

Understanding the Laffer Curve



In 1974, economist Art Laffer reportedly first sketched his now-famous curve on a napkin to illustrate his belief that reducing tax rates could actually increase tax revenues. The theory is at the heart of supply-side economics, which helped motivate the Reagan-era tax cuts and President Bush's tax-relief efforts in 2001 and 2003.

The Laffer Curve is simply a depiction of the law of diminishing returns. If tax rates are too low, the government can't raise enough funds to meet the needs and expectations of the public. If rates are too high, economic activity could be stifled and cause tax revenues to fall.

A look at the left side of the curve shows that at a tax rate of 0%, the government collects no revenue regardless of the size

of the tax base. On the far right side of the curve, a tax rate of 100% also results in no revenue, because there is no incentive to work, and thus no tax base. Somewhere on the curve between 0% and 100% lies a tax rate (t) that should maximize tax revenues.

Policymakers usually disagree on whether tax rates are resting too far to the left or right on the curve. Unfortunately, there is no concrete formula that uncovers the taxation "sweet spot," so they must ultimately rely on trial and error.

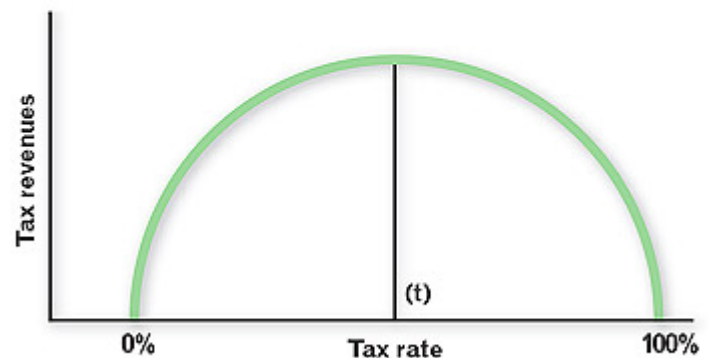
There is considerable debate about the controversial graph. Supply-siders point to the positive effects that tax cuts can have on productivity, investment, and employment in a given economy. They say the curve proves that tax cuts can actually pay for themselves in the long run by increasing the tax base. As evidence, they point to the fact that federal tax receipts and the U.S. economy have grown steadily since federal taxes were cut significantly in 2003.¹

Critics argue that cutting taxes without reducing spending will cost society more over time, primarily in the form of interest payments on larger budget deficits. Others object to the notion of maximizing revenues at all.

The Laffer Curve

In this hypothetical example, (t) represents the rate of taxation at which the government takes in the maximum tax revenue. Theoretically, a higher rate or a lower rate would result in diminishing revenues.

It is important to note that in theory, (t) could appear anywhere on the scale, and not necessarily near 50% as depicted.



Regardless of which side of the debate you take, the Laffer Curve may help with decisions about your own financial situation. For example, if you were to set aside 0% of your income, it is unlikely that you would be able to reach your financial goals.

Conversely, if you were to invest 100% of your income, it is also unlikely that you would be able to reach your goals because you would have nothing to live on. Somewhere in between is the ideal balance. This might seem a bit simplistic, but that's because the idea is clearest at both extremes.

The point is, any financial decision you make should be based on the benefits and drawbacks that apply to your situation, whether you are considering what to do about risk, taxes, asset allocation, or retirement plan contributions.

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1) Haver Analytics, 2006