SOUNDBITE

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What's GOOD for the GOOSE...

CHRISTOPHER SNOWDON takes a gander at tax revenues and the Laffer Curve

If taxation is about plucking the most feathers from the goose with the smallest amount of hissing, as Jean-Baptiste Colbert famously said, the Laffer Curve tells us when the hissing gets too loud.

Devised by the economist Arthur Laffer, the curve shows how tax revenue rises as the rate of tax increases. Eventually, however, revenues reach a point at which further tax rises bring in less money. This may seem paradoxical, but it doesn't take much imagination to see how it could happen. A tax rate of zero on a product produces no revenue but an infinite tax rate also produces no revenue because nobody is able to afford it. Working backwards from infinity, there must be a sweet spot (from the government's perspective) at which the tax rate is high enough to produce large revenues without being so high that it excessively dampens demand.

This is not a theoretical proposition. Laffer Curves can be spotted in the wild. In 2011, Ireland's Office of Revenue Commissioners noticed that revenue from tobacco duty was declining and concluded that: 'It seems likely that a Laffer type effect exists in the cigarette market in Ireland and the current level of taxation may be beyond the optimum. Therefore higher tax rates (higher prices) will lead to lower tax revenue.' For decades, governments have been able to grow their revenue from tobacco, despite the number of smokers falling, by putting up the tax rate, but this has reached its limit in many countries, including Britain where revenues peaked in 2012 and have fallen every year since.

Dwindling tax revenues are not necessarily a bad thing when the intention of the tax is to discourage consumption,

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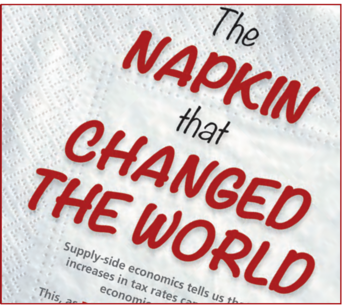
The original Laffer Curve arose from a discussion between Art Laffer and US government officials Dick Cheney and Donald Rumsfeld in the 1970s.

Laffer famously scribbled down his new theory on a napkin to illustrate his argument. To find out more, read 'The Napkin that Changed the World' at:

iea.org.uk/wp-content/uploads/2017/03/EA-SPRING-2017-TAX_NAPKIN.pdf



as it is with cigarettes, but less revenue does not necessarily mean people are avoiding the product. They might just be avoiding the tax.

Take Estonia, for example, which learned its lesson the hard way when it introduced some sharp tax hikes on alcohol. Between 2016 and 2018, spirits duty rose by 30 per cent, wine duty rose by 50 per cent and beer duty doubled. The result? Estonians travelled to neighbouring Latvia for their booze shopping while people from Finland, who had long made the trip to Estonia to buy cheaper alcohol, also went elsewhere. When the Estonian government announced the tax rises, it expected alcohol revenues to rise from €251 million in 2016 to €276 million in 2017. In fact, they fell to €229 million. In 2018, alcohol revenues were 30 per cent lower than expected, losing the treasury €101 million. This sobering experience led the government to drop plans for further tax hikes on alcohol in 2019 and 2020.

If the tax rate is on the wrong side of the Laffer Curve, lower taxes are a win for taxpayers and a win for tax collectors. This, too, has been seen in the wild. When Ronald Reagan cut corporation tax in 1986, revenue rose and exceeded projections of what it would have been had the old tax rate been kept in place. This was no fluke. Economic evidence suggests that most of the cuts to corporation tax seen around the world since 1986 have led to a rise in tax revenue because they incentivise inward investment and stimulate GDP.

The lesson here is not that governments should always aim for the peak of the Laffer Curve. Taxation should be based on what the state needs to spend, not what it can squeeze out of the public. But it is senseless to go beyond the inflection point. A hissing goose is likely to run away●

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