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Did Arthur Laffer Throw a Curve at Fairness and Economic Prosperity?

Who Is Arthur Laffer? Arthur Laffer is an economist who gained much notoriety for developing a simple graphic representation of the relationship between tax rates and tax revenues called the "Laffer Curve." The Laffer Curve was one of the main underpinnings of the "supply side economics" doctrine espoused by President Reagan and his economic advisors in the early 1980s. Laffer was able to convince a number of politicians that you could actually reduce tax rates and raise revenue in one stroke. One journal article noted that "one of the great advantages of the Laffer curve is that you can explain it to a congressman in half an hour and he can talk about it for six months."[1] The notion that governments could raise more money by reducing tax rates is an intoxicating idea, but intensive research by economists since the Laffer Curve was developed has shown that his work was nothing but "smoke and mirrors." George H.W. Bush even derided the Laffer Curve as "voodoo economics." Laffer disappeared from the tax policy scene as his theories were being debunked. Now he's back, taking advantage of the current political climate, but focusing more on individual state tax systems rather than the federal fiscal situation.

Recent Laffer Sightings. Laffer has recently been active in Kansas, Missouri, and Oklahoma. He is a paid consultant of Kansas Governor Brownback, whose tax plan doesn't entirely eliminate the income tax but significantly cripples it by reducing the top rate from 6.45% to 4.9%, eliminating income taxes for roughly 191,000 businesses and abolishing the earned income credit. In Missouri, Laffer has testified in favor of the so-called "Fair Tax" proposal, which would eliminate both the personal and corporate income tax. In Oklahoma, his consulting practice, Arduin, Laffer, and Moore Econometrics, produced a report for the Oklahoma Council of Public Affairs called "Eliminating the State Income Tax in Oklahoma: An Economic Assessment." This report has become the research cornerstone for Governor Fallin's push to phase out the income tax. Laffer is also very active in getting so-called "Right to Work" legislation passed in states. He is being supported in his views by the American Legislative Exchange Council, Americans for Prosperity, *The Wall Street Journal* editorial board, and various other conservative groups.

Voodoo Economics, Part 2. Laffer's main argument for eliminating the income tax as a source of revenue for states is based on his own research comparing the economic performances of the 9 states with no income taxes to 9 states with high income tax rates.[2] The result of this comparative approach is evident in his testimony to the Kansas House Tax Committee on January 20, 2012:

> *"If you look at their performance over the last decade, those states without an income tax compared to the states with the highest income tax… the differences are huge. Those states without income taxes have grown much, much faster."*

In fact, the opposite is true. The Institute on Taxation and Economic Policy (ITEP) found that the 9 "high-rate" states identified by Laffer have actually experienced more economic growth per capita than the states having no income tax.[3] Moreover, ITEP discovered that median family income dropped less in high-rate states than in no-income-tax states and that average unemployment rates over the last 10 years have been essentially identical across both types of states. It turns out that Laffer's economic performance results are based on the comparison of total growth in gross state product and on total growth in employment, variables that are largely determined by population growth.

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[1] Uriel and Templeman. September 22 2004. "A Non-singular Peaked Laffer Curve: Debunking the Traditional Laffer Curve." *American Economist*.

[2] Arduin, Laffer, and Moore Econometrics. November 2011. "Eliminating the State Income Tax in Oklahoma: An Economic Assessment. Oklahoma Council of Public Affairs.

[3] Institute on Taxation and Economic Policy. February 2012. "'High Rate' Income Tax States Are Outperforming No-Tax States." www.itepnet.org.

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Did Arthur Laffer Throw a Curve at Fairness and Economic Prosperity? *(cont.)*

Most of the no-income-tax states had significant economic growth because they had significant population growth. That's why, when you measure economic growth on a per capita basis, as ITEP did, the no-income-tax states don't do nearly as well. Furthermore, population growth has very little, if any, connection with a state lacking an income tax. There are a number of states that do have progressive income taxes as well as strong population growth rates, including Oregon, Idaho, Georgia, and North Carolina. Lower housing costs, higher birth rates, immigration, and even climate are the main reasons population has grown in no-income-tax states.

One item missing from the debate over economic growth relates to rising income inequality. Too often a state's economy might grow, but all the growth goes to the top 1% or to multi-state corporations. Some say there is nothing wrong with growing income inequality in a free market economy. Unfortunately, as income inequality grows, it poses a drag on the entire economy. Power concentrates in the handful of wealthy people and big corporations. The wealthy and big corporations in turn influence laws in their favor, causing a cycle of misfortune for the rest of us. In the end, voters and communities become disengaged and divided. Income inequality in the 9 no-income-tax states was about 30% higher than those with income tax. The only way to create an economy that works for everyone is through a progressive income tax and investment in public education. Public schools are the only way out of poverty for many children.

Why States Need an Income Tax. The income tax has two critical attributes that contribute to fiscal sustainability and equity: progressivity and responsiveness to economic growth.

> Progressivity: A progressive or graduated tax is one in which the relative tax rate increases as the individual's ability to pay increases. The personal income tax is the only major state tax that is progressive. Unless it plays a major role in the state's tax system, the system is virtually sure to be regressive (imposing a greater burden on the poor and middle class).
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> Responsiveness to economic growth: The income tax is the only major tax whose revenue outpaces the growth of the economy. States need significant reliance on the income tax to offset the low responsiveness to economic growth of other taxes (e.g., the sales tax base has not grown nearly as fast as the total economy over the past 30 years). Without an income tax, states would face perpetual and detrimental structural budget deficits.

There are a couple of states – Wyoming and Alaska – that can afford not to have an income tax because of their abundance of natural resources and resulting large severance tax collections. It is worth noting that North Dakota, a state with an income tax and abundant natural resources, ranked first among all states in average unemployment rate and per capita state product growth between 2001 and 2010.

Conclusion. Perhaps legislators and governors buy into Laffer's no-income-tax or low-income-tax club because they believe that the cuts will pay for themselves in terms of overall economic growth. Perhaps these policy makers just want to help the wealthy. Then again, maybe they just don't have the legitimate research that demonstrates a state's economy won't grow simply because of a tax giveaway to the wealthy and to big corporations. It's time they faced the facts. The elimination of the personal and corporate income tax or a reduction in rates will undermine a state's ability to invest in public education and infrastructure. As the quality of education deteriorates, as roads crumble, and as income disparities grow the state's economy will only suffer.

The appeal of Laffer's analysis is that it is simple. The fatal flaw of Laffer's analysis is that it is simply incorrect

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