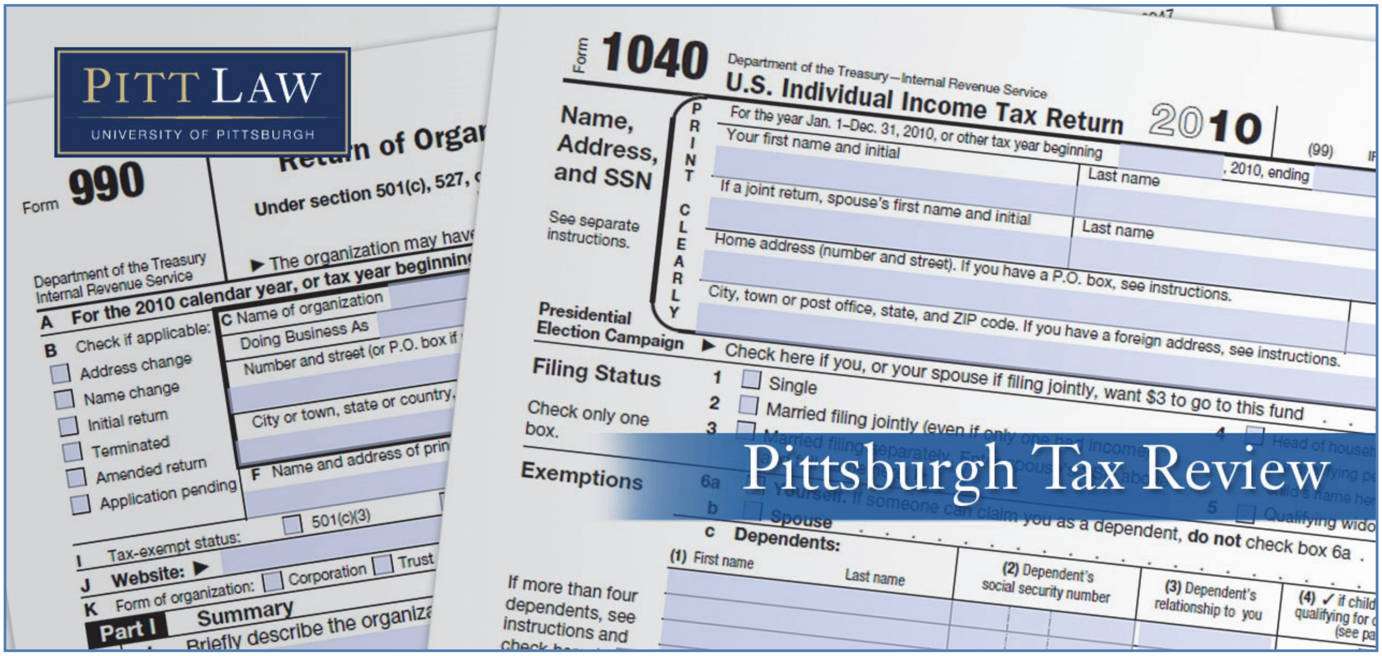

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WHAT ROLE CAN DESERT PLAY IN DESIGNING TAX POLICIES?

Steven M. Sheffrin

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WHAT ROLE CAN DESERT PLAY IN DESIGNING TAX POLICIES?

Steven M. Sheffrin[*]

I. INTRODUCTION

The continued and heightened debate about the role of progressivity in the income tax has generated reflection about its underlying moral and philosophical basis. These are not new concerns: the foundations of the "uneasy case for progressive taxation" were questioned over sixty years ago by Blum and Kalven.[1] Previous foundations for progressive taxation have typically largely rested on utilitarian principles, which are not without controversy.

This paper explores whether the everyday and popular concept of *desert* or "deservingness" can play an important role in the design of our tax policies. The concept of desert is often applied to markets where we ask whether individuals truly deserve the fruits of what they produce or the economic rewards that they earn. For example, are the high salaries of CEOs justified in any deep sense? Although desert in this sense plays a controversial role in philosophy, the psychological foundations of desert resonate with values that are deeply held by individuals. This psychological correspondence raises the possibility that desert may merit serious consideration as a basis for moral judgments and for a normative theory of taxation.

This paper begins by making the case that the theory of progressive taxation could benefit from an alternative basis for normative assessments of taxation, aside from conventional optimal tax theory. It then describes the psychological foundations for the concept of desert, provides a review of the different ways that philosophers have used the concept, and explores the

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[*] Professor of Economics and Executive Director of the Murphy Institute, Tulane University. I thank Monica Betzler, Paul Hurley, and Thomas Mulligan for discussions on desert, and participants at the Tulane Tax Roundtable for valuable comments on an earlier version of this paper.

[1] *See generally* Walter J. Blum & Harry Kalven Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952) (discussing concerns associated with progressive taxation).

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economic perspective. While we do not endorse the view that market outcomes are identical with desert-based outcomes, we do suggest that intuitions derived from the theory of desert are an important element in our account of justice and fairness. Our review suggests that there indeed may be a plausible role for desert-based assessments that could provide normative guidance for some aspects of our tax policy. We finally take the next major step and describe some specific tax policies that would flow from a serious consideration of desert.

II. Do We Need an Alternative to Optimal Tax Theory?

The conventional economic tax policy approach to thinking about income taxation is now based on the theory of optimal taxation, developed in its modern incarnation by James Mirrlees.[2] This approach underlies recent suggestions by Peter Diamond and Emmanuel Saez for distinctly higher income tax rates in the United States.[3] An influential treatise by Louis Kaplow places optimal tax theory at the center of modern public finance, suggesting that all important problems in public finance should be analyzed with optimal income taxation in the background.[4] Joel Slemrod and Christian Gillitzer use optimal tax theory as the bedrock of their analyses of tax systems, incorporating more realistic institutional features into the basic framework.[5] The discussion of whether the preferred tax base should be consumption or income is partly based on the principles of optimal tax theory and the insights of Anthony Atkinson and Joseph Stiglitz.[6] These insights have become well-known within the academic tax community through the work of Joseph Bankman and David Weisbach.[7] Clearly, from the standpoint

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[2] *See generally* J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971) (introducing the theory of optimal income taxation).

[3] *See* Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, J. ECON. PERSP., Fall 2011, at 165, 167–71 (supporting higher tax rates).

[4] LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 303–09 (2008).

[5] JOEL SLEMROD & CHRISTIAN GILLITZER, TAX SYSTEMS 113–36 (2013).

[6] *See generally* Anthony B. Atkinson & Joseph E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55 (1975) (comparing consumption- and income-based tax structures).

[7] *See generally* Joseph Bankman & David Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006) (discussing optimal tax theory and the AS 1976 tax model).

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of model development and progress internal to its underlying approach, optimal income taxation has been a rousing success story.

But all models rest on assumptions and an underlying framework. Optimal income taxation, as developed by Mirrlees and his followers, is based on utilitarianism. In its simplest form, individuals are assumed to have identical utility functions in income and leisure but differ in their native ability levels. The government is assumed to have a revenue target that it must meet from income taxation. With perfect information, social welfare would be maximized by placing more of the tax burden on higher ability individuals, who have to supply less effort to reach any given level of income. However, since abilities are unobservable, the government is instead limited to taxing *observed* income. The government then faces the problem that if tax rates are too high, high ability individuals will reduce their work effort—effectively pretending to be of lower ability. The resolution to this problem is to balance redistribution and efficiency concerns. The precise solution for the optimal tax structure will depend on the distribution of native abilities in the economy, the form of individual utility functions including preferences for leisure, the institutional structure that allows individuals to respond to higher tax rates through changes in reported taxable income, and social preferences over individual utility levels as measured by a social welfare function.[8]

The foundations of optimal tax theory have been subject to critique by legal scholars and philosophers such as Linda Sugin.[9] But recently, this underlying framework has come under attack even within the economics profession. Martin Feldstein and American Enterprise Institute economists Aparna Mathur, Sita Slavov, and Michael Strain have expressed skepticism over the conclusions of recent policy recommendations by optimal tax practitioners, and questioned the underlying ethics of the entire approach.[10]

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[8] KAPLOW, *supra* note 4, at 18–26 (discussing the broad applicability of the optimal tax framework).

[9] *See generally* Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 TAX L. REV. 229 (2011) (criticizing the optimal taxation model).

[10] *See generally* Martin Feldstein, *The Mirrlees Review*, 50 J. ECON. LITERATURE 781 (2012) (reviewing the positives and negatives of the Mirrlees tax model); *see also* Aparna Mathur et al., *Should the Top Marginal Income Tax Rate Be 73 Percent*, 137 TAX NOTES 905 (2012) (discussing critiques of the optimal tax model, including questions of social policy).

Since marginal utility in most formulations diminishes sharply at high incomes, the well-being of high-income individuals is essentially ignored.[11] This triggered Feldstein's plea: "what kind of nation places no value on the welfare of those with incomes in the top bracket, treating them only as the revenue producing property of the state?"[12]

Other economists have emphasized that the optimal tax approach has implications that would not be generally accepted on common ethical grounds. The work by Gregory Mankiw and Matthew Weinzierl on incorporating "height" into optimal tax theory illustrates this point.[13] Mankiw and Weinzierl note that while pure "ability" is not observable, height is observable, not subject to individual manipulation, and positively correlated with income.[14] Adding height to the tax schedule would in principle be a function of both height and income, giving the government an opportunity to fine-tune its social welfare calculations and permit more redistribution with less distortion.

Mankiw and Weinzierl recognize that the vast majority of people would have difficulty basing an income tax on variables such as height, race, or sex. Yet all these variables are potentially available to the government and difficult to alter. In economic jargon, they are "tags" that should in principle be used in optimal tax calculations. Taking optimal taxation on its own terms, Mankiw and Weinzierl demonstrate that its moral foundations are suspect.

Other economists have noted that the public does not necessarily hold intuitions about taxation that are consistent with the implications of basic utilitarian principles. Weinzierl, for example, conducts surveys that indicate the public is willing to accept the consequences of extra income earned through brute luck and not tax the proceeds away.[15] In other work, he also

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[11] *See* Mathur et al., *supra* note 10, at 907–08.

[12] Feldstein, *supra* note 10, at 783.

[13] *See generally* Gregory N. Mankiw & Matthew C. Weinzierl, *The Optimal Taxation of Height: A Case Study of Utilitarian Income Redistribution*, AM. ECON. J.: ECON. POL'Y, Feb. 2010, at 155.

[14] *Id.* at 156.

[15] Matthew Weinzierl, *Popular Acceptance of Inequality Due to Brute Luck and Support for Classical Benefit-Based Taxation* (Nat'l Bureau of Econ. Research, Working Paper No. 22462, 2016).

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finds popular support for the criterion of "equal sacrifice."[16] Recognizing these problems, Saez and Stantcheva attempt to generalize optimal taxation to nontraditional assessments of individual welfare, but only provide a framework of analysis and not specific, grounded recommendations.[17]

In his Presidential Address to the Eastern Economic Association, economist Gregory Mankiw put forward a provocative alternative to optimal tax theory.[18] Mankiw offered the idea that desert or some notion of "deservingness" might be a more appropriate basis for thinking about tax policy than utilitarian-inspired optimal tax theory.[19]

Mankiw then sketched his theory of "Just Deserts" as an alternative to utilitarianism, an approach to taxation based on the idea that rewards in the markets are, for the most part, deserved.[20] But before reviewing Mankiw's views, his suggestions for taxation and our own, we need to develop the foundations for the theory of desert more fully. Psychologists and philosophers have long tread this ground—but tax policy theorists and economists have only recently begun to explore it.[21] We next review the psychological and then the philosophical foundations of desert.

III. Psychological Equity Theory and Desert

Psychologists have long discussed and analyzed "equity theory." Simply put, equity theory is based on the principle that individuals share a deep psychological and emotional need to have outputs commensurate with

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[16] *See generally* Matthew Weinzierl, *The Promise of Positive Optimal Taxation: Normative Diversity and a Role for Equal Sacrifice*, 118 J. Pub. Econ. 128 (2014) (discussing the role of equal sacrifice in the optimal tax model); *see also* Weinzierl, *supra* note 15 (discussing public reactions to income earned via brute luck).

[17] *See* Emmanuel Saez & Stefanie Stantcheva, *Generalized Social Welfare Weights for Optimal Tax Theory*, 106 Am. Econ. Rev. 24, 24–28 (2016).

[18] *See* Gregory N. Mankiw, *Spreading the Wealth Around: Reflections Inspired by Joe the Plumber*, 36 E. Econ. J. 285, 295–96 (2016) (discussing the concept of deservingness in tax models).

[19] *Id.*

[20] *Id.* The suggestions for tax policy in the text below do not require this assumption; merely that desert is an element of justice.

[21] Thomas Mulligan, Justice and the Meritocratic State (forthcoming 2017).

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inputs. Everyday moral and political judgments are made on these grounds. For example, the debate about workfare—"anyone receiving state assistance must work"—is based on equity theory. While not everyone accepts this view, it does reverberate in public discourse.

Equity theory has been established as a core psychological principle. Consider, for example, the results of a classic experiment.[22] Individuals were recruited to participate in a task based on an advertised wage rate. Before they began the task, individuals were told one of three things: in the "fair condition," participants were paid what was advertised; in the "unfair condition," participants were told that there was an error in the advertisement and they would be paid less; in the "overpaid condition," participants were told that the advertisement had incorrectly listed too high a salary, but nonetheless they would be paid at the previously advertised wage. The individuals were later asked how satisfied they were with participation in the experiment. The results, which have proven to be quite robust across many studies, were that the most satisfied individuals were the ones who were deemed to be fairly paid. Both the underpaid and overpaid individuals received less satisfaction, although the least satisfied were the underpaid.

When individuals face inequitable situations, they can use two different strategies to make them seem more equitable. First, they can adjust their inputs to restore proportionality, for example, by increasing or decreasing their work efforts.[23] As an alternative, individuals can restore "psychological equity" by beginning to think of the task in a different light; for example, underpaid individuals may perceive they were less qualified than others who were paid more.[24] Beliefs and expectations, as well as efforts, can all adjust to restore equity in social situations.[25]

In summary, equity theory is the notion that fairness requires a fundamental balance of inputs and outputs. Equity theory's intellectual

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[22] *See generally* Robert Pritchard et al., *Effects of Perceptions of Equity and Inequity on Worker Performance and Satisfaction*, 56 J. APPLIED PSYCHOL. 75 (1972) (conveying the findings of a psychological experiment concerning the effects of equity perceptions on worker performance).

[23] Evidence for adjusting efforts can be found in J. Stacy Adams & William B. Rosenbaum, *The Relationship of Worker Productivity to Cognitive Dissonance About Wage Inequities*, 46 J. APPLIED PSYCHOL. 161 (1962).

[24] *Id.*

[25] *Id.*

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counterpart in philosophy is the notion of desert or deservingness, to which we now turn.

IV. The Contested Philosophical Basis of Desert

Philosophers distinguish between two types of desert. The first and least controversial type of desert is *institutional*. Suppose that two teams play in a basketball game for a championship. Both teams had practiced hard and played well all season. It was not clear who was actually going to win the final game. Team A eventually won the game because they were shooting the ball especially well on the day of the game and one of the star players on the other team was partly injured during the course of play. Despite the injury, we would say that Team A deserved to win the championship. They played by the rules and scored the most points. No one would have trouble awarding the championship trophy to this team.

A second, and more controversial type of desert, is *pre-institutional*. Even recognizing that Team A was partly lucky in the game due to the injury, they had worked hard all season to put themselves in the position to win the championship. We would generally say that Team A deserved to win and to be praised and rewarded for their accomplishments by virtue of their hard work and putting themselves in the position to win the championship. While they shot the ball well that day, they had practiced their shooting all season. They also put themselves in top physical condition to help avoid injuries. According to the theory of pre-institutional desert, Team A's actions were deserving and worthy of praise regardless of the precise rules for championship play and regardless of the precise physical conditions of their opponents.

Equity theory in psychology and its philosophical counterpart of pre-institutional desert both tie rewards to effort. They are framed without reference to institutional structures. Applying these principles to markets, they would lead us away from policies of redistribution of income and towards the acceptance of whatever outcomes result from market transactions. But this line of thought has come under critical scrutiny from many philosophers.

Tax scholars are probably the most familiar with the critiques of pre-institutional desert from the work of Liam Murphy and Thomas Nagel.[26] They argued that too many individuals are in the grip of "everyday libertarianism" in that they believe that they deserve their pretax earnings.[27] Murphy and Nagel make the legitimate point that since taxes support the system of property rights and property rights largely define the parameters in which incomes are earned, we cannot judge the fairness of taxes per se but only judge the fairness of the system of property rights as a whole.[28] Consequently, individuals do not have a presumptively just claim or "deserve" their pretax earnings, as they are dependent on an extensive system of tax-supported property rights.[29]

John Rawls provides a well-known critique of pre-institutional desert. His argument goes beyond Murphy and Nagel by questioning whether individual motivation or effort can ever be any basis for assessing justice.

> Perhaps some will think that the person with greater natural endowments deserves those assets and the superior character that made their development possible. Because he is more worthy in this sense, he deserves the greater advantages that he could achieve with them. This view, however, is surely incorrect. It seems to be one of the fixed points or our considered judgments that no one deserves his place in the distribution of native endowments, any more than one deserves one's initial starting place in society. The assertion that a man deserves the superior character that enables him to make the effort to cultivate his abilities is equally problematic; for his character depends in large part upon fortunate family and social circumstances for which he can claim no credit. The notion of desert seems not to apply to these cases.[30]

In this passage, Rawls asserts that socially determined differences in character, effort, and motivation, all create unfair advantages, as well as differences in traditional property rights. Rawls does recognize an institutional perspective on desert, but then the equity of outcomes depends on the precise institutions in a society.[31]

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[26] LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP (2002).

[27] *Id.* at 15, 34.

[28] *Id.* at 17.

[29] *Id.*

[30] JOHN RAWLS, A THEORY OF JUSTICE 103–04 (1971).

[31] *Id.* at 310–13.

Another prominent strand of recent philosophical thinking—luck egalitarianism—maintains with Rawls that individuals do not deserve material or natural advantages. It departs from Rawls in permitting an important role in recognizing and rewarding individual effort; once we eliminate the effects of luck in terms of endowments or other natural advantages, we can base rewards on desert. For luck egalitarians, desert would only have a role to play after significant redistributions of income and resources have occurred.

Before considering defenses that have been offered for pre-institutional desert, we need to emphasize that desert is not the same concept as "entitlement." Here is an example: Under Robert Nozick's theory of justice, there are principles of both just acquisition of resources and also just transfer of resources. If resources were acquired justly through actions that were consistent with principles of desert, the owner of the resource could legitimately transfer the resources at will, for example, by providing an inheritance to descendants. The recipients of the inheritance would then be fully *entitled* to their inheritance through the principle of just transfer, but they are clearly not *deserving* of the inheritance, as they have not taken any specific actions to deserve their new resources. Thus, entitlement and desert can diverge.[32] Pre-institutional desert is a stronger concept than entitlement and requires more justification.

V. RESURRECTING DESERT

Many philosophers believe desert should play a larger role in our assessments of justice than envisioned by luck egalitarians. David Miller and David Schmidtz both argue that desert should be an *element* of justice, although they each offer a theory of justice with multiple components.[33] Miller recounts a number of scenarios of conduct that warrant desert, even though luck was clearly involved.[34] A young scientist happens to land a job

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[32] Dale Murray, *Robert Nozick: Political Philosopher*, INTERNET ENCYCLOPEDIA OF PHIL. (May 2017), http://www.iep.utm.edu/noz-poli/ (discussing the distinction between desert and entitlement).

[33] *See generally* DAVID MILLER, PRINCIPLES OF SOCIAL JUSTICE (1999); DAVID SCHMIDTZ, ELEMENTS OF JUSTICE (2006).

[34] MILLER, *supra* note 33, at 143–45.

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in a laboratory with a promising line of research and she fortuitously has an insight that lands her a Nobel Prize. Or, a young man is walking on a levee and notices a young toddler has fallen into the river and jumps in and saves her. In both cases, we still admire the scientist for her discovery and the young man for his bravery, even though circumstances placed them in situations in which their talents could shine. In Miller's words, "Desert is strengthened when opportunities to become deserving themselves depend on the initiative and choice of individuals."[35] Moreover, "It is luck that I was born in the time and place that I was, with the range of opportunities that my society provides. I become deserving by taking these opportunities and producing performances of an appropriate valuable kind."[36] Miller here endorses a "forward-looking" view of desert. While this may concur with our intuitions in some cases, in other cases we may demand to see actions that occurred in the past to warrant praise.

Since philosophers differ on their view of desert, what do ordinary people think? Philosophers Christopher Freiman and Shaun Nichols explore commonly held ideas on desert through online experiments.[37] A control group was given the following statement to read: "Suppose that some people make more money than others solely because they have genetic advantages."[38] They were then asked whether such people deserve the extra money and whether it is fair for them to receive the extra money.[39] They labeled the control group the abstract condition, in that respondents were asked about general principles of justice.[40]

In contrast, the experimental group was presented with concrete situations. One of the treatment groups received the following statement to read:

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[35] *Id.* at 145.

[36] *Id.* at 196.

[37] Christopher Freiman & Shaun Nichols, *Is Desert in the Details?*, 82 PHIL. PHENOMENOLOGICAL RES. 121, 127–29 (2011).

[38] *Id.* at 127.

[39] *Id.*

[40] *Id.* at 127–28.

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> Suppose that Amy and Beth both want to be professional jazz singers. They both practice singing equally hard. Although jazz singing is the greatest natural talent of both Amy and Beth, Beth's vocal range and articulation is naturally better than Amy's because of differences in genetics. Solely as a result of this genetic advantage, Beth's singing is much more impressive. As a result, Beth attracts bigger audiences and hence gets more money than Amy.[41]

Respondents in this group were then asked whether Beth deserved more money and whether it was fair.[42]

What were the results? In the abstract condition, respondents did not believe that those with genetic advantages deserved more money, nor was it fair for them to receive it.[43] In contrast, in the concrete setting respondents believed that Beth both deserved more money and that it was fair for her to receive it.[44] One way to put this result is that in theory people support neutralizing natural advantages, but in practice and when confronted with real world situations they are loath to do so. Thus, in practical situations, people may reject the principles of luck egalitarianism.

A quote attributed to the golfer Gary Player—"The harder you work, the luckier you get"—provides another perspective on luck egalitarianism.[45] Implicit in this maxim is the notion that it is difficult to separate luck from preparation. If someone prepares carefully for an event or contest and succeeds in part because they were lucky, we typically would say they deserved to succeed as long as the preparation was sufficient.

Gary Player's quote is consistent with David Miller's distinction between "integral" luck and "circumstantial" luck.[46] Miller offers as an example of integral luck a poorly skilled archer shooting his arrows into the air and hitting the bull's eye purely by accident. This is just a fluke, similar

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[41] *Id.* at 128.

[42] *Id.*

[43] *Id.*

[44] *Id.* at 128–29.

[45] While this quote is typically attributed to Gary Player, he himself credits another golfer, Jerry Barber, and a similar sentiment was expressed by others at earlier times. Indeed, Player himself used the word "practice" rather than "work." At various times, it has been attributed to Samuel Goldwyn and even Thomas Jefferson. For a discussion of the origins of this quote, see *The Harder I Practice, the Luckier I Get*, QUOTE INVESTIGATOR (May 4, 2016), http://quoteinvestigator.com/2010/07/14/luck/.

[46] MILLER, *supra* note 33, at 143–46.

to someone winning a $1 million lottery jackpot. In these cases, neither the archer nor the lottery winner is truly deserving. In contrast, circumstantial luck corresponds to the case where most of the required conditions for a favorable event to occur were produced by acts taken by an individual.

From the Freiman and Nichols experiments, the public view seems to be that as long as autonomous and intentional actions are an important part of the process of bringing about an event, the actor deserves praise or blame. In the law, we are familiar with the idea that an accident while driving while intoxicated will receive a severe penalty, even though the driver may have been unlucky that a pedestrian was just trying to cross the street. Just because luck was involved does not fully offset the role of individual actions. This legal perspective provides some justification for a pre-institutional role for desert even in the face of luck.

VI. Do Market Outcomes Reflect Desert?

Do economic outcomes in markets provide us with appropriate measures of desert? This is quite a difficult claim to make. The links between market outcomes and individual efforts can be quite tenuous. Our discussion of our own tax policy recommendations below does *not* assume that market outcomes necessarily reflect desert. But it is worth exploring these connections, in light of our prior discussion, to determine what role there may be for desert.

Desert claims have the following structure: *A* deserves *B* in light of action *C*. In the market context, *C* would be some action taken in the market such as supplying labor, capital, or entrepreneurship and *B* would be the market reward.

Here is the basic difficulty with claiming that market outcomes reflect desert. A key result of modern economic theory is that the precise pattern of wages and prices that emerge in any economy will depend on the initial distribution of income or endowments.[47] If income were initially distributed to those individuals who like classical music then, through normal supply and demand channels, classical musicians would earn higher salaries than if

[47] Starting from initial endowments, individuals can trade to improve their situation, but their ultimate welfare will depend on where they start. This is implicit in basic welfare economics. For a classic exposition, see Frances Bator, *The Simple Analytics of Welfare Maximization*, 47 AM. ECON. REV. 22, 31–36 (1959).

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the initial distribution were slanted to rock and roll aficionados. The inherent dependence of market wages and prices on initial endowments makes it difficult to accept the outcomes from an historical set of endowments as a "deserving" outcome.

The related institutional critique of using desert in market contexts contends that the reward structure *B* in a market economy depends on the underlying institutions in the economy and the set of property rights currently in force. Certainly, at some level, the structure of property rights does matter. If patents and copyrights were not enforced, the economy would likely be poorer although the distribution of rewards from innovation and authorship would be less skewed. Murphy and Nagel argue that because taxes support property rights, no independent judgments can be made about the justice or fairness of the distribution of market outcomes.[48]

Many other morally arbitrary factors other than the underlying structure of property rights matter. For example, an increasingly global market allows "superstars" to flourish. LeBron James's jerseys along with Lady Gaga's music can be sold in China and throughout the world, vastly increasing the premium that the very best can earn in the world economy. Why buy a jersey from a lesser player or download music from a less exciting performer?

A somewhat different critique of using desert to justify the structure of rewards in a market economy contends that the rewards that are generated are not reasonably related to the underlying actions taken to generate these rewards. In other words, the connection for person *A* between his reward *B* and his action *C* stretches the notion of desert too far.

Jonathan Weinstein makes convincing arguments along these lines.[49] Weinstein argues that the competitive model fails to account for a great deal of the inequality of resources. Instead, he believes that much inequality can be accounted for by the "superstar" model in which small differences can

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[48] Geoffrey Brennan outlines factors that are important for justice other than the distribution of final outcomes, including process and procedure. *See generally* Geoffrey H. Brennan, *The Myth of Ownership: A Review Essay*, 16 CONST. POL. ECON. 207 (2005) (reviewing MURPHY & NAGEL, *supra* note 26).

[49] *See generally* Johnathan Weinstein, *Fairness and Tax Policy: A Response to Mankiw's Proposed "Just Deserts,"* 37 E. ECON. J. 313 (2011). An alternative argument offered by Nien-Hê Hsieh, *Moral Desert, Fairness, and Legitimate Expectations in the Market*, 8 J. POL. PHIL. 91, 96–98 (2000), is that different actors in the market receive different levels of consumer surplus from transactions. Thus, different sellers selling their goods at the same price generate different amounts of surplus for consumers yet earn the same.

lead to great divergences in income. As we noted, small differences between LeBron James, Lady Gaga, and their competitors in talent, style, and determination can lead to vastly different fortunes and are dependent in a different way on markets. There is an element of increasing returns to scale in the superstar phenomenon, so that small differences in talent can lead to large differences in outcomes. In turn, this may have normative implications:

> Anyone whose output is easily scalable, including inventors, entertainers, and financiers, is able to create value in proportion to the size of the economy. Fairness would seem to dictate that they owe a greater proportion of their income to the upkeep of society than those in non-scalable professions such as hairdresser, teacher etc.[50]

Suppose we do stipulate that there is some arbitrariness to individual reward arising from a superstar phenomenon. Does that fundamentally undercut a justification of market rewards based on desert? Again, the Gary Player maxim may also be useful here. Consider all the basketball players, musicians, actors, and other performers drawn into their respective professions. They know that rewards may be disproportionate for a few and whether they do poorly, well, or extremely well in economic terms may in part be determined by luck and other things outside of their control. But they also know that hard work, commitment, and perseverance can place them in the position to take advantage of any "circumstantial luck" that may emerge. The harder they work, the luckier they get. The average person knows that, apart from winners of the state lottery, it is very difficult to distinguish outcomes based on luck from other deserving actions. Yet, if the differences in monetary rewards are too large, it is hard to make the case that these differences are all deserved.

VII. Taxes Simply Compatible with Desert

In his "Just Deserts" theory, Mankiw offered his thoughts about what types of tax policies would be consistent with a theory of just deserts. What he was trying to do was to provide alternative bases of taxation that respect the market outcomes and not arbitrarily take income away from individuals who are perceived to have earned them. As we discuss below, he does not really use the concept of desert to design his tax policies, but merely seeks to avoid what he deemed arbitrary redistribution from market outcomes.

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[50] Weinstein, *supra* note 49, at 314.

Moreover, his arguments are based on criteria derived from economic efficiency and have nothing directly to do with arguments from desert.

The first class of tax policies Mankiw advocates for is Pigouvian taxes or subsidies to offset negative or positive externalities. Taxes on gasoline, for example, could be used to offset the environmental effects of the internal combustion engine. Carbon taxes could be used to offset global warming. Subsidies to education also might be appropriate if there are positive externalities. In principle, taxes on negative externalities—for example, a carbon tax—could raise substantial revenue.

From the point of view of economic theory, this recommendation is relatively non-controversial. Most economists believe in taxes to offset positive or negative externalities, although the public holds many of these taxes, such as gas taxes, in low esteem. Sometimes concerns are expressed even by economists of the distributional impacts of these taxes, but even optimal tax theorists incorporate them into their bag of tools as long as distributional elements are offset by adjustments to the income tax.[51]

However, to tax on the basis of externalities implies that the gains from earning income that were generated by the pollutions an agent generates are not deserved. This requires an additional value judgment to override the existing market outcomes on grounds of economic efficiency and justify the taxation.

Mankiw also recommends optimal payments for public goods. There is a long tradition in economics going back to the classic work of Paul Samuelson that develops the optimal taxes for public goods—defense, the civil justice system, environmental preservation—based on the underlying utility functions and demand for these goods by individuals.[52] With public goods, market mechanisms are difficult to implement so the task typically falls to government to provide these goods. Mankiw suggests that the demands by individuals for these goods would certainly rise with income; indeed, if the income elasticity for public goods is greater than one, demands would rise faster than income. Thus, taxes based on the provision of public

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[51] This is essentially the approach taken in KAPLOW, *supra* note 4, at 211–17, and thus consistent with modern tax theory.

[52] *See generally* Paul Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. STAT. 387 (2006).

goods could be progressive. The theory again in principle is shared widely among economists. However, the practical task of ascertaining demands and assigning tax shares for public goods such as national defense or the environment remains formidable. And the moral basis here again appears to be economic efficiency, which is distinct from the principle of desert.

The final class of taxes that Mankiw suggests is for transfers to the less well-off based on altruism. As originally suggested by Lester Thurow, aid to the poor can be conceived as a public good in order to improve the income distribution.[53] Under this theory, there is a role for government to supply the public good or transfer income or resources to the poor. The taxation under this category would likely be quite progressive at least towards the poor, but perhaps would not permit redistribution from the wealthy to the middle class, which is often preferred by the public.[54] Moreover, there would be difficulties in ascertaining the correct level of provision for this public good.

What is striking about Mankiw's recommendations is that none of them are directly connected to any particular notion of desert, but instead rely on economic efficiency. While they avoid using the utilitarian calculus, they are simply traditional recommendations that economists make in the name of economic efficiency. In Mankiw's approach, desert simply plays a negative role in ruling out most forms of redistributive taxation. It does not offer a positive theory of taxation based on principles of desert.

VIII. Taxes Based on Principles of Desert

What if we took desert seriously as its own criteria and asked what tax policies would be consistent with our intuitive notions of desert?[55] For this exercise, we simply need to believe that there is *some* element of pre-institutional desert in our social judgments. Our review of the theory of desert clearly supports this: we use desert judgments to critique social arrangements and we do not discount earnings based on natural advantages from being

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[53] Lester Thurow, *The Income Distribution as a Pure Public Good*, 85 Q.J. Econ. 327 (1971).

[54] *See* Rebbecca Reed-Arthurs & Steven M. Sheffrin, Public Attitudes Towards Redistribution Through Taxation, *in* Building Trust in Taxation 311 (Bruno Peeters et al. eds., 2017).

[55] *See* Mulligan, *supra* note 21 (asking a related question: what policies based on desert can enhance a meritocracy?).

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deserving. Thus, taking desert as an *element* of justice seems to be a rather modest claim.

Thinking through the implications of desert can potentially lead us in a number of different directions and with different implications for the progressivity of taxation. There are five different areas of taxation that can, in principle, be influenced by the concept of desert: rejecting utilitarian balancing, the treatment of windfalls, the distinction between "earned" versus "unearned income," inheritance versus estate taxes, and consumption versus income taxation. As we discuss below, the last two topics also require some auxiliary psychological assumptions. Some of the areas in which desert can be applied have politically conservative implications while others have politically liberal implications.

A. Rejection of Utilitarian Balancing

Rejecting the utilitarian calculus of trading off one person's utility for another person's would place limits on the range of potential redistribution away from the rich to either the poor or the middle class. We would not use the argument that the marginal utility of the last dollar Steve Jobs earned may be extremely low, relative to others, to serve as a basis for taxation. To the extent that Jobs materially participated in the creation of innovative and marvelous products valued by millions of consumers, we would not target his earnings (just because they are large) for redistribution, even if he had been fortunate with circumstantial luck.

B. Taxing Windfalls

The principle of desert suggests we should tax windfalls due to luck at higher rates. For example, winners of lotteries who had minimal active involvement in securing their earnings would not "deserve" their income and could be subject to a higher rate or perhaps a surcharge. Bonus payments to officials whose companies receive public bailouts might also fall into this category.

The practical difficulties of distinguishing circumstantial luck (where retaining economic returns are consistent with desert) from integral luck (where they are not) might lead us to draw the windfall exception narrowly. Even those with faith in government generally will recognize how difficult it would be for any government agency to administer a broad program of taxing "undeserved" windfalls. Given all the practical difficulties in administering government programs to compensate individuals for adverse outcomes that the noted lawyer and expert Kenneth Feinberg highlights, one can imagine how difficult it would be in practice to administer programs to tax windfalls on the basis of deservingness.[56]

One of the key difficulties is that some outcomes that appear to be windfalls may not be. While mere lottery winnings may seem undeserved, not all voluntary gambles would be seen as such. Consider, for example, a typical "tournament" to be the CEO of a large firm among its vice-presidents and other potential leaders. The compensation structure of the firm may be designed to place an extremely high value on the compensation of the CEO in order to motivate vice presidents in the company to work extraordinarily hard. The winner of this "tournament" would earn an incredibly large salary that, to some, might seem like excessive compensation and even a windfall. While the eventual winner of the competition certainly benefited from some circumstantial luck, that person had entered a years-long competition and toiled long hours to be in this position. Becoming the CEO does not really provide a windfall under this scenario.

Our common notions of fairness also suggest that we may not want to tax windfalls at confiscatory rates. There is a substantial literature in experimental game theory on the dictator game where one party is given a sum of money and may, but is not required, to give some of those funds to a second party. In practice, dictators do not keep all the proceeds but do give some away (often around twenty percent) to the second party.[57] In some sense, taxing windfalls can be seen as a reverse dictator game, in that the government or society decides how much of the windfall to take.

C. "Earned" vs. "Unearned" Income

Historically, the concept of desert appears to have influenced the tax policy treatment of "earned" versus "unearned" income. At various times our tax code in the United States and other countries have made this distinction, with income from capital—interest, dividends, and capital gains—dubbed

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[56] Kenneth Feinberg, Who Gets What?: Fair Compensation After Tragedy and Financial Upheaval (2012).

[57] *See* Nick Wilkinson & Matthias Klaes, An Introduction to Behavioral Economics ch. 10 (2d ed. 2012).

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"unearned" income and taxed at higher rates. In the 1970s in the United States, for example, dividends and interest payments were taxed at a maximum rate of 70% compared to a maximum rate of 50% for wage income or "earned" income.[58] Income from capital gains has always been treated more favorably, but this difference arises primarily because our system typically requires a voluntary act to "realize" income, which is under the control of the individual. High capital gains rates may cause a decrease in realizations.[59] In addition, there may be concerns about the taxation of nominal and not real capital gains on assets held for long periods of time. Neither of these reasons is because income from capital gains is more deserving than income received in the form of dividends or interest. By 1981, the United States abandoned the distinction between earned and unearned income, but does preserve the distinction between ordinary income and capital gains.

This particular application of desert theory does run counter to a great deal of current thinking on tax policy. Indeed, one popular view about the relationship between tax rates for wages and capital income is that capital income should be taxed at a *lower* rate than wage income.[60] The underlying rationale for a lower tax rate for capital income is that the distortions created by taxing capital (and hence savings) can be so great as to create large losses in economic efficiency.[61] Even the Nordic countries, which are known for their extensive welfare state, have had "dual" tax systems in place that taxed capital income at lower, flat rates and wage income at higher, progressive rates.[62]

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[58] United Kingdom began taxing earned income at a lower rate in 1909. *See* Anthony B. Atkinson, *Income Tax and Top Incomes over the Twentieth Century*, HACIENDA PÚBLICA ESPAÑOLA: REVISTA DE ECONOMÍA PÚBLICA, Mar. 2004, at 123, 124–25.

[59] This is especially true because of the step-up in basis at death. I.R.C. § 1014.

[60] See the introduction by Robert E. Lucas for a discussion of how thinking about capital taxation has changed over time in economics. Robert E. Lucas Jr., *Supply-Side Economics: An Analytical Review*, 42 OXFORD ECON. PAPERS 293, 293–95 (1990).

[61] Diamond & Saez, *supra* note 3, at 175, note that the presence of capital income serves as a "tag" that dictates even higher tax rates for wage income in the Mirrlees framework.

[62] Edward Kleinbard provides a discussion and history of these taxes. Edward Kleinbard, *An American Dual Income Tax: Nordic Perspectives*, 5 NW. J.L. & SOC. POL'Y 41 (2010).

Taxing capital income at low rates, however, potentially does create issues for an approach to taxation based on desert. What about the son or daughter of a wealthy family who inherits a fortune and then just lives off the capital income? If capital income faces a low (or even zero) tax rate, then the son or daughter will enjoy a high standard of living owing virtually nothing in taxes. In what sense could this income and their lifestyle be said to be "deserved?" These considerations often inform practical tax policy considerations. The 2005 President's Advisory Panel on Federal Tax Reform added a personal income tax on interest and dividends to their consumption tax "growth and investment" alternative precisely to avoid this problem.[63]

D. Estate vs. Inheritance Taxation

In another area of tax policy, principles of desert may suggest inheritance taxes as an alternative to our current system of estate and gift taxation. Currently, in the United States we place the focus of our intergenerational transfer taxation on the decedent or donor, while any gifts received are tax free to the recipient or donee.[64] Above a specified threshold, estates and gifts are subject to high rates of taxation. Estate and gift taxes are extremely unpopular as they seem to run against an ingrained American ethos of promoting wealth accumulation and encouraging individual aspirations for success.[65]

Although there is no clear evidence of this point, I would suggest that taxing inheritances does not trigger the same emotional reactions as taxing estates. When we tax an estate, the tax is nominally levied on the same person who ostensibly earned that wealth. From a psychological point of view, this appears to be singling out the same person twice, generating the clear appearance of "double taxation." On the other hand, taxing those who inherit wealth removes the tax one level from those who earned the funds, creating more psychological distance. Taxing a gift as it is made by a donor may in some cases generate the same outcome as if it were taxed when received by

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[63] *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 151, 182 (2005).

[64] I.R.C. §§ 102, 2001–2002, 2501, 2502(c).

[65] An excellent account of opinion about estate taxes can be found in MICHAEL J. GRAETZ & IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH (2006).

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a donee, but this need not be the case. Under an inheritance tax, the distribution of gifts would also matter. For example, a graduated, progressive inheritance tax would create incentives to spread the wealth, whereas the conventional estate and gift tax would not.[66]

E. Consumption vs. Income Taxation

Finally, principles of desert could be used to justify taxes based on consumption rather than income for several different reasons. From a psychological perspective, similar to that we discussed for inheritances, the act of consumption is one step removed from the work and effort necessary to earn income. Certainly, income is necessary to consume, but there are intervening decisions, as well as the passage of time, from the initial exertion of effort to earn income to eventual consumption. Our moral intuitions for respecting income that is earned do seem different than the intuitions that would respect consumption, even if the consumption is ultimately financed—immediately or in the future—by the same income. The decision to consume income, rather than save it, breaks the immediate psychological connection between the efforts expended to earn income and the ultimate consumption of that income. For these reasons, Edward McCaffery and James Hines call consumption taxation "the last best hope for progressivity in tax" in that they believe that higher tax rates and more redistribution are possible under consumption taxation.[67]

A variety of tax experts have suggested replacing our income tax with a cash-flow consumption tax.[68] A cash-flow consumption tax would start with income but exclude net savings before applying the tax rates to the remainder. The structure of this tax should be familiar as it mirrors the current tax treatment of contributions to an IRA or to retirement funds. The amount that

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[66] *See generally* Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1 (2009) (presenting a detailed proposal and analysis for replacing the estate and gift tax with an inheritance tax). *See also* James R. Hines, *Taxing Inheritances, Taxing Estates*, 63 TAX L. REV. 189, 203–04 (2010) (raising some practical issues in shifting to an inheritance tax).

[67] *See* Edward J. McCaffery & James R. Hines Jr., *The Last Best Hope for Progressivity in Tax*, 83 S. CAL. L. REV. 1031 (2010).

[68] In addition to McCaffery & Hines, *id.*, a consumption tax alternative was included in the 2005 report of the PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note 63.

we place in an IRA or a retirement system escapes current taxes, but is ultimately taxed when it is withdrawn. Under a cash-flow consumption tax, individuals would make deposits into accounts that would permit them to deduct this amount before computing their taxes. To the extent that individuals save for the future they will not currently pay taxes, but only pay taxes when they withdraw funds to consume. In addition, as McCaffery has emphasized, a cash-flow consumption tax would ensure that the profligate heir to a fortune would incur tax liability immediately as he or she indulged in consumption, but postpone it if they continued to save and invest their funds.[69]

Cash-flow consumption taxes have another property that is consistent with a theory of desert. Under this type of system, extraordinary returns to capital—that is, those returns above a normal market return as measured by market interest rates—would be taxed fully. For example, if an individual deducted $10,000 from income before computing taxes and invested the money in the stock market, they would be taxed on the full proceeds when the sums were withdrawn. If the value of the stock investment soared beyond normal expectations, the government would share in the extraordinary gains from the investment. Essentially, the government becomes a silent partner in the original $10,000 investment and shares in gains and losses, with the sharing percentage determined by the tax rate.[70]

Consistent with a desert-motivated tax policy, these "windfalls" could be taxed with additional justification because they were not truly earned. If investment gains beyond a normal return are taxed—even at proportional rates—the final result could still be progressive as, by definition, windfalls accrue to the relatively wealthy. Now, under a desert perspective, one could argue that sophisticated investors deserve their extra returns because of their diligence and effort in their investment activities. While that certainly may be the case, one can argue that the relative balance of effort versus luck in this case tilts towards the side of luck. And, the tax here is not confiscatory but simply at normal income tax rates.

[69] Edward McCaffery provides a spirited and nontechnical defense of consumption taxes. EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER (2002).

[70] Not all consumption taxes share this property. Prepaid consumption taxes, such as Roth IRAs where contributions are on a posttax basis, do not provide any taxation of windfall gains.

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We do add a word of caution here. Our conjectures about the psychological effects of inheritance versus estate and gift taxes or income versus consumption taxes need to be subject to rigorous empirical testing of the underlying psychology. For example, while it may seem plausible that inheritance taxes are more compatible with equity theory than estate and gift taxes, there are no empirical studies that provide direct evidence on this claim. Nicole Florack and Steven Sheffrin demonstrate that equivalent tax structures from the point of view of economic theory can generate different behavioral reactions in the field.[71] For example, they find that the willingness to take a second job under a wage tax is less than under an economically equivalent consumption tax. Thus, further empirical work is needed to provide a firmer psychological basis for conjectures relating to the psychology of desert taxation.

IX. Alternative Desert Bases

A theory of rewards based on desert must specify on what basis rewards should be given: philosophers dub this the "desert basis." To this point, we have assumed that some measure of social contribution was appropriate and have discussed in what sense market rewards reflect true social contribution.

But there are potentially other bases on which to make rewards other than social contributions as reflected in market outcome. One common desert basis is *effort*. In the account of the two basketball teams, the efforts that both teams expended in part contributed to our sense that they both deserved our praise for competing in the championship game. Only one team could win the game and that was Team A. But the other team also practiced hard all year and put themselves in the position to compete for the final prize. Most theorists who write about desert give a prominent role to effort in their accounts.

However, giving effort too large a role could undercut any justification for market outcomes. Presumably, the Ph.D. student in social anthropology who spent eight years working on a dissertation put in as much effort into her

[71] Nicole Florack & Steven M. Sheffrin, *Psychological Non-Equivalence of Tax Bases: An Empirical Investigation*, 106TH ANN. CONF. PROC. NAT'L TAX ASS'N (2013), https://www.ntanet.org/wp-content/uploads/proceedings/2013/003-florack-sheffrin-pyschological.pdf.

study as the Ph.D. student in computer science who was able to complete her dissertation in five years and then went on to earn a much higher salary.

Arguments of this nature are familiar to all of us. Effort as well as investment in training can potentially provide a desert basis. This is the sentiment behind comparable worth, where salaries are ideally to be set on the basis of prior training and the skills required in the job. Comparable worth ideas have been adopted in settings such as employment for municipalities where output and performance are difficult to measure and where nonwage benefits, such as generous pensions and flexible work hours, are important components of compensation.[72] While originally this doctrine was explicitly used to narrow the wage gap between male and female employees, the philosophical foundation of comparable worth rests on some notions of desert.

In most large bureaucracies—including public and private universities—salaries are at least partially set by criteria that proxy skill and responsibility.[73] Human resource departments will only "reclassify" employees if there is evidence that a particular job now requires additional specialized skills or educational requirements or that the number of "direct reports" has increased. Of course, human resource departments must respond in part to market conditions, but market conditions are only part of the salary-setting equation in many large organizations. The salary surveys conducted by human resource departments operate as a constraint on the desires of the organizations.

Comparable worth ideas generate very different outcomes than respecting pure market transactions. But both approaches share a common foundation in the theory of desert, differing only in their desert bases. Proponents of market-based measures would naturally contend that effort without effect is not a proper measure for reward; defenders of effort would contend that it is a more robust measure for rewards that are not contingent on market outcomes, which may be affected by many factors extraneous to moral criteria.

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[72] For a discussion of comparable worth by a noted female labor economist, see Carolyn Shaw Bell, *Comparable Worth: How Do We Know It Will Work?*, 108 MONTHLY LAB. REV. 5 (1985).

[73] For a discussion of comparable worth see JOAN PYNES, HUMAN RESOURCES MANAGEMENT FOR PUBLIC AND NON-PROFIT ORGANIZATIONS (4th ed. 2013).

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X. CONCLUDING THOUGHTS

Taking the concept of desert seriously led us to think about several types of taxation in a new light. Desert theories would suggest that we should tax true windfalls, although the difficulties in identifying them and our sense of fairness may limit our willingness to subject them to high rates of taxation. Inheritance taxes conceivably could play a larger role in a desert-based framework. Inheritance taxes can be seen as partly taxing windfalls. From a psychological point of view, they are one step removed from taxing the estates of those individuals who directly generated them, thus perhaps avoiding the label of "double taxation." Desert principles may also suggest a larger role for consumption taxes for similar psychological reasons. As consumption is one step removed from earning income, taxing consumption may also interfere less with the feelings of desert that accompany the act of earning income. In addition, progressive personal consumption taxes that allow deductions for net savings effectively tax windfalls. Among academic tax experts today, one can find strong proponents for each of these ideas—increased taxation of true windfalls, inheritances, and consumption. However, another policy perhaps suggested by principles of desert—taxing "unearned income" at a higher rate than "earned income"—is generally not viewed as favorably by many tax experts today. As an element of justice, desert taxation can play a role in helping us think through the equity of the tax system and suggest a different foundation for our beliefs in redistribution.