Journal of Public Economics 90 (2006) 1215–1233
www.elsevier.com/locate/econbase

Optimal redistributive taxation when government's and agents' preferences differ

Sören Blomquist [a], Luca Micheletto [b,*]

[a] Uppsala University, Department of Economics, Box 513, SE-751 20 Uppsala, Sweden
[b] L. Bocconi University, Department of Economics, Via U. Gobbi 5, 20136 Milan, Italy

Received 21 February 2005; received in revised form 30 August 2005; accepted 5 September 2005
Available online 8 November 2005

Abstract

Paternalism, merit goods and specific egalitarianism are concepts we sometimes meet in the literature. The thing in common is that the policy maker does not fully respect the consumer sovereignty principle and designs policies according to some other criterion than individuals' preferences. Using the self-selection approach to tax problems developed by Stiglitz [Stiglitz, J.E., 1982. Self-selection and Pareto-efficient taxation. Journal of Public Economics 17, 213–240] and Stern [Stern, N.H., 1982. Optimum taxation with errors in administration. Journal of Public Economics 17, 181–211], the paper provides a characterization of the properties of an optimal redistributive mixed tax scheme in the general case when the government evaluates individuals' well-being using a different utility function than the one maximized by private agents.

JEL classification: D11; D60; H21; H23
Keywords: Optimal taxation; Behavioral economics; Paternalism; Merit goods; Non-welfarism

1. Introduction

Paternalism, merit goods (or wants) and specific egalitarianism are concepts that we now and then come across in the literature. Their common distinctive feature is that the policy maker does not fully respect individuals' preferences but regards them as deficient in some way. The decisions made by individuals need to be corrected. Although fairly frequently

* Corresponding author. Tel.: +39 02 58365332; fax: +39 02 58365318.
E-mail address: luca.micheletto@unibocconi.it (L. Micheletto).

0047-2727/$ - see front matter
doi:10.1016/j.jpubeco.2005.09.001

mentioned in the literature, there is not much formal analysis of the implications of these ideas for policy making. In this paper we attempt to close this gap by providing a framework that covers all three ideas mentioned above and study the implications for optimal income and commodity taxation. The framework we provide can also handle some other non-welfaristic approaches.

Paternalism is probably the concept with the oldest tradition dating back as far as Plato's writings. The general idea is that (some) individuals do not know what is best for them. Some other person with the power to decide knows "better" what will be beneficial for the individuals, and overrules their wishes. Laws restricting the behavior of individuals are often motivated by paternalistic arguments. The concept is still much discussed among philosophers as well as economists.[1] The notion of paternalism is also crucial in the literature on behavioral economics. Much of this literature builds in fact on the assumption that, due to a self-control problem, (some) individuals may exhibit a tendency to pursue immediate gratification in a way that they themselves regret in the long run (hyperbolic discounting). This time-inconsistent preference for immediate gratification implies that the individual's current self imposes negative external effects (or, as it has also been called, a "negative internality")[2] on future selves, which in turn suggests the possibility of a corrective role for the government in designing (paternalistic) policies that help people make better choices.[3]

The concept of merit wants was introduced by Musgrave (1957, 1959). According to him (Musgrave, 1959, p.13) "Such wants are met by services subject to the exclusion principle and are satisfied by the market within the limits of effective demand. They become public wants if considered so meritorious that their satisfaction is provided for through the public budget, over and above what is provided for through the market and paid for by private buyers." It has indeed been difficult to give a strict definition of merit goods in terms of properties of the policy-makers preference function. Sandmo (1983) discusses decision making in a context of uncertainty. Individuals' information on probabilities might be incorrect, whereas the policy maker has better information. According to Sandmo this might provide the underpinnings for the policy maker to use a merit good formulation of its policies. This line of reasoning resembles the ideas presented in Blomquist and Micheletto (2003). In a model of age related income taxation they argue that in their decision making individuals maximize expected lifetime utility, whereas the policy maker is interested in the distribution of actual lifetime utilities. In their model the policy maker respects individual preferences, but it is still the case that the policy maker maximizes another function than what individuals maximize.

There have been attempts to capture the notion of merit goods in terms of properties of a direct utility function. Besley (1988) is an example. However, as shown by Schroyen (2005), the Besley formulation is ambiguous. Schroyen (2005) and Racionero (2001) provide still other ways to try and capture the notion of a merit good in terms of a property of a direct utility function. We will consider both in the paper. Another possibility that we discuss extensively below is to define a merit good as a good whose consumption should be encouraged by the commodity tax system in some particular way.

[1] An evidence of this can be regarded the fact that in the 2003 May issue of the American Economic Review a full session is devoted to a discussion of paternalism and its role in shaping policy making. See in particular Thaler and Sunstein (2003) where a strong argument in favor of paternalism is provided.

[2] This terminology is due to Herrnstein et al. (1993).

[3] See for instance O'Donoghue and Rabin (2005) who study the welfare effect of taxes on "sin goods" in a two-commodity economy populated by agents with both heterogeneous tastes and different degrees of self-control problems.