Tax Revenues, Tax Rates and Curves

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The purpose of this document is to define how we budget for the effect of taxes. In other words, this document defines the relationship between tax revenues and tax rates. If you raise tax rates and the revenue goes down, can you lower tax rates and forecast the revenues to go up? No, because we cannot predict the relationship between these revenues and rates.

An Unpredictable Curve

When people budget, they are forced to assume that relationship is linear, but history says it is a curve, a curve we cannot predict. Common sense also says it should be a curve. Common sense says that when taxes are either 100% or 0% government will receive zero revenue. In between 0% and 100% revenues go up and then down as the tax rate increases. In other words, common sense says that as the tax rate goes up, revenue goes up to a point as a function of the tax rate; but that function changes or curves as the rate goes up. It changes because people are free to end businesses, free to retire. As long as people are free, we cannot predict that point. It is like navigation. The weather throws curves to the navigator all the time, but he is forced to navigate with linear functions. The navigator experiences curved functions because the weather is an open system, but when they budget (predict when things are going to happen) navigators are forced to assume linear functions in the short term. Like business markets, weather has proven to be an open system producing unpredictable curves. Therefore, tax revenue budgets like weather forecasts are only good for the short term.

Because People Go Out of Business

Common sense says that it is very hard to budget tax revenues. Even if there is no rate change, in free markets the return of revenues on those rates may go up or down. For example: hard working people are free to take their money and retire. When it is not fun to be in business, people retire. Who can predict when people will retire? The most we can say about the relationship between revenues and rates is that when we raise rates past a certain point revenues will go down, and before that point the return on the rate will go down. The point where the return goes down is where the line begins to curve. Because people go out of business, it may curve from the beginning (anytime we raise rates). The problem: nobody can predict that revenue decrease or the curve before and after that point. Because people are free, it is an unpredictable curve.

Summary: Tax Revenues, Tax Rates & Curves

The purpose of this document is to define how we budget for the effect of taxes. If you raise tax rates and the revenue goes down, can you lower tax rates and forecast the revenues going up? No, because we cannot predict the relationship between revenues and rates, we cannot say rate changes cause revenue changes. Like the weather, business markets are open systems. The weather is free to change and people are free to retire from or enter into business.