Economics Seminar Series 2017

SOUTH ASIAN UNIVERSITY
FACULTY OF ECONOMICS

Seminar

Some principles for corrective taxation of externalities in a second-best world

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Time: 2:30 p.m.
Venue: FSI Hall,
Akbar Bhawan, Satya Marg, Chanakyapuri
New Delhi

All are Welcome

In a second-best world with externalities, commodity taxation helps in meeting not only the conventional revenue and redistributive objectives of the government but also in correcting externalities. In the presence of production externalities such as carbon and congestion, Diamond and Mirrlees' seminal 1971 result on the desirability of production efficiency at the second-best optimum is violated. Optimal intermediate input taxation involves (i) taxation of non-substitutable inputs and/or outputs produced by them in manufacturing chains that include the externality-generating goods and (ii) taxation of commodities whose use as inputs is complementary to the input usage of goods that generate externalities. Second-best optimal consumption taxes involve both the conventional "many person Ramsey rule (MPRR)" component that balances equity and efficiency considerations and an externality-correction component. The externality components of both optimal consumption and optimal intermediate input taxes are linked, indicating several degrees of freedom in choosing them at a second-best. The MPRR component of a commodity tax is typically implemented as a VAT or GST, while its externality component is implemented as an excise duty. For commodities such as electricity, motoring fuel, and road-services, the MPRR component is shown to be zero leading to the prescription that GST on these commodities should be zero. The input tax credit to a producer who pays retail prices when buying inputs should be equal to his GST payment plus the excess of the externality excise paid under the consumption tax over the corresponding second-best intermediate input tax.