

FISCAL EXTERNALITY AND COMPENSATED DEMAND IN NORMATIVE TAX THEORY

by

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ABSTRACT

The excess burden - measuring the utility loss associated with the use of an indirect tax structure - is often represented as the triangular area beneath the compensated demand curve. Similarly, the "Ramsey Equations," which characterize the indirect tax structure which minimizes the utility loss, are often written using changes in compensated demands. Because utility is constant along a compensated demand curve, the use of compensated demands to measure utility changes appears paradoxical. I interpret the distortion as a fiscal externality, and explain the paradox.

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