

# The Laffer Curve and the Failure of Stimulus Spending

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**Dr. Arthur Laffer**

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## About the author

Dr. Arthur B. Laffer is founder and chairman of Laffer Associates and was a member of President Reagan's Economic Policy Advisory Board for both of his two terms. Dr. Laffer also advised Prime Minister Margaret Thatcher on fiscal policy in the U.K. during the 1980s. He has been a faculty member at the University of Chicago, University of Southern California and Pepperdine University. Dr. Laffer received a B.A. in economics from Yale University in 1963. He received a MBA and a Ph.D. in economics from Stanford University in 1965 and 1972 respectively.

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## Executive Summary

- If there is a Republican administration after the November presidential elections, we can expect a significant change of policy on tax, spending and stimulus.
- There is a rich variety of data from the USA that demonstrates that raising tax rates often reduces revenues and vice versa. This is especially so when raising taxes from the high rates that we currently have.
- There are many examples over the last century when tax rates were reduced, economic growth increased and the proportion of the tax take from rich people increased.
- So-called fiscal stimulus policy does not work. A stimulus has to be financed and the income effects on those benefiting from the stimulus are cancelled by the “destimulus” from those financing it.
- To make matters worse, a fiscal stimulus will normally raise taxes – at least in the long term – and may well be used to provide benefits to those not paying taxes. This reduces work incentives, gives better off people incentives to hide income by avoidance and evasion and reduces economic growth. The better off are particular adept at finding ways not to pay taxes.
- During George W. Bush’s last two years in office the USA had the biggest ever increase in federal government spending in peacetime – from around 21 per cent of GDP to 27.5 per cent of GDP. The Great Recession began in that period.

## Lecture

We have an election coming up in November, and, obviously, it's President Barack Obama versus former Governor Mitt Romney, the presumptive Republican nominee, and it's a very different time today than it was four years ago.

Four years ago, it was hard to tell the players without a play-card. Both Barack Obama and John McCain took a day off so that they could go back to Washington and vote for TARP. TARP was the 'Toxic Asset Relief Programme'. Most of the Republicans voted for TARP, most of the Democrats voted for TARP. If you look at the issues back in 2008, you really couldn't tell a Republican from a Democrat. If you look at what George W. Bush did - we had a stimulus package in 2007 - add-ons to a housing bill and a farm bill to "stimulate the economy": deficit-financed stimulus spending.

And then, of course, in March 2008 we had the Larry Summers' famous \$600 per capita tax rebate. They called it a tax rebate but, of course, it wasn't really a tax rebate, because if you paid too much in taxes, they didn't give it to you but, on the other hand, you didn't have to pay any taxes for them to give it to you. You just received a cheque.

Then we had the bailout of AIG. That was about \$170 billion. Forgive me for rounding errors on some of these things. Then we had some asset swaps with Bear Stearns. Do you even remember that one? And then, of course, we had TARP. The bill Paulson gave to Congress that he insisted had to be passed in one day granted him total control over \$700 billion to spend as he saw fit to save the US economy. It was a four-page bill, but those are Congressional pages. Congressional pages have really wide margins, big print and large spaces between lines. It's about 100, 150 words per page max on a Congressional bill. So, it was maybe a 400-600-word bill that gave him \$700 billion with no hearings or any other oversight.

We then nationalised Fannie Mae and Freddie Mac followed by Barack Obama with his own plans. He had an \$862 billion stimulus package; Obamacare; and the Dodd-Frank Bill.

So, we had all this stimulus. At first, it was during the Bush years: there was no distinction between him and the Democrats. However, while you couldn't tell the players apart in 2008, this year, in 2012, the lines are drawn precisely and very sharply. I'm going to go through a couple of them with you because they're really fun issues.

Today, there is not one Republican who would vote for additional stimulus spending. In fact, there's

not one Republican who would ever admit that he or she ever voted for TARP. Republicans are, to a person, against any additional stimulus spending. The Democrats, to a person, are for additional stimulus spending. The divide has been really made very sharp and very clear. The divide is not just on stimulus spending but it is also on tax rates on the rich.

This election is probably the single most important election in my lifetime; maybe the 1980 election was right at the same level - but this one will be a huge determinant of future policy.

If the Republicans win, you will see something along the lines of Simpson-Bowles, where the tax base is going to be broadened substantially. We are going to have a much lower rate flat tax. You will see spending restraint: something along the lines of the Ryan Budget or 'Cut, Cap and Balance'. You are going to see monetary policy change dramatically, much more towards a sound monetary policy. And you are going to see trade move to a free trade type of model.

I think you'll see all that and I think you are going to see regulation reform in the US as well. We don't want regulations going beyond the specific purpose at hand and thereby doing a lot of collateral damage to the overall system.

So, what I think you're going to see in the US is a lower rate flatter tax, spending restraint, sound money, free trade and minimal regulations going forward.

But let me take further two of the issues that I think are really important: tax rates on the rich and stimulus spending. Those two issues have really, crystallised. If you look at the tax rates on the rich, President Obama has been arguing that we should raise them to fund programmes etc. These people have plenty of money, they can afford to pay a little bit more, it's only just and fair and we need the money badly, it is argued.

## Raising tax rates and reducing revenues

Let me take you through the Republican view of this. Rich people don't like to pay taxes. That may in fact be why they're rich. We have had a long experience in the US on tax rates and the rich. We put in the progressive income tax in the United States in 1913. When we put in the progressive income tax in 1913, the highest marginal tax rate was seven per cent. Seven per cent was the tax rate on the rich.

I want to stipulate today, just so no-one has any ambiguities in relation to my views, that, by raising the highest rate from zero per cent to seven per cent, tax revenues on the rich went up. Now, let me take you through what happened after that. By 1919, Washington had raised the highest tax rate on the rich to 77 per cent.

After the War, Woodrow Wilson picked his candidate to run for president. He was the governor of Ohio, a man named James Cox. Cox picked his best friend to be his running mate, New York Governor Franklin Delano Roosevelt (FDR). So, the race of 1920 was James Cox and FDR versus Warren Harding and Calvin Coolidge. The issue was exactly the same issue we face today: tax rates. Calvin Coolidge and Warren Harding ran on a slogan of "a return to normalcy," which meant cutting tax rates back to their pre-World War I level. Harding and Coolidge beat Cox and Roosevelt by the largest percentage ever in US history. It was a landslide victory. Let me now tell you what they did once in office.

They cut the highest income tax rate in America from 77 per cent to 25 per cent.

We have magnificent data on taxes including data on tax revenues from the top one per cent of income earners. Now, as you know, in the US, as opposed to the rest of the world, we had a boom during the Harding-Coolidge period. It was called the 'Roaring Twenties,' a huge economic expansion. If you look at the tax revenues from the top one per cent of income earners, as a share of GDP - not just in dollars but as a share of GDP - tax revenues from the top one per cent of income earners went through the ceiling during the Roaring Twenties.

Then, as you know, we had a period of Herbert Hoover. He put in the Smoot-Hawley Tariff and signed it into law into May of 1930. And thus began the Great Depression. In January of 1932, we raised the highest tax rate on the top income tax earners from 25 per cent to 63 per cent. Is that a good enough rise for you in the middle of a depression? We were trying to tax ourselves into prosperity! Hoover lost the election in 1932: it was a landslide. Roosevelt came in. Roosevelt in 1935 realised he didn't

have enough money. He put through a tax bill in 1935 which raised the highest tax rate on income earners in the US from 63 per cent to 79 per cent and then on up to 83 per cent.

By the way, I'm missing a lot of other taxes in there. Roosevelt also put on a 25 per cent annual retained earnings tax, raised the inheritance tax. It went just on and on and on.

If you look at the data on taxes, tax receipts from the top one per cent of income earners, in spite of the fact that the highest tax rate more than tripled, actually declined during that period. In the 1920s, despite the fact that they lowered the top rate of tax from 77 per cent to 25 per cent, tax revenues as a share of GDP went up.

If you come to the post-World War II era – in January 1961, Jack Kennedy came into office, and the highest tax rate was 91 per cent on income earners. President Kennedy lowered that highest tax rate from 91 per cent to 70 per cent, cut the highest corporate tax rate from 52 per cent to 48 per cent. Just for some fun US history, Bob Dole voted against cutting the highest marginal income tax rate from 91 per cent to 70 per cent because he said we could not afford the revenue losses. I don't know if you find that humorous, but Bob Dole had never seen a tax increase that he didn't love<sup>1</sup>.

In this Kennedy period - the go-go '60s - there was a huge boom in the US economy. We have tax revenue data, and tax revenues from the top one per cent of income earners again went through the roof as a share of GDP.

Then we had a period which I like to refer to as the 'Four Stooges': Johnson, Nixon, Ford and Carter. They raised tax rates throughout that whole period. That's when I did the curve on the napkin for my classmate and friend, Dick Cheney and Don Rumsfeld at the Washington hotel. President Ford had proposed a 5% tax surcharge called the WIN program. I used the curve trying to explain to Chief of Staff Don Rumsfeld and his deputy Dick Cheney that they probably wouldn't get 100 per cent of the revenues they thought they were going to get from a tax increase.

If you look at that 16-year period, tax revenues as a share of GDP under those four presidents dropped. Then came Ronald Reagan. President Reagan took office on January 20th, 1981. In 1978, as a harbinger of the election, the US put in the Steiger-Hansen capital gains tax rate reduction. During the next 25-plus year period, we cut taxes on everything. Take a look at that period - from 1980 to 2007. In 1980, tax revenues from the top one per cent of income earners were 1.5 per cent of GDP. The top one per cent of income earners paid 17.5 per cent of all the income taxes in the US. Those were the numbers. Let's move now to 2007 - by the way, the trend is just a linear trend throughout this period; it bobbles and wiggles, but it moves in the same direction. By 2007, the top one per cent of income earners paid 3.2 per cent of GDP in income taxes. The share had more than doubled. If you look at total income taxes paid, the top one per cent of income earners paid 42.5 per cent of all the income taxes collected in 2007. This should not surprise you.

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<sup>1</sup> Bob Dole has run for the Republicans as a presidential candidate (1996), vice presidential candidate (1976) and was Republican majority leader in the senate (1985-1987).

Top income earners not only do not like paying taxes – like everybody else – but they also have the means to be able to hire people to help them around the taxes. They can hire lawyers, accountants and deferred income specialists. They not only have the means to minimise their taxes, they have the ways to do it as well. The highest income earners can change the location of their income. I moved from San Diego, California to Nashville, Tennessee seven years ago. Why? There is no state income tax in Tennessee. There is a state income tax by the way in California - it's really high. People can change the timing of their income. We have all sorts of provisions - IRAs, Keoghs, 410(k)s - that allow people to change the timing of their income to control the payment of taxes. If you look at Jack Welch's contract upon leaving GE, it's enormous and full of details and provisions relating to taxes. All these detailed things that he's paid in kind are driven by taxes.

Rich people can also change the composition of their income. Let me use the example of Warren Buffett. Warren Buffett is worth \$47 billion according to Forbes. At least at the end of 2010 he was. Now, if I had Warren Buffett's balance sheet in front of me, what would be on the asset side? He owns stock in a company called Berkshire Hathaway. He got that stock at very low prices long ago when it wasn't worth much and now it's appreciated dramatically. And his net worth, if you take out all the costs of exercise of his options, is \$50 billion in a form called 'unrealised capital gains'. Can any of you tell me what the tax rate is on unrealised capital gains? It's zero. Warren Buffett and virtually all of the top 500 wealthiest people in America have a large proportion of their income and wealth in very, very income tax-advantaged forms.

If you read Warren Buffett's 2010 letter to the *New York Times*, he wrote that he pays lower tax rates than his secretary. He wrote he paid nearly \$7 million in taxes and that represented 17.4 per cent of his income. So, his taxable income was about \$40 million. In that year, 2010, his net worth went from \$37 billion to \$47 billion and, in addition to that, he gave away \$1.6 billion to the Bill and Melinda Gates Foundation.

Now, the way I calculate income using the Henry Simon definition of income, is that his income that year was at least \$11.6 billion and he paid \$7 million in taxes, which means that he paid about six one hundredths of one per cent of his income in taxes. Do you think he recommended to Congress and the President that there should be a tax applied to unrealised capital gains? No!

What I'm trying to tell you is rich people have lots and lots of options to lower their taxes that middle and lower income people don't have. You shouldn't be surprised if you find rich people highly sensitive to tax rates. And they are. When you raise taxes on rich people, you collect less revenue. When you lower tax rates on rich people, they give up their lawyers or accountants, their programmes, and they actually pay their taxes on their income.

It is also worth mentioning that, not only will we reduce tax revenues from the rich if we raise tax

rates on the rich, but we will hurt the economy. I have, again, never heard of an economy being taxed into prosperity, but maybe I missed that in Econ 101.

## “Stimulus” spending

The second topic I want to cover is stimulus spending. Do you remember your Keynesian economics? Let me, if I can, describe deficit-financed stimulus spending. I am going to use Larry Summers' description of it. And I'm going to use it with regard to his proposal, which was made in March 2008, to give everyone a cheque for \$600.

He said: “If you give a person a cheque for \$600. That person is going to spend more than he otherwise would have spent had he not received that cheque for \$600.” It was argued that this would create jobs, output and employment by the people who are now going to supply him with the goods and services that he otherwise would not have purchased had he not spent the money. Those people who now produce the additional goods and services that he is now buying and that he wouldn't have bought had he not got the cheque, are going to have higher incomes than they otherwise would have had. And they will spend more. There is going to be this cascading effect through the economy.

Some of you may remember that the increase in spending per dollar of income that you get is the marginal propensity to consume. The multiplier is the total increase in output that we get when we sum the infinite series allowing for spending by those who receive the money in the first round, and the second round, and so on and divide it by the original stimulus spending. This can be written as  $1/(1 \text{ minus the marginal propensity to consume})$ .

That is exactly the logic. You can go through this with Bernstein-Romer's paper in January of 2009. They go through this exact model; that is what stimulates the economy.

Now, as far as it goes, that description is accurate. If you give a person \$600 more than that person otherwise would have had, he is probably going to spend a little bit more than he otherwise would have spent. That's true. That in turn will create more jobs, more output, more employment. That's true too: those people will have higher incomes and there'll be this cascading effect through the economy.

But that is only part of the truth. It is one chapter in a three-chapter story. Let me try to go through the second and third chapters with you.

Government doesn't create resources. Government redistributes resources. For everyone the government bails out, there is someone they put into trouble dollar for dollar. You can't bail someone

out of trouble without putting someone else into trouble.

If there are 100 apples and you take 10 of those apples and give them to people, based upon some characteristic other than work effort, the workers and producers who produced those 100 apples have 10 apples fewer than they otherwise would have had. It is the Slutsky equations which show the income and substitution effects of a change in the price or a transfer payment, if any of you remember that.

If you look at your Slutsky equation and sum it over an economy, the sum of the income effects in an economy is always zero. This was brought into economics by a French economist named Léon Walras. It was introduced into English by Lord Hicks in his wonderful book, *Value and Capital*.

The example I like to use is, “If the price of apples rises, it is very true that apple growers will be wealthier, they’ll have higher incomes and they will spend more.” That’s very true. But it’s equally as true if the price of apples rises, apple consumers will be poorer, they will have lower incomes and they will spend less. And these two effects will offset each other by the hour, by the day, by the week, by the month, by the year, to the 9,874th decimal place. There is no stimulus in stimulus spending - period. The stimulant to the transfer recipient is completely offset by the de-stimulant to the transfer payer. While the transfer recipient is known, the transfer payer in the case of a fiscal stimulus may not be easy to identify.<sup>2</sup> But believe me, they’ll know their income loss.

Imagine for a moment that we had a two-person world. Farmer A and Farmer B. That’s it, no one else! If Farmer B gets unemployment benefits, who do you think pays for those unemployment benefits to Farmer B? Farmer A is the correct answer. As my former colleague Milton Friedman used to say, “Government spending is taxation, pure and simple.” Governments, when they spend the money, not only add to demand, they also reduce demand by taking the resources from the rest of society. Good economics works just as well in a two-person world as it does in a 315 million person world. Good economics is scalable. The only thing that’s neat about a two-person world is you can actually see the results in a two-person world.

While the transfer recipients are stimulated, the transfer payers are de-stimulated, and these two groups exactly offset each other. But that is only the second chapter. The third chapter gets really ugly.

The third chapter has to do with the substitution effects. If you go back to your Slutsky equations and you sum the Slutsky equations in an economy, the income effects do net out to zero. But the substitution effects don’t net to zero. The substitution effects aggregate – they do not cancel out. The person you give the money to now finds a new way of getting resources without working. The substitution effect will cause him to work less. The person from whom you take the resources finds he get less resources for working than he otherwise would have and he works less as well. The substitution effects accumulate, causing everyone to work less.

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<sup>2</sup> Editor’s note: of course, it might be those who buy the government bonds that finance the deficit used to finance the tax cuts whose present consumption is curtailed. And it is then future taxpayers who service the debt who ultimately pay and suffer from the substitution effects (see below).

Back in 1974, U.S. President Gerry Ford tried to use the free lunch of stimulus spending in the form of a tax rebate. I and three other economists were testifying before Senator Gaylord Nelson from Wisconsin including Otto Eckstein, Paul McCracken and Gardner Ackley. The other three economists loved the programme and, of course, I didn't love it. I thought a tax rebate was nonsense. And I was trying to explain to Senator Nelson the substitution effects, and I just couldn't figure out an easy way of explaining it to make him really see it intuitively. So, finally, I said to him: "Senator Nelson, if these other three economists are correct, what's wrong with you? I mean, why would you only do \$600? That's just a little improvement in the economy. Let's have a boom. Let's do \$6,000, \$60,000, \$600,000, \$1 million, 100% of GDP. Imagine what would happen to the economy if the government gave everything to all those who didn't work and didn't produce and gave nothing to all those who did work and did produce. Senator, what do you honestly think would happen to output?"

So, the transfer recipients are stimulated and the transfer payers are de-stimulated and the substitution effects means the net effect of stimulus spending is always negative.

The reason why we have the Great Recession today is because of the stimulus spending not in spite of it. When the government undertakes all this stimulus spending, it not only doesn't improve things, it is the reason why things are as bad as they are today.

Milton Friedman is totally correct when he says government spending is taxation. I don't know if any of you saw my piece in the *Wall Street Journal*. I think it was about a week ago, where I looked at the US. During Bill Clinton's presidency, government spending fell a lot. Government spending as a share of GDP fell by more than the combined effects of the next four best presidents. Look at the boom we had under President Bill Clinton.

Consider President George W. Bush during his last two years in office when U.S. House Speaker Nancy Pelosi took over the House and US Senate leader Reid took over the Senate, we had the biggest increase in government spending in peacetime ever: a huge increase from 21 per cent plus of GDP to 27.5 per cent of GDP. Look at what happened to the US economy during that period. The Great Recession began.

I dare you to take a look at all those countries that did not go along with the deficit-financed stimulus spending in the last six years and look at how their economies have performed versus those that had large stimulus spending. Let me just say that this is the issue in the US election; it is clear, it is crystal clear. Not one Republican will vote for any additional stimulus spending; all the Democrats will. It is the most consequential election for many, many years. I can go through a lot of other issues with you on this election, but I have never seen an election more crystallised with regard to the brands of economics that's on offer.

## Questions and discussion from the floor

**Charles Vickers:** Looking back 43 years, would you say that you were now a wiser man or not? Would you say that you were sadder or happier? What would you attribute that to? If there's something you now know that you didn't know 43 years ago but you felt you would have taught us had you known it, what would that have been?

**Arthur Laffer:** I'm as happy today as I've ever been. You know, it ebbs and flows, but we are really making huge headway. I went back with you in this discussion to say that, at the end of World War Two, the highest marginal income tax rate in America was about 93%. When Kennedy took office, it was 91%. It has been coming down dramatically. Markets are much freer today than they ever have been.

**Quentin Langley:** You've come up with a politically convenient way for governments to raise more revenue. Aren't you worried that, as a result, governments will raise more revenue and spend it on stupid stuff?

**Arthur Laffer:** Yes, that's a good worry. You don't want to maximise revenues. That is not the role of government. What you want to do is really maximise the welfare of your electorate, of the people. And that would mean that you will always want tax rates way below where they would be on the revenue maximising position. You don't really ever want to be anywhere near that position.

And if you look at the UK today... The discussion about going from a 40p to a 50p tax rate. The evidence is so obvious about what happens to revenues. Or raising VAT from 17.5% to 20%...you know, the revenues aren't coming in; you're going to a double-dip. You have a second recession going on here.

Look at all the other taxes that these people have: property taxes, sales taxes, payroll taxes, all these other taxes that are lost in addition to the revenues that didn't come in because people reduce employment when tax rates are higher or they leave the country. I would guess that the revenue loss is a multiple of what these people are saying. Not only is the revenue loss a multiple,

but having a slower economy means you have more people unemployed, more people in poverty and more welfare spending. You know, that's not what you want to do. And so, when I look at a country, my first thought is not: "What is the maximum revenue tax?" My first thought is, "How do you create prosperity?"

What you do is you look at the benefit of spending an additional dollar and you compare it with the cost of raising an additional dollar in taxes. And you want to make that benefit a smidgeon higher than the cost of raising that additional dollar in taxes; and it is at that level that you stop spending. That is where you stop.

If you tax rich people and give the money to poor people, you're going to get lots and lots of poor people and few rich people. The dream in this world has always been to make the poor rich, not to make the rich poorer. You balance up not down. There's nothing wrong with being rich. But there's something desperately wrong with being poor. What you want to do is cure the poor problem, not create a rich problem. And when you look at poor people, you know what the answer is, I know what it is. No-one ever becomes prosperous on handouts. That doesn't happen.

The best form of welfare is still a good high-paying job, and you can't love jobs and hate job creators. You just can't do it.

**David Brand:** Socialists often talk about the multiplier effect of stimulus spending. In practice, what do you think that value is? And, connected to that, what percentage of such stimulus is taken by government bureaucracy?

**Arthur Laffer:** The multiplier is zero. It is zero. With the research and everything, the stimulus to the transfer recipients, as I said, is offset by the de-stimulus elsewhere. There is no stimulus in the stimulus package.

Now, if you go to the Bernstein-Romer paper, they go through all the literature of all the multiplier effects and all that and they come to a consensus multiplier. If you remember what they did was they then did an estimate of the increase in output from the \$862 billion stimulus package that Obama proposed. They then spread it over a number of quarters. So they took that, they took a multiplier...I forget what it was 1.7 or something like 2. Then they used Okun's Law and they worked it backwards to see what the increase in employment would be and then what the reduction in the unemployment rate

would be.

If you look at their numbers, they said that by now we would be down to an unemployment rate of around five per cent. They missed. I don't want to criticise them for doing the paper. If you're an economist, you should say what you think actually will happen, you should do a paper on it and do an unconditional forecast to allow people to come back and evaluate whether you were right or not. There's nothing wrong with being wrong in the broad sense of the word. That's how knowledge goes forward.

So, I'm not criticising Romer and Bernstein for doing the paper. What I am saying is that the model doesn't work, and it has not worked here either.

**Male speaker:** Both the US and UK governments have gone on a binge of printing money called 'quantitative easing'. I'd be curious to know your views on (a) did the first £200 billion really work and was it the right thing to do; and, if it was, was the subsequent printing of the next £125 billion worth it?

**Arthur Laffer:** Yes, I assume they are the UK numbers. In the US, we did a lot more than that. So, excuse me, I shall use US numbers. In August or September 2008, the monetary base of the US, which is currency in circulation plus member bank reserves, was about \$840 billion. Of that, about \$10 or \$11 billion was reserves, member bank deposits held at the Fed and at about \$830 billion was currency in circulation.

We have had two rounds of quantitative easing: Quantitative Easing 1, Quantitative Easing 2, and then we had Operation Twist. It was all done by Ben Bernanke.

Today, the balance sheet of the Fed is maybe somewhere of the order of between \$2.7 trillion and \$2.8 trillion. The currency in circulation has gone from around \$830 billion to around \$1.1 trillion. So, we have reserves held at the Fed of perhaps around \$1.5 trillion, an increase from \$10 billion. We've expanded reserves not only by more in percentage terms than any time ever in our history, but expanded it nearly 150 times. It's a huge expansion.

We have basically monetised Treasury debt. If you look at the balance sheet of the Fed now, they own a huge proportion of all long-term bonds in the US. With Operation Twist, they sold short-term bonds and they purchased all the long-term bonds to try to keep those rates down.

That is exactly what's happened. My fear, of course, is that you can't keep going forever. In fact if you ever saw interest rates up again, let's say from 1.5 per cent on the 10-year bond to maybe 7 per cent or more, you would have a capital loss on the Fed's balance sheet of about \$1 trillion. The Fed would technically be insolvent to the amount of about \$1 trillion. That's not a bail-outable number. It really isn't, and what you've got is a real problem.

**Paul Bowes:** What is your view on a general anti-tax-avoidance provision?

**Arthur Laffer:** Tax policy doesn't work, unless you get the implicit approval of the taxpayers. There has to be voluntary compliance. Now, you're always going to get some person who cheats. But, you know there are two types of incentives in this world. There are positive and negative incentives. By way of illustration, if you beat a dog you have no idea where the dog is going to be. By beating the dog, the dog's going to run. But you don't know where it's going to run. If on the other hand, you feed a dog, the positive incentive, you know exactly where the dog will be. Positive incentives tell people what to do and negative incentives tell them what not to do.

Taxes are like beating the dog. Do you know what people will do? They will not report taxable income. What you don't know is how they won't report taxable income. They'll use evasion, avoidance, underground economy, they'll go out of business, they'll move offshore, they'll do all these things to avoid reporting taxable income. So, what you want to do on taxes is levy the lowest possible tax rate on the broadest possible tax base so that you provide people with the least incentives to evade, avoid or otherwise not report taxable income and you give them the least places to which they can escape. And that's the optimum...

Yes, you're always going to get some person trying to avoid taxes, but, as long as it's legal, it's the way you should have it. You know, raising tax revenues is not cheap or costless. And it causes all sorts of distortionary behaviour amongst taxpayers that is far more expensive: they have additional expenses of hiring lawyers, accountants and audits and all that other nonsense and hiring IRS agents. So, you've got to be really careful to make sure you get as much a voluntary compliance in the code as possible.

In the US, I recommend that we have a federal, state and local tax amnesty programme along with a flattening tax and broadening base. You know, the IRS estimates that some 18 per cent of all income is shadow economy. I

don't know what it is here. I'm sure it's may be even higher than that. If you look at our total federal tax revenue alone, it is about \$2.5 trillion today. If you look at state and local taxes, maybe another \$1.5 trillion. So, you have about \$4 trillion worth of taxes every year, collected. Now if 20 per cent of that is shadow economy, that means \$800 billion is being lost by tax evasion, avoidance and so on.

If a person has been cheating for 20 years and not reporting income, he can't start paying his taxes this year as he will be investigated. He will carry on evading. My guess is that, if we had a federal, state and local tax amnesty programme, we would raise somewhere between \$800 billion and \$1 trillion in 90 days. That's a real big quick hit to that budget deficit.

If you want to raise revenues, you can raise revenues dramatically and very quickly. My view is that you want to raise taxes as much as you possibly can but not raise tax rates. You want to raise taxes by creating prosperity, growth, output and employment. You can't balance the budget on the backs of the unemployed. Tax them all you want, you still won't get anything. You need output employment and production.

**Rory Meakin:**

You've spoken a lot and made the case wonderfully for lower rates to improve the incentive effects and to get people working more and producing more. With the Institute of Directors, we've published a proposal for the single income tax, which radically simplifies taxes, particularly direct taxes. Can you let us know what you think about it?

**Arthur Laffer:**

Of course, a single income tax or something of that ilk is what we need. The one I worked on was Jerry Brown's tax in 1992. He was a liberal Democrat. The idea was that you get rid of all federal taxes and have two flat-rate taxes. I got rid of the income tax, the corporate tax, all payroll taxes for both employer and employee, Medicare, Medicaid taxes, capital gains tax, death tax, all of them. I would have got rid of, every single tax; well, with one exception, I would have kept sin taxes. The reason I would have kept sin taxes is that sin taxes are really not so much for revenue as they are to change people's behaviour. You know what I mean? We, Americans, for example, don't like drunk people smoking while they shoot each other.

If you had those two flat-rate taxes, made it static revenue neutral at full employment. If you did that, you could match all revenues with a rate of 11.8 per cent; and in most cases, people wouldn't even have to file a tax return.

**Female:** The most elegant underlying thought of economics is that it is the management of the household and we're not really doing that. Our ecology is in a state of despair, and there are a lot of problems with our environment and everything, and this is leading to rather illiberal conclusions on flogging the rich. And I was wondering what would your solution be in order to make sure that we take care of the things that sustain us?

**Arthur Laffer:** Let me tell you what I would do. If I had one thing I could do to ensure that politicians run the "household" correctly it would be this. If you had two companies, Company A and Company B. Identical companies, okay? Except there is one difference. In Company A, the officers and directors, have very high salaries, they own no stock and they have no stock options. In Company B, the officers and directors have low salaries, they have a lot of stock options, they own a lot of stock. Which one of those two companies would you like to invest in? Company B, of course.

The problem is the politicians don't have any skin in the game. They don't bear the consequences of their own actions. Mr Smith goes to Washington. He goes there imbued with human kindness; he works all day long; and he's able to bring inflation way down; interest rates way down; the unemployment rate way down; the employment rate and production soar; the stock market soars, prosperity abounds in the land; foreigners that are hostile to us wilt before our very eyes; the animals multiply in the fields; the fields turn green; the trees blossom; and the children are all dancing in the street. What happens to that congressman's salary? Nothing.

Now, his evil twin comes. Inflation goes way up; unemployment goes way up; interest rates go way up; prosperity diminishes; foreigners are at our borders with weapons; animals are starving to death out in the fields; the trees are bare and there is no fruit; and the little children are dying in the orphanages. What happens to that congressman's salary? Nothing.

You know, they don't bear the consequences of their own actions. So, if I had one policy I could enact and just one, I would take all government officials and put them all on commission. I would take a shadow portfolio of \$5 million. Every congressman, the day he or she takes office, you give them a shadow portfolio of \$5 million, you let them keep all the capital gains tax free, but hold them personally liable for all the capital losses. I guarantee you that they would never, ever, ever vote the way they do now. They don't have skin in the game and you've got the classic agency problem. I spend other people's

money a lot more freely than I'd spend my own money, and that's your household problem.



**Institute of Economic Affairs  
2 Lord North Street  
London  
SW1P 3LB**

**[www.iea.org.uk](http://www.iea.org.uk)**