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Supply-Side “Ideas”: The Other View

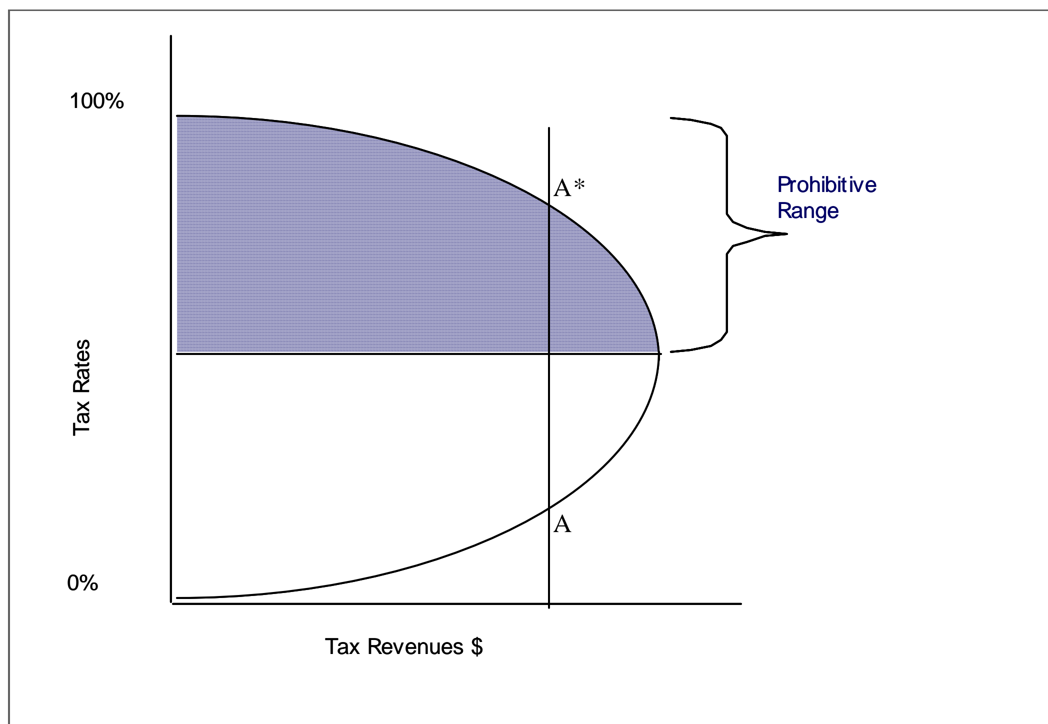
By Thomas E. Nugent

Ever since Time magazine selected Arthur Laffer as one of the one hundred greatest minds of the 20th century for his supply-side economic theories, economists, authors and media commentators have offered explanations of supply-side economics and the now famous Laffer curve.[1] A compendium of such explanations, “*A World Of Ideas*,” by Chris Rohmann is a so-called dictionary of “important theories, concepts, beliefs, and thinkers.”[2] As with any second hand explanation of “ideas,” there can be distortions and misunderstandings. So, to set the record straight, here is the inside scoop on the origins of the Laffer Curve and Supply-side economics.

The Supply-Side View

At a dinner in 1974, Dr. Arthur Laffer met with Donald Rumsfeld, the current Secretary of Defense, and Jude Wanniski, a journalist for the Wall Street Journal. The purpose of the meeting was to discuss President Ford’s proposal to increase taxes to stop inflation. [I remember President Ford’s economic summit at that time and have the memento of the time, the little red WIN button that stood for Whip Inflation Now.] During dinner, Dr. Laffer sketched the now famous Laffer curve on a napkin at the Washington Hotel restaurant to illustrate his concept of the relationship between tax rates and tax revenues. Jude Wanniski, a noted author and editorial writer for the Wall Street Journal described that meeting, and what he first named as the “Laffer Curve,” in an article for *The Public Interest* entitled: “Taxes, Revenues, and the Laffer Curve.”

THE LAFFER CURVE



The Laffer Curve is a unique pedagogical device that captures the important role of incentives in a free economy. The application of the curve to the structure of the tax system allows for a visual representation of what happens when taxpayers respond to disincentives to pay taxes: tax revenues fall when tax rates are high. Using the example of taxes, the act of lowering or raising tax rates has two revenue effects: the arithmetic effect and the economic effect. The arithmetic effect, or static effect is obvious: when you raise tax rates, you get more tax revenue. The economic or dynamic effect recognizes that, at certain high levels of taxation, people will not work, save or invest. In the extreme, a zero tax rate produces no revenues and a 100% tax rate is likely to produce minimal revenues.

The principal of the Laffer Curve is present in virtually every business decision where the overall objective is to maximize profitability through the determination of setting prices consistent with the ability and desire for the consumer to buy. Setting prices too high produces a shortfall in sales and revenues while setting prices too low produces a shortfall in profits.

The parabolic shape of the Laffer Curve demonstrates that there is no one exact point or tax rate that changes incentives. However, there are at least two tax rates that will produce the same tax revenue (points A and A* in the graph). At lower tax rates, there is little resistance to paying tax but as tax rates rise, each of us reaches a point where we take actions that will reduce our exposure to these higher tax rates.

Another View

As mentioned earlier, Chris Rohmann's idea of supply-side economics is a little different. Mr. Rohmann describes the Laffer Curve in terms of a pot belly. "As the "belly" (tax rate) grows, revenues increase; but when the tax rate gets too high, people are discouraged from making the extra effort to generate more wealth to spend, save, or invest and are more inclined to use legal loopholes or false claims to avoid paying taxes, so the "belly" of tax revenue begins to diminish."[3]

The "belly" (or outline of the Laffer Curve) doesn't get bigger. There are points along the outline of the "belly" that represent a mix of tax rates and tax revenues. There are two distinct partitions of the Laffer curve; one is the normal range and one is the prohibitive range. When in the prohibitive range, higher tax rates produce lower, not higher tax revenues. The relationship between these two variables is a plot point on the curve and is not the shrinkage of the "belly."

Mr.Rohmann revisits history and appears to have acquired limited knowledge of the effects of the Laffer Curve on tax revenues in the 1980s.

> "The Laffer curve was used to justify large tax cuts in the early 1980s, when President Reagan's economic advisors were convinced that tax rates had passed the optimal level. But tax revenues fell rather that increasing, and this failure to achieve the predicted outcome contributed to a perception of the Laffer curve as simplistic and unreliable."[4]

According to a number of subsequent studies, tax revenues collected from individuals in the higher tax brackets expanded dramatically in the 1980s while tax revenues from people in the normal zone fell as was to be expected. According to the Internal Revenue Service, from 1980 to

1997, the share of total federal income taxes paid by just the top 1 percent of taxpayers (ranked by adjusted gross income) rose from 19% to 33%. The top 25% of taxpayers increased their share from 73% to 82%! The effective tax rate on those with high incomes is substantially lower today than it was when their share of total income taxes was much smaller. In 1980, the effective tax rate on the top 1% of taxpayers was 34.5%. In 1990, it fell to a rate of 23%. In other words, lower effective tax rates appear to have produced higher tax revenues!

According to the Treasury Department, marginal tax rates on the wealthy are down dramatically. In 1981, the top federal income tax rate was 70%. Today it is 39.6% Looked at in another way, the retention rate, the rate of income that individuals keep after taxes, went from 30% to 60.4%, an increase of 100% since 1981!

Mr. Rohmann goes on to identify what he calls a "corollary hypothesis," the so called *trickle down* theory, the greater spending and investing power unleashed by tax cuts for those at the top of the economic ladder eventually "trickles down," in the form of increased employment, to benefit all of society. The term "trickle down" is a derogatory term invented by the detractors of supply-side ideas. An appropriate description of the effects of supply-side policies was captured by John F. Kennedy's saying: "a rising tide raises all boats" in reference to the importance of economic growth in driving up the well being of all Americans.

To the extent that the author's presumed perception of the Laffer curve is simplistic and unreliable, we would say that the Curve represents a simple explanation of the way the world works, simple in the sense that people respond to incentives, high tax rates being one potential disincentive to work, save, and invest. However, "unreliable" is an obviously inaccurate characterization of incentive based economics by those who would adhere to other, more complicated economic theories.

Here are but a few insightful quotes collected by Bruce Bartlett of the National Center for Policy Analysis that indicate supply side economics is reliable and has had a remarkable impact on the U.S. economy:

> In 1989, after denouncing Reagan's economic program throughout the 1980s, liberal economist Paul Samuelson of MIT, a longtime advisor to Democratic presidents, conceded that, "the latter half of the 1980s, historians will recognize, has been an economic success story."
>
> In 1994, in its annual Economic Report, President Clinton's Council of Economic Advisers made this admission: "It is undeniable that the sharp reduction in taxes in the early 1980s was a strong impetus to economic growth."
>
> In 1995, Business Week magazine, which opposed the Reagan tax cut in 1980, said, "the basic supply-side notion has become commonplace: Economic growth depends on how tax rates, regulations, and inflation affect investment, entrepreneurship, and work effort." The same article quoted respected Harvard University economist N. Gregory Mankiw as saying of supply-side economics, "There's no doubt mainstream economic research is more focused on incentives and supply factors."

> In 1996, Clinton's chief economic adviser, CEA Chairman Joseph Stiglitz, even justified the administration's own policies as being based on supply-side economics. "Our growth policies are supply-side," he told the New York Times.
>
> In a 1996 poll, 48 percent of voters said that Reagan's economic policies were good for the country. Only 36 percent said they were not.
>
> In 1999, supply-side economist Robert Mundell won the Nobel Prize in economics!

Also, the author's claim that supply side economic policy was influential only in the U.K. and the U.S. entirely misses the dramatic reductions in tax rates around the world during the 1980s as a result of the tax reductions in the U.S. and U.K. By one count, more than 72 countries had reduced taxes in response to the supply-side experiment in America.

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[1] "The Century's Greatest Minds," Time Magazine March 29, 1999
[2] Chris Rohmann, "A World of Ideas," The Ballantine Publishing Group, October 1999
[3] ibid, page 391
[4] ibid page 391

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