The Laffer Curve

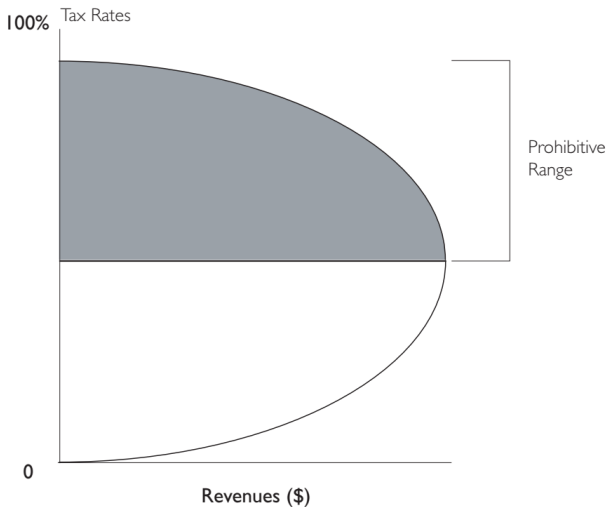Our story starts with 4 friends at a restaurant...

D. Cheney (Rumsfeld's deputy), J. Wanniski (WSJ), D. Rumsfeld (Pres. Ford's Chief of Staff), A. Laffer (UChi), talking about Ford's proposed tax increases

THE LAFFER CURVE

▶ Source (very ideological) **(link)**

▶ Not a new idea

▶ Ibn Khaldun (14th century)

▶ Keynes: "taxation may be so high as to defeat its object, [...] [like] a manufacturer who, running at a loss, decides to raise his price"

▶ Arithmetic effect

▶ Economic effect (output, employment, hence tax base)

▶ People care about post-tax income

▶ at 0% and 100% no revenues and 2 points for any other level of revenues

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The Laffer Curve

A few notes:

▶ It makes some sense, but probably not in that shape

▶ National preferences and trust in government surely impact it (also modelled in Antoci et al., 2014)

▶ Difficult to prove: models are tautologic, data is probably insufficient for estimation

▶ Indeed, the current literature has evolved only in the direction of more sophisticated models (plus some experimental)

▶ Anecdote: self-employed professionals in Italy

THE LAFFER CURVE

Problems, according to Mirowski (1981):

1. Size of elasticities

2. Problems of empiricism

3. Omitted variables

4. Size of the underground economy

"Diamond" bullet points [◇] taken from Fullerton (2008)

The Laffer Curve: Size of Elasticities

▶ The evidence then was that the men's elasticity of income & subs wrt marg tax rates was about zero

▶ Positive for married women and teenagers

▶ Supply-siders discredit empirical work but then remake their own estimates

◇ Heterogeneity implies *the* elasticity does not exist

◇ Tax systems are too complex for people to know the effective tax rate and it's progressive too

◇ Avg rate affects revenue, marg rate affects behaviour $\rightarrow$ Laffer effect more likely from cut at top of marg rate

◇ If you don't care, the most recent estimates for the peak $t^{\star}$ is 71%

The Laffer Curve: Empiricism

- ▶ The curve is undetermined both qualitative and quantitative

- QT Laffer says the US is in the *prohibitive range* but cannot measure the peak of the curve

- QL The 100%-0-revenues point might not exist (in communist regimes people do work) ⇒ no *prohibitive range*

- ▶ They hide behind story-telling of past cuts → but cuts are per se expansionary already

  - ◇ The existence of point-100% depends on how much revenue is spent on public goods vs transfers

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The Laffer Curve: Omitted Variables

▶ There is no single rate: not for an individual, not for the economy

▶ To test for the existence of such curve you need a very good model of the economy

▶ In the current literature I found models able to produce the curve, used as evidence in favour

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The Laffer Curve: Underground Economy

▶ No one knows how big it is

▶ Unlikely that tax evasors would change their minds in mass

▶ You would need highly elastic, high evasion → both unmeasurable

▶ Tax evasion is only a minor point though