This is the first in a series of papers from The Laffer Center assessing, and calling to account, the major academic trends in inequality research of recent years.

THE LAFFER CURVE IS ALIVE AND WELL – ON THE LEFT AND THE RIGHT

By Arthur B. Laffer, Ph.D. and Brian Domitrovic, Ph.D.

When the recent public health crisis took shape in early March, one of the intriguing events that was postponed until the fall was a debate between Arthur Laffer and Emmanuel Saez on the issues of inequality, top income tax rates, and the possibility of a wealth tax. The debate was to have taken place at Pepperdine University in California. Saez, a proud man of the left, is one of the most prominent economists in the world—recent striking evidence being the honorary degree that Harvard University conferred upon him last year (see picture).


Harvard University honorary degree recipients, May 2019. Back row from left to right: Ingrid Daubechies, William Chester Jordan, Wu Hung, Drew Gilpin Faust, David Remnick, and Emmanuel Saez; front row: Dame Marilyn Strathern, Provost Alan Garber, President Lawrence Bacow, Chancellor Angela Merkel, and Lonnie G. Bunch III

The prominence that Saez, who is a professor of economics at the University of California at Berkeley, has gained in economics, and to a good degree in political discussion as well, owes to two major achievements. The first is his collaboration with Thomas Piketty[1] that supplied the information for Piketty's mega-bestseller *Capital in the 21st Century* (2014). Piketty and Saez together brought into the popular consciousness the concepts of the "U-shaped curve" of

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[1] Several European Organizations have attempted, to no avail, to set up one or several debates between Arthur Laffer and Thomas Piketty. In the early 1980s, Arthur Laffer then debated Jacques Attali, French President Francois Mitterrand's chief economist, in Paris at the Hotel de Crillon. According to the Spanish newspaper, El Mundo, "several emails [have been sent] to Mr. Piketty and his Spanish publisher has also contacted him. He hasn't responded to a single one."

inequality over the twentieth century (Figure 1) and the notable size and share of total income paid to the "top 1 percent" of earners. This measure of income inequality displaced the abstruse "Gini coefficient".

Figure 1
Top Marginal Personal Income Tax Rate vs. Top 1% Income Share
(annual, 1913-1998)
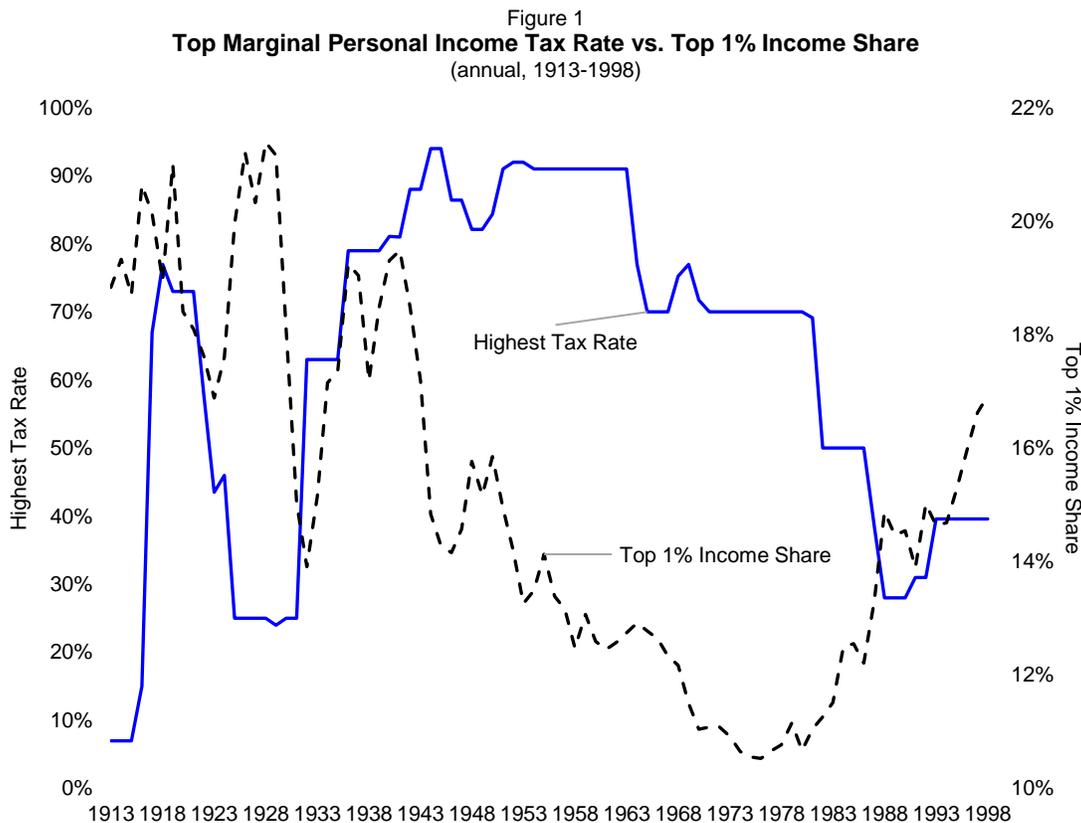
Source: Tax Policy Center, Piketty/Saez/Zucman

Saez' second major achievement is his formula for a "Laffer rate"—Saez actually uses this term—that yields a 73 percent federal income tax rate as the "high income tax rate maximizing tax revenue" for the United States. This Laffer tax rate and Saez' formula for calculating it is based upon the chronology of the highest tax rates from the early 1910s through 1998 (Figure 1). Harvard's announcement of Saez' honorary degree noted: "His research with French economist Thomas Piketty examined tax policy and inequality from both theoretical and empirical perspectives, finding that the top earners in the U.S. have taken increasingly larger shares of total income over the past 30 years, and that current income inequality levels are as high as they were before the Great Depression. Saez has recommended a marginal tax rate of 73 percent or more for the wealthy."[2]

Had we had the Pepperdine debate in March, Saez surely would have begun his affirmative case as he usually begins one of his many public talks. For example, in his tour promoting his book with his Berkeley colleague Gabriel Zucman, *The Triumph of Injustice, How the Rich Dodge Taxes and How to Make Them Pay* (2019), he offered these remarks during a visit to Harvard last October:

> **"I am mostly known for this type of series"—pointing as he did to the U-shaped curve as in Figure 1 on a slide—"showing the evolution of the top one percent income share over the [twentieth] century and more in the U.S.A…You get that big U-shape…In the recent period [since the early 1980s], the top one percent's income share doubled from something like ten percent to about twenty percent."**

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[2] Emmanuel Saez, "Using Elasticities to Derive Optimal Tax Rates," *Review of Economic Studies* 68 (2001), 212; "Harvard awards nine honorary degrees,"

Then he went on to show (also Figure 1) that when the bottom of the "U" prevailed, i.e. when income was most equitably distributed from the 1940s through the 1970s, the highest marginal federal income tax rates were high—70-94%. Tax rates during the period of more equitably distributed income were much higher than the 25-40% of the latter 1920s and the post-1980 periods, which correspond to the sides of the "U." Saez told his audience to look hard at the high American tax rates of the middle twentieth century, because this example reveals the wisdom of the past:

> **"The U.S. also invented progressive income…taxation. It is something that is not as well remembered as it should [be]… …The U.S. was the first country to realize that once you have those things on the ground and working, you can crank them, you can crank tax rates to levels unimaginable a few years before…. And the U.S. was the first….to impose rates over 50%. No country had ever done something that just a few years before looked completely nuts."**

Saez continued by expressing his confidence that the political moment in America today is apt for the kind of changes he has in mind:

> **"I say this in those debates today about wealth taxation imported from Europe….The reason [these themes] come in the debate in the U.S. at this moment...[is that they] could be the setup for another, yet another, fiscal progressive revolution….[High tax rates] can generate revenue…to fund valuable government spending....Perhaps we should restore some progressivity as it existed decades ago."[3]**

Using Saez (and Piketty's) U-shaped curve, we will demonstrate why that curve doesn't show what Saez says it shows. What Saez' and Piketty's curve does show is that low tax rates on the top one percent correspond to more tax revenues from the top one percent, a smaller tax burden for the bottom 95 percent and substantial increases in economic prosperity. Our complete description of the curve differs quite radically from the purpose its creators have put it to. With just one simple addition that Saez didn't report in re the U-shaped curve, it is clear that his data prove that the U.S. is and has been in the prohibitive range of the Laffer curve.

We shall offer the details and evidence below, but one can anticipate where we are going just by pondering Saez' own remarks. If the top one percent of earners' share of the nation's income was down by half in the middle decades of the century when tax rates at the top were high, the revenue generated from those tax rates cannot have been, at least proportionately, so very large. After all, at those high tax rates, the share of income of the top one percent went way down. The high tax rates therefore had less of a top income share to take tax revenue from.

And do remember even though the highest tax rate may be very high, the average tax rate on the rich is much lower than the highest tax rate, and it is this average tax rate that generates tax revenues along with total income. Internal Revenue Service data show that since 1979, the average tax rate of the top 1% of earners has consistently hovered around 22%—even though the top tax rate of the income tax has varied in that span from 28% to 70%.[4]

Likewise, when the share of total income of the top one percent doubled, as it did after 1980, the highest tax rates fell—surely tax receipts from that group could have come in higher. The low tax rates had more of a top-income share to farm. Saez just assumed higher tax rates on the one-percenters meant more tax revenues. Saez ignores what happened to the actual amounts of income that were to be taxed.

Actual tax revenues collected from the top one percent of income earners is by definition equal to the amount of total income earned by the top one percent times their average tax rate. We know from Saez' work that a higher top tax rate on income earners reduces their income earnings, which by itself would lower tax revenues. What Saez doesn't know is the effect of a higher top tax rate on the average tax rate paid by top income earners. What we will show conclusively is that when the top tax rate is increased, the tax threshold for the top one percent falls and tax revenue also falls.

Whether tax revenues from the top one percent of income earners rose or fell when the highest tax rate was high or low is an empirical issue. However, we do know that total incomes from the top one percent of income earners rose when their top tax rates were low and shrank when their top tax rates were high. What we shall discover is that the evidence, as supplied by Saez and his collaborators, confirms that when tax rates on high incomes have been high in

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[3] Emmanuel Saez, "The 2019 Stone Lecture in Economic Inequality," https://inequality.hks.harvard.edu/2019-stone-lecture-emmanuel-saez
[4] "Historical Average Federal Tax Rates for All Households 1979-2016," Tax Policy Center.
https://www.taxpolicycenter.org/statistics/historical-average-federal-tax-rates-all-households

this country, tax revenues from this source have been low; and when tax rates on high incomes have been low, tax revenues from this source have been high. And that's a fact.

The Laffer curve lives—as the left's own evidence shows conclusively.

When the Rich Get Poorer
As shown in Figure 1, the share of total national income of the top 1% was high, then low, then high, over the hundred some years since the establishment of the income tax in 1913: this is the cornerstone of everything written by Saez, Piketty and the resurgent left in scholarly macroeconomics today. This share of the top one percent was at about 20% through the Roaring 1920s, fell such that by the 1940s it was at 10% where it stayed through the 1970s, then zoomed right back up to 20% for the duration after the 1980s.

The top one percent's share of total income inversely correlates to the highest marginal tax rate: high tax rates correspond to a lower share, low tax rates correspond to a higher share. Saez and his collaborators show this correlation without ever mentioning that the top one percent's threshold income fell, as well. Tax revenue from the top one percent also fell and tax revenue from the bottom 95 percent rose all while the economy faltered. They flat out state incorrectly that the high tax rates improve income equality, increase tax revenues and are good for America.

Only in the original Piketty-Saez paper outlining their argument in 2001, was a table included showing the chronology of the "threshold" income it took to get into the top 1%. As Piketty and Saez were inquiring after the top 1%'s income share, they had to know what the boundaries of the top 1% were in each year in their long series. Their data on this "threshold" income, as they called it, came in constant 1998 dollars.

Most interestingly, this series on threshold income also followed a U-shaped curve. In the original Piketty-Saez data used to construct the U-shaped curve, the threshold income to get into the top 1% was high through the 1920s, then fell such that by the 1940s it was substantially lower than it was in the 1920s. This low threshold level held through the early 1960s, after which the top 1%'s threshold income went up, stabilized again in the 1970s, and in the 1980s the threshold income of the top 1% rose sharply for the duration.

The numbers were as follows. In the 1920s, the amount of yearly income (in 1998 dollars) it took to make the top 1 percent of income earners went from well below $200,000 to a peak of $327,000 in 1928. In 1931, it took less than $150,000 (again in 1998 dollars), a drop of more than half. Over the following three decades, the threshold income for the top one percent of earners in 1998 dollars averaged about $240,000. The highest value from 1930-1960 came in 1959; it was $279,000. Several years later, the threshold income in constant dollars of the top 1 percent took a permanent leap up. In 1964, the threshold breached $300,000 again, averaging about $340,000 from that point through 1980. Then it went up still more, rising continually in the 1980s and 1990s to a top level of $790,000 in 1998.[5]

The highest tax rates are an important consideration for the top one percent of income earners because their marginal after-tax incentive to earn income is what is called the retention rate, or one minus the highest income tax rate. The higher the top tax rate, the less worthwhile it is for the top one percent of income earners to earn more income. Using the retention rate, Figure 2 maps the Piketty-Saez data series. Obviously tax rates and retention rates are in percentages and have no natural trend while thresholds are in constant 1998 dollars and do have a natural trend. Therefore we have "detrended" the top 1%'s threshold income, meaning that we show thresholds' variation from trend established by the opening year of 1913 and the closing year of 1998. It is remarkable how closely they match Figure 2.

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[5] Piketty and Emmanuel Saez, "Income Inequality in the United States," NBER Working Paper (2001), Table A6.

Figure 2
Retention Rate of Top 1% vs. Threshold Income of Top 1% Detrended
(annual, 1913-1998)
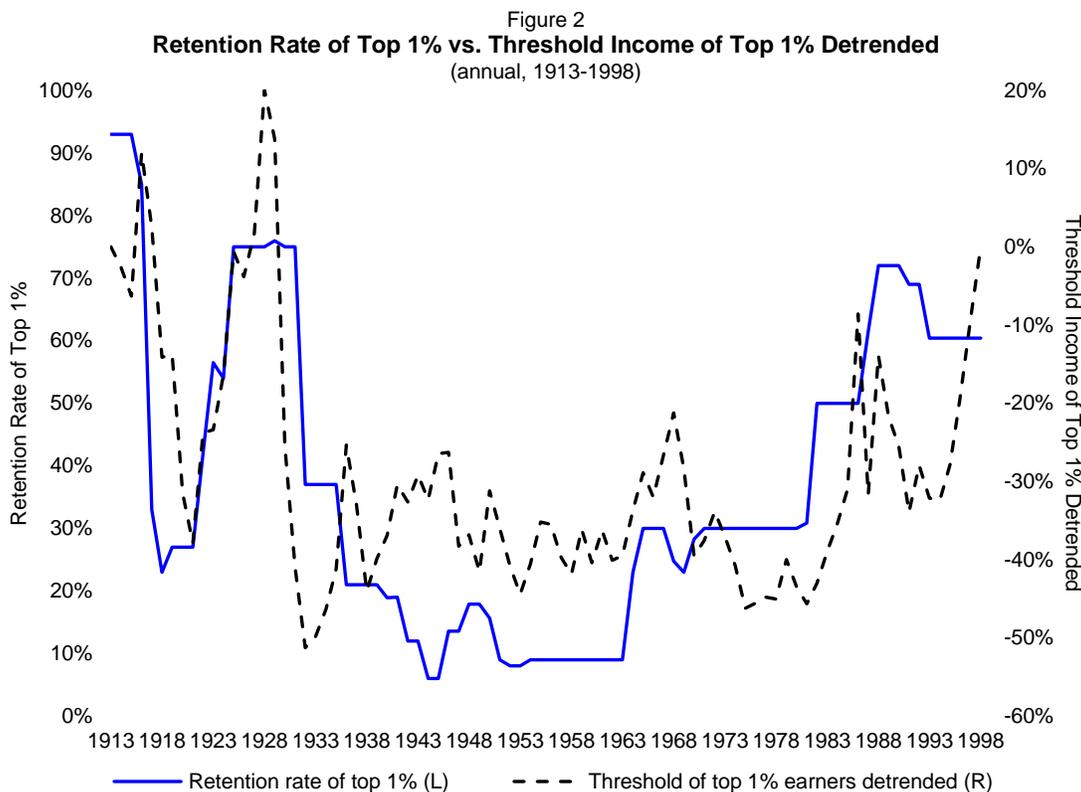
Source: Tax Policy Center, Piketty/Saez/Zucman, Laffer Associates

The overlay with the marginal tax rate / retention rate was phenomenal. In the late 1920s, when the top tax rate was 25%, top-threshold income rose mightily. After 1932, when the top tax rates were taken up past 60%, top-threshold income took a dive. It stayed below the late 1920s levels as top tax rates were in the 82-94% range from the 1940s to the early 1960s. Top 1% threshold income began to recover precisely with the John F. Kennedy tax-rate cuts of the mid-1960s. Top threshold income stagnated in the 1970s, as real top tax rates increased with inflation. Then the threshold level went up with the Ronald Reagan tax-rate cuts of the 1980s.

Please remember that we do not vouch for the Piketty-Saez data; we are simply presenting them here as reported. Independent data, such as those of the Census Bureau dating back to 1967, follow a similar pattern over the latter portion of the time period.[6]
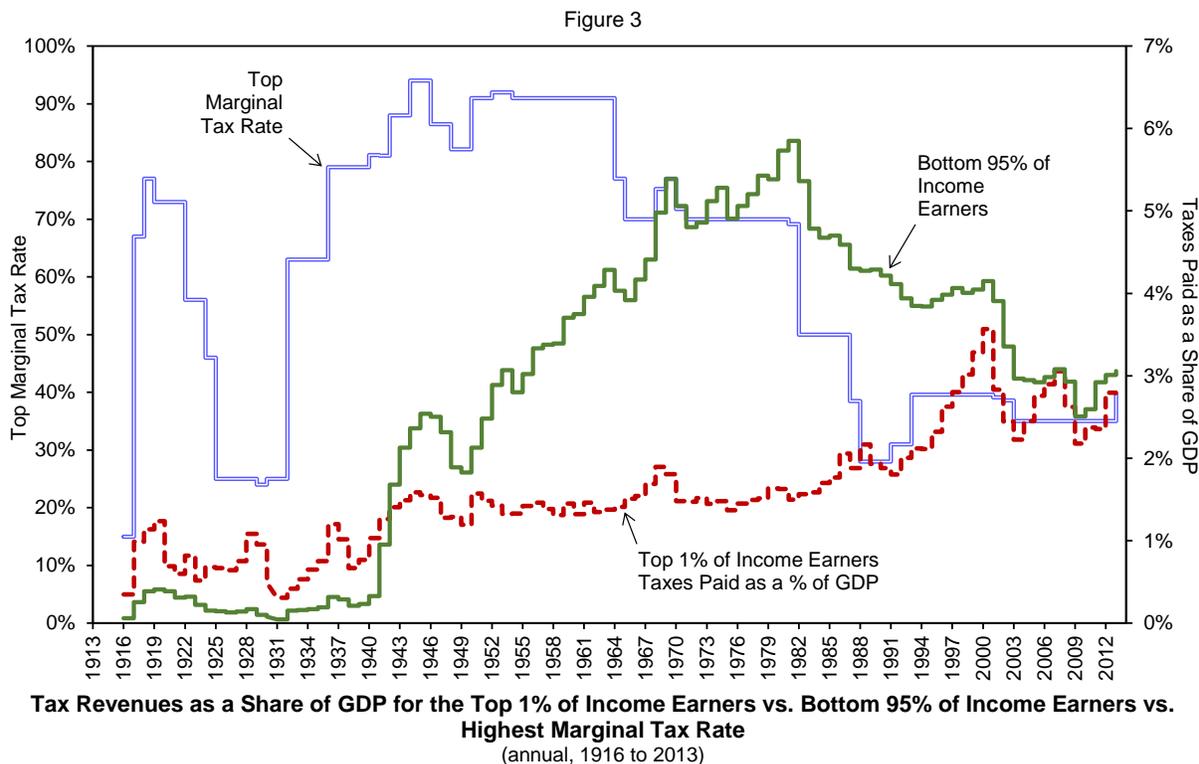
In census data, top 5% threshold income went up by 2.6 percent per year from 1967 until 1973, when it began a period of nil growth that lasted until 1981. From 1981-89 (as top tax rates were cut), top 5% threshold income growth once again averaged a 2.6% per annum increase. As top tax rates went up from 1990-93, the threshold income statistic went flat, and after 1993 (and the end of top-tax-rate increases for some time), it resumed its 2.6% per annum rate of increase. After the 1990-1993 tax rate increases, taxes on the top one percent actually went down even though this isn't shown by the highest tax rate. Capital gains tax rates fell, income effective tax rates for recipients of Social Security fell and government spending as a share of GDP fell precipitously. Tax cuts at the top led to a higher threshold for top income, and real tax increases (owing to inflation in the 1970s and early 1980s) led to stagnation in that threshold.

The Consequences for Tax Share
It is obvious what can happen to tax-receipt collections from a top-income group when that group's threshold income goes up or down. When the threshold income goes up, lower tax rates can collect similar or even more revenue than when higher rates bring the threshold down. Consistent with Piketty and Saez' calculations on top-threshold income, the history of income tax collections per Internal Revenue Service data confirms this impression with abundance and regularity.

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[6] We have conducted a statistical analysis, not included in this paper, confirming that the top 1% threshold income in Piketty and Saez's data strongly correlates, negatively, with the previous three years of the marginal tax rate.

Top earners carried almost the entire load of income taxation until the top rate of the income tax went up for the long term in the 1930s (Figure 3). Prior to that point, total income taxes paid by the bottom 95% had barely ever breached even a half a percent of the nation's GDP. Indeed, when the top tax rate was at the late 1920s low of 25%, the bottom 95%'s tax share of GDP was close to nil. Taxes as a share of GDP were permanently changed for this bottom group only with the tax increases at the top that began in the 1930s.

Figure 3

Tax Revenues as a Share of GDP for the Top 1% of Income Earners vs. Bottom 95% of Income Earners vs. Highest Marginal Tax Rate
(annual, 1916 to 2013)

Source: IRS Statistics of Income, Laffer Associates

The tax share of the bottom 95% doubled to past 1% as the top income-tax rate went beyond 60% beginning in 1932. That share then approached 2% during World War II as top tax rates of the highest income earners were upwards of 94%. Postwar, the bottom 95%'s total taxes as a share of GDP briefly paused, then resumed its march up. It peaked at 6 percent of GDP in the early 1980s. The whole while, over the 35-year postwar period, the top tax rate of the income tax—which was not a rate to which the bottom 95% were directly subject—remained at exceptionally high levels, from 70-91%.

Conversely, the tax share of the top 1% income earners held at the same level, just under 2%, barely higher than the level of the late 1920s. In the late 1920s, the top tax rate had been 25%. From the 1940s until 1980, it was 70-94%. No matter—the very high level of the top tax rate, which directly applied to this group, did not correspond to any appreciable increase in the share of GDP this group had to pay in taxes. These very high marginal tax rates were associated with big new tax burdens only on the bottom 95%. There was no material change in the tax burden on the part of the top 1%. High tax rates on the rich lost tax revenues which were recouped by higher tax burdens on the bottom 95%.

A new dawn came in the 1980s, when at last the tax burden of the bottom 95% went down, and that of the top 5% went up. The correlation with the marginal tax rate is that the tax burden on the bottom 95% went down substantially and permanently as the highest tax rate fell from 70% to 50% in 1981 and then to a range between 28% and 40%. The graph of the whole development since 1913 is most arresting.

IRS data show that high income tax rates at the top are associated with invariance at a low level in the tax share of highest earners. During eras of high marginal tax rates on the highest income earners, the share from those who are not subject to that tax rate is phenomenally large, as the saga of the bottom 95% in this graph makes plain.

We initiated this discussion with Piketty and Saez' own data about the income thresholds of the highest earners, in particular the top 1%. Their threshold data suggested that high tax rates correlated to low tax receipts from the highest earners, and vice versa. Calling on tax-receipt data confirms this implication of their work comprehensively.

Top income and top-income-tax return data show the validity of the Laffer curve, specifically that this country was in the "prohibitive range" of the curve at the top before the great tax-rate cuts on the highest earners, especially in the 1980s. We can add to this the remarkable fact that the very centerpiece of contemporary progressive academic-celebrity macroeconomics—the U shaped curve of inequality of Thomas Piketty and Emmanuel Saez—was built on data that bleed the Laffer curve at every point.