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The Real 'Laugher' Curve
The Real 'Laughing' Curve

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Abstract

In the early 1980s, a new economic paradigm embodying 'supply-side' doctrines was instrumental in shaping many of President Reagan's economic policies. A key component of the supply-side ideology was that reductions in individual federal income tax rates could lead to greater federal government tax revenues, and reverse the trend of growing federal budget deficits. The proposed relationship between tax rates and tax revenues was commonly displayed in a graph called the Laffer Curve. Unfortunately, the postulated revenue benefits never materialized, the federal budget deficit swelled to record levels, and 'supply-siders' quickly exhibited chameleonic traits. This paper presents a reconstructed Laffer Curve reflecting the actual budget outcomes that resulted from the tax policies implemented in the prior two decades.

JEL Classification Code: H24, H39, H62
Key Words: fiscal policy, tax rates, budget deficits

Introduction

In the late 1970s, Arthur B. Laffer, a distinguished professor at the University of Southern California, was the chief architect of a new paradigm in economic theory called 'supply-side economics.' In its broadest form, supply-side economic doctrines suggested that policies designed to enhance the supply of labor, goods, or services often would be cost efficient as output or revenue

* The Real 'Laughing' Curve. The purpose of this note is to provide an amusing parody of a former key component of the ill-fated 'supply-side' economic paradigm known as the Laffer Curve. It is intended to be a somewhat 'tongue-in-cheek' slightly satirical appraisal of the original highly publicised Laffer Curve. Although based on public taxation and revenue principles, this non-technical, empirically based, and hopefully entertaining short comment is quite timely given the recent US tax cut legislation. It is written for a wide audience, has multi-disciplinary appeal, brings into question current economic policy based on conventional doctrines.
gains would more than offset the cost and consequences of policy implementation.

In particular, Laffer argued that individual federal income tax rates were too high, and that lowering marginal tax rates would generate greater tax revenues to the federal government. The underlying premise supporting this contention was that as personal disposable income rose as tax rates fell, the added spending would catalyze the traditional multiplier process further boosting personal income and spurring even greater incremental spending and so on. The postulated end result of lower tax rates was that the resultant income growth would provide a larger income tax base generating greater federal government tax revenues. This postulated elastic relationship between tax rates and tax receipts was simplistically reflected in a graph called the 'Laffer Curve' as displayed below in both its conventional forms:

![Figure 1: The Laffer Curve](http://epubs.scu.edu.au/jesp/vol8/iss2/1)

During the 1980 presidential election, Ronald Reagan wholeheartedly embraced the Laffer Curve implications, and successfully campaigned on a platform anchored by across-the-board tax cuts (Dr Laffer was a member of the Economic Policy Advisory Board for both of Reagan's terms). However, in a deft political move, Reagan secured a greater tax break for individuals at the upper end of the income spectrum by reducing the 'effective' capital gains tax
from 28 percent to 20 percent on long-term investments held over one year. At that time, only 40 percent of long-term capital gains were subject to income tax (60 percent tax-free); whereby individuals in the highest 70 percent marginal tax bracket paid an effective 28 percent on these gains (40% x 70% = 28%). The 'effective' capital gains tax was reduced to 20 percent by slashing the highest marginal tax rate from 70 percent to 50 percent, a rather clandestine and well camouflaged rate reduction that far exceeded that of all the other tax brackets.

Given that individuals at the top 1 percent of the income spectrum pay approximately one-third of all federal income taxes, the generous rate reduction for upper-income taxpayers should have alerted government policymakers of impending federal budget shortfalls in the ensuing years. Subsequent tax legislation enacted in Reagan's second term (the 1986 Tax Reform Act) pushed the highest marginal tax rate even lower to 28 percent. This tax legislation became infamous for creating the tax rate 'bubble' which provided an income threshold above which the marginal tax rate fell from 33 percent to 28 percent. Under pressure from Congress, whose constituents belatedly realized this unprecedented 'quirk' in the normally progressive tax structure, George Bush Sr. grudgingly endorsed the antithetically named Deficit Reduction Act of 1990 - simultaneously breaking the 'bubble' and his 'read my lips, no new taxes' pledge which contributed greatly to his failed 1992 re-election. Spearheading a highly unusual, unorthodox, and politically precarious movement to raise taxes on the wealthy, Bill Clinton surged to victory in 1992 and subsequently created two new marginal tax rates – 36 percent and 39.6 percent - imposed on higher level incomes.

The resultant impact of this series of highest marginal tax rate reductions and subsequent gradual and partial retraction on the federal government budget position is clearly reflected in the graph below; respectfully but facetiously named the 'Laugher Curve' when viewed with the caricature embellishments:
The Real 'Laugher' Curve

Sadly, the projected government revenue gains envisioned by 'supply-side' enthusiasts and modeled by the Laffer Curve never materialized (the Laffer Curve in 'frown' format probably best captures the mood of 'supply-siders' as these doctrines were quickly dispelled by reality). In spite of (or possibly because of) the lack of empirical confirmation, the creation of the Laffer Curve was deemed a 'memorable event' in financial history by the *Institutional Journal of Economic and Social Policy, Vol. 8, Iss. 2 [2004], Art. 1*
Investor in its 1992 issue, 'The Heroes, Villains, Triumphs, Failures, and other Memorable Events'.

What has become quite apparent and clearly portrayed by the 'Laugher Curve' is that reductions in marginal tax rates on the wealthiest individuals generated government revenue shortfalls and burgeoning budget deficits; while increases in the highest marginal tax rates contribute mightily to shrinking deficits and eventual budget surpluses. Unfortunately, this economic and fiscal reality apparently was not acknowledged or embraced by the current Bush administration, as they determinedly pushed highly questionable fiscally irresponsible tax cut legislation through a reluctant and resistant Congress in 2001. With tax rates scheduled to be pared in accordance with the timetable depicted below, it is hardly surprising to those that acknowledge the existence of the real 'Laugher Curve' that the 2002 budget surplus evaporated, with multi-hundred billion budget deficits forecast for future years.

Table 1: Scheduled Tax Rate Reductions

<table>
<thead>
<tr>
<th>Tax year beginning in:</th>
<th>28%</th>
<th>31%</th>
<th>36%</th>
<th>39.6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>27.50%</td>
<td>30.50%</td>
<td>35.50%</td>
<td>39.10%</td>
</tr>
<tr>
<td>2002 or 2003</td>
<td>27.00%</td>
<td>30.00%</td>
<td>35.00%</td>
<td>38.60%</td>
</tr>
<tr>
<td>2004 or 2005</td>
<td>26.00%</td>
<td>29.00%</td>
<td>34.00%</td>
<td>37.60%</td>
</tr>
<tr>
<td>2006 or later year</td>
<td>25.00%</td>
<td>28.00%</td>
<td>33.00%</td>
<td>35.00%</td>
</tr>
</tbody>
</table>

Although yet to be acknowledged by conventional textbook economic theory or given credibility by an emerging economic paradigm, those that respect doctrines unquestionably 'supported by the facts' hope that future economic and fiscal policies are governed by the implications of the real 'Laugher Curve'.