Consumption taxes and taste heterogeneity

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Abstract
We study optimal commodity taxes in the presence of non-linear income taxes when agents differ in skills and tastes for consumption. We show that commodity taxes are partly determined by a many-person Ramsey rule when there is taste heterogeneity within income classes. The usual role of consumption taxes in relaxing incentive constraints explains the remaining part of these taxes when there is taste heterogeneity between income classes. We quantify the importance of these two components on Canadian microdata using a new method to identify empirically the binding incentive constraints. Incentives matter but tax exemptions are mostly justified by Ramsey considerations.

(with Fanny Henriet)

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