

ECONOMICS IN THE REAL WORLD

STUDENT RESOURCES

A-LEVEL

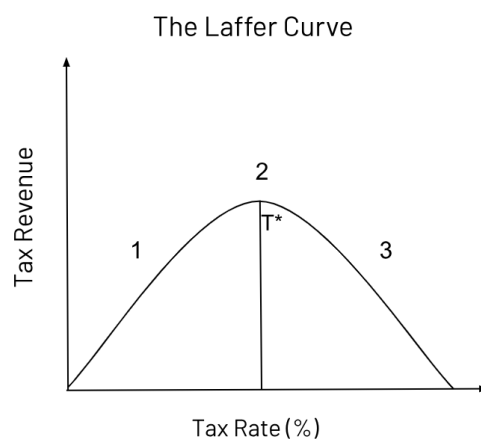


ADAM SMITH
INSTITUTE

Edexcel A-Level Economics: 4.5.2 Taxation, b) Tax revenues: The Laffer curve

AQA A-Level Economics: 4.1.8.9 Government intervention in markets, 4.2.5 Fiscal Policy and supply-side policies

The Laffer curve sets out the relationship between tax rate and tax revenues.



Explanation of the curve

- 1** At low tax rates, increasing the tax rate leads to increased tax revenue. This is because more income is subject to taxation.
- 2** T^* is the maximum tax rate that can be reached before tax revenue begins to decrease as tax rate increases.
- 3** If the tax rate exceeds T^* , tax revenue begins to fall.

This is for a variety of reasons:

- Workers lose the incentive to work due to the high amount of their salary the government is claiming in tax
- People begin to engage in tax avoidance or tax evasion (illegal) strategies.
- 'Brain drain' effect. By increasing the tax rate, the country is at risk of losing high income taxpayers or large companies who seek lower tax rates in other countries.

ECONOMICS IN THE REAL WORLD

STUDENT RESOURCES

A-LEVEL



ADAM SMITH
INSTITUTE

Criticisms of the Laffer curve

- Lack of empirical evidence to support the Laffer Curve's claims. E.g. The United Kingdom implemented a series of tax cuts in the early 2010's, but government revenue remained relatively stable during this period.
- Vague ideal tax rate: An exact numerical value of T^* is not provided, the Laffer curve merely identifies it as being somewhere between 0% and 100%.
- The Laffer curve assumes that all taxpayers will respond to a tax cut/rise in the same way. In reality, the way citizens are motivated is dependent on a multitude of factors and taxpayers react in different ways.
- According to the backward bending supply curve, as tax rates decrease, some people choose to take more leisure time and work less resulting in lower tax revenues.

When can it be used?

The Laffer curve is a great graph to use when reviewing any tax increases or tax cuts.

E.g. If making a point that a tax increase could lead to extra revenue, this can be evaluated using the Laffer curve such as:

However, a tax rate increase may not always lead to increased tax revenue. As seen on the Laffer curve, this is entirely dependent on the existing tax rate of the country. If increasing the tax rate further pushes a country's rate past T^ then tax revenue can decrease.*

KEY TIP: In your exam, do not only write your point but draw and annotate a graph also.