News and Views from the Dismal Science

Dr. Econ's commentary on global economic and other affairs

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Tbe "Brauer curve"

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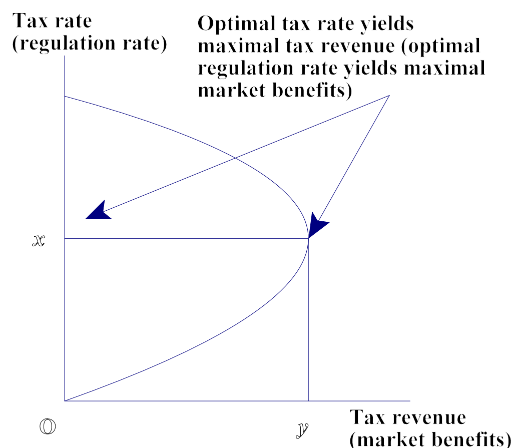

On 13 September 1974, Mr. Arthur Laffer famously drew a graph on a dinner napkin (see the Figure on the left), now widely known as the "Laffer curve." [1] Mr. Laffer explained to his companions, Dick Cheney, Don Rumsfeld, and Jude Wanniski, that raising tax rates above zero would, at first, raise tax revenue as well, but that beyond a critical point, *x*, raising tax rates further would begin to reduce maximal tax revenues (*y*) collected. In the figure, the area below *x* is the "normal range" (increases in the tax rate yield higher total tax revenue), and the area above *x* is the "prohibitive range" (where increases in the tax rate yield lower total tax revenue).

In drawing this curve, Laffer never claimed to have made an original contribution to economics. But the curve became the bedrock of the Reagan presidency's supply-side economics revolution in the 1980s. Specifically, Mr. Reagan believed that tax rates were in the prohibitive range so that lowering tax rates toward *x* should increase government tax revenue. Congress eventually concurred, and tax rates in the United States were cut.

The curve received much theoretical and empirical critique. The critique did not concern the extreme points. Clearly, when tax rates are zero, there is no revenue. Likewise, when tax rates are 100 percent, no one has any incentive to work, and there will no revenue either. Rather, the controversy was about just where the "tipping point" was — to use a currently fashionable phrase — at which the system moves from the normal to the prohibitive range.

I was reminded of the Laffer curve when listening to the debate about the current world financial crisis. Much is blamed on deregulation of the financial markets over the past 20 to 30 years. Even Mr. Greenspan — once adored as a demigod — conceded in U.S. Congress this month that during his tenure as Fed chairman he had made regulatory "mistakes." Regulation rates may have been too "low," and the system crashed. Europeans crowed and hailed the demise of American-style capitalism — until their own supposedly better regulated financial markets

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[1] For an image of the napkin, see http://www.polyconomics.com/gallery/Napkin003.jpg.

collapsed as well. Strict re-regulation is on the agenda.

In Arthur Laffer's spirit, I therefore propose (tongue-in-cheek) the Brauer curve. It states (see the Figure) that raising rates of regulation above zero would, at first, raise the benefits society derives from the operation of free markets, but that beyond a critical point, *x*, raising the rate of regulation further would begin to reduce the maximal benefits free markets provide. Raising regulations up to *x* would be the normal range over which an ever better, smoother, more beneficial functioning of free markets may be expected. Raising regulations beyond *x* would be the prohibitive range over which an ever worse, stuttering, less beneficial functioning of free markets may be expected.

More seriously, it is obvious that zero regulation leads to unfettered competition. Economists know that this is not how to run an economy. Likewise, 100 percent regulation strangles an economy as well. Rather obviously, the solution lies somewhere in-between. Just as economies can be over or undertaxed, so they can be over or underregulated. It is an empirical matter to find out where *x* lies.

One way to think about this, as I argued in last month's column, is to assess the systemic risk any one market poses to other markets. When the market for chewing gum collapses, it is unlikely that this will have substantial knock-on effects for the system as a whole. Therefore, it can probably remain lightly regulated. But with globally entwined asset markets the risk of system collapse is large. Therefore, they should be more tightly regulated and supervised. *The Economist* magazine and others (including myself) had argued this in the past. Now we seem to have won some converts. Regrettably, it's too late in the game, and the damage has been done.

Jurgen Brauer's latest book, co-authored with Hubert van Tuyll is *Castles, Battles & Bombs: How Economics Explains Military History* (Chicago, IL: The University of Chicago Press, 2008).

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