

The Case for a Flat Tax

Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE



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Richard A Epstein

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He has been a member of the American Academy of Arts and Sciences since 1985 and a Senior Fellow of the Center for Clinical Medical Ethics at the University of Chicago Medical School. He served as editor of the *Journal of Legal Studies* from 1981 to 1991, and as editor of the *Journal of Law and Economics* from 1991 to 2001.

His books include *Skepticism and Freedom: A Modern Case for Classical Liberalism* (University of Chicago, 2003), *Cases and Materials on Torts* (Aspen Law and Business, 7th edition 2000), *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (Perseus Books, 1998), *Mortal Peril: Our Inalienable Right to Health Care* (Addison Wesley, 1997), *Simple Rules for a Complex World* (Harvard, 1995), *Bargaining with the State* (Princeton, 1993), *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992), *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985) and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects. He has taught courses in civil procedure, communications, constitutional law, contracts, corporations, patents, individual, estate and corporate taxation, Roman law, criminal law, health law and policy, legal history, labour law, property, real estate development and finance, jurisprudence, land use planning, torts and workers' compensation.

Introduction

Rob McLeod, chairman,
New Zealand Business Roundtable

It is my pleasure to welcome you to what I am certain will be a stimulating address by Richard Epstein, professor of law at the University of Chicago and a senior fellow at the Hoover Institution. This is professor Epstein's fourth visit to New Zealand. We are very fortunate to have him again and, in particular, to hear him speak on the case for a flat tax.

The topic is relevant to New Zealand. It is also close to my own heart as chairman of the 2001 government tax review that recommended a move to flatten the tax scale. Our recommendation was driven by the knowledge that the highest tax rates do the most damage to the growth potential of an economy. That is an efficiency argument. In addition, a good case can be made on grounds of fairness for a flat or proportionate tax. Such a tax structure is also administratively simpler.

I am certain that professor Epstein will add to our arguments for favouring a flatter personal income tax scale.

The Case for a Flat Tax

Intuitive fairness and economic efficiency

Originally, I intended to take a non-economic approach to this topic and examine how a concept of fairness would lead one to support a flat or proportional tax. I have deviated from that path and instead will start the analysis with an explanation of how a flat tax derives from a constitutional norm. The non-economic issues, however, never recede entirely from view, for there turns out to be a latent connection between ideas of economic efficiency and certain bedrock instincts that lie beneath that elusive notion of 'fairness'. However, here there is a paradox, because in dealing with fairness our instincts often provide us with a tremendously reliable mechanism to govern human affairs, precisely because they depend on snap judgments that have proved themselves reliable over time. When people try to rethink their instincts case by case, they are apt to stress the refinements and ignore the basics, and come up with conclusions that are wrong. There is little doubt that in dealing with one-on-one personal interactions first impressions really do matter. It is more difficult to show that these impressions work as well for large-scale social issues like taxation. But it is equally wrong to disregard them entirely. As a working approximation, policymakers will often do better if they follow a hard, intuitive rule, unless there is powerful evidence to take a different path. Often, many arguments about fairness amount to intuitive judgments that are dressed up in some grander moral form.

In dealing with these issues, I once thought that this common-sense view of the subject had to dominate on both sides of the political spectrum. That

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conclusion, however, does not jibe with the dominant academic style of today, and it is worth a moment to say why I disagree with the modern trend. My view about taxation is to treat the rest of the world as it is, and then figure out how to raise the revenues required to support the functions that a government does or should provide. There is no effort to tie the design of the optimal tax to all the other institutions of government. But that view has run into the criticism, made most notably by Liam Murphy and Thomas Nagel in their book that carries the provocative title *The Myth of Ownership: Taxes and Justice* (Oxford University Press, USA, 2002), that no tax system should operate on the assumption that all individuals “own their pre-tax income”. Their view is that this pre-tax income is itself a function of the other rules and institutions in society, and thus provides no independent normative base on which to establish a tax system. What is required instead is that we have a thorough understanding of the full range of social institutions needed to constitute a just society.

For all its apparent sophistication, I think that this approach gets it exactly backwards. It is not that these collateral institutions are flawlessly designed. Quite the opposite, I have spent much of my academic career criticising many of them, albeit on grounds that differ from those that Murphy and Nagel might oppose. But that is just the point. We must make our decisions about taxation today, even if we have to wait until the next millennium to rectify all the institutions of civil society. Whether or not people have some deep right to their ‘pre-tax income’ is neither here nor there. It (or their pre-tax consumption) are the only workable bases on which a tolerable system of taxation can rest. There is no way that a system of taxation can try to correct the imbalances brought on by other mistakes in social policy without falling of its own weight. The best that we can do is to treat the taxation issues in relative isolation from the rest of the world, and then move to correct mistakes in other arenas when and if they occur. It would not be possible to decide, for example, that we should have higher tax rates for the profits of firms that work behind protective tariffs or for workers who enjoy unmerited job protection from the state. The intuitive view is the correct one: ignore these complications and get on with the business of taxation.

How then do these various impulses play out in choosing a sensible regime of taxation?

The partnership analogy

In dealing with this question, it is best to begin with fundamentals. A major problem of social organisation is achieving cooperation. Picture the simplest situation where two people are engaged in a joint venture partnership, to which each has to make only a small financial contribution to receive a large gain if the venture succeeds. There are many ways to split costs but regardless of what proportion either party pays, both will be better off after the transaction. Thus there is no determinate solution to the cost-sharing problem, given that multiple distributions will still leave both parties better off than before.

The parties should, intuitively of course, realise that each could manoeuvre to gain a larger share of the surplus generated from the transaction. But, before they march down this path, they have ask themselves whether they wish to bargain over the surplus. Most people recognise that the more they bargain, the smaller the surplus that will be left for them to divide. A powerful focal point thus emerges: the two partners could cut through the morass by following a rule that allocates the gains to their joint venture in proportion to their contributions to it, which has been the dominant default rule for partnerships from Roman times to the present day. From this naive sense of how to organise a partnership in a voluntary setting comes an intuition in favour of proportionality that can be extended from partnerships of two members to those with many more. When generalised to the political arena, this intuition counts as a fairness argument in favour of a flat tax.

The question is whether that intuition can be shaken by a more complete analysis. In particular, I will examine two alternative tax regimes before explaining why, on balance, the flat tax emerges better than its competitors – the politically unpopular head tax and the much more accepted progressive tax. The analysis of how the taxes should be raised must in turn be augmented by one on how they are to be spent. Here, it is possible to make two quite different assumptions about what the government does with the tax revenues it raises – one that concentrates on the provision of public goods, the other that allows for redistribution of income and wealth.

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The simpler of the two is the classical liberal model. Using this model, we start with reasonably coherent definitions of individual liberty and private property and assume that the government will ensure the provision of essential public goods in order to preserve liberty and property. This model requires two further strong assumptions. One is that public goods are perfectly homogeneous in the sense that every individual values the same public good in the same way. We would find this assumption false if we examined many public projects, but it sets an appropriate framework for the initial analysis. The second assumption is that any form of distributive transfer from A to B will not count as a public good, so that such transfers are not regarded as a proper function of the state. At this point, realism is not part of the model, given how common it is in practice for political institutions to take property from A and to give it to B. Some people even define redistribution (often for perverse reasons) as what politics is about. If this process can be achieved by direct expropriation it can certainly be achieved within a regime of differential taxation: people put in an amount of money determined by one formula and receive something established by another. The proportionality rule used for partnerships is violated. As one side systematically loses, the other side systematically gains. However, for our purposes, we do not want pooling arrangements for the supply of public goods to be confused with redistributive arguments.

The simplicity of that first model cannot survive because we are dealing with a modern state where many cross currents exert powerful influences, simultaneously and inconsistently. Sooner or later we shall have to relax the second assumption and presume some forms of redistribution will be allowed. The issues then are these: what is the best method for understanding this redistribution? Are some forms of redistribution more defensible than others? Are arguments in favour of a flat tax sufficiently robust so that, even as the functions of government are expanded, it remains the optimal mode of public finance for these diverse programmes?

Social contract theory

Within these different frameworks, it remains necessary to determine what a tax system is supposed to do. Here, I rely on standard social contract theory. The

words 'social' and 'contract' should be given equal weight. In a voluntary situation a contract is a transaction from which both sides emerge with something greater than they had. The great engine of classical liberalism is mutual gain through voluntary exchange. The lower the transaction costs, the more rapid the exchanges. The more rapid the exchanges, the higher the levels of social welfare.

The word 'social' placed before 'contract' means we are dealing with a different mode of contracting, rather than a subset of contracts. In designing taxes, there are huge transactional obstacles to the construction of voluntary arrangements that ensure everybody contributes and receives a proportionate gain. A 'social contract' signals the necessity for government compulsion, and indicates the end that it should serve. Social contract theory is based upon an assumption that the state will only use force in transactions that make the coerced parties better off than they were before. Therefore, we hope taxes can lead to general social improvement by enabling the provision of public goods that voluntary arrangements cannot produce given the transactional obstacles they face.

This instinct can be formalised. If property rights are established in which individuals have personal wealth, the following question should be asked about each individual, and then about all individuals cumulatively: if a tax is subtracted from your wealth and you are given something back in the form of a public good or service, are you in a better position afterward? If W is initial wealth, T are taxes and B are public benefits, the real question for all persons is whether W is greater or less than $W - T + B$.

Under traditional social contract theory, the primary benefit provided through government action is public order. The assumption that benefits received are greater than taxes paid is based on a general view that the mutual renunciation of force secured by the imposition of public power produces gains that loom so enormous that there is little need to worry about their distribution among individuals. If we believe the social gains are very large then we will not be troubled by the question of whether to supply the good using the coercive power to tax. Even if there were variation in individual temperaments and tastes, it is unlikely many people would prefer to be in the state of nature without any public order.

That is the first condition. It has provided an argument in favour of Pareto improvements – ones that make some people better off without making anyone worse off – through government coercion. So far, so good – but is it good enough? I think not. In effect, all we have learned from this condition is that the system should not be used in a way that makes people subjected to tax worse off than they were. It is silent on the question of how to divide the gains achieved through taxation.

I pointed out that taxation can result in a large surplus that would shrink if all individuals were encouraged, or even allowed, to compete over its division. If there were 1,000 units of gain and a society of 100 people, somebody would figure out how to obtain 15 or 20 units of gain rather than just ten. Everybody else will want the same thing. If competition over the surplus were allowed, the gains achieved through cooperation would be systematically diminished.

However, it may be said that the gains obtained through the social contract may not be ideally proportionate, as they are with dividend distributions. But they are likely to be largely so. It becomes unwise therefore to try to estimate these gains precisely on a person-by-person basis in the vain hope that we could organise transfer payments between citizens to equalise their gains from government action. It is beyond the capacity of human institutions to make those refined judgments. The effort to idealise equal gains will serve as an open invitation to the dissipation of a surplus through political competition.

In addition to meeting a Pareto test, we want to go one step further. Our collective objective is to obtain the largest possible improvements through the most stable form of political organisation. A great advantage of a flat tax or proportionate share rule as used in a partnership is that the surplus will be allocated in proportion to contributions in rough and ready ways that defeat political competition over the surplus. Proportionality is a distinctive, cheap method of allocation. The basic intuitive norm of fairness works to prevent the dissipation of the surplus.

Multiple models of taxation

To advance this exploration we should think about two models of taxation. The first will be a simple and surprisingly uninformative model. The second will start to show the relative virtues of a flat tax.

Homogeneous individuals

First, let us suppose we have a system in which equal and independent individuals are subjected to taxation. But let us also assume in the good old fashion of neoclassical economics that every individual has identical tastes, preferences, wealth and sentiments. What system of taxation do we want? The answer is: frankly my dear, I don't give a damn!

Three possible methods of taxation could be used. One is a head or poll tax – a fixed exaction upon individuals of a sum that does not vary with the amount of income received. Head taxes attract an enormous amount of popular hostility. In a moment I will explain why that hostility is well-founded. The second choice is a progressive tax structure where the rate of taxation increases as the taxable income increases. Marginal dollars are subject to higher rates of tax than inframarginal dollars. The third option is a flat tax where the rate of taxation is constant regardless of the amount of income earned. (For the purposes of this analysis I will exclude the possibility of a regressive tax, which would share some of the characteristics of a head tax.)

If perfect homogeneity is assumed, then this choice will not matter. The head tax no longer retains its sting, because it will impose identical burdens on everyone. To be sure, it is possible to impose a head tax greater than the income of everybody in society. This novel legal regime would produce splendid public goods for people with empty stomachs and no private homes. The political disequilibrium would be so great that it would be instantly rejected by all citizens in one voice. No one wants to be worse off solely because it is a way to make fellow citizens worse off. I doubt whether even New Zealand's most extreme socialists would have a taste for a tax in excess of 100 percent of income for every individual.

How far should the rate be scaled back if the head tax is retained? The answer essentially pivots on the way the supply of public goods is organised. In principle, most individuals want a marginal dollar spent on a public good to yield precisely the same return as a marginal dollar spent on a private good. That is why, generally speaking, people collectively choose to pay larger amounts of tax as they become richer. Nobody wants to live in a grand palace on a run-down street filled with rubbish and potholes. The aim, therefore, would be to lower the head tax until an optimum level is reached. Because,

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by assumption, all individuals are exactly the same, the optimal level will be identical for everybody. And it will leave us all with substantial chunks of disposable income.

Now, let us leave the head tax for a moment and turn to the progressive tax. This only makes sense as a construct if there is income inequality. If everybody were identical, the steepness of the tax scale would be irrelevant. The analysis works in the same way as with the head tax: people will agree to tax themselves to the point where the value derived from spending the marginal dollar in the public sector is equal to the value of the marginal dollar of private spending. Any proportional tax will produce the same result. It can be set to generate the same amount of tax dollars and will be allocated across all individuals in the same way.

Heterogeneous individuals

There is a point to taking this particular parable and pushing it as far as I have. It makes explicit the reason why it is necessary to worry about the choice of tax regimes. People are not identical. Once differential incomes are factored into the mix, the choice of tax regime *does* matter.

Let us array our 100 individuals from one to 100 in terms of increasing income and consider how each tax fares given a broad dispersion of income.

The head tax gets into serious problems very quickly. So long as there is a single person who earns so little that the uniform head tax is greater than his or her income, we can no longer say the taxation of that individual satisfies the general Pareto condition. That person will be reduced to starvation by being forced to consume public goods that are less highly valued relative to the demands of an empty stomach.

The government might decide it could not inflict such hardship on this individual and remit the head tax in whole or in part. However, because the tax rate has been set to allow the provision of an optimal level of public goods, it then becomes necessary to raise taxes on other individuals to compensate for the deficit.

Given variation in incomes, the head tax simply fails to reflect accurately individual desires for public and private goods. Those at the bottom will scream – and with perfect justification. Flat dues for everybody might be appropriate

for country club membership, which sorts voluntarily by wealth, but there will be no political willingness to tolerate a taxation system along similar lines.

At this point, the head tax can be knocked out of contention. The question becomes: is a flat tax or a progressive tax more robust? The arguments grow more difficult.

Having relaxed our assumptions about equal incomes, it is clear that we must do the same with respect to the benefits that individuals receive from public goods. If people are no longer homogeneous they will not attach equal value to any standardised goods.

It is instructive to add another complication, which will start to indicate some underlying problems with a progressive tax. Individual wealth is more comprehensive than a simple measure of individual property and money in the bank. Wealth can be thought of as the sum of hedonic pleasures and financial assets. By hedonic pleasures I mean things as mundane (and vital) as good health, happy relationships, being able to laugh and enjoy life. When somebody's income is taxed and that person is supplied with, for example, police protection, the government is not only protecting their property but also their liberty and hedonic resources, both of which fall outside the conventional tax base.

Large differences of financial wealth obviously exist. But, setting aside people who are seriously ill, the dispersion of hedonic wealth in society will generally be much narrower. In addition, the variations that do remain will only imperfectly track the differences in financial wealth. The different metrics respond to different elements in an individual's life.

A flat tax hits financial wealth but the revenues it generates are used to protect both financial and hedonic resources. It follows then that redistribution will occur towards people who are relatively poor in financial terms. Suppose, for example, that a society's hedonic wealth varies by a ratio of 1:5 and its financial wealth by 1:10. The government taxes on the 1:10 ratio and returns a gain to individuals on the 1:5 ratio. There is a greater rate of net return from government expenditures to individuals with lower financial wealth. To give one example, a person who has \$1 million in cash income could have hedonic wealth of \$750,000. The person who has

\$100,000 in cash income could have hedonic wealth of \$250,000. A flat tax of 10 percent on both yields \$100,000 from the first and \$10,000 from the second. However, the benefits it generates protect \$1.75 million for the first person, an effective return of 5.7 percent, while protecting \$350,000 for the second, an effective return of 2.86 percent, which is obviously lower. Those disparities will increase for persons of much lower financial income.

It would be a mistake, therefore, to believe a flat tax has no redistributive component. That would only be true if public resources solely protected financial assets. But that is not true if one believes the function of government is to protect property and liberty. Liberty has major non-pecuniary elements.

Again, we must add another dimension: the political equation. Any system of taxation or provision of public goods requires a state for administrative purposes. This state will not be a perfect machine that allows individuals to accumulate income and that distributes public goods flawlessly. There will be many frictions and tastes to consider.

I will put aside the serious problem of the allocation of public goods, other than to mention that, given the vagaries of the political process, it cannot be assumed that the benefits of a public good are evenly spread across all individuals subject to taxation. Everybody in Auckland could be taxed to fix up roads in one suburb, with the result that a public good would be created by a regime that combines neutral taxation with major wealth redistribution by area. However, I shall assume such problems can be solved in order to continue to focus on the taxation side of the equation. My task is to explore the reasons that might be advanced to prefer a flat tax over a progressive tax.

The virtues of the flat tax

The flat tax is robust and unique. Once a government has decided on a flat tax, be it by legislative choice or constitutional design, it does not need to face the prospect of periodic alterations in the form of the tax to take into account matters like inflation, changes to standards of living, and so forth. If the government needs greater revenue it simply raises the flat rate. If it needs less, it lowers the rate.

The tilt in taxation is thus properly taken out of the political process. The government is left in the convenient position that it could, if necessary, spend 100 percent of national income on public sector operations through a flat tax. The flat tax is not, as some have proposed, a limit on the percentage of gross domestic product that can go through the government's coffers, although this might be desirable for other reasons. Such a tax does not starve a government. Most importantly, it does not require any reconsideration of the rate structure as the percentage of income that has to go into the public coffers goes up or down. The fixity of form reduces political friction by eliminating one dimension on which bargaining might take place. It is all short and sweet.

The vices of the progressive tax

This point is important because some people incorrectly assume a progressive tax has the same characteristics as a flat tax. Yet, within canonical definitions, a progressive tax might have a marginal rate for the first dollar at 30 percent and a marginal rate for the last dollar at 30.1 percent. Alternatively, a tax also counts as progressive if it starts at zero and goes up to 100 percent. Once somebody decides to favour a progressive tax, they must address the uniqueness theorem: which particular progressive tax rate structure do they support out of the billions of schedules that could be conjured up, all of which satisfy the definitional constraint? In answering this question, the defender of the progressive tax will point to the undisputed proposition of the diminishing marginal utility of wealth. Move out far enough on the income scale and the *n*th dollar generates less utility for its owner than the first. But that proposition conceals the same difficulty associated with the ideal structure of the progressive tax, which in principle depends on the *rate* at which the marginal utility of money diminishes. The more rapid the rate of diminution in utility, the more attractive the case for the progressive tax, for it means that each extra dollar taken from the rich is worth less than would otherwise be the case.

But again, how do we decide what the rate is, whether for any individual or for a taxpaying population as a whole? Here, the first point is that the marginal value of an additional unit of money, which could be used for an

infinite set of purposes, diminishes far less rapidly than the marginal utility of the tenth home, or the thousandth CD, or the fifth charitable venture. Indeed, the well-publicised holdouts by well-heeled athletes and entertainers suggest that the rate of decline is probably lower than many egalitarians suspect, if only because of the enticing prospect that additional wealth brings on to the scene new opportunities – for example, civic leadership, fine art – that are largely closed to individuals with lesser wealth. When we combine this with the fact that non-pecuniary income is both high and imperfectly correlated with wealth, the question, *how rapid* is the diminishing marginal utility of wealth?, does not receive a definitive answer.

Important implications follow from this set of observations. If our advocate cannot come up with a principled, intellectual answer to setting the rate of the diminishing marginal utility of wealth, then he or she cannot do the same with the marginal increases in the rate of the progressive tax, so the task effectively becomes a purely political matter. It is political because no principle will point to the desired conclusion given the muddy substrate on which the discourse takes place. Without principled argument, setting tax rates must be a consensual activity in which it is difficult to avoid a strong division of opinion and clash of wills. There will never be anything close to uniform agreement. Without that agreement, legitimacy is difficult to obtain in the first instance and to retain over time. The process of figuring out the optimal level of progressivity will create uncertainty and dissipate political capital that could be better spent on productive activity in either the public or private sector.

Unfortunately, the progressive tax has these political dogfights ‘built in’. It is no accident that the United States has seen endless political debates as it moved from the Reagan scale, which topped out at below 30 percent, to the Bush I scale that hit around 35 percent, to the Clinton scale that edged close to 40 percent, and to the Bush II scale, which is back to around 35 percent. The one good piece of news is that no working politician today will support income taxes at over 40 percent, which means that the intellectual climate on the subject has happily changed from the pre-Reagan years where rates of 70 percent (and even 91 percent) were introduced, only to be

mitigated by unprincipled tax shelters that worked for some people in high brackets but were of little or no use to others.

In some sense, this is a major achievement because the rhetoric of the progressive tax always calls for making the tax steeper via a one-way ratchet. Thus, one divisive and recurring feature in the debate has been the claim that when taxes rise any increase in progressivity is an increase in fairness. Yet when cuts are on the horizon, the proposal is never to go back to the old rate structure. It is to cut back more steeply at the bottom, so that today the bottom 50 percent of the taxpayers contribute about 4 percent of the taxes paid by the public in general, with many in the zero tax bracket. But why should any flattening of the rate structure be subject to the divisive charge that it is a sop to the rich? This rhetorical ploy inspires people to worry more about envy than productivity. The ensuing debate does not produce anything particularly useful.

Let us suppose, however, that we can avoid those rhetorical flourishes, and adopt an approach that looks to get to the optimal level of progressivity from where we are at the moment, and is indifferent to the political fallout of raising or lowering the steepness of the curve. What next? There is a deep dilemma here. If a government adopts a low level of progressivity – say an ‘almost-flat-tax’ that increases from 20 to 25 percent – the quizzical response is ‘why bother?’. The government will not gain enough additional revenue to make it worthwhile, yet it must bear the costs of the additional administrative complexity. A person on a low income will obtain a slightly larger share of a somewhat smaller pie as the progressive tax shrinks the economy somewhat. Multiply the two variables together and the outcome is likely to be close to a wash: this person will be no better off than before. The people at the high end of the scale, however, will receive a smaller share of a smaller pie: they are unambiguously worse off. This is a lose-lose situation. ‘I can make you much worse off, so long as I hope to be no worse off myself’ does not seem an ideal campaign slogan. The more naive win-win approach should have a lot more appeal, even to people who have never heard of the principle of Pareto improvements.

So, it looks as though we have to choose a much steeper gradient to make progressivity worthwhile. But this alternative immediately runs into the

problem that decisions by citizens about where to set up their homes and businesses are not independent of the tax system. This is a dynamic, not static world. Faced with a very steep progressive rate, the rich and enterprising will leave. Exit rights can be a very powerful force for restraining taxation. The United States illustrates this point. There is little progressivity in state income taxes because people who live in California can readily relocate to Nevada, which has a lower tax structure. Each state government would rather have 10 percent of something than 25 percent of nothing. Tax competition causes state governments to exercise restraint. It is particularly relevant for a small nation like New Zealand, which must worry about tax havens in Britain, Switzerland and elsewhere. The implementation of a very steep progressive system would create the significant danger of an exodus of the successful people who make lives better for everyone else.

A less drastic version of this risk affects a much larger group of people, albeit to a lesser extent. This is the risk of decreased production. If taxes are high, the most productive individuals in society will reduce their effort. The total base will shrink, and, as Martin Feldstein always reminds us, we lose *all* taxes on the economic income that is forgone. To maintain a given level of public goods the government must increase taxation, further reducing overall production. This is a vicious cycle that can only end by a reversal of policy that is difficult to engineer, as I noted earlier, given the political heat that the topic generates.

Long before these matters became formalised Adam Smith advocated a regime of 'easy' taxation that treated individuals as though they were in a partnership such that each had to contribute in proportion to his or her stake, that is a flat tax. The word 'easy' is not particularly technical but we know it does not mean having a 98 percent top tax rate, as Britain had at one point in the 1970s. No proportionate tax is remotely sustainable at that level.

There are other risks. A progressive tax system will provoke private and political responses. In the United States, there is a close correlation between high marginal rates of taxation and the proliferation of senseless tax shelters, such as accelerated depreciation, oil depletion allowances and interest deductions. Political representatives tend to act at the behest of high-income

earners who would be savaged by high progressive tax rates. Instead of changing the general tax rate, which could provoke political and populist opposition, politicians tinker with obscure provisions to allow the wealthy to squirrel away millions. Few people understand the loopholes besides those who benefit from them. High progressive tax rates coupled with gaps in the tax base create genuine unfairness because people at the same income level pay different rates according to their private expertise, their pattern of investments and their political clout.

An advantage of a flat tax applied to a broad base of income is that the same amount will be collected by the government regardless of the taxpayer's identity. Under a progressive tax system, who pays and when they pay become very important. This leads to inefficient economic transactions designed to obtain private gains with no social benefit. Family partnerships, deferred compensation devices and complex trust arrangements become popular ways to 'split' income to take advantage of the low marginal rates on the first dollars. Some of these occur 'naturally' while others are put in place with the explicit aim of minimising tax liabilities. Rules are needed to allow the government to curb evasion. Provisions dealing with family partnerships and trusts, income averaging across periods of high and low incomes and imputation arrangements all clutter the tax code and introduce the equivalent of an arms race as clever lawyers find new loopholes that reformed-minded legislatures then diligently plug.

This is no small matter. Probably somewhere between one-quarter and one-third of the complexity of any tax code is a result of having to deal with problems created by a progressive scale. These provisions are difficult to administer and understand. They reduce the level of transparency and increase popular cynicism about the system. At this point, the proper inquiry shifts. No longer can we ask: what is the right way to apportion taxes on the assumption that the choice of tax regime does not affect overall levels of efficiency? Now it is: what kind of resource loss are we prepared to suffer to implement the uncertain ideal of a progressive tax? One cannot help but draw the conclusion that we should prefer, to coin a phrase, 'simple rules for a complex world'.

Selling the flat tax

Given its intrinsic merits, the next question is how to sell a flat tax system politically. Suppose a society supports redistribution. If you do not believe in a progressive tax rate, you have to find some other way to handle that social function. What might that be?

Part of the answer is negative in form: the tax system should not be the only mechanism for redistribution. If redistribution became a prime objective of the tax system, then pushed to its logical conclusion there would be a fairly large portion of the population paying no taxes whatsoever to support government operations. Politically, that is an extremely unstable situation – people would be able to vote for additional expenditure without bearing any share of the burden. The entire dynamic of public discourse would change, and for the worse.

To avoid that risky state of affairs, I would proceed as follows. First, the government should sort out the provision of public goods, then get private markets organised and regulated efficiently. Only when these jobs are complete should it consider how many people need substantial assistance or protection. If the first two tasks have been done well, the number of people in need should shrink over time in a growing economy. If the group is very small, the government could consider whether private means of support – for example, charitable contributions and friendly societies – would solve the problem. A progressive tax regime is not going to do the entire job because the most it could achieve is to reduce anyone's tax liability, in the limit, to zero. Under a progressive system, nobody can receive a level of income greater than what they earn before tax. In cases of serious need, there will have to be a direct transfer.

Thus, a flat tax system could be coupled with an explicit transfer system based on criteria that establish who should qualify for welfare assistance, and what form of assistance they should receive. Rather than redistribution occurring solely through the tax system, such transfers are a more efficient, powerful and comprehensive means of redistribution.

Here is one illustration. During the Clinton welfare reforms in the mid-1990s there were warnings that many people were dependent on the system

and that cutting welfare would lead to massive dislocation and chaos. This baleful prediction never materialised. The lesson is obvious. If a government tells a group of people that they are hopeless and will always need help, it is in the interest of group members to remain dependent on others. But, if the same group is told the rules for receiving public assistance will be made a little tougher, many will change their behaviour and become more self-reliant. The challenge is to incentivise people to look for feasible market alternatives for obtaining income rather than relying on open-ended welfare provision. People who are poor are not immune to those incentives.

It also needs to be remembered that a flat tax itself brings about significant redistribution when used to fund these social programmes. Typically, those on higher incomes pay more in absolute terms while they often make less use of government services – for example, they may use private means to protect their property. And, as we have seen, the redistributive aspect of a flat tax is even greater when non-pecuniary income is taken into account.

I conclude that a flat tax combined with a transfer system allows considerable scope for redistribution while a progressive tax creates less wealth to redistribute in the first place. When the overall questions of wealth production and wealth transfer are combined, the flat tax emerges as a very powerful, durable and simple institution.

On this point I am not alone, for it is no accident that every strong defender of limited government has gravitated toward the flat tax. This is true of John Locke, Adam Smith and Friedrich Hayek. Nobody would attempt to put themselves in that league, but I shall cast my vote with the giants and let those who dissent find some other champion – perhaps Karl Marx. In sum, the best way to sell the flat tax is to make clear that it works to raise the welfare of everyone, simultaneously. Banish envy, and the battle is half won.

Questions

Would you extend a flat tax to capital?

In designing an income tax it is necessary to decide what the base of taxation ought to be and then to apply a flat rate to assessable income. If you examine the work of economists Robert Haig and Henry Simons, among others, you will discover they treat capital appreciation as an increment in net wealth, and therefore as a form of income. With a comprehensive base, at least certain capital gains would be treated the same as other income. New Zealand's accruals regime has this property. When progressive taxes were introduced in the United States for ordinary income, fairly sharp limitations were imposed on the taxation of capital gains. The ensuing rate differentials had the unattractive effect of spawning a new industry that converted earned income into tax-exempt capital gains through mechanisms such as intermediate corporations. Expenditure discipline coupled with a low flat tax on a relatively comprehensive definition of income has a lot going for it.

There is another way to approach the problem, which I have come to favour. If capital gains were exempted from ordinary income taxes, the result would be a significant move toward a consumption tax. The gains would be exempt until they were spent or consumed in ways that were properly subject to tax. However, a complete exemption may not be desirable because it might allow capital gains that should be taxed at some point in time to fall outside the system altogether.

Another possibility is to forgive tax when capital assets are sold if the proceeds are reinvested. The state would only tax the net gain after individuals had traded their capital for cash. Sophisticated investors would receive very

long deferrals but these would be justified by their willingness to allow the productive deployment of their capital by others.

My current position on these issues is to recommend one small change to the internal revenue code of the United States, which might have a parallel in New Zealand. Section 1031 of the US tax code says that when people are engaged in an exchange of properties (excluding securities and stocks) then the gain will be exempted from tax. The parties will, in effect, keep their old basis (the figure on which gain and loss is ultimately calculated) for their new property and the gain will be picked up later with some other taxable event. If you took away the above parenthesis and followed the same formula with stock, you would create a huge exemption. Because stocks and other securities are fungible assets, it could result in a more efficient capital market. That would avoid many tricky issues such as how to deal with durables if you wanted to shift overtly to a consumption tax.

Another variation on this argument is to exempt savings from taxation until they are withdrawn from certain types of accounts. Because compliance would be easy, this would get you 80 percent of the way toward a consumption tax. The price of replacing an income tax with a consumption tax is a higher rate on a somewhat smaller tax base. On balance, however, I believe that over time this would be a better system than the status quo.

A more radical option is to scrap income tax and adopt a value-added tax (VAT) – almost by definition a flat consumption tax. If a flat tax were imposed on the purchase of a house and amortised over the property's life, the fact that a one-off payment is made up front does not matter. In terms of present value, it is the same as taxing the rental value of the property on an annual basis over its economic life. The moment you introduce progressivity into a VAT the system becomes complex and will not work.

Which of these options is best? The variations I have discussed have small differences in overall efficiency, and all are far more preferable to any steep progressive tax system. The question is a hard one but often the harder the question, the less important is the answer. If that is the case, I am willing to be ecumenical on the second-order question so long as people will join me in being somewhat dogmatic on the first-order question.

How does the idea of eminent domain relate to a system of taxation? How should we understand the concept of 'no taxation without representation and consent'? In New Zealand, the 1981 Public Works Act states that property will not be taken by the state unless fair compensation is provided. Is there an analogy with the taxation system?

There is a precise analogy. Taxation and eminent domain are a perfectly continuous non-discrete problem. How do we know that? The answer is that if you decide you do not want to pay tax, some public official will put a lien on your property. That surely counts as a taking.

The next question to ask is whether the lien imposed on everybody should be judged by different standards from a lien imposed upon one individual because the state needs that person's property for the construction of a public work. In my book *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985), I argued that exactly the same rules ought to apply. This approach leads to the conclusion that taxation should not be based on an ability-to-pay theory but on what used to be called the benefit theory of taxation. In effect, taxes are calibrated to give benefits to the people who are taxed. That leads to the same argument that I began with: the benefit must exceed the total amount of the burden.

This principle has been eroded in the United States and elsewhere through a sleight of hand. The key issue is to establish the baseline on which the benefit should be measured. Every time an exaction by taxation or eminent domain is proposed, it should satisfy the test of an improvement at the margin before it is allowed to go forward. Public coercion will generate huge improvements when tax is first applied. Subsequent increases in tax will generate smaller improvements. At some point the return on money used by the government will be less than its return in private hands.

Citizens must be satisfied that a system of taxation to fund government services would put them in a better position than if they were in a state of nature. But is that the only baseline that matters? Consider this example. Suppose you were paying taxes of \$100 and receiving benefits of \$1,000, for a surplus of \$900. Then a \$500 tax is proposed for a \$100 benefit, cutting your surplus by \$400. You are still better off than you would be in the state of nature, but the second exaction is welfare-reducing. Sometimes people have allowed

the second tax to pass because if the two imposts are combined the party taxed still enjoys \$500 in surplus from both government actions combined. Some writers think that all this is fine. To quote Justice Harlan Fiske Stone, “The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organised society, established and safeguarded by the devotion of taxes to public purposes” (*Carmichael v Southern Coal & Coke Co*, 301 US 495, 522 (1937)).

Under that approach, the only grounds to oppose a particular regime are those that literally call for an exercise of the right of revolution or withdrawal from the social compact. That means that all taxes pass muster no matter what their content. That approach yields much too much freedom to political actors. Rather, the right way to proceed is to be unrelentingly marginalist. You must justify every coerced action. A new intervention cannot be used as a justification for eroding the surplus that had been created by previous government actions.

Consider another example, a public road built beside somebody’s property. The road costs \$100 and the property owner’s share of the cost is \$10.00. The value of the property increases by \$90.00. The government then says, ‘we gave you the public road, so we can impose a tax of \$89.00 on what we’ve created’. This aggressive approach will never be conducive to public improvements. Nor is it defensible intellectually.

The basic theory of limited government has a profound solution to the problem of allocating the social surplus from public improvements. It holds that the disposition of money and resources will generally be achieved more efficiently by private means than public. When intervention is needed to overcome coordination and holdout problems among private individuals, the state should be able to cover its costs but no more.

The social welfarist view is that the state can take as much as it wants so long as it leaves the individuals who benefit with at least a cent’s worth of advantage. In the example of the public road, that means that if the value of each owner’s private property increases by \$90.00, the tax could be up to \$89.00. Under the theory I have discussed, if your pro rata share of the expenditure were \$10.00, that would be your maximum exposure.

To recapitulate, the first condition I set was a Pareto optimum – that an improvement benefits some people while making no one worse off – and the second condition was that the allocation of the surplus be fair across individuals. In a public works context that second condition turns out to be extraordinarily important to limit the endless increase in the size of government. There is a striking implication here for general social-welfare theory. A typical economist is a pure Paretian who believes in what I like to call the theorem of North-East Ho! From the starting point, the economist will be happy with a move somewhere along a diagonal in that north-east quadrant because both sides are better off and the slope of the change does not really matter.

While that conclusion makes sense for ordinary bargains, where the parties can determine the allocation of the surplus, it is not a strong enough condition for regulating coercive public action. When people have the chance to bargain over the slope, the surplus will be dissipated. What would work would be a proportionality rule keeping you on a 45-degree line – everybody gets an equal portion of the surplus and nobody can claim more than others. That is what makes the rule enormously powerful. It is the only rule that satisfies the Paretian condition *and* stabilises the surplus that is created by sensible government policy.

When you are dealing with the burdens of taxation, you are looking at people in a defined geographical area. You can assess the burdens with some confidence. But the benefits of public goods are very difficult to value and the distribution of them will always be lumpy. In an earlier example we taxed everybody in Auckland for the improvement of roads and spent all the money on one part of town. That strategy just does not past muster. You need a crude matching system. If all the benefits accrue to the west side of town and none to the east, you have two choices. One is to use special assessments so that a property owner in the east is not taxed. The second is to impose general revenue taxes only on people who live in the west. The point is to have the taxes track the benefits to the extent that is possible.

Unfortunately, the assumption that the two regions are hermetically separated is usually indefensible. The problem is that westsiders use roads

in the east and eastsiders use roads in the west. If you resort to the taxation of general revenues, you will do it about right if you are going to spend roughly as much on one side as on the other so as to equalise the burden across town. I think the preferred solution is to have good government by careful control on the expenditure side, rather than trying to fiddle with multiple regimes of taxation for each project. The tax accounting can get too complex for its own good.

The basic principle of linking funding to benefits does not always point to an income tax or some other general revenue source. Taxes on real property are often very weak proxies for services received. A better system may be a user charge in a form such as a toll or a smart card. If methods of metering and monitoring become available with new technologies, what were once public goods will become private and the problems of collective evaluations and lumpiness will be no longer with us. Roothing is a case in point. This is simply the modern application of the older principle that when user charges are feasible, generally speaking, they will be preferable. Maybe charges should not be at the 100 percent level, having regard to externalities, but they can make up a good part of the revenues needed to maintain services.

Have you got any views on the consequences of making interest non-deductible and non-assessable? Taxation of savings has been a contentious issue in New Zealand.

In New Zealand, if you save you are taxed on the interest you receive. Interest deductions on home mortgages are not allowed. I believe this is the right view. Unless the implicit income from housing services could be taken into account for tax purposes – and it is difficult to impute a rental value – the deduction should not be allowed.

The Haig-Simons definition of income is consumption during the taxable period plus the increment in net worth. If taxation of imputed income from home ownership is ruled out for practical reasons, so that it falls outside the tax system, you are now in a second-best world. If someone has an imputed income of \$1,000 a year and has \$800 in mortgage payments, the right rule says that if the \$1,000 income is within the system then the \$800 is also in the system, so the person should be taxed on the net \$200

benefit that they receive. But, in effect, what you have done is take the \$1,000 of imputed income out of the system because you do not think you can measure it. Once that move is made, if you leave the \$800 as a deduction you are treating the individual as if they have suffered an \$800 loss when in fact they have made a \$200 net gain. That would create an additional artificial subsidy in favour of home ownership.

When you run a taxation system you should avoid having any friends. You should be disliked by everybody equally so that all subsidies go, including ones for favoured constituencies. The argument in favour of the deduction of interest payments for home mortgages in the United States is very similar to arguments for the protection of small businesses from competition: 'this is a nation of homeowners and the state ought to subsidise housing to give people an ownership stake in society'. But what about those renting apartments? They do not benefit in the same way as homeowners from this preferred regime yet they have to pay more in taxes than the direct beneficiaries. Somebody might respond by proposing a write-off on their rental. Now everybody gets a subsidy and you have another distortion – too much housing relative to other goods. You do not fix one distortion by creating another in a second market. Instead, you should push back against the original error and try to eliminate it.

Unless you can find a reason for a subsidy, I think you ought to follow the old nineteenth-century maxim that the distribution of activities in a pure pre-tax world is the one you should aim to preserve in a post-tax world. That suggests equal taxes at low levels on any two substitutable activities to discourage people from moving from one to another for tax reasons. To that we could add the modern theory of public choice that tells us that tax deductions and preferences do not come from heaven – they are all generated by political manoeuvres. In addition to undermining sound resource allocation, rent-seeking for such tax treatment creates the additional problem of political intrigue and class strife.

Some years ago I gave a talk in New Zealand on the benefits of 'boring' courts. What I was getting at was that when you have large numbers of standard, virtually indistinguishable, transactions you want rules that are easy

to administer – such as a tort law that does not have to take into account unobservable differences in individual utility for money when two parties collide on the highway. The same goes for taxation where billions of transactions are involved. The moment you introduce complexity you have a billion problems a year instead of one common solution. Keeping it simple is the only way to ensure transparency and balance, which are crucial to the integrity of the political process and people’s sense of fairness. The only outstanding question concerns income redistribution. As I have made clear, this difficult topic should be examined *last*. The gains from trade should first be exhausted, then interpersonal comparisons of utility considered. Never do it in the reverse sequence.

You mentioned ability to pay, which is essentially the Marxist idea, ‘from each according to his abilities, to each according to his needs’. Progressive taxation was also a Marxist idea. How do you see the link between the two?

You can certainly find people who believe that the more you have, the more you should be taxed, for that reason and that reason only. Most of them would say that diminishing marginal utility of income means that you should tax to the point of equal sacrifice.

However, there are problems with this argument. As I have mentioned, the utility of wealth declines less rapidly than that of money. Nor is it safe to assume an equal appetite for money. The equal sacrifice test necessitates inquiries of each and every person. It necessitates an accumulation of information that is impossible to obtain. The very difficulty of measuring the benefits people receive from public goods is matched by that of trying to establish the marginal utility of an additional dollar to diverse individuals in society.

Even establishing a representative person’s level of sacrifice is impossible. Nobody knows the reservation price of anything they own until it becomes a potential target for exchange or confiscation. For personal items, the reservation price is much greater than the market value. In the end, supporters of equal sacrifice must simply say, ‘we think the optimal amount of sacrifice is such and such’. But who knows if that amount is constant at all income levels? There is no way you can describe an equilibrium that is publicly verifiable.

Another thought experiment on progressivity is to examine how much redistribution takes place through private and informal mechanisms. In concrete terms, if you start with families, you may already be up to 60 or 70 percent. Small children do not earn anything but they get something. The person who earns less than his or her partner does not live in the garage: the standard of living is about the same within a family. The moment you make redistribution a state function you have necessarily compromised it as a function of a family, church or other effective group. This is what has happened in practice. Charitable giving has gone down sharply with the expansion of the social welfare net. Now, people tend to give to research programmes and educational scholarships rather than to alleviate poverty because they see that task being taken care of by the welfare system.

Would charitable giving to alleviate poverty revive if the state backed away? I do not know. But if you worry about redistribution last, there will be very few people earning below a minimum level of support. With a smaller problem, a much easier solution will be available through either private or political means.

Issues of compliance costs and entity taxation add further weight to your argument. Compliance and administration costs are higher under a system with multiple rates. Most capital income is taxed at the level of the company or some other entity. Arguably, the flat tax better manages the integration of entity taxation with tax on individuals.

I fully agree. I would add a third point to the two you mentioned: tax evasion. When the marginal tax rate is higher, it is more likely that people will use evasive devices. Barter transactions will occur to avoid or evade tax. Barter is always less efficient than exchanges based on money but the loss to the individuals involved may be smaller than the total tax avoided.

The costs of a progressive system are vast relative to those of a simpler one. Every time you shrink the tax base by increasing deadweight costs you have to increase tax rates in order to maintain revenue and the same level of public services. In the end, that turns out to be unsustainable. Members of the public will eventually decide they do not want to enjoy tree-lined streets if they all live in dismal hovels.

In all of these cases, the mark of a well-organised political system is the rough estimation that the marginal dollar in public hands produces as much benefit as it would in private hands. When resources are in public hands, individuals do not have anything like the same level of control over the mix of goods and services they need. This brute fact means there must be a strong public goods justification for government provision, otherwise the argument favouring individual competence for individual consumption decisions dominates. Take the case of the public road. Public demands for public roads are quite uniform because the road has a single use that all can share, regardless of the reasons for their trips. However, people going to a supermarket with an equivalent amount of cash are not going to choose the same groceries. An instructive way to figure out the level of individual consumer surplus is to ask yourself how much you would be willing to pay for somebody else's bundle of goods at the check-out counter. Typically, if you do not choose the bundle of goods yourself and it costs \$100, you may be willing to pay \$40.00 or \$50.00 for it. The other person will have exactly the same estimation of the value of your bundle of goods. Clearly, who gets what matters a lot.

The variety of consumer products that we observe indicates the disparity in tastes. The secret is to make sure public goods are sufficiently limited in number that the variance in value to individuals will not be great. That is why buildings along a street are usually very individualistic, while for the most part streets should have standard sets of traffic signals. In a mature society, the value of the road will generally shrink relative to the value of private goods and services that take advantage of it. In the absence of threats to security, the secular trend with respect to taxation for public goods should decline in a relatively systematic fashion. Superior pricing mechanisms should also reduce the level of exactions through taxation in favour of user fees. It is now feasible to put roading on a common carrier basis with reasonable charges for use instead of providing it for free and funding it through general taxation. At that point we can replace guesses about use value with more precise mechanisms, and thin out the traffic as well.

How would you handle the political issues created by the transition from a progressive to a flat tax? Families on low incomes are likely to be made worse off, for example, because under a progressive system their rates are low.

There would be political issues in the transition, including the fact that in the United States the leading champion of the flat tax, Steve Forbes, would receive a short-term benefit of \$15 million a year.

I think the response should be two-fold. First, you must explain the long-term benefits to the public, including the effects on saving, investment and economic growth over 15–20 years. I think the worst thing politicians do is assume that citizens do not want to understand complicated arguments. Discussions like this one – perhaps at a slightly more basic level – can win the intellectual debate.

Second, I would phase in a move to a single tax rate. Lowering the rate of progressivity will get rid of some – but not all – of the complexity and costs. In a crisis such as New Zealand experienced in 1984 it is possible and desirable to act quickly. If you move slowly you will be swamped by requests for exemptions, political support will decline over time, and the reform will be eroded. However, I do not believe there is the same potential for this to occur with tax changes, which means a transition period could work. The United States did not make straight-line progress towards a flatter tax scale but there was a sharp truncation of the rates under Kennedy and in the early Reagan years. Neither has been fully reversed so that we can say that the case for a *flatter* tax has been won, even as most commentators continue to support the proposition that flat taxes are somewhat unfair.

You can also entertain political compromises if necessary. I believe in a straight first dollar to last dollar flat tax for the reasons I have stated. But I believe that a progressive tax system with a very gentle slope would get you 80 percent of the benefits of a flat tax. If the gap between the highest and lowest rates is not large, the incentives to go in for tax minimisation through structures like partnerships and trusts are a lot weaker. The Bush tax-cutting programme is far from perfect, but it goes in the right direction and seems to have stimulated investment.

However, there are limits to what can be done. United States experiments with a negative income tax to deal with the problem of those on low incomes have had mixed results. A very steep rate of taxation is required as the subsidy is reduced, which creates serious disincentives. Taxation cannot be looked at in isolation from other policies. The kind of reform I have been advocating will work better if accompanied by general market liberalisation that would reduce the number of families on low incomes. We should use these stylised models to establish the advantages of one system over another and then see how they would fare under more realistic assumptions. Progressivity turns out to be a relatively fragile institution whereas the flat tax is much more durable.

I will make one final point. In the United States it is interesting that when we really care about the dangers associated with government redistribution and rent-seeking we arrive at a form of flat tax by constitutional means. Suppose you had two newspapers, one very profitable and the other struggling. A progressive tax based on sales, profits or any similar measure would be unconstitutional in the United States because by treating the two papers differently it abridges freedom of speech. We do not take the same approach to property, including a person's property in their own labour. So one way I try to make the case for the flat tax is to say that you really should care about property in general as much as you care about speech in particular.

