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The optimal income tax when poverty is a public ‘bad’

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Abstract

Poverty is considered as an aggregate negative externality that may affect people differently depending on their aversion to poverty. If society is on average averse to poverty, then the optimal income tax schedule displays negative marginal tax rates at least for the less skilled individuals. Negative marginal tax rates play the role of a Pigouvian earnings subsidy and foster the supply of labor of poor individuals. The no-distortion at the endpoints result which is therefore violated can be restored once the focus is shifted from individual to social distortions. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The optimal income taxation literature began with the seminal paper of Mirrlees (1971). In a society composed of individuals with different exogenous income earning possibilities, Mirrlees characterizes the best income tax function a social planner (or government) can implement. In his context, ‘best’ must be understood with reference to (i) the reaction of the individuals to the tax function, and (ii) the objective of the planner. The recognition of (i) is the main contribution of Mirrlees to this literature. Indeed, he introduced explicitly, in a tractable way and for the first time, the (dis)incentive effects associated with the taxation of (endogenous)

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income. In defining (ii), Mirrlees followed the tradition in welfare economics by postulating that the government maximizes a social welfare function, i.e., a function depending solely on the individuals' welfare, social judgements and preferences being present through the weights assigned to different agents' well-being. Mirrlees' approach is in this sense 'welfarist'.

Welfarism has been criticized on several grounds. In a stream of important papers gathered in a single book, Sen (1982) argues that welfarism is informationally restrictive. Welfarism rejects any information unrelated to personal individual welfare, i.e., non-utility information. Such information is given for instance by the possibility to exercise one's 'rights', the freedom to express one's views or ethical concepts such as 'liberty', 'justice', etc. From a policy standpoint also, welfarism is considered too narrow to provide sound policy prescriptions. Many important issues are missed or simply left out by the welfarist approach.

There are principles of social judgement that require essential use of non-utility information, and while such principles (e.g., liberty, non-exploitation, non-discrimination) are typically not much discussed in traditional welfare economics, they do relate closely to the subject matter of welfare economics. [Sen (1982), p. 338]

Alternative approaches to policy analysis, using non-utility information, have been developed following the work of Sen (1982). These approaches are usually ranked under the generic term of 'nonwelfarist'.

In setting the policy agenda, a social planner may then want to take into account, utility as well as non-utility information, departing from the usual welfarist approach. In the economics literature however, the welfarist and nonwelfarist viewpoints have been adopted each to the exclusion of the other. A recent exception is however provided by Atkinson (1995) who explicitly recognizes that a government can pursue several objectives and has to combine them in a sensible way:

The objectives of securing individual freedom, avoiding dependency, or rewarding effort do not replace concern for the welfare of individuals. Rather we have now to recognize that we have a plurality of principles. [Atkinson (1995), p. 63]

Atkinson therefore advocates a social objective function that trades off different, possibly conflicting, concerns. While this would take us away from the welfarist approach, in this paper we stick to the latter while accounting for the multidimensionality of welfare.

According to Sugden (1993), the industry standard in welfare economics is 'revealed preference welfarism' where the welfare of an individual is associated with the actions she undertakes. For instance, in the optimal taxation literature, a

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