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The Supply-Side Revolution Was Good For Economics and the World

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The award of a US Presidential Medal of Freedom is usually an uncontroversial affair. Yet President Donald Trump's honouring of the "godfather of supply-side economics" Art Laffer sent some economists and the US left into apoplexy.

Nobel Prize winner Paul Krugman branded Laffer a "crank" and a "charlatan". Others dismissed Laffer's "theory", or revived claims he represented "voodoo economics".

Reading the ensuing debate, neither Laffer's biggest cheerleaders nor fiercest critics do justice to his ideas and impact. The effect on global tax policy of Laffer's "supply-side" school is indisputable. Economies across the globe followed the US in slashing top tax rates on income and profits.

The top US income tax rate was 70pc when Ronald Reagan was elected, but now stands at 37pc. In the UK, the top rate fell from 83pc in 1979 to 45pc today. Across the whole OECD, top income tax rates fell from an average of just under 70pc to 40pc, while the average corporate tax rate tumbled from 48pc to just 23pc.

Art Laffer and his famous curve were a big reason why. Drawn on a napkin for politicians Donald Rumsfeld and Dick Cheney in 1974, Laffer illustrated an obvious economic truth with a hump-shaped graph.

Taxing someone at a 0pc rate gets you no revenue. Neither does taxing someone at 100pc, given they would have no incentive to work. Between these extremes, a marginal tax rate hike has two effects.

First, paying the higher tax rate for a given amount of earned income raises revenue. But, second, the higher rate reduces the incentive to work, produce or declare income, shrinking the economy and/or revenue. At some tax rate these two counteracting effects on receipts are exactly equivalent, maximising revenues. Tax rates set beyond this are self-defeating for closing budget deficits, since the incentive effect dominates.

Incentives matter and taxes change behaviour. Deny it? Then why do people advocate carbon taxes, sugar taxes and excise duties on tobacco.

People who say Laffer's ideas are some sort of "myth" are talking nonsense. In fact, so internalised are supply-siders' ideas now that the UK government outlines both "static" and "behavioural" revenue estimates for tax changes.

The coalition justified raising the top capital gains tax rate to 28pc and lowering the top income tax rate from 50pc to 45pc precisely because they estimated revenues would be maximised.

Laffer, as a policy entrepreneur and public communicator, helped popularise with his curve important tax policy principles we now take for granted.

Incentives matter. Marginal tax rate cuts raise GDP by increasing the potential size of the economy. Good tax reform broadens tax bases and lowers marginal rates. The revenue impact of a tax cut depends on how easily those affected can change behaviour.

All these insights have improved policymaking. They were especially critical in the Eighties, when tax cuts and deregulation helped offset the demand-sapping efforts to reduce inflation.

Why then does Laffer's name today invoke such ire?

Economists' main beef is the bastardisation of these ideas by the right. Self-declared supply-siders, and sadly Laffer himself, often exaggerate the growth impact of tax cuts, implying more often than justified that they "pay for themselves". Top income tax rates in the Seventies were often on the Laffer curve's downward slope.

Few reputable economists would say though that across-the-board income tax rates today would be self-financing. Yet many Republican politicians made precisely that claim when justifying their 2017 tax reform.

This clear mis-selling, easily empirically falsified, has contributed to larger structural US deficits. That has emboldened commentators who say the Laffer curve is just a faulty "theory" – an intellectual veneer for pro-rich tax cuts. But left-wing critics go far too far in their denunciations.

Current top rates on transactions (capital gains tax and stamp duty) probably have a big enough impact on activity to be near-enough self-defeating in the UK. Some claim the additional 45p income tax rate, applying as it does to highly mobile people with sophisticated accountants, loses revenue too. Even if tax cuts aren't self-financing, the economic impact of cutting them might be desirable.

People wrongly label the "revenue-maximising tax rate" the "optimal tax rate". But if your aim is robust economic growth rather than maximising money for government spending, you would want tax rates far to the left of the peak of Laffer's curve.

This idea is not "trickle-down" – the belief that leaving the rich more money to spend will filter out to the economy. It's the same supply-side argument that all economists recognise: tax rates affect incentives to work or produce, and so affect how much people work to earn income in the first place.

Art Laffer has been too Panglossian about these growth and revenue impacts of tax cuts from lower levels in recent years. Arguably, some supply-siders have always exaggerated them, even in the Reagan era.

Critics have a point that this has filtered out into an incorrect view about what tax cuts can achieve among many conservatives. Yet Laffer's ideas had important application to maintain growth in the transition to low inflation in the Eighties.

They generated a global tax revolution, and the concepts he and others popularised became the bedrock of good tax policy for practitioners. Supply-side economics, on net, has improved both economics and the world for the better.

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