

On Policy Relevance of Ramsey Tax Rules Author's response to comments by referee

The referee makes one major point and some minor points about the paper. I appreciate the referee's contribution to the paper.

Major Point The Corlett-Hague Tax Rule and other references

I completely agree that the paper Corlett W. J. and D. C. Hague (1953) in RES is an important one which needs to be consulted, quoted and discussed in the current paper. The Corlett-Hague tax rule states that the commodity which is more complementary to leisure should carry a relatively high tax burden in order to offset the tendency of the tax system to induce substitution towards leisure. Put more simply, indirect tax system should discourage the purchase of commodities that are consumed jointly with leisure. Intuitively, this rule is perfectly consistent with optimal commodity taxation rule proposed by Ramsey (1927). In the current paper I have made extensive use of this rule in explaining the Ramsey tax principle (see page 5 first para and page 10 last para), but I have not quoted the famous Corlett-Hague paper. I plan to discuss this paper and quote it properly in a revised version of the paper.

There are other important papers which will be consulted and discussed in the revised version. One of these papers is Diamond and Mirrlees (1971) AER, which the referee has pointed out in the minor remarks section (more discussion on it to follow). The other papers which I plan to discuss in the revised version include Auerbach (1989) JPubEcon, Kleven (2004) JPubEcon, Sandmo (1990) OEP, Kleven, Richter and Sorensen (2000) OEP, and Saint-Paul (2007) Ee-journal. I will discuss later where in the current paper consultation of these papers will add value.

Minor Points

Page 5 (uniform commodity taxation): In the current paper, I have explained why VAT or GST type commodity taxation has led the policy reforms. My explanation is based on lower administrative costs, simplistic tax administration and tax neutrality. I think the Diamond and Mirrlees (1971) paper's key finding (that tax wedge should be placed between the firm and the consumer and that no tax should be levied on intermediate goods) *may be* drawn as an intuition supporting the administrative simplicity as well as the tax neutrality grounds of VAT or GST type commodity taxation schemes; But I think Diamond and Mirrlees (1971)'s findings are more useful in explaining why despite the VAT or GST type schemes some goods are taxed differently. More precisely, their findings explain well why even with the VAT or GST type commodity taxation schemes certain goods or services that are close substitutes for untaxed household production should be exempt or should be taxed at concessionary rates. This issue (optimal taxation with household production) is an important part of the optimal taxation literature which the current version does not discuss. In

page 5 and 6 of the current version, I have discussed about the UK tax policy where some goods and bads are taxed at different effective rates than the VAT rate. In the revised version I will extend this discussion with intuitions drawn from this particular literature. This is where I plan to discuss the findings of Kleven (2004), Kleven et al. (2000) and Sandmo (1990).

The referee points out that the current paper provides an insufficient explanation of how one can reinterpret the Ramsey principle as favouring uniform commodity taxation. The explanation is based on tax neutrality, which follows right after the statement (in para 2 of page 5).

Page 22 (corporate tax cut): The referee suggests that an alternative explanation behind the corporate tax rate cuts in some countries is that tax competition between European countries has become more intense. I agree that this could be an explanation, and adding this as a footnote may add value to the analysis. But I think the explanation I provide is more relevant to the discussion. In page 22, the main discussion is on the recent trend (in industrialized countries) of removing or lowering direct capital subsidy and cutting corporate tax rates in pursuit of increasing corporate tax revenue. The idea that lower corporate tax rates provide lesser incentives for firms to hide profits or evade taxes fits in well with this line of discussion.

Page 25 (optimal incomplete taxation): Here the referee correctly points out that this is not the original Ramsey problem. Having an informal production sector means that private factor allocation in the informal sector allows income from some factors to go untaxed. The planner in this scenario faces a problem similar to that of a Ramsey planner in an otherwise standard neoclassical economy, except that the available tax scheme is incomplete. Although this problem is not the original Ramsey problem, it is certainly an extension of it. One can preserve the essential settings of a Ramsey problem (exogenous government spending, distorting tax instruments, implementability and welfare maximizing objective of the government) and can formulate the optimal incomplete taxation problem. The resulting tax rules therefore is optimal tax rules given a particular context, although they are not standard Ramsey rules.