

**A PARADIGM SHIFT?**  
**THE ELEMENTARY PHILOSOPHY OF OPTIMUM**  
**INCOME DISTRIBUTION AND TAXATION**  
**Serge-Christophe KOLM**

**1. Three basic statements of J. Mirrlees**

The paradigm shift that Erik Schokkaert sees in *Macrojustice* is from the theory of optimum income taxation that dominates the institutions of economics and derives from Jim Mirrlees's article of 1971.<sup>1</sup> What is the difference, however? It could be: (1) deep, in the principles, ethical; or (2) factual, in the constraints, practical; or again (3) in the formulation of the problem.

The analysis can be based on three basic statements of Mirrlees's article, which express respectively his views about the ethical role of individuals' utilities and earning capacities, and about information, for optimum income taxation:

1) *Mirrlees's First Moral Statement:*

"Differences in tastes... raise rather different kinds of problems."

2) *Mirrlees's Second Moral Statement:*

"The great desirability of ... offsetting the unmerited favours that some of us receive from our genes and family advantages."

3) *Mirrlees's Practical Statement:*

"[We] could... introduce a tax schedule that depends upon time worked as well as upon labour-income: with such a schedule, one can obtain the full optimum... We also have other means of estimating a man's skill-level."

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<sup>1</sup> The new paradigm is the object of the contributions to the volume *On Macrojustice*, edited by C. Gamel and M. Lubrano (2008). See also the contributions by Trannoy and Simula and by Fleurbaey and Maniquet in the volume *Normative Economics and Social Ethics*, edited by Fleurbaey, Salles and Weymark (2008).

Labour income divided by time worked gives the wage rate. Mirrlees's Practical Statement found an application on October 1<sup>st</sup> 2007, when the income tax of French wage-earners (9/10 of labour income) became based on their wage rate, in the form of an exemption of overtime labour over a low official duration (35 hours per week, or 218 days per year for executives). It so happens that this tax reform was inspired by this proposal in *Macrojustice* and in a journal article presenting it (read by the closest adviser of a presidential candidate: this became the main policy proposal of this candidate, who was elected). Thus, there has been a few quarters from publication to application, to be compared with the 37 years since the publication of Mirrlees's work, or of Rawls's *A Theory of Justice* – the only more famous work on distributive justice, published simultaneously –, none of which have found otherwise the beginning of an application yet.

A number of economists go on claiming: "Taxing wage rates, you can't, you can't." Perhaps one cannot, but the French tax administration just does it. Seeing this, the same economists propose, as a Pavlovian reflex, that firms will agree with employees to cheat in declaring as overtime some income that is not. The good or bad news is that this does not happen (except, perhaps, for very small firms), simply because falsifying the whole system of pay sheets is too complicated and risky, not possible without the tax administration being aware of it or informed about it. Note that, for the tax based on all earned income, cheating by not declaring overtime work was much easier and very common, amounting to about half overtime work (to this extent, the tax was already based on wage rates) – remember that, in all countries, 30% of income evades the tax based on its total amount.<sup>2</sup> Finally, the same models that begin with asserting that one cannot know wage rates go on with assuming that the tax authority knows the utility functions of the individuals, functions that are even interpersonally comparable and cardinal for describing pleasure!<sup>3</sup>

Note that Mirrlees's two moral statements are similar to Rawls's ethics, and that the bulk of his paper, before he presents his Practical Statement, is about the disincentive effect of a tax based on earned income, which explains the incentive effects of inequality so central in

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<sup>2</sup> See for instance Slemrod (2002) for the USA. For non-wage labour (1/10 of labour earnings) see Kolm (2004, 2008).

<sup>3</sup> Such hedonistic cardinal utility functions can exist only in a much more limited domain than is assumed (cf. Kolm 1996, pp. 364-366).

Rawls' view. This analogy is supposed to be surprising, since Rawls's aim is to criticize, and to provide a substitute to, the ethics that Mirrlees is commonly presumed to model.<sup>4</sup>

## 2. From Mirrlees to ELIE via Rawls and Musgrave

In particular discarding tastes as irrelevant for optimum income distribution is exactly Rawls's opinion. He notes, for instance, the classical example of "expensive taste": you do not have to finance some other person's beverage because she only likes expensive wines. He could have added the case of cheap tastes: you probably do not have to finance another person's beverage because she likes cheap beer and this produces utility at low cost, as demanded by utilitarianism.

Rawls concludes that individual utilities have to be dropped from the optimality principle of "social justice" (i.e. macrojustice, he says "macro" and "not micro"), and that, therefore, the material of this principle consists in individuals' means of free choice and action: basic liberties and "primary goods." There is one economic primary good, income (or wealth). Rawls's *prima facie* ideal is an equality in primary goods. However, an equal redistribution of earned income in a large society with free labour discourages anybody to work for an income. Rawls settles, therefore, for a maximin in primary goods, his "difference principle."

However, Mirrlees's Practical Statement suggests that Rawls is excessively incentive-pessimist. The public transfers do not discourage labour if they are based not on the labour of the individuals but on their wage rate (earned income is labour multiplied by wage rate). Then, everybody can have an equal income, and this income can even be very high, even if wage rates are known or estimated only roughly and with uncertainty. It suffices, indeed, to demand to each individual a tax amounting to what she can earn with a very long and hard

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<sup>4</sup> Two remarks may be useful here. First, Mirrlees's followers often call "Rawlsian" a maximin in utility, but Rawls's (1982) explicitly rejects this interpretation of his "difference principle" as a "complete misunderstanding from a philosophical standpoint" (Rawls had just interestingly discussed the leximin in comparable preference orderings – without specified application – analyzed in Kolm, 1971). Second, in Kolm (1970a, 1970b) I determined the optimum non-linear price schedules of public utilities from the maximization of a social welfare function, function of the actual different utility functions of the individuals, these functions being uncertain for the policy maker. I did not apply this scheme, proposed for the efficient allocation of a specific good, to the formally similar question of optimum income taxation because it seemed to me that the ethical criterion demanded was different.

labour, and to divide the proceeds equally. The problem, of course, is that everybody finds that she works too long and hard and wants to work less. This “slavery of everybody” is not Pareto efficient. Indeed, everybody would join the ensuing tax revolt.

In 1974, however, a cultured economist who left us recently, Richard Musgrave, explained to Rawls the disincentive effect of people substituting untaxed leisure to taxed income and proposed, as a solution, to introduce leisure as another primary good. Rawls (1974) accepted. Therefore, we now have two economic primary goods, income and leisure. The equality can be in each of these two goods. Budget balance requires that this is done in demanding to each individual the proceeds of the same labour (the complement to the equal leisure), with her specific productivity, and in equally sharing the total amount. This is Equal-Labour Income Equalization or ELIE. However, the basic right of free exchange, which enables people to freely buy consumption goods with their income, should also enable them to freely exchange labour for income from this basic equal allocation of income and leisure or labour, that is, to freely work and earn given the financial transfers of the ELIE scheme.<sup>5</sup> This outcome is Pareto efficient if markets (possibly corrected for any “failure”) are, when all the relevant dimensions of labour are considered (duration, intensity, formation, etc.), because the tax-subsidy base is inelastic.<sup>6</sup> However, this extra part of individuals’ incomes is not equalized, but it can a priori be chosen smaller or larger, and hence the equalized income can be chosen larger or smaller, as discussed below.

This constitutes an allocation of people’s productive capacities. Before seeing how it compares with the moral stand of both Mirrlees and Rawls in this respect, let us emphasize the nature of the difference between them concerning the treatment of tastes.

### 3. Taste irrelevance

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<sup>5</sup> Various conceptions of equal liberty, and axioms provided by Maniquet (1998), yield the same result (Kolm, 2004, 2008).

<sup>6</sup> Since the outcome is Pareto efficient, there exist classical social welfare functions increasing functions of the individual utilities that are maximal for this state. However, they are defined by the fact that they yield this result and not by intrinsic properties about comparisons of individual utilities (variations or levels). Pareto efficiency does not imply that the distribution is determined by welfarism. It can also be determined by resourcism (i.e. allocating given resources and evaluating justice directly in this respect) plus efficient free markets for freedom and efficiency. Misunderstanding this point is a frequent mistake.

The difference between Rawls's and Mirrlees's (1971) moral views concerning the relevance of tastes for macrojustice seems to be tiny, but it appears to create the great divide in the theories of optimum distribution and taxation. For Rawls, tastes are irrelevant, whereas, for Mirrlees, "differences in tastes" are irrelevant. Mirrlees interprets his view by assuming that all individuals have the same utility function. This may seem natural, and any such function can do the job. His numerous followers endorse this assumption. It raises problems, however. This function determines the optimum tax scheme (along with the choice of an aggregation principle). Which function should we choose? What is the meaning of this function? Moreover, actual individuals have different tastes and hence this function is the utility function of none of them (or of one only). Therefore, this function does not represent the welfare of the actual individuals, as wanted by the welfarist ethic that this study seems to endorse. As a consequence, the result is not Pareto efficient. Nor does this function represent what the individuals seek to maximize, whereas the assumption that it does constitutes the logical basis of the following working of the theory.

These problems do not appear if the interpretation of the view about tastes is to discard them and utility functions altogether for the choice of the distribution: this is Rawls's way. Mirrlees chose the other way, discarding his initial view, and presented, fifteen years later (1986), the theory with different individual utility functions (yet with a particular formulation of differences in tastes and analogy in utility functions for convenience).<sup>7</sup>

However, this welfarism derives the optimum from comparisons of intensities of preferences. But should you pay a higher income tax than someone else because she enjoys the euros taken away more than you do, or, on the contrary, because the euros left please her

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<sup>7</sup> There are also intermediate solutions, but, for what is left of individuals' tastes in the social criterion, an individual's tastes can influence directly another's optimum income tax. A priori, such criteria have a larger scope of application for microjustice or mesojustice. Associating this moral problem to the classical economic emphasis on ordinal utility on preference ordering leads to keeping these and dropping all reference to intensity in the ethical criterion. (But should a person's income tax depend a priori on others' relative preferences for leisure vs. consumption?). At any rate, this has led to several groups of theories, sometimes applied to income taxation. In one case, the happiness of different individuals can be ranked in a domain ("fundamental preferences"). This is not the case in others. Criteria in the family of "equity-no-envy" are related to a type of equality or comparison of liberty, and have been used for the distribution of earned income (Bös and Tillman, Fleurbaey and Maniquet (1996)). The "theory of equivalence" offers many possibilities but at the cost of raising a new question (chapter 26 of *Macrojustice* shows its general logic and numerous applications, notably for income distribution, but there has been instances of applications for a long time, and it constitutes the basis of three elaborate recent theories of income distribution and taxation by Fleurbaey and Maniquet (2005, 2006) and Luttens and Ooghe (2007)).

less than than they please you – the requirements of the two polar cases of utilitarianism and of maximin in utility, respectively –, if these comparisons make sense? Note that these differences hold even if people had the same utility functions when they have different incomes and labours. Should you pay a higher income tax than someone else because she or you have a more cheerful character? No tax authority even thought of that, indeed nobody even thought of that. This hardly seems serious. In fact, these comparisons provide generally accepted reasons if the enjoyment and pleasure mean lower suffering, or sometimes for distribution among people close to one another (the two basis of altruism, compassion and empathy), for instance for allocations in hospitals or within families; but this is not the case for the income tax in a nation in normal situation (no disaster) where specific aid or insurance deals with cases of particular suffering (issues of microjustice).

#### **4. Productive capacities: Mirrlees and Rawls, and Friedman, versus common opinion**

Not only do Rawls and Mirrlees (1971) almost agree about the allocation of eudemonistic capacities, but they fully agree about the moral rights in productive capacities: no individual is a priori entitled to any value of her productive or earning capacities, due to nature and family influence. This moral stand is the full opposite to that of the full self-ownership of “classical liberalism” (e.g. J. Locke (1789), M. Friedman, R. Nozick (1974), or the “leftist” brand that also wants an equal allocation of non-human natural resources). However, it is commonly acknowledged, in communities of all kinds, that individuals who are well endowed with earning capacities because of genes, family, and society’s demand for skills, provide some help to people who do not have this “brute luck” and are poorly endowed in this respect. Nevertheless and conversely, people usually think, in national communities, that individuals have *some* right to their good fortune in this respect. Relatedly, almost nobody wants an inheritance tax of 100% and the full ban of bequest. In most countries, someone who finds a treasury is entitled to keep some part of it for herself, and this is admitted. No one has proposed – it seems – that handsome people compensate those born with a less attractive face. A main reason for not imposing higher redistributive taxes is the notion that this would be unjustly confiscatory of individuals’ efforts and products of their capacities. Limiting disincentive effects is only added to this reason and is certainly not actually the only one (and it is clearly often a pretext for this policy).

The ELIE distributive scheme found above equalizes the products of labour for the same given labour, and leaves them to the worker for the rest of labour. It corresponds to public opinion: neither full self-ownership of productive capacities, nor the complete collectivization of these capacities favoured by Rawls and Mirrlees. For instance, present-day national redistributions diminish inequality as would a complete equalization of the incomes earned during one to two days a week (from the US to Scandinavian countries). The solution becomes classical liberalism when this “equalization labour” vanishes, and goes towards the Mirrlees-Rawls ethics when it becomes larger.

However, in both Rawls’s view and Mirrlees’s model, individuals with more productive capacities tend to have a higher income. This is not for a reason of partial self-ownership, though, but only for the practical reason of limiting disincentives. Rawls does not explain this disincentive. Mirrlees does, and this result is due to the fact that the tax in his model is based on the full earned income, and therefore does not take advantage of the possibilities pointed out by this author. Finally, neither the level nor the structure of this correlation are those that would result from partial self-ownership with the optimal tax base.

## **5. Summary and the sovereignty of common moral opinion**

For optimum overall income distribution and taxation (in “macrojustice” at national levels), four positions have been considered:

- Mirrlees’s and his numerous following,
- Rawls’s, the most discussed philosopher of our times,
- Classical liberalism advocating full self-ownership, the basic historical social ethics of modernity,
- Common opinion.

A person’s characteristic or capacity can be either assigned to this person, or put in the common pool for distribution directly or by compensations.

For all these ethics, individuals’ tastes, resulting from individuals’ consumptive or eudemonistic capacities, and described by individual’s specific utility functions, should be self-owned. However, Mirrlees (1971) describes this in a particular way, which is not

possible, and as a result he abandons this basic ethical assumption fifteen years later; but his followers keep his initial formulation.

Productive and earning capacities should be fully self-owned for classical liberalism, not at all for Mirrlees and Rawls, and something in between for common opinion.

Mirrlees sees the large possibilities of basing the tax on wage rates (which is now applied), but models a tax based on full earned income. The resulting disincentive effect explains the resulting inequality in a Rawlsian maximin in income. A more efficient tax base makes this result vanish by transforming it into a forced-labor high equal income, which is avoided by introducing leisure (the complement of labour) as a second economic “primary good”, as proposed by Musgrave (1974). The resulting bidimensional equality can coincide with common opinion about the allocation of the value of productive capacities.

Since common opinion includes the opinion of voters, politicians and tax officials, a policy proposal that does not abide by it cannot be implemented, unless the proposer has a private army and is ready to make a putsch and take power for implementing her scheme (this should then be opposed with more tangible weapons in the name of democracy). Hence, we do not even have to appeal to a moral Pareto rule for this application of individuals’ values.

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