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## The taxation of trades in assets

A. Citanna<sup>a, b, \*</sup>, H.M. Polemarchakis<sup>c</sup>, M. Tirelli<sup>d</sup>

<sup>a</sup>*Department of Economics and Finance, HEC - Paris, France*

<sup>b</sup>*Columbia Business School, New York, NY, USA*

<sup>c</sup>*Department of Economics, Brown University, USA*

<sup>d</sup>*Department of Economics, University of Rome, Italy*

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### Abstract

When the asset market is incomplete, there typically exist taxes on trades in assets that are Pareto improving. This fiscal policy is anonymous, it is fully and correctly anticipated by traders, and it results in ex post Pareto optimal allocations; as such, it improves over previously proposed constrained interventions.

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### 1. Introduction

Ever since Arrow [1] and Debreu [7] stated definitively and demonstrated the theorems of classical welfare economics, the focus has been on possible sources of failure of the Pareto optimality of competitive equilibrium allocations. Complete markets in elementary securities or in contingent commodities allow the theorems of welfare economics to encompass economies with uncertainty, as in [2] or [9]. The absence of a complete asset market is a well-recognized reason for the Pareto suboptimality of competitive allocations.

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\* Corresponding author. Graduate School of Business, Columbia University, Uris 525, New York, NY 10027, USA. Fax: +1 212 662 8474.

*E-mail addresses:* [ac2258@columbia.edu](mailto:ac2258@columbia.edu), [citanna@hec.fr](mailto:citanna@hec.fr) (A. Citanna), [hpolemar@brown.edu](mailto:hpolemar@brown.edu) (H.M. Polemarchakis), [tirelli@uniroma3.it](mailto:tirelli@uniroma3.it) (M. Tirelli).

Competitive equilibrium allocations in economies with an incomplete asset market are suboptimal in a strong sense: Pareto improvement is possible even under the restrictions implied by the incompleteness. Constrained (sub)optimality, defined by Diamond [10], was formally shown in [22], and then proved robust or generic by Geanakoplos and Polemarchakis [18] and Citanna et al. [6], which extended the argument. Constrained suboptimality, a positive argument for intervention in competitive market economies, is compelling when intervention is compatible with the structural characteristics that underlie the incompleteness; it is anonymous; it results in ex post Pareto optimal allocations of commodities; and it is anticipated by traders in asset markets.

Compatibility restricts alternative allocations, but it is hard to assess or make precise when reasons for the incompleteness of asset markets are not explicit; it is commonly taken to require that interventions take the asset structure as given. Anonymity economizes on information and complexity, and it circumvents incentive-compatibility constraints. Ex post optimality guarantees against further intervention or deviations. A anticipation allows for repeated intervention.

A variety of intervention policies and corresponding notions of constrained suboptimality have been introduced in the literature, all compatible with the incompleteness of the asset market. The robust constrained suboptimality results obtained to date—[18] for individual portfolio reallocations, [23] for rationing in asset and spot commodity markets, [6] for lump-sum taxes and transfers—fail at least one of the criteria: for instance, portfolio reallocations or lump-sum taxes and transfers are not anonymous, a fact emphasized by Kajii [26], and rationing does not yield ex post optimal allocations of commodities.<sup>1</sup>

Here, the instruments of intervention are linear taxes or subsidies on the purchase of assets. The main result is that if the asset market is sufficiently incomplete, generically, there exist Pareto-improving fiscal policies. The taxation of assets is anonymous; the resulting allocation of commodities is ex post Pareto optimal, and there are no ex post constraints on asset trades enforced by shutting down financial markets; intervention is compatible with the incompleteness of the asset market; and it does not require the announcement of future or state-contingent taxes or subsidies, which could be subject to credibility constraints.

The argument is easy to understand. With portfolio reallocation policies, as in [18], individual asset holdings are redistributed in order to control the state-contingent distribution of wealth. Here, a redistribution of portfolio holdings is induced through taxes on trades in assets, with possibly negative tax rates or subsidies: asset holdings are indirectly controlled by creating a bid-ask spread—possibly negative. The core of the technical argument consists in bypassing the nondifferentiabilities and nonconvexities that taxes and subsidies create and in showing that taxes and subsidies can indeed induce the required redistribution of portfolios.

Taxation has been extensively studied as a policy instrument. Since Dupuit [14], and through Hotelling [24], Boiteux [4] and Debreu [8], economists have established that commodity taxation, whether through a quantity tax or a tax ad valorem or excise with a rebate, generates a welfare burden on individuals at a competitive equilibrium, the “deadweight loss triangle” in textbooks.

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<sup>1</sup> The introduction of new assets or the alteration of asset payoffs in [5,15,16] preserves anonymity, but either it reduces incompleteness or it requires state-contingent policies.

The interest in taxation arises from the impossibility of lump-sum transfers or the presence of distortions, such as externalities or, here, incomplete hedging opportunities.<sup>2</sup> The taxation of asset trades affects the holdings of assets and the distribution of state-contingent wealth, and, as a consequence, relative prices in spot markets; Indeed, with multiple commodities, and for a generic choice of utilities and endowments, ad valorem taxes on asset prices and uniform rebates in fact are *locally, effectively welfare-controlling*: they can be employed to attain any distribution of welfare; this requires that the number of independent policy tools (the number of assets subject to taxation) be at least as large as the number of policy objectives (the levels of utility of individuals) and that state-contingent marginal valuations of revenue by individuals be sufficiently dispersed, which rules out identical, homothetic state-contingent preferences that insulate spot commodity markets from variations in the distribution of wealth.

In the economies we consider here, information is symmetric and the differential taxation of assets is designed to affect the distribution of state-contingent revenue; taxation applies to all trades, whether “speculative” or not.<sup>3</sup>

Though taxation is anonymous, Pareto-improving intervention requires information about the fundamentals of the economy—here, the preferences and endowments of individuals. It is then an issue whether the information required for determining the welfare consequences of taxation can be obtained from market data, in particular from equilibrium prices. The argument in [27] is that market data, namely, the equilibrium prices of commodities and assets as endowments vary, suffices to identify the profile of utilities. Evidently, this is demanding, and the result only establishes that identification is possible “in principle.” Further work should then investigate the implementation of Pareto-improving taxes on asset trades.

## 2. Economies

The economy is of pure exchange over two periods, with uncertainty, and finitely many individuals and commodities. Uncertainty is described by states of the world  $s \in \mathcal{S} = \{1, \dots, S\}$ , with  $S \geq 2$ . Physical commodities are  $l \in \mathcal{L} = \{1, \dots, L\}$ , also with  $L \geq 2$ . At a state of the world  $s$ , commodities are indexed by  $(l, s)$ , and a bundle of commodities is a nonnegative real vector  $x_s = (\dots, x_{l,s}, \dots)'$ ; across states of the world, a bundle of commodities is  $x = (\dots, x_s, \dots)'$ .

Individuals are  $i \in \mathcal{I} = \{1, \dots, I\}$ , with  $I \geq 2$ . The preferences of an individual are described by the ordinal utility function  $u^i$ , with domain the consumption set of strictly

<sup>2</sup> Following Ramsey [29], several papers characterized optimal commodity taxes, among them [11,20], while others, among them [17,19], studied the possibility of tax reform—Auerbach [3] and Mirrlees [28] survey the literature. The implications of market incompleteness on optimal commodity taxes appeared in [12]. Anonymous Pareto-improving commodity taxes can be shown to exist generically also in economies with externalities (J.D. Geanakoplos and H.M. Polemarchakis, “Pareto-Improving Taxes,” mimeo, 2001).

<sup>3</sup> There have been other arguments for the taxation of trades in assets. Tobin [32,33] advocated the taxation of financial transactions and emphasized the impact of the financial system on macroeconomic performance. The argument there concerned, however, the taxation of speculative transactions and it was designed to curb destabilizing volatility in a dynamic context, as in [13] or [31].

positive bundles of commodities across states of the world; the endowment of the individual is  $e^i$ , a bundle of commodities across states of the world. The utility function is smooth, differentially strictly increasing:  $Du^i \gg 0$ , and differentially strictly quasi-concave: if  $x \neq 0$  and  $Du^i x = 0$ , then  $x' D^2 u^i x < 0$ ; while along a sequence of consumption plans  $\{x_n \gg 0 : n = 1, 2, \dots\}$ , if  $\lim_{n \rightarrow \infty} x_n = x \gg 0$ , then  $\lim_{n \rightarrow \infty} \|Du^i(x_n)\|^{-1} x_n' Du^i(x_n) = 0$ ; <sup>4</sup> the endowment is strictly positive:  $e^i \gg 0$ .

The preferences of an individual may, but need not, admit a von Neumann–Morgenstern representation,  $(v^i, \pi^i)$ , where  $v^i$  is a state-independent cardinal utility index,  $\pi^i = (\dots, \pi_s^i, \dots)$  is a (subjective) probability measure on the set of states of the world, and  $u^i = E_{\pi^i} v^i$ ; alternatively, preferences may have an additively separable representation,  $(\dots, v_s^i, \dots)$ , where  $v_s^i$  is a state-dependent cardinal utility index, and  $u^i = \sum_{s \in \mathcal{S}} v_s^i$ .

Commodities are traded in spot markets after the resolution of uncertainty. Prices of commodities at a state of the world are a row vector  $p_s = (1, \dots, p_{l,s}, \dots) \gg 0$ : commodity  $l = 1$  is the numéraire, and prices are strictly positive; across states of the world, prices of commodities are  $p = (\dots, p_s, \dots)$ . At a state of the world, the value of a bundle of commodities  $x_s$  at prices of commodities  $p_s$  is  $p_s x_s$ ; across states of the world, the expenditures associated with a bundle of commodities  $x$  at prices of commodities  $p$  are  $p \otimes x = (\dots, p_s x_s, \dots)$ . The multiplicity of commodities and the diversity of individuals guarantee that spot markets for commodities are active.

Financial assets are  $a \in \mathcal{A} = \{1, \dots, A\}$ , a finite, nonempty set. They are exchanged prior to the resolution of uncertainty, and they serve to transfer revenue across states of the world, and they are in zero net supply. A portfolio of assets is  $y = (\dots, y_a, \dots)'$ . At a state of the world, the payoff of an asset is  $r_{a,s}$ , denominated in units of the numéraire commodity; across states of the world, the payoffs of an asset are  $r_a = (\dots, r_{a,s}, \dots)'$ . Asset payoffs at a state of the world  $s$  are  $R_s = (\dots, r_{a,s}, \dots)$ , and the matrix of asset payoffs is

$$R = (\dots, r_a, \dots) = (\dots, R_s, \dots)'$$

The column span of the matrix of asset payoffs is  $[R]$ , the subspace of attainable reallocations of revenue across states of the world. Prices of assets are  $q = (1, \dots, q_a, \dots)$ . The assumptions on the payoffs of assets are standard: there are no redundant assets,  $\dim[R] = A$ ; the asset market is active,  $A \geq 2$ ; and the payoffs of asset  $a = 1$  are positive,  $r_1 > 0$ .

An allocation of commodities is a  $\vec{x} = (\dots, x^i, \dots)$  such that  $x^i \geq 0$  for every individual. Aggregate (global) consumption is  $x^g = \sum_{i \in \mathcal{I}} x^i$ , while the aggregate endowment is  $e^g = \sum_{i \in \mathcal{I}} e^i$ . An allocation of commodities is feasible if  $x^g = e^g$ . An allocation of portfolios of assets is  $\vec{y} = (\dots, y^i, \dots)$ ; the aggregate portfolio is  $y^g = \sum_{i \in \mathcal{I}} y^i$ . An allocation of portfolios of assets is feasible if  $y^g = 0$ .

Economies are identified by  $\omega = (u, e) \in \Omega$ , the utility functions and endowments of individuals. The space of utilities is endowed with the topology of  $C^2$ -uniform convergence over compact sets, while the space of endowments has the standard Euclidean structure.

<sup>4</sup> The boundary condition on the utility function is satisfied if the closure of the indifference surface through a consumption plan is contained in the consumption set, a stronger condition.

Quadratic perturbations of utilities will be used to establish density in the main proposition. For an economy  $\omega \in \Omega$  and given an equilibrium consumption plan  $\bar{x}^*$ , a perturbed utility for an individual  $i$  is a function

$$u^i_{(x^{i*}, \rho, \varepsilon)}(x^i, M^i) = u^i(x^i) + (1/2)\varepsilon\rho(x^i)[(x^i - x^{i*})'M^i(x^i - x^{i*})],$$

where  $x^{i*}$  is the equilibrium individual consumption plan;  $\varepsilon > 0$  is a scalar;  $\rho(x^i)$  is a bump function [21, Chapter 1]; and  $M^i$  is a symmetric,  $LS$ -dimensional matrix—details on these perturbations are in [6]. The second derivative of this function with respect to  $x^i$  is exactly equal to  $D^2u^i(x^i) + \varepsilon M^i$  in a small open neighborhood of the equilibrium allocation  $x^{i*}$ . The vector of quadratic perturbations is  $M = (\dots, M^i, \dots)$ , while  $u^i(x^i, M^i)$  denotes  $u^i_{(x^{i*}, \rho, \varepsilon)}(x^i, M^i)$ . A generic set of economies is an open and dense subset of  $\Omega$ ; a property holds generically if it holds for a generic set.

### 3. Fiscal policy

Taxes on asset purchases are the instruments of fiscal policy. Rates of taxation or subsidy on the purchase of assets are  $t = (\dots, t_a, \dots)$ , with  $t_a > -1$  for all  $a \in \mathcal{A}$ . Then, the purchase prices of assets are  $(1 + t) \otimes q = (\dots, (1 + t_a)q_a, \dots)$ . Taxation of both purchases and sales does not entail any essential change, and, in order to ease exposition, we consider the taxation only of purchases. The value of a portfolio of assets  $y$  at prices of assets  $q$  and rates of taxation  $t$  is  $((1 + t) \otimes q)y_+ - qy_-$ .<sup>5</sup>

Aggregate fiscal revenue from the taxation of assets is  $T = \sum_{i \in \mathcal{I}} (t \otimes q)y_+^i$ . It is distributed across individuals according to a fixed scheme  $\delta = (\dots, \delta^i, \dots) \gg 0$ , with  $\sum_{i \in \mathcal{I}} \delta^i = 1$ —the uniform distribution scheme is  $\delta = (\dots, (1/I), \dots)$ ; the revenue of an individual is  $\delta^i T$ . Fiscal policy is conducted through the vector of tax rates  $t \in \mathcal{T}$ , where  $\mathcal{T}$  is an open neighborhood of zero, of dimension  $A$ —aggregate fiscal revenue,  $T$ , is determined endogenously, as a residual.

With taxes, the optimization problem of an individual is

$$\begin{aligned} \max_{x, y} \quad & u^i(x) \\ \text{s.t.} \quad & ((1 + t) \otimes q)y_+ - qy_- - \delta^i T \leq 0, \\ & p \otimes (x - e^i) \leq Ry. \end{aligned} \tag{P}$$

The specification of the budget constraint does not allow the individual to buy and sell an asset simultaneously; this restriction is immaterial when the tax  $t_a$  is nonnegative, but it is needed when the buyer receives a subsidy and an arbitrage opportunity arises.

**Definition 1.** A competitive equilibrium with fiscal policy  $t$  consists of a feasible allocation and prices of commodities and assets and fiscal revenue,  $(\bar{x}, \bar{y}, p, q, T)$ , such that, for every individual,  $(x^i, y^i)$  is a solution to the optimization problem.

<sup>5</sup> Here  $y_{a,+} = \max\{0, y_a\}$ , while  $y_{a,-} = \max\{0, -y_a\}$ , and  $y_+ = (\dots, y_{a,+}, \dots)$ , while  $y_- = (\dots, y_{a,-}, \dots)$ .

A competitive equilibrium in the standard sense corresponds here to a competitive equilibrium with inactive fiscal policy,  $t = 0$ : there is no fiscal revenue and the distribution scheme is immaterial.

The vector of utilities associated with an allocation of commodities is  $u(\vec{x}) = (\dots, u^i(x^i), \dots)$ . An allocation of commodities,  $\vec{x} = (\dots, x^i, \dots)$ , is strictly Pareto superior to another,  $\vec{x}' = (\dots, x^{i'}, \dots)$ , if  $u(\vec{x}) \gg u(\vec{x}')$ .

**Definition 2.** A feasible allocation of commodities is strictly constrained Pareto suboptimal if there exists a strictly Pareto superior competitive equilibrium allocation with fiscal policy.

Constrained interventions are restricted to the taxation of trades in assets. For the generic existence of Pareto-improving taxes on asset trades we require that the economy is (sufficiently) heterogeneous and the asset market is (sufficiently) incomplete.

**Assumption 1.** The asset market is sufficiently incomplete:

$$\min\{A - 1, S - A\} \geq I.$$

The assumption is strong, but it serves to yield a strong result: anonymous Pareto improving taxes—we discuss it further in Section 4.

**Proposition (Constrained suboptimality).** *Generically, every competitive equilibrium allocation with inactive fiscal policy is strictly constrained Pareto suboptimal. The fiscal policy that implements the strict Pareto improvement can be chosen to involve no fiscal revenue.*

The general argument uses the method developed in [6] to compute the equilibrium indirect utility vector and evaluate its derivative. The method requires the construction of a smooth system of equations representing a competitive equilibrium with fiscal policy. For this, we require a couple of regularity results.

### 3.1. Regularity and the existence of equilibria

We define, for every individual, the function  $F^i$  by

$$F^i = \begin{pmatrix} F_L^i \\ F_{II}^i \\ F_{III}^i \\ F_{IV}^i \end{pmatrix} = \begin{pmatrix} D_{x^i} u^i(x^i, M^i) - \lambda^i \otimes p \\ \lambda^i R - \mu^i q^i \\ q^i y^i - \delta^i T \\ -p \otimes (x^i - e^i) + Ry^i \end{pmatrix},$$

where  $\lambda^i = (\dots, \lambda_s^i, \dots) \gg 0$  and  $\mu^i > 0$  are Lagrange multipliers associated with the budget constraints across states of the world and the asset market, respectively,  $\lambda^i \otimes p = (\dots, \lambda_s^i p_s, \dots)$  and  $q^i = (\dots, q_a^i, \dots)$  where

$$q_a^i = \begin{cases} (1 + t_a)q_a, & \text{if } y_a^i \geq 0, \\ q_a, & \text{if } y_a^i < 0. \end{cases}$$

Across individuals, we define the function  $F^0$  by

$$F^0 = \begin{pmatrix} F_V^0 \\ F_{VI}^0 \\ F_{VII}^0 \end{pmatrix} = \begin{pmatrix} \tilde{x}^g - \tilde{e}^g \\ \tilde{y}^g \\ T - (t \otimes q)y_+^g \end{pmatrix},$$

where  $\tilde{x}^g$  is the aggregate demand for commodities and  $\tilde{e}^g$  the aggregate endowment of commodities other than the numéraire across states of the world,  $\tilde{y}^g$  is the aggregate demand for assets other than the numéraire, and  $y_+^g = \sum_{i \in \mathcal{I}} y_+^i$ .

Finally, we define the function  $F$  as  $F = (\dots, F^i, \dots, F^0)'$ ; elements of the domain of this function are  $(\zeta, t, \omega) = (\vec{x}, \vec{y}, \lambda, \mu, p, q, T, t, \omega)$ , where  $\zeta = (\vec{x}, \vec{y}, \lambda, \mu, p, q, T)$  are endogenous variables, with  $\lambda = (\dots, \lambda^i, \dots)$ , and  $\mu = (\dots, \mu^i, \dots)$ . The domain of endogenous variables is  $\Xi$ , an open set of dimension  $N = (ILS + IA + IS + I + S(L - 1) + (A - 1) + 1)$ , which coincides with the dimension of the range of the function  $F$ .

The zeros of the function  $F^i$  represent the Kuhn–Tucker conditions for the individual optimization problem (P) when  $t = 0$ . For an economy  $\omega \in \Omega$ , a competitive equilibrium with inactive fiscal policy,  $t = 0$ , augmented with the associated Lagrange multipliers of the budget constraints of individuals, is then determined as a solution to the system of equations  $F_{(0,\omega)}(\zeta) = 0$ . The argument in [18] applies and shows that competitive equilibria with inactive fiscal policy exist:  $F_{(0,\omega)}^{-1}(0) \neq \emptyset$ .

In general,  $F^i$  does not correspond to the Kuhn–Tucker conditions for (P) when  $t \neq 0$ : when  $t_a < 0$ , the budget constraint is not convex; while, in addition, if at a solution to the optimization problem of an individual  $y_a^i = 0$  for some  $a$ , then the optimum occurs at a kink and the equations that characterize the optimum are not smooth. However, both the potential lack of differentiability and the lack of convexity problems can be bypassed, as shown in Lemma 2 below, as long as: (a) the equilibrium with inactive fiscal policy is locally unique, and all individuals trade all assets or  $y_a^i \neq 0$ ; and (b)  $t$  is restricted to an appropriate neighborhood of  $t = 0$ . The first condition holds generically as is summarized in the following standard lemma—items 1 and 2.<sup>6</sup>

The excess demand of an individual is the row vector  $z^i = (\dots, z_s^i, \dots)$ , where  $z_s^i = x_s^i - e_s^i$ .

**Lemma 1.** *There exists a generic subset of economies  $\Omega^0$ , such that, for every economy  $\omega \in \Omega^0$ ,*

1. *the function  $F_{(0,\omega)}$  is transverse to 0:  $\dim[D_\xi F_{(0,\omega)}] = N$ ; and, at a competitive equilibrium with inactive fiscal policy,*
2. *every individual trades every asset:*

$$F_{(0,\omega)}(\zeta) = 0 \quad \Rightarrow \quad y_a^i \neq 0, \quad a \in \mathcal{A}, \quad i \in \mathcal{I}, \quad \text{and}$$

<sup>6</sup> The proof of Lemma 1 is standard and therefore we omit it; it follows immediately from the analogous argument in [18]. We state item 3 here, but we use it only later, in the proof of density; it is this item that requires the condition  $(S - A) \geq I$  that appears in Assumption 1, and we discuss it in Section 4.

3. the matrix

$$\begin{pmatrix} \vdots \\ \lambda^i \otimes z^i \\ \vdots \end{pmatrix} = \begin{pmatrix} \vdots \\ \dots \lambda^i z^i \dots \\ \vdots \end{pmatrix}$$

has full row rank,  $I$ .

In Lemma 1, as well as in the next lemma, genericity refers to perturbations only in endowments. Essentially by continuity, Lemma 1 implies that, for small enough  $t$ , the zeros of  $F$  represent competitive equilibria with fiscal policy  $t$ , and since the equations  $F_{(t,\omega)}(\xi) = 0$  are smooth, they determine, locally, the equilibrium impact of taxes on asset trades. This is the content of the following lemma, which corresponds to condition (b) above, the key element of the analysis.

**Lemma 2.** *For every economy  $\omega \in \Omega^0$ , there exists an open neighborhood,  $\mathcal{O}_\omega \subset \mathcal{T}$ , of  $t = 0$  of fiscal policies, where competitive equilibria exist, they are obtained as solutions to the system of equations  $F_{(t,\omega)}(\xi) = 0$ , and they are locally smooth functions of the fiscal policy parameters and of the quadratic perturbations:*

$$d\xi = -(D_\xi F)^{-1}(D_t F dt + D_M F dM).$$

Notice that, once the function  $F$  is restricted to the open and dense subset  $\Omega^0$ , at all equilibria with  $t = 0$ , necessarily  $y_a^i \neq 0$ , and there is no need to impose this condition as an additional restriction on the domain of  $F$ . While  $F$  may still be nondifferentiable for some combination  $(\xi, \omega)$  in its domain, it is smooth in  $\xi, t$  and  $\omega$  at those vectors  $(\xi, t, \omega)$  for which  $\omega \in \Omega^0, t \in \mathcal{O}_\omega$  and  $F_{(t,\omega)}(\xi) = 0$ , which is all that it is needed for the analysis—the reader should keep this in mind when openness of the subset of economies in  $\Omega^0$  where a Pareto-improving fiscal policy exists will be proved.

3.2. Pareto-improving fiscal policy

The proof of the proposition now follows closely [6]; that is,

$$\tilde{\Phi}(\xi, t, \omega) = \begin{pmatrix} D_\xi F & D_t F \\ D_\xi u & 0 \end{pmatrix}$$

represents the derivative of the equilibrium system and of the utility vector when computed at any  $\omega \in \Omega^0, t \in \mathcal{O}_\omega$  and  $\xi$  such that  $F_{(t,\omega)}(\xi) = 0$ . An equilibrium with inactive fiscal policy is constrained suboptimal if the row rank of  $\tilde{\Phi}(\xi, t, \omega)$  is full [6, Proposition 1] at such  $\xi, t$  and  $\omega$ , with  $t = 0$ . The rank condition on  $\tilde{\Phi}(\xi, t, \omega)$  is indeed equivalent to showing that the system defined by

$$F_{\text{opt}}(\xi, b; t, \omega) = \begin{pmatrix} b_1 D\tilde{F} + b_2 Du \\ \|b\| - 1 \end{pmatrix} = 0,$$



where  $b = (b_1, b_2)$  is a vector of dimension  $N + I$ , has no solution at  $F_{(0,\omega)}(\xi) = 0$ , for a given  $\omega$ .  $D\tilde{F}$  is nothing but an appropriately chosen submatrix of the derivative matrix  $DF$ . Hence, if a planner were to choose  $t$  (a tax policy) to maximize the utility vector  $u$  (the social welfare) subject to  $\tilde{F} = 0$ , the value  $t = 0$  would not satisfy the first-order conditions for an optimum: a tax reform (a local change in taxes) would do better.

Constrained suboptimality holds for a generic subset of economies in  $\Omega$ . In order to show density, and using the quadratic, finite-dimensional parametrization  $M$  of utility functions, it suffices to show [6, Proposition 3] that the matrix  $D_{b,M}F_{\text{opt}} = (D_b F_{\text{opt}}, D_M F_{\text{opt}})$  has full row rank.

## 4. Discussion

### 4.1. Market incompleteness

The natural requirement that the number of policy instruments exceed the number of policy targets is the object of Assumption 1: instruments are taxes on trades in assets and the rebate, while targets are the utility levels of individuals at equilibrium. If Pareto improvement may involve fiscal revenue, it suffices that  $A \geq I$ ; if intervention must satisfy fiscal balance,  $T = 0$ , the argument requires that  $A \geq I + 1$ .

Sufficient market incompleteness relative to the number of individuals,  $S - A \geq I$ , also in Assumption 1, is used to prove item 3 in Lemma 1. The matrix represents the relative commodity price effects of tax reforms. Indeed, for a marginal change of policy instruments or tax rates  $dt$ , and fixing  $dq = 0$  and  $dy^i = 0$ , the change in individual  $i$ 's indirect utility induced via a relative spot prices change is  $du^i = (\lambda^i Z^i) \otimes D_i p dt$ . Then, item 3 of Lemma 1 guarantees that there is sufficient variation of utilities due to these price effects, a necessary property that fails to hold with homogeneous homothetic preferences. While Geanakoplos and Polemarchakis [18] used item 3, Lemma 1, they did not require  $S - A \geq I$ , since the no-arbitrage equations need not be satisfied by a direct portfolio reallocation policy.

Since  $S > A$ , Assumption 1 implies that  $LS > I$ , a condition used in [18] to establish the constrained inefficiency of financial equilibrium when the planner changes asset holdings directly and must take into account the initial asset prices.<sup>7</sup> Kajii [25] showed that Pareto improvement through anonymous direct asset reallocations can be obtained only if indeed the planner must take into account the initial asset prices, but this condition is not sufficient, and he gives a counterexample. Here, anonymity is obtained with the additional condition of sufficient incompleteness, and this suggests that, once no-arbitrage equations as well as initial asset prices are taken into account, but with the slack provided by taxes, portfolio reallocations are anonymous.

Taxation of both purchases and sales of the numéraire asset gives more degrees of freedom and generic Pareto improvements under the less stringent condition  $\min\{A, S - A\} \geq I$ —the proof mimics that of the proposition and we omit it. The taxation of both purchases and

<sup>7</sup> That is, portfolio reallocations must be balanced not only in terms of the units of assets redistributed, but also in value, where their value is computed at the initial equilibrium prices.

sales for an asset other than the numéraire is redundant, since the asset price can adjust as the tax rates change and, thus, effectively nullify one of the tax instruments in each market.

#### 4.2. Negative tax rates

Pareto-improving taxes cannot be guaranteed to be all nonnegative, and some are guaranteed to be negative when we impose the fiscal balance requirement  $T = 0$ .<sup>8</sup> Negative asset trading tax rates limit their decentralization through markets, as certain trades must then be prohibited in order to avoid unbounded tax arbitrage profits. Here, we banned these arbitrage trades by definition of  $y_{a,+}$  and  $y_{a,-}$ , since no individual can be simultaneously on both sides of an asset market.

The following numerical example shows that sometimes Pareto-improving tax rates can be negative even if  $T$  is not restricted to be zero. There is no aggregate risk, utilities are von Neumann–Morgenstern, homothetic, and individuals are heterogeneous both in endowments and preferences. Setting  $I = 2 = A$  and  $S = 4$ , the proposition applies assuming that tax revenues are not restricted to be zero, since  $S - A = 2 \geq I = 2$  and  $A = 2 \geq I = 2$ , which is enough as discussed above. Further,  $L = 2$ , and utilities are of the form

$$u^i(x^i) = \sum_s \pi_s (\alpha_s^i \ln x_{1,s}^i + (1 - \alpha_s^i) \ln x_{2,s}^i).$$

Heterogeneity in  $\alpha$ 's is needed as shown in the example of Section 3. For every commodity and every state of the world,  $\sum_i e_{i,s}^i = 1$ . The asset payoff vectors are  $r_1 = (1, 0, 0, 0)'$  and  $r_2 = (0, 1, 1, 1)'$ . Asset 2 is a discount bond.

With no taxes, the individual budget constraint is  $q_1 y_1 + q_2 y_2 = 0$ . Buying asset 1 then corresponds to selling asset 2, i.e., borrowing money, while selling it corresponds to buying asset 2 or lending. Hence, while taxes are on the purchases of assets, this can be interpreted as taxing purchases and sales of asset  $a = 2$  only. Then, *other things equal*, a tax  $t_1 > 0$  corresponds to an increase in the borrowing rate (from  $1/q_2$  to  $(1 + t_1)(1/q_2)$ ), while a tax  $t_2 > 0$  corresponds to a decrease in the lending rate (from  $1/q_2$  to  $[1/(1 + t_2)](1/q_2)$ ). The actual change in the rate depends of course on the resulting after-tax  $q_2$ .

For normalization,  $q_1 = 1$ , and  $p_{1,s} = 1$  at every state of the world. In the example, the parameters of the economy are set as follows:

$$\alpha_s^1 = \begin{cases} \frac{1}{3}, & s \text{ odd,} \\ \frac{2}{3}, & s \text{ even,} \end{cases} \quad e_s^1 = \begin{cases} (\frac{1}{2}, \frac{3}{10}), & s \leq 2, \\ (\frac{3}{10}, \frac{1}{2}), & s > 2, \end{cases}$$

$$\alpha_s^1 = (1 - \alpha_s^2), \quad \pi = (5, \frac{1}{3}, \frac{1}{3}, \frac{1}{3}).$$

At the computed no tax equilibrium  $y_2^1 = 0.0153$  and  $q_2 = 0.1844$ — $i = 1$  is a lender and  $i = 2$  a borrower—and utilities are  $u^1(x^1) = -4.9463$  and  $u^2(x^2) = -2.8891$ . After taxes of  $t_1 = -0.16\%$  and  $t_2 = 0.07\%$  are introduced, the new equilibrium has a price

<sup>8</sup> We thank an anonymous referee for pointing out to us that negative taxes are found in the US tax code: for instance, when a worker's contribution to a 401(k) plan is deducted at the marginal tax rate in effect when he works, but later withdrawals are taxed at the lower marginal tax rate in effect in retirement.

of  $q_2' = 0.1842$ , unchanged  $y_2^{1'} = y_2^1$  (obviously,  $y_1^1$  changes), and utilities of  $u^1(x^{1'}) = -4.9462$  and  $u^2(x^{2'}) = -2.8890$ .<sup>9</sup> Small perturbations in endowments do not affect the sign of tax changes, and Pareto improving taxes may be robustly negative. To guarantee that  $t \in \mathcal{O}_\omega$ , tax rates and corresponding utility changes are nonzero, but small. With a change in certainty equivalent of less than  $1/10^3$ , this example is obviously not meant to try and assess the quantitative importance of our results, which remains to be assessed.

### 5. Proofs

**Lemma 2.** *For any given  $\omega \in \Omega^0$ , one parametrizes the utility using  $M$ , the quadratic perturbation term, and considers the associated finite-dimensional parametrization  $(M, e)$  where  $M = 0$  at the initial  $\omega$ .*

As  $F_{(0,\omega)}^{-1}(0) \neq \emptyset$  for all  $\omega$ , Lemma 1, item 1 (regularity) allows the application of the Implicit Function Theorem to claim that the system of equations  $F_{(t,\omega')}(\xi) = 0$  has a solution, where  $(\xi, t, \omega') \in \mathcal{N}_{(\bar{\xi},0,\omega)}$ , for some open neighborhood  $\mathcal{N}_{(\bar{\xi},0,\omega)}$  of  $(\bar{\xi}, 0, \omega)$ , with  $\bar{\xi} \in F_{(0,\omega)}^{-1}(0)$ . Standard compactness of  $F_{(0,\omega)}^{-1}(0)$  implies that  $\#F_{(0,\omega)}^{-1}(0) = K < \infty$ , and so implies the existence of finitely many such neighborhoods,  $\mathcal{N}_{(\bar{\xi}_k,0,\omega)}$ , one for each  $\bar{\xi}_k \in F_{(0,\omega)}^{-1}(0)$ ,  $k \leq K$ . Projecting  $\mathcal{N}_{(\bar{\xi}_k,0,\omega)}$  onto  $\mathcal{T}$ , and taking the intersection over  $k$ , we get an open set  $\mathcal{O}'_\omega \subset \mathcal{T}$  around  $t = 0$ , such that  $F_{(t,\omega)}(\xi) = 0$  has finitely many, locally unique smooth solutions  $\xi_k(t; \omega)$  for each  $t \in \mathcal{O}'_\omega$ .

Next, there exists an open neighborhood  $\mathcal{O}_\omega \subset \mathcal{O}'_\omega$  of  $t = 0$  such that for  $t \in \mathcal{O}_\omega$ , for each  $i \in \mathcal{I}$  any solution to the individual optimization problem (P) obtains at  $F_{(t,\omega)}(\xi) = 0$ . If not, there exists a sequence  $\{t_n : n = 1, 2, \dots\} \subset \mathcal{O}'_\omega$  with  $\lim_{n \rightarrow \infty} t_n = 0$  and, for each  $n$ , an individual  $i_n \in \mathcal{I}$  and a portfolio  $\tilde{y}_n^{i_n}$  solving (P) with fiscal policy  $t_n$ , prices  $p_n$  and  $q_n$ , and revenue  $T_n$ , such that  $\tilde{y}_n^{i_n} \neq y_n^{i_n}$ , where  $p_n, q_n, T_n$  and  $y_n^{i_n}$  are part of the vector  $\xi_n$  with  $F_{(t_n,\omega)}(\xi_n) = 0$ . Since the sets of individuals and assets are finite, passing to a subsequence if necessary,  $i_n = i$ , and  $\tilde{y}_{a,n'}^i \tilde{y}_{a,n''}^i \geq 0, y_{a,n'}^i y_{a,n''}^i \gg 0$  (by Lemma 1, item 2), for all  $a \in \mathcal{A}$ , for  $n, n', n''$  large enough.

First,  $\lim_{n \rightarrow \infty} y_n^i = \bar{y}_k^i$ , for all  $i \in \mathcal{I}$ , by smoothness of  $\xi_k(t; \omega)$ , where  $\bar{y}_k^i$  obtains at  $F_{(0,\omega)}(\bar{\xi}_k) = 0$ , some  $k \leq K$ . Dropping the subscript  $k$ , again by Lemma 1, item 2,  $\bar{y}_a^i \neq 0$ , for all  $a \in \mathcal{A}$ . Along the sequence as well as in the limit prices of commodities are strictly positive, prices of assets do not allow for arbitrage, and the matrix of asset payoffs has full rank. Also, at  $t = 0$ , for each  $i \in \mathcal{I}$ ,  $\bar{q}y_+ - \bar{q}y_- \leq 0$  and  $\bar{p} \otimes (x - e^i) \leq Ry$  implies that there

<sup>9</sup> Here  $'$  represents equilibrium values after taxation. We compute equilibria by first solving for optimal consumption,  $x_{1,s}^i = \alpha_s^i m_s^i$  and  $x_{2,s}^i = (1 - \alpha_s^i) m_s^i / p_{2,s}$ , where  $m_s^i = e_{1,s}^i + p_{2,s} e_{2,s}^i + r_s y^i$ . Then, the commodity price  $p_{2,s}$  and, therefore, Lagrange multipliers  $\lambda_s^i$  are computed as a function of 1's holdings of asset  $a = 2$ , and of the price of this second asset,  $y_2^1, q_2$ . Since Lagrange multipliers  $\mu^i$  can also be determined as a function of  $y_2^1, q_2$ , equilibrium computations boil down to solving by norm minimization the system of no arbitrage equations for asset  $a = 2$  and the two individuals, in the unknowns  $y_2^1$  and  $q_2$ , with positivity constraints on consumption through the individual rationality constraints. Programming was done using the 'fmincon' routine of MatLab v. 6.0. Numerical errors are below  $1/10^9$ .

is an  $(\bar{x}^i, \bar{y}^i)$  such that  $\bar{q}\bar{y}_+^i - \bar{q}\bar{y}_-^i < 0$  and  $\bar{p} \otimes (\bar{x}^i - e^i) \ll R\bar{y}^i$ , and  $(\bar{x}^i, \bar{y}^i)$  is close to  $(x, y)$ , a local cheaper consumption condition: this is a standard argument. Then, again by a standard argument the correspondence of solutions to the individual optimization problems (P) is verified to be upper hemi-continuous in  $p, q, t, T$  at  $t = 0$ —and at corresponding values  $\bar{p}, \bar{q}, \bar{T}$  from  $F_{(0,\omega)}(\xi) = 0$ —, and  $\lim_{n \rightarrow \infty} \tilde{y}_n^i = \tilde{y}^i$ . Since at  $t = 0$  the budget set is convex,  $\tilde{y}^i = \bar{y}^i$ , so that  $\tilde{y}_a^i \bar{y}_a^i > 0$ , all  $a \in \mathcal{A}$ . As a consequence,  $\tilde{y}_{a,n}^i y_{a,n}^i \geq 0$  for  $n$  large enough.

We restrict individual  $i$  to  $y_n$  such that for each  $a \in \mathcal{A}$ ,  $y_{a,n} \geq 0$  if  $\text{sign}(\tilde{y}_{a,n}^i) \geq 0$ , and  $y_{a,n} \leq 0$  if  $\text{sign}(\tilde{y}_{a,n}^i) < 0$ . Let (P') be (P) at  $t_n, p_n, q_n, T_n$  with the additional inequality constraints. Since  $\tilde{y}_{a,n}^i$  is feasible for (P'), and the constraint set in (P') is contained in the constraint set in (P),  $\tilde{y}_{a,n}^i$  is also an optimum for (P'), and the additional inequality constraints are not binding. Observe that the constraint set in (P') is convex. The Kuhn–Tucker conditions for (P') are necessary and sufficient for an optimum, and are represented by  $F_{(t_n,\omega)}^i(\xi_n) = 0$ ; they are satisfied by  $\tilde{y}_n^i$  and by  $y_n^i$ . Since by strict quasi-concavity of utility, the optimum for (P') is unique,  $\tilde{y}_n^i = y_n^i$ , a contradiction with  $\tilde{y}_n^i \neq y_n^i$ .  $\square$

### 5.1. Constrained suboptimality

The vector of coefficients in  $F_{\text{opt}} = 0$  is  $b = (b_1, b_2) = (\alpha, \beta, \gamma, \delta, \varepsilon, \theta, b_2)'$ . Then,  $F_{\text{opt}} = 0$  is the system of equations

$$\begin{aligned}
 \alpha & \quad \alpha^i D^2 u^i - \gamma^{i \setminus} P + \delta \tilde{I} + b_2^i D u^i = 0 & \text{all } i & \quad \text{(i)} \\
 \beta & \quad \gamma^i \begin{pmatrix} -q^i \\ R \end{pmatrix} + (0\varepsilon) = 0 & \text{all } i & \quad \text{(ii)} \\
 \gamma & \quad -\alpha^i (0P') + \beta^i \begin{pmatrix} -q^i \\ R \end{pmatrix}' = 0 & \text{all } i & \quad \text{(iii)} \\
 \delta & \quad \sum_i (\alpha^i A^i + \gamma^{i \setminus} Z^i) = 0, & & \quad \text{(iv)} \\
 \varepsilon & \quad \sum_i (\mu^i \beta_a^i - \gamma^{i,0} y_a^i) = 0 & \text{all } a > 1 & \quad \text{(v)} \\
 \theta & \quad -\sum_i (1/I) \gamma^{i,0} + \theta = 0, & & \quad \text{(vi.a)} \\
 & \quad \sum_i [\beta_a^i \mu^i q_a I(y_{a,+}^i) - \gamma^{i,0} q_a y_{a,+}^i] + \theta q_a \sum_i y_{a,+}^i = 0 & \text{all } a & \quad \text{(vi.b)} \\
 b_2 & \quad -\gamma^{i,0} + \theta = 0 & \text{all } i & \quad \text{(vi.c)} \\
 & \quad b_2^i b_2 - 1 = 0, & & \quad \text{(vii)}
 \end{aligned}$$

where  $\gamma^i = (\gamma^{i,0}, \gamma^{i \setminus})$ , and the following notation has been used:  $\tilde{I} = \text{diag}[0 I_{L-1}, \dots, 0 I_{L-1}]_{S(L-1) \times SL}$  is an  $S(L-1) \times SL$  block-diagonal matrix formed by  $S$  blocks, each corresponding to an  $(L-1) \times L$ -dimensional matrix, with a first column of zeros and the  $L-1$ -dimensional identity matrix;  $P = \text{diag}[p_1, \dots, p_S]_{S \times SL}$ ,  $Z^i = -\text{diag}[z_1^{i \setminus}, \dots, z_S^{i \setminus}]_{S \times S(L-1)}$ ,  $A^i = -\text{diag}[\lambda_1^i(0, I_{L-1})', \dots, \lambda_S^i(0, I_{L-1})']_{SL \times S(L-1)}$  and  $\mu^i Q_i = -\mu^i \text{diag}[q_1 I(y_{1,+}^i), \dots, q_A I(y_{A,+}^i)]_{A \times A}$ ; a backslash,  $\setminus$ , on a variable denotes that the first component has been deleted, and  $I(y_{a,+}^i) = 1$  if  $y_a^i > 0$ , and is zero otherwise.

For  $I$  objectives (the utility vector) and one budget constraint (Eq. (vii)), there are a total of  $(1 + A)$  instruments,  $(T, t)$ ; hence the requirement that  $(1 + A) \geq (1 + I)$ , or  $A \geq I$ ; for fiscal revenue to vanish,  $T = 0$ , the requirement is that  $A \geq 1 + I$ .

Eq. (vii) must be true for otherwise, in a generic set of economies, this would contradict Lemma 1, item 1. The first column displays the matching of variables to equations. Of Eq. (vi), only Eqs. (vi.a) and (vi.b) should be counted when fiscal policy allows for fiscal revenue; only (vi.b) should be counted when  $T = 0$ . The number of equations, at least  $(N + A)$ , is greater than the number of variables  $b$  under Assumption 1 and the remaining variables  $\xi$  are matched by the equations  $F = 0$ , in number  $N$ . Therefore, that system, generically, has no solution as long as  $D_{b,M}F_{\text{opt}}$  has full rank.

The quadratic finite-dimensional parametrization of utility used to compute  $D_M F_{\text{opt}}$  allows one to perturb the Hessian of the utility function without altering its gradient at any equilibrium point. For an economy  $\omega \in \Omega^0$ , equilibria are locally finite, by Lemma 2, so that this construction is well-defined.

To demonstrate the Proposition, we need an additional lemma.

**Lemma 3.** *Constrained suboptimality is dense: for a dense subset of economies,  $\Omega^{**}$  of  $\Omega^0$ ,  $F_{\text{opt}} = 0$  has no solution.*

**Proof.** The proof is split in two cases, according to whether or not utility perturbations are effective—Cases a and b, respectively. Delete Eq. (vi.c) and, possibly, some equations (vi.b), reducing the number of equations to  $I$ .

*Case a* ( $\alpha^i \neq 0$ , for all  $i$ ): One perturbs Eq. (i) using  $M^i$ ; Eq. (ii) using  $\gamma^i \setminus$ —this is possible by no redundancy:  $\dim[R] = A$ ; Eq. (iii) using  $\alpha^{i,s,1}$ , all  $s, i$ , and Eq. (iv) using  $\alpha^{i,s,l}$  some  $i$ , all  $(s, l)$  with  $l \neq 1$ .

From Lemma 1, item 2:

- (i) for each  $a$ , there exists  $i(a)$  with  $y_a^{i(a)} > 0 : \mathcal{I}(a) \equiv \{i \in \mathcal{I} : y_a^i > 0\} \neq \emptyset$ ,
- (ii) for each  $a$  there exists  $i'(a)$  with  $y_a^{i'(a)} < 0 : \mathcal{I}'(a) \equiv \{i \in \mathcal{I} : y_a^i < 0\} \neq \emptyset$ .

It follows that one can use  $\beta_a^i$  with  $i \in \mathcal{I}'(a)$  to perturb Eq. (v); to perturb Eq. (vi.a) one can use  $\theta$ , and choose  $\beta_a^i$  with  $i \in \mathcal{I}(a)$  to perturb the  $a$ th Eq. (vi.b). Eq. (vii) one perturbs by using  $b_2^i$ , for some  $i$ . The rank of  $D_{b,M}F_{\text{opt}}$  is full.<sup>10</sup>

*Case b* ( $\alpha^i = 0$ , some  $i$ ): To fix ideas, and without loss of generality,  $i = 1$ . Then, taking  $l = 1$  and combining Eq. (i),  $b_2^1 D_1 u^1 = \gamma^1 \setminus$ , with the first order conditions for  $i = 1$ ,  $D_1 u^1 = \lambda^1$ , one obtains  $\gamma^1 \setminus = b_2^1 \lambda^1$ . Therefore, (i) holds only if  $\delta = 0$ . Similarly,

<sup>10</sup> When double-sided taxation of asset  $a = 1$  is introduced, the rate of tax on sales  $\bar{t}_1$  as instrument and the equation

$$\sum_i [\beta^{i,1} \mu^i I(y_{1,-}^i) + \gamma^{i,0} y_{1,-}^i] + \theta \sum_i y_{1,-}^i = 0, \quad (\text{vi.}\bar{b})$$

are added to the system  $F_{\text{opt}} = 0$ . One can use  $\beta^{i,1}$  with  $i \in \mathcal{I}(1)$  to perturb Eq. (vi.b), and  $\beta^{i,1}$  with  $i \in \mathcal{I}'(1)$  to perturb Eq. (vi.b), and another equation can be deleted (i.e., another instrument  $t_a$  can be dispensed with). Notice that adding Eq. (vi. $\bar{b}$ ) for  $a > 1$  creates a redundancy with Eq. (v), and the system cannot be perturbed. This is consistent with our discussion of ineffectiveness of double-side taxation.

from (ii) and the first-order conditions,  $\gamma^{1,0} = b_2^1 \mu^1$ , and  $\varepsilon = 0$ ; from no redundancy and (iii),  $\beta^1 = 0$ .

It is immediate that, for  $i > 1$ ,  $Du^i \alpha^i = 0$  (again one uses (iii) and the first-order conditions), while, if  $\alpha^i \neq 0$ ,  $\alpha^i D^2 u^i \alpha^{i'} = 0$ , contradicting differential strict quasi-concavity of  $u^i$ . Thus,  $\alpha^i = 0$  all  $i$ , and  $\gamma^i = b_2^i (\mu^i, \lambda^i)$  (i.e.,  $\gamma^i$  is colinear to  $(\mu^i, \lambda^i)$ ),  $\beta^i = 0$  for all  $i$ . Substitution into the system of equations yields that (iv) becomes  $\sum_i b_2^i \lambda^i Z^i = 0$ , or equivalently  $(b_2^1, \dots, b_2^I)(\dots, \lambda^i \otimes z^i, \dots)' = 0$ . By Lemma 1, item 3, the matrix on the right has full rank  $I$  and therefore (iv) implies  $b_2 = 0$ , a contradiction to (vii), or  $b_2^1 b_2 = 1$ . Hence  $\alpha^i = 0$ , some  $i$ , cannot be (or there is no solution to the system of equations in this case).  $\square$

When fiscal revenue is assumed to vanish,  $T = 0$ , the argument is similar. Delete Eqs. (vi.a) and (vi.c). Some equations (vi.b) can possibly be deleted reducing them to  $I + 1$ . For Case a, Eqs. (i)–(v) are perturbed as when  $T \neq 0$  is allowed; assuming without loss of generality and possibly after relabelling that the Eq. (vi.b) left are those corresponding to  $a \leq I + 1$ , they are perturbed using  $\beta_a^i$ , with  $i \in I(a)$  for each  $a \leq I$ , while the last Eq. (vi.b) is perturbed using  $\theta$ . Eq. (vii) is perturbed using  $b_i^i$  some  $i$ . Case b is dealt with exactly as above.

**Proof of the Proposition.** Lemma 3 established density of the constrained suboptimality property, and all is left to show is that  $\Omega^{**}$  is open in  $\Omega^0$ . But this is a trivial exercise, since properness of the natural projection for the system  $F(\xi, t, \omega) = 0$  of equilibrium equations at  $t = 0$  is already known—[6], Lemma 1. This concludes the proof.  $\square$

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