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 commod- ity 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 relax- ing 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.

Keywords: both

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