Funding the Future

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Arthur Laffer's "curve" is one of the most destructive ideas in modern economics.

Sketched on a napkin in the 1970s, it claimed that cutting tax rates could increase government revenue.

It became gospel for Reagan, Thatcher and every neoliberal government since.

But it was wrong.

In this video, I explain why Laffer misunderstood tax, ignored inequality, and helped unleash tax competition that undermined democracy.

I debated Laffer in person — and I'll show you why his logic collapses when tested against modern money and real economies and the idea that fair taxation builds strong societies, whilst low taxation builds fragile ones.

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This is the audio version:

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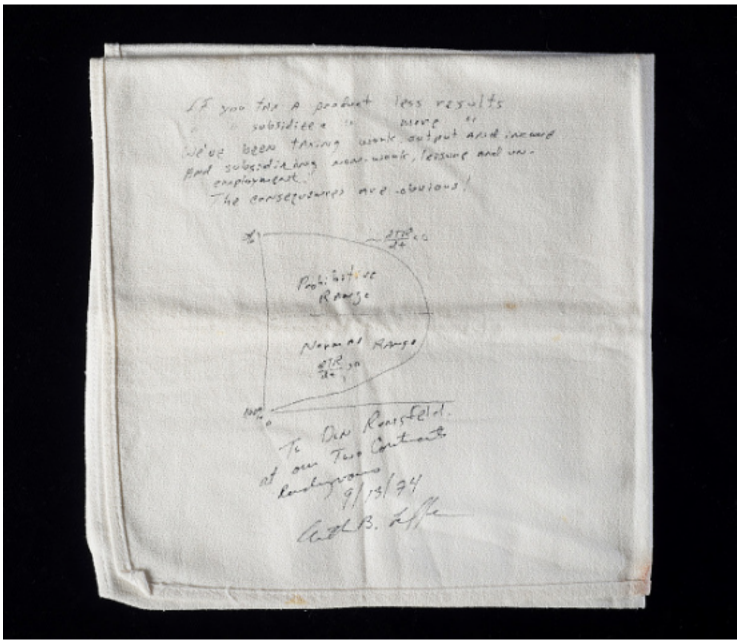
This is the transcript:

Arthur Laffer is one of the bogeymen of tax.

Whenever there's a discussion about tax rates, his name comes up, and that's because his idea, called the Laffer Curve, has shaped 40 years of neoliberal tax policy. But there's just one thing wrong with this so-called Laffer Curve, and that is that it is wrong.

Arthur Laffer didn't understand tax. He didn't understand why tax rates are set, and he came up with answers that were deeply destructive with regard to wealth distribution, but which also led directly to tax competition, which undermined states, markets, and democracy. So let's unpack what Arthur Laffer had to say and why it's so dangerous.

In the mid-1970s, Laffer sketched a simple curve on a napkin. He did so whilst having dinner with two people. One was Donald Rumsfeld, who later became the US Secretary of Defence. And the other was Dick Cheney, who later became Vice President and served no less than four US presidents and died very recently.



It showed tax revenue on one axis and tax rates on the other. He drew them in a slightly odd way in his original diagram, and we'll switch them around in the course of this presentation. But the point is that what he claimed was that at 0% tax, a government raises no money. And at 100% tax, he said, people stop working, so revenue is also nothing, which, by the way, isn't exactly true because that's what happens in communist states, and therefore, people do carry on working with 100% tax, but let's not go there because we don't want a communist state.

Somewhere in between, he argued, there lay an optimal tax rate that maximises revenue, in his opinion.

The diagram that Arthur drew, when translated into a more easily seen format, looked like this. We've got government revenue going up the Y-axis, that's the vertical. And we've got the tax rate going along the horizontal axis, that's the X-axis. And the tax rate runs from 0% to 100%, and in Arthur's worldview, there was this nice, even curve. If tax rates were below the optimal rate, which is the dashed line, then you could increase tax rates and get more revenue. And if taxes were above the optimal tax rate, you had to cut taxes because you would actually raise more money as a consequence of cutting them. That was what he said.

Laffer's logic was simple. Higher taxes, he said, discourage work and enterprise, and beyond the optimal tax rate, people avoid taxes, evade taxes, or simply stop working altogether. That's what Arthur claimed. And he therefore suggested that lower tax rates might actually increase total revenue, although he could provide no examples to prove that this was true.

Despite that, this claim underpinned both Reaganomics and Thatcherism. And it is now the economics that underpins the policies of Reform, the Tories and even Labour in the UK, all of whom still seem to believe that low tax rates will, somehow or other, without any evidence to support the claim, deliver an economic nirvana. But there was, as I've already said, never any evidence to support the claim.

In 2017, I debated this issue with Arthur at the OECD. We met in person. We had a couple of meals together. We got on terribly affably until the debate was over. And what we were asked to discuss was exactly what I'm talking about in this video. And there was a voting audience for the debate that we had. Over 300 people voted from an American business organisation who sponsored the event; inherently right-wing, as a consequence, with a bias built in. And I won, I beat Arthur by 58% to 31% with the rest being undecided.

The point is quite simple, that I know what I'm talking about here because Arthur and I have discussed this face-to-face and behind podiums. And the point I made then and which I repeat now, is that the data shows there is no revenue-maximising tax rate in most economies.

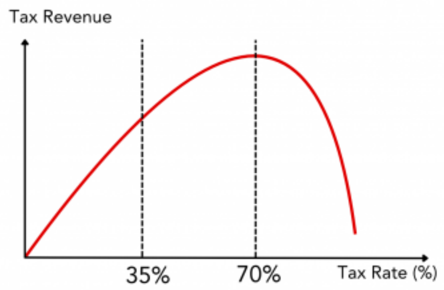
The curve ignores inequality.

Tax avoidance is not motivated by the desire to bring the rate down to an optimal level, but simply because people don't want to pay.

And it ignores real-world behaviour, which doesn't give many people the option to actually opt out of work once they've started. If you are at work, you can't say after 27 hours, "Now my effective tax rate is too high, and therefore I'm going to do no more hours this week." When you're contracted to do 37.5, you are going to do the 37.5 whether you like it or not.

And anyway, Scandinavian countries disprove Arthur's claim. High taxes have been equated with strong growth. Look right across Europe, and look at the countries which are seeing much higher rates of productivity than the UK and much higher rates of growth, and they've got higher taxes too. In other words, most people don't stop working when taxed more. The theory confuses economic incentives, if Arthur ever got those right, with social reality.

More than that, though, even those who can choose to link their work effort to the tax rate provide evidence that they will actually still carry on working at current tax rates. The actual evidence from academic research is that the tipping point rate inside most economies is around 70% overall tax rate. But in most economies, like the UK, the actual effective tax rate is between 35% and 40%. So, we are so far away from the tipping point tax rate that cutting taxes will always guarantee that the government will get less tax revenue.



This doesn't mean to say that there isn't a point where the reverse could be true. But in practice, no one is anywhere near that situation literally, almost anywhere in the world, so we don't need to worry about it. And there is no such marginal tax rate in the UK except for some people on very, very low earnings when they come off benefits and go into work. Those people should have their situation corrected. For everybody else, the Laffer Curve does not apply; Arthur taught nonsense.

And he taught nonsense for another very particular reason, which is very rarely discussed. In the 1970s, when Laffer first drew his curve on the back of that napkin, he thought that taxes funded the government. And in the early 1970s, he wasn't necessarily wrong, because the USA had only just come off the gold and the consequences of that with regard to government funding simply were not understood at the time, let's be clear about it: modern monetary theory (MMT) was not known.

But now we know that taxes don't fund the government; government money creation funds the government. And tax plays an entirely different role in the economy now that we have what are called fiat currencies; currencies that only have value because the government makes them legal tender. And in that situation, tax is used to recover from the economy the money that the government has spent into existence through its spending programmes. In other words, the dynamic around tax has changed totally since Arthur Laffer first thought of his curve.

We now know that there is a twofold purpose to tax: one, reclaiming money, and secondly, to enforce a social agenda that is imposed via the taxation system, whether that be with regard to tackling inequality or to dealing with mispricing within the marketplace, or to simply promote certain chosen activities that the government wants to be undertaken.

And all of that makes a mockery of what Laffer said, because if tax is not paid out of private sector money - the euphemistic taxpayers' money that politicians always talk about, but which doesn't actually exist, because all the money that is used to pay tax was created by the government in the first place - then this idea that the capacity to pay has a direct impact on the willingness to work doesn't hold. The tax issue is not, as Laffer said. Governments don't now try to maximise revenue; instead, they seek to control inflation by taxing. And therefore, the relationships are fundamentally different now.

So this is why there is a fundamental flaw in everything that Arthur Laffer had to say. But despite that, what he did create, the so-called Laffer Curve, has become political dogma. And it's rolled out time and time and time again by our right-wing think tanks in particular, but also by Conservative politicians and others from Reform, and even from Labour. And it has served the interests of those who want lower tax on wealth and capital very well, which is why so much money has been paid to promote this falsehood within our economy.

It has effectively become a slogan for those who want to cut the size of the state. They say they want to cut taxes to grow the economy; actually, they want to cut taxes to reduce the size of the state so that others lose out, and they think they get wealthier. This is all about an idea promoted to increase inequality.

And that is seen in the other dimension of the consequence of this curve, because it has been used to promote the idea of tax competition as well. Tax competition still exists, and it's something that I have worked against for a very long time. The Tax Justice Network, which I was the co-creator of with John Christensen in 2003, existed to fight tax competition because tax competition exists to cut corporate tax rates in particular, but also to attract the mobile capital of the wealthy. And it basically did this by promoting a race to the bottom with regard to tax rates on companies and wealth.

The result was obvious. Multinational companies shifted their profits on paper to low-tax havens, and the wealthy hid their money in those same places. That was what Arthur Laffer thought was the right outcome for society. And I know, because again, I repeat, I've debated this with him.

Laffer believed, when saying that low tax rates were good for firms, that the government was like a firm. In other words, his logic was that the state could fail and be replaced if it wasn't efficient. And he claimed that low taxes equalled an efficient state. But that's ridiculous because a company can fail and be replaced, so long as it's small enough, but a state that fails leaves chaos. There are only a few real failed states in the world, and just look at the consequences in Sudan and other such places.

The state cannot fail, but the whole point of Laffer's tax competition was to deny revenues to the government, so there was a collapse in services and a resulting democratic decay.

Tax isn't the price we pay for government; it's the foundation of a currency. But if you undermine tax, what you do is undermine the capacity of the state to govern and all that it does. That means that tax competition is a direct assault on democracy itself, in the process transferring power to global corporations.

The consequence is that tax competition has distorted markets, rewarded tax avoidance, and it has denied necessary innovation because money has been spent on financial engineering and not real engineering. It increases inequality and shifts the burden of tax onto ordinary workers. And Laffer and the Republicans were, of course, entirely indifferent to that, as we can still see in the behaviour of Donald Trump today. But worse still, this competition has reduced fiscal stability, leaving some governments weaker in crises.

The answer is that we don't need to adopt any of the thinking of the Laffer Curve. What the evidence now shows is that countries with fair, progressive tax systems are almost invariably more stable than those with low tax systems. And it is cooperation and not competition that supports healthy markets, and lower taxes do not guarantee growth. In fact, chronic under-taxation only breeds mistrust and disillusionment.

The Laffer idea collapses when tested against real-world economies. So we must end the global race to the bottom in tax. We must use the tools that are available to assess the risks from it, and that includes the tax spillover assessments that I have created with Professor Andrew Baker at Sheffield University, because that's exactly what they were created to appraise. And we must enforce tax transparency and data exchange from tax havens because these are essential tools to challenge this whole idea of tax competition, and I was pretty pivotal in the creation of some of those ideas.

The consequence is that we need to restore fiscal sovereignty and democratic control. We must tax wealth and profits and carbon fairly, and we must ensure that those who have little are not taxed a lot.

Laffer's napkin became a global myth. It promised prosperity, but it delivered inequality.

Fair taxation builds strong societies, low taxation builds fragile ones.

The Laffer Curve was wrong, and it's time to stop letting that myth guide our future when the reality is that low tax on the wealthy and large companies are helping destroy our well-being.

Poll

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