



# STRAIGHT TALKING on the LAFFER CURVE

**PHILIP BOOTH** interviews one of the world's best-known economists, **ART LAFFER**, about the Laffer curve, tax and more

**What can you tell us about the origin of the so-called "Laffer curve"?**

The so-called Laffer curve, as I have described it, is a diagram relating tax rates to tax revenues, or in some instances to government budgets. Just

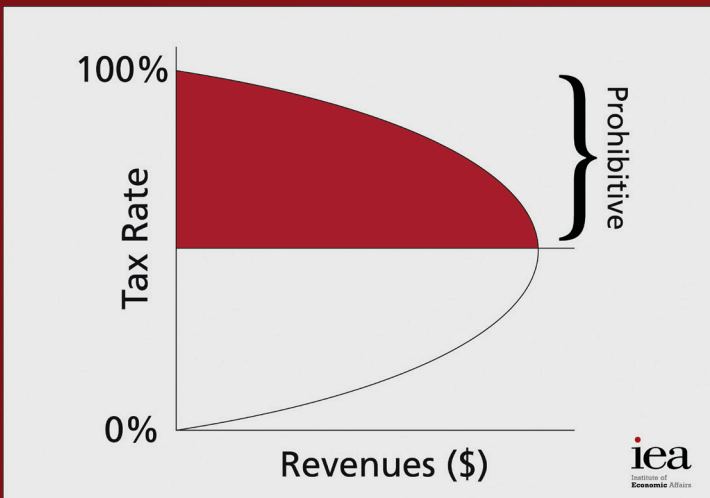
for the record, it was Jude Wanniski in his article "Taxes, Revenues and the Laffer curve" who gave the curve my name. But even before then, the curve had a long, long pedigree.

Given the basic economic

proposition that imposing or increasing a tax reduces the economic product available to be taxed, it is a simple logical extension to derive what is now called the Laffer curve.

In fact, even the idea that tax rates could be sufficiently high, so that an increase might actually result in lower tax revenues, has been described many times. With need-based welfare programmes, the curve is even more obvious because lower tax rates lead to more growth and thus, less need-based welfare.

The oldest explicit reference to the "wrong" side of the Laffer curve I have seen is from Ibn Khaldun in the Muqaddimah, written in 1377 AD: "It should be known that at the beginning of the dynasty, taxation yields a large revenue from small



assessments. At the end of the dynasty, taxation yields a small revenue from large assessments.”

Apart from the obvious point that tax rates do have a negative impact on the tax base, there is the question as to whether the concept of the Laffer curve is relevant in public policy.

Up until the late 1970s, the Laffer curve was virtually unheard of and had been under-used in my opinion to the grave detriment of countries’ economies the world over. Tax rates are way too high, and, as a result, prosperity has suffered.

The Laffer curve is as obvious as any economic concept can be, yet, in a debate at Oxford, I was told that slides in the very first lecture of Oxford’s undergraduate economics course describe the Laffer curve as “the economics of wishful thinking”.

In addition, I was told that, in a 2012 survey of the top 40 US economists at Princeton, Yale, MIT and Harvard, “Not a single one agreed with the curve!”

***What does the Laffer curve tell us about governments that already levy high levels of taxes trying raise more revenue by increasing tax rates further?***

The Laffer curve, of course, is a pedagogical device that illustrates a stylised relationship between tax rates and total tax revenues. At a tax rate of over 100 per cent, who would work? Tax revenues would be zero at both 100 per cent tax rates and at zero tax rates.

In between zero and 100 per cent tax rates, tax revenues would be positive, rising at first, from the zero tax rate, then hitting their

maximum somewhere in the middle, and falling once again to zero revenues at some very high tax rate.

The power of the Laffer curve is its simplicity and practicality. Even a politician can understand it. But, when it comes to applying the curve, most politicians and academics would prefer to be precisely wrong than approximately correct. Too often they conflate tax rates and tax revenues, which are never the same.



**THE POWER OF THE LAFFER CURVE IS ITS SIMPLICITY AND PRACTICALITY... EVEN A POLITICIAN CAN UNDERSTAND IT**

Although we rarely know the exact relationship between tax rates and tax revenues, we do know that the increase in revenues is always less than the increase in tax rates and that an increase in tax rates may even result in less revenue.

Politicians and economists alike are disappointed by tax revenues that they expected to flow following a tax hike and are pleasantly surprised by the tax revenues that arise following a tax cut. And the higher tax rates are to start with, the greater will be the effect of any change in the tax rates and the more likely it is that revenues will actually fall if tax rates increase.

This is the stuff of first-year undergraduate economics. People don’t work or save to pay taxes. They work and save

to receive an after-tax return. Therefore it is the after-tax return that motivates people, not the tax rate per se.

At a 10 per cent tax rate, the after-tax return is 90 per cent of total pay. Double that tax rate and the after-tax return drops to 80 per cent. That drop from 90 to 80 represents an 11 per cent cut in incentives (10/90).

However, if the tax rate is 45 per cent to begin with, the after-tax return is 55 per cent of total pay. Double the

tax rate to 90 per cent and the after-tax return drops to 10 per cent. This represents over an 80 per cent decline in after-tax returns.

The point here is simply that the higher tax rates are, the greater will be the reduction in incentives for any given increase in the tax rate and the less will be the increase in revenues if there is any increase in revenues at all.

***Can you give us an example of a government that cut taxes and raised revenue?***

Former British Prime Minister Gordon Brown increased the UK’s highest tax rate from 40 per cent to 50 per cent, and tax revenues went down - as did the British economy and the Labour government. And then George Osborne cut the highest tax rate to 45 per cent and

revenues went up.

US Presidents Harding and Coolidge cut the highest tax rate – from 77 per cent in 1919 to 25 per cent in 1925 – and tax revenues from the rich soared. The story was repeated when President Kennedy cut the highest tax rate from 91 per cent to 70 per cent and repeated yet again when President Reagan dropped the highest tax rate from 70 per cent to 28 per cent. I could go on and on, but I think you get the picture.

***In the US, there is effective tax competition between states. How does this help discipline state governments?***



## TAX RATES ARE WAY TOO HIGH...AS A RESULT PROSPERITY HAS SUFFERED

The US is special in that each of our 50 states controls its own tax structure, and any barriers to the free movement of people and goods between these states are unconstitutional.

Over any ten-year period for the past 50 years, the nine states with no state income tax have grown faster according to virtually every metric as compared with the nine states with the highest tax rates. The states with no state income tax even had faster growth in state and local tax revenues than the states with the highest income tax rate.

Eleven states since 1960 have introduced an income tax, and each and every one of those states has declined in population, employment,

gross state product, and yes, in state and local tax revenues relative to the rest of the nation.

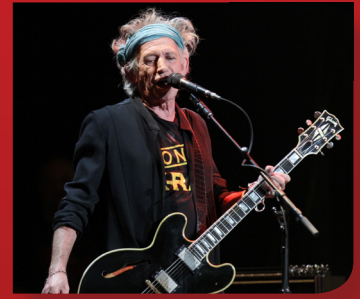
***In your experience, if you want the rich to pay more tax, how do you achieve that?***

Because of the vast array of resources available to the rich and their special ability to alter their own circumstances, it is the case that, as often as not, reducing their tax rates increases tax revenues, increases employment, increases output and makes for a far happier society.

The rich, at lower tax rates, eschew the use of lawyers, accountants, deferred income

specialists and political favour-grabbers and actually pay the taxes they should pay.

What we have found is that when treated civilly, rich people for the most part are willing to pay what they owe. Rich people, like everyone else, take offence at being demonised, and move their tax domiciles, shelter their income, hire lawyers and accountants and pay off crooked politicians.



Just read what Andy Sewer wrote of the Rolling Stones in *Fortune* magazine, 30 Sept. 2002:

*The Stones are famously tax-averse. I broach the subject with Keith in Camp X-Ray, as he calls his backstage lair. There is incense in the air and Ronnie Wood drifts in and out – it is, in other words, a perfect venue for such a discussion. “The whole business thing is predicated a lot on the tax laws,” says Keith, Marlboro in one hand, vodka and juice in the other. “It’s why we rehearse in Canada and not in the US. A lot of our astute moves have been basically keeping up with tax laws, where to go, where not to put it. Whether to sit on it or not. We left England because we’d be paying 98 cents on the dollar. We left, and they lost out. No taxes at all.”*

***Will the next US President cut taxes? (This interview was conducted a couple of weeks before the election).***

My answer is, “no...not if the President’s name is Hillary.” •

## FOR MORE:

See Art Laffer’s brief – and humorous – explanation of the Laffer curve at:

[www.iea.org.uk/films/laffer-curve-explained/](http://www.iea.org.uk/films/laffer-curve-explained/)