ON THE DRY SIDE 210 THE LAFFER CURVE John Hyde

Supply-side economists contend that unemployment will disappear and living standards soar if only people are given free market signals to produce the things other people want. Tax, which drives a wedge between production and its rewards, is an important part of their story. Nonetheless, before the evidence started to come in, the Laffer Curve, with which popular debate associates them, embarrassed some supply-siders. It is a fiscal fairy story: government revenues can't be increased by lowering taxes---or can they?

We know that smaller government, that is less public expenditure and less tax, will eventually cause an economy to grow faster and that the growth will give more to everyone, including the government---Korea, Japan, Singapore, Taiwan and many other countries testify to that possibility. Laffer, with direct reference to his famous curve, puts another proposition. He argues that cutting taxes can increase revenues almost immediately, whatever we do with expenditure.

Taxes discourage people from earning and declaring income. Tax revenue is the base times the (average) rate. Should the base grow proportionately more than the rate is cut, then revenue rises. If a tax rate were 100% no-one would undertake any taxed activity, and both the tax base and the revenues would be zero. At the other extreme, a zero tax rate yields zero revenues whatever the tax base. Anywhere in between the government gets some money. The Laffer curve joins the two extremes.

Far from being wrong, it is a truism. But where do we sit on the curve? On the top half where even higher tax rates would decrease revenues or on the bottom half where higher tax rates increase the government's bag?

In the United States a Battle Royal has raged over Professor Laffer's curve but governments in many other nations, including our own, have quietly accepted that very high marginal tax rates don't work. Mr Hawke is reducing the top rate from 60% to 49%. Does that make him a supply-sider? Does he expect to get more revenue or less from Australia's top taxpayers?

Mrs Thatcher reduced the top marginal rate from 83% to 60%. Mr Frank Field, Labour MP for Birkenhead, put a question on notice asking Treasury what tax was paid by the wealthy before and after the cut. This is the answer he did not rush to the newspapers with: before the tax cut the one percent with the highest incomes found 10.4% of total revenues; six years after the cut they provided 12% and; whereas the top three percent once paid 18%, they now pay 20.7%.

Professor Lawrence Lindsey looked at the US scene following Reagan's 1981 tax cut. When Reagan cut the top rate from 70% to 50%, lo and behold, the share of the taxes paid by the rich increased (Americans are so impressed by the evils of high marginal taxes that they have just cut their top rate to

34%). Apparently one way to soak the rich was to cut their taxes, but a lot of people couldn't believe it. They said 1982 was an odd year. It was, it was the year the US bottomed out of the worst recession since the war. Professor Lindsey accepted all the criticisms levelled against the Laffer argument and ran arithmetic tests taking them into account. He found that the top 180,000 taxpayers would have paid $25.95 billion at the 70% rate. If the tax base had not broadened in response to the cut, adjusting for all the claimed oddities, they would have paid $22.44 billion. In fact they paid $26.62 billion. In 1984 their actual tax payments were $42 billion compared to $34 billion predicted using the old tax scales.

What is true of the top rates is not necessarily true for everyone. In 1982, the US Treasury expected $311 billion at the old rates; they actually got $277 billion. If there had been no response to the cuts Treasury could have expected $267 billion from the lower rates. In the first year, even before people had had enough time to fully adjust to the lower rates, about a quarter of the cost of the tax cut had been picked up by the tax base becoming wider.

Lindsey calculated a revenue-maximising tax rate. It was 33%. He then let some anti-supply-siders at his calculation, made all the adjustments any of them wanted and came up with 50%. The tax rate which collects most tax is therefore somewhere between 33% and 50%.

He makes it clear that he is not advocating a government which collects the maximum possible amount of tax. He is just observing that rates above 50% (or 33%) collect increasingly less tax. Of course the best way not to collect tax is with lower rates.

Tax cuts allow low-income people to pay less tax and encourage high-income people to pay more. No doubt Mr Keating knew this when he agreed to cut the top rate to 49%. He presents the Labor left with a dilemma---cutting tax rates is favoured by the ACTU; Keynsians, monetarists and supply-siders all say tax cuts increase employment; and, as if that were not enough, within the range of practical debate tax cuts are egalitarian.

My criticism of Mr Keating is that he has not made nearly enough expenditure cuts to compensate for the effect of the tax cuts on low and middle incomes. This is the problem that Reagan ran into. In an extraordinary about face American left-liberals are criticising Reagan for his budget deficit. For once they are right. Australia's deficit problem is already worse than the America's. Mr Keating cannot afford to spend appreciably more than he raises.