The Laffer Curve

Expostion: Given that the Economic Policy Objective is to maximize Tax Revenues—$T_{revenue}$—the Tax Rate—T_{rate}—must be set so as to achieve that maximization. The following three graphs show how to do that:

I: Tax Revenue = f(Tax Rate) II: High School Geometry III: Economic Policy Decision

Graph I lays out the Tax Rate/Tax Revenue relationship: the horizontal axis will show the independent variable--Tax Rate (T_{rate})—going from 0% to 100%. The vertical axis will show the dependent variable—Tax Revenue (T_{rev})—collected at each Tax Rate percentage.

Graph II is merely a High School Geometry truism: at 0% Tax Rate (point A), no Tax Revenue will be collected. And at 100% Tax Rate (point B), no Tax Revenue will be collected, because no one will work (on the books) knowing that all his/her wages will be taxed away. At any Tax Rate between 0% and 100%, some Tax Revenue will be collected. Thus Graph II depicts the Laffer Curve.

Graph III shows the analytical challenge to Economic Policy. Given that the objective is to maximize Tax Revenue, the policymaker must determine whether the current Tax Rate is C- or C+. If C- is the current Tax Revenue, then raising the Tax Rate to C will increase Tax Revenue. Conversely, if C+ is the current Tax Revenue, then Tax Revenue will be increased by lowering the Tax Rate to C.

Empirical Evidence: Experience from our country—in the 1920s (under then Treasury Secretary Mellon), the 60s (President Kennedy), the 80s (President Reagan), and today in such countries as Spain, Bulgaria, Kuwait, Estonia, and Ireland--demonstrates conclusively that the Laffer Curve accurately describes the real-world effects of cutting Tax Rates.

Economists' Explanation: Economists classically recognize three factors of Production: Land, Labor and Capital. Asset owners of Land (fixed assets) and Capital (money), knowing that they will be allowed to keep more of the revenue they earn if the tax rate is reduced, will employ more of these assets in consumption or investment, rather than holding them. And Labor (people) will also shift from leisure to work, and use the increased assets to further improve their productivity. Real world observers of factor deployment add Information (secondary and primary scientific and market research) and Managerial Judgment (that blend of intuition, past experience, values, entrepreneurial insight, and leadership skills) to the economists' traditional three factors. The two additional factors respond in the same way as do the traditional three—lowering tax rates results in more deployment, thereby increasing tax revenues. This explanation, which has roots in the Austrian School of economic thought, has become known as The Supply-Side Revolution in economic theory.

2008 Corroborating Evidence: Marsden's massive 2008 Study, *Big, Not Better?*, provides rigorous empirical support. He reviewed the performance of 20 countries—10 with "slimmer governments (those with revenue and expenditure levels below 40% of Gross National Product)" compared with 10 "higher-taxed, bigger government economies." His conclusion:

> The early supply-siders were right. My fndings firmly reject the widely held view that lower taxes inevitably result in cuts in public services, shower growth and widening income inequalities. Today's policy makers should take note of how tax cuts and the pruning of inefficient government programs can stimulate sluggish economies.

