



*Acknowledged.
J. Kelly 31/3/08*

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Our Ref: JA/FG

Your Ref:

Date: 28th March 2008.

Mr. Jim Kelly,
Secretary,
Commission on Taxation,
Le Pole House,
Ship Street Great,
Dublin 8.

Dear Mr. Kelly,

Re: Invitation to make submissions.

I am an auditor, accountant and tax consultant in practice on a self employed basis for fifteen years and have extensive experience in dealing with taxation at the "coalface". I am acutely aware of how taxation affects small and medium sized business.

Using the parameters set out by you, I can comment as follows:

As regards resources to meet public services, the tax system and debates surrounding the tax system consistently fail to mention the "Laffer Curve" (see attached). It has been proven time and again that increases in the levels and rates of taxation do not necessarily increase the tax intake. In fact, the basis of the "Laffer Curve" is that often the reverse applies whereby cuts in tax rates increase the tax generated. The increased economic output generated by the tax cut together with reduction in levels of evasion more than compensate for the cut in rates/levels. I would be curious as to how many of our tax legislators are familiar with the "Laffer Curve". Not too many from what I have seen as they continuously talk about having to increase tax rates to increase tax take and this is an oversimplification. The most outstanding example of this concept in Irish taxation was the increase in the capital gains tax take following the cut from 40% to 20%.

There are two specific tax rates at the moment in the R.O.I. which are completely counter productive by way of raising revenue.

1. The 9% rate of stamp duty. There are now a plethora of stamp duty avoidance schemes. When stamp duty was at a maximum of 6% there were no avoidance schemes such as "resting on contract" and "building on licence". The increase in rates incentivised the need for avoidance schemes which are now costing the exchequer more than €250M per annum (Sunday Business Post 23/03/08). Furthermore, the 9% rate has driven millions of Euro abroad to be invested in U.K. commercial property.

Consultations Strictly by Appointment

Joseph G. Arkins F.C.P.A., F.C.C.A. John P. Kenny C.P.A.

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2. The top rate of income tax is activated at slightly above the average industrial wage (single person or married couple both working). This rate is the root cause of most income tax evasion and avoidance among the self employed. The principles of the "Laffer Curve" could be usefully applied here to increase the tax take.

In relation to the balance between taxes collected on income, capital and spending; in my view, the most equitable philosophy is that persons who work for their money should be allowed to keep it in so far as is possible and the shortfall, if any, may be bridged by taxing those fortunate enough to inherit a windfall to which they did not contribute a jot. In other words, increases in inheritance/gift taxes can be justified by cuts in the top rate of income tax.

Trusting my humble submission will be of assistance.

Yours sincerely,



Joe Arkins

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Laffer curve

From Wikipedia, the free encyclopedia

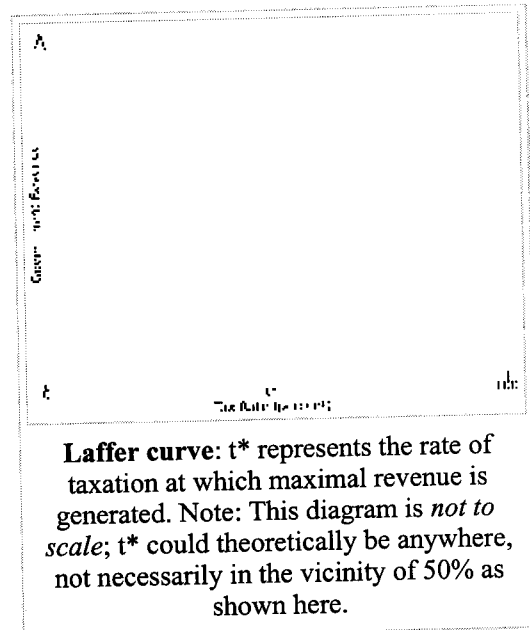
The **Laffer curve** is used to illustrate the concept of "taxable income elasticity", which is the idea that government can maximize tax revenue by setting tax rates at an optimum point and that neither a 0% tax rate nor a 100% tax rate will generate government revenue. The curve was popularized by Arthur Laffer (b. 1940), although the underlying principle was known since the time of Ibn Khaldun's *Muqaddimah* (1377). John Maynard Keynes, in his *General Theory of Employment, Interest, and Money*, described how increasing taxation past a certain point might lower revenue and vice versa.

[1] Libertarian economist Ludwig Von Mises wrote in 1949: "In the United States the recent advances in tax rates produced only negligible revenue results beyond what would be produced by a progression which stopped at much lower rates". [2] Other economists have questioned the utility of the Laffer Curve. According to Nobel prize laureate James Tobin, "[t]he "Laffer Curve" idea that tax cuts would actually increase revenues turned out to deserve the ridicule with which sober economists had greeted it in 1981." [3]

The Laffer-curve concept is central to supply side economics, and the term was reportedly coined by Jude Wanniski (a writer for *The Wall Street Journal*) after a 1974 afternoon meeting between Laffer, Wanniski, Dick Cheney, and his deputy press secretary Grace-Marie Arnett (Wanninski, 2005; Laffer, 2004). In this meeting, Laffer reportedly sketched the curve on a napkin to illustrate the concept, which immediately caught the imaginations of those present. Laffer himself professes no recollection of this napkin, but writes, "I used the so-called Laffer Curve all the time in my classes and with anyone else who would listen to me" (Laffer, 2004). Laffer also does not claim to have invented the concept, attributing it to 14th century Islamic scholar Ibn Khaldun and, more recently, to John Maynard Keynes.

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How the curve works

The curve is most understandable at both extremes of income taxation—zero percent and one-hundred percent—where the government collects no revenue. At one extreme, a 0% tax rate means the government's revenue is, of course, zero. At the other extreme, where there is a 100% tax rate, the government collects zero revenue because (in a "rational" economic model) taxpayers presumably change their behavior in response to the tax rate: either they have no incentive to work or they avoid paying taxes, so the government collects 100% of nothing. Somewhere between 0% and 100%, therefore, lies a tax rate percentage that will maximize revenue.

The point at which the curve achieves its maximum will vary from one economy to another and depends on elasticities of demand and supply and is subject to much theoretical speculation. Complexities arises when taking into account possible differences in incentive to work for different income groups and when introducing progressive taxation.

Arguments about the curve

Critiques commonly point out that socialist states, such as the U.S.S.R., have been able to derive revenues at a 100% tax rate, though they would have derived more if tax rates had been lower.^[4]

The extent to which these assumptions are true beyond the scope of the underlying mathematics is unprovable, as most economics takes place in the realm of political theory with implied objectivity that is impossible to prove or completely disprove. They nonetheless provide a basis for argument. You can "back into" a continuous curve by assuming the tax rate will be legislated with no more than a given number of decimal points. The resulting discrete function could then be interpolated with line segments, with the same result as the assumption of continuity.

Another contentious issue is whether a government should try to maximize its revenue in the first place. Moreover, the ideal level of taxation is dependent upon the use of government funds, as certain types of spending do more to encourage growth than others. The curve is primarily used by advocates who want government to reduce tax rates (such as those on capital gains) and believe that the optimum tax rate is below the current tax rate. In that case, a reduction in tax rates will actually increase government revenue and not need to be offset by decreased government spending or increased borrowing.

Context in U.S. history

The Laffer curve and supply side economics inspired the Kemp-Roth Tax Cut of 1981. Supply-side advocates of tax cuts claimed that lower tax rates would generate more tax revenue because the United States government's marginal income tax rates prior to the legislation were on the *right-hand*

side of the curve.

David Stockman, President Ronald Reagan's budget director during his first administration and one of the early proponents of supply-side economics, maintained that the Laffer curve was not to be taken literally — at least not in the economic environment of the 1980s United States. In *The Triumph of Politics*, he writes:

[T]he whole California gang had taken [the Laffer curve] literally (and primitively). The way they talked, they seemed to expect that once the supply-side tax cut was in effect, additional revenue would start to fall, manna-like, from the heavens. Since January, I had been explaining that there is no literal Laffer curve.

Critiques of the Laffer curve

Conventional economic paradigms acknowledge the basic notion of the Laffer curve, but they argue that government was operating on the *left-hand* side of the curve, so a tax cut would thus lower revenue. The central question is the elasticity of work with respect to tax rates. For example, Pecorino (1995) argued that the peak occurred at tax rates around 65%, and summarized the controversy as:

Just about everyone can agree that if an increase in tax rates leads to a decrease in tax revenues, then taxes are too high. It is also generally agreed that at *some* level of taxation, revenues will turn down. Determining the level of taxation where revenues are maximized is more controversial.

At least one empirical study, looking at actual historical data on tax rates, GDP, and revenue, placed the revenue-maximizing tax rate (the point at which another marginal tax rate increase would decrease tax revenue) as high as 80%. Paul Samuelson argues in his popular economic textbook that Reagan was correct in a very limited sense to view the intuition underlying the Laffer curve as accurate, because as a successful actor, Reagan was subject to marginal tax rates as high as 90% during World War II. The point is that in a progressive tax system, any given person's perspective on the validity of the Laffer curve will be influenced by the marginal tax rate to which that person's income is subject.

Supporting examples

Laffer himself, in article published at the Heritage Foundation, has pointed to Russia and the Baltic states who have recently instituted a flat tax with rates lower than 35%, and whose economies started growing soon after implementation. He has also referred to the economic success following the Kemp-Roth tax act, the Kennedy tax cuts, the 1920s tax cuts, and the changes in US capital gains tax structure in 1997 as examples of how tax cuts can cause the economy to grow and thus increase tax revenue.^[5]

Difficulties of measurement

The Laffer curve is a static model, in that it models an economy with identical productive capacity under two different sets of tax rules. In a dynamic economic model, economic growth is a relatively general phenomenon, and one would therefore expect tax revenue to increase over time even if the tax regime remains identical. This leads many to suggest that the common comparisons stated to support the Laffer Curve are an unfair test.

Others respond that, even if the Laffer Curve itself is a static model, a programme of tax cuts nevertheless provides incentives for innovation and investment, which will increase the rate of economic growth, as predicted by endogenous growth theory.

Also, the Laffer Curve is clearly a model assuming uniform tax rates across all income ranges. Since most governments do not have a flat tax rate the Laffer curve would not hold for them, although similar effects may apply, and so it is a useful simplification to think about.

Keynesian critique

Some economists argue that while tax cuts are beneficial to the economy, they are beneficial for different reasons. Keynesian economics suggests that an increased government deficit - for instance, resulting from a tax cut - will stimulate economic output. This leads some to identify instances of the 'Laffer curve' as periods of Keynesian demand stimulation.

The wrong incentives?

Some economists argue that, while it is correct to focus on the problems of incentives in the economy, the problem is not the general level of taxation. The inelasticity of labor supply means that tax rates will have little effect on labor. The focus of analysis should be on the effective use of the labor already available. These economists point to, for instance, principal-agent problems in ensuring staff have appropriate incentives for performance, rather than the level of tax the staff face.

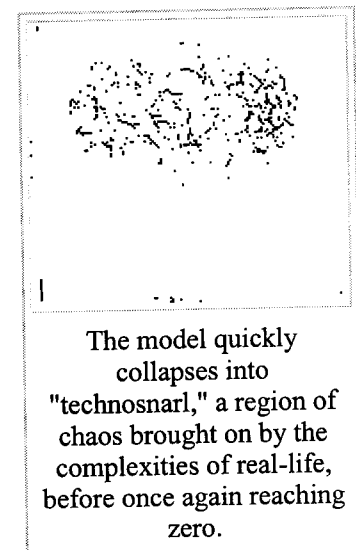
Incorrect assumptions

The Laffer Curve assumes that the Government will collect no tax at a 100% tax rate because, rationally, no person will choose to carry out work if they receive none of the economic return from that work. However some economists question whether this assumption is correct.^[4] For example, in classically structured Communist societies, there was an effective 100% tax rate and, whilst these societies may have been highly inefficient, people did continue to work to some extent.

The Neo-Laffer curve

A harsher critique of the Laffer Curve can be seen with Martin Gardner's satirical construct, the so-called neo-Laffer Curve. The neo-Laffer curve matches the original curve near the two extremes of 0% and 100%, but rapidly collapses into an incomprehensible snarl of chaos at the middle. Gardner based his curve on actual US economic data collected in a fifty year period by statistician Persi Diaconis.

The satire illustrates the major fallacy commonly committed with the Laffer curve, namely the assumption that the middle is a smooth, concave function merely because the two extreme endpoints are well-defined. A realistic tax curve would most certainly not resemble a smooth parabola or even any other simple function, but rather a very complex curve with many peaks, valleys, and multiple local maxima. Inside the middle, a wide range of various economic factors confound any simplistic attempt at this interpolation.



The model quickly collapses into "technosnarl," a region of chaos brought on by the complexities of real-life, before once again reaching zero.

As a pedagogical tool, a Laffer curve helps illustrate a specific application of the law of diminishing

returns, where the inhibitory cost of taxes may eventually outweigh the increased rate of taxation, and thus led to a counterintuitive lower realization of tax revenue. However the Laffer curve should not be taken as a literal model for a tax revenue curve, especially in debates between relatively moderate amounts of taxation. It is in this context that the Laffer curve is often abused, taken as a serious model for tax revenue when it has little to no predictive value in debates between intermediary rates of taxation.

Estimates of the effectiveness of the Laffer curve

In 2005, the Congressional Budget Office released a paper called "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates" that casts doubt on the idea that tax cuts ultimately improve the government's fiscal situation. Unlike earlier research, the CBO paper estimates the budgetary impact of possible macroeconomic effects of tax policies, i.e., it attempts to account for how reductions in individual income tax rates might affect the overall future growth of the economy, and therefore influence future government tax revenues; and ultimately, impact deficits or surpluses. The paper's author forecasts the effects using various assumptions (e.g., people's foresight, the mobility of capital, and the ways in which the federal government might make up for a lower percentage revenue). Even in the paper's most generous estimated growth scenario, only 28% of the projected lower tax revenue would be recouped over a 10-year period after a 10% across-the-board reduction in all individual income tax rates. The paper points out that these projected shortfalls in revenue would have to be made up by federal borrowing: the paper estimates that the federal government would pay an extra \$200 billion in interest over the decade covered by his analysis.^[6]

Critics at the libertarian Cato Institute have charged that to support these calculations, the paper assumes that the 10% reduction in individual tax rates would only result in a 1% increase in gross national product, a figure they consider too low for current marginal tax rates in the United States.^[7]

Precedents to the Laffer curve

The idea inherent in the Laffer curve has been described many times prior to Laffer, including:

- The 14th century Islamic scholar Ibn Khaldun
- The 18th century politician Alexander Hamilton
- The 19th century French economist Frédéric Bastiat
- The 19th century constitution of the Confederate States of America
- The 20th century economist John Maynard Keynes

Note that Laffer himself does not claim credit for the idea,^[5] although he does seem to be responsible for popularizing the concept and its implications to policy makers.

In popular culture

- Jackie Mason can be seen making an indirect reference to this phenomenon in "The World According to Me" (while describing Reagan's tax policies).
- Ben Stein spends time explaining this to a class of teenagers in *Ferris Bueller's Day Off*.

See also

- Trickle-down economics
- Supply-side economics

- Inflation-driven revenue
- Reaganomics
- Macroeconomics
- List of economics topics
- Lawrence Kudlow

Notes

1. ^ John Maynard Keynes, *The Collected Writings of John Maynard Keynes* (London: Macmillan, Cambridge University Press, 1972).
2. ^ Von Mises, Ludwig (1949). *The Crisis of Interventionsim: 2. The Exhaustion of the Reserve Fund*. Mises Institute. Retrieved on 2007-09-27.
3. ^ Tobin, J. (Summer 1992). Voodoo Curse. *Harvard International Review*, 14, p10, 4p, 1bw.
4. ^ *a b* Chait, J. (September 10, 2007). Feast of the Wingnuts: How economic crackpots devoured American politics. *The New Republic*, 237, 27-31
5. ^ *a b* Laffer, A. (June 1, 2004). *The Laffer Cruve, Past, Present and Future*. Retrieved from the Heritage Foundation.. Retrieved on 2007-12-11.
6. ^ CBO. (December 1, 2005). *Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates*.. Retrieved on 2007-12-11.
7. ^ Moore, Stephen (2003-03-18). President Bush's Economic Growth Tax Cut. CATO Institute. Retrieved on 2007-12-11.

External links

- Have the Bush tax cuts spurred economic growth? An analysis by economists at the liberal Economic Policy Institute
- Analysis of the Bush tax cuts by the centrist Brookings Institution
- Arthur Laffer describing the Laffer Curve, at the conservative Heritage Foundation
- The Logic of the Laffer Curve
- Have the Bush Tax Cuts Generated Higher Revenues? Views of conservative Economists

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Categories: Economics curves

Hidden category: Articles with trivia sections from February 2008

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