

THE HORIZONTALLY S-SHAPED LAFFER CURVE

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Abstract

In a neoclassical growth model with incomplete markets and heterogeneous, liquidity-constrained agents, the properties of the Laffer curve depend on whether debt or transfers are adjusted to balance the government budget constraint. The Laffer curve conditional on public debt is horizontally *S*-shaped. Two opposing forces explain this result. First, when government wealth increases, the fiscal burden declines, calling for lower tax rates. Second, because the interest rate decreases when government wealth increases, fiscal revenues may also decline, calling for higher taxes. For sufficiently negative government debt, the second force dominates, leading to the odd shape of the Laffer curve conditional on debt. (JEL: E0, E60)

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