The Laffer Curve

Do Tax Cuts Cut Revenues?

0% or 100% Rate = Zero

A 10% Rate

A 10% Rate
The Laffer Curve

Pushing Our Luck

There Comes a Point

Its downhill

The Laffer Curve

The logic is flawless. There is some rate that maximizes tax revenues.

Are we here?
The Laffer Curve

If the tax rate is above $\tau^*$, cutting taxes raises revenue.

Are we here?

The revenue decline above $\tau^*$ is due to incentive effects and avoidance.

Are we here?

If the tax rate is below $\tau^*$, cutting taxes lowers revenue.

Or here?

The 1964 Tax Cuts

In 1964, the top marginal rate was cut from 91% to 70%. We may have been above $\tau^*$.

Or here?

The 1981 Tax Cuts

In 1981, we cut the top rate to 50%. Some claimed we were above $\tau^*$. Most economists don’t think so.
In 1986, we cut the top rate to 31% by eliminating some exemptions. Again, some claimed we were above $\tau^*$. Most economists think overall rates are below $\tau^*$. But perhaps a $1$ cut only costs us $67\%$

There are specific taxes where the Laffer Effect probably works. A city raising cigarette taxes might get less revenue.

Suppose NYC raised taxes $1$ a pack, so cigarettes went from $7$ to $8$ a pack.

If $\eta=-0.2$, a $14\%$ rise should reduce demand by $\cong 3\%$. Not enough to reduce revenue.
Cigarette Taxes

But what about tax avoidance? Smuggle cigarettes in from NC, NJ, CT?

Capital Gains Taxation

If you own common stock, hold it for more than a year before selling it, your top tax rate is 20%.

Capital Gains Taxation

One of the arguments given for cutting capital gains taxation was the Laffer Curve.

Supply Side Economics

We know taxation has an impact on the demand for GDP; that is how we cut C and I to make room for G.

Supply Side Economics

Supply side economics talks about making the pie bigger.

Supply Side Economics

\[ Y_t = A_t K_t^\alpha L_t^{1-\alpha} \]
The Laffer Curve

Supply Side Economics

\[ Y_t = A_t K_t^\alpha L_t^{1-\alpha} \]

How do taxes impact \( A \)?

Supply Side Economics

\[ Y_t = A_t K_t^\alpha L_t^{1-\alpha} \]

How do taxes impact \( A \)?

Supply Side Economics

\[ Y_t = A_t K_t^\alpha L_t^{1-\alpha} \]

How do taxes impact \( L \)?

Supply Side Economics

\[ Y_t = A_t K_t^\alpha L_t^{1-\alpha} \]

That requires a detailed look at taxes

Militant Supply Siders

The higher the percent of GDP taken by taxes, the lower the value of GDP

Militant Supply Siders

They have a point. Take 100%, and you remove all incentives.
The Laffer Curve

Militant Supply Siders

Size of National Pie

% Taken for Taxes

GDP will be zero.

This is simplistic. Different taxes have different incentive effects.

End

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