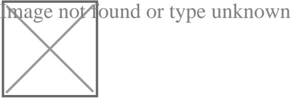



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Laffer’s Lessons

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*On 18 March 2015, the IPA was delighted to host Dr Arthur Laffer, a well-known economist and creator of the Laffer Curve, who also served as Reagan’s economic adviser during his presidency. Reagan’s presidency, renowned for its pro-freedom, reformist agenda, created conditions for the largest peace-time expansion of the US economy.*

*IPA guests and members were treated to a wonderfully entertaining speech from Dr Laffer. This article is a heavily abridged version of his speech. The full transcript and a video of the speech is available from the IPA website.*

I’m going to have a little bit of fun with you tonight, if I may. Is that alright? We’ll have a little fun, and we’ll wander over a little economics. I’m going to take you through two battlegrounds. The first is ‘tax the rich’.

We put in a progressive income tax in the US for the first time in 1913, the tax rate on the rich going from 0 to 7 per cent. Tax revenues from the top 1 per cent of income earners went up. But they never went up again. Even by 1919, when they’d raised the highest tax rate from 7 per cent to 77 per cent, tax revenues did not increase.

The war finished and Harding and Coolidge cut the highest tax rates from 77 per cent to 25 per cent. Tax revenues from the top 1 per cent as a share of GDP went through the ceiling.

In the 1930s Herbert Hoover signed into law the biggest tax increase on traded products in US history and the highest marginal tax rate went from 25 per cent to 63 per cent. He put in the estate tax for the first time and increased excise taxes. The economy went down—bang!

Then FDR raised the highest marginal tax rate from 63 per cent to 83 per cent. Tax revenues from the top 1 per cent went down as a share of GDP. The inheritance tax went up to 90 per cent. They had a 25 per cent per annum retained earnings tax for businesses. Is it any wonder it was the longest, deepest depression in US history?

After World War II, John F. Kennedy cut the highest marginal tax rate from 91 per cent to 70 per cent and the corporate rate from 52 per cent to 48 per cent. Tax revenues in the top 1 per cent went up as a share of GDP.

Then we had the four stooges— Johnson, Nixon, Ford, and Carter. Tax revenues as a share of GDP from the top 1 per cent went down during that period. And then the clouds cleared, the sun shone forth on America, and Ronald Reagan was elected.

We cut the highest marginal tax rate from 70 per cent to 28 per cent and the corporate rate from 46 per cent to 34 per cent. I could go on. It wasn't just Reagan; Clinton was phenomenal. He pushed NAFTA through Congress against his own party and the unions. He cut government spending as a share of GDP by 3.5 per cent-more than the next four peacetime presidents combined. Welfare reform—the idea that you have to look for a job before you get welfare? That was Clinton.

When you raise taxes on the bottom 95 per cent, revenues go up; when you lower them on the bottom 95 per cent, revenues go down. Why? Rich people are different to other people. They're rich! They can hire lawyers, accountants, deferred income specialists, and politicians.

Rich people have the means and the ways. They can change the location, timing, composition and volume of their income. Rich people have options that are not open to other people and they don't like paying taxes they don't think are fair. They really adjust their behaviour.

This is Warren Buffet's story. In a letter to the *New York Times* he said he pays less tax as a share of his income than anyone in his office: 'I pay $ 7 million in taxes—you may think that's a lot but as a share of my income, that's not very much. That is only 17.4 per cent of my income'.

Now, he said his taxes were $7 million. So I divided that by 17.4 per cent and voilà! His adjusted gross income is about $40 million. In 2010, Buffet had a wealth increase of $10 billion. He gave the Bill and Melinda Gates Foundation $1.75 billion. So if you look at Buffet's income in 2010, he made over $12 billion. And his tax payment was $7 million. His tax percentage wasn't 17.4 per cent. He paid 0.06 per cent of his income in taxes.

The next battleground is stimulus spending. Incentives matter. If you tax people who work and you pay people who don't, you're going to get a lot of people not working. If you tax rich people and give the money to poor people, you're going to get lots of poor people and no rich people.

Total stimulus spending after the GFC in the US was about $3.75 trillion; as a share of GDP, government spending went from about 30 to 39 per cent.

I'll give you the Larry Summers logic. If you give someone an additional $600, that person will spend more than they otherwise would have if they didn't have this money. That will create jobs, output, production and income for those people. According to Summers, spending the $600 stimulates the economy. As far as he went, he's right. If you give a person an additional $600 they will spend more and there will be a cascading effect as the spending recipient—the transfer recipient—is stimulated.

But that's only the first chapter. The second chapter starts with, 'The tooth fairy no longer works at the US Treasury'.

The Treasury doesn't create resources. The Treasury redistributes resources. Government redistributes. For every transfer recipient there is a transfer payer. It's a double-entry accounting system. The income effects always offset each other. They sum to zero.

This is economist Léon Walras' idea. In his example, if the price of apples rise, apple growers will be wealthier, have higher incomes and spend more money. But it's equally true that if the price of apples rise, apple consumers will be poorer, have lower income and spend less. The income effects offset each other.

If you have 100 apples in the economy and you give ten of those to people based upon some characteristic other than work effort, those people will be stimulated. But the people who had 100 apples now only have 90. They will be de-stimulated. While the transfer recipients are stimulated, the transfer payers are de-stimulated. Those two effects offset each other completely.

It's hard to see in an economy of 335 million people. But if it's good economics it works in an economy of 330 million people, one of 30 million, and one of two people. The difference in a two-person economy and a 330 million-person economy is that you understand what's happening in the first. Imagine we have two farmers: Farmer 'A' and Farmer 'B'. Imagine Farmer B gets unemployment benefits. Who pays for them? Farmer A. The income effects always equal zero. That's chapter two: 'There is no stimulus in a stimulus package'.

Now chapter three gets ugly. While the income effects equal zero, the substitution effects don't. They aggregate. If the price of apples rise, it does two things for both apple producers and apple consumers.

The higher price of apples incentivises suppliers to supply more and demanders to demand less. The substitution effects work across all people in the same direction. And the same is true with the substitution effects of a stimulus package.

In 1974, I was testifying before Senator Nelson of Wisconsin. I was trying to explain the substitution effect and I got so frustrated I said, 'Senator Nelson, if the other economists are correct, what's wrong with you? Why only $600? Don't you love our country? Let's get a boom! Let's do $6,000! Let's do $60,000! Let's do $600,000! Let's do a stimulus package equal to 100 per cent of GDP so all those who work and produce receive nothing and all those who don't work receive everything. Senator, what do you think would happen to GDP?' He answered with: 'Go to zero'. The substitution effects of a transfer are exactly what Milton Friedman said: government spending is taxation. And the larger your stimulus package, the larger your government spending, the larger your tax is.

This is today's political battleground: what are the roles of government? My view has always been do no harm. When you look at it from the pro-growth agenda, there are five key points.

You want a l**ow-rate, broad-based, flat tax** so you give people the least incentive to evade, avoid or not report taxable income rate. Warren Buffet should pay taxes. And he should pay the same percentage as everyone else across the board. It should be a flat rate.

**Spending restraint.** Milton's right. Government spending is taxation.

**Sound money.** There is nothing that can bring an economy crashing quicker than unsound

money. In the 1980s, the prime interest rate in the US was 21.5 per cent. We had double-digit inflation. Today we have the opposite. Quantitative easing has pushed interest rates to almost zero. When interest rates are too high, they discourage people from buying homes; too low, they discourage people from lending mortgages. In both cases you get less homes. The right price is the equilibrium price in a free market.

**Free trade.** There are some things we do better than foreigners and there are some things they do better than us. We are foolish if we don't sell them products we make better than them in exchange for products they make better than us. It's a win-win situation. Without China, there is no Walmart. And without Walmart there is no middle or lower-class prosperity in the US. Free trade is essential to economic prosperity.

Lastly**, minimal regulations**. You can't wake up in the morning and decide which side of the street you're going to drive on. You need some regulations. But you mustn't go beyond the specific purpose at hand and do a mass of collateral damage to the economy.

A low-rate, broad-based, flat tax. Spending restraint. Sound money. Free trade. Minimal regulations. Then get the hell out of the way and let the market solve itself.

It took Jimmy Carter to create Ronald Reagan. And in the same sense it took Jimmy Carter to create Ronald Reagan, you cannot imagine the great president who is going to follow Barack Obama.