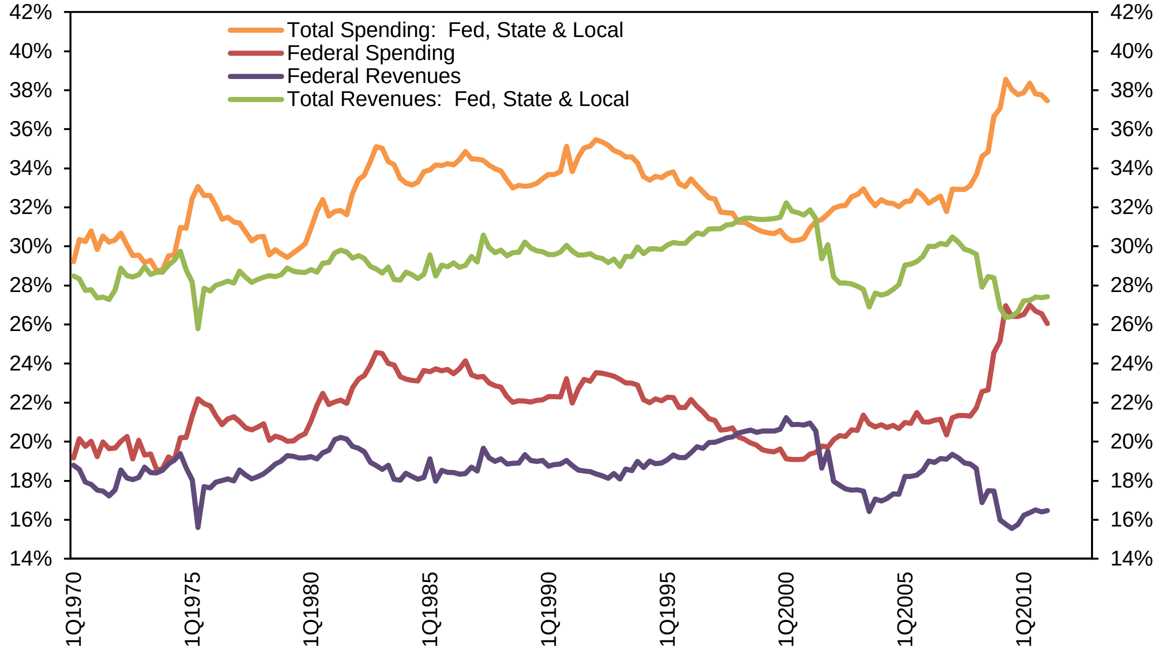
U.S. Economic Policies

Now, looking at the U.S. today from this perspective, not only do I not see anything on the near term horizon that leads me to be optimistic about faster growth in the U.S. economy, I see a number of things in the near term that are pretty pessimistic. And let me go through a couple of these with you, just from the most recent trends.

Government spending as a share of GDP has increased dramatically over the last several years (figure 2). Total Government Spending has gone from 31.8% of GDP in the last quarter of 2006 to 37.5% of GDP in the first quarter of 2011. Federal government expenditures have gone from 20.3% to 26.1% during the same period. It's been a very sharp increase in government spending, and as you all know, government spending is total taxes, pure and simple.[1] The amount of resources the government takes is the net tax take.[2]

[1] Arthur B. Laffer, "Taxes, Depression, and our Current Trouble", *Wall Street Journal*, September 22, 2009.
[2] Source: BEA

Figure 2
U.S. Government Spending & Revenue as a Percentage of GDP
(Quarterly, 1Q1970 to 1Q2011)



Source: BEA

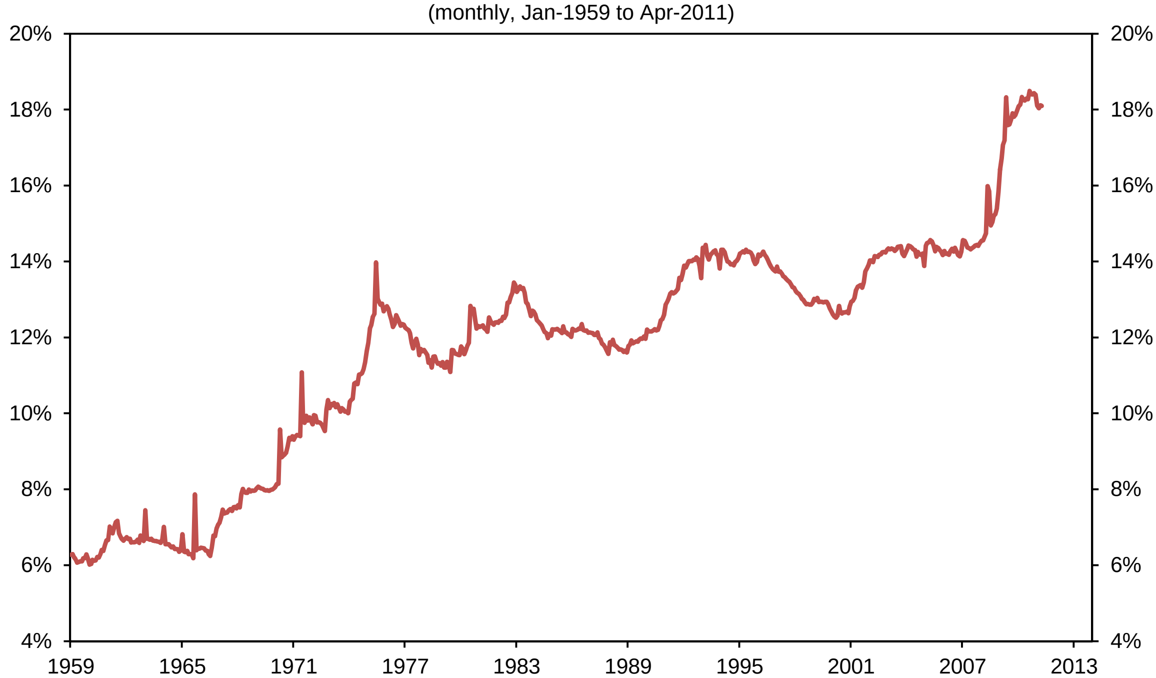
This is Milton Friedman's old line on it, but you can see it really clearly in a two person economy. Let's imagine that the whole world is made up of 2 farmers. If one of those farmers gets unemployment benefits, who do you think pays for them? Obviously it is the other farmer. Government spending *is* total taxes, and over the last several years there's been a huge increase in government spending. Total government payments as a percent of personal incomes have gone from 14.3% in the beginning of 2007 to 18.1% in April 2011 (figure 3). Now, of those increases in social payments that have been made by the government, 90% of the increases are federal. From 2006, this number is up 4 percentage points. Healthcare services are up a very large amount in the last four years, by 0.7% of personal income. Medicare is up by 0.7% of personal income, and unemployment compensation is up by 1.0% of personal income. Social Security is up 0.8% of personal income. A lot of others are up. Only one category is down and that's Farm Income Stabilization. But the total increase in government transfer payments as a share of personal income is up 4.1% percentage points, which is a huge increase.[3] The middle '60s up until the late '70s was the last time you had a big increase here in the U.S. Just think of these numbers: today, 44 million people are on food stamps and 8.4 million people are on employment insurance. To my way of thinking, we not only have not reduced the wedge between wages paid and wages received, but that wedge has increased dramatically over the last two to three years. It is no wonder that you've had a poor performance in the U.S. economy during this period.

[3] Source: OMB, Table 3.2, http://www.whitehouse.gov/omb/budget/Historicals

Figure 3

Transfer Payments as a Percent of Personal Income

(monthly, Jan-1959 to Apr-2011)



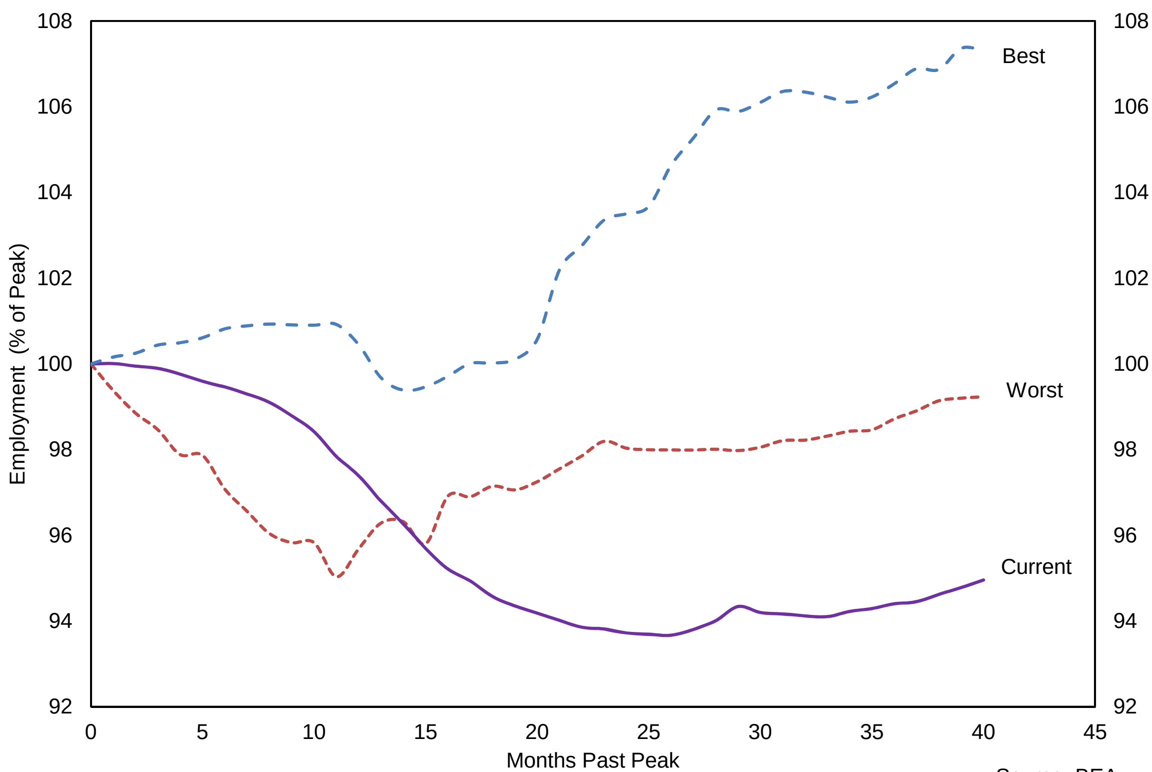
Source: BEA

In 2010 45% of our population had jobs. That number is down 8 percentage points from the year 2000, another drop. The U.S. recovery from the previous peak is the worst single recovery since the Great Depression. In fact, it's almost as much below the next worst as the next worst is below the best. And that includes ten recovery periods (figure 4). On the U.S. GDP path from peak, you find a very poor performance. Not only is it a poor performance, it's a poor performance compared to other countries as well. So, the U.S. is not only poor relative to its own past, it is also very poor relative to other countries.

Figure 4

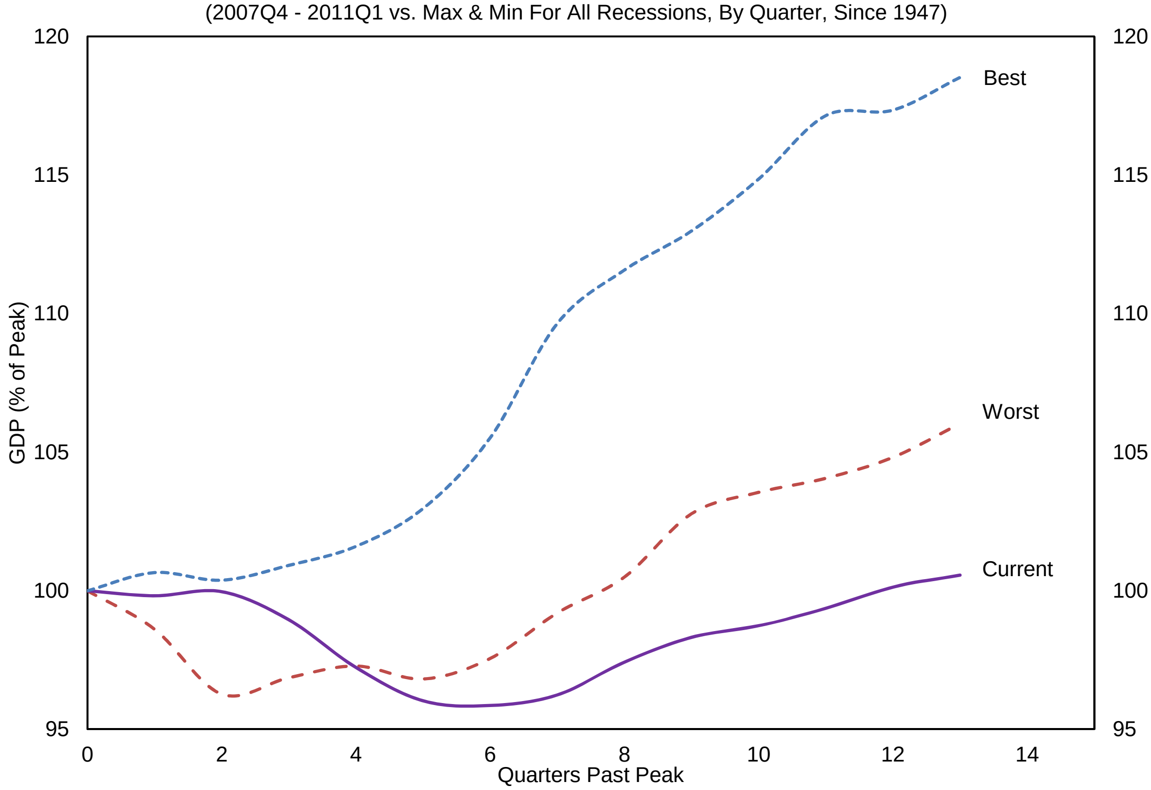
U.S. Employment - Path from Peak

(2007.12 – 2011.4 vs. Max & Min For All Recessions, By Month, Since 1947)



Source: BEA

Figure 5
U.S. GDP - Path from Peak
(2007Q4 - 2011Q1 vs. Max & Min For All Recessions, By Quarter, Since 1947)



Source: BEA, Federal Reserve

And if you look at employment, the same thing is true. The path from the previous peak, again, is the worst single recovery since the Great Depression, and it is as much worse than the next worst as the next worst is from the best (figure 5). And again, we have a much worse record than other countries. So from a time series perspective, as well as from a cross-section perspective, the U.S. economy is performing very, very poorly.

Now, that shouldn't surprise anyone, given that government spending over the last several years has increased dramatically. That has increased the wedge in the U.S. sharply and that increase in the wedge is what is really holding the U.S. back.

Another interesting number, and again I don't mean to belabor numbers, is that total non-farm employment has gone from 62% of total civilian population in the beginning of 2001 down to just under 55% today (figure 6). Total private employment has gone from 52.1% down to 45.4% during the same period.[4] So, no matter how you look at it, the U.S. economy is really performing badly, and the reason it is really performing badly is because we have dramatically increased the wedge between wages paid and wages received in the last few years. Looking to the future, frankly, I don't see how that wedge comes down. Government employment as a share of the labor force has stayed about flat, while private employment has dropped like a stone. There are today 22.5 million government workers versus about 11.5 million workers in manufacturing. Today, it's about 2:1 government to manufacturing. In 1960, it was about 1:2.[5]

Also, tax income and tax collections for the U.S. have changed dramatically over the last 30 years. It's an amazing shift. Income taxes from lower income people have declined dramatically while income taxes collected from upper income people have increased quite substantially. They've not only increased as a percentage of GDP, they have also increased as a percentage of total income taxes collected. Let me just give you a number. This is just a trend line that has gone on, but in 1981 17.6% of all income taxes collected in the Unites States came from the top 1% of all earners in the latest numbers for which we have data (2007), the top 1% of all earners pay about 40.4% of all income taxes collected. So that number has gone up more than twofold in that period. In that same period, tax collections from the bottom 95% have fallen sharply. As a share of GDP, in 1981, tax collections from the top 1% were 1.5% of GDP. They're now at 3.3% of GDP. So tax collections normalized by GDP on the top

[4] Source: BLS
[5] Stephen Moore, "We've become a Nation of Takers, Not Makers", *Wall Street Journal*, April 1, 2011.

1% have gone way up. Tax collections from the bottom 95% as a share of GDP have gone from 5.9% of GDP in 1981 to just 3.2% (figure 7). Today, the top 1% of income earners pays more in taxes than the whole bottom 95% of income earners.[6]

Figure 6

Total Non-Farm Payroll/Total Population 16 & Over

(monthly, through Apr-11)

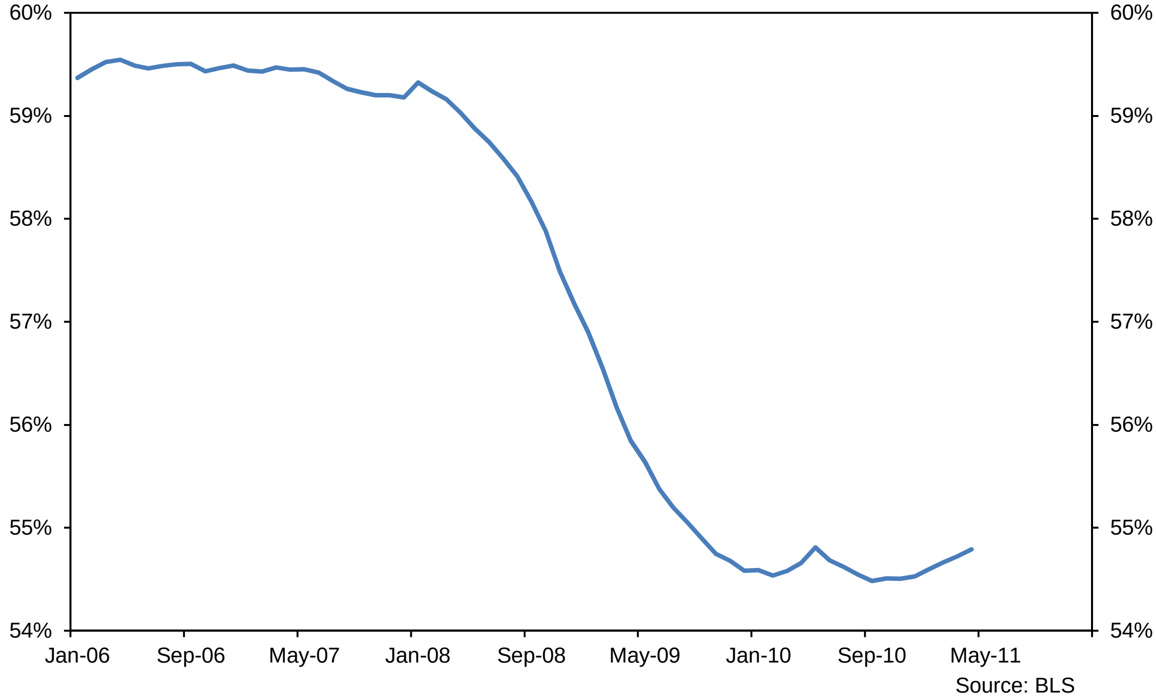
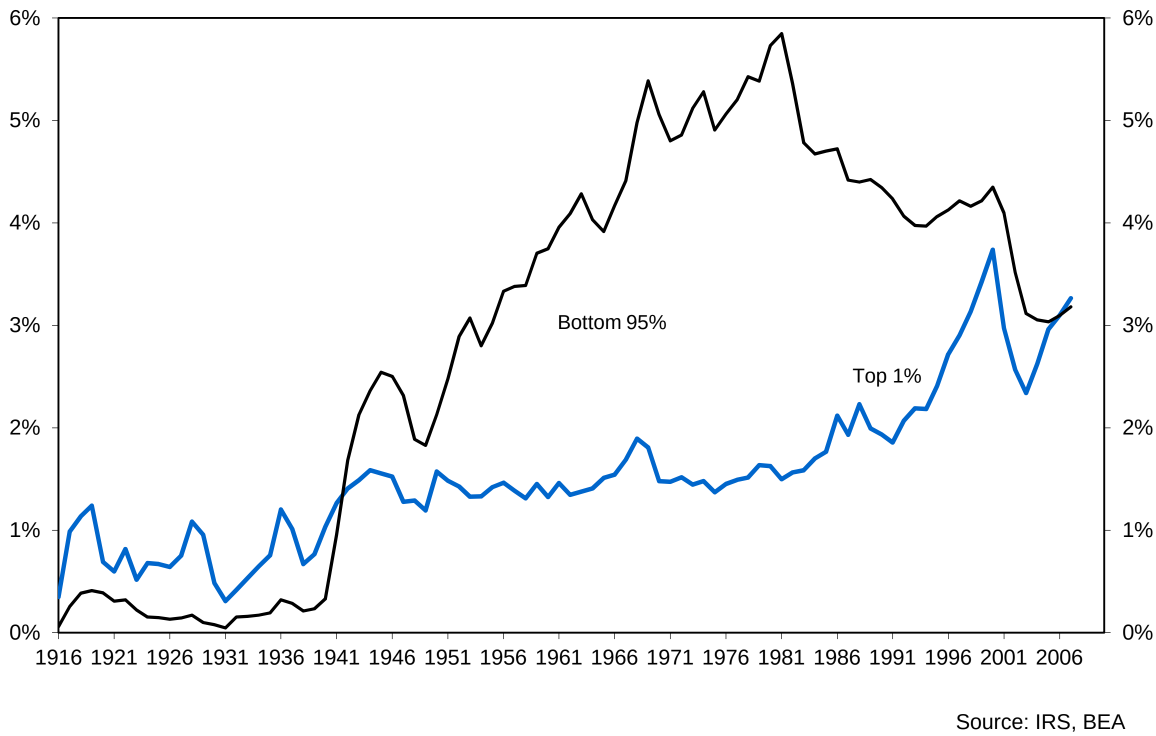


Figure 7

Income Taxes Paid as % of GDP

(annual, through 2007)



[6] Source: IRS

This change in the distribution of taxes is both a very important political factor as well as an important component of the wedge. Additionally, the costs of collection – the total cost to the taxpayers for filing their taxes, getting reviewed, having audits, the IRS, and also the payment of lawyers and accountants and valuing their own time are incredibly large. For every dollar of taxes a person pays, that person also pays on average a little over thirty cents in out-of-pocket costs to file those taxes. This doesn't even include any costs with respect to sheltering income, or diverting resources.[7]

Some state and local governments are just getting out of hand. Now there are a number of states that are not out of control, including Tennessee, which is just an amazing state. But my former residence, California, is a mess. Just in the paper today, the Supreme Court in a 5-4 decision said that California cannot keep all of those prisoners in jail.[8] They've got to do something with all those prisoners, and will most likely just let a number go on the streets. It's not a pretty situation.

The recent decision of the National Labor Relations Board (NLRB) on Boeing also represents a pretty sharp increase in the wedge. The NLRB denied Boeing the right to build a new facility in South Carolina because they think Boeing's decision is retribution against the unions. I have never seen a decision like this in my life. Now, the decision is going to be reviewed and it's going to be adjudicated, but the mere fact that it's there and that it's happening is an incredible increment to the wedge in the U.S. It also has an enormous impact on states. Steve Moore and I did an op-ed in the *Wall Street Journal* that showed what happened to the zero-income tax states versus the highest income tax states.[9] Obviously, the zero-income tax states way outperformed the highest income tax states. But in the subset of the zero-income tax states, there are six states that are right-to-work states (i.e., they have no mandatory union membership) and three of those states are not right-to-work states (i.e. they have mandated unions), Washington being one of those three. It's no wonder that Boeing would like to move. The difference in performance between those six no income tax states that are not required to have unions and those three no income tax states that are required to have unions is amazing. The right-to-work states preformed far better compared to the other states.

This is the background for what's happening in the U.S. today. In my way of thinking, the U.S. today reminds me a heck of a lot of the period 1979-1983. From 1979-1983, you had this lull period before you got the revolution. We are having a long lull period now. It's early 2011. We don't have any elections until November 2012. Ben Bernanke's reappointment, won't be until 2013, so you have a long, long way to go.

<u>Fiscal Dilemma</u>

Now, I want to go through the fiscal dilemma and I want to specifically focus on Ron McKinnon's article in the *Wall Street Journal* today and the article about Bob Mundell in the *Wall Street Journal* yesterday because Ron McKinnon was my thesis advisor at Stanford University and I worked most closely with Bob Mundell at the University of Chicago. The two of them are absolutely wonderful. Both of them great economists from Canada, and we've had a long history together. Yet, the two of them totally disagree on the consequences of what's going on.

What I want to do is talk through the fiscal dilemma here in the U.S. Number one fact: net debt is currently 70% of GDP. That means, for every dollar of GDP, there are seventy cents of net debt. Now, gross debt is approximately 90% of GDP, but net debt, we mean consolidating all of the government balance sheets. So, the 70% number is the right number to use. The second number to look at is that the federal budget deficit is approximately 8.8% of GDP.[10]

The next fact that's really important is that the 90-day T-bill yield this morning is at about 4 basis points per annum. Yes, that's 4 basis points per annum. If you hold a $100 bond for a year, if you role it over you get a full four cents of return. Now from July of 2008 to April of 2011 the Federal Reserve has purchased $1.9 trillion in federal debt. The deficits during that period were $2.3 trillion and the Federal Reserve has purchased $1.9 trillion of all the Treasury issues that has also resulted in an increase in the monetary base. Now, to bring this to the current issue, Ben Bernanke has stated that they're going to stop QE2 sometime soon. The Federal Reserve will no longer be willing to buy U.S. Treasuries. Instead they're going to have "QE2 light," which means that they will replace the Treasuries that expire, but they will not be buying net debt in the overall system.

Now, Mundell came out and said that if the Fed doesn't continue quantitative easing there will be a huge collapses in commodity prices – deflation – and the economy will go into a depression.[11] Ron McKinnon has been arguing this is going to be stagflation and not deflation.[12] But let me just say that there's no way from here to Sunday that Ben Bernanke will be able to stop QE2 and stop expanding the Fed's purchases of U.S. Treasuries. Can you imagine? Given the U.S. deficit at 10% of GDP, you have a deficit of $1.5 trillion. Now the Fed has been buying up to 80% of that deficit in the marketplace over the last three years. If the Fed decided to stop buying the bonds, it is inconceivable to me that the bond prices would not fall, and interest rates rise, very sharply.

[7] Arthur B. Laffer, Wayne H. Winegarden, John Childs, "The Economic Burden Caused by Tax Code Complexity", *The Laffer Center for Supply-Side Economics*, April 1, 2011.
[8] Vauhini Vara and Bobby White, "Prison Ruling Rattles California Budget", *Wall Street Journal*, May 25, 2011.
[9] Arthur B. Laffer and Steve Moore, "Boeing and the Union Berlin Wall", *Wall Street Journal* , May 13, 2011.
[10] Source: BEA
[11] Sean Rushton, "Mundell: Deflation Risk for the Dollar", *Wall Street Journal*, May 23, 2011.
[12] Ronald McKinnon, "The Return of Stagflation", *Wall Street Journal*, May 24, 2011.

For an example of what would happen if interest rates were to rise across the whole term structure, consider going from 5 bps to 105 bps. Given sufficient time, government spending would increase by approximately 0.7% of GDP just by increasing the whole term structure by one percentage point (with the national net debt at 70% of GDP, if you raise the interest rate on by one percentage point, the result would be a 0.7% of GDP increase). Under this scenario, the deficit would go from 10% of GDP to 10.7% of GDP, and that's with just a 100 basis point increase in the term structure. If rates rose by 500 basis points, which would still be a fairly reasonable set of numbers (a 5% 91 day T-bill is not unheard of), instead this would increase the deficit by 3.5% of GDP, or it would take the deficit from 10% of GDP to 13.5%. So by having interest rates rise, not only does the cost of the debt increase, but the amount of the deficit and the amount of these bonds being sold also increases. So therefore, this is a self-reinforcing process, whereby higher interest rates lead to higher deficits, which lead to higher interest rates.

Now, if people really believed that these deficits were going to be eliminated in the not too distant future, and if there was a reasonable budget proposal[13], there would be a ceiling on interest rates. Similarly, if investors knew that the deficits were going to stop, the issue of inflation was contained, and those bonds were solvent, that would put a very nice lid on spending and on the price of bonds. But the problem is the political dilemma in Washington does not allow that to happen. While the House is going through all these proposals to bring down spending and the budget deficit, the Senate, under the control of Congressman Harry Reid, has turned these proposals down time and time again without offering any alternative. President Obama has made it very clear that he is not interested in reducing the deficit or in reducing government spending. So, given the stalemate that exists right now, I don't see anyway that we are going to get any major movement to reducing the federal deficit.

Given that we're not going to get any reduction in the federal deficit, I don't see any way that we don't have more bonds being issued and that the Fed won't step in to buy them. If the Fed does step in to buy them, which I believe it will, that means that the monetary base of the U.S. is going to increase much more rapidly. With the increase in the monetary base, my view is that the threat of inflation becomes ever greater. From July of 2008 the monetary base was $871 billion. Today that number is a little over $2.5 trillion (figure 8).[14] There's been a huge increase in the monetary base. What you also find is that the money supply, M1, is increasing rapidly (figure 9). M2 is also starting to grow fairly rapidly. At this time in the world economy, that is not what should be happening.

Figure 8
U.S. Monetary Base
(01/1999 to 04/2011, biweekly, semi-log, in $billions)

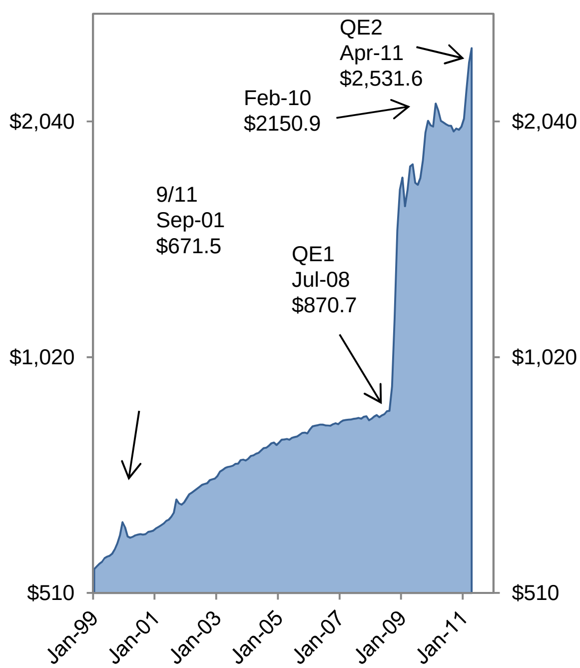
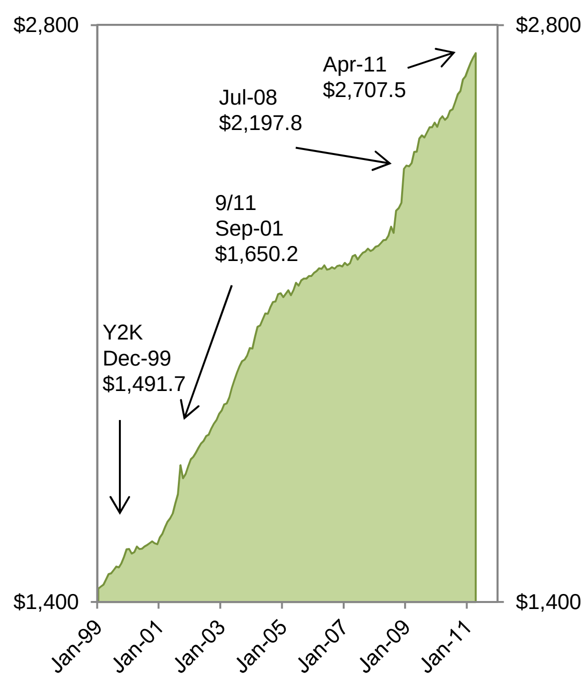


Figure 9
U.S. M1
(01/1999 to 04/2011, monthly, sweep adjusted, semi-log, in $billions)



Source: FRED

[13] The best paper on this was by John Cochrane who wrote a piece about a week ago in the *Wall Street Journal* on the importance of the long term budget numbers. John Cochrane, "Why the 2025 Budget Matters Today", *Wall Street Journal*, April 28, 2011.
[14] Source: Federal Reserve Bank of St. Louis

My belief is that with the Fed monetizing the debt and increasing the monetary base, they have no way of controlling the issuance of bank liabilities to the extent that they need to when the economy stabilizes. Housing prices will meet their bottom. All of the sudden, bank lending will start up again. You will see a very rapid rise in the money supply, and my guess is that you will see inflation coming along, even if the Fed does step in and buy the Treasuries. I think what Bob Mundell is talking about in his piece is that if the Fed doesn't buy the Treasuries, we'll have a recession, a double dip. I think he's completely correct. And if we have a double dip, he thinks there would be a run for the dollar. I'm not so sure of that. But I think what Ron McKinnon is talking about is that by increasing the monetary base and printing more money, you're having an inflation effect, whether you want it or not. And what Ron McKinnon is also talking about is, given the increase in the wedge over the past several years, you're not going to have good growth in the economy. The combination is, I think, both of the authors are correct. My view it that the Fed is going to monetize the debt and that we are going to have inflation, along with very slow growth in the U.S. economy for the next several years.

Now, how long can the Fed do this type of stabilization by buying Treasury securities? It can do it for a long time. From 1945-1951 they did it during peace time. They obviously did it during the war. They were able to hold interest rates very low for a long time until they reached the Accord with the Treasury in 1951, which separated monetary policy from fiscal policy. But the Fed can control interest rates if they're willing to go in there and buy all the debt. It's just printing money, rather than having debt issuance.

Politics

I don't see the House of Representatives under the control of John Boehner doing anything other than what they're trying to do. Unfortunately, they are passing legislation that won't make it through the Senate. It has become one of the most politically hostile worlds I've ever seen. The Senate will not go along with any of these House measures, nor will the President.

At the Fed, Bernanke has skin in the game. It is possible that three years ago he could have looked at the economy objectively and made a call. But he did the Quantitative Easing programs, and once he's done it, he owns it. There is no way he can undo that. He is not an objective observer any longer. Bernanke is in as Chairman until 2013. There's no way around that. Bernanke is 2013, the President is 2012, the Senate is 2012, and the House is also 2012. We have to wait for these potential changes until we get an answer to these questions about the wedge hurting growth; we have to wait before we can get any answer to the fiscal dilemma of deficits, monetary base, and controlling the issuance of debt. We're going to have to wait for sure until 2013, and maybe a little longer than that. That's a long, long time.

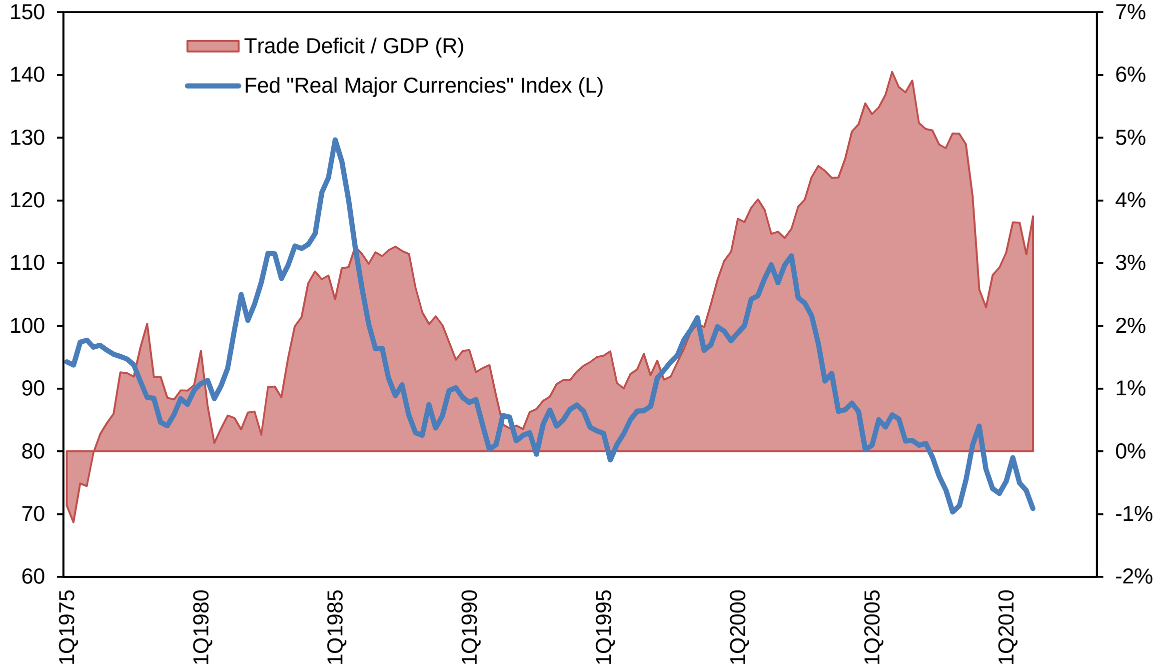
You know, these are the long days when you just have to tread water and keep your eye on the ball. In these times, when things are really rocky and not going along well, there's no coordination of policy. These are also the times where there's lots of black swans flying around. Things will happen that will be unpleasant. My guess is that there are black swans out there and I don't know what they're going to be. But bad things will happen that will shock the market in a down direction more than it will in an up direction. But when I look at 2012-2013, I remain optimistic about the politics of this country. I do believe that in the House the Republicans will increase their control in 2012. I think the Republicans will take over the Senate, and I believe the Republicans will also take over the White House. When that happens, you will also see a massive change in policy. That massive change in policy will lead to one of the greatest booms of the U.S. But we have a long time to wait with a lot of unpleasant things that could happen between now and then.

Q: *How does this play out in terms of international trade? Our trade deficit has been improving, with manufacturing and agriculture picking up. Does that trend continue?*

A: When countries go into low growth periods, their trade balances improve dramatically. It's sort of the old line that growth companies don't lend money, they borrow money. And in the same context, growth countries don't lend money, they borrow money. The U.S. has gone from a growth country to a non-growth country, and my guess is that you'll see the trade balance improve as the capital balance decreases, with people no longer willing to invest in the U.S. (figure 10). Simultaneously, the decline in the dollar will help export industries. It will also help import substitute industries substantially as the trade balance improves.

Just remember that the terms of trade, the exchange rate, is a consequence of shifting of the demand curve and supply curve, not a cause of it. Everyone talks about the dollar being weaker and that helps export industries. But really it's the other way around; it's the supply of dollars that make the real rigor that helps the export industries and import substitute industries.

Figure 10
Trade Deficit vs. Value of U.S. $
(1Q1975 to 1Q2011)



Source: CB, BEA, FRB

Q: *Stanley Druckenmiller was the Weekend Interview in the* Wall Street Journal *last week and basically said technical default may not be a bad thing if it means you are postponing interest payments for weeks to months in return for assuring yourselves that payments in years five, six, seven, eight, nine, ten are going to be sound and not inflated away.*[15] *What are your opinions on that?*

A: Well, that's the one where I referred to John Cochrane's piece, which says that long term budget balances are not trivial things, even though they're far out in the future. If we could do a technical default right now, and if that improved our chances for surpluses in the future, I think it would be wonderful. I don't think that's what's going to happen, however. When I look at the administration and when I look at the Senate and what goes on, any type of reduction in spending today will not be offset by bigger reductions in the future. I'm very worried that what will happen is that they'll just not pay the interest and instead keep on spending. I think there's a real problem in the political structure of Washington that does not allow them at present to go through and find bigger surpluses or lower deficits. It has become a political war where logic no longer matters.

Q: *We were looking at the government expenditure wedge earlier on in the conversation. Is there a marginal curve in that area itself? Obviously if someone is on unemployment and he makes $400 per week, he's not going to go to work for $401 per week. Do you have any idea of the slope of that curve, as to what gets people back?*

A: I don't know the shape of the curve itself, although I do have some casual observations. For example, when they extended the unemployment benefits to 99 weeks, it's amazing what happened to the unemployment rate for people going from 99 to 100 weeks. It dropped sharply. So unemployment benefits are an extraordinarily important component to causing people to be unemployed. I don't know exactly what the slope of that curve would be, though. And I also don't know what it would be with respect to how much you pay them. But I think it's pretty steep. I think the unemployment rate is very sensitive to the amount of unemployment assistance people can get per week, as well as for a long period of time. And if you look at the unemployment compensation, and what it's done to the wedge over the last four years, it's added 1% of the wedge to personal income, which is one-quarter of the increase in the wedge over the last four years. And that doesn't include stuff like the minimum wage and other regulatory burdens, all of which are non-budget.

Q: *Your discussion about the wedge notwithstanding, can you talk about the budget issue of can we really solve this budget dilemma with cuts alone, or is it going to take cuts and taxes?*

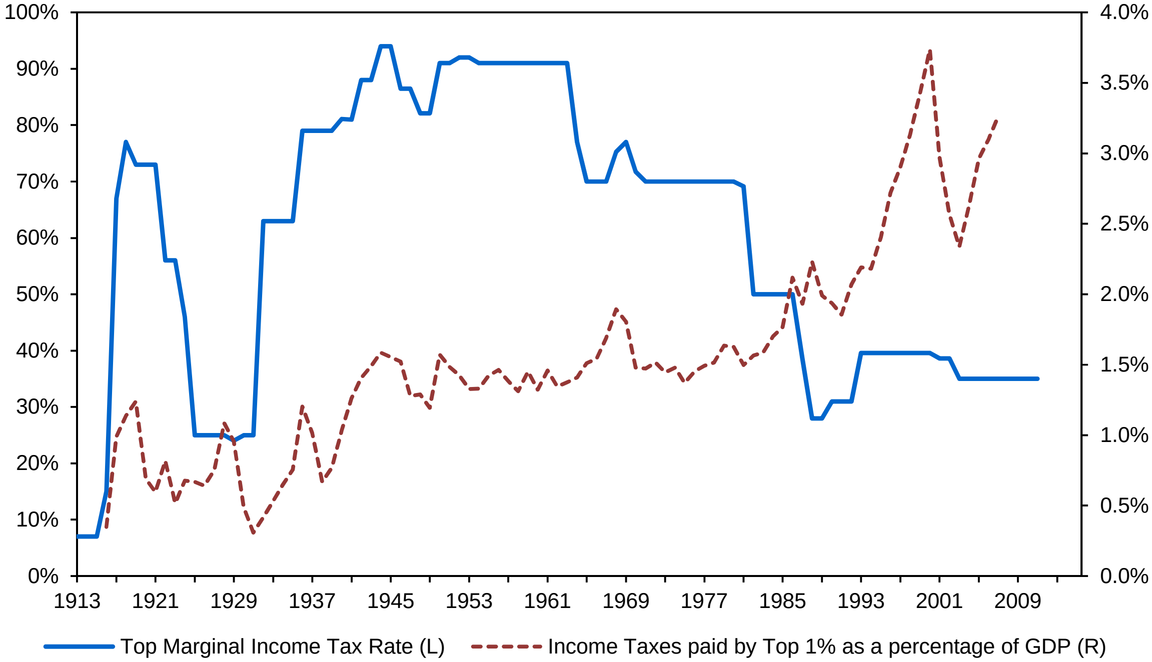
[15] James Freeman, "What if the U.S. Treasury Defaults", The Wall Street Journal, May 14, 2011.
http://online.wsj.com/article/SB10001424052748703864204576317612323790964.html?KEYWORDS=druckenmiller

A: The budget can, and I believe will, be solved with cuts alone as a policy variable. It will be solved with enormous tax increases, but not because they raise rates – because the economy expands and profits increase. There's no question that it requires a huge increase in tax revenues. But not tax rate increases. I make that distinction strongly here, and it really is the key distinction you want to make. But I do think it requires a cut in government spending and reforms in the tax codes. If you reform the tax code with a low rate flat tax, that would have an enormous benefit to the U.S. economy. If you then use spending restraint on top of that, that would also be an enormous benefit. Then you would have to have sound money. Then you would have to have free trade. Then you have to have minimal regulations. If we put that through, we could send this country into a rocketship of prosperity. And by the way, that would get rid of the deficit right as it stands.

Figure 11

Income Taxes as a Percentage of GDP for the Top 1% vs. Highest Marginal Tax Rate

(Yearly, 1916-2010)



Source: IRS, BEA

You can't balance a budget on the back of the unemployed. I don't care how much you raise tax rates, if you don't have people working, you're not going to collect the revenue. I went back to the beginning of the income tax, 1913 to the present, and every time they raised the highest rates, revenues went down (figure 11).[16] Every time they lowered the highest rates, revenues went up—all because of the base effect. People don't like to pay taxes. And they'll do all they can to avoid it. So if you have too high rates, they'll make sure they find ways around it. When you raise tax rates, the highest income-earners not only don't work as hard, but they also find shelters and other ways around paying taxes. You simply don't come out ahead.

Q: *What was the feeling in Washington on the timing of the resolution of the debt ceiling, and what would be the main planks of the accord?*

A: When I was in Washington a few weeks ago I did not see a consensus view from Republicans on the debt ceiling. We were with Congresswoman Michele Bachmann (R-Minnesota) and Congressman Darrell Issa (R-California), both of whom are exceptional. And both had very strong, though opposing, views. Michele was talking about putting the heat to the Democrats, refusing to raise the debt ceiling without significant concessions. Darrell was saying just the reverse, talking about how this is not yet the GOP's time, but they should instead wait until 2012 when they'll have control of the House and Senate, and then really push the agenda. I like Michele Bachmann's position very, very much, but I'm sort of a chicken and I guess I would side with Darrell Issa.

Darrell has also made the point that lookit, we agreed to the budget for 2011. The Republicans voted it in after getting concessions and all that stuff. How can you vote for the budget and then not agree to fund it? I think he has a logical point there

[16] Arthur B. Laffer, "The Soak the Rich Catch-22", *The Wall Street Journal*, August 2, 2010.

that's pretty strong. So my guess is that this Congress will go along with raising the debt ceiling. They will try to get something for it, but I don't think anyone is willing to go to a closed down government. I just don't think they are.

Q: *Is the window on the trade agreements fading for this time leading up to the presidential election?*

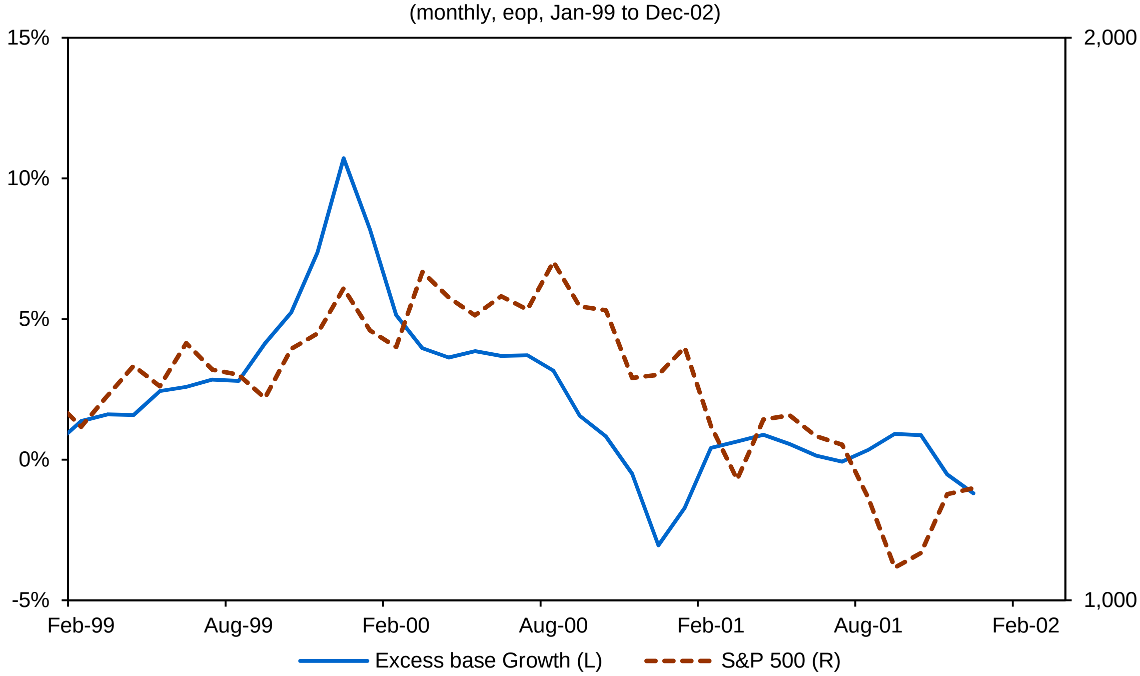
A: I think we've got two of the trade agreements pretty much locked in Panama and Korea. It's Columbia we have a problem with, and I don't think we're going to get that one through. It's unfortunate because that one makes the most sense of all.

Q: *David Malpass is basically describing this time period as the same as Y2K. He believes that the market is negatively reacting to potential crash warnings with the end of QE2 but that the market will rally into the end of QE2 as it becomes clear those concerns are unwarranted.*[17] *Is his perspective just too short term?*

A: Well, we had wildly explosive growth in the monetary basis in '99 and then, when there was no Y2K problem, in the first two weeks of 2000, they contracted the monetary base dramatically (figure 12). They brought it back to where it had been before, just thump! The analogy is that this was like taking the punch bowl away and making everyone who drank a glass return it. And you saw what happened after they took the punch bowl away.

I believe that aspect of the comparison with Y2K is more appropriate, and I think that's what Mundell is talking about as well. So if they stop buying Treasuries, you will see a sharp downturn in the U.S. economy. And I think you will see a sharp upturn in interest rates. My view.

Figure 12
Excess Base Growth vs. S&P 500
(monthly, eop, Jan-99 to Dec-02)



Source: FRED, Bloomberg

[17] David Malpass, "QE2 a Y2K?", Townhall.com, May 14, 2011. http://finance.townhall.com/columnists/davidmalpass/2011/05/14/qe2_a_y2k