LOWER TAXES, HIGHER REVENUE

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Let's discuss an important concept from economics, the Laffer Curve.

This concept is named after the man who developed it, Arthur Laffer, a major American economist who has taught at the University of Chicago, University of Southern California, and elsewhere.

The Laffer Curve illustrates the two most important things we need to know about taxes: how much money the government can raise from taxes and at what level of taxation the government might start getting less, not more, revenue.

The Laffer Curve is illustrated here by a two-dimensional graph. The horizontal line is the tax rate that the government chooses, and the vertical line is the revenue that the government receives from that tax rate.

First, because zero times any number is zero, if the tax rate is zero, then the government receives zero revenue. Accordingly, zero-zero is our first point on the curve. Now suppose the government chooses a very small tax rate, say 1 percent. The government will then begin to receive some revenue from citizens. This means that another point on the curve must be something like this. Now suppose the government charges a 2 percent tax rate, then everyone would agree that it will receive even more revenue -- which means that another point on the graph must be something like this. And if the government keeps raising the rate, then revenue will continue to go up. at least when we're in the low-tax-rate part of the graph.

This means that if we fill in the curve, it has an upward slope -- at least when we're in the low-tax-rate-part of the graph.

Now suppose the government charges a 100% tax rate. If this happens, then no one would work. That is, why would anyone work when the government is going to take all the money that they make? And if no one works, the national income would be zero. This means that government revenue would be 100% of zero, or zero. This means that another point on the curve must be here.

Now let's complete the curve. When we do, we see that the curve must have a hump. That is, it could look like this, or this, or this, but it has to have a hump. This is simply because the revenue line has to go up in the low tax-rate part of the graph and has to start going down to reach the point we drew at the 100% tax rate.

But if the curve slopes downward it implies something remarkable -- something that few of

those who push for higher and higher taxes want to admit. It means that when tax rates are high, if you make them higher, you'll actually bring in less revenue to the government.
This has in fact occurred in practice. For instance, during the Great Depression, when Congress passed the Hawley-Smoot tariff bill, although the bill raised taxes on imported goods, the revenue that came from those taxes actually decreased. A more recent example occurred in the early 1980s. After President Reagan and Congress drastically reduced the tax rates on the rich, the tax revenue that came from the rich actually increased.

All economists -- even the most leftwing ones -- agree that the true Laffer Curve, the one that reflects real life, has a hump, and that therefore the curve has a downward sloping part, meaning at some point tax revenues start going down when you increase rates. So where, then, do economists disagree? They disagree about exactly where the hump occurs.

When I took my first economics class, in 1984 at Stanford University, the textbook said that the hump occurs somewhere around the 70% tax rate. But apparently was I taught something wrong! New evidence from an unexpected source suggests that the hump occurs at a much lower tax rate, something around 33 percent.

That source is a study by Christina Romer and her husband David Romer. Both are economics professors at the University of California Berkeley. Christina Romer was the chairman of President Barack Obama's Council of Economic advisors. In other words, the study was written by one of the most influential liberal economists in the United States. And it was published in the American Economic Review, the most widely respected economics journal in the world.

The study examined how national income responds to tax rates. But as far what concerns us here, they key point is, that if you do the math, the results imply that the hump on the Laffer Curve occurs where the tax rate is around 33 percent -- much lower than economists previously thought.

Let's now put these findings into political terms. They suggest that, no matter what your politics, you should not want tax rates to be above 33 percent. Obviously, conservatives and many moderates think rates should be lower than that. But even if you are an extreme leftwinger and your only goal is to make government as big as possible -- you should still oppose a tax rate higher than 33 percent. The reason is that, as the Romer and Romer study suggests, when taxes go higher than that, the government actually gets less money.

Everyone of every political persuasion should pay attention to the Romer and Romer Study and its important implications. They suggest that if we decrease tax rates, government revenues might actually rise.

I'm Tim Groseclose, professor of political science and economics at UCLA for Prager University.