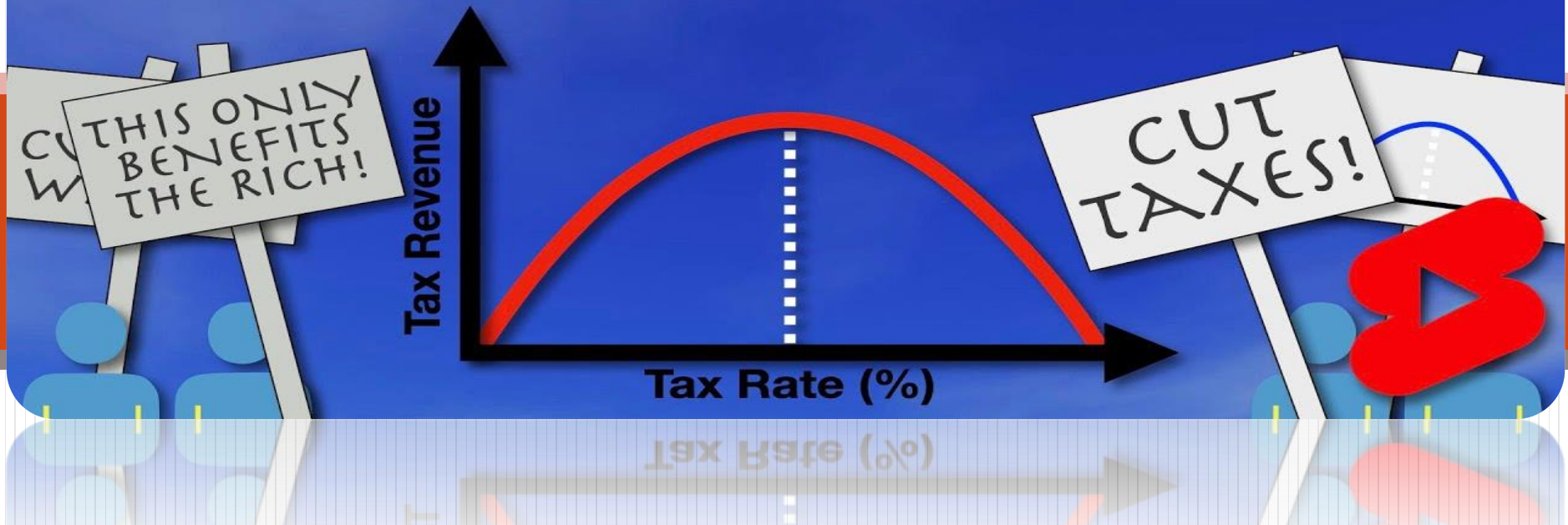# THE LAFFER CURVE ANALYSIS

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- ## THE LAFFER CURVE ANALYSIS

  A Significant aspect of the supply side economics called as the **Laffer Curve Analysis** is given by *Arthur B. Laffer.* This analysis is concerned with the relationship between tax rates and tax revenues. It rests upon the assumption that a reduction in the marginal rate of tax makes addition to the inducement to work, save and invest. The cut upon tax rate thereby can bring about an increase in tax revenues. According to Laffer, the extreme tax rates of zero per cent and 100 percent result in zero tax revenue to the government. In case of a zero per cent rate of tax, obviously no tax revenues will become available. On the other extreme, if the rate of tax is 100 per cent, the entire additional income will be taken away by the government and people will have little incentive to work, save and invest. So even in this situation, the tax revenue will fall down to zero. Between the two extremes of zero percent and 100 per cent tax rates, an increase in the tax rate will be associated with an increase in the tax revenues upto some maximum level. Thereafter, the increase in tax rate will cause a decline in the tax revenues and at the 100 per cent tax rate, the tax revenues fall down to zero. So according to Laffer, the optimum rate of tax is one at which the tax revenue is maximum. When the tax rate is higher than the optimum rate of tax, it is desirable to cut down the tax rate for maximizing the tax revenues.

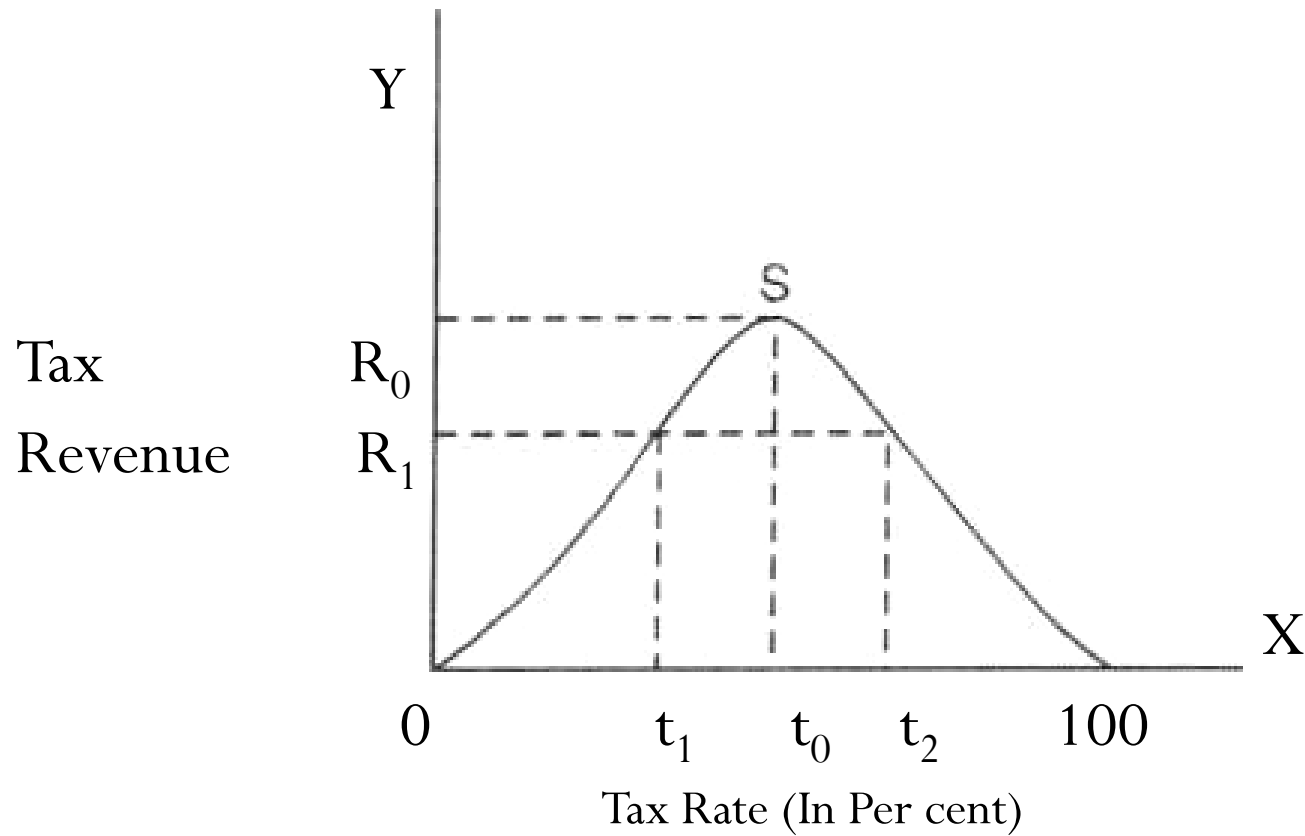The Laffer curve, expressing the relation between tax rate and tax revenues, is shown in Fig. AV-1

Fig. A V-I

In Fig. A V-1, the tax rate is measured along the horizontal scale and tax revenue is measured along the vertical scale. The tax rate ranges from zero per cent to 100 per cent. The Laffer Curve initially slopes positively. After the tax rate t_0, this curve slopes negatively. The tax revenues to the government are zero at the zero per cent and 100 per cent rate of tax. At the tax rate to, the tax revenue is maximum at OR_0 $(=St_0)$. So the tax rate t_0 is the *optimum* tax rate. When the tax rate is less than t_0, it is possible for the government to secure higher tax revenues by raising the rate of tax. If the tax rate is higher than t_0, say t_2, the tax revenue is OR_1 which is less than the maximum tax revenue OR_0. In such a situation, the government can raise the tax revenue through a reduction in tax rate. The Laffer Curve shows that except for the optimum rate, there are always two tax rates that can yield the same tax revenue. Fig A V-l shows that tax revenue OR] can be obtained by the tax rates t_1 and t_2. If tax rate is t_1 the maximum tax revenue can be secured by the government through raising the tax rate upto the optimum rate of t_0. On the opposite, if the tax rate is t_2, the reduction in tax rate upto t_0 can result in increase in tax revenue.

The Laffer Curve displays two distinct ranges *(i)* the normal range and *(ii)* the prohibitive range. The normal range lies to the left of the optimum tax rate t_0. In this range, an increase in tax rate brings about an increase in tax revenues. To the right of optimum tax rate t_0, there is prohibitive range. In this range, an increase in tax rate adversely affects the inducement to work, save and invest. The fall in output offsets the effect of increase in tax rate upon the tax revenues and there is a fall in the total tax revenue. As the rate of tax reaches the level off 100 per cent, nobody is inclined to work and invest, so that tax revenues fall down to zero. So high tax rate leads to low economic growth and high unemployment. In the prohibitive range, a cut upon rate of tax will strengthen the inducement to work, save and invest. In addition, people switch their funds out of low-yielding tax shelters and untaxed under-ground economy into more productive and socially desirable channels of investment. In such a situation, there will not only be an increase in tax revenues but also the higher rates of economic growth and employment.

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THANKS

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