Chapter 4

The World Discovers the Laffer Curve

Stephen Moore

For 15 years, the *Index of Economic Freedom* has provided an indispensable road map for countries that want to achieve prosperity. The rules aren't complicated. As the *Index* has revealed, lasting prosperity is a result of a persistent commitment to low tax rates, a stable currency, limited government, strong private property rights, openness to global trade and financial flows, and sensible regulation. Together, these factors empower the individual and induce dynamic entrepreneurial activity.

Over the 15-year course of the *Index*, politicians have evidently been listening. Tax rates have been ratcheted down substantially. Inflation, despite recent setbacks, has been tamed in many parts of the world. Government spending is still growing, but not as fast as in the 1970s and 1980s, and in many countries, private-sector growth is outpacing the public sector. In other words, economic freedom is on the march, spreading more opportunities and higher standards of living around the world.[1]

1. Evidence of this comes from a Millennium Project assessment of how nations are working to alleviate poverty. Entitled *The State of the Future*, the report concludes that, beginning in 1985 and projected through 2015, 600 million people—twice as many as live in the United States—will have escaped dire poverty across the globe. Most of the progress comes from the two most populous nations, China and India, which are following free-market supply-side economic policies to the great economic benefit of their citizens. See Jerome C. Glenn and Theodore J. Gordon, *2007 State of the Future*, Millennium Project, 2007. The Millennium Project functions under the auspices of the World Federation of UN Associations, an "independent, non-governmental organization with Category One Consultative Status at the Economic and Social Council (ECOSOC) and consultative or liaison links with many other UN organizations and agencies," and "is a global participatory futures research think tank of futurists, scholars, business planners, and policy makers who work for international organizations, governments, corporations, NGOs, and universities." See Millennium Project Web site, at *http://www.millennium-project.org*.

In this chapter, I focus on the extraordinary tax-cutting revolution that started in the early 1980s, gathered momentum in the 1990s, and is now the most important economic policy trend on the planet. The movement was captured in a May 2007 story on Bloomberg News, which reported: "A tax-cut bidding war is spreading across Europe as leaders of the continent's biggest economies give up criticizing smaller neighbors for cutting business tax rates and decide to join them instead."[2]

The Wall Street Journal reports the same phenomenon. "Many countries have slashed their corporate rates," a July 1, 2008, story proclaimed.[3] Scott Hodge, president of the nonpartisan Tax Foundation, adds that "[t]ax rates are being cut so quickly around the world that it's hard to keep a good tally of all the latest developments."[4]

This essay investigates how much tax rates have fallen, where they have fallen, and what the consequences have been.

THE LOW-TAX REVOLUTION

Let's start the story in Sofia, Bulgaria. In early 2008, I met the instigator of the world's lowest flat tax, Svetla Kostadinova, director of the Institute for Market Economics in Sofia. Ms. Kostadinova persuaded a socialist government in Bulgaria to adopt a flat tax. She and her free-market think tank colleagues managed to persuade the politicians that the flat tax would increase revenues to the government—money that could be used for social programs.

Ms. Kostadinova told me that "the situation was getting desperate in Bulgaria. We were losing our population and our best workers. They were leaving for Western Europe to find jobs, and the number one form of foreign capital came from remittances." That changed when the corporate tax was cut to 10 percent in 2007 and the personal income tax to 10 percent in January of 2008. "We told the politicians that it would be symbolically important for Bulgaria to have the lowest flat tax," she noted. Today, a nation that 10 years ago had a double-digit unemployment rate now has a 6 percent jobless rate. And instead of people leaving Bulgaria to find jobs overseas, she laughed, "now it is the reverse. Western Europeans come to Bulgaria for jobs. We're gaining population now."[5]

I asked her: Don't the socialists say that the rich should pay more? "Of course, many do, and they want to raise the rates, but most understand that the flat tax gives us more jobs and more revenues."[6] In an interview in Washington later that year, Richard Rahn, the former chief economist for the U.S. Chamber of Commerce and now a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth, agreed and added: "These countries understand that the flat tax is the key to enhancing their prosperity—even the former Communists know this."

Mart Laar, the former Prime Minister of Estonia, was the first politician to bring the flat tax to Eastern Europe. Mr. Laar told me when I met him in 2007 that when he first pushed the flat tax, the major opponents were not the Estonian citizens, "who love the flat tax," but the economists and other wise men of government "both inside and outside of this tiny country. Almost all of the smartest minds told me 'We cannot have a flat tax. It is untested. It will not work. It will cause budget deficits,'" he recalls about their litany of objections.

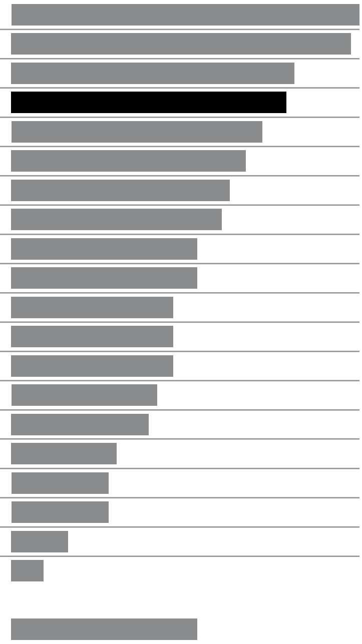
But remembering the virtues of the flat tax in Milton Friedman's classic book, *Free to Choose*, Mr. Laar insisted that the plan would work. So, in 1994, he heroically and wisely ignored the economic pundits and snapped in place one of the world's first flat taxes at 23 percent. Since then, Estonia has had one of the most rapid growth spurts of any nation in the world, and the country's adoption of the flat tax has been widely heralded as a cornerstone of its prosperity.

2. Simon Kennedy, "Tax-Cut War Widens in Europe as U.K., France, Germany Jump In," Bloomberg.Com, May 29, 2008, at *http://www.bloomberg.com/apps/news?pid=20601085&sid=aev_LMGsw3aw&refer=europe*.
3. "Corporate Tax Cut Windfall," *The Wall Street Journal*, July 1, 2008, p. A16.
4. Interview, July 2008.
5. Interview, August 2008.
6. *Ibid*.

The U.S. has never had a flat tax, but the global tax-cutting spree, in fact, began in the U.S. when Ronald Reagan enacted two tax cuts—one in 1981 and another in 1986—that reduced the highest marginal personal income tax rate to 28 percent from 70 percent. Reagan also tamed the double-digit inflation that had crippled the U.S. economy in the late 1970s. Those policies proved to be a gravitational pull on foreign investment capital of more than $5 trillion from 1982 to 2007. This tax advantage for the U.S. forced other nations to cut rates themselves or face a loss of competitiveness.

Top Personal Income Tax Rates Are Falling

Country	1980	2007	Change (Percentage Points)
United Kingdom	83%	40%	–43
Portugal	84	42	–42
Norway	75	40	–35
United States	**73**	**39**	**–34**
Sweden	87	56	–31
Italy	72	43	–29
Mexico	55	28	–27
Belgium	76	50	–26
New Zealand	62	39	–23
Spain	66	43	–23
Canada	64	44	–20
Germany	65	45	–20
Netherlands	72	52	–20
Ireland	60	42	–18
Finland	68	51	–17
Australia	62	49	–13
Austria	62	50	–12
France	60	48	–12
Denmark	66	59	–7
Switzerland	38	34	–4
Average	68	45	–23



Source: Organisation for Economic Co-operation and Development, OECD Tax Database, Table I.4, at *http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html*; World Tax Database, at *http://www.bus.umich.edu/otpr/otpr/introduction.htm.*

Chart 1 heritage.org

Over the past 20 years, and especially in the past five years, global personal and corporate tax rates have fallen at a faster pace than at any time in the past 100 years. (See Charts 1 and 2.) The average personal income tax rate among industrialized countries in 1980 was 68 percent. That rate fell to 50 percent in 1995 and today stands at 45 percent. This means that average personal income tax rates at the top of the income scale have fallen by over one-third. On the corporate income tax side, the tax-cutting momentum is even more pronounced. The average tax rate in industrialized nations has fallen by half, to 25 percent from 48 percent since the start of the Reagan era.

In the late 1980s, there was one nation in the world with a true flat tax: Hong Kong. Now there are 24 such jurisdictions, and most of these are in Eastern Europe. (See Table 1.) These nations, formerly behind the Iron Curtain of Communism, endured suffocating economic controls and declining living standards for half a century. Now they are capitalists par excellence and avid flat-tax partisans. The average flat tax rate is 20 percent, which has made the tax rates of Old Europe (40 percent to 60 percent) look as high as the Swiss Alps.

For many decades after it adopted a flat tax rate of 15 percent in 1947, Hong Kong enjoyed the benefits of a competitively low tax rate with no tax on dividends or capital gains or money earned outside of the island. Hong Kong has also embraced free trade, which explains why it has evolved into a capitalist paradise brimming with entrepreneurial spirit. The tax code is about 180 pages, compared to tens of thousands of pages for the U.S. tax code. The result has been that Hong Kong, over several decades, evolved into one of the richest places on Earth despite its tiny land mass and no natural resources. The only mystery is why it took nearly half a century for the rest of the world to start copying the Hong Kong flat-tax model.

Tax reductions are also an underappreciated part of the story of China's economic surge. In 1978, the late Chinese leader Deng Xiaping unleashed a series of free market–based economic reforms, including the legalization of privately owned farms (which caused a near doubling of food output above what the communist state-owned farms produced), the establishment of coastal economic enterprise zones, new opportunities for foreign investment and the privatization of state-owned enterprises.

But as Alvin Rabushka of the Hoover Institution points out, "The application of supply-side tax policies was the main component."[7] It helped to generate the double-digit rates of economic growth on the mainland that have become the stuff of economic legend. China is staying on the supply-side course. Effective January 2008, the Chinese corporate tax rate became 25 percent, down from 33 percent.

Corporate Tax Rates Are Falling

Country	1980	2007	Change (Percentage Points)
Ireland	45.0%	12.5%	–32.5
Austria	55.0	25.0	–30.0
Netherlands	48.0	25.5	–22.5
United Kingdom	52.0	30.0	–22.0
Portugal	47.2	26.5	–20.7
Germany	56.0	38.9	–17.1
Finland	43.0	26.0	–17.0
Australia	46.0	30.0	–16.0
France	50.0	34.4	–15.6
Denmark	40.0	25.0	–15.0
Belgium	48.0	34.0	–14.0
Mexico	42.0	28.0	–14.0
New Zealand	45.0	33.0	–12.0
Sweden	40.0	28.0	–12.0
Luxembourg	40.0	30.4	–9.6
Italy	40.0	33.0	–7.0
United States	**46.0**	**39.3**	**–6.7**
Canada	37.8	33.5	–4.3
Japan	42.0	39.5	–2.5
Norway	29.8	28.0	–1.8
Spain	33.0	32.5	–0.5
Average	43.5	30.3	–13.2

Source: Organisation for Economic Co-operation and Development, OECD Tax Database, Table II.I, at *http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#table_II1*; World Tax Database, at *http://www.bus.umich.edu/otpr/otpr/introduction.htm.*

Chart 2 heritage.org

EUROPE DISCOVERS THE SUPPLY SIDE

Even the fat welfare-state nations of Western Europe, whose tax rates climbed to hopelessly uncompetitive levels in the 1970s and 1980s, have been getting into the supply-side tax-cutting act.

The economic growth rate of European Union nations between 2002 and 2006 was about half the pace of U.S. economic growth. In the 1990s, European unemployment rates were consistently about 50 percent higher than the U.S. jobless rate. Euroland was no workers' paradise.

The Europeans are now slowly shedding many of the excesses of cradle-to-grave socialism and their confiscatory tax rates. In 2007, Germany under Chancellor Angela Merkel chopped the corporate income tax rate by about nine percentage points.[8] Now, amazingly, Germany, which started this century with an effective corporate income tax rate of over 50 percent, has sliced and diced

7. Alvin Rabushka, "The Great Tax Cut of China," *Hoover Digest* 1998, No. 1, Hoover Institution, at *http://www.hoover.org/publications/digest/3523046.html.*

8. Invest in Germany, "Company Taxation," at *http://www.invest-in-germany.com/homepage/business-guide-to-germany/the-tax-system/company-taxation.*

Flat-Tax Jurisdictions and Their Rates

Iceland	35.7%	Mauritius	15%
Lithuania	27%	Montenegro	15%
Jamaica	25%	Ukraine	15%
Latvia	25%	Russia	13%
Estonia	21%	Georgia	12%
Guernsey	20%	Albania	10%
Jersey	20%	Bulgaria	10%
Slovakia	19%	Kazakhstan	10%
Romania	16%	Kyrgyzstan	10%
Czech Republic	15%	Macedonia	10%
Hong Kong	15%	Mongolia	10%
Iraq	15%	Prednestrovie	10%

Source: Daniel J. Mitchell, "The Global Flat Tax Revolution: Lessons for Policy Makers," The Center for Freedom and Prosperity, *Prosperitas*, Vol. VIII, Issue I (February 2008), at *http://www.freedomandprosperity.org/Papers/flattax/flattax.shtml.*

Table 1 heritage.org

the corporate rate down to slightly less than 30 percent.[9] Ms. Merkel sounds a lot like Jack Kemp or Ronald Reagan when she says that the purpose of the tax cuts is to boost "Germany's attractiveness as a location for international investment."[10]

Spain has also driven its taxation lower. Under José María Aznar, the former conservative Prime Minister, as well as under the leadership of José Luis Rodríguez Zapatero, the current socialist Prime Minister, measures to reform Spain's taxation have been implemented. Spain's top personal income tax rate has been reduced to 43 percent from 56 percent while its corporate tax rate has been cut to 30 percent from 35 percent.[11] Prime Minister Zapatero may have taken a staunchly anti-American stand on the war in Iraq, but he was able to recognize a bad tax when he saw one, and Spain's wealth tax was abolished in 2008.

The surest sign of all that there is a new economic paradigm taking hold in Europe is that just two years ago, Sweden, the socialist workers' paradise, completely eliminated its estate tax because the political leaders realized that the tax was economically counterproductive. In promising to "abolish the wealth tax," Swedish Prime Minister Fredrik Reinfelt said, "We hope to give a boost to the desire to invest in Sweden and to create a condition for new, expansive companies to create more jobs."[12] So now Sweden and, more recently, Russia have no estate tax, while the land of the free, America, taxes death at 45 percent. In late 2008, Sweden also announced a plan to reduce its corporate tax rate by another percentage point to 24 percent, which is 11 points lower than the U.S. statutory rate.

Nor is Asia being left behind in this competition. South Korea cut its income tax to 40 percent by the late 1990s from 87 percent in 1978. Its tax revenues soared from $2 billion in 1980 to $24 billion by 1996 to nearly $50 billion in 2007. Vietnam announced in 2008 that it intends to reduce the corporate rate to 25 percent from 28 percent while removing other government barriers to growth.

The motivation for this tax-slashing on every continent is the free flow of investment. In this age of information and technology, borders don't matter much any more. The world has become one massive shopping market for capital. Nations are in a contest to climb past each other in a race up the economic growth ladder. Singapore, for example, recently approved a corporate tax cut to keep pace with its low-tax rival Hong Kong. Northern Ireland is making a bid to lower its corporate tax rate to 12.5 percent in an effort to catch up to the economic gazelle of Europe: Ireland. When I recently met with the Prime Minister of Scotland, Alex Salmond, he related the same

9. *Ibid*. Germany's standard federal corporate tax rate is 15 percent.
10. Kennedy, "Tax-Cut War Widens in Europe as U.K., France, Germany Jump In."
11. Economist Intelligence Unit, "Spain," *Country Briefing*, September 30, 2008, at *http://www.economist.com/countries/Spain/profile.cfm?folder=Profile-FactSheet*; Economist Intelligence Unit, *Country Commerce*, 1997 and 2000, available with subscription.
12. "Björn Borg, Come Home," *The Wall Street Journal*, April 11, 2007.

story. "Supply-side economics works. We've seen that in Ireland." Then he added: "Their low tax rates are attracting all the capital of Europe, and if we want to compete, our rates need to fall to near theirs."

I call this global phenomenon Reaganomics 2.0. The supply-side economics model, which the Gipper installed with such great controversy 28 years ago, is now the economic operating system around the globe. Foreigners have witnessed with envy the American prosperity boom of the past quarter-century. Where American politicians have decried "tax cuts for the rich," the rest of the world has taken note of the impressive and sustained rates of growth. Now it is possible that capital will begin to flow back as many of these economies start to treat investors and capital more kindly at home.

REVISITING THE IRISH MIRACLE

Ireland does not qualify as a flat-tax country because it only has a low flat-rate corporate tax. Regrettably, it still has steeply graduated personal rates. Yet the Irish economic miracle may be the greatest supply-side economics success story of recent times (other that the Reagan revolution). Ireland turned to the idea only when the nation was on its knees and all other inferior alternatives had been tried.

Just over a century and a half ago, Ireland had a population of some 8 million, but by 1980, that number had dwindled to 4 million, with far more Irish living in America than in Ireland. From the 1960s to the 1980s, Ireland became a giant welfare state burdened with high taxation, generous benefits for not working, and an industrial base in demise. The movie *The Commitments* depicted a rock-and-roll band with several of the struggling band members collecting free welfare benefits from the government. "It beats working," was the famous response of one band member when asked why he stood in long lines for monthly benefits. Indeed, it did, and Ireland's GDP stagnated.

In the 1990s, things began to change. Welfare was reformed; government services and enterprises became more efficient through privatizations; and, most important, the corporate income tax rate was cut to 12.5 percent—not just the lowest in Euroland, but one-third the average rate on the continent. In the succeeding 10 years, the population grew for the first time in decades, rising to 5.7 million; GDP rose at twice the rate of Europe's; and more than 1,000 international companies, such as Intel, Bristol–Myers Squibb, Microsoft, Dell, and Motorola, moved in. By 2000, Ireland's growth rate hit 8.7 percent a year and, perhaps most astonishing of all, with the lowest corporate tax rate in all of Europe, it achieved the biggest budget *surplus* as a share of GDP.

The winners in this economic transformation have been rank-and-file workers. The average hourly manufacturing wage soared by 126 percent from 1985 to 2004 at a time when many industrial nations were experiencing stagnant wage growth. The country's real GDP per person has climbed up to $30,736 from $9,957,[13] and the Irish on a per capita basis are now more than three times as rich as they were in 1980.

In 1991, Germany had a per capita income that was twice that of Ireland. By 2004, Ireland's per capita purchasing power exceeded Germany's.[14] In less than a decade and a half, Ireland climbed from last to first in Europe. That's economic development at warp speed. The Irish brain drain, which started during the potato famine of 1845 and continued almost unabated for the next 150 years, has finally reversed course. Now brains are coming back to Ireland where more job opportunities have been created. The unemployment rate has fallen to 4.5 percent from over 17 percent in 1985. (See Chart 3.)

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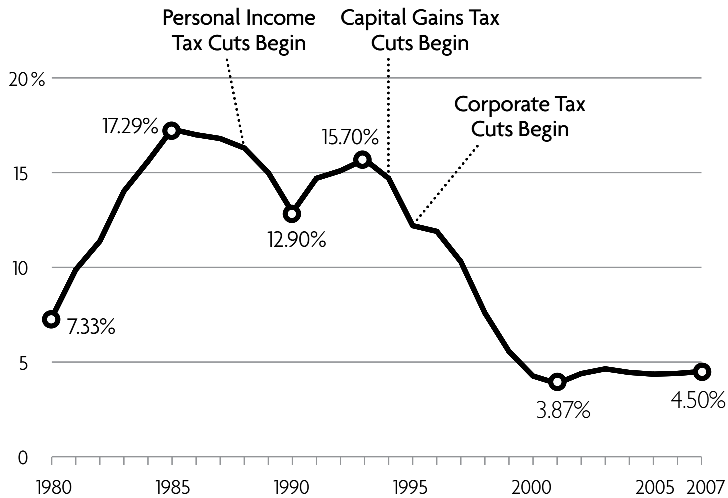
13. Figures are in real GDP per capita (in constant 2000 U.S. dollars). See World Bank, *World Development Indicators Online*, available with subscription at *http://www.worldbank.org/data.*
14. Eurostat, "GDP per Capita in 2004: GDP per Capita Varied by One to Five Across the EU25 Member States," news release 75/2005, June 3, 2005, at h*ttp://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2005/PGE_CAT_PREREL_YEAR_2005_MONTH_06/2-03062005-EN-BP.PDF.*



Source: International Monetary Fund 2008 World Economic Outlook, April 2008, at *http://www.imf.org/external/pubs/ft/weo/2008/01/weodata/index.aspx*; Central Statistics of Ireland, Labor Market, Principal Statistics, at *http://www.cso.ie/statistics/sasunemprates.htm.*

Chart 3 heritage.org

CUTTING CORPORATE TAXES

As the Irish success story illustrates, one of the taxes that has a large impact on a nation's ability to compete in global markets is the corporate tax, which is coming down rapidly just about everywhere—except the U.S. In 2006 and 2007, 12 nations cut their corporate rates, including Germany, Spain, and the Netherlands. In 2008, nine of the 30 most developed nations and 20 countries worldwide—from Israel to Germany to Turkey—cut corporate tax rates. For the first time ever, the U.S. statutory rate is now a full 50 percent higher than the average of our international competitors. (See Chart 4.)

The *Index of Economic Freedom* has shown that commitment to lower taxation is a key component of a country's effort to create a virtuous cycle of entrepreneurship, growth, and lasting prosperity for its citizens. A 2008 study by the Organisation for Economic Co-operation and Development, "Tax and Economic Growth," examines why some countries are becoming more prosperous than others and concludes that "corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes."[15] The study finds, not surprisingly, that investment rates fall when corporate tax rates rise and that the most profitable and most rapidly expanding companies tend to be the most sensitive to corporate tax rates.

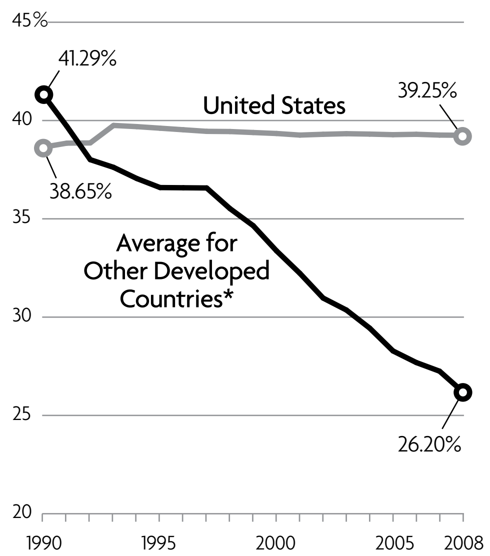
High corporate tax rates are also self-defeating because they don't produce much if any revenue. The average European nation's tax rates on corporate income are 10 percentage points *lower* than those in the U.S., but those countries on average raise almost twice the share of GDP in corporate taxes. Ireland, with its bargain-basement 12.5 percent rate, captures a higher share of its GDP in corporate taxes than the U.S. captures with a tax rate that is *three times higher* than Ireland's.

Policymakers in the two highest corporate tax nations, the U.S. and Japan, may want to take a look at a 2006 study by two scholars, Kevin Hassett and Aparna Mathur, at the American Enterprise Institute (AEI).[16] They

15. Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, "Tax and Economic Growth," Organisation for Economic Co-operation and Development, Economics Department *Working Paper* No. 620, July 2008, at *http://www.olis.oecd.org/olis/2008doc.nsf/LinkTo/NT00003502/$FILE/JT03248896.PDF*.
16. Aparna Mathur and Kevin A. Hassett, "Taxes and Wages," American Enterprise Institute *Papers and Studies*, March 6, 2006, at *http://www.aei.org/publications/pubID.24063/pub_detail.asp*.

Comparing Corporate Tax Rates

On average, other developed nations have decreased their corporate tax rates, while the U.S.'s rate has remained relatively flat.



* Combined central and subcentral government corporate tax rate.

Source: Organisation for Economic Co-operation and Development, Taxation of Corporate and Capital Income, Table II.1, at *http://www.oecd.org/dataoecd/26/56/33717459.xls*.

Chart 4 heritage.org

find that the burden of the corporate income tax rate is borne in large part by workers in the form of lower wages. In a study of 72 nations, they found that manufacturing wages were negatively associated with high corporate tax rates.

The Laffer Curve effect suggests that nations will increase their economic output and competitive stature in the global race for capital by cutting business tax rates even further. Alan Reynolds, an economist at the Cato Institute (and formerly of the Hudson Institute), has confirmed this relationship: Countries that cut tax rates sharply outperform those that don't. He labels the tax rate reduction countries "supply-side economies" and the countries that raised tax rates in the 1990s "demand-side economies." The "supply-side economy nations—whose tax rates fell to an average of 34 percent from 61 percent—experienced economic growth rates three times higher than the demand-side countries." (See Table 2, work Mr. Reynolds did while an economist at the Hudson Institute.) "Hong Kong, Singapore, and most other economies that have adopted supply-side tax strategies, have seen their private consumption, and investment, good measures of living standards, increase three times the pace of the demand-side economies,"[17] he wrote in a later paper.

WHY RATES MATTER

Very high tax rates can distort economic behavior and reduce the incentive to work and earn. Consider celebrities. Rock stars and highly paid actors regularly engage in tax-minimization strategies, much to the consternation of their home countries, as a January 2007 story in *The Economist* explained:

> Sometimes it takes a rock star. By moving to Switzerland to flee punitive French taxes, Johnny Hallyday, France's 63-year-old rock idol, has set off a new debate. Many other high-earning French celebrities have become tax exiles, prompting periodic moral outrage. But this departure is politically embarrassing: Mr Hallyday's friend, Nicolas Sarkozy, is set to be the centre-right's presidential candidate. "If he reforms the wealth and inheritance law," Mr. Hallyday told *Paris-Match*, "well, then I will come back to France."[18]

Hallyday said that 70 percent of his earnings goes to the state and that he had "a particular gripe about the annual wealth tax, or ISF, which is applied to almost all assets, whether revenue-generating or not." According to *The Economist*'s account, "Even Thierry Breton, the finance minister, once called the wealth tax 'economically dangerous.'"[19]

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17. Alan Reynolds, "A Depressing Situation," *The Washington Times*, May 4, 2003, at *http://www.cato.org/pub_display.php?pub_id=5674*.
18. "Tax 'n' Wealth and Rock 'n' Roll," *The Economist*, January 4, 2007.
19. *Ibid*.

Comparing Supply-Side and Demand-Side Economies

Top Marginal Tax Rate

	Supply-Side Economies	Demand-Side Economies
1979	61%	63%
1989	43%	46%
1995	34%	49%

Average Growth in GDP

	Supply-Side Economies	Demand-Side Economies
1985–1994	5.10%	1.40%

Source: Hudson Institute.

Table 2 heritage.org

Ségolène Royal, then the Socialist presidential candidate, "said top earners should 'set an example' and pay their taxes without a fuss."[20] But they do put up a fuss, because rock stars are like everyone else: They don't want to pay confiscatory taxes. The academic evidence confirms these anecdotes. One 2004 study by Nobel prize–winning economist Edward Prescott for the National Bureau of Economic Research (NBER) found that people work more when tax rates are lowered:

> Americans now work 50 percent more than do Germans, French and Italians. This was not the case in the early 1970s.... [T]his marginal tax rate accounts for the predominance of the differences at points in time and the large change in relative labor supply over time.[21]

Another NBER study found that among rich nations, a lowering of tax rates in the 1990s led to an increase in hours worked and an increase in the number of people in the labor force. It also found that the "shadow economy"—i.e. underground activity—rises "by 3.8 percent of GDP for every 12.8 percentage point increase in the tax rate."[22]

Finally, in a 2007 study financed by the National Science Foundation, Christina Romer and David Romer examined tax policy changes in the United States from 1947 through today. Their study found that "tax increases are highly contractionary. The effects are strongly significant, highly robust, and much larger than those obtained [in earlier studies]. The large effect stems in considerable part from a powerful negative effect on investment."[23]

CONCLUSION

Fifteen years ago, when the first edition of the *Index of Economic Freedom* was published, the supply-side idea of the Laffer Curve—that high tax rates reduce growth and can even reduce revenues—was still highly controversial and disregarded among the political class and even trained economists. Today, however, more nations around the globe are embracing the idea.

The sentiment among the tax-chopping nations is that lower tax rates are a critical component of the process of capitalizing on the globalization of financial markets. Hundreds of billions of dollars of investment capital are traded every day across international boundaries, and investors are attentive to each jurisdiction's tax rates.

But there is still one place on the globe where the idea that lower tax rates generate more entrepreneurial activities and economic growth is being disparaged: the United States. James Surowiecki, a *New Yorker* financial page columnist, argued in 2007 that supply-side tax prescriptions for the economy are the equivalent of "saying that the best way to treat sick people is

20. *Ibid*.
21. Edward Prescott, "Why Do Americans Work So Much More Than Europeans?" National Bureau of Economic Research *Working Paper* No. 10316, February 2004.
22. Steven J. Davis and Magnus Henrekson, "Tax Effects on Work Activity, Industry Mix, and Shadow Economy Size: Evidence from Rich-Country Comparisons," National Bureau of Economic Research *Working Paper* No. 10509, May 2004.
23. Christina Romer and David Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," University of California, Berkeley, November 2006, at *http://www.economics.ucr.edu/seminars/fall06/ets/Romer11-27-06.pdf.*

to bleed them to let out the evil spirits."[24]

Today much of the talk in Washington is of higher income taxes, capital gains taxes, dividend taxes, payroll taxes, energy taxes, and hedge fund taxes. The threat of this tax assault on wealth and capital is taking a toll on investor confidence in the U.S. economy. Michael Darda, a top Wall Street economic analyst for MKM Partners, hypothesizes that this is "one reason the U.S. dollar has fallen relative to the currencies of other nations."

What this suggests is that if the U.S. refuses to cut its tax rates—or, even worse, if it follows the "tax-hike on the rich" course that has become so popular among many politicians in Washington—America's economic freedom, competitiveness and prosperity will be in great peril.

24. James Surowiecki, "Tax Evasion: The Great Lie of Supply-Side Economics," *The New Yorker*, October 29, 2007, at *http://www.newyorker.com/online/2007/10/29/071029on_onlineonly_surowiecki.*