Laffer Curve

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The Laffer Curve©
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So, a few months ago a friend posted a video on my Facebook wall about an economics concept called the "Laffer Curve." Now, for those of you who have never heard of it, the Laffer Curve is an interesting topic of debate. In 1974, during a dinner meeting with Donald Rumsfeld and Dick Cheney - two names that might be familiar from the Bush administration - economist Art Laffer sketched out a concept on a napkin, and forever gave it his name. Essentially, the Laffer Curve posits that there is a relationship between the rates of taxation on income and different levels of economic growth.

Here's what the Laffer Curve hypothesizes: at 0% tax, the government will collect no revenue…obviously. And at 100% tax, the government will also collect no revenue, because if, at the end of the day, you don't get to keep any money, then nobody would work. So somewhere between 0 and 100, there must be an equilibrium level that maximizes both revenue for the government, and economic growth. i.e., raising taxes beyond a certain level would be counterproductive, because it would cause growth to slow down, resulting in *less* tax revenue for the government than it might otherwise collect if tax rates were lower *but* the overall economy were bigger.

Among economists, none of that theory is controversial - where there *is* significant debate, though, is over the shape of the curve, and at what point tax rates are so high that they become counterproductive. And that debate is fierce.

In the 1980's, Republican politicians in the United States seized the idea of the Laffer Curve to promote "Reaganomics" under the presidency of Ronald Reagan. Promoting the idea that cutting taxes would increase growth, and thus revenues, they slashed top income tax rates from 70% to 31%. Two decades later, George Bush would employ the same logic in support of his massive tax cut package that distributed benefits heavily towards the highest earning taxpayers.

Now, if that whole idea sounds a *little* bit too good to be true, then that's because it is. While Laffer was right about the general idea of a curve, he was way off in his estimation of where the equilibrium point lies. Over the decades since the Laffer Curve's introduction, there has been a host of academic research by economists like Christina

Romer, Emmanual Saez, Thomas Pikkety, Simon Wren-Lewis, Peter Diamond and Paul Krugman into just what that optimal tax rate might be. Over and over, they find that the optimal top rate is most likely where it was when the Reagan Administration started urging cuts - 70%, with a caveat. That decreases as income decreases.

Interestingly enough, there's also a relatively recent, real world experiment with the Laffer Curve. The interesting thing about American states is that two states that border each other can follow drastically different policies. Kansas and Missouri are especially interesting because they more or less share a large metropolitan area that spills across the state lines - Kansas City. When Republican Sam Brownbeck became governor of Kansas, he brought Art Laffer himself into his government as an economic advisor.

Together, they slashed the top tax rates, which instead of increasing revenue for the state government, resulted in far less revenue and big budget deficits. Then, to address the deficits Brownbeck was forced to introduce huge cuts to public spending on everything from infrastructure to schools, leaving the state with a huge shortage of teachers - who, following economic incentives, left Kansas for higher paying jobs at public schools in other states. Missouri, on the other hand, did none of the above. The end result? Job growth ended up being 4 times higher in Missouri than in Kansas.

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