"The Laffer Curve Comes Back From the Dead"

Liberal American

Like one of those Hollywood monsters that cannot be killed, the once-ridiculed Laffer Curve has again come back from the dead to haunt the current tax cut debate just in time for Halloween and the November elections.

Legend says the curve was scrawled on a napkin by Arthur Laffer for a luncheon audience that included Dick Cheney. A journal article on the Laffer Curve defined the essence of snake oil, noting:

One of the great advantages of the Laffer curve is that you can explain it to a congressman in half an hour and he can talk about it for six months. [Spiegel, Uriel; Templeman, Joseph, "A Non-singular Peaked Laffer Curve: Debunking the Traditional Laffer curve," *American Economist*, September 22, 2004]

From that crude beginning the Laffer Curve went on to become the somewhat shaky underpinning of what became known as "supply side economics," the doctrine that also was known as Reaganomics for the President who relied on it, especially during his first term.

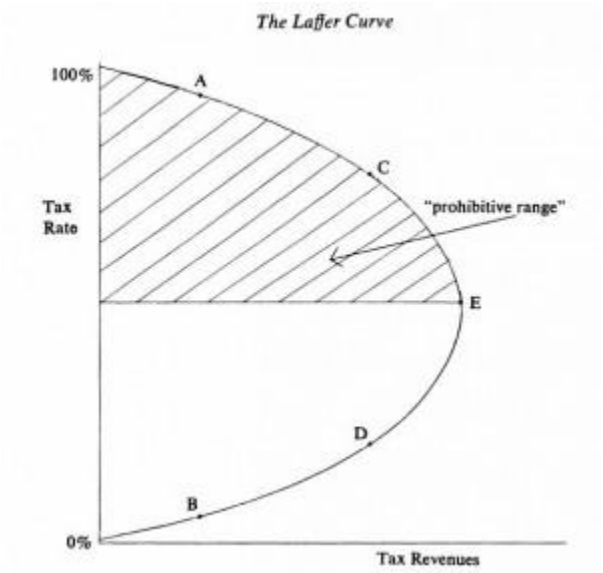
Since then the Laffer Curve has been gospel for a generation of conservative Republicans, the centerpiece in their long-standing campaign against taxes and big government. But many people saw those who still preached the Laffer Curve as irrelevant as someone who still believes the world is flat.

This is the theme of several books and articles that have appeared about Laffer and supply side economics since the Reagan Administration. The details of how "amateurs," "cranks" and the "borderline insane" made tax cuts for the rich acceptable and bankrupted the government is told in Jonathan Chait's *The Big Con* and Robert Atkinson's *Supply Side Follies*.

Meanwhile most Americans had forgotten the Laffer Curve the way people on Elm Street forget Freddie Krueger. But the Laffer Curve is back with a vengeance; the nightmare on Wall Street.

What is the Laffer Curve?

What made the Laffer Curve acceptable to many was that it seemed a neat explanation for the economy. The original Laffer Curve made the claim that government tax revenue would be zero if tax rates were either zero or 100%–one of those simple assertions on which grandiose structures are built. This was then used to construct a neat, half-moon-shaped curve that purported show that the more tax rates went up, the more government revenue would go down. Here is the Laffer Curve:



Of course the problem is precisely delineating the shaded area and "A," "B," and "D." . Laffer himself declined to do this in testimony over the Kemp-Roth tax cut bill:

SENATOR PACKWOOD: Now, let's go back to finding this optimum again, because obviously, if indeed you can define it and we can arrive at it …
MR. LAFFER: I cannot measure it frankly, but I can describe to you what the characteristics of it are; yes, sir.

During the soo8 campaign Mc Cain adviser Kevin Hassett, director for economic policy studies at the conservative American Enterprise Institute, made a similar statement to *the New York Times*.

What really happens is that the economy grows more vigorously when you lower tax rates. It is beyond the reach of economic science to explain precisely why that happens, but it does.

Statements like that have given "supply side economics" the nickname "voodoo economics."

Given that during the Eisenhower Administration the highest tax rate was 91% and the country did not fall apart; empirical evidence rejects the neat curve, producing a much more complex shape. Even defenders of Laffer have abandoned the neat, half-moon curve he first proposed.

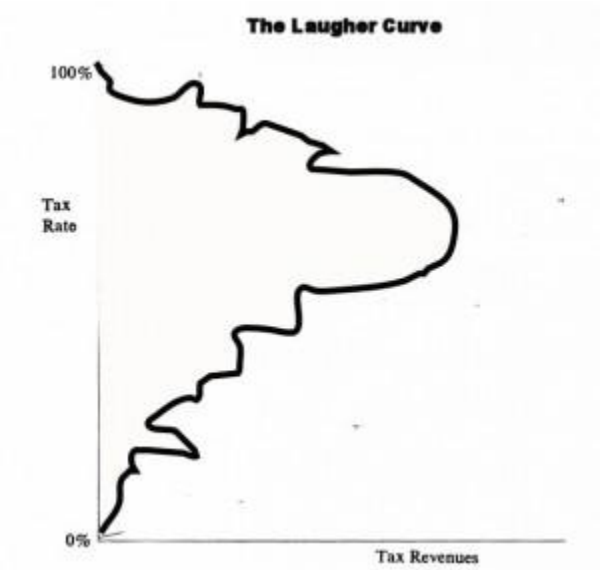
Problems with The Laffer Curve

From the original Laffer Curve emanated an entire generation of government policy that essentially said lower taxes were good and higher taxes were bad. However, even if you accept the basic Laffer Curve there is a point where both high taxes and low taxes are counter-productive.

Where those points lie has been obscured by political rhetoric and bogus arguments. What we do know is that if you lower taxes too far, you bankrupt government to the point of where bridges fall into rivers and reduced services such as police and fire cannot handle the load.

On the other hand it is true that if you raise taxes too high, investment moves overseas. The reason we will never see a return to the Eisenhower tax rates is that American companies will move to low tax states or countries if the burden gets too high. The problem is that for over two decades economic researchers have failed to define those points–in part because they have been shooting at a moving target.

The difficulty in precisely defining the exact impact of various tax rates results in the following semi-serious diagram which I term the Laugher Curve. The shaky line is intentional for it asks what are the mathematical determinants of the Curve? Where do you put the bulge and how big is it?



The Makeover of Tax Policy

While many thought the Laffer Curve dead, behind the scenes economists have been exploring tax policy with more complex data that would reshape tax policy. Nobody used the phrase Laffer

Curve or was it mentioned in most of the key papers on taxes. Instead the phrase became "income elasticity" (throw that one around at your next after-work conversation about tax cuts).

The economist most credited for his research on elasticity and revising how we look at taxes is Martin Feldstein, whose work has justifiably been mentioned as deserving a Nobel Prize. In simple terms what Feldstein did was to add behavior to the tax equation. Elasticity refers to the real value of a tax cut or tax increase because when you raise and lower taxes the result is not a simple revenue increase or decrease. People will change their work and investment habits in response to changes in the tax laws.

What emerged was not as simplistic as the Laffer Curve. Many Republicans never did pay attention, after all Feldstein's work cannot be sketched on the back of a napkin nor explained to a politician in half an hour. Perhaps the most influential and accessible statement of Feldstein's position is in his paper "The Effect of Taxes on Efficiency and Growth" from the National Bureau of Economic Research.

At one point in the paper Feldstein notes if you raise my taxes I can choose to change my behavior in response, in essence reducing taxable income and hence government revenue.

It doesn't matter if the taxable income is reduced because the employee works fewer hours or makes less effort per hour or chooses an untaxed form of compensation.

As an illustrative example Feldstein proposes that taxes can distort how we are paid. We know CEO's now make more on stock options than salary because their salary is taxed at a higher level than the capital gains on the stock if and when they cash it in. Says Feldstein:

The fact that cash compensation is taxed and the other forms of compensation are not taxed tips the balance to increase compensation in the nonaged [i.e. more flexible, my note] form.

While Feldstein's focus on the impact of taxes on behavior is notable what many believe makes him Nobel material is that unlike Laffer, whose use of mathematical proofs is elementary at best, in a series of papers and publications Feldstein actually computes the impact of taxes on elasticity.

The most cited example comes from that much-quoted paper:

An elasticity of one implies that reducing someone's marginal tax rate from 40 percent to 30 percent – i.e., increasing the marginal net of tax share from 60 percent to 70 percent – implies about a 16 percent increase in taxable income.

You can do the math to understand what Feldstein implies. Divide the ten percent reduction by the 60 percent tax share and you get 16%. Feldstein points out that this is with an elasticity of one, which Feldstein believes reflects the impact of behavior such as changing work habits, compensation, etc.

Feldstein sums up the policy impacts of elasticity:

The result of this failure to take into account the behavior of taxpayers leads the revenue estimators to overestimate the positive effect on revenue of tax rate increases and also to overestimate the negative effect on revenue of tax rate decreases.

Since Feldstein enriched the idea of elasticity it has been at the center of tax debates among real economists, although some of the rigid supply-siders still don't get it. Feldstein himself summed up his view of Laffer in the book *American Economic Policy in the 1980s:*

I objected therefore to those supply-siders like Arthur Laffer who argued that a 30 percent across-the-board tax cut would also be self-financing because of the resulting increase in incentives to work.

An example of the impact Feldstein's work has had on tax policy discussions among economists comes from Gregory Mankiw, author of the textbook that weighed down many a college backpack. Econ 101 students across the country have read his case study of the Laffer Curve. In the 1998 edition of his text he referred to economic policy makers in the Reagan Administration as "charlatans and cranks."

An example of fad economics occurred in 1980, when a small group of economists advised presidential candidate Ronald Reagan that an across-the-board cut in income tax rates would raise tax revenue. They argued that if people could keep a higher fraction of their income, people would work harder to earn more income.

Congress passes the cut in tax rates… but the tax cut did not cause tax revenue to rise… tax revenue fell… government began a long period of deficit spending… largest peacetime increase in the government debt in U.S. history. Fads can make experts seem less united than they actually are… when the economics profession appears in disarray, you should ask whether the disagreement is real or manufactured… [by] some snake-oil salesman who is trying to sell a miracle cure. (pages 29-30)

The quote has been omitted from subsequent editions and Mankiw himself has written in his blog that it was misinterpreted. In the most recent edition of his textbook Mankiw's discussion reflects the complexities created by Feldstein's work.

How much revenue the government gains or loses from a tax change cannot be computed just by looking at tax rates. It also depends on how the tax change affects people's behavior. (*Principles of Economics,* p. 171)

BTW, Mankiw, who served briefly as head of George W. Bush's Council of Economic Advisors, is in favor of keeping the Bush tax cuts, at least for the short run.

The Debate Over Elasticity

For most real economists the debate shifted years ago to computing the impact of elasticity. In his article Feldstein argued for an elasticity of one, but as Mankiw points out there others who would compute the impact differently. To illustrate the importance of this suppose in Feldstein's

example the elasticity were less than one. Then depending on where it was defined the gain he cites would be less than 16%. An elasticity of 50% could reduce the gain by at least half–I say at least because computing elasticities is for those who have gone far beyond Econ 101.

In a long 1999 article current Obama economic advisor Austan Goolsbee examined six decades of evidence on the Laffer hypothesis for the Brookings Institution. He concluded:

The notion that governments could raise more money by cutting rates is, indeed, a glorious idea. It would permit a Pareto improvement of the most enjoyable kind. Unfortunately for all of us, the data from the historical record suggest that it is unlikely to be true at anything like today's marginal tax rates.

Among the many arguments Goolsbee makes is to propose a far different elasticity number than Feldstein. After reviewing major changes in tax policy over the last century his elasticity estimates vary widely:

If there were only one rate in the tax code, the revenue-maximizing tax rate given the elasticity estimated using the 1985-89 data (column 4-1 of table 4) would be 42 percent. It would be 63 percent using the 1922-26 data, 83 percent using the 1931-35 data, 86 percent using the 1948-52 data, and 98 percent using the 1962-66 data.

Goolsbee also shows the fallacy of the argument that higher taxes lower income for the super-rich by using data from the Great Depression.

These data suggest that although taxes rose most for the very rich, this sample provides little evidence that their relative incomes declined. Indeed, they may well have risen.

Goolsbee summarized his longer paper in a 2008 op ed piece for the *New York Times*:

In the four years after the increase in top marginal rates in 1993, average salaries grew 18.7 percent among the top 1 percent of earners and less than 0.1 percent for the bottom 90 percent.

The academic debate continues, but thus far, the new Laffer curve has looked more like a fleeting figment of economic imagination. That is sad, because it would be great if we could cut taxes and raise revenue at one stroke. Alas, the research suggests that we will have to pay for high-income tax cuts the old-fashioned way — by actually cutting spending or just busting the budget.

So Who Is Right?

If all this talk about elasticity has your head spinning, you are not alone. It has everyone's head spinning. But the bottom line is that only Laffer (who has a new book out based on his rediscovery) and his most rigid disciples still buy into the theory that there is some simplistic curve that can be used to decide tax policy.

Instead, the debate centers on Feldstein's behavior question. Some believe that elasticity itself applies mostly to high wage earners who have the flexibility to change their behavior. If you raise the average worker's taxes they cannot move income to stock options and choosing to work less might get you fired. Others believe it only applies to economies with aggressive tax rates such as in some European countries.

But since the argument is about tax cuts for the rich, it puts Feldstein–not Laffer–at center stage. Those who favor Feldstein's higher elasticity calculations such as Mankiw favor letting the rich keep their tax cuts. Those such as Goolsbee who favor a lower figure favor the Obama position.

The historical evidence would tend to favor Goolsbee–I'll explain why in a second. We know that after the Reagan tax cuts per capita revenue from personal income taxes, adjusted for inflation, rose an average of just 0.7 percent. Since 2001, the annual per capita revenue from income taxes fell 1 percent under President Bush even though tax collections picked up sharply starting in 2005. Meanwhile under Bill Clinton revenues increased 6.5 percent and we had a balanced budget.

Reagan had to go back on his word and actually passed a tax increase. Bush left us with the largest deficit piled up in the shortest amount of time in history.

The Impact of Spending

One reason Reagan and Bush did not enjoy the economic nirvana Laffer predicted has to do with spending. Feldstein tells us that there is not a 1:1 ratio between tax cuts or increases and changes in revenue. The gain or loss is some fraction of that. Which means that the difference has to be made up somewhere.

George W. Bush may have been our worst economic president because he lowered taxes and raised spending, much of it because of the Iraq War. I argued years ago in this blog that Democrats should have made changes in the Bush tax cuts part of the deal for supporting the Iraq War, but they did not. Tax cuts plus Iraq was the Republican version of Lyndon Johnson's "guns and butter" Vietnam policy.

The Obama Plan

What Barack Obama is proposing to do is an interesting mix of old-fashioned New Deal stimulus along with tax cuts for a majority of Americans. During the New Deal FDR financed his stimulus with a tax increase which fell mainly on the wealthy since so many Americans were unemployed or earning marginal incomes.

Obama is saying that he will finance his spending increase by keeping the taxes on the rich. One thing we do know is if we keep the spending increase and the Bush tax cuts we risk the return of high deficits. That is why most economists favor repealing all the Bush tax cuts. However, in this election year that will not fly, so half a loaf is better than none. By that I mean somehow we have to pay for the impact of the spending increases in the stimulus bills.

Republicans are also calling for more spending cuts to finance their tax cuts. Unfortunately none of them are telling us what they would cut. That is like "voodoo economics." Some of them even refer to Laffer. But Laffer, like Freddy Krueger, only leaves bloodshed behind, and some of that blood is ours.

What is needed at this point is something neither side seems willing to do: rethink the entire role of government. Some on the far right are doing this, but their solutions–cutting Social Security and Medicare–are draconian. Nobody wants to go back to the 1890s. But those on the left have not proposed any innovative ideas to counter this.

A Reverse Feldstein Theory

I am not an academic economist, but it seems to me Feldstein is on to something with his emphasis on behavior. What he reminds us is that we need to understand the economy as a system with multiple feedbacks. Those feedbacks mean there is a trade-off for any policy. Raise taxes too high and some people will cheat on their taxes (like certain Tea Party founders) or try to shelter their income.

What we need are policies that encourage economic behavior that has positive feedbacks and what I will term "social elasticity." By that I mean government expenses and programs should have a multiplier impact that becomes the expense side equivalent of Feldstein's revenue side theory.

Programs should encourage asset building. There are two shining examples of that in American history, both of which had huge payoffs: the Homestead Act of 1862 and the post World War II GI Bill that financed education and housing, turning the 1950s into what some still remember as "Happy Days."

In both of those programs grants were made to people, but especially in the case of the Homestead Act, people had to also make a personal contribution. I believe Barack Obama and the Democratic Party could make a historic contribution to American and turn this country around if they would propose an equivalent to the Homestead Act and the GI Bill, one that stresses asset building.

Joseph Stiglitz, one economist who seems to get it, has proposed what he terms a "better stimulus:"

So what is a "good" stimulus? It may seem obvious — but the top criterion is that it stimulates. It can't be like decaffeinated coffee. It also is obvious that some kinds of spending do more than others. Some are more "jobs" intensive — the likely increase in jobs for every dollar of gross domestic product is greater.

This is essentially what I mean by asset building and "social elasticity." I have some specific suggestions on what should be in such a bill but unfortunately they are in the next book, which looks at the importance of the level playing field for economic policy. It examines the payoffs of past asset building strategies and ideas for future ones.

Economists are telling us that despite all the talk of the recession being over, we are still in a deep hole. Stiglitz writes:

With credit constrained, unemployment high, mortgage defaults continuing apace and the first stimulus running out, unless something forceful is done, it is more likely that the economy's woes won't be over anytime soon.

What the American people seem to be saying about taxes and tax increases is that if they promise something in return, they would support them. Right now people don't think they are getting their money's worth. If that continues, we will all be having nightmares about Arthur Laffer.