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In this article, the author discusses the necessity of updating the applicability of the Laffer curve theory to the modern global digital economy.

It's staggering to think that notes scribbled on a restaurant napkin can transform into a fundamental notion that has for decades served as a rationalization for major tax cuts.

That's just what occurred in 1974 when U.S. economist Arthur Laffer sketched out a simple yet powerful economic model while breaking bread with a couple of President Gerald Ford's top advisers.

The Laffer curve maintains that there is an ideal income tax rate somewhere between 0 and 100 percent that enables governments to simultaneously lower tax rates while raising revenues. Laffer therefore asserted that some tax cuts would pay for themselves. However, new data and research offer compelling evidence that it is time to rethink the Laffer curve's applicability as a tax-reduction justification amid 21st-century political, economic, and trade dynamics.

That's not to disparage the Laffer curve, which has become widely accepted.[1] Instead, the economic theory could use a redesign for our modern global digital economy. In fact, most economic theories and models evolve in how they're framed and/or applied over time. As economist Dani Rodrik notes in his book, *Economics Rules: The Rights and Wrongs of the Dismal Science*, "older models remain useful: we add to them."

Additions to the theory could be important to business and tax executives, given how the Laffer curve and the Tax Cuts and Jobs Act it theoretically helped create continue to produce economic, policy, and trade ripple effects around the world. The influence on economic cycles and national debt levels in turn have major implications for tax policy decisions, as well as strategic tax planning activities in the (possibly near) future.

Lower Taxes, More Revenue

Laffer served as a member of President Ronald Reagan's Economic Policy Advisory Board throughout most of the 1980s. His influence is evident in the two most sweeping U.S. tax cuts — also referred to, not quite accurately, as reforms — of the past four decades: the 1986 Tax Reform Act and the 2017 TCJA. Laffer more recently served as an economic advisor to the 2016 presidential campaign of President Donald Trump, who in June awarded Laffer with the Presidential Medal of Freedom, the country's top honor for civilians.

The Laffer curve has been both convincing and controversial since its inception. While supply-side economists tend to use the theory as a primary justification to reduce taxes, fiscal hawks have argued that tax rate reductions inspired by the Laffer curve do not ultimately increase government revenue. Still, few economists dispute the Laffer curve's fundamental notions,

[1] "'The Laffer Curve — the idea that lower tax rates can result in higher tax revenues — is undoubtedly right in theory,' tweets Brookings economist William Gale." James Pethokoukis, "Thinking About the Laffer Curve," AEIdeas (June 3, 2019).

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and the theory has gained credibility and diverse applicability in many academic circles.[2]

The theory consists of two primary assumptions. The central principle of the Laffer curve — that tax rate and income tax revenue are correlated — first surfaced in the 14th century.[3] According to this tenet, if the tax rate was zero, the government would not collect any tax revenue. Of course, the same would likely hold if the government set the tax rate to 100 percent: Individuals and businesses would not be motivated to work or operate because they would not be able to keep any of the fruits of their labor. Dialing down both of those extremes gets us closer to an optimal tax rate, according to Laffer's theory. Higher tax rates may not necessarily generate increased revenue, because those higher rates weaken the economic and social incentives created by labor and investment. On the other hand, lower tax rates theoretically provide a greater incentive to work, produce, and invest, triggering an increase in government revenue because the higher personal and business revenue more than makes up for the lower tax rate, and promotes fiscal growth.

The Laffer curve's second assertion is that tax cuts will eventually pay for themselves. Additional tax revenue, as was argued during the passage of the TCJA, can even help reduce the national debt.

Reform or Reduction?

Before considering recent research and government data that challenges the efficacy of the Laffer curve as a tax-cut justification, it's important to reconsider the major U.S. tax cuts that have taken place in recent decades.

While the long-standing call for simplifying the highly complex U.S. tax code is often characterized as "tax reform," recent legislation resulting from these reform efforts really amount to "tax cuts." Two of the most sweeping so-called tax reforms of the past 40 years — the 1986 TRA and the 2017 TCJA — did not simplify the tax code. In fact, it is fair to say the IRC is significantly more complicated than it was prior to the passage of both laws. A less comprehensive tax cut, the Economic Growth and Tax Relief Reconciliation Act of 2001, also provided little, if any, relief from tax code complexity. However, tax code simplification may not have been a necessary or intended consequence of the Laffer curve.

These major tax cuts differ in meaningful ways. The TRA, which preserved a worldwide taxation system in the midst of globalization, partly paid for tax cuts through capital export and international trade expansion in what was then primarily a traditional, global trade economy based on goods and services. This scenario has been inverted under the TCJA, which lowered the corporate tax rate from 35 percent to 21 percent. Although the United States now has in place what amounts to a quasi-territorial system, it has also shifted more toward a tax system approaching national neutrality. As such, it amplifies national welfare, moves away from capital export neutrality, and favors a reverting capital import scheme in the form of income or profit repatriation.

Unlike the TRA, which relied on globalization, capital export, and international trade of goods and services to compensate for lower tax revenues, the TCJA is counting on longer-term fiscal strategies to pay for the lower tax rates with the goal of reducing the national debt. Additionally, several TCJA provisions are designed to incentivize companies to return intellectual property and other intangible assets to the United States while reducing reliance on the offshore tax deferral system and other key base erosion planning mechanisms. This is occurring at a time when the global economy is moving away from traditional manufacturing — and to some extent, a trade-based transfer economy — while continuing to transform into a digital economy.

Although the repatriation of IP income strategy has been somewhat effective under the TCJA, like the 1986 TRA it has fallen short of other objectives, including those that the Laffer curve espouses.

[2] N. Gregory Mankiw remarked that "the Laffer curve is undeniable as a matter of economic theory. There is certainly some level of taxation at which cutting tax rates would be win-win." Mankiw, "Snake-Oil Economics: The Bad Math Behind Trump's Policies," 98(1) *Foreign Affairs* 176 (2019); and "Can Countries Lower Taxes and Raise Revenues?" *The Economist*, June 19, 2019.

[3] Ibn Khaldun, *The Muqaddimah* (1377), cited in Arthur Laffer, "The Laffer Curve: Past, Present, and Future," The Heritage Foundation (June 1, 2016).

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No 'Laffin' Matter: Research Raises Questions

Recent evidence highlights a range of limitations and questions about the Laffer curve's applicability, without adaptations, in the 21st century. A higher-level issue is that the TCJA does not yet appear to be reducing U.S. national debt. An analysis conducted by the Joint Committee on Taxation indicates that the national debt has increased since the TCJA was enacted.[4] A separate study by the Congressional Budget Office found the same thing.[5] However, it is not clear if this is because of trade dispute issues, contractions in other related market sectors, or the effect of combined (counter) cyclical reactions or events. Still, some economic research has not supported the claims of large supply-side growth effects in the second half of the 20th century.[6] This suggests that top tax rate increases would raise substantial sums of revenue — consistent with estimates of nonpartisan "scorekeepers" like the JCT, CBO, and the Tax Policy Center.

Several academic research efforts have shed new light on the Laffer curve's two key assumptions. University of California, Berkeley, economists Christina and David Romer conducted an analysis of the comprehensive effects of all U.S. legislated tax changes from 1945 to 2007. The Romers' 2010 research does not name or endorse the Laffer curve, but it does identify an optimal income tax rate of 33 percent.[7]

Perhaps in this new global digital economy in which the combination of complex innovative networks, interdependent economic agents, and intricate economic interaction is the global economic engine, we should not underestimate the Laffer curve model's influence on economic expansion. While not supporting or opposing the Laffer curve, Romer and Romer stated that their research into historical tax fluctuations over the periods in question showed that tax cut effects on economic growth may have a greater influence on economic activity than some standard economic models previously indicated.[8]

Giving the Laffer curve a more contemporary application, in 2017 Jacob Lundberg, a Swedish economist, projected how the taxpayers of 27 OECD countries would respond to different tax rates. The results revealed that while most countries examined set tax rates at or below the Laffer curve's optimal rate, only one could increase tax revenue by cutting rates (the research focused on how rate cuts affected the highest-income earners).[9]

A 2018 study by Aleksandar Vasilev of the International Business School at the University of Lincoln in the United Kingdom makes interesting connections among the Laffer curve, VAT rate increases, and high VAT evasion rates. The research concludes that although raising VAT rates may be a convenient way to finance government expenditure, it can quickly lead to a drop in revenue associated with that category, especially in countries with substantial VAT evasion.[10]

Other research has shown that the Laffer curve can help estimate diverse cross-country (United States and EU) consumption tax elements, as well as assess other factors, including human capital and labor components, that influence changing tax revenues.[11]

Laffer Curve 2.0

While some research casts doubt on the Laffer curve's value as a tax-cut justification tool, other academic inquiries have shown the value of applying the theory more broadly to draw new insights into relationships among tax fraud and avoidance, tax revenues collected, tax rates, cross-border differences, and more. This research

[4] Joint Committee on Taxation, "Macroeconomic Analysis of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-69-17 (Dec. 22, 2017).

[5] Congressional Budget Office, "Historical Budget Data" (May 28, 2019).

[6] Andrew Fieldhouse, "A Review of the Economic Research on the Effects of Raising Ordinary Income Tax Rates," Economic Policy Institute (Apr. 2, 2013).

[7] Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," 100(3) *Am. Econ. Rev.* 763 (2010).

[8] *Id.*

[9] Jacob Lundberg, "The Laffer Curve for High Incomes," Luxembourg Income Study Working Paper No. 711 (Aug. 2017); and "Can Countries Lower and Raise Revenues?" *The Economist*, June 19, 2019.

[10] Aleksandar Vasilev, "Is Consumption-Laffer Curve Hump-Shaped? The VAT Evasion Channel," 45(3) *Journal of Econ. Studies* (2018).

[11] Mathias Trabandt and Harald Uhlig, "How Do Laffer Curves Differ Across Countries?" Board of Governors of the Federal Reserve System International Finance Discussion Papers No. 1048 (May 4, 2012); and Tamás K. Papp and Előd Takáts, "Tax Rate Cuts and Tax Compliance — The Laffer Curve Revisited," IMF Working Paper WP/08/7 (Jan. 2008).

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suggests that the Laffer curve can still be applied as a key consideration of prudent tax policy implementation.

This is welcome news in today's global and increasingly complex business landscape — one in which the tax policy implications of creating new taxes, raising previous tax rates, or cutting them altogether is certain to alter the compliance responses and other reactions of taxpayers. Rather than dismissing the Laffer curve or condemning its principles, economists, advisers, and policymakers should strive to bring the theory into the 21st century by expanding its applications to an adaptive system model. This should not be too much to ask, given how other models and economic theories have been adapted to address the contemporary global digital economic landscape in all its interactive complexity.

Just ask Rodrik, who also points out that "knowledge accumulates in economics not vertically, with better models replacing worse ones, but horizontally, with newer models explaining aspects of social outcomes that were unaddressed earlier. Fresh models don't really replace older ones. They bring in a new dimension that may be more relevant in some settings."[12] ■

[12] Dani Rodrik, *Economics Rules: The Rights and Wrongs of The Dismal Science* (2015).

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