COLUMN-From Russia with Laffer, a tax cut tale:Christopher Swann

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- Christopher Swann is a Reuters columnist. The views expressed are his own --

By Christopher Swann

NEW YORK, June 23 (Reuters) - The current woes of the U.S. economy have given many Republicans an opportunity to reaffirm their faith in the magical power of tax cuts. It has long been a central tenet of the party's credo that tax cuts can provide such a strong kick to growth that they actually increase revenues.

So there was great glee in Republican circles when highly-prized proof of this elusive phenomenon was uncovered in Russia. When Putin introduced a flat tax in 2001 at 13 percent, more than halving the top rate, the government's haul actually grew by a quarter in just a year. Ever since, the case has been widely deployed by tax cut enthusiasts to back their cause.

Now a new piece of research suggests that Russia's example may indeed provide a strong case for tax cuts in many countries. Sadly, the United States is not among them.

The appealing notion that lowering the tax burden can produce extra revenue was popularized by U.S. economist Arthur Laffer. In nations where governments have become too voracious, tax cuts can pay for themselves as the incentive to work increases and the allure of dodging taxes is reduced.
http://www.heritage.org/research/taxes/bg1765.cfm

The study on Russia, published in this month's Journal of Political Economy, found that although the tax cut did increase tax compliance, it did nothing to boost the work ethic. This would suggest that only countries suffering from widespread tax evasion would benefit from following Russia's lead.
http://www.econ.berkeley.edu/~ygorodni/flat_tax_evasion_GMP.pdf

Using surveys of household spending, the study found that prior to the tax cuts, Russians were typically spending 30 percent more than they reported in income. Since most had little or no savings to draw on, the gap is largely explained by people hiding pay from the taxman.

This evasion declined sharply after the tax rate was lowered to produce a bumper tax yield. By contrast, they found no evidence that Russians worked harder or earned more. The lesson is not to expect the productivity boost predicted by the Laffer curve, says co-author Yuriy Gorodnichenko, a professor at Berkeley.

This undercuts the case that tax cuts can pay for themselves -- or anything close -- in nations like the United States.

The IRS estimates of the U.S. tax gap sound big at around $290 billion a year. In fact, America may already be pushing up against the limits of how low tax evasion can go. According to some estimates the United States has the smallest black market of any nation relative to its size.
http://www.dur.ac.uk/john.ashworth/EPCS/Papers/Schneider.pdf

With relatively low tax rates and a fiercely efficient tax collection system, tax cuts undermine revenues. Even under the leadership of Republican Douglas Holtz-Eakin, the Congressional Budget Office estimated that the boost to economic activity from a cut in income tax would offset no more than a fifth of the revenue lost. http://www.cbo.gov/ftpdocs/69xx/doc6908/12-01-10PercentTaxCut.pdf

While America would lose from following Russia, several BRICs colleagues could gain.

This is particularly true of Brazil, where the black economy may be as high as 40 percent of the total. Punitive payroll taxes have pushed a large share of the workforce into the black economy. Brazil could certainly get a Laffer curve effect by cutting their Scandinavian-level employment taxes, according to Christopher Granville, Managing Director of Trusted Sources.

India, where the informal economy is about a quarter of GDP, might take a punt on Laffer-curve tax cuts. (Although with a budget deficit of more than 10 percent of GDP it would be a leap of faith.)

The Laffer curve offers an important insight for nations with shaky tax systems and ubiquitous evasion. For America it is a pernicious and misleading idea that Republicans should now abandon. (Editing by Martin Langfield)