Laffer curve : a case study on how tax rate and government revenue influence each other

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Abstract

The Laffer curve is a representation of the relationship between government revenue raised by taxation and possible rates of taxation. It illustrates the concept of taxable income elasticity – that taxable income will change in response to changes in the rate of taxation. The Laffer curve usually postulates that no tax revenue will be raised at the extreme tax rates of 0% and 100%. If both a 0% and 100% rate of taxation generate no revenue, but some intermediate tax rate generates some tax revenue, it follows that there must exist at least one rate where tax revenue would be a non-zero maximum. The Laffer curve is typically represented as a graph which starts at 0% tax with zero revenue, rises to a maximum rate of revenue at an intermediate rate of taxation, and then falls again to zero revenue at a 100% tax rate. The actual existence and shape of the curve is uncertain and disputed. One potential result of the Laffer curve is that increasing tax rates beyond a certain point will be counterproductive for raising further tax revenue. A hypothetical Laffer curve for any given economy can only be estimated and such estimates are controversial. The New Palgrave Dictionary of Economics reports that estimates of revenue-maximizing tax rates have varied widely, with a mid-range of around 70%.