

An Income Tax Laffer Curve – the Indian Experience*

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With a view to know whether the Indian Economy is on the downward-sloping portion of the Laffer Curve an attempt has been made in the present exercise by a simple methodology. The estimates of elasticities of income tax revenue with respect to peak marginal rate of income tax are persistently negative and drastically declined on account of reduction in peak marginal rate of personal income tax from 50 per cent in 1991-92 to 40 per cent in 1992-93 confirming the validity of the thesis of the negatively sloped region of the Laffer Curve in India.

The estimates of elasticities of income tax revenue with respect to peak marginal rate of income tax are persistently negative and more than unity on account of reduction in peak marginal rate of personal income tax from 50 per cent in 1991-92 to 40 per cent in 1992-93 confirming that so far as income tax revenue and its relationship with peak marginal tax rate is concerned India was operating on the negatively sloped income tax Laffer Curve in the post-reform period.

The responsiveness of revenue from income tax to change in peak tax rates has become a critical aspect in India in view of lowering of peak income tax rates on the popular belief that the Laffer curve phenomenon works. A number of studies on measuring the effect of cuts in tax rates on raising revenue from income tax have been carried out in India. Amaresh Bagchi and Govind Rao (1982) raised doubts about the validity of the presumption in vogue that a reduction in tax rates leads to a higher yield of income tax owing to better compliance. Sahota (1991) on the basis of results of the study pointed out that revenue from income tax will increase with further cuts in the marginal tax rates at the upper end. Pinaki Chakraborti (1997) examined whether the lowering of tax rates has resulted in higher tax mobilisation or not in recent years. He pointed out that the reduction in tax rate cannot generally make a tax more buoyant instantly. There is a time lag involved. Since there is a time lag, the expectation that the Laffer Curve phenomenon, accepting that it has validity for some taxes for some time, though not in its purest form, will start operating instantaneously with a reduction in tax rate, may prove far too optimistic. Though the Laffer Curve is getting a lot of attention in India, not even a single exercise has been carried out to examine the impact of the reduction in the maximum marginal rate of personal income tax from 50 per cent in 1991-92 to 40 per cent in 1992-93 on income tax revenue by estimating the elasticities of income tax revenue with respect to peak rate of income tax. This petite exercise examines the validity of negatively sloped region of the Laffer Curve by a simple methodology using secondary data. For this purpose, data on income tax revenue (R) and maximum marginal rate of income tax (TR) have been collected from the documents published by the Centre of Monitoring Indian Economy (CMIE), the Economic Times, Public Finance Statistics

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