The Idle Speculator™

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WING NUTS UNITE!

Economist Art Laffer has penned his first defense against the New Republic’s assault on supply side “wingnuts", and it’s available on Larry Kudlow’s corner of National Review Online. It's a solid rebuttal, and as Laffer observes, the timing of the debate couldn't be more important, with the importance of the 2008 presidential election and tax overhaul proposals coming out of Congress. In fact, these events may be the primary motivators for Chait's and others’ attacks on tax cutting in general, and on “supply side economics” in particular.

THE GROWTH VERSUS REVENUE DISTINCTION

A critical distinction is often overlooked when discussing the effects of taxes (or more properly, tax changes), and that is: what's the dependent variable? Is it government revenues, or is it economic growth?

When the variable in question is economic growth, the "wingnut" aspersion is almost entirely without merit. This is especially true in an increasingly integrated and competitive world, where national economies are competing for capital. Marginal capital--whether financial, physical, or human--will tend to migrate toward the highest expected marginal returns. And steeper tax rates directly lower the expected (and thus the required) return on investment, all else equal. While it is only logical to assume that the optimal level of public capital formation and investment for economic growth is greater than zero, it is quite another to assume that the current tax system is close to optimal (or more implausibly, falls short because it imposes too light a burden!). One can make that argument if they dare (many do), but as assumptions go, it's a dangerous one.

In a relative sense the U.S. tax system is probably more optimal than most, but that competitive edge is eroding at the margin, a fact that is critical to our future well-being. While other nations are creating increasingly friendly (and thus competitive) environments for capital, the U.S. is largely treading water (even taking it on, perhaps). In fact, if James Surowiecki (who, despite his recent political hatchetry, is a wonderful writer) wants to put his money where his pen has been (in The Wisdom of Crowds) he ought to propose that the best way to optimize taxation would be to subject its form(s) and its rate(s) to public referendum, and direct, ongoing public control. After all, the public is the ultimate marketplace for political goods, and is thus a far wiser crowd than politicians and agency bureaucrats alone. It would make for a fascinating experiment, and whatever its outcome, I'd be willing to bet that the answer would come nowhere close to a top marginal rate of 40-50% on anything (anything legal, that is).

On the other hand, when the variable in question is government revenues, then the "wingnut" assertion has some merit: a lower tax rate will *not* always and everywhere be more productive of revenue. That's a fallacy that the supply side movement has become popularly and inextricably identified with, in part by its own hand (and perhaps by necessity in the 1970's, when federal budget deficits carried far more weight as an objection to tax cuts). Surowiecki is quite right about this in his article, but despite that, it is just as incorrect to assume that a lower rate cannot produce more revenue than would otherwise have occurred (as Kudlow and Laffer pointed out to him regarding capital gains tax revenues in a recent debate on Kudlow's CNBC program). And it's the absolute height of foolishness to believe that human beings will not respond to changes in incentives (or as an economist would say, to assume away 'utility maximizing agents'). As Laffer puts it in his response to Chait:

> ...the world isn't frictionless and raising taxes isn't costless. What people pay is not what the government receives. It takes lots and lots of resources to raise taxes. People hire accountants and lawyers, shift assets, move, change jobs, cheat and all sorts of other things to avoid paying taxes. Government hires all sorts of revenuers and spends mega-bucks to collect taxes. These wasted resources can be huge...

On a side note, it's entirely plausible (though not often mentioned) that wasted resources represent social losses, and that these in turn lead to a greater reliance on government services. Assumedly, Chait would try to appropriate the necessary resources from high income earners, corporations, and the wealthy, but this leads again to the behaviors articulated by Laffer, creating a vicious cycle of accumulating inefficiencies. Candidly, no one really knows what kind of effects a more efficient tax system would have on the demand for certain types of public services. In fact, the political left and right are likely to disagree about what "efficiency" means, perhaps maximizing net revenue as a percentage of output for the former, versus minimizing public demands imposed upon the private sector for the latter.

A DEBATE ABOUT SOCIAL VALUES, NOT ECONOMICS

What this really demonstrates is that at its core, the tax debate is about personal values and worldviews, and *not* economic theories. Economists from different schools of thought can agree on some fundamental points about taxation. Ideologues with differing worldviews cannot. And consistent with this, Chait's approach is not economic, but historic, and his focus is on a particular social construct of fairness. He (or someone posting under his name) admitted this in a blog post regarding his book The Big Con; in response to a reader's question following Ezra Klein's blog review of the book, the alleged jonathan chait wrote:

> ...the book is definitely written for readers without prior economic knowledge. **There's very little actual economics in it -- it's mostly history and politics --** and what economics there is is aimed at the lay reader. Posted by: jonathan chait | Aug 27, 2007 10:24:52 PM [emphasis added; accessed at http://ezraklein.typepad.com/blog/2007/08/the-big-con.html on 11/7/07]

The argument over taxes always--always--comes down to maximizing future economic growth versus maximizing current distribution. Using pies as an analogy, growth is about maximizing the future size of the pie, independent of variations among the slices, while distribution is about minimizing variation in slices, independent of the pie's future size. Laffer calls this the "timeless growthist versus redistributionist debate." Human beings, even primates, fundamentally embody these tensions, so the debate is indeed timeless. Being found at work in family dynamics, in anthropologists' field narratives, in myths handed down from ancient oral traditions, etc, we can safely assume that it will never go away. However, we can certainly improve the quality of the debate. As a first step, supply siders should avoid claiming that every tax cut will produce greater revenues for government (in other words, if you're going to cite the Laffer Curve, realize that it embodies the principle of diminishing returns). Likewise, Chait and others should admit that their attacks on tax cutting are *not* about economics, but about their own social values, which are of course highly subjective. The evidence Laffer marshals in his rebuttal is about economics, should Chait care to read it.

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