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The 'Laffer Curve' Renamed

by Alan Reynolds

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Greg Mankiw, the distinguished former head of the President's Council of Economic Advisers, used the occasion of Hank Paulson's appointment as treasury secretary to give a little lecture in The Wall Street Journal on what distinguishes supply-side economists from the respectable variety.

"Some supply-siders like to claim that the distortionary effect of taxes is so large that increasing tax rates reduces tax revenue. Like most economists, I don't find that conclusion credible for most tax hikes. ... Yet the supply-siders are right about one thing: Because higher tax rates reduce the size of the tax base, raising taxes generates less revenue that the 'static' revenue estimates assumed in Washington would suggest."

Mankiw went on to say: "One of Mr. Paulson's first briefings from the Treasury staff should be about what high taxes have done to the economies of Europe. According to research by Nobel laureate Edward Prescott and by economists Steven Davis and Magnus Henrekson, the high tax rates in Europe have reduced work effort and distorted the industrial mix."

Aside from that odd remark about what some nameless supply-siders like to claim, Mankiw simply restated what real supply-siders really did claim. He emphasized that higher (marginal) tax rates reduce work effort and cause other inefficient distortions. He added that higher tax rates also reduce the size of the tax base -- people respond to higher tax rates by taking it easy or figuring out ways to report less taxable income. This used to be called "the Laffer Curve," but it now goes by the more respectable name of "taxable income elasticity."

I grow weary of people telling me what supply-siders supposedly said, thought or wrote without bothering to actually quote anyone. No economist ever claimed that all taxes are so distortionary that increasing any tax rate would reduce revenue. Art Laffer never said that. Bob Mundell never said that. Larry Lindsey, Larry Kudlow, Craig Roberts, Steve Entin and Bruce Bartlett never said that. I never said that.

Ben Stein recently wrote an aptly named "Quick Course in the Economics of Confusion" for The New York Times. He offered to clarify some "breathtaking confusion about supply-side economics" (a label I borrowed from his father in 1976). Stein spoke indulgently about "Art Laffer, a likable and intelligent man who, with no substantial backup at all in data that I am aware of, said that if you cut taxes on income, you would stimulate so much economic activity that you would collect as much in tax as you did when rates were higher." The key phrase is "data that I am aware of." Ben Stein is a likable and intelligent man whose unawareness of data is not

Laffer's fault.

In a paper I'll soon be presenting at the annual Western Economic Association meeting, I wrote that "reductions in marginal tax rates may induce people to alter their taxable income in many ways: Entrepreneurs may start more businesses, spouses of high-bracket taxpayers may rejoin the labor force, those previously working in the underground cash economy may take jobs that require taxes to be paid, skilled professionals and managers may work harder and retire later, executives may negotiate for cash rather than perks, high-income investors may hold fewer tax-exempt bonds and trade stocks more frequently, taxpayers may not try so hard to maximize tax deductions and adjustments."

That is not significantly different from what supply-siders were saying 30 years ago. It is also what Mankiw and other mainstreamers are saying today.

More than a dozen highly regarded studies have shown that the amount of income reported by those facing the highest marginal tax rates is extremely sensitive to changes in those tax rates. This is measured by the "elasticity" (responsiveness) of taxable income.

Harvard's Martin Feldstein pioneered this research and much more. It is a professional scandal that he has not been awarded the Nobel Prize. In a new paper on "The Effect of Taxes on Efficiency and Growth" from the National Bureau of Economic Research, which he heads, Feldstein recaps his estimate that "the elasticity of income with respect to one-minus-the-marginal-tax rate is about one." If so, cutting someone's marginal tax from 40 percent to 30 percent would typically result in about 16 percent more income being reported. With 16 percent more income and a 10 percent lower tax rates, revenues would certainly not go down. Even if the elasticity is half that large (0.50), any loss of revenue would be modest at best and arguably offset by improved economic performance.

Two Treasury Department economists, Robert Carroll and Warren Hrung, wrote in The American Economic Review last year as though everyone agreed that the elasticity of reported income was much lower than one, closer to 0.40. But that figure is near the bottom of the range of 14 estimates surveyed by the Congressional Budget Office. Wojciech Kopczuk of Columbia University has an estimate of 0.53. The two studies reporting a lower 0.40 estimate found the response much higher at higher incomes. Jon Gruber and Emmanuel Saez estimated the elasticity rose to 0.56 at incomes above $100,000. Saez has a separate estimate of 0.63 among the top 1 percent of taxpayers.

What all this means is that cutting the top tax rate in half has resulted in much more income being reported and taxed in every country that tried it -- the United States, United Kingdom, New Zealand and India, for example. Some mistakenly imagined that proved the rich suddenly became richer when U.S. tax rates fell from 1986 to 1988. What it actually proved was that the rich reported more taxable income when tax rates on an extra dollar became more reasonable. These facts are not seriously in dispute regardless what portion of this widely observed "Laffer Curve" phenomenon was due to a change in actual income (a supply-side effect) or to a change in the proportion reported to tax collectors.

In other words, supply-side economists were right all along. Their critics were wrong. Several Nobel Laureates in economics have now said as much. Get over it.

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