

Laffer Curve

The Laffer curve shows the relationship between tax rates and a nation's total tax receipts. The Laffer curve shows that as a nation increases its tax rates, its total tax revenues will increase as well, but only up to a point. At some point, tax rates become so burdensome that the average taxpayer chooses not to work, and tax revenues start to decline. At some point, tax revenues hit a maximum and start falling as tax rates increase.

A Laffer curve will resemble the first half of a sine curve. When tax rates are at zero, tax revenues will be zero. When tax rates are at 100 percent, tax revenues will be zero (since no one will work). At some point between 0 – 100, tax revenue will hit a maximum.

What exactly is the rate that will lead to optimal tax revenue is hard to say. Those people who would like to raise tax rates claim the optimal rate is very high. Those people who would like to cut tax rates claim the optimal rate is very low.

One thing is certain. The optimal rate is clearly not 100 percent. The average tax payer would cut back on working long before the effective tax rate is even close to 100 percent.

The main implication of the Laffer curve is the following. If tax rates are higher than the rate necessary to optimize tax revenues, and if the government tries to raise revenues by raising rates, then tax revenues will actually go **down**. Furthermore, if tax rates are above the optimal rate, the government can actually raise revenues by **cutting** tax rates.