Optimal Second Best Taxation of Addictive Goods in Dynamic General Equilibrium

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Abstract

In this paper we derive conditions under which optimal tax rates for addictive goods exceed tax rates for non-addictive consumption goods in a rational addiction framework where exogenous government spending cannot be financed with lump sum taxes. We reexamine classic results on optimal commodity taxation and find a rich set of new findings. Our dynamic results imply tax rates on addictive goods which are smaller than those implied by the static framework. This is the case because high current tax rates on addictive goods tend to reduce future tax revenues, by making households less addicted in the future. In general, the optimal tax on addictive goods smooths intertemporal distortions by raising current addictive taxes when elasticities are falling. The rise in future elasticities caused by households which become less addicted offsets the decline in elasticities over time. Classic results on uniform commodity taxation emerge as special cases when elasticities are constant and the addiction function is homogeneous of degree one. Finally, we consider features of addictive goods such as complementarity to leisure that, while unrelated to addiction itself, are nonetheless common among some addictive goods. In general, such effects are weaker in our dynamic setting since if taxing addictive goods has strong positive revenue effects today, then taxing addictive goods has a strong offsetting effect on future tax revenues.

Keywords: Ramsey model, dynamic optimal taxation, addictive goods, habit formation.
JEL Codes: E61, H21, H71.
1 Introduction

A popular and increasingly common way for local, state, and federal governments to raise revenue is through taxation of addictive goods, including cigarettes, alcohol, and gambling. What is the optimal excise tax for addictive goods, when the government must raise revenue to finance a stream of exogenous government expenditures? The goal of this paper is to determine the optimal tax on addictive goods and characterize and analyze the conditions under which taxation of addictive goods might differ from taxes on labor and non-addictive consumption goods (hereafter ordinary goods).

This paper extends classic results of optimal commodity taxation (e.g. Atkinson and Stiglitz 1972) to the case of addictive goods and obtains a rich set of new dynamic findings not found in typical models which are either static or assume quadratic utility or both. For common cases such as homothetic and separable utility, we show that the classic results obtained in the literature on optimal taxation of ordinary goods do not necessarily extend to addictive goods, when addiction is modeled as a rational dynamic process as in Becker and Murphy (1988).

In particular, if utility is homothetic in ordinary and addictive consumption, then the classical result of uniform commodity taxation holds only for special cases. Intuitively, homotheticity implies that ordinary consumption goods taxation yields marginal tax revenue equal to the marginal tax revenue of addictive consumption in the current period. However, some of the marginal tax revenue of addictive consumption is realized in the next period, when elasticities may be different. Suppose for example that addictive consumption is becoming more income inelastic over time.\(^1\) By homotheticity, taxation of ordinary consumption results in a distortion equal to the distortion caused by addictive consumption at current elasticities. However, if addictive consumption is taxed at a higher rate than ordinary consumption today, then households will be less addicted in the future. This is attractive because, since the income elasticity is falling, the government will still be able to tax addictive consumption without too much distortion in the next period. The falling income elasticity is at least partially offset by the increase in income elasticity caused by a lower addiction level.

In other words, optimal addictive goods taxation deviates from ordinary consumption taxation so as to smooth intertemporal distortions caused by taxation for revenue raising. In this sense, our results are related to those on capital taxation (Chamley 1986, Chari and Kehoe 1998). A disadvantage of capital taxation is that it reduces the future capital stock

\(^1\)For example, if incomes are low but rising due to growth, cigarettes may move from a luxury good to a necessity.
and thus the future tax base. Similarly, taxation of addictive goods reduces the future stock of addiction, and through the elasticity, the future tax base. Nonetheless, our results differ because addictive consumption acts like both a finished good (current addictive consumption) and as an intermediate good (current addictive consumption affects future addictive consumption). For instance, optimal steady state tax rates on addictive goods equal tax rates on ordinary consumption in some cases where optimal capital tax rates are zero, because addictive consumption acts like a finished good.

As noted by Becker and Murphy (1988), addictive goods are characterized by tolerance (also known as harmful addiction): past consumption lowers current utility. We show that tolerance makes taxing addictive goods less attractive from a revenue raising perspective. Suppose, for example, that consumption in excess of that required to sustain the addiction (hereafter effective consumption) is complementary with leisure. Standard public finance theory suggests that the tax rate on addictive goods should be relatively high, since reduced consumption of addictive goods will increase labor supply, thus raising labor income tax revenues. However, if the good is addictive, then reduced current consumption of addictive goods raises future effective consumption (households are less addicted in the future, and therefore get more effective consumption in the future from a given quantity of addictive goods). But then future labor supply falls, and future labor income tax revenues fall, offsetting some of the revenue gains in the current period.\(^2\) This type of dynamic effect is not captured by standard static models that compute optimal tax rates on addictive goods. Thus ignoring the dynamic nature of addiction when designing optimal fiscal policy may result in lower welfare.

The literature typically models effective consumption in one of two ways: the subtractive specification (e.g. Campbell and Cochrane 1999) and the multiplicative specification (e.g. Abel 1990). These two models differ in terms of their homogeneity properties.\(^3\) In this paper, we show that the optimal tax policy depends crucially on the degree of homogeneity of the addiction function. In particular, we show that the income elasticity of the addictive good is decreasing in the degree of homogeneity, given separable or homothetic utility with constant

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\(^2\)Of course, households respond to the change in current tax and future addiction by adjusting all current and future decisions, including addictive and ordinary consumption and labor supply. Nonetheless, we show that all future revenue effects caused by changes in household decisions due to lower addiction levels have the opposite sign of the current revenue effects caused by changes in current household decisions, due to the tax. Since the revenue effects offset, the dynamic effects are weaker than the static effects.

\(^3\)A good is habit forming if the marginal utility of the good is increasing in past consumption. We use the standard definition of addiction, which is when current consumption is increasing in past consumption, holding fixed the marginal utility of wealth and prices. Habit formation is often used in the macro literature, whereas addiction was introduced by Becker and Murphy (1988). It is straightforward to show that the subtractive model of habit formation implies the good is addictive, and the multiplicative model of habit formation implies the good is addictive with an additional restriction.
relative risk aversion. Thus, taxation of addictive goods is more attractive if the addiction model is homogeneous of degree one, as in the subtractive case, than if the addiction model is homogeneous of degree less than one, as in the multiplicative case, since it is optimal to tax necessities at a higher rate. Further, strong tolerance in the multiplicative model decreases the degree of homogeneity, making addictive goods more income elastic, which therefore lowers the optimal tax rate on addictive goods.

To compute optimal allocations, we use the Ramsey framework (e.g. Chari and Kehoe 1998), which restricts taxes to be linear. Nonlinear taxes on income are perhaps optimal (since high incomes signal for example higher productivity among heterogeneous households) and possibly feasible (since the government can aggregate all income in the household). Similarly, high addictive consumption may signal high stock of addiction, and therefore inelastic demand, which implies higher optimal tax rates. While allowing for nonlinear taxes is possible using the Mirrless approach (Golosov, Kocherlakota, and Tsyvinski 2003, Kocherlakota 2005), we chose not to adopt that framework for three reasons. First, nonlinear taxation of addictive goods is not likely feasible in practice. Households can evade nonlinear taxes by buying addictive goods in small quantities or over the internet (Goolsbee, Lovenheim, and Slemrod 2009), or by bootlegging across states, and the government cannot easily aggregate all addictive good purchases by the single household. Second, the majority of addictive taxes in the US are administered locally and states and municipalities tax addictive goods mostly because they are concerned with raising revenue, rather than optimal redistribution. Indeed, the vast majority of redistribution efforts are carried out at the federal level, since tax competition across states limits the ability of state’s to maintain discriminatory tax rates and since incomes within states and municipalities are more homogeneous than across the US. Lastly, in practice (probably because of the first two reasons), in the US tax system we see almost exclusively linear excise taxes.

In the next section we describe the three main motives for taxing addictive goods found in the literature. In sections 3 and 4, we develop a dynamic, rational addiction model and determine conditions under which optimal tax rates for addictive goods exceed tax rates for ordinary consumption goods. Sections 5-7 give results for a specific example and general classes of preferences.

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4 On the other hand, consumption of many addictive goods is subject to variable consumption patterns such as binges.

5 We provide evidence of the revenue raising motivation in section 2.3.
2 Taxing Addictive Goods

Three classical motivations exist in the literature for taxing addictive goods differently than ordinary goods. The first is to lower the external costs often associated with consumption of addictive goods. The second is because some consumers fail to take into account some private costs and thus over-consume. The third motivation is to raise revenue.

2.1 Addictive Goods and Externalities

The standard economic rationale for taxation of addictive goods is that their consumption is often associated with external costs, such as second-hand smoke, drunk driving, and crime. The literature often finds addictive goods are taxed at a rate less than the rate which is second best in the sense that the government cannot discriminate between consumers who generate external costs and responsible consumers.\(^6\)

If we include a negative consumption externality for the addictive good, then our results go through under slightly different conditions. In particular, the conditions for which the optimal tax rate of an addictive good is above the rate which corrects the externality is similar to the conditions derived here for which the optimal tax rate of an addictive good is above the tax rate for ordinary consumption goods. Hence, our results can be simply interpreted as relative to the tax ratio which corrects the externality.

However, we decided not to include an externality in our problem for three reasons: first, it is well known (Kenkel 1996; Pogue and Sgontz 1989) that taxing an addictive good (e.g. alcohol) whose consumption is imperfectly correlated with an externality is a second-best solution. Taxing the actual behavior causing the externality (e.g. make the punishment for drunk driving more severe) is more efficient. Indeed, Parry, Laxminarayan, and West (2006) show that welfare gains from increasing drunk driving penalties exceed those from raising taxes on alcohol, even when implementation costs and dead-weight losses associated with incarceration are included. Second, as noted above the results are similar when an

\(^6\)For example Kenkel (1996) finds that a tax rate on alcohol of about 42% is optimal for the drunk driving externality, while the actual average tax rate ranges from over 50% in 1954 to 20% in the 1980s. Moreover, Grinols and Mustard (2006) estimate external costs of casino gambling are 47% of revenues, thus the optimal tax would be higher than 47% if demand for casino gambling is inelastic, or less than 47% if a significant fraction of casino gamblers do not impose external costs. Anderson (2005) reports that casinos pay 16% of gross revenues in taxes. The empirical evidence is, however, mixed for cigarettes taxation: Manning, Keeler, Newhouse, Sloss, and Wasserman (1989) estimated the gross external cost of smoking in the U.S. of approximately $0.43 per pack, but only $0.16 per pack once reductions in health care expenditures stemming from premature deaths were included. Viscusi (1995) finds that after accounting also for the lower nursing home cost and retirement pension savings the net external costs of smoking are negligible for the U.S. Conversely, Gruber and Koszegi (2001) estimate external costs of smoking at $0.94 to $1.75 per pack, versus an average excise tax of about $0.65.
externality is included. Finally, our focus is on the effect of addiction on revenue raising, rather than externalities.

2.2 Addictive Goods and Non-market Internal Costs

Another source of non-market costs occurs if addiction is modeled as non-fully rational excess consumption. Suppose consumers fail to take into account the self-adverse health effects caused by consumption of addictive goods, either because they are unaware that addictive goods consumption has adverse health effects (e.g. Kenkel 1996) or because some consumers are exogenously assumed to be unable to take into account the health gains from reducing addictive goods consumption (e.g. Pogue and Sgontz 1989). When some consumers are exogenously assumed not to consider some private costs, they over-consume. The resulting “internality” causes the optimal second best (again, in the sense that the government cannot distinguish between naive and rational consumers) tax rate to rise considerably.\(^7\)

A related, subsequent literature makes excess consumption endogenous and rational by defining “sin goods” as goods for which preferences are time inconsistent (Gruber and Koszegi 2001, Gruber and Koszegi 2004, O’Donoghue and Rabin 2003, O’Donoghue and Rabin 2006). In this approach, consumers optimally choose to consume more now and less in the future. However, next period consumers also optimally choose to consume more now and less in the future. Hence consumers are rational, but over-consume in the sense that consumer welfare increases with a tax that reduces consumption to a level which consumers would choose if they could pre-commit to consume less in the future.\(^8\)

However, it is important to distinguish between a benevolent social planner and the government here. While the former may reduce addictive consumption to maximize according to the long run (i.e. time consistent) preferences, the latter is generally accountable according to the preferences of the current time inconsistent consumers. It is therefore unclear if time inconsistent consumers will vote for a government which sets addictive tax policies in a time consistent manner. If in our setting addictive consumers and government both have hyperbolic discounting,\(^9\) then all the main results of our analysis carry through.

Even if we model the interaction between the fiscal authority and consumers in this peculiar way, then computational difficulties necessitate the imposition of strong assumptions on preferences (indeed, the internalities literature generally assumes a quadratic utility

\(^7\)Kenkel (1996) finds the optimal tax rate on alcohol rises to about 106% while Pogue and Sgontz (1989) find the optimal tax rate on alcohol rises to 306%.

\(^8\)O’Donoghue and Rabin (2006) compute numerical examples where the optimal tax on unhealthy foods ranges from 1-72%. Gruber and Koszegi (2001) show that the optimal tax on cigarettes rises to at least $1 per pack when the time inconsistency problem is included.

\(^9\)For these kind of preferences see Laibson (1997).
function). Since we show here that properties of the utility function such as homotheticity, tolerance, and homogeneity of addiction are important, it is unclear which assumption is more restrictive: quadratic utility or the absence of externalities paired with a time consistent government. Given the stated concern for revenue raising in many of the state and municipal addictive tax programs, it is natural for this paper to focus on how the dynamic properties of the utility function, such as tolerance, affect optimal revenue raising. In particular, we study the dynamic revenue raising properties of addictive goods taxation in a rational addiction framework.

2.3 Addictive Goods and Fiscal Concerns

A final motivation for taxing of addictive goods is revenue raising. Taxation of many addictive goods, such as lotteries, have an obvious revenue raising component. Taxes on many other addictive goods have at least a stated goal of raising revenue. For example, Parry, Laxminarayan, and West (2006) note that the last two increases in federal alcohol taxes were part of deficit reduction packages.\textsuperscript{10} Since the poor presumably spend a higher fraction of income on addictive goods, choosing addictive goods for revenue raising must be justified on efficiency grounds, rather than redistribution.

A few papers consider the efficient revenue raising motivation by treating addictive goods in a static way as simply goods with external costs, which are possibly complementary with leisure. If so, one can apply the ideas from the “double dividend” literature (e.g. Bovenberg and Goulder 1996). Taxing a good with external costs raises revenues which can be used to reduce taxes on labor income (the “revenue recycling effect”). If taxing addictive goods results in lower dead-weight losses than taxing labor (say if demand for addictive goods was very inelastic), then the revenue recycling effect is positive and it is optimal to tax addictive goods at a relatively high rate. Moreover, a good with external costs may also be taxed above its Pigouvian rate for revenue raising if it is complementary with leisure, since the tax therefore increases labor supply and labor income tax revenues (the “tax interaction effect”).\textsuperscript{11} This literature models addiction in a static way as simply a good with external costs.

\textsuperscript{10}For lotteries, external costs are presumably small, but the nationwide average lottery tax ranges from 40\% in 1989 (Clotfelter and Cook 1990) to 31\% in 2003 (Hansen 2004), accounting for 2\% of state tax revenues. States spent about $272 million on lottery advertising in 1989, which is at least a strong indication that states are motivated by revenue concerns, rather than the external costs of lotteries and other forms of gambling. Finally, proposal exists to use higher cigarette taxes to close budget deficits in Florida, Illinois, West Virginia, and elsewhere.

\textsuperscript{11}Sgontz (1993) finds the revenue recycling effect to be positive, and Parry, Laxminarayan, and West (2006) finds both the revenue recycling effect and the tax interaction effect to be positive: alcohol is complementary to leisure and also reduces labor productivity. Therefore, they find it is optimal to tax alcohol above it’s Pigouvian rate as part of the optimal revenue raising package.
costs; the dynamic nature of addiction is ignored. It remains unclear how dynamic addictive properties such as tolerance affect optimal revenue raising.

This paper fills this gap in the literature by considering a dynamic model of rational addiction while explicitly considering a revenue raising motive. Throughout the rest of the paper we model addiction using the rational addiction framework of Becker and Murphy (1988). In this approach, consumption of the addictive good is specifically related to past consumption. Although not conclusive, some evidence for rational addiction exists in that current consumption of cigarettes,\textsuperscript{12} alcohol,\textsuperscript{13} and caffeine (Olekalns and Bardsley 1996) respond to announced future price changes, as predicted by the rational addiction model. Gruber and Koszegi (2001), however, show that evidence of rational addiction does not preclude time inconsistent preferences.\textsuperscript{14} The main alternative, modeling addiction as either rational or irrational excess consumption, has intuitive appeal but also some practical difficulties. First, it is difficult to determine the degree of excess consumption, especially since it must be heterogeneous across the population. The optimal tax is sensitive to both the degree of excess consumption and the fraction of the population that suffers from excess consumption. Furthermore, computational difficulties of time inconsistent preferences require separability in addictive and ordinary goods, no savings, and often quadratic utility functions. All of these assumptions affect the optimal tax rates, especially if the government has a revenue raising requirement.

The Becker and Murphy framework has no internality motivation for taxation of addictive goods, but a fiscal motivation can still exist. Thus we examine the revenue-raising motivation, using the long standing tradition of the Ramsey approach (see for example Chari and Kehoe 1998). Unlike static models, in our dynamic framework changes in tax rates on addictive goods affects future revenues, by changing future elasticities.

3 Model

We consider an infinite horizon closed economy in discrete time. The economy is populated by a continuum of identical households of measure one who maximize the discounted sum of instantaneous utilities. A large number of identical firms produce both addictive and ordinary goods using a constant return to scale technology. Finally, there is a government


\textsuperscript{14}Although laboratory evidence of time inconsistent preferences are strong, little formal econometric evidence exists for or against time inconsistent preferences in actual markets.
that needs to finance a constant stream of government expenditures through fiscal policy.

### 3.1 Firms

A large number of identical firms at time \( t \) rent capital \( k_t \) and labor \( h_t \) from households to produce a composite good using a technology \( F(k_t, h_t) \). We assume throughout the paper that:

**Assumption A1** \( F(.,.) \) is constant returns to scale and increasing, concave, and satisfies Inada conditions in each input.

Let \( w_t \) denote the wage rate and \( r_t \) the rental rate of capital, then the objective of the firm is to maximize profits, which equal:

\[
\max_{k_t, h_t} \left\{ F(k_t, h_t) - r_t k_t - w_t h_t \right\}.
\]

(3.1)

Let subscripts on functions denote corresponding partial derivatives. The equilibrium rental rate and wage rate are:

\[
r_t = F_k(k_t, h_t),
\]

(3.2)

\[
w_t = F_h(k_t, h_t).
\]

(3.3)

For simplicity we assume that the composite good can be used for either addictive or non-addictive goods consumption or investment.\(^{15}\)

### 3.2 Households

A representative household derives utility from consumption of an ordinary (non-addictive) good, \( c_t \), the fraction of time allocated to leisure, \( 1 - h_t \equiv l_t \in [0, 1] \), and consumption of an addictive good, \( d_t \). Let \( s_t = s(d_t, d_{t-1}) \) denote effective consumption, i.e. consumption in excess of that required to sustain the addiction. The per period utility depends on consumption of ordinary goods, effective consumption, and leisure through the utility function \( u(c_t, s_t, l_t) \).\(^{16}\) We assume throughout the paper that:

**Assumption A2** \( u(.,.,.) \) is strictly increasing, concave, and satisfies the Inada conditions in each argument.

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\(^{15}\)Note that it is possible (but cumbersome) to extend the analysis to allow the production technology to differ by consumption goods.

\(^{16}\)This specification is clearly equivalent to Becker, Grossman, and Murphy (1994), who assume a utility function of the form \( u(c_t, d_t, d_{t-1}) \), except they assume no preferences for leisure. Our assumption below that \( s \) is homogeneous is the main restriction we impose on their utility specification.
Lifetime utility is:

$$U = \sum_{t=0}^{\infty} \beta^t u(c_t, s_t, l_t); \quad (3.4)$$

where $\beta$ is the discount factor with rate of time preference $\rho = \frac{1-\beta}{\beta}$.

For effective consumption, we assume throughout the paper that:

**Assumption A3** $s(.,.)$ is homogeneous of degree $\alpha$ in $[d_t, d_{t-1}]$ (HD-$\alpha$) and satisfies $s_1 > 0$, $s_2 < 0$, $s_{11} \leq 0$.

The first inequality states that households get positive utility from consumption of the addictive good. The second inequality states that the addictive good has the tolerance property, meaning past consumption lowers current utility, which is also known a harmful addiction. The third inequality is a sufficient condition which ensures that the household return is globally concave in the choice set $[c_t, l_t, d_t]$ if the return function is concave when $s_t = d_t$ (i.e. the standard problem with no addiction is concave), which we also assume throughout. The role of homogeneity will be discussed below.

**Habits versus Addiction**

The term habit formation is often used in the macro literature, whereas addiction was introduced by Becker and Murphy (1988). These two notions are equivalent under certain conditions, which are spelled out below.

Gruber and Koszegi (2004) and others define habit formation as past consumption increasing the taste for current consumption.\(^{17}\) Therefore, a good is habit forming if and only if:

$$\frac{\partial^2 u}{\partial d_t \partial d_{t-1}} > 0. \quad (3.5)$$

From the assumptions on $s$, a good is habit forming if and only if:

$$\sigma_s (c_t, s_t, l_t) \equiv \frac{-u_{ss} (c_t, s_t, l_t) s_t}{u_s (c_t, s_t, l_t)} > \frac{s_t s_{12} (d_t, d_{t-1})}{s_1 (d_t, d_{t-1}) s_2 (d_t, d_{t-1})}. \quad (3.6)$$

Becker and Murphy (1988) and others define addiction as when past consumption increases current consumption, holding fixed prices and the marginal utility of ordinary consumption. Let $c_t = y_t - p_t d_t$, where $y_t$ represents income in period $t$ and $p_t$ is the price of $d$

\(^{17}\)Becker and Murphy (1988) define reinforcement as when past consumption increases the taste for current consumption.
in period $t$, then $d$ is addictive if and only if:

$$\frac{\partial d_t}{\partial d_{t-1}} = \frac{\partial^2 U}{\partial d_t \partial d_{t-1}} > 0,$$  \hfill (3.7)

holding fixed the marginal utility of consumption. Using the concavity assumptions, equation (3.7) simplifies to:

$$\frac{\partial^2 U}{\partial d_t \partial d_{t-1}} = \frac{\partial^2 u}{\partial d_t \partial d_{t-1}} > 0.$$  \hfill (3.8)

Thus $d$ is addictive if and only if $d$ is habit forming given our one-lag specification of effective consumption, and our concavity assumptions.

The two most commonly used specifications of effective consumption, $s$, in the literature are the *subtractive model* (see for example Campbell and Cochrane 1999), where effective consumption is:

$$s_t = d_t - \gamma d_{t-1},$$  \hfill (3.9)

and the *multiplicative model* (see for example Abel 1990), which specifies effective consumption as:

$$s_t = \frac{d_t}{d_{t-1}^\gamma}.$$  \hfill (3.10)

In both models $\gamma \geq 0$ denotes the strength of tolerance. If $\gamma = 0$, then past consumption has no weight at all, in which case the model reduces to the standard time separable model, and utility is fully determined by absolute consumption levels and not by the changes in consumption.

Both specifications satisfy our assumptions on $s$, but two key differences exist. In the subtractive model, effective consumption is HD-1. In the multiplicative model, effective consumption is HD-$(-1 - \gamma)$, and the degree of homogeneity depends on the degree of tolerance. Moreover, equation (3.6) implies that if $s$ is subtractive, then $d$ is addictive for all $\gamma > 0$. However, if $s$ is multiplicative, then $d$ is addictive if and only if $\sigma_s (c_t, s_t, l_t) > 1$ for all $[c_t, s_t, l_t]$.

**Household Resources and Optimal Decisions**

The household budget constraint sets after tax wage and rental income and government bond redemptions (equal to $R_t b_t$, where $b_t$ are bonds issued in $t-1$ and redeemed in $t$)

18In general, if $s$ has more than one lag, addiction is more restrictive than habit formation. Thus, for example, habit formation and addiction are not equivalent in Becker and Murphy (1988), but are equivalent in Becker, Grossman, and Murphy (1994).
equal to after tax expenditures on government bond issues and consumption of addictive, ordinary, and investment goods given by
\[ i_t = k_{t+1} - (1 - \delta) k_t, \]
where \( \delta \) is the depreciation rate. Since consumption of ordinary, addictive, and investment goods all have the same production technology, they have the same pre-tax price, which is normalized to one. Let \( \tau_c \) and \( \tau_d \) be the tax rates on consumption of ordinary and addictive goods, respectively and let \( \tau_h \) be the tax rate on labor income. The household budget constraint is then:
\[
R_t^b b_t + r_t k_t + (1 - \tau_{h,t}) w_t h_t = (1 + \tau_{c,t}) c_t + (1 + \tau_{d,t}) d_t + i_t + b_{t+1}. \tag{3.11}
\]

Let \( \lambda_t \) denote the Lagrange multiplier on the budget constraint. The resulting household first order conditions are:
\[
(1 + \tau_{c,t}) \lambda_t = \beta' u_c (c_t, s_t, l_t), \tag{3.12}
\]
\[
(1 - \tau_{h,t}) w_t \lambda_t = \beta' u_l (c_t, s_t, l_t), \tag{3.13}
\]
\[
(1 + \tau_{d,t}) \lambda_t = \beta' u_s (c_t, s_t, l_t) s_1 (d_t, d_{t-1}) + \beta^{t+1} u_s (c_{t+1}, s_{t+1}, l_{t+1}) s_2 (d_{t+1}, d_t), \tag{3.14}
\]
\[
\lambda_t R_t = \lambda_{t-1}, \quad t \geq 1, \tag{3.15}
\]
\[
\lambda_t R_t^b = \lambda_{t-1}, \quad t \geq 1, \tag{3.16}
\]
\[
R_t = r_t + 1 - \delta. \tag{3.17}
\]

Equations (3.12)-(3.16), the budget constraint (3.11), initial conditions \( k_0 \) and \( d_{-1} \), and the appropriate transversality conditions characterize the optimal household decisions \( k_t, b_t, h_t, c_t, d_t, \lambda_t \). In equation (3.14), the household increases effective consumption by increasing \( d_t \) (first term on the right hand side), but also increases tolerance and therefore reduces future effective consumption (second term on the right hand side). From equations (3.12) and (3.14) we have a dynamic Ramsey rule:
\[
\frac{1 + \tau_{d,t}}{1 + \tau_{c,t}} = \frac{u_s (c_t, s_t, l_t) s_1 (d_t, d_{t-1}) + \beta u_s (c_{t+1}, s_{t+1}, l_{t+1}) s_2 (d_{t+1}, d_t)}{u_c (c_t, s_t, l_t)} \equiv \frac{MU_{d,t}}{MU_{c,t}}; \tag{3.18}
\]
where \( MU_{i,t} \) represents the marginal utility of good \( i \) at time \( t \).

Any difference in tax rates drives a wedge between the marginal utilities of the consumption of ordinary and addictive goods. Thus the optimal tax rate of addictive goods exceeds
the tax rate of ordinary consumption goods ($\tau_{d,t} > \tau_{c,t}$) if and only if $MU_{d,t} > MU_{c,t}$. The goal of this paper is to find conditions under which the marginal utility of addictive goods differs from that of ordinary goods.

### 3.3 Government

The government finances an exogenous sequence of expenditures, $g_t$, with bond issues and consumption and labor income tax revenues. The government budget constraint is:

$$g_t = \tau_{h,t}w_t h_t + \tau_{c,t}c_t + \tau_{d,t}d_t + b_{t+1} - R_t b_t.$$  

As will be clear below, three wedges exist in our model: one between the marginal utility of addictive and ordinary consumption, a second between the wage and the marginal rate of substitution between consumption and leisure, and a third between the intertemporal marginal rate of substitution and the rate of interest. Thus we need only three tax instruments for a complete tax system. We therefore set interest taxes equal to zero, noting that the government can affect all three margins by setting a time-varying consumption tax, a wage tax, and an addictive goods tax. To see this, use equation (3.12) to eliminate $\lambda_t$ from the household first order conditions so that equation (3.15) becomes:

$$\left(1 + \tau_{c,t} - 1 \right) R_t = \frac{u_{c,t-1}}{\beta u_{c,t}}.$$  

Given a tax rate $\tau_{c,t-1}$, the planner can create an effective interest tax by varying $\tau_{c,t}$, while using $\tau_{d,t}$ to alter the wedge between the marginal utility of addictive and ordinary consumption, and $\tau_{h,t}$ to alter the wedge between the wage and the marginal rate of substitution between consumption and leisure. Alternatively, suppose we remove the tax on consumption and add a tax $\tau_k$ on interest so that (3.20) becomes:

$$(1 - \tau_{k,t}) R_t = \frac{u_{c,t-1}}{\beta u_{c,t}}.$$  

Now the planner can equivalently use $\tau_{k,t}$ to vary the wedge between the intertemporal marginal rate of substitution and the interest rate, while again using $\tau_{d,t}$ and $\tau_{h,t}$ to vary the other wedges. Thus, the optimal allocations derived below can be decentralized using either tax system.

As is common in the literature (see for example Chamley 1986), the government optimally uses bonds to smooth tax burdens over time. In the absence of bonds, the government may

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19 We also do not allow a tax on effective consumption, since informational asymmetries rule out taxes on effective consumption in practice.
favor the tax with better smoothing properties. Changes in current addictive goods tax rates affects both current and future tax revenue. The existence of government bonds enables us to conveniently summarize the effect of a change in current addictive tax rates on all periods as the effect on the infinite horizon version of the government’s budget constraint.

Let \( \pi = \left( (\tau_c,t)_{t=0}^{\infty}, (\tau_d,t)_{t=0}^{\infty}, (\tau_h,t)_{t=0}^{\infty}, (g_t)_{t=0}^{\infty} \right) \) denote an infinite sequence of government policies. As is standard in the literature (e.g. Gruber and Koszegi 2001), we assume the existence of a commitment technology, so that the government commits to all future policies at time zero.

4 Equilibrium and Ramsey Problem

Equations (3.2), (3.3), (3.11), (3.12) - (3.15), and (3.19) form a system of nine nonlinear equations that characterize the competitive equilibrium. Hence:

**Definition 1** Given initial values \( k_0 \) and \( d_{-1} \), a competitive equilibrium is a set of allocations \( \{c_t, d_t, h_t, \lambda_t, k_t\} \), prices \( \{w_t, r_t, R^b_t\} \) and a sequence of policies \( \pi \) that satisfy the household budget constraint (3.11), firm profit maximization (3.1), the government budget constraint (3.19), and household maximization of (3.4) for all \( t \).

We use the primal approach (see for example Chari and Kehoe 1998) to determine optimal taxation. The primal approach uses household and firm first order conditions to eliminate prices and policies from the equations that define the competitive equilibrium. The planner then chooses allocations which maximize welfare subject to the remaining equations from the competitive equilibrium. These equations are the resource constraint:

\[
F(k_t, h_t) = c_t + d_t + k_{t+1} - (1 - \delta) k_t + g_t,
\]

and the implementability constraint (IMC):

\[
\frac{u_c(c_0, s_0, l_0) R_0(k_0 + b_0)}{1 + \tau_{c, 0}} = \sum_{t=0}^{\infty} \beta^t \left\{ u_c(c_t, s_t, l_t) c_t + \left[ u_s(c_t, s_t, l_t) s_1 (d_t, d_{t-1}) + \beta u_s(c_{t+1}, s_{t+1}, l_{t+1}) s_2 (d_{t+1}, d_t) \right] d_t - u_l(c_t, s_t, l_t) h_t \right\}. \tag{4.2}
\]

The IMC uses the household first order conditions to substitute out for all prices and policies in the budget constraint and then recursively eliminates \( \lambda_t \). Thus, the IMC is the infinite

\[20\] However, addictive taxes are common at the state and local level, which frequently have constitutional borrowing restrictions. We leave this interesting case to future research.

\[21\] In principle the government could promise low future taxes on addictive goods, and then find it optimal to renge on the promise once households become addicted.
horizon version of the household budget constraint where all prices and policies have been written in terms of their corresponding marginal utilities. It is immediate from Walras Law and the resource constraint that the IMC can also be thought of as the infinite horizon version of the government budget constraint. The Ramsey approach is therefore very convenient in that the planner can, through the IMC, determine the effect of a change in $d_t$ on government revenues over the infinite horizon.

The first proposition gives the relationship between the competitive equilibrium and the IMC and resource constraint.

**PROPOSITION 1** Let assumptions (A1)-(A3) hold. Given $k_0$, $d_{-1}$, $\tau_{h,0}$, and $\tau_{c,0}$, the allocations of a competitive equilibrium satisfy (4.1) and (4.2). In addition, given $k_0$, $d_{-1}$, $\tau_{h,0}$, and $\tau_{c,0}$, and allocations which satisfy (4.1) and (4.2), prices and policies exist which, together with the allocations, are a competitive equilibrium.

All proofs are in the appendix.

The Ramsey Problem (RAM) determines the optimal tax package that maximizes welfare subject to the IMC and resource constraint:

$$\text{RAM} = \max_{c_t,d_t,h_t,k_t} \left\{ \sum_{t=0}^{\infty} \beta^t \left[ u(c_t, s_t, 1-h_t) + \mu \left[ u_c(c_t, s_t, 1-h_t) c_t + (u_s(c_t, s_t, 1-h_t) s_1(d_t, d_{t-1}) + \beta u_s(c_{t+1}, s_{t+1}, l_{t+1}) s_2(d_{t+1}, d_t)) d_t - u_l(c_t, s_t, 1-h_t) h_t \right] - \mu \frac{u_c(c_0, s_0, l_0) R_0(k_0 + b_0)}{1 + \tau_{c,0}} + \phi_t \left[ F(k_t, h_t) - c_t - d_t - k_{t+1} + (1-\delta) k_t - g_t \right] \right] \right\}. \quad (4.3)$$

The term multiplied by $\beta^t$ in (4.3) is the social welfare in period $t$ consisting of private welfare $u(c_t, s_t, 1-h_t)$ plus public welfare which is discounted tax revenue (expressed as marginal utilities) multiplied by the marginal value of public funds $\mu$.

The first order conditions that characterize optimal taxation are:

$$\frac{\phi_t}{\beta^t} = MU_{c,t} + \mu \frac{\partial \text{IMC}}{\partial c_t}, \quad (4.4)$$

$$\frac{\phi_t}{\beta^t} = MU_{d,t} + \mu \frac{\partial \text{IMC}}{\partial d_t}, \quad (4.5)$$

$$\frac{\phi_tF_h(k_t, h_t)}{\beta^t} = u_l(c_t, s_t, 1-h_t) - \mu \frac{\partial \text{IMC}}{\partial h_t}, \quad (4.6)$$
\[
\phi_t (F_k (k_t, h_t) + 1 - \delta) = \phi_{t-1}.
\] (4.7)

Conditions (4.4)-(4.6) equate the marginal social welfare of \(c, d,\) and \(l\) with the marginal resource cost \(\phi\). Equation (4.7) equates the return on capital with the intertemporal marginal rate of substitution.

From equations (4.4) and (4.5):

\[
MU_{c,t} - MU_{d,t} = \mu \left( \frac{\partial IMC}{\partial d_t} - \frac{\partial IMC}{\partial c_t} \right).
\] (4.8)

Hence using equation (3.18), we find that addictive goods are taxed at a higher rate than ordinary goods if and only if the derivative of the IMC with respect to \(d_t\) is smaller than the derivative with respect to \(c_t\):

\[
\tau_{d,t} > \tau_{c,t} \iff \frac{\partial IMC}{\partial d_t} < \frac{\partial IMC}{\partial c_t}.
\] (4.9)

Since the marginal rate of transformation between \(c\) and \(d\) is one, the marginal rate of substitution minus one is the tax wedge. The Ramsey problem computes the optimal wedges between the marginal utilities as:

\[
\frac{MU_{d,t}}{MU_{c,t}} = 1 + \text{Wedge} = 1 + \frac{\mu}{MU_{c,t}} \left( \frac{\partial IMC}{\partial c_t} - \frac{\partial IMC}{\partial d_t} \right).
\] (4.10)

From equation (4.10), if \(MU_{d,t} > MU_{c,t}\), reallocating a marginal resource from ordinary to addictive consumption raises private welfare by \(MU_{d,t} - MU_{c,t}\). Thus, tax revenue must fall by \(\frac{\partial IMC}{\partial c_t} - \frac{\partial IMC}{\partial d_t}\), resulting in a loss of public welfare of \(\mu\) times the loss of tax revenue. Hence addictive goods are taxed at a higher rate than ordinary goods if and only if moving a resource unit from addictive to ordinary consumption raises revenue, that is, if the marginal tax revenue of ordinary goods exceeds that of addictive goods. Equivalently, \(\mu\) is the marginal welfare cost of the distorted margins. Addictive goods are thus taxed at a higher rate if and only if the welfare distortion induced by addictive taxation is less than that of ordinary taxation.

In turn, the marginal tax revenue of ordinary consumption depends on how a small change in ordinary consumption affects ordinary consumption tax revenue, addictive tax revenue, and labor income tax revenue:

\[
\frac{\partial IMC}{\partial c_t} = u_{c,t} + u_{cc,t} c_t + \alpha u_{cs,t} s_t - u_{cl,t} h_t.
\] (4.11)

An increase in \(c_t\) directly increases ordinary consumption tax revenue (first term), but decreases the marginal utility of consumption and thus requires the planner to lower the or-
ordinary consumption tax rate in order to maintain equilibrium, which lowers tax revenues (second term). The third term contains two offsetting effects. Suppose for example that \(u_{cs} > 0\). Then an increase in \(c_t\) raises \(MU_{d,t}\), so the planner must raise the tax on \(d_t\) to maintain equilibrium, which increases addictive tax revenues. In addition, an increase in \(c_t\) lowers \(MU_{d,t-1}\): consuming \(d_{t-1}\) is less attractive because it causes effective consumption to fall in \(t\) (tolerance), which lowers utility since \(u_{cs} > 0\). Thus, the planner must also lower \(\tau_{d,t-1}\) reducing revenues. Thus an increase in \(c_t\) has offsetting addictive tax revenue effects, but both work through the \(u_{cs}\) term. Given the homogeneity assumption, these two effects can be combined into a single effect, as if a smaller tax on \(s_t\), rather than \(d_t\), existed. Finally, the fourth term implies an increase in \(c_t\) increases preferences for leisure, and thus causes the planner to decrease the labor income tax rate to maintain equilibrium, if and only if \(u_{cl} > 0\).

The marginal tax revenue of addictive goods depends on how a change in addictive consumption affects ordinary consumption tax revenue, addictive consumption tax revenue, and labor income tax revenue:

\[
\frac{\partial IMC}{\partial d_t} = \alpha (MU_{d,t} + u_{ss,t}s_{1,t} + \beta u_{ss,t+1}s_{2,t+1}) + u_{cs,t}s_{1,t}c_t + \beta u_{cs,t+1}s_{2,t+1}c_{t+1} - u_{sl,t}s_{1,t}h_t - \beta u_{sl,t+1}s_{2,t+1}h_{t+1}
\]

(4.12)

A small increase in \(d_t\) directly increases addictive goods tax revenue, but reduces the marginal utility of effective consumption, which requires the planner to decrease \(\tau_{d,t}\). An increase in \(d_t\) increases the marginal utility of ordinary consumption and thus increases \(\tau_{c,t}\) if and only if \(u_{cs} > 0\). An increase in \(d_t\) increases the marginal utility of leisure and thus decreases \(\tau_{h,t}\) if and only if \(u_{sl} > 0\). An increase in \(d_t\) also increases tolerance in period \(t+1\), thus reducing \(s_{t+1}\). Thus an increase in \(d_t\) affects all three types of tax revenue in period \(t+1\) as well but in the opposite direction.

In summary then, simple static results and intuition might indicate that taxing addictive goods is a good revenue raiser because addictive goods tend to be income inelastic and complementary to leisure. However, dynamic considerations are likely to yield more moderate results. Consider, for example, the last two terms of (4.12). if leisure and effective consumption are highly complementary \((u_{sl} > 0)\), then a decrease in \(d_t\) raises labor income tax revenues in period \(t\) (second to last term), but increases \(s_{t+1}\), reducing labor income tax revenues in period \(t+1\) (last term). Thus the dynamic and static terms offset (a similar intuition holds for the other terms). In addition, the stronger the tolerance, the stronger is the dynamic effect. To obtain further results requires more specific preference assumptions. These results will shed further light on the optimal tax rates on addictive goods in a dynamic setting.
5 An Analytical Example: The Quadratic Case

In this section, we consider a linear-quadratic utility function. The linear-quadratic utility, a common specification in the literature (e.g., Becker, Grossman, and Murphy 1994, Gruber and Koszegi 2001), offers several advantages. First, we obtain an analytic solution, which allows us to study how optimal taxation changes the dynamics of addictive consumption. Second, since this specification has only trivial income effects and no labor supply effects to complicate the dynamics, we can derive an exact relationship between tolerance and addictive taxation. In the next sections we consider classes of utility functions with non-trivial income and labor supply effects.

Suppose the subtractive specification for effective consumption and that the utility and production function are:

\[ u(c_t, s_t, l_t) = \omega c_t + \nu s_t - \frac{s_t^2}{2} + e l_t - \frac{l_t^2}{2}, \quad e < 1, \quad \nu > \frac{\omega}{1 - \beta \gamma}, \]  

\[ F(k_t, h_t) = k_t^{\theta} h_t^{1-\theta}. \]  

(5.1)  

(5.2)

Here, the assumption on \( e \) ensures positive steady state hours and the assumption on \( \nu \) is required for positive steady state addictive consumption (see Proposition 4).

Inspection of equations (4.4) and (4.5), given the utility function (5.1), reveals that the marginal utility of \( d_t \) is constant in the optimal second best allocation. In particular:

\[ \omega (1 + \mu) = (1 + 2\mu) \, MU_{d,t} - \mu \nu (1 - \beta \gamma). \]  

(5.3)

Hence:

\[ MU_{d,t} = \frac{\omega + \mu (\omega + \nu (1 - \beta \gamma))}{1 + 2\mu}. \]  

(5.4)

The marginal utility of \( d_t \) divided by \( \omega \) equals the tax ratio given by equation (3.18). Hence the tax ratio is constant over time. Furthermore, inspection of equations (3.12), (3.15), (4.4), and (4.7) indicates that \( \tau_c \) is constant over time. Therefore, \( \tau_d \) and \( \tau_h \) are also constant over time. Thus the implicit interest tax rate is zero for all \( t \).

Equation (5.4) implies \( MU_{d,t} > MU_{c,t} \) and thus \( \tau_{d,t} > \tau_{c,t} \) for all \( t \). Hence we have shown:

**PROPOSITION 2** Let \( u(, , ,) \) and \( F(, , ) \) be given by equations (5.1) and (5.2) and let effective consumption be given by the subtractive model. Then \( \tau_{d,t} > \tau_{c,t} \) for all \( t \) and the ratio of tax rates \( \frac{1+\tau_{d,t}}{1+\tau_{c,t}} \) is constant over time.

In the static version of the model without addiction, \( d_t = s_t \) has an income elasticity equal
to zero whereas the income elasticity of $c_t$ is positive. Since no cross price or labor supply
effects exist and since $c_t$ is everywhere more income elastic than $d_t$, it is optimal to tax $d_t$ at
a higher rate regardless of $k_t$ or $d_{-1}$, because $d_t$ is a necessity.

It is also clear from equation (5.4) that the second best optimal $d_t$ is the solution to a
linear second order difference equation,

$$-\beta \gamma d_{t+1} + \left(1 + \beta \gamma^2\right) d_t - \gamma d_{t-1} = \frac{1+\mu}{1+2\mu} (\nu (1 - \beta \gamma) - \omega),$$

and that the second best optimal $s_t$ is the solution to a linear first order difference equation.

However, before computing the solution to $d_t$, we must verify that a solution exists for $\mu$. As
the next proposition shows, a unique, positive solution exists if government spending is not
so large as to exhaust the maximum feasible revenue in the economy, and not so small that
given initial tax rates are sufficient to pay for all current and future government expenditures.

**PROPOSITION 3** Let the conditions for Proposition 2 hold. Let $g_t$ be a stationary se-
quence with limiting value $\bar{g}$. Then there exists an interval $[\zeta_l, \zeta_h]$, with $0 < \zeta_l < \zeta_h < \infty$
such that if $G \equiv \sum_{t=0}^{\infty} \beta^t g_t \in [\zeta_l, \zeta_h]$, then a unique positive solution for $\mu$ exists.

Given a unique solution for $\mu$, $d_t$ is the solution to the second order difference character-
ized by equation (5.4).

**PROPOSITION 4** Let the conditions for Proposition 3 hold. Then the explicit solution
for $d_t$ is:

$$d_t = \frac{\nu (1 - \beta \gamma) - \omega}{(1 - \gamma) (1 - \beta \gamma)} \left(\frac{1+\mu}{1+2\mu}\right) (1 - \gamma^{t+1}) + d_{-1} \gamma^{t+1}.$$  \hspace{1cm} (5.6)

The solution for $d_t$, given by equation (5.6), allows us to derive some interesting properties of
the second best solution, both over time and as compared to the first best solution ($\mu = 0$).
First, optimal consumption of $d_t$ increases over time, assuming $d_{-1}$ is less than the steady
state. The planner decreases $d_t$ and the growth rate of $d_t$ relative to the first best solution
through the tax. However, $d_t$ in the second best optimum is at least one third of the first best
level in the steady state, and greater fraction of the first best solution along the transition.

We can also explore how the strength of tolerance affects second best addictive consump-
tion. Since the solution for $\mu$ is unique, we can use the implicit function theorem to derive
comparative statics using equation (5.4). Our intuition is that strong tolerance should mod-
erate the optimal tax ratio, as gains in current tax revenue from taxation of addictive goods
are offset by losses in future tax revenues. If $d_{-1}$ is sufficiently large, it is indeed true that
the optimal tax ratio is inversely related to the degree of tolerance. In particular, we have:

$$d_{-1} \geq \frac{\beta \omega}{(1 - \beta \gamma)(1 - \beta)} \Rightarrow \frac{\partial^{1+\tau_d}}{\partial \gamma} < 0.$$  \hspace{1cm} (5.7)

Condition (5.7) is a sufficient condition calculated assuming $\mu = \infty$. In practice, for $\mu$ small, the optimal tax ratio is decreasing in the degree of tolerance under much less restrictive conditions.

Table 1 gives parameter values for a simple numerical example. Table 1 indicates that the optimal tax ratio is decreasing in the degree of tolerance, even though condition (5.7) is violated, since the parameter $G$, set to 30% of GDP for all $t$, generates at most a value of only $\mu = 4.74$. The planner relies increasingly on labor taxes and less on addictive taxes as the degree of tolerance increases. For $\gamma = 0.55$, taxation is nearly uniform. Figure 1 shows the time path of the first and second best levels of $d$ for various values of $\gamma$. Increasing the level of tolerance severely reduces addictive consumption since the future costs of current consumption are higher. As expected, the difference between first and second best addictive consumption is widest at the steady state.

6 Results for General Preference Classes

As in the literature on optimal commodity taxation, characteristics of the utility function play an important role in determining any deviations from uniform taxation. Two well-known cases are homothetic and separable utility functions. In the next sections we explore these two cases as well as the possible interaction between consumption of addictive goods and leisure.

6.1 Homothetic Utility

In this section we assume utility takes the form:

$$u(c_t, s_t, l_t) = q(v(c_t, s_t), l_t),$$  \hspace{1cm} (6.1)

where $v(.)$ is homothetic and $q(.)$ is an increasing function.

To determine whether or not addictive goods should be taxed at a higher rate than ordinary goods, we combine equations (4.9), (4.11), and (4.12), assuming (6.1). Let us define the following elasticities:

$$\sigma_{cs,t} \equiv \frac{u_{cs}(c_t, s_t, l_t)}{u_c(c_t, s_t, l_t)} c_t, \quad \sigma_{sc,t} \equiv \frac{u_{cs}(c_t, s_t, l_t)}{u_c(c_t, s_t, l_t)} s_t, \quad \sigma_{hs,t} \equiv \frac{u_{sl}(c_t, s_t, l_t)}{u_s(c_t, s_t, l_t)} l_t.$$  \hspace{1cm} (6.2)
and let $\sigma_{hc,t}$ be defined analogously. Then we have the following result.

**PROPOSITION 5** Let assumptions (A1)-(A3) hold. In addition, let $u(.)$ be of the form given in equation (6.1). Then $\tau_{d,t}>\tau_{c,t}$ if and only if:

$$
(1 - \alpha) (1 - \sigma_{s,t} - \sigma_{sc,t}) > \frac{\beta u_{s,t+1}s_{2,t+1}M_U}{M\alpha\sigma_{s,t+1} - (\sigma_{cs,t+1} - \sigma_{cs,t}) + (\sigma_{hs,t+1} - \sigma_{hs,t})}
$$

(6.3)

Homotheticity in $c$ and $s$ does not generally imply uniform taxation of $c$ and $d$ for two reasons: tolerance and because $d$ is taxed but homotheticity is in $c$ and $s$. Even if no tolerance exists ($s_2 = 0$), homotheticity in $c$ and $s$ does not imply homotheticity of $c$ and $d$ unless $s$ is HD-1 in $d$ only. To see this, suppose without loss of generality that $s$ is HD-$\eta$ in $d$ only and rewrite equation (6.3) as:

$$
(1 - \eta) + (\eta - \alpha) (1 - \sigma_{s,t} - \sigma_{sc,t}) > -s_{2,t+1}J,
$$

(6.4)

where $J$ is the right hand side equation (6.3), excluding the term $-s_{2,t+1}$. Now let $s_2 \to 0$, so no tolerance exists. The right hand of equation (6.4) approaches zero, and under our maintained assumptions $s_2 \to 0$ implies $\alpha \to \eta$. The remaining term thus represents the difference between homotheticity of $c$ and $s$ versus $c$ and $d$. Clearly this term is zero if $\eta = 1$, since $\eta = 1$ if and only if homotheticity of $c$ and $s$ is equivalent to homotheticity of $c$ and $d$. Thus $s_2 = 0$ and homotheticity in $c$ and $d$ implies uniform taxation. If $\eta \neq 1$, then homotheticity in $c$ and $s$ implies $d$ is a necessity (luxury) if $\sigma_{s} + \sigma_{sc} < (>) 1$ implying $d$ ($c$) should be taxed at a higher rate. This is the classical result that it is optimal to tax necessities at a higher rate than luxuries.\footnote{Let $M$ denote non-labor income and $M + h = p_c c + p_d d$ be the budget constraint for a static version of the model. Then equation (6.4) when $s_2 = 0$ is positive if and only if $d$ has a lower elasticity with respect to non-labor income than $c$ in the static version of the model. Note that the simple partial equilibrium intuition that goods that are more price inelastic should be taxed at a greater rate does not hold in general equilibrium, unless utility is separable and no income effects exist (see for example Chari and Kehoe 1998).}

To see the effect of tolerance, assume now that $\eta = 1$ or that homotheticity of $c$ and $s$ is equivalent to homotheticity of $c$ and $d$. Then all terms in equation (6.3) arise because of tolerance. Consider the labor supply terms only, and suppose $d$ is becoming more complementary with leisure over time ($\sigma_{hs,t+1} < \sigma_{hs,t}$).\footnote{Note that given the utility function (6.1), $c$ must also be becoming more complementary with leisure over time.} Considering only the labor supply terms of equation (6.3) and rewriting results in:

$$
u_{s,t}s_{1,t}\sigma_{hs,t} + \beta u_{s,t+1}s_{2,t+1}\sigma_{hs,t+1} > \sigma_{hs,t} (u_{s,t}s_{1,t} + \beta u_{s,t+1}s_{2,t+1}).
$$

(6.5)
If taxes were equal, then the right hand side of equation (6.5), or the increase in labor income tax revenues resulting from taxing $c$, would be identical to the increase in labor income tax revenues resulting from taxing $d$. But all of the change in labor income tax revenue occurs in the current period for $c$, whereas some of the change in labor income tax revenues from taxing $d$ come in the next period for $d$, when the complementarity of addictive consumption and leisure is higher (the left hand side of equation 6.5). Taxing $d$ at a higher rate means the loss of revenues resulting from households being less addicted in the future will be offset to some extent by the increase in future labor income tax revenues because leisure and addictive consumption are more complementary. Thus taxing $d$ more than $c$ today better smooths distortions over time.

A similar intuition holds for the other elasticities. Tolerance by itself only implies taxation at rates which exceed ordinary goods if the distortions caused by revenue raising are falling over time, so that addictive taxation smooths distortions, because taxing addictive goods now makes taxing addictive goods more distortionary later. As shown in the following corollaries, however, some common specifications for $v$ and $s$ induce constant elasticities which imply uniform taxation.

**COROLLARY 6** Let the conditions of Proposition 5 hold, and let $q(.) = z(l) + \frac{(\xi_s)^{1-\xi} - \xi_s}{1-\sigma}$, and $z(.)$ be concave, then $\tau_d = \tau_c$ for all $t$.

Although we have assumed here that $v(.)$ is constant relative risk aversion (CRR), this corollary is considerably more realistic than the existing literature which assumes a static utility function and/or separable quadratic utility for tractability. If utility is CRR in $c$ and $s$ and no labor supply effects exist, then we obtain the classic result of uniform commodity taxation as in Atkinson and Stiglitz (1972).

Optimal uniform commodity taxation occurs in the steady state under a weaker condition. Let $\bar{x}$ denote the steady state value of any variable $x$, then we have:

**COROLLARY 7** Let the conditions of Proposition 5 hold. Then $\bar{\tau}_d > \bar{\tau}_c$ if and only if:

$$(1 - \alpha) (1 - \bar{\sigma}_s - \bar{\sigma}_{sc}) > 0.$$  

Equation (6.6) holds if and only if the steady state income elasticity of $d$ is less than the steady state income elasticity of $c$. For HD-1 addiction functions, including the subtractive model, Corollary 7 indicates that the steady state tax rates are uniform. An increase in $\bar{d}$ increases $\bar{s}$ by the same percentage, preserving homotheticity. For the multiplicative case, the degree of homogeneity is decreasing in the strength of tolerance. Since $\sigma_s > 1$ is required for addiction in the multiplicative case, strong tolerance tends to reduce the tax rate on the
an addictive good, unless addictive and ordinary consumption are sufficiently strong substitutes (that is, unless \(-\sigma_{sc} > \sigma_s - 1\)), because stronger tolerance implies strong offsetting future revenue effects from current addictive taxation. When the degree of homogeneity is less than one, as is the case for the multiplicative model, then equation (6.6) reduces to:

\[
\bar{\sigma}_s - 1 < -\bar{\sigma}_{sc}
\]  

(6.7)

Since with multiplicative habits addiction and reinforcement occur if and only if \(\bar{\sigma}_s > 1\), it is optimal to tax addictive goods at a higher rate only if addictive and ordinary consumption goods are sufficiently strong substitutes. Finally, Corollary 7 and Proposition 5 indicate that the choice of addiction function is not innocuous when designing optimal tax policies. In particular, given condition (6.7), the subtractive model implies a higher tax rate on the addictive good than the multiplicative model, since \(\alpha = 1\) in the subtractive model.

6.2 Additively Separable Utility

In this section we consider the case in which utility is additively separable. Following a similar procedure as with Proposition 5, we have:

**Proposition 8** Let assumptions (A1)-(A3) hold. In addition, let \(u(\cdot)\) be additively separable in \(c, s,\) and \(l\). Then \(\tau_{d,t} > \tau_{c,t}\) if and only if:

\[
\alpha\sigma_{s,t} + 1 - \alpha - \sigma_{c,t} > \frac{\beta\alpha u_{s,t+1}s_{2,t+1}}{MU_{d,t}} (\sigma_{s,t+1} - \sigma_{s,t}).
\]  

(6.8)

In a static model, separable utility removes all labor supply and cross price revenue effects, so we have left only two effects: \(c\) and \(d\) have potentially different income elasticities in a static sense and the effect of tolerance.

To see the static income elasticity terms, suppose without loss of generality that \(s\) is HD-\(\eta\) in \(d\) only and rewrite equation (6.8) as:

\[
\left[ (\eta\sigma_{s,t} + 1 - \eta) - \sigma_{c,t} \right] + (\alpha - \eta) (\sigma_{s,t} - 1) > -s_{2,t+1} J,
\]  

(6.9)

where \(J\) is the right hand side equation (6.3), excluding the term \(-s_{2,t+1}\). Now let \(s_{2} \rightarrow 0\), so no tolerance exists. The right hand of equation (6.9) approaches zero, and under our maintained assumptions \(s_{2} \rightarrow 0\) implies \(\alpha \rightarrow \eta\). The remaining term is:

\[
\eta\sigma_{s,t} + 1 - \eta > \sigma_{c,t},
\]  

(6.10)
The left hand side equals the income elasticity of $c$ divided by the income elasticity of $d$ in the static version of the model. Condition (6.11) says to tax the more income inelastic (the necessity) good at a higher rate. If $\eta = 1$ then $s = d$ and the income elasticity ratio is $\sigma_{s,t}/\sigma_{c,t}$. If $\eta < 1$, then $\eta$ affects the concavity of $u$ in $d$ and thus the income elasticity.

To see the effect of tolerance, rewrite equation (6.8) as:

$$\frac{\eta \sigma_{s,t} + 1 - \eta}{\sigma_{c,t}} > 1. \quad (6.11)$$

Suppose that $d$ is becoming more income inelastic relative to $c$ over time ($\sigma_{s,t+1} > \sigma_{s,t}$). If tax rates were equal, then the right hand side of equation (6.12), or the increase in tax revenues resulting from taxing $c$, would be identical to the increase in tax revenues resulting from taxing $d$. But all of the change in tax revenues comes in the current period for $c$, whereas some of the change in tax revenues from taxing $d$ come in the next period for $d$, when $d$ is more income inelastic (the left hand side of equation 6.12). Taxing $d$ at a higher rate today means $d$ will become more income elastic in the future, offsetting to some degree the decrease in income elasticity resulting from $\sigma_{s,t+1} > \sigma_{s,t}$. Thus, as in Proposition 5, the existence of tolerance implies it is optimal to use the tax on $d$ to smooth intertemporal distortions.

As shown in the following corollary, however, the common CRR specification has constant elasticities which implies tolerance affects optimal taxation only through it’s effect on the income elasticity.

**COROLLARY 9** Let the conditions of Proposition 8 hold, and let $u(.) = v^1(c) + v^2(s) + v^3(l)$, with $v^1$ and $v^2(.)$ CRR. Then $\tau_{d,t} > \tau_{c,t}$ for all $t$ if and only if:

$$\alpha \sigma_s + 1 - \alpha > \sigma_c. \quad (6.13)$$

Condition (6.13) holds if and only if $d$ has a lower income elasticity than $c$. In turn, tolerance only affects the ratio of income elasticities if it affects the homogeneity of $s$. For $s$ functions such that $\alpha$ is independent of tolerance, such as the subtractive model, addiction has no effect on the optimal tax rates. With constant elasticities, no distortion smoothing motivation exists. However, for $s$ functions such that $\alpha$ depends on tolerance, such as the multiplicative model, stronger tolerance reduces the income elasticity and thus moderates the optimal tax rate on addictive goods, since $\sigma_s > 1$. In particular, if $d$ is a necessity in period $t$, then taxing $d$ at a high rate raises revenue with less distortions in period $t$, but will nonetheless reduce future addiction and thus $d_{t+1}$ and revenue in $t+1$. Since the income elasticity is constant,
the revenue effects tend to cancel. That is, the stronger the revenue effect in period \( t \), in general the stronger the offsetting revenue effect in period \( t+1 \). Thus strong tolerance makes taxing addictive consumption less attractive. Finally, the subtractive model implies a higher tax rate on the addictive good than the multiplicative one, since \( \alpha = 1 \) in the subtractive model.

In general, the optimal tax on addictive goods depends on the degree of tolerance and the relative income elasticities. The tax ratio rises as the income elasticity of the addictive good falls, irrespective of the degree of addiction. Tolerance allows the planner to smooth intertemporal distortions by increasing the tax rate on addictive consumption if the income elasticity is falling (if \( \sigma_s \) is rising). Taxation of addictive goods reduces future tolerance and thus makes addictive consumption more income elastic, offsetting the fall in income elasticity. However, when \( \sigma_s \) is constant, as is the case for for CRR utility functions and at the steady state, no distortion smoothing motivation exists. Strong tolerance still tends to moderate the optimal tax on addictive goods, since taxing \( d \) reduces future tax revenues.

### 6.3 Labor Supply Effects

The homothetic and separable cases examined above assume that changes in \( c \) and \( s \) have identical effects on labor supply. Nonetheless, some addictive goods are highly complementary with leisure. For example, alcohol is complementary with leisure and reduces productivity (Parry, Laxminarayan, and West 2006).\(^{24}\) In this section we consider the possibility that ordinary and addictive goods differ in their static labor supply effects. Addiction, as defined here, is related to reinforcement and tolerance, neither of which depends on complementarity with leisure. Thus we should expect to see extra terms which reflect how addictive goods consumption affects labor income tax revenues in addition to the relative income elasticity and degree of tolerance.

To see this in a concise way, let us consider the following class of utility functions:

\[
u(s_t, d_t, l_t) = q(c_t) + v(s_t, l_t).
\]

Given the specification (6.14), addictive consumption is potentially more complementary with leisure than ordinary consumption. For this specification, we find:

**PROPOSITION 10** Let assumptions \((A1)-(A3)\) hold. In addition, let \( u(.) \) be of the form given by (6.14). Then \( \tau_{d,t} > \tau_{c,t} \) if and only if:

\[
1 - \alpha + \alpha \sigma_{s,t} + \sigma_{hs,t} > \sigma_{c,t} - \frac{\beta u_{s,t+1} s_{2,t+1}}{MU_{d,t}} (\sigma_{hs,t+1} - \sigma_{hs,t} + \alpha (\sigma_{s,t+1} - \sigma_{s,t})).
\]

\(^{24}\)On the other hand, goods like lotteries do not seem to exhibit strong labor supply effects.
The left hand side of equation (6.15) indicates that, ignoring the dynamic effect caused by tolerance, strong complementarity between addictive consumption and leisure tends to increase the relative tax on addictive goods.

However, tolerance may change this effect. To see how, note that equation (6.15) can be rewritten as:

$$\frac{u_{s,t} s_{1,t} (1 - \alpha + \alpha \sigma_{s,t} + \sigma_{hs,t}) + \beta u_{s,t+1} s_{2,t+1} (1 - \alpha + \alpha \sigma_{s,t+1} + \sigma_{hs,t+1})}{MU_{d,t}} > \sigma_{c,t}. \quad (6.16)$$

Since utility is separable in $c$, the right hand side of equation (6.16) incorporates only two effects: an increase in $c$ directly raises revenue but requires the planner to lower the tax rate on $c$ to maintain equilibrium. Conversely, the tax on $d$ raises labor supply if $\sigma_{hs} > 0$, which raises labor income tax revenues. However, taxing $d$ is not as attractive as taxing $s$, since taxing $d$ creates an offsetting effect on next period’s labor income tax revenue, since $s_2 < 0$. Further, the stronger the effect on today’s labor income tax revenues, the stronger the offsetting effect on future labor income tax revenues. Ignoring the dynamic effect on future labor income tax revenues results in a tax rate on addictive goods that exceeds the optimal rate.

Condition (6.15) simplifies in the steady state or for CRR preferences.

**COROLLARY 11** Let the conditions of Proposition 10 hold, and let $v(.) = (s_{t+1}^{1-\xi} - 1)^{1-\sigma} - 1$, with $\sigma \geq 1$. Then $\tau_{d,t} < \tau_{c,t}$ for all $t$.

Corollary 11 is an example with complementarity between leisure and consumption of addictive goods, which nonetheless has a lower tax rate on $d_t$ than $c_t$.

**COROLLARY 12** Let the conditions of Proposition 10 hold. Then $\tau_{d} > \tau_{c}$ if and only if:

$$\alpha (\bar{\sigma}_s - 1) + \bar{\sigma}_{hs} > \bar{\sigma}_c - 1. \quad (6.17)$$

In this case the condition depends only on the relative income elasticities and the labor supply effect.

7 Conclusions

This paper is the first attempt in the literature to characterize and analyze the conditions under which taxation of addictive goods might differ from taxes on labor and ordinary consumption goods in a dynamic rational addiction setting. We derive a rich set of results. In particular, we derive conditions for a variety of classes of utility functions for which tax
rates for addictive goods exceeds tax rates for non-addictive goods in an environment where exogenous government spending cannot be financed with lump sum taxes.

We find that, regardless of the utility function and addictive specification, if taxing addictive goods has strong positive revenue effects today, then a strong offsetting effect on future tax revenues also exists. This dynamic property of addictive goods might explain why static models, which do not model tolerance, but incorporate revenue raising and externalities motives, tend to derive tax rates in excess of that observed in the data.

For the homothetic and separable cases that we consider, the dynamic nature of tolerance justifies tax rates in excess of ordinary consumption goods for the purpose of smoothing intertemporal distortions. For example, if the income elasticity of addictive consumption is falling over time, then a higher tax rate on the addictive good today reduces future addiction and thus tends to offset some of the decrease in the income elasticity. It is also possible that the offsetting revenue effects of addictive taxation makes addictive goods more income elastic, thus decreasing the optimal tax rate on addictive goods. Classic results on uniform commodity taxation reemerge in the homothetic case if elasticities are constant, as is the case for CRR utility.

Finally, we also consider features of addictive goods such as complementarity to leisure that, while unrelated to addiction itself, are nonetheless common among some addictive goods. In general, such effects are weaker in our dynamic setting.

Consideration of other intertemporal goods, such as durable goods and storable goods, while outside the scope of this paper, are natural extensions. Some properties of the addiction function would likely change with these intertemporal goods, but our basic intuition would still apply.

Our results come with a few caveats. First, one common feature of addictive goods, the presence of externalities, has not been considered in this paper. However, it is unclear whether externalities are not better dealt with by regulating the exact behavior that causes the externality, such as banning smoking in public places, rather than the second best solution of taxing consumption of the addictive good. In addition, if we include an externality, then our results go through under slightly different conditions. Hence our results can be interpreted as relative to the tax ratio which corrects the externality.

Second, we consider only the optimal tax package, not the optimal addictive goods tax taking as given other taxes. Certain features of the tax code such as balanced budget rules and positive capital tax rates, if taken as given, may change our results. Third, we have no heterogeneity in addictive consumption or wealth. However, if we assume that the poor are more likely to consume addictive goods, then our results would likely strengthen, because consumers of addictive goods would have a higher marginal utility of income. Finally, by
choosing to adopt the Ramsey approach, we are subject to the typical criticisms made to this framework: it takes the set of possible fiscal instruments as given and it allows for distortionary linear taxes only. Our results might change if we allowed for heterogeneous households and nonlinear tax rates within a Mirrless framework. However, while capital and income taxes are nonlinear in the data, addictive taxes are typically linear. In addition, it would be very hard, in particular at the state level, to monitor addictive consumption for each household. Finally, and most importantly, the majority of redistributive fiscal policy is carried out at the federal level in the US. Excise taxes at the state level are not typically set with a redistributive intent, as in a Mirrless framework, but rather to generate fiscal revenues and balance the state budgets. We leave the interesting theoretical issues concerning taxation of addictive goods in the Mirrless framework for further research as well.


8 Appendix: Proofs

8.1 Proof of Proposition 1

To see that a competitive equilibrium satisfies the IMC and resource constraint, we substitute the factor prices (3.2) and (3.3) into the budget constraint (3.11). Using constant returns to scale, we then have:

\[ R^b_t b_t + F (k_t, h_t) - \tau_{h,t} F_h (k_t, h_t) h_t = (1 + \tau_{c,t}) c_t + (1 + \tau_{d,t}) d_t + i_t + b_{t+1}. \]  

(8.1)

Combining the above equation with the government budget constraint (3.19) gives the resource constraint (4.1).

To derive the IMC from the budget constraint, we substitute the household first order conditions (3.12)-(3.14) into the budget constraint (3.11), eliminating the tax rates, so that:

\[ \lambda_t R_t k_t + \lambda_t R^b_t b_t - \lambda_t k_{t+1} - \lambda_t b_{t+1} = \beta^t (u_c (c_t, s_t, l_t) c_t + MU_{d,t} d_t + u_l (c_t, s_t, l_t) h_t). \]  

(8.2)

Next using the first order conditions (3.15) and (3.16), we have:

\[ \lambda_t R_t (k_t + b_t) - \lambda_{t+1} R_{t+1} (k_{t+1} + b_{t+1}) = \beta^t (u_c (c_t, s_t, l_t) c_t + MU_{d,t} d_t + u_l (c_t, s_t, l_t) h_t). \]  

(8.3)

The above equation characterizes a sequence of budget constraints that can be used to recursively eliminate \( \lambda_t R_t (k_t + b_t) \), yielding:

\[ \lambda_0 R_0 (k_0 + b_0) - \lim_{t \to \infty} \lambda_{t+1} R_{t+1} (k_{t+1} + b_{t+1}) = \]
\[ \sum_{t=0}^{\infty} \beta^t (u_c(c_t, s_t, l_t) c_t + MU_{d,t} d_t - u_l(c_t, s_t, l_t) h_t) . \]  

(8.4)

The transversality conditions imply the second term on the left hand side equals zero. Again using the household first order conditions at period zero gives:

\[ \frac{u_{c,0}(k_0 + b_0)}{1 + \tau_{c,0}} (F_{k,0} + 1 - \delta) = \sum_{t=0}^{\infty} \beta^t (u_c(c_t, s_t, l_t) c_t + MU_{d,t} d_t - u_l(c_t, s_t, l_t) h_t) , \]  

(8.5)

which is the IMC.

We next show that, given allocations which satisfy the IMC and resource constraint, prices and policies exist which, along with the allocations, are a competitive equilibrium. Let \( \{c_t, k_t, h_t, d_t\} \) be a sequence which satisfies the IMC and resource constraint. Then \( r_t \) and \( w_t \) are defined using equations (3.2) and (3.3). Since \( \tau_{c,0} \) is given, we can define \( \lambda_0 \) using equation (3.12). Then \( \lambda_t \) can be defined recursively using equation (3.15). Then \( R_t^b \) is defined using equation (3.16). Next, we define the government policies:

\[ (1 + \tau_{c,t}) = \frac{\beta^t u_c(c_t, s_t, l_t)}{\lambda_t} , \]  

(8.6)

\[ (1 - \tau_{h,t}) = \frac{\beta^t u_l(c_t, s_t, l_t)}{\lambda_t F_h(k_t, h_t)} , \]  

(8.7)

\[ (1 + \tau_{d,t}) = \frac{\beta^t MU_{d,t}}{\lambda_t} , \]  

(8.8)

\[ g_t = \tau_{h,t} w_t h_t + \tau_{c,t} c_t + \tau_{d,t} d_t \]  

(8.9)

Given the above prices and policies, all equations which define a competitive equilibrium are satisfied except the household and government budget constraints. We use \( b_t \) to satisfy the household budget constraint:

\[ b_t = \frac{1}{R_t^b} (-r_t k_t - (1 - \tau_{h,t}) w_t h_t + (1 + \tau_{c,t}) c_t + (1 + \tau_{d,t}) d_t + i_t + b_{t+1}) . \]  

(8.10)

We can multiply the above equation by \( \lambda_t \) and recursively eliminate \( b_{t+1} \) from the above equation. After eliminating prices and policies using the household first order conditions
(3.12)-(3.14), \( b_t \) is a function of the allocations:

\[
b_t = \left( \prod_{i=0}^{t-1} (F_k (K_i, H_i) + 1 - \delta) \right) \frac{1 + \tau_{c,0}}{\tau_{c,0}} \sum_{i=t}^{\infty} \beta^i \left( u_{c,i}c_i + MU_{d,i}d_i - u_{l,i}l_i \right) - k_t \quad (8.11)
\]

The above equation is the debt allocation which implies the household budget constraint is satisfied.

Since the budget constraint is satisfied, we simply substitute the resource constraint into the budget constraint to see that the government budget constraint is satisfied. Finally, by substituting the prices and policies into the IMC and reversing the derivation of the IMC, we see that the transversality conditions are satisfied.

### 8.2 Proof of Propositions 2-4

Proposition 2 was proved in the text. For Proposition 3, we derive the solution for \( \mu \) as follows. First, for the quadratic case, the first order conditions for the Ramsey problem (4.4)-(4.7) are now:

\[
\frac{\phi_t}{\beta_t} = \omega (1 + \mu), \quad (8.12)
\]

\[
\phi_t (1 - \theta) \left( \frac{k_{t}}{h_{t}} \right)^{\theta} = (e - 1) (1 + \mu) + (1 + 2\mu) h_t, \quad (8.14)
\]

\[
\phi_t \left( \theta \left( \frac{k_{t}}{h_{t}} \right)^{\theta-1} + 1 - \delta \right) = \phi_{t-1}. \quad (8.15)
\]

Using equation (8.12) to eliminate \( \phi_t \) gives:

\[
\omega (1 + \mu) = (\nu (1 + \mu) - \mu) (s_t - \beta \gamma s_{t+1}), \quad (8.16)
\]

\[
\omega (1 + \mu) (1 - \theta) \left( \frac{k_{t}}{h_{t}} \right)^{\theta} = (e - 1) (1 + \mu) + (1 + 2\mu) h_t, \quad (8.17)
\]
\[
\beta \left( \frac{k_t}{h_t} \right)^{\theta - 1} + 1 - \delta = 1. 
\] 
(8.18)

For the subtractive model equation (8.16) implies:
\[
\omega (1 + \mu) = \nu (1 - \beta \gamma)(1 + \mu) - (1 + 2\mu) (d_t - \gamma d_{t-1} - \beta \gamma (d_{t+1} - \gamma d_t)),
\] 
which simplifies to (5.5), and which we show in the next proof has general solution given by (5.6). Proposition 4 thus holds if a non-zero and finite solution for \(\mu\) exists, which we now show.

Equation (8.18) implies the capital to labor ratio, denoted by \(A\), is constant:
\[
A \equiv \left( \frac{\theta}{\rho + \delta} \right)^{1 - \sigma}. 
\] 
(8.20)

Thus, equation (8.17) implies
\[
h_t = \frac{1 + \mu}{1 + 2\mu} \hat{h}, \quad \hat{h} \equiv 1 - e + \omega (1 - \theta) A^\theta,
\] 
(8.21)
is constant. Thus, \(k_t = Ah_t\) is constant and equation (5.6) implies \(s_t\) and thus \(MU_{d,t}\) is constant as well. Since elasticity of substitution of consumption over time is infinite, the planner absorbs all changes in \(g_t\) by varying \(c_t\). Combining these results with resource constraint (4.1) yields a solution for \(c_t\):
\[
c_t = \frac{1 + \mu}{1 + 2\mu} \hat{h} \left( A^\theta - \delta A \right) - \hat{d} \left( 1 - \gamma^{t+1} \right) - \gamma^{t+1}d_{t-1} - g_t,
\] 
(8.22)

\[
\hat{d} \equiv \frac{\nu (1 - \beta \gamma) - \omega}{(1 - \gamma)(1 - \beta \gamma)}.
\] 
(8.23)

Now since \(h_0\) enters into the left hand side of the IMC (4.2) and \(k_0\) is given, the solutions for \(h_0, k_0\) and therefore \(c_0\) generally differ from the solutions for \(t \geq 1\). Therefore, we let \(x \equiv \frac{1 + \mu}{1 + 2\mu}\) and insert the solutions for \(c_t, d_t,\) and \(h_t\) into the IMC (4.2) for \(t \geq 1\), so that:
\[
\frac{R_0 (k_0 + b_0)}{1 + \tau_{c,0}} = \sum_{t=1}^{\infty} \beta^t \left[ x \omega \left( \hat{h} \left( A^\theta - \delta A \right) - \hat{d} \left( 1 - \gamma^{t+1} \right) \right) - \omega \gamma^{t+1}d_{t-1} + (1 - \beta \gamma) \left( \nu - (1 - \gamma) \hat{d}x \right) \left( \hat{d}x (1 - \gamma^{t+1}) + \gamma^{t+1}d_{t-1} \right) - \left( e - 1 + \hat{h}x \right) \hat{h}x \right] + \omega c_0 + MU_{d,0}d_0 - u_{t,0}h_0 + \omega g_0 - \omega G.
\] 
(8.24)

Next, recall from Proposition 1 that \(\tau_{c,0}\) and \(\tau_{h,0}\) are given. It follows from equations
(3.12) and (3.13) that the planner cannot choose \( h_0 \) in this example, and instead takes the solution for \( h_0 \) from the competitive model as given. Further, the terms inside the summation depend on time only through \( \gamma^{t+1} \) and \( \beta^t \), and the equation is quadratic in \( x \). Therefore, after evaluating the summation we can write equation (8.24) as:

\[
ch(x) \equiv -\zeta_1 x^2 + (\zeta_1 - \zeta_2) x + \zeta_2 - \zeta_3 = 0,
\]

(8.25)

\[
\zeta_1 \equiv \hat{h}^2 + \frac{(1 - \gamma)^2}{\beta} \hat{d}^2,
\]

(8.26)

\[
\zeta_2 \equiv \left(\frac{1 - \beta}{\beta}\right) (1 - \gamma) \hat{d} \hat{d}_{-1},
\]

(8.27)

\[
\zeta_3 \equiv \frac{1 - \beta}{\beta} \left( \frac{\omega(1 + \tau_{c,0}) - \theta}{1 + \tau_{c,0}} k_0 h_0^{1-\theta} + u_{l,0} h_0 \right).
\]

(8.28)

\[
\zeta_3 \equiv \frac{1 - \beta}{\beta} \left( \frac{\omega(1 + \tau_{c,0}) - \theta}{1 + \tau_{c,0}} k_0 h_0^{1-\theta} + u_{l,0} h_0 \right).
\]

(8.29)

A solution such that \( \mu > 0 \) is a solution in the range \( \frac{1}{2} < x < 1 \). Note that equation (8.25) can be written as:

\[
ch(x) = (\zeta_1 x + \zeta_2) (1 - x) - \zeta_3 = 0.
\]

(8.30)

Now \( ch(x) \) attains a maximum at \( x^* = (\zeta_1 - \zeta_2) / (2\zeta_1) < 1/2 \) and \( ch(0) > ch(1) \). Hence it is immediate that \( \zeta_3 > 0 \) is necessary for \( x < 1 \).

From equation (8.29), \( \zeta_3 > 0 \) if and only if:

\[
G > \zeta_3 \equiv \frac{\omega(1 + \tau_{c,0}) - 1}{\omega(1 + \tau_{c,0})} (1 - \delta) k_0 - R_0 b_0 + \frac{\omega(1 + \tau_{c,0}) - \theta}{1 + \tau_{c,0}} k_0 h_0^{1-\theta} - u_{l,0} h_0 \frac{\omega}{\omega(1 + \tau_{c,0})}.
\]

(8.31)

This is the lower bound for \( G \).

Condition (8.31) implies that \( \zeta_3 > 0 \) which implies both roots have modulus less than one. It remains to show that the roots are real and that one root is greater than one half. Since \( x^* < 1/2 \), the smaller root has modulus less than one half. The larger root is real and greater than one half if and only if:

\[
ch\left(\frac{1}{2}\right) = -\frac{\zeta_1}{4} + \frac{\zeta_1 - \zeta_2}{2} + \zeta_2 - \zeta_3 > 0,
\]

(8.32)
8.3 Proof of Proposition 5

First, we rewrite equations (4.11) and (4.12), using the σ definitions, so that:

\[
\frac{\partial \text{IMC}}{\partial c_t} = u_{c,t} \left(1 - \sigma_c + \alpha \sigma_{sc,t} - \sigma_{hc,t}\right),
\]

\[
\frac{\partial \text{IMC}}{\partial d_t} = MU_{d,t} \left(\alpha - \alpha \sigma_{s,t} + \sigma_{cs,t} - \sigma_{hs,t} + \frac{\beta u_{s,t+1}s_{2,t+1}}{MU_{d,t}} (\alpha \sigma_{s,t} - \alpha \sigma_{s,t+1} - \sigma_{cs,t+1} + \sigma_{hs,t} - \sigma_{hs,t+1})\right).
\]

Now since \(v\) is homothetic, we know that:

\[
\frac{v_c(\psi c, \psi s)}{v_s(\psi c, \psi s)} = \frac{v_c(\psi c, \psi s)}{v_s(\psi c, \psi s)},
\]

(8.40)
which implies:

\[
\frac{v_{cc}(c,s)c}{v_c(c,s)} + \frac{v_{cs}(c,s)s}{v_c(c,s)} = \frac{v_{ss}(c,s)s}{v_s(c,s)} + \frac{v_{cs}(c,s)c}{v_s(c,s)},
\]

(8.41)

which, using the definition of \( u(.) \) in equation (6.1), implies:

\[
\sigma_{sc} - \sigma_c = \sigma_{cs} - \sigma_s.
\]

(8.42)

It is also immediate from the definition of \( u(.) \) that \( \sigma_{hc} = \sigma_{hs} \). These facts and equations (4.4), (4.5), (8.38), and (8.39) together imply:

\[
\frac{MU_{d,t}}{u_{c,t}} = \frac{1 + \mu (1 - \sigma_{s,t} + \sigma_{cs,t} - (1 - \alpha) \sigma_{sc,t} - \sigma_{hs,t})}{1 + \mu \left( \alpha - \alpha \sigma_{s,t} + \sigma_{cs,t} - \sigma_{hs,t} + \frac{\beta u_{s,t+1}s_{2,t+1}}{MU_{d,t}} j_t \right)},
\]

(8.43)

where \( j_t \equiv \alpha \sigma_{s,t} - \alpha \sigma_{s,t+1} - \sigma_{cs,t} + \sigma_{cs,t+1} + \sigma_{hs,t} - \sigma_{hs,t+1} \). Hence, \( \tau_{d,t} > \tau_{c,t} \) if and only if the right hand side is greater than one, or:

\[
1 - (1 - \alpha) \sigma_{sc,t} - \sigma_{s,t} > \alpha - \alpha \sigma_{s,t} + \frac{\beta u_{s,t+1}s_{2,t+1}}{MU_{d,t}} \left( \sigma_{s,t} - \sigma_{s,t+1} - \sigma_{cs,t} + \sigma_{cs,t+1} + \sigma_{hs,t} - \sigma_{hs,t+1} \right),
\]

(8.44)

which simplifies to the desired result.

8.4 Proof of Corollaries 6-7

For the CRR case, note that \( \sigma_{sl} = 0, \sigma_s = 1 - \xi (1 - \sigma) \), and \( \sigma_{sc} = (1 - \xi) (1 - \sigma) \), which implies the left hand side of condition (6.3) is zero. The right hand side of (6.3) is also zero since \( \sigma_{cs} \) and \( \sigma_s \) are constant.

For the steady state case, \( \sigma_{i,t} = \sigma_{i,t+1} \) for all \( i \in \{s, sc, cs, hs\} \), so the result follows immediately from condition (6.3).

8.5 Proof of Proposition 8

If utility is separable, equations (8.38) and (8.39) become:

\[
\frac{\partial IMC}{\partial c_t} = u_{c,t} (1 - \sigma_c),
\]

(8.45)

\[
\frac{\partial IMC}{\partial d_t} = MU_{d,t} \left( \alpha - \alpha \sigma_{s,t} + \frac{\beta u_{s,t+1}s_{2,t+1}}{MU_{d,t}} \left( \alpha \sigma_{s,t} - \alpha \sigma_{s,t+1} \right) \right).
\]

(8.46)
Equations (4.4), (4.5), (8.45), and (8.46) together imply:

\[
\frac{MU_{d,t}}{u_{c,t}} = \frac{1 + \mu (1 - \sigma_{c,t})}{1 + \mu \left( \alpha (1 - \sigma_{s,t}) + \frac{\beta u_{s,t+1} s_{2,t+1}^t}{MU_{d,t}} (\sigma_{s,t} - \sigma_{s,t+1}) \right)},
\]

(8.47)

Hence, \(d\) is taxed at a higher rate if and only if the right hand side is greater than one, or:

\[
1 - \sigma_{c,t} > \alpha (1 - \sigma_{s,t}) + \beta \alpha u_{s,t+1} s_{2,t+1}^t \left( \sigma_{s,t} - \sigma_{s,t+1} \right),
\]

(8.48)

which simplifies to the desired result.

### 8.6 Proof of Corollary 9

For CRR preferences, \(\sigma_{i,t} = \sigma_{i,t+1}\) for all \(i \in \{s, c\}\), so the results follow immediately from condition (6.8).

### 8.7 Proof of Proposition 10

If utility is given by equation (6.14), equations (8.38) and (8.39) become:

\[
\frac{\partial IMC}{\partial c_t} = u_{c,t} (1 - \sigma_{c,t}),
\]

(8.49)

\[
\frac{\partial IMC}{\partial d_t} = MU_{d,t} \left( \alpha - \alpha \sigma_{s,t} - \sigma_{h,s,t} + \frac{\beta u_{s,t+1} s_{2,t+1}}{MU_{d,t}} \left( \sigma_{s,t} - \sigma_{s,t+1} + \sigma_{h,s,t} - \sigma_{h,s,t+1} \right) \right).
\]

(8.50)

Equations (4.4), (4.5), (8.49), and (8.50) together imply:

\[
\frac{MU_{d,t}}{u_{c,t}} = \frac{1 + \mu (1 - \sigma_{c,t})}{1 + \mu \left( \alpha (1 - \sigma_{s,t}) - \sigma_{h,s,t} + \frac{\beta u_{s,t+1} s_{2,t+1}}{MU_{d,t}} (\alpha (\sigma_{s,t} - \sigma_{s,t+1}) + \sigma_{h,s,t} - \sigma_{h,s,t+1}) \right)}.
\]

(8.51)

Hence, \(d\) is taxed at a higher rate if and only if the right hand side is greater than one, or:

\[
1 - \sigma_{c,t} > \alpha (1 - \sigma_{s,t}) - \sigma_{h,s,t} + \frac{\beta u_{s,t+1} s_{2,t+1}}{MU_{d,t}} \left( \alpha (\sigma_{s,t} - \sigma_{s,t+1}) \sigma_{h,s,t} - \sigma_{h,s,t+1} \right),
\]

(8.52)

which simplifies to the desired result.
8.8 Proof of Corollaries 11 and 12

For the CRR case, note that \( \sigma_s = 1 - \xi (1 - \sigma) \), and \( \sigma_{sl} = (1 - \xi) (1 - \sigma) \frac{h}{1-h} \). Substituting in these conditions into equation (6.15) gives:

\[
\xi (1 - \alpha) (1 - \sigma) - \sigma_{c,t} > -\left(1 - \xi \right)(1 - \sigma) \left( \frac{u_{s,t}s_{1,t}}{l_t} + \frac{\beta u_{s,t+1}s_{2,t+1}}{l_{t+1}} \right). \tag{8.53}
\]

For \( \sigma \geq 1 \), the left hand side is negative. Further the right hand side is positive if:

\[
\frac{u_{s,t}s_{1,t}}{l_t} + \frac{\beta u_{s,t+1}s_{2,t+1}}{l_{t+1}} > 0, \tag{8.54}
\]

\[
u s_{1,t}l_{t+1} > -\beta u_{s,t+1}s_{2,t+1}l_t. \tag{8.55}
\]

If \( l_{t+1} \geq l_t \), then the above inequality is satisfied since marginal utility is positive. But stability analysis indicates \( l_t \) is an increasing sequence along the transition path. Therefore, the right hand side is indeed positive, and so the inequality (6.15) cannot be satisfied, and hence \( \tau_{c,t} \geq \tau_{d,t} \).

For the steady state case, \( \sigma_{i,t} = \sigma_{i,t+1} \) for all \( i \in \{s, hs\} \), so the result follows immediately from condition (6.15).

9 Appendix: Tables and Figures

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Table 1: Parameter values and results for variables which are constant over time. The parameters \( h_0 \) and \( k_0 \) are set equal to \( h_t \) using equation (8.21) and \( k_t = Ah_t \), respectively. The parameter \( g_t \) is set equal to 30% of GDP for all \( t \).
Figure 1: Dynamics of first and second best addictive consumption for various values of $\gamma$. 