Funding the Future

Dear Tim, love Alex

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Tim Worstall, the right wing blogger who likes to think he can answer all objections with reference to neo-liberal economics, challenged some of the assumptions in the Compass tax report, with reference to the Laffer curve.

Alex Cobham, a real economist, has rebuffed his claim to authority in a paper not freely available on the web, writing as follows:

Tim, I think this paper's assumptions are so strong that - at least in terms of the argument that you use it to make - the approach may in effect assume the answer that you are looking for.

Here is the abstract in full:

"*We characterize the Laffer curves for labor taxation and capital income taxation quantitatively for the US, the EU-14 and individual European countries by comparing the balanced growth paths of a neoclassical growth model featuring "constant Frisch elasticity" (CFE) preferences. We derive properties of CFE preferences. We provide new tax rate data. For benchmark parameters, we find that the US can increase tax revenues by 30% by raising labor taxes and 6% by raising capital income taxes. For the EU-14 we obtain 8% and 1%. Denmark and Sweden are on the wrong side of the Laffer curve for capital income taxation.*"

Although the paper can't be accessed freely via the NBER, you can find the University of Chicago version here:
http://mfi.uchicago.edu/wp/pdf/trabandt_uhlig_laffer_vers21_WP.pdf

The model has three key (sets of) assumptions on which any results must therefore rely:
i. the assumptions underpinning the neoclassical growth model; and
ii. the assumptions underlying constant Frisch elasticity preferences.
iii. a closed-economy

Let's take these in turn...

(i) The neoclassical growth model has been largely superceded by endogenous growth

models, although it is still taught in e.g. undergraduate development economics courses as a simple way of begining to think about the growth process. Steve Keen's debunking of the assumptions (e.g. showing the internal contradictions, never mind the lack of empirical support) is a little over the top but very clear; see his book but also e.g. http://www.debunkingeconomics.com/Talks/KeenGrowthTheory.PPT A longer perspective, encompassing the theory's marginalisation of income distribution issues and highlighting some key flaws (e.g. the critical lack of evidence for fundamental underpinnings like the production function) is in e.g. Pasinetti: http://www.unicatt.it/docenti/pasinetti/pdf_files/Treccani.pdf Since the assumptions of the neoclassical model cannot be stood up, and have a direct bearing on the returns to capital and labour, we should be rather wary of putting much weight on the predictions of tax elasticity (of e.g. labour supply!) that the paper generates.

(ii) The assumption of constant Frisch elasticity is, if anything, a more serious concern. The Frisch elasticity of labor supply is defined as the percentage change in labor supply resulting from a one percent increase in the expected wage rate, holding the marginal utility of wealth constant. Constant marginal utility of wealth means, for example, that an extra £1 is worth the same to someone with nothing or someone with £10m. You can think for yourself what that assumption might do to an assessment of responses to taxation.

In their 'Proposition 3', the authors demonstrate mathematically how the Laffer curve emerges from the CFE (and broader neoclassical) assumptions - the existence of the curve is thus entirely based on the mathematical extension of these assumptions.

(iii) The closed-economy assumption is an obvious concern for anyone who thinks that there may be anything to phenomena like international tax competition or tax-induced capital flows — e.g. profit-shifting , which is estimated to reduce Germany's tax take by more than 10% - see Huizinga and Laeven: http://www.luclaeven.com/papers_files/huizinga_laeven2007.pdf When this model is used to calibrate real economies, in which we would expect to see both real capital flows and also artificial shifting of profit and income declaration locations, it seems inevitable that the calibration will give rise to upward bias in the estimates of capital tax elasticity. This would make the authors much more likely to find (erroneously) that any given real country is near the peak or even on the wrong side of the capital tax Laffer curve whose existence they have effectively assumed.

This is exactly what transpires: "we find that the US can increase tax revenues by 30% by raising labor taxes but only 6% by raising capital income taxes, while the same numbers for EU-14 are 8% and 1% respectively."

[Open-economy assessment might favour, for example, better regulation of such international manipulations, rather than capital tax cuts.]

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A final thought, Tim: even after all the assumptions are made, and the results thereby

determined, the authors still find that tax cuts would not pay for themselves in either the US or the EU as a whole - indeed, tax increases would increase revenues. And all of this is without mentioning the likely inequality impact (ignored in the paper), or the fact that the authors focus on taxes being used to pay for transfers rather than e.g. public goods (which the authors, in fairness, point out as distorting the findings)... Imagine what the results of an assessment based on more realistic assumptions might look like.

That's an argument Tim.

Note for future reference.