NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

THE LAFFER CURVE

WHY HIGHER TAX RATES DON'T ALWAYS INCREASE REVENUES

Proponents of higher taxes often argue that tax rate hikes are needed because they will bring in more government revenues. Even the nonpartisan Congressional Budget Office (CBO) considers tax increases to be revenue enhancers when analyzing legislation using their "static" budget Models. This argument appears to have some mathematical logic to it – if a person making $100,000 paid a 40% tax rate instead of 35%, this would increase tax revenues from $35,000 to $40,000, right? Not necessarily.

Consider the harmful effects that tax increases impose on individuals and the economy. Tax increases reduce the money available for businesses to make new investments or hire new workers. Tax increases also reduce individuals' "disposable income" (income remaining after taxes), which tends to decrease consumer spending. Tax increases also alter people's incentives. When individuals get to keep less of their earnings from work, putting in extra hours becomes less attractive – the supply of labor and the amount of earned income shrinks as a result. Investors will invest less in new projects, ventures, and opportunities when the after-tax earnings of investments are lower. That which you tax, you discourage.

When spending, investment, and hiring slow because of higher tax rates, the economy as a whole slows as well. That means less income from labor and business revenue for the government to tax. The government is stuck with lower revenues, and individuals and businesses are left worse off. Unfortunately, this often leads government to hike taxes again in an attempt to raise more revenue and the whole system feeds back on itself over and over with higher taxes, less growth and lower revenues.

QUICK FACTS

- When the government raises taxes, it discourages individuals and businesses from engaging in the taxable behavior and, as a result, collects less revenue. That which you tax, you discourage.
- Four of the largest tax cuts in the last century actually increased revenue coming into the Treasury.

NOTABLE & QUOTABLE

"Let me make clear why, in today's economy, fiscal prudence and responsibility call for tax reduction even if it temporarily enlarged the federal deficit; why reducing taxes is the best way open to us to increase revenues."

- **President John F. Kennedy** (1)

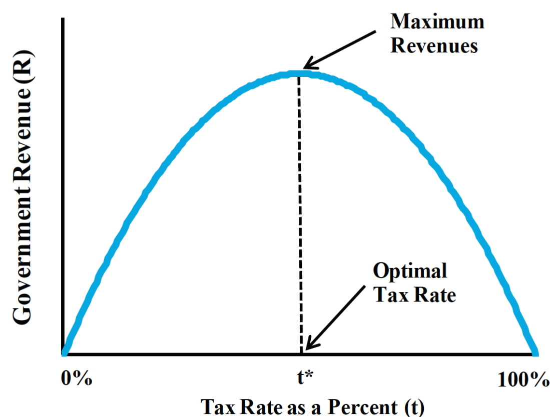
In 1974, economist Arthur Laffer created a graphic, dubbed the "Laffer Curve," to illustrate this basic concept: that tax increases, paradoxically, can actually depress government revenue collections. As you can see from the curve on the next page, tax increases obviously do increase government revenue, as expected, up to a certain point. However, at some point taxation becomes so burdensome that businesses and individuals stop engaging in taxable behavior altogether, causing total government revenues to decrease (2). Consider the following: how much revenue would the government collect is they taxed everyone at a 100% rate? Dr. Laffer's curve shows that they would collect no revenue at all. This makes sense of course because no one would bother to undertake a certain economic activity if they knew the government would take 100% of the profit.

The curve shows that somewhere between a 0% and 100% rate is a point where raising taxes does more harm than good, though Dr. Laffer's Curve does not specify what the optimal rate is.

THE LAFFER CURVE IN ACTION

There are a number of real-life examples of the Laffer Curve in action. It may seem counter-intuitive that cutting tax rates can actually increase overall government revenues, but in many cases that is precisely what has occurred.

President Ronald Reagan made substantial cuts in a number of tax rates in the 1980s (most significant was his 25% reduction in individual income tax rates for all Americans) (3). The rate reductions stimulated economic growth and ultimately increased overall government revenue. The opposite is true as well. The Cato Institute has shown that while both George H.W. Bush and Bill Clinton raised tax rates during their administrations, they saw a slower rate of government revenue growth (19.3%) than the tax-cutting Reagan did during his presidency (24.1%) (4).



Arthur Laffer created the Laffer Curve in 1974 to explain the paradox that tax rate increases can sometimes decrease overall revenues.

In 2003, President George W. Bush enacted tax reform that reduced capital gains tax rates from 20% to 15%. Because investment is particularly sensitive to tax rate increases or decreases, this tax cut stimulated a significant amount of new investment activity. Revenues from capital gains taxes more than doubled from $50 billion in 2003 to $103 billion in 2006, at a much faster rate than the CBO had predicted under its flawed "static" scoring method (5).

CONCLUSION

The Laffer Curve lends credence to the idea that economic freedom creates more prosperity. When individuals and businesses are less burdened by government through taxation, they are able to use their resources in ways that more effectively promote economic growth. Moreover, individuals and businesses are not the only ones that benefit from growth- government revenues increase as well when economic activity skyrockets.

Endnotes:
1. Thomas Sowell, Taxing Times, National Review Online (Oct. 29 2008) (http://www.nationalreview.com/articles/226127/taxing-times/thomas-sowell)
2. Stephen Moore and John Silvia, The ABCs of the Capital Gains Tax, Cato Institute (Oct. 4 1995) (http://www.scribd.com/fullscreen/31267939)
3. Stephen Moore and John Silvia, The ABCs of the Capital Gains Tax,Cato Institute (October 1995) (online at http://www.cato.org/publications/policy-analysis/abcs-capital-gains-tax).
4. Thomas Sowell, Capital Gains & `Trickle Down', Sun Sentinel (Oct. 2 2001) (http://articles.sun-sentinel.com/2001-10-02/news/0110010385_1_gains-tax-capital-gains-tax-shelters)
5. Stephen Moore and John Silvia, The ABCs of the Capital Gains Tax, Cato Institute (Oct. 4 1995) (http://www.scribd.com/fullscreen/31267939)
6. William McKenzie, What Barack can learn from JFK, Clinton and Carter about lower capital gains rates, The Dallas Morning News (Aug. 1 2008) (http://dallasmorningviewsblog.dallasnews.com/archives/2008/08/what- barack-can.html)
7. https://www.irs.gov/taxtopics/tc409.html

Americans for Prosperity Foundation's "Need to Know" informational series explores current events and recent scholarship on public policy isues from a free-market economics perspective. A full list of "Need to Know" briefings is available at www.AmericansForProsperityFoundation.org/NeetToKnow.
©2012 Americans for Prosperity Foundation. All Rights Reserved.