Pareto efficient taxation and expenditures: Pre- and re-distribution

Joseph E. Stiglitz
Columbia University, United States

ABSTRACT
This paper shows that there is a presumption that Pareto-efficient taxation entails a positive tax on capital. When tax and expenditure policies can affect the market distribution of income in ways that cannot be directly offset, those effects need to be taken into account, reducing the burden imposed on distortionary redistribution. The paper extends the 1976 Atkinson-Stiglitz results to a dynamic, overlapping generations model, correcting a misreading of the result on the desirability of a zero capital tax. That result required separability of consumption from labor and that the only unobservable differences among individuals were in (fixed) labor productivities. In a general equilibrium model, one needs to take into account the effects of policy changes on binding self-selection constraints. In a simple model with time separability but with no-separability between consumption and leisure, capital taxation depends on the complementarity/substitutability of leisure during work with retirement consumption.

The final section constructs a simple two class model, capitalists who maximize dynastic welfare and workers who save for retirement, whose productivity can be enhanced by (publicly provided) education. It derives a simple expression for the optimal capital tax, which is positive, so long as the social welfare function is sufficiently equititarian and the productivity of educational expenditures is sufficiently high.

1. Introduction

Beginning with my supervision of Tony Atkinson in Cambridge in 1965–1966 while I was a junior research fellow at Gonville and Caius College, Tony and I enjoyed a close collaboration and friendship. One of our early results that received a great deal of attention was that when there was separability in the utility function between consumption and leisure,1 if there existed an optimal income tax, it was optimal to have no commodity taxation (Atkinson and Stiglitz, 1976). An immediate corollary of that result was that, under the stipulated conditions, there should be no tax on interest income—treating consumption at different dates as different commodities. This and similar results from optimal tax theory were seized upon as a basis of policy by those critical of capital taxation.2 Those who did so typically did not understand (or did not want to understand) the limitations of the model. As always, one has to look carefully at the assumptions going into a model to judge whether they provide an appropriate basis for policy.

This paper argues that even within the confines of a model in which differences in labor productivity are the only source of differences in income, the conclusion that there should be no capital taxation is in general wrong, even in the presence of separability, and that in a plausible model where individuals differ as well in the amount of inherited capital, there is a presumption for a possibly quite high tax on income from capital.

This paper is divided into eight parts. The first presents some general reflections on our 1976 paper, our motivations in writing it, what we saw as some of the limitations, and some of the important extensions of the result in the subsequent literature. The second presents the basic model, based on Stiglitz (1982a), including some straightforward but important

---

1 That is, utility $U$ could be written $U = U(C, L)$ where $C$ is the vector of consumption goods and $L$ is labor supply. We do not require additive separability.

2 See, for instance, Markiew et al. (2009) and Atkinson et al. (1999). Using a quite different framework, with individuals with infinite lives, Chamley (1986) has also concluded that the optimal tax rate on capital should be zero in the long run. In Section 3, we consider a social welfare maximization problem extending infinitely far into the future, but using an overlapping generations model, and show that his results obtain if and only if there is separability in the utility function between labor and consumption. Later sections present still more general frameworks, showing that even with separability, results on asymptotic zero capital taxation are not general.
extensions to Pigouvian taxation and the provision of public goods. In both cases, in the case of separability, results obtain that are much more akin to those that arise when government can impose out-of-lump-sum taxes than to those generated when government relies on distortionary Ramsey results. For instance, the sum of the marginal rate of substitution equals the marginal rate of transformation. In the standard Ramsey-Diamond-Mirrlees model with public goods with distortionary taxation, the Samuelson (1954, 1958) condition for optimal supply—that the marginal rate of transformation (MRT) equals the sum of the marginal rates of substitution (MRS)—is altered, and instead MRT < Σ MRS, the marginal rate of transformation is less than the sum of the sum of the marginal rate of substitution; and the level of consumption of public goods is reduced. 3

Section 3 shows that the Samuelsonian condition is restored with optimal non-linear taxation, provided there is separability between labor and consumption goods. 4 Similarly, first-best Pigouvian taxation is optimal with separability either between leisure and consumption, or between the externality on the one hand and consumption and labor on the other, though in the latter case, the Pigouvian tax has to be interpreted as the tax in excess of the optimal commodity tax (the shadow price). 5

To analyze optimal interest taxation in general equilibrium, once has to construct a dynamic general equilibrium model. Section 4 does this, embedding optimal non-linear taxation in a general equilibrium overlapping generations model. While Atkinson and Sandmo (1980) had extended the Atkinson and Stiglitz (1972) model to a similar overlapping generations setting, this paper, a development of Stiglitz (1985a, 1985b), provides the corresponding extension of Atkinson and Stiglitz (1976). The conclusion of Atkinson and Sandmo (1980) was that “it is difficult to make a strong case either for the expenditure tax or for taxing interest income at the same rate as wage income.” By contrast, we find that the basic results of our static model extend to this dynamic framework: (a) With separability, and fixed relative productivities, there should be no taxation of capital income provided that relative wages are either observable or unaffected by taxation or investment (by the consumption/labor supplies which they induce); but (b) in the absence of separability between consumption and leisure, but with inter-temporal separability, whether there should be an interest income tax or subsidy depends on whether first-period consumption is a complement or substitute for leisure. 6 But both separability and the italicized proviso are crucial. While the latter result is reminiscent of that of Corlett and Hague (1953) (in a model with no income taxation and just commodity taxation), we establish it in the presence of an optimal non-linear income tax. (This is important, because in many cases, the presence of one tax—in particular an income tax—markedly changes the taxes that should be imposed elsewhere in the system. For reasons we explain, with unconstrained non-linear taxes, results that hold only with lump-sum taxes are often restored.) As a prelude to the later discussion of public investment in the next section, the section also extends the analysis to show that the standard result on the desirability of productive efficiency holds.

The rest of the paper then provides a critique of the Atkinson and Stiglitz (1976) result. The fifth section focuses on the case where relative wages are not fixed. Even with separability between labor and consumption, (a) it is in general desirable to impose distortionary commodity taxation, even on high-ability individuals; (b) there should be a distortionary income tax, even on high-ability individuals; (c) there should be an interest income tax (or subsidy), even on high-ability individuals; (d) productive efficiency of the economy (where there are no production taxes and the marginal rate of transformation of all goods is the same among all firms) is not desirable; (e) even asymptotically, the rate of return on public capital goods may not equal either the pure rate of time discount or the rate of return on private goods; the long-run return to some kinds of public capital may be lower than the social discount rate.

Recent policy discussions have suggested the desirability of focusing on policies which improve the market distribution of income, leaving less of a burden on redistribution. 8 Standard models which assume that relative wages are fixed cannot address this issue. Our analysis establishes that this intuition is correct. In each of the cases listed above, taxes and expenditures are adjusted at the margin to increase wages of the low skilled relative to the highly skilled. 9 Formally, the improvement in the distribution of income loosens the binding self-selection constraint, allowing for a Pareto improvement.

The optimal tax literature developed in the context of an economy of seemingly self-employed individuals, say making widgets. The only information problem was that of the government, which, seeing the output of widgets (or income from producing widgets) could not tell whether a high output was the result of hard work (long hours) or high ability. But most individuals in a modern economy work for others, and employers have an analogous information problem to that of government: they seek to discriminate among individuals, including by using self-selection mechanisms. But private screening is affected by public tax policy, and optimal taxation needs to take this into account. Section 6 does this, again showing that the Atkinson and Stiglitz (1976) result may not hold, even with separability. Sections 7 and 8 consider optimal taxation with inheritances. Inheritances mean that individuals differ not just in their labor productivity, and optimal taxation ought to take that into account. This is so even in a world with dynastic families optimally sharing their wealth with their children. We show that the appropriate public policy response is taxation of inheritances and the return to capital. But the design of capital taxation is more nuanced than populist calls might suggest: careful attention has to be paid to incidence. A simplistic call for capital taxation with proceeds distributed to workers may actually leave workers worse off. In a simple two class model (workers and capitalists), we derive a simple formula for optimal taxation when the proceeds are invested in human capital or in productive capital investments. The real argument behind the taxation of capital is almost surely related to disparities in inherited capital and in the ability to obtain returns out of capital—and in luck—than with differences in productivities among workers, the subject of our 1976 paper.

Section 9 provides some concluding remarks, including putting the results presented here into some broader perspectives.

2. Reflections on the Atkinson-Stiglitz theorem

Our analysis was motivated in part as a critique of Ramsey taxation (Ramsey, 1927), which seemed to justify not just high taxes on basic necessities like food (which had a low elasticity of demand) but also patterns of pricing by monopolies like AT&T. 10 Ramsey had established that optimal commodity taxes should be inversely related to the

---

6 Similar in spirit to the Corlett and Hague (1953) analysis.

7 One of the important results in Diamond-Mirrlees (1971) was establishing that optimal taxation entailed only consumption taxes, no production taxes, and that the economy was productively efficient. Dasgupta and Stiglitz (1971, 1972) had established that this was not so in the standard Diamond-Mirrlees model, but with restricted taxation (i.e. the government could not impose 100% taxes on pure rents or profits and could impose taxes on all goods and services at differential rates). The result here generalizes that of Naito (1999), whose analysis built on Stiglitz (1982a).

8 See Hacker and Pierson (2011) and Stiglitz et al. (2015).

9 In Stiglitz (1982a), I showed that this was true for taxes on labor income, but did not explore the full range of issues examined here.

10 See, e.g., Baumol and Bradford (1970) and Boiteux (1956). Elsewhere, David Sappington and Stiglitz (1987) explained that while there were some similarities between the two problems, there were also some critical differences.
elasticity of demand and to the elasticity of supply in a model in which everyone was identical; hence there were no distributional concerns—and therefore a lump-sum tax presumably would have been acceptable. Our 1972 paper (Atkinson and Stiglitz, 1972) had shown that in the absence of an income tax, optimal commodity taxes could be described by a simple Ramsey-like formula incorporating distributional effects, which suggested that when distributional concerns were given sufficient weight (for instance, in a society with a high level of both inequality and aversion to inequality) goods like food, with a low price elasticity of demand but a low income elasticity of demand, would not be taxed at a high rate, but rather, that luxuries like perfume might face high rates, even though they have a higher price elasticity than food. We were, however, never satisfied with that result, since it was obvious that we had an income tax, the intent of which was at least partly redistributive.11 The question was, given the existence of such a redistributive income tax, was commodity taxation still desirable? Our 1976 paper yielded stronger results than we had anticipated.

Another of the motivations behind our paper was to demonstrate two general results in the general theory of screening in the context of optimal taxation:

(a) In general, the optimal commodity taxes depended on the set of other taxes that were available.12 The analyses of Ramsey (1927) and Diamond and Mirrlees (1971) clearly depended on the absence of lump-sum taxes. With lump-sum taxes, they would be employed, and the optimal commodity taxes would be zero. Some of the Diamond-Mirrlees results, both on production efficiency (not using producer taxes) and the structure of taxation, were shown to be undermined if there were profits (rents) that could not be taxed directly at 100%13(Dagupta and Stiglitz, 1971, 1972). Our 1976 paper (Atkinson and Stiglitz, 1976) thus explored the interaction between an (optimal) income tax and commodity taxation.

(b) The optimal income tax problem was at its heart a standard problem in asymmetric information with adverse selection. We assumed that individuals differed only in their abilities to perform work, and they all had the same endowment of time and the same utility functions. The Mirrlees optimal tax problem could be thought of as efficiently extracting information about those differences as one raised tax revenues. Even though there was a single “dimension” in which individuals differed (ability), in general, it seemed possible that one could extract information about that difference more efficiently by looking not just at the individual’s labor supply, but also at his consumption patterns. While that conjecture turned out to be true in general, in the special case of separability, Pareto-efficient taxation required only one income tax; there was no benefit to be had by using information about consumption patterns.

We never thought that the separability assumption was plausible. It meant that there were no goods that were complementary to leisure. Clearly, the marginal rate of substitution between skis and, say, food depends on the amount of leisure. Someone with no leisure time simply doesn’t value skiing much. Thus, we never attached much weight to the result that there should be no tax on capital with separability.

But this was not the only, or even the most important, reason that our theorem did not provide the basis of policy for capital taxation. For instance, if individuals differed in other ways—as in fact they do, in their level of inherited capital and their ability to earn returns on capital—it was possible that capital taxation was desirable, even if the separability assumption held. Indeed, it is not hard to generate more general plausible models in which capital taxation is clearly desirable. Showing this is one of the main objectives of this paper.

Thus, in Section 8, we consider a simple model, which perhaps captures key aspects of the sources of inequality that give rise to the desirability of capital taxation far better than generalizations of Atkinson and Stiglitz (1976) discussed earlier in the paper. We assume that there are two classes of individuals: a group of capitalists with large endowments of capital who invest their capital, earn returns, consume, and leave bequests to their children; and workers. The capitalists are sufficiently richer than the workers that the social marginal utility of a dollar to the capitalists is negligible.14 It is obvious that in such a situation the optimal utilitarian15 tax on capitalists is close to a Rawlsian tax, maximizing the revenue that one could obtain from a tax on capital.16 It is clear that the optimal capital tax is significantly greater than zero, and considerable evidence that it is far higher than the current tax on capital, especially the tax on capital gains.17 There are other thought experiments that help us understand the role of capital taxation, and why in general it should be positive. Consider, for instance, a simple model in which all members of a group of individuals have an equal endowment of capital, but some individuals are better at transforming a unit input of capital into output (i.e., they are better at selecting good projects). Assume that the more effort an individual exerts, the higher income; and that there is disutility associated with the exertion of effort.18 Then the optimal tax structure for this group would be parallel to that which we analyzed in our paper: with separability between the utility of goods and effort, then the optimal tax is only a tax on capital income. In the absence of separability, both goods taxes/subsidies and a capital tax are desirable.

With individuals having equal endowments of both capital and

---

11 Our 1972 results would, presumably, still be relevant for developing countries and emerging markets in which income taxation played little role, though in many such economies other considerations (such as migration and rural/urban income differences) play an important role. See Sah and Stiglitz (1992).

12 There are a set of parallel questions in the more general theory of incentives and selection with asymmetric information. For instance, the design of the optimal share-cropping contract is affected by the ability of the landlord to affect credit, the purchase of inputs, and the choice of technology. See Stiglitz and Breverman (1982, 1986a, 1986b.)

13 See Dagupta and Stiglitz (1971, 1972). They thus reconcile the Diamond-Mirrlees results, where supply elasticities play no role, and Ramsey’s analysis, where they are central. Dagupta and Stiglitz also show that other restrictions on taxation fundamentally change optimal tax structures, including the desirability of efficiency.
labor, with full separability (of consumption from effort and labor, and effort and labor from each other), but differing in both the ability to transform labor and capital into "income," if one can separately identify income from labor and from capital,\(^{19}\) optimal taxation involves separate non-linear taxation of capital income and labor income, but no commodity taxation. But even with separability of consumption from effort and labor, but effort and labor not being separable from each other, matters are far more complicated. While there would still be no indirect taxation, in general, taxes would not just be a function of total income.\(^{20}\)

Of course, some individuals have larger endowments of wealth. If such wealth were observable, a utilitarian would want to impose a lump-sum tax on it. If the supply of that wealth were elastic—parents' transfers to children could be affected by the taxes imposed on the transfer or assets or the after-tax income generated

---

2.1. Taxing capital goods and rents

Moreover, the result that one does not want to tax the returns to individuals is often confused with not taxing the returns to particular assets or corporations. If land is inelastically supplied, there is nothing in our analysis that undermines the conventional result that one would want to tax the returns on that asset at a very high rate (100%) (George, 1879).\(^{21}\) The price of the asset would fall, to reflect the tax. Indeed, more recent results—extending the overlapping generations model as expounded in Atkinson and Stiglitz (1980) to include land as an asset—note that since land crowds out capital, a tax on land leads to a higher steady-state level of capital (per capita) and thus to higher levels of income.\(^{22}\) All that the Atkinson-Stiglitz theorem said was that (under the stipulated conditions) one should not tax the returns received by the individual.

2.2. Risk

We ignored uncertainty, as did most of the subsequent literature. This was an important omission. In a world in which there are imperfect risk markets, Domar and Musgrave (1944)\(^{23}\) had already shown that an income tax with appropriate loss offsets could encourage risk taking. With, say, expensing of capital goods, the government entered as a savior of the world, with, say, expensing of capital goods, the government entered as a savior of the world—like a trade-off, with higher tax rates generating more tax revenue but leading to less accumulation and transfer of wealth. Even a Rawlsian would impose a tax that was < 100%. It may be that the actual value of the wealth transfer is not observable, but only the income generated by it. Then there is no presumption that the optimal tax (whatever the social welfare function) on the income generated by that wealth would be taxed at zero. Quite the contrary: there is a presumption that it would be taxed, and possibly at high rates.

But taking account of risk, the tax actually led to more investment.\(^{25}\) A utilitarian government would again want to impose a capital income tax. Indeed, it would be part of Pareto efficient taxation.

2.3. Extending Atkinson-Stiglitz

There were two natural extensions to our analysis: to ask whether there were more general conditions under which commodity taxation was not necessary, and to ask whether the result remained true with an income tax that was not the optimal non-linear tax, e.g. with an (optimal) linear income tax. Deaton (1979, 1981) showed that with an optimal linear income tax, weak separability between goods and leisure, together with linear Engel curves for goods, are sufficient conditions for no indirect taxation. But when these restrictive conditions are not satisfied, in general commodity taxation is required, even with an optimal linear tax (Stiglitz (2009a), a revision and extension of Stiglitz (1976a)).\(^{26}\) Gauthier and Lauroque (2009) provide a more general account of the role of separability in optimal taxation and expenditure.

Sections 3 and 4 explore some of the more general results (some, as we note, already in the literature) in which separability suffices to ensure that commodity taxation is not needed with an optimal income tax. Later sections show that, in particular, an interest income tax is needed.

3. The basic model

We begin our discussion with the standard model, with two types of individuals, differing in ability, but having the same utility function, reviewing the results of Stiglitz (1982a), as a prelude to the subsequent analysis. The \(i\)th individual faces a before-tax wage (output per hour) of \(w_i\) and thus, in the absence of taxation, his budget constraint is simply

\[
\sum_i C_{ij} = w_i L_i
\]

where \(C_{ij}\) is the \(i\)th individual's consumption of good \(j\), all goods are normalized to have a price of unity, \(L_i = \text{number of hours worked by the } i\text{th individual. Neither } w_i \text{ nor } L_i \text{ is observable, but the product of the ith individual, } Y_i = w_i L_i. \text{ The } i\text{th individual receives utility from consuming goods and disutility from work:}

\[
U_i = U(C_i, L_i)
\]

where \(w_i > 0, U > 0, U\) is quasi-concave, and \(C_i\) represents the \(i\)th individual's consumption vector: \(C_i = (C_{i1},...,C_{ip})\). Assume the government imposes a tax, \(T\), as a function of income: \(T_i = T(Y_i)\). The individual's consumption now is his income minus his tax payment, \(\sum_i C_{ij} = Y_i - T(Y_i)\). The individual maximizes his utility subject to his budget constraint:

\[
\max \sum_i U_i(C_i, L_i) \text{ s. t. } \sum_i C_{ij} \leq w_i L_i - T(w_i L_i) \tag{3}
\]

---

\(^{19}\)Note that for small businesses, tax authorities cannot separately identify income from capital and labor. At best they can impute income from consumption.

\(^{20}\)Let \(W = \text{wage income, } C = \text{capital income, and } T = \text{total taxes paid. The optimal tax function } T(W, C) \text{ is not of the form } T = TW + C\).

\(^{21}\)For a more modern rendition, see Arnott and Stiglitz (1979, 1981).

\(^{22}\)This is a result obtained earlier in models with money and capital accumulation (see, e.g. Shell et al. (1969)). For more recent and general results, see Stiglitz (2015, 2017).

\(^{23}\)Their analysis was put into modern expected utility form by Stiglitz (1969b). See also Piketty and Saez (2013) who explain how if there is uninsurable uncertainty about future returns, capital taxation can be viewed as providing insurance against returns. (The older literature emphasized the importance of loss offsets.)

\(^{24}\)A fuller analysis would address why the government is better able to spread risks than the market. Well-developed theories based on information asymmetries have explained imperfections in capital markets and their ability to share risk.

\(^{25}\)Domar and Musgrave (1944) used mean variance analysis, Stiglitz (1969b) showed that this was true more generally, for risk-averse individuals.

\(^{26}\)It is worth noting, though, that the structure of optimal commodity taxation does not look like that described by Ramsey (1927) (where tax rates were simply related to elasticities of demand and supply) or Diamond and Mirilees (1971). At the same time, one can still derive a simple formula, given the optimal commodity taxes, for the optimal linear tax rate, based on an appropriately weighted average of the labor supply elasticities. The optimal tax can be related to a measure of the marginal benefit associated with inequality reduction (this marginal measure differs from the Atkinson measure, which identified how much individuals would be willing to pay to get rid of all inequality. Obviously, at the margin, there is greater social cost of inequality. Stiglitz (1976a) relates this to a societal measure of inequality aversion (or risk aversion), obtaining a remarkably simple approximation for the optimal tax: \(1 - \frac{\gamma}{\beta} = \frac{1}{1 + \frac{\gamma}{\beta}}\) where as usual \(\gamma\) is the (income) tax rate, \(R\) is the measure of risk (inequality) aversion, \(n_0\) is the variance of income inequality, \(g\) is the share of government revenue spent on public goods, and \(g\) is a welfare-weighted average compensated labor supply elasticity. (Earlier, Sheshinski (1972) analyzed the optimal income tax, but did not derive the above simple expression for the optimal tax rate. Subsequently, Piketty and Saez (2012) extended these earlier papers to provide tax formulae based on observable sufficient statistics.)
yielding the first-order condition (assuming differentiability, etc.): 
\[
\frac{dU_i/dL_i}{dU_i/dC_i} = -w_i(1 - T) 
\]
(4)

The left-hand side is the individual's marginal rate of substitution. The right-hand side is the after-tax marginal return to working an extra hour.

The problem of the government concerned with Pareto efficiency is to maximize the utility of, say, individuals of type 2, subject to (a) individuals of type 1 having at least a given level of utility and (b) raising a given amount of revenue. It does this by offering two \((C_i, Y_i)\) packages, one of which will be chosen by the first group, the other of which will be chosen by the second group. \(^{28}\) We write \(U_i(C_i, Y_i) = U_i(C_i, Y_i) \equiv V_i(C_i, Y_i)\). The government thus solves the following program:

\[
\max_{(C_i,2),Y_i} V_2(C_2, Y_2) \quad \text{s.t.} \quad V_1(C_1, Y_1) \geq \frac{\partial V_2}{\partial C_2} (C_2, Y_2) \geq V_2(C_1, Y_1); \quad V_1(C_1, Y_1) \geq V_2(C_2, Y_2) \quad (\text{the self-selection constraints}) \quad \text{and} \quad R = (Y_1 - C_1)N_1 + (Y_2 - C_2)N_2 \geq \bar{R} 
\]
(5)

where \(N_i\) is the number of individuals of type \(i\). If we let \(\mu_i\) be the after-tax marginal rate of substitution and \(\gamma_i\) be the after-tax marginal return to working an extra hour, the Lagrangian can be written as: \(^{29}\)

\[
\Lambda = N_1\mu_1 + N_2\mu_2 - \gamma N_1 \quad \text{with} \quad \gamma \equiv \frac{\partial V_2}{\partial C_2} \quad (\text{for simplicity}) \quad \text{and} \quad \frac{\partial V_2}{\partial C_2} \quad (\text{for simplicity}) \quad \text{where} \quad R = (Y_1 - C_1)N_1 + (Y_2 - C_2)N_2 \geq \bar{R} \quad \text{is the revenue constraint}.
\]

(6)

Then, the first order conditions are:

\[
\frac{d\Lambda}{dC_{ij}} = N_i\mu_i \frac{dV_1}{dC_i} - N_j\lambda_j \frac{dV_2}{dC_j} + N_j\lambda_j \frac{dV_1}{dC_j} - \gamma N_i = 0
\]
(7a)

\[
\frac{d\Lambda}{dY_{ij}} = N_i\mu_i \frac{dV_1}{dY_i} - N_j\lambda_j \frac{dV_2}{dY_j} + N_j\lambda_j \frac{dV_1}{dY_j} - \gamma N_i = 0
\]
(7b)

\[
\frac{d\Lambda}{dX_i} = N_i\mu_i \frac{dV_1}{dX_i} - N_j\lambda_j \frac{dV_2}{dX_j} + N_j\lambda_j \frac{dV_1}{dX_j} + \lambda N_1 = 0
\]
(7c)

\[
\frac{d\Lambda}{dY_2} = N_i\mu_i \frac{dV_1}{dY_i} + N_j\lambda_j \frac{dV_2}{dY_j} - N_j\lambda_j \frac{dV_1}{dY_j} + \gamma N_1 = 0
\]
(7d)

It is easy to show that at most one of the two self-selection constraints will be binding. We focus on the case where \(\lambda_1 = 0\) and \(\lambda_2 > 0\): only the second self-selection constraint is binding. Note that the standard case of \(\text{optimal utilitarian tax policy}\), where the government maximizes \(\sum_i V_i^*\) implies that \(\mu = 1\). \(^{30}\)

From Eqs. (7a)–(7d) we obtain:

\[
\frac{dV_2/dC_2}{dV_2/dY_2} = 1
\]
(8a)

\[
\frac{dV_2/dC_{ij}}{dV_2/dC_{ij}} = \frac{\gamma + \lambda_i dV_2/dC_{ij}}{\gamma + \lambda_i dV_2/dC_{ij}}
\]
(8b)

\[
\frac{dV_2/dC_{ij}}{dV_2/dC_{ij}} = \frac{\gamma + \lambda_i dV_2/dC_{ij}}{\gamma + \lambda_i dV_2/dC_{ij}}
\]
(9a)

\[
\frac{dV_2/dC_{ij}}{dV_2/dC_{ij}} = \frac{\gamma + \lambda_i dV_2/dC_{ij}}{\gamma + \lambda_i dV_2/dC_{ij}}
\]
(9b)

We have formulated the problem as directly a control problem on \((C_i, L_i)\), but the solution can be implemented by a simple non-linear tax system, i.e. individual 1 is confronted with indirect taxes giving relative prices corresponding to the LHS of Eq. (9a), a marginal income tax rate given by the LHS of Eq. (9b), and a non-linear income tax, giving the equivalent of a lump-sum tax combined with a linear income tax with marginal rate given by Eq. (9b) yielding utility level for individual 1 of \(V^*(V^*)\). Similarly, the high-ability individual has no marginal income tax or consumption tax, but faces a non-linear income tax giving the equivalent of a lump-sum tax yielding \(V^k\), where \((V^k, V^*)\) are the utility levels given by the solution to the optimal tax problem. Thus, we have the familiar result:

**Proposition 1a.** There should be no distortionary taxation on the individual with the highest utility while the labor supply of the less-able individual is distorted.

This result goes beyond that of Mirrlees (1971) which said that the top marginal income tax rate should be zero. \(^{31}\) Eq. (8a) says that there should be no commodity taxation on the high ability as well. \(^{32}\)

Fig. 1 provides a simple diagrammatic illustration with a single consumption good. In Fig. 1A, the two types are quite different, so different that the high ability does not want to mimic the low ability if we impose non-distortionary taxation. Point \(E^*\) is the point on the low-ability indifference curve \(U_1\) which maximizes revenues, i.e. in which there is no distortionary taxation, so the slope of the indifference curve is unity. (Government revenue is just the difference between \(Y_1\) and \(C_1\). Knowing \(R_1\), the revenue raised from the low-ability individuals (or, as illustrated in this figure, the subsidy provided to them) and the required government revenue, we know the revenue that has to be raised from the high-ability individuals. \(V^k\) is the highest level of utility of the high ability consistent with raising that revenue, \(E^k\) the maximum revenue-raising point on the corresponding indifference curve. It is clear that the high-ability individual does not want to imitate the low-ability individual. But Fig. 1B shows the more typical case, where he would. The maximal revenue consistent with \(U^k\) being equal to \(\bar{V}\) requires a sufficiently high tax on the high ability that he would mimic the low risk. In the figure, we depict the tax on the high ability that would make him indifferent between mimicking, and we assume it does not suffice. For the self-selection constraint to be satisfied, \(E_i^*\) now must entail lower levels of income and consumption (labor supply) and lower tax revenues from the low ability, and hence a higher level of revenues raised from the high ability. At the optimum, the high ability is just indifferent to imitating the low.

The interpretation of Eq. (9a) is, however, somewhat more subtle. For simplicity, denote

\(\bar{V}\) becoming, in effect, an endogeneous variable.

\(^{27}\) The notion of Pareto-efficient tax structure is a slight generalization of the "optimum" tax analysis of Mirrlees and Diamond and Mirrlees. Pareto-efficient tax structures are those (given the admissible set of taxes and the required public revenue) which are such that no one can be better off without making someone worse off. We identify properties of Pareto-efficient tax structures that hold regardless of the social welfare function. See, e.g. Stiglitz (1982a, 1987) and Brito et al. (1990).

\(^{28}\) Obviously, the government can offer a continuum of \((C, Y)\) packages (i.e., an entire tax function), but at most two will be chosen, and therefore we need be concerned with at most two.

\(^{29}\) Recall that \(C_i\) (bold) represents the vector of consumption by the ith individual, \(C_i\) represents the total value of consumption of the ith individual, valued at producer prices (unity.)

\(^{30}\) With \(\bar{V}\) becoming, in effect, an endogeneous variable.

\(^{31}\) See also Sadka (1976), Seade (1977), and (for an overview) Tuomala (1990). Saez (2001), following Mirrlees (1971), shows that these results are not robust to a distribution with no top income (e.g a Pareto tail) and derives simple asymptotic results. See also Diamond (1998). But the Pareto tail is used as a good approximation of a description of the probability distribution of the tail. There is, in practice, an identifiable person with the top income. Thus, we would have no problem in the United States identifying who that person is (assuming honest reporting of income), and setting a top marginal tax rate for that individual at zero. That income will be going up over time—as the incomes of all individuals will be changing, implying a change in the optimal structure. But there is no reason to impose a distortionary tax on that individual simply because we could conceive of there being a higher-income individual.

\(^{32}\) This result does not depend on separability of the utility function.
\( a^*_j = MRS_{jk}(C_j, Y_j) \)

i.e., \( j \)'s marginal rate of substitution between \( j \) and \( k \) at the bundle \((C_j, Y_j)\). Individual 1 and 2 differ only in their abilities. Let \( \gamma_b \equiv \frac{\partial}{\partial C_{ij}} b_h = b \). Then, Eq. (9a) can be rewritten as: \( a^*_j = \frac{\gamma_b}{\gamma_b + b} \) and it immediately follows that \( a^*_j = a^*_k = \frac{(1 - \alpha^*_k)}{(1 + \gamma)} \). The denominator of the preceding expression is positive. In the case of separability, the marginal rate of substitution between \( j \) and \( k \) is unaffected by the amount of leisure, so \( a^*_j = a^*_k \), which in turn implies \( a^*_j = a^*_k = 1 \), thus establishing:

**Proposition 1b.** There should be no commodity taxation on either high- or low-ability individuals if leisure and consumption are separable.

Whether commodity \( j \) should be taxed (relative to \( k \)) depends simply on the impact of an increase in leisure on the marginal rate of substitution between commodities \( j \) and \( k \). This property that nothing has to do with Ramsey's focus on deadweight loss, but tax structure is related to the deadweight loss associated with the self-selection constraints that come into play if government needs to raise a given revenue and cares about distribution, but is in an environment in which governments cannot tell who is able and who is not. The self-selection constraints that the government employs to achieve fair taxation create first-order distortions. Commodity taxation can, under certain conditions, reduce the force of those distortions.

The intuition is simple: consider a good that is complementary with leisure. If a high-ability individual tries to mimic a low-level individual, he has more leisure, and his demand for that good will accordingly be higher. Hence, taxing that good and using the proceeds to subsidize a good that is a substitute for leisure will make mimicking the low-ability individual less attractive. With a weakened self-selection constraint, the low-ability individual can work more, moving along his indifference curve—and in doing so generate more revenue for the government. Thus, the utility of both individuals can be increased and still satisfy the revenue constraint: indirect taxation is a Pareto improvement. However, if there is separability, then the levels of consumption of the goods are identical when the high ability imitates the low ability, and hence there is no way to use differential taxation to weaken the self-selection constraint.

There is another intuition that may prove helpful. In the case of separability, where \( V = V(\phi(C_i), L_i) \), one can think of \( \phi \) itself as an aggregate consumption good. Individuals take their wage income and buy \( \phi \). We know from Diamond and Mirrlees (1971) that we want production efficiency.\(^{35}\) Productive efficiency in producing \( \phi \) implies no commodity taxation.

### 3.1. Taxation of interest income

An immediate implication of these results is that in the case where consumption in different periods is separable from leisure — typical of many of the simplified models explored in the macroeconomic literature — there should be no interest income taxation.

There is no strong presumption whether in the absence of separability there should be an interest income tax or subsidy. Consider, for instance, the standard life cycle formulation (dropping for the moment subscripts describing the individual, and simplifying by assuming consumption is uni-dimensional).

\[
U^t = u_t(C_t, L_t) + u_{t+1}(C_{t+1}),
\]

where there is time separability, but not separability between consumption and leisure and where \( C_t \) is consumption of the individual when he is young and working and \( C_{t+1} \) is consumption in retirement. Then the marginal rate of substitution between second period consumption and first period consumption is \( \frac{\partial u}{\partial C_t} \). It follows that:

**Proposition 2.** With the time separable utility function (Eq. (10)), if an increase in leisure increases the marginal utility of consumption in the first period, i.e. if leisure and consumption are complements, then there should be an interest income tax. Conversely, if an increase in leisure decreases the marginal utility of consumption in the first period, i.e. if they are substitutes, then there should be an interest income subsidy. Either is plausible and individuals may differ.

The intuition provided earlier helps understand what is going on. We want to make it more expensive (less advantageous) for the high-ability person to pretend to be the low-ability person. In doing so, he increases his leisure. Skiing is a complement to leisure, so we want to tax skis; household help is a substitute for leisure, so we want to subsidize domestic help. High income people who work long hours with high savings rates, in anticipation of an enjoyable retirement, are evidencing complementarity between leisure and consumption; a subsidy on the return to savings increases the cost of cutting back on savings (as would happen if the high ability pretends to be a low ability).\(^{34}\)

#### 3.2. Atmospheric externalities

Still another generalization that is easy to incorporate into the model is atmospheric externalities,\(^{35}\) i.e. there is some variable \( B \) (for Bad) which is a function of the aggregate consumption variables. Both production and utility can be adversely affected by \( B \):

\[
V^i = V^i(C_i, L_i, B) \text{ where } V^i_B < 0
\]

and \( Q = F(K, L, B) \), where \( F_B < 0 \). It is useful if we reformulate our self-selection constraints, to represent the self-selection constraint as:

\[
V^2(C_i, L_i, B) \geq V^2(C_i, \tilde{L}_2, B)
\]

where \( \tilde{L}_2 \) is the labor a type 2 individual would have to put forth to imitate the income of a type 1 individual, i.e.,

\[
\tilde{L}_2 = \frac{wL_i}{w^2} = vL_i
\]

\(^{33}\) Later, we will qualify this result. See also Dasgupta and Stiglitz (1971, 1972).

\(^{34}\) It should be clear from the structure of the analysis that if individuals supplied labor at different dates, so \( u^t = U(C_i, L_i, ... C_t, L_t, ... L_{t-1}) \) but the utility function remained separable between consumption and leisure (work) \( u^t = u^t(\phi(C_i, C_{t+1}, ... C_t) + v^t(\lambda, L_{t+1}, ... L_1) \) it would remain true that no interest income tax should be imposed, though, in general, the tax an individual would pay on wage income in one year would depend in wage income earned in other years.

\(^{35}\) An atmospheric externality is an externality the value of which depends on aggregate consumption. In the notation below \( C \) is the vector aggregate consumption of all commodities.
where \( \psi \) is the ratio of the productivity of the low ability individual to the high ability individual, assumed now fixed. Then we have:

\[
\frac{d\Lambda}{dC_i} = \ldots + \left( \sum \mu_i \frac{dV_i}{dB} + \frac{dF}{dB} + \lambda_i (V_{i2} - \bar{V}_{i2}) \right) \frac{dB}{dC_i}
\]

(13)

where \( \ldots \) represents the derivative of the Lagrangian in the absence of externalities. There are three additional terms: (A) represents the direct consumption externality; (B) represents the production externality; and (C) represents the impact on the self-selection constraint.

In the case of a separable utility function, which can take on the form of:

\[
V^c = v(C, L) - Z(B),
\]

(14a)

the third term disappears, and there are only the direct externality effects of the kind that have been analyzed by Pigou (1920) and Sandmo (1975). The results for Eq. (14a) are obvious: because of the structure of preferences, the level of \( B \) can't affect any choices made by anyone, and therefore can't affect the structure of taxation. However, in the case of Eq. (14a), the very presence of self-selection constraints changes the social marginal valuation of consumption (in effect, the shadow price on different consumption goods). The additional terms A and B represent alterations to these shadow prices, as opposed to the market prices. Moreover, the presence of atmospheric externalities (under Eq. (14b)) does not affect choices, and so we can ignore the indirect income effects arising from \( B \), though obviously, not those arising from the taxation of labor or goods.

Alternatively, separability could take the form of

\[
V^c = v(C, B) - Z(L),
\]

(14b)

The results for Eq. (14b) follow directly from our earlier analysis. A change in \( B \) simply shifts the common utility function for goods.

**Proposition 3A.** If labor is separable from consumption then a straightforward Pigouvian tax/subsidy is optimal. If the externality is separable from consumption and labor (but consumption and labor are not necessarily separable), then a first-best Pigouvian tax/subsidy—over and above the shadow prices (prices with optimal commodity taxes/subsidies)—is desirable.

In other words, in these cases, the complicated formulae underlying the literature on corrective taxation that focus on interactions between the corrective taxes and other taxes are not relevant. What has been called “first best Pigouvian taxation”—where the tax is imposed to reflect marginal harm, is desirable. (Kaplow, 2006a). On the other hand, if the utility functions are not separable, simple Pigouvian corrective taxation is not appropriate, but the deviations from simple Pigouvian corrective taxation do not depend (just) on indirect revenue effects, but (also) on the impacts on self-selection constraints.

**Proposition 3B.** With non-separable utility functions, Pigouvian corrective taxation has to be modified to take account not just of the second-order effects on government revenue but of the first-order effects on the self-selection restraints.\(^{38}\)

36. Obviously, it can also be fully separable, and the analysis does not require additive separability.

37. Sandmo (1975) provided the classic modern discussion of optimal taxation in the presence of externalities, but he conducted the analysis in the standard Ramsey-Diamond-Mirrlees framework with no income tax. The contribution here is simply to add the self-selection constraint. Kaplow (2006a) analyzes the problem posed here, using a very clever approach which he applies to the analysis of public goods and to the general problem of indirect taxation discussed above (Kaplow, 1996, 2006b), which highlights the role of separability. He shows that if there were a differential tax on commodities, there would always exist a perturbation in the tax function that would lead to a Pareto improvement. In some respects, his result is stronger than that here, for he shows that differential commodity taxation is not desirable regardless of whether the imposed income tax is optimal or not, so long as it is possible to make any perturbation in the income tax function.

In particular, if those with more leisure are more sensitive to the quality of the environment than those with less leisure, then the (Pareto) optimal level of consumption of negative-externality-generating consumption is higher, because by increasing the level of the atmospheric externality, it enhances the ease of separation.

3.3. Public goods

The previous subsections’ analysis can be directly applied to public goods. A public good, like a public bad, enters everyone’s utility, and since we are assuming all individuals have the same preferences: \( V^c = V^c(G, L, G) \). Assume the production function is of the form \( \Sigma C_i = G = \Sigma w_i J_i \), and let \( \gamma \) now represent the overall resource constraint. Then optimal \( G \) entailed:

\[
\sum_i \left( \mu_i N V_{i2} + \lambda_i (V_{i2} - \bar{V}_{i2}) \right) = \gamma
\]

In the utilitarian formulation, \( \mu^i = 1 \), for all \( i \). With separability (of either the form of Eq. (14a) or Eq. (14b), with \( G \) replacing \( B \)), the sum of the marginal utilities of the public good equals the marginal social cost, \( \gamma \). But \( \gamma \) is normally itself influenced by the self-selection constraint. Consider first the case where neither self-selection constraint is binding (Fig. 1A). Then we have \( \lambda_2 = 0 \), which implies that \( \left( \mu_i / \gamma \right) \frac{dV_i}{dC_i} = 1 \) or

\[
\sum_i \left( \frac{dV_i}{dC_i} \right) = 1\] even with distortional taxation, the Samuelson rule holds. In a sense, the result should not be too surprising. With unconstrained optimal non-linear taxation, there is no distortion associated with the top person, and with separability, the self-selection constraint is effectively not binding. Then there is, in effect, no marginal distortion arising from raising additional revenue—even though taxes are, as a whole, distortional. In the absence of separability, the sum of the marginal rates of substitution may be either greater or less than the marginal rate of transformation. It depends on the effect of \( G \) and of the numeraire (the “private good”) on the self-selection constraint. In the case of separability between \( G \) and (goods and labor), \( G \) doesn’t affect the self-selection constraint, but the private consumption good may either tighten the constraint (leading to lower consumption and a higher valuation of the private good for the low ability individual) or loosen it.\(^{38}\) Note that since different public goods may enter into preferences differently, for some goods the sum of the MRS’s may be less than the MRT, for others greater.

4. Extension to many periods with overlapping generations

If we are to meaningfully analyze the desirability of an interest income tax, we have to do so within a model in which the return to capital is determined endogenously. We do so in the standard overlapping generations model. Each generation is assumed to live for two periods, working in the first, and consuming in both periods. Within each

(footnote continued)

The last observation, though, is critical. For instance, Stiglitz (1976a, 2009a) considers differential commodity taxation in the presence of an optimal linear income tax. There are both administrative, economic, and political reasons for a linear, or a piece-wise linear, tax system, implying that arbitrary deviations from (quasi-) linearity may not be feasible or will entail costs not incorporated into the analysis. Kaplow’s analysis focuses on the case of separability between consumption and labor Eq. (14b).

38. Boadway and Keen (1993) provide a fuller analysis of the optimal provision of public goods. Note that the question of whether the sum of the MRS’s is greater or less than the marginal rate of transformation does not translate directly into whether the supply of public goods with distortional taxation is less than or greater with lump-sum taxation, since this is a matter of general equilibrium, in which all the variables are endogenous. See Atkinson and Stern (1974) for a discussion of the matter in the context of the Ramsey-Diamond-Mirrlees model.
generation, there are two types (the able and the less able), but the government does not know who is who. The utility function of the ith type in the ith generation is denoted by \( V_i^t(C_{it}, L_{it}, t_i) \) where \( C_{it} \) is the ith type's consumption vector of the first (working) period, and \( L_{it} \) is the ith type's consumption during the second (retirement) period of this life. As before, the self-selection constraint can be written as:

\[
V_i^t(C_{it}, L_{it}, t_i) \geq V_i^t(C_{it}, C_{it+1}, t_{i+1}).
\]

Output at the time \( t \) is given by a neoclassical production function of the form \( Q = f(K_t, E_t) \), where \( E_t = v N_t L_{it} + N_t J_t \) is the effective labor supply. If there are no constraints on the government's ability to use social security or debt policy to control the capital stock (see Atkinson and Stiglitz, 1980) then the only macro-constraints that need to be taken into account are the period resource constraints, which we write as

\[
Q_t = K_{it+1} + N_t C_{it} + \mu_i + N_t C_{it+2} + G = F_t (K_t, E_t)
\]

where we have assumed that capital wears out each period. Forming the Lagrangian as before39, but with separate constraints for each period (including for the self-selection constraint and the resource constraint Eq. (15) that replaces the budget constraint), and differentiating with respect to the consumption vector, we obtain

\[
\frac{dV_i^t}{dC_{it}} = \gamma_t
\]

\[
\frac{dV_i^t}{dC_{it+1}} = \frac{N_t \gamma_t + \lambda_t dV_i^t/dC_{it+1}}{N_t \gamma_t + \lambda_t dV_i^t/dC_{it+2}}
\]

\[
\frac{dV_i^t}{dL_{it}} = 1
\]

\[
\frac{dV_i^t}{dL_{it+1}} = \frac{N_t \gamma_t + \lambda_t dV_i^t/dC_{it+1}}{N_t \gamma_t + \lambda_t dV_i^t/dC_{it+2}}
\]

where \( \gamma_t \) is the Lagrange multiplier associated with the \( t \)th period government budget constraint Eq. (15). By differentiating the Lagrangian with respect to \( K_t \), we obtain

\[
\mu_i, F_t (K_{it+1}, E_{it+1}) = \gamma_t
\]

Thus \( \frac{\mu_i}{\gamma_t} = F_t (K_{it+1}, E_{it+1}) \) is the (gross) marginal return on capital.

**Proposition 4a.** In the overlapping generations model with two types of labor at every \( t \), there should be no interest income tax on the savings of the high ability individuals, a zero marginal income tax, and no commodity taxation; while, as in the static model, low ability individuals face distortionary taxation on labor, commodities, and savings. With separability between leisure and consumption, there should be no commodity or interest taxation on the low ability. Without separability, there should be commodity and interest income taxes (or subsidies).

Rather than focusing on Pareto optimality, we could have maximized intertemporal social welfare, say using a utilitarian social welfare function: max \( \frac{1}{2} \delta (N_t V_i^t + N_t V_j^t) \), where the welfare of future generations are discounted at the rate \( \delta \) (the pure rate of social time preference). In steady state \( \frac{\partial}{\partial t} = 0 \) is the modified golden rule, where the rate of return equals the pure rate of social time preference. With separability, both individuals' MRS is equal to that rate, but in general, the low ability individual's may not be.

39 Where \( \mu_i \) is the Lagrange multiplier associated with the constraint \( V_i^t \geq \gamma_t, \mu_i, \phi = 1 \).

**Proposition 4b.** In the steady state of the overlapping generations utilitarian optimal tax problem, with (and, in general, only with) separability, the rate of interest (both the producer and consumer rate of interest, for both the low and high ability individuals) equals the pure rate of social time preference.

### 4.1. Public and private investment

It is easy to extend the analysis to incorporate public as well as private investment. Let \( K_p \) represent public investment, \( K_p \) private investment, and let the production function now be \( Q = C + K_p + K_f = F(K_p, K_p, E) \), where \( C \) is aggregate consumption. It immediately follows that \( F_K = F_{K_f} \).

**Proposition 4c.** Pareto efficient taxation-cum-expenditures requires that the return on public capital equal the return on private capital, which asymptotically, is just equal to the pure rate of time preference.

These results are clearly parallel to those of Diamond and Mirrlees (1971), who argued for production efficiency.

### 5. Distributive effects of tax and expenditure policy

The analysis so far has established that the results derived earlier, both with respect to taxation and public production, in simple partial equilibrium models hold more generally in a dynamic, overlapping generations, general equilibrium model; it has shown that Ramsey's analysis provides little guidance either for the design of efficient or redistributive commodity taxation; it has confirmed that the Diamond-Mirrlees result on the desirability of efficiency holds in this setting; and it has shown that the analysis can be extended to incorporate externalities, with modifications from Pigouian corrective taxation based not on Ramsey-like indirect impacts on tax revenues but on impacts on self-selection constraints.

Unfortunately, several of these results are not robust, if government tax or expenditure policies can affect the distribution of income in ways which cannot be directly offset by tax policy: in our model, relative wages, \( v \). If the two types of labor are not perfect substitutes, then in general \( v \) will be affected by levels of consumption of each of the goods and labor supply of the two types of labor. Optimal tax theory is predicated on the inability to observe either output per hour or the number of hours worked, because if one could do so, one could infer ability, and thus impose lump sum taxation.40 Thus, dropping the time subscripts (focusing on the basic model of Section 3), the first order condition for \( C_{ij} \) is:

\[
\frac{dA}{dC_{ij}} |_{N_i (\cdot)} = \frac{\frac{\partial A}{\partial C_{ij}}}{\frac{\partial A}{\partial L_j}} + \lambda_i \left( \frac{\frac{\partial V_j}{\partial C_{ij}}}{\frac{\partial V_j}{\partial L_j}} \right) \left( \frac{\frac{\partial V_i}{\partial E_i}}{\frac{\partial V_i}{\partial C_{ij}}} \right) - \gamma = 0.
\]

Any tax or expenditure which changes \( v \) affects the self-selection constraint, and hence all of the previous conditions are altered. Note that \( \frac{\partial V_j}{\partial L_j} < 0 \). Proposition 5 follows directly.

**Proposition 5.** If relative wages are affected by consumption levels of different commodities by the highly skilled, then there should be indirect taxation on the highly skilled; if relative wages are affected by levels of different commodities by the low-skilled, then there should be indirect taxation on the low-skilled even with separability between consumption and labor; if labor supply by highly skilled individuals affects relative wages, then high-wage individuals should face a marginal income tax (or subsidy). Any change in \( C_{ij} \) or \( L_i \) that improves the distribution of income (i.e. increases the low-ability individual's wage relative to that of the high ability) improves

40 Of course, that would not be the case if output per hour was itself a function of some unobservable variable besides ability, e.g. effort or education. We cannot pursue these ideas here.
welfare, and hence taxes should be designed to reflect this.

This means that the consumption of unskilled labor-intensive goods should be encouraged (their consumption prices reduced). In particular, we know from Samuelson’s (1948) analysis of the two-factor two-good international trade model, where output in each sector is a function of skilled and unskilled labor, that a movement along the production possibilities schedule (with fixed inputs of skilled and unskilled labor) towards the production of the unskilled-intensive good leads to an increase in relative wages of unskilled workers. The implications for labor supply (taxation of labor income) are, in this model where there are no other factors of production, disquieting (Stiglitz, 1982b). Since in such a model, the two types of labor have to be complements ($$F_{12} > 0$$), an increase in skilled labor has to increase the relative wage of the unskilled. This means that we have to encourage more labor supply by the skilled (from what it would be in the absence of an effect on relative wages), i.e. the top marginal tax rate should be negative. This result, however, is not general: if we have a three factor production function (output is a function of the two types of labor and land), then skilled and unskilled labor can be substitutes, in which case the top marginal tax rate should be positive, in contrast to the standard result in optimal (income) taxation, that it should be zero. (See Mirrlees (1971) and Saez (2001).)

Similarly, the optimal Pigouvian tax formulae for correction of externals and the formulae for the optimal supply of public goods have to be corrected for induced wage effects: the externality or public good may have an effect on relative wages, and thus on the self-selection constraints. The required modifications in the optimal formulae are straightforward. Note, in particular, that the simplifying results that hold with separability (that the effects on self-selection constraints can be ignored) no longer hold.

5.1. Production efficiency

Soon after Diamond and Mirrlees established their efficiency result—that optimal commodity taxation should ensure production efficiency—Dasgupta and Stiglitz (1971, 1972) showed that this would not be so in general, in particular if there were restricted taxation, for instance if there were rents (pure profits) that could not be taxed at 100%, or if there were some factors or goods that had to be taxed at the same rate. A direct implication of the Diamond Mirrlees efficiency result was that it was not optimal to impose tariffs. Correspondingly, an implication of the Dasgupta-Stiglitz results was that it was often desirable to impose tariffs (Dasgupta and Stiglitz, 1975). Not surprisingly, the same result holds in the current context. Here, the critical issue is distribution. In the previous paragraphs, we assumed that government could not directly control v by the imposition of (optimal) indirect taxes on the labor supply of skilled and unskilled labor—an assumption we noted that was fully consistent with the standard optimal tax model, where only the product of hours worked and wages per hour is observable. But even if the wages received by or paid to any individual are not observable to the government, the government can affect the relative wage paid to unskilled workers.

Thus, if the government imposes a tariff on the relative price of the unskilled labor-intensive good, it increases v, relaxing the self-selection constraint.44 The benefit of relaxing that constraint has to be compared with the cost of the resulting inefficiency, which is captured by the impact on the resource constraint of an increase in p, the domestic producer price, over the international price, which we assume is unity. With international trade,45 the resource constraint can be written

$$\lambda_t \left\{ -\frac{\partial V}{\partial L} + \lambda_L \left( \frac{\partial V}{\partial a} \right) \right\} = \frac{2}{\gamma} \delta_1 \left( \delta + \gamma L \right) \left( 1 - \delta \right) \frac{\partial V}{\partial a} = \delta \dfrac{\partial V}{\partial a}$$

where $$\delta = \frac{\partial V}{\partial a}$$ and $$\delta_1 = \frac{\partial V}{\partial a}$$ (where MRT stands for the marginal rate of transformation). The first term is the benefit from the relaxation of the self-selection constraint; the second term the resource cost of the tariff.

There are similarly many ways within the closed economy to show the (potential) desirability of distortionary production taxation in a world where we cannot separately tax skilled and unskilled labor. For instance, assume we have two sectors in the economy, each producing all the goods (a dual economy), one of which is more unskilled labor intensive. For each we have a transformation function

$$J_1, J_2, G_1, G_2, L_1, L_2 = 0,$$

where the jth element of $$\mathbf{C}$$ is output of good j in the kth sector, so $$C_{1j} + C_{2j} = \sum_{k=1}^{M} \frac{p_k}{\beta_k}$$ total production of commodity j in the kth sector, which in equilibrium must be equal to the total consumption of that product. We can differently tax the consumption of good j depending on the producer. Doing so is equivalent to imposing a producer tax. In our direct control problem, where we specify the level of consumption of each good by each type of individual, we now specify the level of consumption of each good by sector. Since what we are concerned about is relative wages, what matters is aggregate consumption across the two individuals of output from the two sectors, which can variously be thought of as the advanced or large corporate sector, and the informal or small and medium-sized enterprise (SME) sector. In equilibrium, there are additional constraints imposed by the fact that while the government cannot observe wages, individuals do, and they allocate themselves so that the wages in the two sectors for each type of labor are the same. (A more realistic model would incorporate labor market frictions.) The Lagrangian now needs to be rewritten, with additional terms representing resource constraints

$$\gamma = \frac{\partial V}{\partial a} = \frac{\partial V}{\partial a},$$

and the free labor mobility constraint, ensuring equal marginal products of labor in the two sectors relative to say, the numeraire, 0:

$$\gamma = \frac{\partial V}{\partial a} - \frac{\partial V}{\partial a} = \frac{\partial V}{\partial a} - \frac{\partial V}{\partial a},$$

where the superscript a stands for the advanced sector, and u for the less advanced sector, and $$\gamma = \frac{\partial V}{\partial a}$$ is the wage in the kth sector of type i labor in terms of the numeraire, denoted “a”.

The optimization equation (the derivative of the Lagrangian) for $$C_{1k}$$ now contains an extra set of terms, one focusing on the effect of the consumption of the jth good from the kth production sector on the self-selection constraint, another simplifying the resource constraint itself, the third embedding the free movement of labor across sectors. Production of a good in one production process may affect the self-selection constraint differently from that of the other.

Specifying p determines where on the production possibilities curve the economy operates. In Fig. 2, AB measures the inefficiency at the equilibrium of aggregate consumption of one good in terms of the other good: how much more aggregate consumption could have been had a tariff not been imposed. We impose a tariff on the unskilled labor intensive good, which increases unskilled relative wages. The optimal tariff satisfies the first order condition46:

$$\lambda_t \left\{ -\frac{\partial V}{\partial L} \right\} = \frac{2}{\gamma} \delta_1 \left( \delta + \gamma L \right) \left( 1 - \delta \right) \frac{\partial V}{\partial a} = \delta \dfrac{\partial V}{\partial a}$$

where $$p = \frac{\partial V}{\partial a}$$ and $$\delta_1 = \frac{\partial V}{\partial a}$$ (where MRT stands for the marginal rate of transformation).

41 See also Naito (1999)

42 Assuming all goods are tradable.

43 The effect on the budget constraint is $$\frac{\partial V}{\partial a} + \frac{\partial V}{\partial a} = \frac{\partial V}{\partial a}$$ (1 − MRT).

44 Obviously, without loss of generality, we can drop the term −$$\gamma$$

45 Production efficiency requires that the marginal rate of transformation of all goods that are produced in both sectors be the same in the two sectors, i.e. $$\gamma = \gamma$$

where j and m are any two goods.
Inefficiency of tariff on good 1
(increasing production of unskilled labor-intensive good 1)

\[\frac{dV^2}{dx} = \frac{\xi}{\lambda} = F_k - \lambda_i^2 x_i \frac{dV^2}{dx} (C_{2a+i+1}, C_{a+i+2}, v L_{2i+1}) \frac{dv}{dK} \]

where \(C_{2a}, i\) is the high ability individual of generation \(t\)'s consumption of commodity \(j\) in time \(t\), \(C_{2a}, i, t+1\) is that at time \(t+1\). A similar calculation applies to type 1 individuals. So too, consider two types of capital goods, say \(K_1\) and \(K_2\), using the same amount of resources to construct, \(q_k = K_{1t+1} + K_{2t+1} + \Sigma c_{ij}\), so production efficiency requires \(F_{K_1} = F_{K_2}\), the marginal returns to these two types of capital should be the same. Proposition 7a thus immediately follows.

**Proposition 7a.** If the level of capital affects relative wages, the marginal rate of substitution is in general not equal to the marginal rate of transformation even for the high-ability individual; even in the presence of separability, it may be optimal to have an interest income tax or subsidy on both high- and low-ability individuals. Production efficiency is not desirable if different kinds of capital affect the distribution of income differently.

Increases in capital (and in different types of capital goods) change wage inequality. We impose a tax on interest income if an increase in \(K\) increases wage inequality, i.e., if capital (like robots) lowers unskilled wage relative to skilled wages. The reason we do so is related to how the self-selection constraints are affected. More generally, whether there should be a tax or subsidy on capital depends on whether an increase in the capital stock increases or decreases relative wages, i.e., makes the self-selection constraint more or less binding.

If we can differentiate among different kinds of capital, i.e., \(K\) is a vector, with some components labor-saving or using for different kinds of labor, then there should be a tax on those kinds of capital goods which are unskilled labor-saving and a subsidy on those which are unskilled labor-using. The returns on different kinds of capital goods should, accordingly, differ. There is no reason that the effect on inequality of public and private capital goods will be the same. In general, if government can have more control (directly) in the choice of the extent to which public capital goods are complementary to unskilled labor (i.e. increase \(v\)), then public capital goods should be advantaged over private capital goods; the marginal return ("\(F_y^v\)" to public investment goods should be less than that for private capital goods, and in a utilitarian dynamic optimal growth model, in steady state, \(F_{Kg} \leq \frac{1}{\delta}\). More generally, the economy's transformation curve can be written as before as

\[\lambda(C_1, C_2, L_1, L_2, K_{t+1}, K_t) = 0, \quad v = \frac{\lambda u}{\lambda v}\]

Eq. (19) describes an economy in which different consumption or capital goods are produced with different production functions. A movement along the transformation curve changes the relative demand for highly skilled and low-skilled workers, i.e. affects relative wages. Now, in general, even the basic formulae for consumption tax (Eq. (15)), which we have shown hold in the more general overlapping generations model, have to be changed. Proposition 7b follows.

---

**Footnotes:**

46 It is thus conceivable that the government observe the type of labor input, but not the "name" of the individual providing that type of labor. Especially in the unincorporated sector, our assumption is more plausible; and so long as there are some sectors of the economy where the type of labor being provided is unobservable, our results on the desirability of distortionary production taxation hold.

47 Hicks (1932) defined an innovation as labor saving if at the given levels of inputs the marginal return to labor is reduced. Labor-saving innovations lead to a reduction in wages. The vocabulary extends directly to the context here: an increase in capital is unskilled labor saving if at the given levels of inputs, the marginal return to unskilled labor decreases. We are particularly concerned here how a change in \(K\) affects relative wages, \(\gamma\).
Proposition 7b. If relative wages depend on consumption or public expenditure patterns, then in general, even with separability (i) the rate of return should not equal the intertemporal marginal rate of substitution, (ii) the rate of return in the public sector should not equal that in the private one, and (iii) even asymptotically, with utilitarian intertemporal optimization, it will not equal the pure rate of time preference.49

Consumption at date $t$ affects the self-selection constraint at date $t$, while consumption at date $t + 1$ of the same commodity affects the self-selection constraint at $t + 1$. But individuals consume different commodity bundles; if the elderly on average consume more unskilled labor-intensive services (e.g. home care), then we want to encourage individuals to consume more later in life, because that drives up the relative wages of unskilled workers, reducing before-tax inequality and the extent to which the self-selection constraint binds, i.e. we would want to subsidize high-income individual's savings. Conversely, if the elderly on average consume more skilled-labor-intensive goods and services, like complex medical procedures, then we want them to do the opposite, i.e. consume more earlier in life (the first period). Thus, the demand for skilled labor in the next period doesn’t unduly increase compared to unskilled labor (which would then drive down the relative wages of the unskilled workers). In other words, we would want to tax high-income individuals’ savings. (As we explain in the next section, we do not believe that this model captures accurately the most important aspects of capital taxation.)

Thus, in the utilitarian dynamic optimization problem, even with separability, the consumer rate of discount may not converges to $\delta$ (neither for high- nor low-ability individuals), and the producer rate of return is greater or less than $\delta$ as increasing $K$ decreases or increases $\nu$, the relative wage. If an increase in capital accumulation increases the wage differential (if capital is a complement to highly skilled labor and a substitut-skilled workers) the optimal level of $F_k$ (assuming separability in consumption) is higher than the pure discount rate, i.e. the optimal level of capital accumulation is lower.

5.3. Distortions in the overlapping generations model with unskilled labor replacing robots

We have already seen that the level of investment in different kinds of investment goods, whether in the private or public sector, depends in part on the impact of that good (at the margin) on the distribution of income. Recently, there has been some controversy over the taxation of robots.49 Assume we have robots that are perfect substitutes for unskilled labor.

Consider robots (a particular type of machine), each costing one unit of ordinary capital goods, replacing unskilled labor. Our production function is now $Q = F(L_1 + R, L_2, K - R)$. Production efficiency requires $F_{L_1} = F_k$. But maximizing social welfare entails:

$$\alpha (2\beta L_1) = \gamma (F_{L_1} - F_k)$$

where $\frac{\partial \ln Q}{\partial \ln F_k} = F_{L_1} = F_k - F_{L_1}$ and $F_{L_1}$. Eq. (20) implies that when there is production efficiency ($F_{L_1} = F_k$) there should be further investments in unskilled labor replacing robots if it increases $\nu$; and if it decreases $\nu$, the level of investment in robots should be decreased (there should be a tax on that kind of robot). Thus, so long as the direct effect of “competition” from robots driving down wages ($F_{L_1} < 0$) dominates any secondary effects from the decrease in $K$ on wages of highly skilled workers, it is desirable to tax unskilled labor replacing robots. It is easy to see that this is the case for the standard Cobb-Douglas production function $Q = L_1^{\alpha_1} L_2^{\alpha_2} K^{1-\alpha_1} - \alpha_2$.51,52

5.4. Central message

The central message of this section of the paper is simple: tax and expenditure policies can have effects on the distribution of income that cannot be fully offset by other tax and subsidy policies. Measures that improve the market distribution of income (here increase $\nu$) are desirable. Heuristically, we can think of such measures as reducing the burden imposed on distortionary consumption taxation. This result provides theoretical underpinnings for recent policy perspectives, noted in the introduction, which have emphasized the importance of achieving greater equality of market incomes. Thus, tax and expenditure policies need to be sensitive to the general equilibrium distributional consequences. A tax that has the effect of reducing the demand for unskilled labor should be reduced from the level which it otherwise would have been; conversely if it increases the demand for unskilled labor, it should be increased. Public investments should be targeted to increase the productivity of unskilled workers. Private expenditures aimed at replacing unskilled labor with machines should be discouraged (through taxation).

The mechanism by which the welfare benefits are generated in this model is not just the direct effect on, say, unskilled workers. In the context of a government already engaged in welfare-maximizing redistributions with lump-sum taxes, all that would matter is what happens to aggregate output. But such taxes and redistributions are not feasible. Hence, changes in relative wages also matter because they may affect the constraints on redistribution. Here, the central constraint is the self-selection constraint. In our model, an “improvement” in the distribution of income through an increase in the relative wage of unskilled workers loosens the self-selection constraint and thus enables the government to engage in further redistributions that improve societal welfare. Our analysis formalizes the notion that improving the before-tax distribution of income makes it easier to get a better after-tax distribution of income.

More generally, there are a broad set of hard-to-model political constraints. It is apparent that tax policy does not quickly (if at all) act to offset changes in the market distribution of income. Thus, an improvement in the before-tax distribution of income will typically lead to an improvement in the after-tax distribution of income and in societal welfare.

Perhaps the most striking result is that these concerns over distribution are so strong that they justify policies that lead to production inefficiency. In Diamond-Mirrlees, any distributive benefits achieved through production inefficiency could be achieved at lower cost simply by adjusting tax rates. But if there are restraints on the set of feasible taxes that go beyond just limitations on lump sum taxes, then government cannot necessarily achieve the general equilibrium effects on distribution that are obtained through distortionary production taxes (including tariffs).

6. Layered self-selection

There is one more important set of circumstances requiring significant modification of the Atkinson and Stiglitz (1976) framework. The standard Mirrlees model, of which our analysis can be viewed as an elaboration, is based on self-employed individuals producing widgets. The government can only observe the number of widgets produced, not the hours worked, and therefore it cannot infer abilities. But in fact, in

49 In contrast to the earlier result where $F_k = 1/\alpha$.

50 Bill Gates suggested that there should be such a tax (Delaney, 2017). There was the predictable backlash among those who thought that that was foolish, since it would interfere with efficiency and impede innovation. This paper explains why the former charge has no validity. The second might. If there is learning by doing with spillovers to other sectors, there is a presumption that the government should be subsidizing robot development. (See Stiglitz and Greenwald, 2014), and a tax or subsidy discussed here should be viewed as an increase or decrease in that tax.

51 Where $(F_{L_1} - F_{L_2})/(F_{L_2} - F_2) = -Q/(L_1 + R^*) < 0$.

52 A similar analysis applies to skilled-labor-replacing robots.
modern economies, most individuals work for others, and their employers also need to identify abilities. Individuals too will seek to demonstrate to their employers that they are more able, so as to obtain higher wages.\textsuperscript{53} While screening and signaling may be done in a number of ways, the government may be able to partially free ride on this information; and in any case, government has to take into account that tax policies affect screening and signaling.

Consider the simplest case where an employer cannot observe either an individual’s output, Y, or his ability, but can observe his level of education. But Y itself is a function of education, E, and ability, A. High- and low-ability individuals differ in the cost of education, so we can write utility as $V = V(w, E)$, for $i = 1, 2$, where w is the wage paid to the individual with education E, with a low-ability individual’s indifference curve in $(E, w)$ space being steeper: he requires a greater increase in wages to compensate him for getting more education. The standard competitive equilibrium entails a separating equilibrium, with $(E_1, w_1)$ being the point on the low-ability production function (or more precisely, $w_1 = f_1(E_1)$) that maximizes $V^1 = V^1(w_1, E_2)$, subject to the self-selection constraint: $V^1((E_1, w_1^*) \geq V^1(E_2, w_2)$, where $w_2 = f(E_2)$ yielding $MRS = \frac{dC_1}{dL_1} = \frac{dC_2}{dL_2}$.

Consider the simplest case where an employer cannot observe either an individual’s output, Y, or his ability, but can observe his level of education. But Y itself is a function of education, E, and ability, A. High- and low-ability individuals differ in the cost of education, so we can write utility as $V = V(w, E)$, for $i = 1, 2$, where w is the wage paid to the individual with education E, with a low-ability individual’s indifference curve in $(E, w)$ space being steeper: he requires a greater increase in wages to compensate him for getting more education. The standard competitive equilibrium entails a separating equilibrium, with $(E_1, w_1)$ being the point on the low-ability production function (or more precisely, $w_1 = f_1(E_1)$) that maximizes $V^1 = V^1(w_1, E_2)$, subject to the self-selection constraint: $V^1((E_1, w_1^*) \geq V^1(E_2, w_2)$, where $w_2 = f(E_2)$ yielding $MRS = \frac{dC_1}{dL_1} = \frac{dC_2}{dL_2}$.

In this formulation, E and C occur simultaneously. A more natural formulation (especially in our dynamic model) is that there are three periods in an individual’s life, in the first of which he gets educated, in the second of which he works, and in the third of which he is retired. None of the results are dependent on this formulation. Moreover, this formulation assumes that skilled and unskilled labor are perfect substitutes. The more general case is considered in Section 5.

\textsuperscript{53} See Stiglitz (1975), where it is established that under certain conditions, there may exist a pooling equilibrium. The only competitive self-selection equilibria entail separation.

\textsuperscript{54} The taxes will, of course, affect equilibrium wages and education levels, because of income effects.

\textsuperscript{55} In this formulation, E and C occur simultaneously. A more natural formulation (especially in our dynamic model) is that there are three periods in an individual’s life, in the first of which he gets educated, in the second of which he works, and in the third of which he is retired. None of the results are dependent on this formulation. Moreover, this formulation assumes that skilled and unskilled labor are perfect substitutes. The more general case is considered in Section 5.

\textsuperscript{56} In general, there are several self-selection constraints, all of which could be binding: (a) the low-ability individual is indiff erent between mimicking the high-ability in the eyes of the firm; (b) the high-ability individual who has obtained a high level of education is indifferent between mimicking the low-ability individual who has obtained a low level of education in the eyes of the government; and (c) the low-ability individual who has mimicked a high-ability individual in obtaining a high level of education (and thus has become more productive) is indifferent between mimicking a low-ability individual who has not obtained a high level of education. But in this model, if a high-ability individual is indiff erent between mimicking a low-ability individual in the eyes of the government, then a low-ability individual would not want to simultaneously pretend before his employer to be high ability (and thus get a high level of education) and pretend before the government to be low ability, for in doing so, he reduces the value of education, since in imitating the low ability, he must restrict the number of hours worked. Thus, here we can focus simply on the single additional self-selection constraint. Whether we have to include a still further self-selection constraint, the more general point remains valid that the addition of the new self-selection constraint means that only when certain separability conditions are satisfied will it be desirable not to impose distortionary taxation on the high ability individual.
ensure that the market is Pareto efficient; (b) redistributive taxation, to move us towards a “better” Pareto efficient allocation. Not surprisingly, when both of these are taken into account, the presumption of AS 76 that there should not be intertemporal taxation no longer holds.

7. Inheritance

The most critical assumption underlying Atkinson and Stiglitz (1976) was that all individuals were identical except for their abilities. But there are huge differences in inherited wealth and huge differences in returns to capital of those with wealth. Much of the argument for capital taxation is that taxation of capital and returns to capital can achieve greater equity at a lower cost (say in terms of the deadweight losses associated with the tax) than just reliance on an earned income tax. In Section 3, we commented on the taxation of capital in the context of a world in which individuals differ in their ability to generate returns on capital. Here, we focus on inheritances.

It is easy (in principle) to separate the taxation of inheritances and the return on inheritances from the life-cycle savings discussed in previous sections. The latter can be thought of as put into Income Retirement Accounts (IRA’s), and the analysis of earlier sections argued that in the absence of e.g. distributive effects and with separability, there should be no taxation of returns in IRA’s. But that says nothing about the taxation of capital in general, which we will argue should be taxed, and possibly at a high rate. If some inherited savings slips into IRA’s and not all life cycle savings is included in tax-exempt IRA’s, there would be some presumption for taxing the return to capital in IRA’s, but still taxing the return to capital not in IRA’s.

An analysis of optimal/Pareto-efficient taxation of inheritances entails two complications, beyond the general equilibrium distributive effects upon which Section 5 focused. (a) A full analysis of taxation and inequality in the presence of bequests has to come to terms with the drivers of financial and human capital bequests—the determinants of the intergenerational transmission of advantage and disadvantage. (b) It is not obvious what the appropriate social welfare function should be.

7.1. Determinants of Inheritances and the Intergenerational Transmission of Advantage

Individual’s life time income (wealth) is determined by their endowments—inherited ability, education provided by their parents and the state, and inherited financial wealth—and the returns on those endowments, themselves a function of those endowments, effort and luck. Thus, there are three sources of high levels of lifetime wealth: children who have the good fortune of having parents who bequeath them good endowments, either high abilities or substantial amounts of financial and human capital; high levels of effort; and those who get high earnings on their endowments, often as a result of luck. The latter include the inventors and entrepreneurs who earn outsized incomes, often through the exploitation of market power. Gates and Rockefeller are examples. The “successful” also include individuals who are particularly effective in receiving favors from the state, e.g. in the form of land grants. In many cases, wealth begets wealth through a variety of mechanisms, including the exercise of market and political power and returns to information asymmetries.

While some of the determinants are under the control of the individual, others are not: most importantly, inherited ability. (Some important aspects of the transmission process, besides taxation, are matters of public policy—most importantly, education.) This implies that any model of equilibrium wealth distribution must entail at least two (linked) stochastic difference or differential equations—one for ability and one for (financial and human) capital (Stiglitz, 1966, 2015; Bevan, 1974, 1979; Bevan and Stiglitz, 1979). While some receive a high inheritance because of the luck of having parents with a high “taste” for bequests, others because of the luck of having very rich parents, others because they have fewer siblings among whom the wealth of the parents have to be divided, there is still a fourth source of differences in inherited wealth (more important among “life-cycle savers”): in the absence of good annuities and reverse mortgages, upper individuals who do not wish to turn to the government for support in their final years have to hold more than what they actuarially need to live; on average, they die before eating up all of their savings. The children of those who die early may receive a small fortune, especially if there are no siblings. While it is natural that economists begin with a discussion of choices and tastes (some individuals or dynasties might give greater weight to their descendants than others), almost surely, these other factors are as or more important.

In most of these cases there is little reason to believe that, in general, taxing transfers at the top at a high marginal rate would have significant adverse effects on economic activity. For instance, the amount of money that individuals hold for their old age as a result of the absence of annuity markets is likely determined largely by the individual’s risk aversion, the extent of public support for the aged and expectations of support from one’s children, and uncertainties about life expectancy. Fertility decisions are similarly unlikely to be significantly affected by inheritance taxation. The efforts of those like Gates and Rockefeller (either at innovative and entrepreneurial activities or at exerting market power) are unlikely to be affected much by high inheritance or capital taxation at levels of wealth and income exceeding some billions of dollars. Indeed, there is some positive evidence and theory that high marginal tax rates might reduce incentives for rent seeking and exploitation, thereby increasing economic efficiency.61

Thus, there is some presumption that there should be high tax rates on very large bequests, the main concern being not that individuals won’t work as hard, but that they would engage more in tax avoidance activities (in the extreme cases, changing residence to avoid taxation).62 Concern about inherited wealth inequality would center progressive taxation on inheritances, not bequests.

Whatever the reason, in practice, in most countries there is still substantial intergenerational transfer of wealth, implying that even with bequest taxes, there will be individuals with substantial incomes from inherited capital. Thus, (progressive) taxation on capital arises naturally within any utilitarian framework. It can be viewed as an indirect (and imperfect) way of taxing bequests, as a second-best response to an important source of inequality.63

7.2. Objectives

While Pareto efficiency and utilitarianism provide a natural framework for evaluating alternative taxes on wages, the welfare evaluation of inheritance taxes is more complicated. As Stiglitz (1987) noted, bequests are doubly blessed: while they give utility to the giver, they also give utility to the receiver. There is a positive consumption externality. There is thus a presumption that there will be an

57 In a world without uncertainty in returns, the taxation of capital and the return to capital are equivalent, but this is not so in general.

58 See Stiglitz (1966, 1969a, and, most related to the discussion here, 2015 and 2017) and Becker and Tomes (1979, 1986) for a more extensive discussion.

59 This theory supports a Pareto tail distribution. See Stiglitz (1978), Flemming (1979) and Kopczuk and Lupton (2007) show the empirical importance of such bequests.

60 See, for instance Piketty and Saez (2013).

61 See Piketty et al. (2014) and Stiglitz (2017).

62 To the extent that individuals are engaged in intertemporal income smoothing with their children, inheritances lead to less variability in consumption. But taxing inheritances and using the proceeds for investments in human capital and redistributive transfers can more than offset both these and other adverse general equilibrium effects. See Stiglitz (1978), Bevan and Stiglitz (1979) and the discussion below.

undersupply of bequests, all else being equal, and that they should be subsidized. In the context of models such as those considered in previous sections, apart from this externality effect—and possible general equilibrium distributive effects of the kind discussed in the previous section—bequests are just another form of utility-generating expenditure, and thus there should be no bequest taxation if (and only if) there is separability between consumption (now including bequests) and labor (Kaplow, 2001).

7.2.1. Trade-offs between consumption inequality and wealth inequality

But there are two reasons for thinking that this analysis does not fully capture societal concerns about inequality. First, note that there may be a trade-off: the imposition of inheritance taxes, in the absence of offsetting taxes, may increase consumption inequalities, in a world in which bequests serve to smooth consumption within a dynasty, i.e. where rich parents share some of their wealth with their children (Stiglitz, 1976b). Consider a model (such as Bevan and Stiglitz, 1979) where individuals themselves think about their children and, when they have good luck, either being born with high ability or getting an unusually large return on their investments, set aside an optimal amount to share with their descendants. Ignoring general equilibrium effects (impacts on the distribution of income and self-selection constraints), each individual is optimally smoothing income over generations. It might seem that so long as the family’s intertemporal discount rate is the same as the social welfare function, there is no reason for government to engage in intertemporal distribution. But that is not correct: it is still the case that at this moment some families have a possibly substantially larger endowment of “ability” and capital than others, and therefore a redistributive tax would be desirable. Moreover, at each period in the future, some individuals get a better roll of the dice—given their parents, they have higher wages or higher returns on their inherited capital. While they optimally share their good fortune with their descendants, they don’t share their good fortune at all with others who have had a bad roll of the dice, ending up with low wages or low returns on capital. A utilitarian would wish to redistribute income between the lucky individual and those who had a bad roll of the dice. (Indeed, so would an individual, behind a veil of ignorance, not knowing how the dice would roll.)

If the government can observe inherited wealth \( I_t \), then, at time 0, there should obviously be a tax on the inheritance and on returns to inherited capital. Indeed, taxing past bequests (capital that individuals have already inherited) at 100% is non-distortionary and would thus be part of a utilitarian optimal tax program. Of course, this is just the standard paradox of capital taxation: in the absence of some form of commitment, savers would know this, and there would be no savings and investment. There has to be some way that governments can make a credible commitment not to impose such taxes. We do not answer that question here, but rather ask, if the government could make a credible commitment to, say, a fixed inheritance tax and/or return to capital, how would those taxes be determined? With such a commitment, the government must balance the benefits of greater equality across families with reduced intertemporal smoothing of consumption within the dynastic (and more broadly, other aspects of deadweight loss associated with distortionary taxation). In principle, the optimal tax function would relate the tax paid by the individual at time \( t \) to all observables related to his current behavior and past history (i.e. to \( Y_t, I_t \) for all \( t \leq t_o \), where \( t_o \) is today’s date), since such data (together with knowledge of the stochastic processes) convey information about relevant current-period variables, in particular \( w_t \) (the individual’s ability). For instance, if ability were perfectly inherited, information from previous periods’ incomes of the parents perfectly conveys information about the individual’s current ability. If there is a high correlation, past data would still convey considerable information. (Since the standard models assume Markovian processes for ability, only the previous period income is relevant.)

Of course, individuals know this, and if they care about their descendants, as assumed here, their behavior would correspondingly adjust. This can have profound consequences, including that the equilibrium is not a separating equilibrium (as in the previous sections of this paper) but a pooling one. We thus have to compare the level of social welfare with the optimal tax of the form \( T(Y_t, I_t) \) with that generated simply by a tax of the form: \( T(Y_t, I_{t-1}) \). In the latter case, taxes would have to take into account the self-selection constraints described in previous sections of the paper.

64 This idea has been incorporated into and commented upon by many of the more recent models of inheritance taxation. See, e.g. Kaplow (2001) and Piketty and Saez (2011). At the same time there is another important externality, that associated with an increase in inequality. There is a large literature emphasizing how inequality affects economic performance and society more generally. Most of the economics literature on bequests has not incorporated these important externalities.
65 Much of the literature models the utility of bequests in a reduced form, rather than as a result of increasing the utility of one’s descendents, the benefits of which are incorporated into one’s well-being. Standard structural modelling (e.g. a dynastic utility function) also naturally entails separability between labor and bequests.
66 And putting aside the fact noted above that in a utilitarian framework, a bequest gives utility to both the giver and the receiver.
67 One obviously cannot study this effect in a model in which, starting at time 0, all individuals begin with the same wealth and ability, and making random draws going forward. In that world, at time 0, there would be no need for taxation; but subsequent periods would begin with wealth and ability inequalities, and redistributive taxation would be desirable. Of course, at time 0, individuals would know this, and that would affect behavior at time 0.
68 No democratic government can make such commitments, and it is apparent that (footnote continued)
69 There is some evidence that the ability generating process is not so simple, e.g. that characteristics of the grandparents may affect the grandchildren independently of the state of the child.
70 See Roberts (1982) and Stiglitz (2009b).
71 In our earlier analysis, we implicitly assumed that the government did not make use of the information implicit in the inheritability of ability. But while using such information would almost surely be viewed as politically unacceptable, inheritances are correlated with the income of previous generations. It is worth noting that equality of opportunity is a distinctively different norm that that associated with, say, maximizing an inequality averse dynastic social welfare function (Kambur and Stiglitz, 2015, 2016). Equality of opportunity says the probability that an individual will be in any given decile during his life is independent of the decile of his parents. A two period egalitarian family social welfare function \( W(\text{WU}(U_{1-1})) \) would seek to compensate an individual whose father is poor (and therefore whose childhood has more likely been spent in poverty) with higher income, calling for a quite different transition matrix.
marginal costs of small distortions are small, and, given the large inequities which currently exist, the marginal benefit of the corresponding reduction in inequalities arising from inheritance taxes and taxes on non-life-cycle capital income are large, there is a presumption in favor of such taxes.

8. Optimal taxation in a two-class model

A simplification in which these perspectives can be investigated more closely and which captures well key elements of a modern capitalist economy entails workers in an overlapping generations model and a second group with so much inherited wealth that their wealth dwarfs their wage income, and so we ignore it. The latter group we refer to as capitalists; the former as workers. We focus on the differences in well-being between these two groups, rather than differences within each group.

Total capital in the economy is workers' capital and capitalists' capital, generating a two-class model along the lines studied earlier by Pasinetti (1962), Samuelson and Modigliani (1966) and Stiglitz (1967, 2015). We extend the model here by introducing utility-maximizing workers and capitalists. Capitalists maximize a standard intertemporal utility function with discount factor 1/δ. We normalize by assuming workers have a (fixed) population of unity, capitalists of N, so capitalists' consumption is NCτ. We simplify the analysis by assuming the government simply wishes to maximize workers' steady-state consumption.75 We assume, for simplicity, that the labor supply is fixed (at unity as well). Here, we assume all revenues from taxation are spent on education. Later subsections will generalize the results. Then output, Q, is a constant-returns-to-scale function of (private) capital, K, and effective labor, which is a function of investment in human capital per capita, which, noting that labor supply has been normalized at unity, can be written as φ(Kg), with φ(Kg) ≥ 0 and φ′(Kg) ≤ 0. So Q = F(K, φ(Kg)). Investments in education increase productivity, but there are diminishing returns. Because of constant returns to scale in capital and effective labor, we can write:

\[ Q = φ f(K/φ) = φ f(k) \]  

(21)

where \( k = \frac{K}{φ} \) is the capital-"effective labor" ratio. We assume a tax rate of τ on the net return to capital.77 This implies that in long-run equilibrium k is given by:

\[ 1 + r = \frac{1 - τ}{φ′(Kg)} = δ \]  

(22)

where r is the (after-tax net) rate of return on capital, η is the rate of depreciation and the tax is applied only to net returns. The after-tax net return to capital is simply related to the pure rate of time discount. Eq. (23) determines the equilibrium value of k as a function of τ (given η and δ).78

\[ k = \psi(τ), \psi′(τ) = δ/(1 - τ)2τ^2 < 0. \]  

(23)

We denote by \( k_0 \) the value of k when \( τ = 0 \); \( k_0 = w(0) \). Tax revenue is \( τ (f - η)K \), all of which is spent on public education. Hence

\[ K_τ = τ (f - η)K = \frac{ηδ}{1 - τ} K = \frac{ηδ}{1 - τ} ψ(τ) \]  

(24)

Assuming workers have homothetic indifference curves between consumption when young and old,79 worker savings are given by \( s_w(τ) \), where w is the wage:

\[ w = ψ(K_τ) g(k) = ψ(K_τ) (f - k′f) \]  

(25)

where \( g(k) = f - k′f \) is the return per unit of effective labor. Hence

\[ K_w = s_w(τ) φ′(K_τ) g(k) = s_w(τ) (φ′(K_τ) g(ψ(τ))) \]  

(26)

using Eq. (23). Eq. (24) can be used to solve \( K_τ \) as a function of τ. There is a unique solution if τ is small or if \( ζ < 1 \), where \( ζ = \frac{d ln K_w}{d ln K_τ} \), the elasticity of productivity with respect to investments in human capital. We can also solve for workers' steady-state utility, \( W = W^*(w, r) \), which depends just on \( (w, r) = (w, δ) \), from Eqs. (24) and (25) depends just on τ.

Taking the logarithmic derivative of w (from Eq. (25)), we can establish the tax rate that maximizes workers' welfare (and, given social weights that put little weight on capitalists' well-being, approximately maximizes societal welfare). Increasing r increases \( K_w \) but decreases k and hence g, the wage per efficiency unit. The optimal tax balances the two effects:

\[ 0 < τ^* = \frac{a}{1 + a} < 1 \]  

(27)

where \( a = \frac{c}{1 - κ φ′(K_τ)} \) with \( c = \frac{1}{κ} \); \( b = S_κ/φ′_κ \) and \( d = \frac{φ′}{(1 - κ φ′(K_τ))} \), where \( φ′ \) is the elasticity of substitution and \( S_κ = f/k′f \). The larger is the elasticity of the return to human capital, the larger \( τ^* \); and the larger the elasticity of substitution, the smaller is the adverse effect on wages of an increase, and thus the larger is \( τ^* \). Hence, we have Proposition 8a below.

Proposition 8a. Provided 0 < ζ < 1, there is a strictly positive tax rate on capital taxation to finance education.80

These results assume that there is no productive public investment to augment the productivity of capital goods and no transfers. More generally, the total income of a worker with transfers but net of labor taxes τ is given by

\[ W = ψ(f - k′f) + τ rK - K_τ - τ \]  

(28)

where \( K_τ \) is investment in public capital goods allocated to augmenting capital productivity, and K represents as before just private capital. Output is a CRS function of effective labor, \( K_τ \) and K: \( Q = F(K, K_τ, φ(K_τ)) \).

If the tax were only used to finance lump-sum transfers to workers, then workers' (after transfer) wage is given by \( W = g(k) + r(f - η)k \). At \( τ = 0 \), \( \frac{δW}{δτ} = -k′S + (f′ - η)k = 0 \). But straightforward differentiation shows that for τ > 0, \( \frac{δW}{δτ} < 0 \), implying Proposition 8b below.

Proposition 8b. A tax on capital used to finance a lump sum-transfer to workers is welfare-decreasing.

If all tax revenues go to public capital that augments the productivity
of private capital, then \( Q = F \left( H \left( \frac{K}{\delta} \right) K, L \right) \)
and in equilibrium the effective capital/labor ratio is determined so that:
\[
(Hf)'(k) - \eta (1 - \tau) = \delta.
\]
(28)

Since public investment is financed by a tax on capital: \( K_H = \tau Hf' \),
implying that \( z \equiv \frac{Hf'}{\delta} \) is given by
\[
z = H(zf)'(k)
\]
(29)

Substituting into Eq. (28), we obtain:
\[
\frac{z}{\tau} (1 - \tau) = \delta
\]
implies that
\[
z = \tau \left( \frac{\eta + \delta}{\tau} \right).
\]
This can be solved for \( z \) as a function of \( \tau \), substituted into Eq. (29), so that we can solve for \( k \) as a function of \( \tau \). Workers' wages increase as \( k \) increases, i.e.
\[
as(1 - m) \left( 1 + \frac{\delta}{\tau + \delta} \right) > 1,
\]
where \( \frac{Hf'}{\delta} \). Thus, if public capital investments are not too "capital-augmenting," then workers' incomes are increased by an increase in capital taxation with revenues used for capital-augmenting public capital (even with capital goods capturing the direct returns).

On the other hand, if the funds are spent on capital goods that substitute for private capital goods, then the aggregate capital labor ratio need not even fall; even with limited productive human capital investments, workers' income (through an increase in wages and/or transfers) may increase, and so will their welfare.82 With the return to capitalists' capital below the critical threshold, they eventually consume their wealth. The economy is then supported by public investment. This result holds even if public investment is not as productive as private investment, so long as it is not too much less productive.

The central point is simple: while a capital tax (the proceeds of which are simply distributed to workers) hurts workers because of adverse incidence effects, under quite general conditions,83 with an equilibrating social welfare function it is desirable to impose a tax on capitalists' return to capital, and with large disparities in income between capitalists and workers, strong equilibrating, and high productivity of investments in human capital, the optimal tax on capital may be very high. If tax revenues are invested in capital goods that either increase the productivity of private capital goods (but not too much) or substitute for private capital goods, then again taxation on capital is desirable. Indeed, in the latter case, a tax on capital over the long run may result in capitalists consuming all of their capital.

9. Concluding remarks

It is remarkable that so much of the policy literature has focused on simplistic models in which differences among individuals were limited, arising mostly out of differences in wage incomes. The Atkinson and Stiglitz, 1976 model was useful in reminding us that the role of commodity taxation had to be seen in conjunction with other taxes that were in place as well as taxes that we might have wanted to have in place, but which are not there—a general principle of considerable importance. When there was an optimal non-linear income tax, the role of commodity taxation was limited. Its role could be seen in two ways. First, as improving the before-tax (market) distribution of income, and how it alters the distribution of income and self-selection constraints within the economy. In general, even asymptotically and even with separability, the rate of discount for public investment varies across public projects, and may be greater or less than the social rate of discount.

There are many other limitations to the basic Atkinson-Stiglitz model that we have not explored here. We have, in particular, assumed the absence of tax evasion and avoidance, and in particular the ability to shift income from one category to another. In practice, it is often difficult to distinguish between capital and labor income, especially for self-employed individuals; and if that is the case, large differences in tax rates provide large incentives to convert wage income into capital income.84

This is perhaps related to one of the deepest criticisms of the literature on optimal non-linear taxes: in practice, there are many restraints. We have noted, for instance, if government is restrained to using a linear income tax, commodity taxation is still desirable. The rationale is somewhat different from that presented above. Such taxation may improve the before-tax distribution of income, as we have emphasized, but even if it does not do this, it may enable us, with little social deadweight loss, to improve the after-tax and transfer distribution of income, and thus social welfare. A tax on perfume may generate significant revenues from a subset of high-income individuals—individuals who, even with an optimal linear income tax, have a much lower social marginal utility than poor individuals. So too for a bread subsidy. Though as Deaton noted, with linear expenditure systems, one can't achieve improvements through perfume taxes and bread subsidies, there may be significant departures from those patterns of expenditure.

This leads to the question: why the restraints? There are obvious advantages to simplicity, but when one looks at the tax code, it is clear that simplicity itself is not the guiding principle. Making the tax system non-linear, with several brackets, adds virtually no cost in a modern computer-driven tax system, raising a key point: what is costly or feasible depends on technology, and that changes over time—some changes endogenously driven. When Vickrey advocated the use of congestion taxes, a good congestion tax could not have been implemented. But advances in technology now make the administrative costs associated with imposing taxes low. Economists often refer to

---

81 This formulation is chosen so that the production function is constant returns to scale. It is assumed that the government does not appropriate directly the returns to public capital goods, but rather, the returns are appropriately by the owners of capital—private persons, but rather, the returns are appropriately by the owners of capital/goods capturing the direct returns.

82 That is, if \( Q = F(K + K_{PI}, L) \), then the expenditures on public capital goods drive down the after-tax rate of interest so that \( (f' - \eta)(1 - \tau) < \delta \), in which case capitalists start to "eat" their capital. To ensure that capital taxation does not decrease wages, it must be the case that \( \tau > s_p \), where \( \tau = \text{relative productivity of public investment and} \)

83 The result can be shown to hold with more general utility functions for capitalists (e.g. recursive Koopmans functions, so that the long-run interest rate need not be invariant to tax policy.) It also holds with different specifications of taxation, e.g. a wealth tax on capitalists, or a tax on intergenerational transfers, rather than a tax on their net income.

84 Thus, it is desirable to introduce random taxation, even though all individuals are risk-averse, if by doing so the self-selection constraints are relaxed. See Stiglitz (1982b) and Brito et al. (1995).

85 There are, of course, other widely noted limitations on the model, which limit the direct applicability of the result: (a) Hours may be partially observable, in which case government would want to use that information; and (b) there may be large stochastic elements in the translation of labor, given an individual's ability and effort, into income. In dynamic models, as we noted earlier, observations of an individual in time \( t \) are relevant to inferences at subsequent dates (and this may even be true of observations of an individual's parents). Optimal taxation ought to make use of that information, but if individuals know this, it affects behavior. In effect, the models here entail a commitment on the part of government not to use such information. The models here are adverse-selection models. There are also important incentive effects, e.g. in effort and education. Thus, a full analysis would include both effects, with incentive compatibility constraints added to the self-selection constraints. (For a discussion of optimal taxation with moral hazard, see Arnott and Stiglitz, 1986.)
political costs, but my experience with “political constraints” is that they are soft and ambiguous. What seems like an insurmountable barrier at one time can be suddenly overcome, especially as economists explain the high costs of such a constraint. I had argued some quarter century ago that there would be substantial benefits from substantially increasing the standard deduction, moving many individuals out of the income tax net and reducing the importance of many key distortionary deductions and credits, but it was claimed that doing so was politically infeasible. Then, suddenly, in 2017, in the US, it happened. I would have thought that in a democracy, a tax cut for billionaires financed by tax increases for lower income individuals would be infeasible; again, in 2017, it happened.

There are two sets of constraints for which there are important rationales. One is that large differential tax rates, say between capital and labor, open up large opportunities for arbitrage. So too for large differential rates among classes of similar activities. More broadly, there are limitations in what government can observe, and what it can precisely define, and those limitations provide openings for arbitrage and distortions. When there are large differences in marginal tax rates, money can be shifted from one person (say in a family) to another. Much of the complexity of the tax system arises from these forms of differentiation, and any tax structure needs to take this into account.

Most importantly, there is a simple reason to tax the returns to capital of the very rich: it is equitable. With any equality-prefering social welfare function with sufficient weight on equity, the benefits in terms of social equity would outweigh the distortionary effects, given the disparities in incomes observed in advanced countries such as the United States. The intertemporal distortions in consumption patterns affect the very rich, when the tax is levied only on very high incomes. But even if a capital tax is also levied on workers it may be desirable. If the proceeds of the tax are invested in ways that sufficiently enhance the productivity of workers and/or provide sufficiently highly valued public goods, workers are better off, and the gains to the workers more than offset the losses to the “capitalists” who bear the tax. We have shown that, in general, the adverse incidence effect on workers as a result of capitalists’ reduced savings can be offset. With the standard utilitarian social welfare functions, with the degree of concavity conventionally assumed, there can be even considerable inefficiency in public investments, and still capital taxes would be desirable.

All of this has been predicated on individualistic inequality-averse social welfare functions. But there is increasing awareness that inequality itself may have an adverse effect on societal well-being, and even productivity. There is an increasing awareness that living in an unequal society changes the nature of society and the nature of those that live within it, with effects on preferences and behavior of both those at the top and the bottom that would widely be agreed to be adverse.

Indeed, there is increasing evidence that inequality itself may affect productivity. Once we take these consequences of inequality into account, the case for a progressive tax on the income from capital, and in particular, taxing at a high rate the return to what we have identified as “capitalists’ capital” becomes even more compelling. I believe that Tony would have agreed with these conclusions.

References

Delaney, Kevin J., 2017. The robot that takes your job should pay taxes, says Bill Gates. Quartz (February 17).
George, H., 1879. Progress and Poverty: An Inquiry Into the Cause of Industrial Depressions, and of Increase of Want With Increase of Wealth, the Remedy. (W. Reeves),