

# The Puzzling Case for Proportionate Taxation

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## I. INTRODUCTION

Over the past half century, the view that the only fair tax is a flat-rate tax has attracted support from a surprising range of political philosophers and pundits, including Friedrich Hayek,<sup>1</sup> Ludwig von Mises,<sup>2</sup> Milton Friedman,<sup>3</sup> John Rawls,<sup>4</sup> and Richard Epstein,<sup>5</sup> along with Walter Blum and Harry Kalven in their famous 1952 essay.<sup>6</sup> Notwithstanding trenchant critiques, the view not only has persisted, but (over the past decade) has gained enormous popularity in political and academic circles. In their 1995 book, *The Flat Tax*, Robert Hall and Alvin Rabushka defended their version of a flat tax with the Grimmsian pronouncement that a flat-rate tax is “the fairest tax of all.”<sup>7</sup> In the same year, Richard Epstein declared, “[f]rom the Lockean perspective, a strong case can be made that . . . the flat tax is the only acceptable [tax].”<sup>8</sup> Similar pronouncements can be found throughout the current political debates, as well as more serious philosophical considerations of the just distribution of tax burdens. There is some non-trivial chance that, over the next few years, that sentiment could carry the day in Congress.

It is, of course, impossible to evaluate these extravagant claims on behalf of proportionality except in reference to a theory of fairness. It goes without saying that these odd bedfellows can-

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1 FRIEDRICH A. HAYEK, *THE CONSTITUTION OF LIBERTY* (1960).

2 LUDWIG VON MISES, *HUMAN ACTION* (1949).

3 MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* (1962).

4 JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

5 RICHARD A. EPSTEIN, *TAKINGS* (1985) [hereinafter *TAKINGS*]; Richard A. Epstein, *Taxation in a Lockean World*, in *PHILOSOPHY AND LAW* 49 (Jules Coleman & Ellen Frankel Paul eds., 1987) [hereinafter *Taxation*].

6 Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

7 ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 3 (2d ed. 1995).

8 *Taxation*, *supra* note 5, at 68. See also *id.* at 70: “The flat tax . . . is an indispensable part of the Lockean program of taxation.”

not all have the same theory in mind. What follows is an attempt to sketch out plausible intuitions of fairness on which these claims might rest, and ask whether any of them supports it. I conclude not.

Let me be clear what I am not arguing. I am not arguing that some version of a flat-rate tax scheme cannot be defended as a sensible policy solution on any other grounds, including administrative convenience, political compromise between warring considerations, or our best guess as to how to achieve a distributive end resting on firmer philosophical grounds. Perhaps it can be so defended. I mean only to try to dislodge the apparently intractable notion that it deserves to be adopted because it is "fair" in itself, or because it is an obvious instantiation of some other fairness principle. I am also not arguing in favor of progressivity, regressivity, or any other rate structure on fairness grounds. The deeper moral is that no sensible theory of distributive justice would fix on rate structures themselves as fair or unfair. Rate structures are just a means to operationalize other prior, moral commitments about the proper role of government. The case for any particular rate structure must stand or fall on how well it realizes those prior commitments. An examination of plausible, prior moral commitments, however, suggests that, of all possible rate structures, proportionality may be the hardest to derive from any coherent theory of fairness.

In the first part of the paper, I consider the case for proportionate taxation in the context of two broad views of governmental power in fiscal matters. The first, an essentially libertarian view of the state, takes the proper role of government to be limited to solving the collective action problems that prevent private actors from spontaneously reaching optimal outcomes through voluntary agreements. While tolerating whatever minimal redistribution might occur as a consequence of solving collective action problems, the libertarian view generally rules out income redistribution as a motive for state action. One recent proponent of that view has located that prohibition in the Constitution, through an expansive interpretation of the Takings Clause.<sup>9</sup> Most have simply deduced it from natural law principles.<sup>10</sup> In tax theory, the clear corollary to libertarianism is the so-called "benefits" theory of taxation. I start with libertarianism, because it is the premise from which most of those who advocate flat-rate taxes on fairness grounds seem to be starting.

The second, a social welfarist view of the state, accepts that income redistribution for the express purpose of improving the

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<sup>9</sup> See TAKINGS, *supra* note 5, at 99-100, 295-303.

<sup>10</sup> See, e.g., HAYEK, *supra* note 1, at 315-18; *Taxation*, *supra* note 5.

welfare of the less well-off in society is a legitimate part of the state's job, although there is obviously much disagreement about the optimal extent and form of redistribution. While there are no clear corollaries to the social welfarist view of the state in tax theory—something that I think is not coincidental—“ability to pay” and “minimum sacrifice” arguments undoubtedly reflect that view in inchoate form.

Other views of the legitimate role of the state in fiscal affairs are, of course, possible, but most that are offered in tax debates, when pushed hard enough, end up being some version of one of these two views.

Both of the foregoing views evaluate taxation in the context of a comprehensive system of government (re)distribution. In the last part of the paper, I take up a number of defenses of a flat-rate tax viewed in isolation from the uses to which tax revenues are put. These include the widespread view that a flat-rate tax vindicates some important notion of equality; that it leaves individuals' choices among various activities undistorted; and that it limits the (unfair) expropriation of the wealthiest classes by the majority. Finally, I consider two other positive explanations for the popular convergence on proportionate taxation. The first is that its apparent properties of mathematical simplicity and certainty have made it a Schelling-like focal point solution to the problem of appropriate tax rates. The second is that its popularity, particularly among libertarians, is a product of political framing—of the fact that, at least in recent history, no one would have considered a regressive rate structure for our broad-based income tax to be a politically viable alternative. Were that fact to change, it seems quite likely that many who support proportionate taxation on libertarian grounds would find regressivity, on reconsideration, a more plausible expression of libertarian ideals.

## II. LIBERTARIAN (BENEFITS) THEORY

In contemporary debate, the most vociferous advocates of a flat-rate tax—Friedman,<sup>11</sup> Hayek,<sup>12</sup> Epstein,<sup>13</sup> and Gauthier,<sup>14</sup> to name some prominent examples—have been animated by liberta-

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11 *See supra* note 3.

12 *See supra* note 1.

13 *See supra* note 5.

14 DAVID GAUTHIER, *MORALS BY AGREEMENT* (1986).

rian impulses.<sup>15</sup> The same is true of earlier defenders.<sup>16</sup> In such a view, the just limits of state power derive from an essentially Hobbesian and Lockean social contractarian view of the state, in which the state exists solely to provide services that, for a variety of reasons of market failure, cannot be provided optimally by private, voluntary agreement. As has been noted, that view implies a quid pro quo relationship between the taxpayer and the state, in which taxes function as the shadow price for goods or services that the state provides.<sup>17</sup> Hayek provided the classic argument for deriving proportionate rates from a benefits theory of taxation: “a person who commands more of the resources of society will also gain proportionately more from what the government has contributed” to the provision of those resources, and taxation ought to be levied in proportion to the benefits so provided.<sup>18</sup>

The first big problem in assessing the case for proportionate taxation under a social contractarian view of the state is that almost none of the proponents of proportionality on (vaguely) libertarian grounds, from Adam Smith on down, have in fact supported proportionate taxation. A true flat-rate tax would tax all income (or consumption, as the case may be) starting with the first dollar,

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<sup>15</sup> For other, recent expositions of a social contractarian justification for a flat tax, see James A. Dorn, *Introduction: The Principles and Politics of Tax Reform*, 5 CATO J. 361 (1985); Richard E. Wagner, *Normative and Positive Foundations of Tax Reform*, 5 CATO J. 385 (1985). A number of other libertarians, while not explicitly defending proportionate taxation, limit their attacks on redistributive (“discriminatory”) taxation to progressivity, thereby, at least by implication, treating proportionate taxation as nondiscriminatory, and hence fair. See, e.g., VON MISES, *supra* note 2, at 803-05, 851-54; HARVEY LUTZ, *GUIDEPOSTS TO A FREE ECONOMY* 73-82 (1945).

<sup>16</sup> For a summary of the proponents of proportionate taxation through the early part of the 20th century, see EDWIN R. SELIGMAN, *PROGRESSIVE TAXATION IN THEORY AND PRACTICE* 148-84 (1908). Notable early proponents included Hobbes, Locke and (somewhat more ambiguously) Adam Smith. For Smith’s famous support of proportionate taxation on fairness grounds, see ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 945 (Regnery 1998). For the contrary impulse, in the context of a tax on house rents, see *id.* at 966, arguing that “[i]t is not very unreasonable that the rich should contribute to the public expence, not only in proportion to their revenue, but something more than in that proportion.”

<sup>17</sup> See RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 62 (1959).

<sup>18</sup> HAYEK, *supra* note 1, at 316. For similar statements, see *Taxation*, *supra* note 5, at 74; FRIEDMAN, *supra* note 3, at 175; ANTONIO DE VITI DE MARCO, *FIRST PRINCIPLES OF PUBLIC FINANCE* (Edith Paolo Marget trans., 1936), *cited in* MUSGRAVE, *supra* note 17, at 72-73; SMITH, *supra* note 16, at 945. Among proponents of a flat-rate tax on (vaguely) libertarian grounds, Blum and Kalven strongly dissent from a “benefits taxation” justification for flat rates, on both empirical and normative grounds. They conclude, as an empirical matter, that the distribution of benefits among income classes is so indeterminate that it is pointless to defend either progressivity or proportionality on these grounds. If forced to guess, they would guess that all citizens benefit approximately alike, leading to a head tax rather than a flat tax. Blum & Kalven, *supra* note 6, at 455. On normative grounds, they adopt the view of Mill that “to assert that individuals receive significantly different benefits from living in a particular society is in effect to assert that there is something seriously wrong with that society.” *Id.* The latter objection seems silly, if it refers to unequal levels of utility derived from government-provided services (why should everyone value all government services the same?), as opposed to unequal access to those services.

at the same rate. Instead, they have supported a so-called degressive version of a progressive tax, in which the first  $x$  dollars of income or consumption, sufficient to cover basic needs, is taxed at a zero rate, and all income or consumption above that is taxed at the same positive rate.<sup>19</sup>

The political advantages of a degressive tax over a proportionate tax are obvious, and hardly lost on its supporters.<sup>20</sup> There is little public support for a true proportionate tax that contains no exemption for basic income. It is hard to overstate, however, the difficulties that that concession entails for those whose opposition to any greater degree of progressivity via a graduated rate structure is based on the fact that such progressivity is motivated by purely redistributive concerns. If all of us earning income above the exemption level have an obligation to pick up the tab for government services provided to the poor, simply because they are poor and we are not, why stop there? Why not tax the rich for government services at an even higher rate than the middle class, simply because the rich have more money than everyone else and hence can better afford to defray the cost? Or, for that matter, why not raise the exemption level to, say, \$30,000 for a family of four, raise the flat rate tax from, say, 19% to 25%, and use the excess proceeds to finance a guaranteed minimum income to all?<sup>21</sup> At that point, "proportionate" taxation would start looking mighty attractive to the sorts of welfare state liberals who would reject the libertarian premises of benefits taxation out of hand. Surely Frank Taussig was right in declaring many years ago that "[t]he demand for the exemption of the lowest tier of incomes results from the same state of mind as the advocacy of progressive taxa-

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19 Under the Hall/Rabushka version of a flat tax, for example, exemption amounts range from \$9500 for a single person to \$25,500 for a family of four; amounts in excess of that are taxed at a 19% rate. HALL & RABUSHKA, *supra* note 7, at 144.

20 For Blum and Kalven's astonishingly bare concession to exemptions, see Blum & Kalven, *supra* note 6, at 420: "It is almost unanimously agreed that some exemption keyed to at least a minimum subsistence standard of living is desirable. Since such an exemption will necessarily result in some degree of progression among taxpayers above the exemption level, and since this degree of progression appears inescapable, the real issue is whether any added degree of progression can be justified." See also 2 FRIEDRICH A. HAYEK, LAW, LEGISLATION AND LIBERTY 87 (1976), endorsing in a slightly different context a uniform minimum income "to all those who, for any reason, are unable to earn in the market an adequate maintenance"; SMITH, *supra* note 16, at 992-94 (opposing taxes on the wages of laborers), 999-1003 (opposing taxes on "necessaries").

21 For a proposal along these lines, see Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1950-55 (1987). Those who oppose progressivity via graduated rates, but support progressivity of a degressive sort, have long seen the potential for the latter to approach the results of the former if exemption levels get high enough. See, e.g., Blum & Kalven, *supra* note 6, at 513. They have erroneously assumed, however, that the two could not converge, because they have ignored the government's redistributive arsenals on the transfer side. See *id.* See also *infra* note 69.

tion [through graduated rates]."<sup>22</sup> If there is some principled basis for absorbing redistributive motives into benefits theory to the extent of basic needs, *but no further*, libertarians have yet to articulate it.<sup>23</sup> Until such time as they do, those few hearty libertarians who have rejected an exemption for basic income as inconsistent with conventional libertarianism seem to have the better of their libertarian fellow travellers, and are to be commended, from the point of view of principle, at least, for sticking to their libertarian guns here.<sup>24</sup>

For the balance of the discussion, I set that difficulty aside, to turn to the central question. If, as benefits theorists argue, taxes ought to function as the shadow price for goods or services that the state provides, how do we set that price? The logical place to begin is with a determination of what a well-functioning private market would have charged for those goods or services. As Musgrave stated many years ago, "[s]ince the relation is one of exchange, the rules of the public household are taken to be more or less the same as those of the market."<sup>25</sup> What then are the rules of the (private) market—or more precisely, which of the rules of the private market do we think ought to be transported to the public household, and once transported, what do those rules imply about appropriate tax rates?

The uncontroversial starting point for analyzing the fairness of the market is the requirement of strict paretianism: the re-

<sup>22</sup> FRANK TAUSSIG, *PRINCIPLES OF ECONOMICS* 499 (1911), *quoted in* Blum & Kalven, *supra* note 6, at 509 n.229.

<sup>23</sup> The familiar argument along these lines, going back at least to Adam Smith, is that there is no point in taxing the poor, because (1) we can't get blood from stone, and/or (2) we will only end up supporting the poor anyway through some kind of welfare system. The second argument misses the boat entirely, since it assumes an obligation to support the poor through affirmative transfers—an obligation that most true libertarians would reject. The first argument has some force, but does not explain our failure to exclude the "dead-beat" poor from those public benefits that are not true public goods, and hence from which exclusion is possible, such as public schools and health care.

Hayek has sought to distinguish a degressive version of a progressive tax from a graduated rate version, on the ground that the former constitutes "a majority's taxing itself to assist a minority," while the latter constitutes the much more egregious decision of a "majority [to] impos[e] upon a minority whatever burden it regards as right." HAYEK, *supra* note 1, at 314. For similar sentiments, see sources quoted in Blum & Kalven, *supra* note 7, at 435. I take up this political process argument in another context below. *See* notes 98-101, *infra*, and accompanying text. For now, I note only that the argument responds to those, like Hayek, who are most concerned with class warfare qua classes, and is not an adequate response to the more conventional concerns of libertarians that the rich are entitled to be protected from expropriation not only by the poor, but also by their fellow, more beneficent rich, on behalf of the poor.

<sup>24</sup> *See*, for example, TAKINGS, *supra* note 5, at 297, supporting a tax that takes "a constant percentage of net income . . . from the first dollar of net income to the last." *See also* ROBERT NOZICK, *ANARCHY, STATE AND UTOPIA* 169 (1974) (equating taxation of wages with forced labor); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 *AM. J. TAX POL'Y* 221, 270-71 (1995) (advocating a head tax as the only fair tax).

<sup>25</sup> MUSGRAVE, *supra* note 17, at 62.

quirement that every trade leave no side worse off, and at least one side better off. This requirement is assumed to be met automatically by any voluntary market transaction. Strict paretianism, however, is a minimally exacting standard, which gives little guidance in resolving the central problems in assigning the tax costs of providing public benefits.

First, the pareto principle provides no guidance on the level of aggregation at which the "betteroffness" from being in society is to be judged. If the level of aggregation is great enough—at the extreme, for example, if we test the pareto superiority of the benefits/taxation deal each American is offered at the level of the decision whether to exit this society or not—then there is almost no redistributive mischief that cannot be justified. At the other extreme, if we insist that *each* government program satisfy strict paretianism, then almost no program can be justified, since there will always be individuals under any feasible tax scheme who are paying more for a particular public good, such as a road through the middle of Kansas, than the benefit they derive from it.

In practice, libertarian benefits theorists seem to employ a mixed criterion, along the following lines. First, strict paretianism is used to judge the aggregate deal each of us has gotten from being in society rather than out of it.<sup>26</sup> This standard will almost always be met if we are comparing any plausible configuration of tax burdens in America circa 1999 to our likely individual positions in some hypothetical Crusoeian state of nature, and, indeed, is met automatically as long as there is a meaningful opportunity for exit from society. Second, a potential pareto (that is, Kaldor-Hicks) test is used to judge expenditures at the maximally disaggregated level. Thus, each particular road through Kansas must be justified by showing that the social gains from building it outweigh the social costs entailed. However, one need not show that each citizen derives benefits from that particular road at least equal to her share of the social costs of building it.<sup>27</sup> Finally, strict

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<sup>26</sup> See, e.g., *Taxation*, *supra* note 5, at 53. Both Nozick's "liability rule" compensation scheme for private protective agencies banished by the ultraminimal state, and his justification of private appropriation out of the commons whenever nonowners are better off with a private property regime than they would be in a state of nature, rely on strict pareto compensation for rights lost in the creation of the Lockean state. See Nozick, *supra* note 24, at 78-84, 174-77. For a similar argument justifying private appropriation of the commons with a liability rule of compensation, see GAUTHIER, *supra* note 14, at 291-92.

<sup>27</sup> Epstein's position on this question is unclear, or at least inconsistent. He invokes strict paretianism at the individual program level to bar "the redistribution of income through the tax system." *Taxation*, *supra* note 5, at 68. At some points, he appears to revert implicitly to a Kaldor-Hicks criterion to judge the acceptability of the remaining programs. TAKINGS, *supra* note 5, at 201. At others, however, he suggests he will require strict paretianism for *every* government program. (See *Taxation*, *supra* note 5, at 55-56, arguing that the system should "tr[y] to insure that every public expenditure is worth more to every party taxed than the revenues that are lost."). See also RICHARD EPSTEIN, *BARGAINING WITH THE STATE*, 82-86 (1993). For a similar insistence on strict paretianism at the

paretianism is used to test the tax/benefits deal over some representative class of incremental public goods being considered. That is to say, in a just state, over a representative period, each individual in the state will derive benefits from government services that are at least equal to the cost she bears for them. This formulation is just a guess, however, since most proponents of a benefits theory of taxation are unclear or inconsistent on the point.

Second, the pareto principle requires only that tax prices be set so that no one is made worse off by the compulsory purchase of public goods. It says nothing about the proper distribution of surplus above that—that is, about distribution of the gains from trade.

In private competitive markets, both of these problems—the level of aggregation on which to test pareto improvements and the just division of gains from trade—are automatically resolved through equilibrium prices. When dealing with public goods, they are not. Since in the latter case we are dealing with hypothetical and not actual markets, and moreover hypothetical markets in which the government operates as a monopoly supplier who can compel payment at dictated prices, we have enormous theoretical latitude in constructing the hypothetical exchange between government as supplier and citizens as consumers. In particular, we have enormous latitude in resolving the two questions above: the level of aggregation at which to bundle goods or services in judging the pareto fairness of our tax scheme, and the just division of surplus value. Depending upon the resolution of both these questions, there is an enormous range of acceptable distributions of tax burdens to finance public goods, within the constraints of paretianism.

At one extreme, imagine the state as monopolist with perfect information about people's reservation prices for public goods, and hence the ability to perfectly price discriminate in setting tax prices for those goods. Consistent with the pareto principle, the state could tax each person in society at a rate that appropriates 100% of the surplus value of public goods. On a broad view of public goods or benefits that should be counted in setting tax rates, including not merely traditional public goods or services, but all the benefits of being in our organized society rather than on a Crusoeian island or in war-torn Rwanda, this broad power to expropriate surplus value would authorize something close to a confiscatory tax on almost everyone.

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level of every individual program ("interaction"), see GAUTHIER, *supra* note 14, at 258. Given that no government expenditure could pass this test, it seems unlikely that either of the foregoing authors really means to require it.

At the other extreme, suppose that the benefits that can be counted are limited to identifiable costly goods or services provided by government, and suppose further that the government must act as a supplier in a private competitive market would act; that is, it is compelled to charge a uniform per unit price for all goods consumed. The most likely outcome of benefits theory on those suppositions is a highly regressive tax.

For the balance of the discussion, I will focus on the second question: how prices for public goods should be set, within the constraints of strict paretianism, and hence how the surplus value generated by public goods should be divided. As the discussion that follows makes clear, neither the libertarian literature approaching the benefits question from the perspective of distributive justice, nor the public economics literature approaching it from the perspective of allocative efficiency, gives a determinate answer to that question.

#### A. The Lessons of the Private Market

There is a fatal ambiguity running through the benefits theory literature about how benefits ought to be measured. This ambiguity is reflected in Hayek's statement that "a person who commands more of the resources of society will also *gain* proportionately *more* from what the government has contributed" to the provision of those resources.<sup>28</sup> Does Hayek mean by "gain . . . more" that the rich consume a proportionately greater *quantity* of public goods, or that the rich derive proportionately greater *utility* from public goods?

Taking the private competitive market as the benchmark, one is pushed to the former interpretation. In a purely competitive market, all consumers face the same per unit price, set by the equilibrium price for the good. Suppliers cannot price-discriminate based on consumers' different reservation prices for the goods, because any effort to set a higher price for any consumer will be undercut by another supplier. As a consequence, the relative prices that consumers pay for a given good depend solely on the relative quantities of the good they consume. Whatever consumer or producer surplus is generated by trades at that price lies where it happens to fall. Assuming a conventional downward-sloping demand curve and an upward-sloping supply curve, equilibrium prices, reflecting the marginal utility or cost of the last unit consumed, will leave each consumer or producer with surplus from all but the last unit consumed or sold. The precise amount of the surplus depends on the fortuitous shape of individual and aggregate demand and supply curves.

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<sup>28</sup> HAYEK, *supra* note 1, at 316 (emphasis added).

Under this interpretation, benefits theory leads to proportionate taxation if and only if the quantity of public goods that people consume is proportionate to income. As even proponents of a proportionate tax concede, this premise is highly implausible.<sup>29</sup> The premise is doubtful for many public goods, such as roads, fire protection, and garbage collection. It is clearly wrong for others, including true public goods (for example, clean air, defense, and broadcast spectra), one of the defining characteristics of which is that they are jointly consumed, with the result that everyone consumes the same quantity (or has the same quantity available for consumption). In the end, such a measure of benefits is much more likely to lead to a highly regressive tax.

If, on the other hand, what Hayek and others mean by “gains more” is that people ought to be taxed in proportion to the utility that they derive from public goods, the implications for appropriate tax rates are much less clear. Indeed, the question is probably completely unresolvable, both because of the impossibility of measuring the relative utility levels each income class derives from public goods, and because of conceptual problems in deciding what one ought to be measuring. If, for example, Bill Gates’s immense wellbeing is a joint product of publicly provided goods and a host of other factors such as social opportunities, talents, and hard work, and each of these factors is a but-for cause of his wellbeing, then how much of his wellbeing gets credited to publicly provided goods, and how much to other sources?

The choice between these two interpretations of “gains more” boils down to the question of what is so great about market-based distribution, beyond its guarantee of strict paretianism. In particular, is there any normative reason to preserve (or mimic) the haphazard distribution of gains from trade that happens to result from uniform, equilibrium pricing in competitive markets, when we move from the private market to the shadow market for public goods? Here, we encounter a wide range of views from the libertarian camp that don’t lead to any obvious conclusion.

Most libertarians treat as sacrosanct the division of surplus that happens to result from market prices, with exceptions often made for privately appropriated, scarce natural resources and other monopoly goods. There is little agreement among libertarians, however, as to *why* market prices are sacrosanct.<sup>30</sup> Moreover,

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<sup>29</sup> A “not clearly inappropriate assumption” is the best that Milton Friedman can do. FRIEDMAN, *supra* note 3, at 175.

<sup>30</sup> Some libertarians, such as Nozick and Hayek, appear to regard market prices as sacrosanct *not* because such prices effect a just division of the surplus, but because they are a necessary byproduct of freedoms independently worth protecting. In Nozick’s case, the relevant freedom is the freedom of the buyer to give away her money to whomsoever she wishes. See Barbara Fried, *Wilt Chamberlain Revisited: Nozick’s “Justice in Transfer” and the Problem of Market-Based Distribution*, 24 *PHILOSOPHY AND PUBLIC AFFAIRS* 226, 233

many of the arguments offered for not disrupting the actual, haphazard assignment of surplus in a well-functioning competitive market do not translate well to public goods. Still others have explicitly treated some or all of the gains from trade, or rents, as morally up for grabs. Among contemporary libertarians, David Gauthier is a leading exponent of that view.<sup>31</sup> Hobbes was as well, maintaining in effect that all individual gains from moving from a Hobbesian state of nature to civilization are expropriable by an all-powerful sovereign. If we are to read Hayek's statement above in the second way, to mean that it is permissible to tax people in accordance with the utility they derive from public goods rather than the quantity they consume, then he, and all others who subscribe to that view, ought to be counted in the Hobbesian camp as well.

When dealing with private, competitive markets, most defenders of the free market would argue that it is unnecessary to resolve these internecine disagreements about the *justice* of market-based distribution. However morally arbitrary the market's division of gains from trade might be, the efficiency costs of the government's trying to alter it through price regulation or other means are simply too great to justify the effort. As one commentator has stated: "[h]ow the gains from trade are distributed [by the market] is determined arbitrarily, but since this distributional issue is resolved as a by-product of a process benefitting all parties, it need not become a bone of contention."<sup>32</sup> When dealing with publicly provided goods, however, that response is not available. The government must set shadow prices in the first instance. As a monopoly supplier with the power to coerce payment through tax-

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n.20 (1995). In the case of Hayek, it is the freedom of the seller of goods or services to "use his knowledge for his own purposes." HAYEK, *supra* note 20, at 69.

Others have defended market-based distribution as just in itself, because it rewards all individuals in accordance with their marginal product—that is, with the value they have bestowed on others. For a discussion of John Bates Clark, a prime expositor of this view, and his critics, see BARBARA H. FRIED, *THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE* 131-45 (1998).

<sup>31</sup> Gauthier's position on rents is at least confusing, if not confused. At one point, he defines the rents that are up for grabs to include any excess paid to a factor of production over the next best price offered—a measure that would confiscate the incremental scarcity rents paid in moving from the second best to best offer, but not those inherent in the second best offer. GAUTHIER, *supra* note 14, at 272-73. At other times, he argues that everyone is entitled to, and only to, their marginal product in a competitive market with no negative externalities—a measure that would confiscate all scarcity rents in noncompetitive markets but not inframarginal rents in competitive markets. *Id.* at 90, 91-92, 95-98. Still elsewhere, however, he suggests that everyone is entitled only to the "full cost of supply for the factor services she provides"—a standard, equivalent to reservation price, that would eliminate a right to inframarginal rents as well. *Id.* at 97-98. Without some clearer view of *why* Gauthier believes that any portion of the market return is sacrosanct, it is difficult to choose among these conflicting measures. The reasons Gauthier suggests, however—some combination of optimization and a desire not to distort choices among activities on libertarian grounds (see *id.* at 93-94)—push towards the last view.

<sup>32</sup> DENNIS C. MUELLER, *PUBLIC CHOICE* II 37-38 (1989).

ation, it *could* price-discriminate if it wished to, without being undercut by competitors. Finally, unlike in the competitive market, price discrimination may well be dictated by *efficiency* considerations, at least in the case of true public goods. I turn to the last point now.

## B. Pricing True Public Goods

A true public good is one that exhibits two characteristics. It is jointly consumed, and exhibits nonexcludibility, meaning that it is either technologically infeasible to exclude people from use (the case, for example, with clean air or defense), or inefficient to do so because the incremental cost of *not* excluding is very low or zero, and/or the cost of monitoring use in order to exclude very high, such as with roads or TV airwaves. Because of the problem of nonexcludibility, a private market cannot provide such goods. From a libertarian point of view, true public goods are the only goods that *ought* to be publicly supplied; that is, the sole justification for coercive government is to correct market failure that would preclude optimal coordination in the absence of coercion. How such goods would or should be priced in the absence of a functioning market is therefore a critical question for any benefits theorist, and a notoriously difficult one.

An extensive literature in public economics over the past 80 years has been devoted to devising a theoretical solution to the problem of optimal output and optimal pricing of true public goods. Since the literature is almost exclusively concerned with efficiency questions—that is, how to determine the optimal output of public goods from an efficiency point of view—in one sense it is all beside the point here. In a couple of other senses, however, it is not. First, the implicit or explicit indifference of the public economics literature in this area to the distributional consequences of optimal pricing schemes undercuts any claim that there is some broadly compelling view about the just distribution of surplus. Second, many of the optimal pricing solutions proposed on efficiency grounds have determinate distributive outcomes that are hard to square with anything resembling a proportionate tax scheme. That means, at the very least, that benefits theorists who are drawn to proportionality on fairness grounds may have to be willing to pay a theoretical price on efficiency grounds.

### 1. Lindahl/Bowen/Samuelson Solutions

The central problem in determining optimal output of true public goods derives from the problem of nonexcludibility: because we cannot exclude anyone from using true public goods, we cannot rely on a decentralized price system automatically to re-

veal true demand for the goods.<sup>33</sup> Eighty years ago, Erik Lindahl proposed a theoretical solution to this problem, subsequently reworked in a general equilibrium framework by Paul Samuelson. His solution remains the starting point for any analysis of public goods.<sup>34</sup>

The mechanics of Lindahl-type solutions are somewhat complicated, but the basic intuition behind them can be stated simply. To achieve an efficient allocation of all resources, we want every consumer to equate her marginal rate of substitution between all commodities, whether privately or publicly supplied. In a competitive market, where everyone faces the same price for goods, that equilibrium is reached by each consumer varying the *quantity* of each good she purchases until the marginal utility of each good equals its set price. In true public goods, where everyone must consume, or have available for consumption, the same quantity of the good, that equilibrium is reached by varying the *price* each consumer pays for the good, until the price equals the marginal utility she derives from that set quantity of the public good.

The hypothetical mechanics for reaching a Lindahl equilibrium quantity and price are as follows. Each citizen, in effect, submits bids, revealing the marginal price she would be willing to pay for a given public good at each plausible quantity of that good.<sup>35</sup> A combined social demand curve for that good is created by adding up the marginal unit price bids from all citizens at each quantity level.<sup>36</sup> The optimal level of supply is the equilibrium point where the combined demand curve, equal to the combined marginal prices for a given quantity of goods, intersects with the supply schedule for that good, equal to marginal cost of production.

Once the equilibrium quantity is determined, each citizen is assigned a tax share to pay for the cost of the goods. That tax share is equal to the marginal price she bid at what turned out to

33 For a classic statement of problem, see Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 *REV. ECON. & STAT.* 387, 389 (1954), reprinted in KENNETH J. ARROW & TIBOR SCITOVSKY, *READINGS IN WELFARE ECONOMICS* 179, 182 (1969). See also MUELLER, *supra* note 32, at 123.

34 For an overview of Lindahl's solution and the variants on it proposed by Bowen and others, see MUELLER, *supra* note 32, at 43-50; ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, *LECTURES ON PUBLIC ECONOMICS* 487-89 (1980); and MUSGRAVE, *supra* note 17, at 74-80. For Samuelson's general equilibrium version of the Lindahl solution, see Samuelson, *supra* note 33.

35 The marginal price at any given quantity represents the marginal utility of the last unit of that good at that quantity. In Lindahl's formulation, the bids reflect the percentage of the cost at any specified quantity that each individual is willing to pay. In Bowen's formulation, the bids reflect the absolute dollars at a specified quantity that each individual is willing to pay.

36 Thus, while in private goods contexts we add up demand horizontally to ascertain the total quantity demanded at a given price, in public goods contexts we add up demand vertically to ascertain the total amount that all individuals are willing to pay for a given quantity of public goods. This difference simply reflects the difference in what we take as given in the two contexts—price v. quantity.

be the equilibrium quantity, times that equilibrium quantity. The result is a set of personalized prices, such that, at those specified prices, everyone demands the same level of each public good.<sup>37</sup>

What are the distributive effects of Lindahl tax shares? They mimic the effects of the competitive market in one respect: they divide the inframarginal surplus from public goods in a haphazard fashion. Each citizen's Lindahl tax price for a public good reflects the utility of the *marginal* unit value of that good at equilibrium output, times the total agreed-upon output. Assuming a downward sloping demand curve, each citizen will therefore realize inframarginal surplus, i.e. gains from trade, on all but the last unit consumed. As in competitive markets, however, the amount of that surplus is arbitrarily fixed by the shape of the individual's demand curve for that good relative to the equilibrium price.<sup>38</sup> In another respect, however, Lindahl tax prices differ from conventional prices in a competitive market: Lindahl tax prices are proportionate to the *marginal utility* each individual derives from a given quantity of a public good, rather than to the quantity of that good consumed. In contrast, in the competitive market, total prices spent on a good would be proportionate to quantity consumed, since, facing a constant price, consumers vary their quantity until the last unit purchased generates marginal utility equal to that price.

Just as it is unclear what Hayek's "total utility" metric for tax shares may imply about tax rates, it is also unclear what Lindahl's "marginal utility" metric for tax shares implies about tax rates. For some true public goods, marginal utility seems unlikely to be positively correlated with income, suggesting a highly regressive tax rate. For others, it might be positively correlated with income, but whether that measure would lead to proportionality seems much more doubtful.

## 2. Demand-Revealing Price Structures

As numerous commentators have noted, Lindahl-type solutions, which tie the ultimate tax shares to stated preferences, all have a central flaw. Since the government cannot exclude individ-

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<sup>37</sup> See ATKINSON & STIGLITZ, *supra* note 34, at 509-12. The solution parallels the optimal solution for pricing jointly produced products, where the shared fixed costs of production are allocated between the products in proportion *not* to their respective variable costs, but in proportion to respective demand. In the public goods context, rather than facing two products with shared fixed costs, we face one product with shared benefits. The solution is the same, however: the costs of the product are allocated among consumers who share the benefits in proportion to their demand schedule for the product.

<sup>38</sup> See T. Nicolaus Tideman, *Ethical Foundations of the Demand-Revealing Process*, 29 PUBLIC CHOICE 71, 74 (1977) ("if cost shares exactly equalled benefit shares . . . redistribution would be confined to that induced by the relatively arbitrary sharing of gains from trade under Lindahl taxes").

uals from using true public goods, whatever their stated preferences, such solutions—which, in effect, require each individual bidder to put her money where her mouth is—create an incentive for individuals to understate their preferences in the bidding process, thereby leading to the suboptimal production of public goods.<sup>39</sup>

Over the past 35 years, a number of public economists have proposed ingenious modifications to Lindahl's basic scheme to solve this central problem.<sup>40</sup> The modifications take different forms, but most share one key feature: the tax share that people ultimately will pay for each public good is decoupled from their stated preferences for that good, in order to induce true revelation of preferences. In most models, that result is accomplished by a two-level pricing system: (1) a first-level tax is imposed to cover the full costs of producing a public good at a given level, with the tax shares assigned independent of each person's true demand schedule for that good; and (2) a supplementary tax is imposed, the sole purpose of which is to force the true revelation of preferences. This latter tax is not used to pay for the public good in question.<sup>41</sup> The level of this supplementary tax in most schemes is loosely correlated with preferences, since it may, and in some cases certainly will, impose some cost on each individual to move the outcome in her preferred direction.<sup>42</sup> To that extent, the supplementary tax may reflect a loose *quid pro quo* for benefits received. The correlation, however, is loose at best. In the case of the leading schemes, once a large number of voters is introduced, the tax disappears entirely.

What does the foregoing imply about the appropriate tax rates to finance true public goods? The critical feature of all of these proposals is that each individual's tax share must be unrelated to that individual's revealed demand for the good, and hence the level of utility she derives from consumption. This requirement rules out, at least in strict form, the one criterion for assigning tax shares, *quid pro quo* on an individual basis, that a benefit theory insists upon. Many of these schemes contemplate that the first-level tax will be apportioned among individuals on a

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<sup>39</sup> See MUSGRAVE, *supra* note 17, at 80; Samuelson, *supra* note 33, at 888-89, 182: "it is in the selfish interest of each person to give *false* signals, to pretend to have less interest in a given collective consumption activity than he really has." For a summary of the other reasons to anticipate that Lindahl's strategy would not achieve an optimal solution, see MUSGRAVE, *supra* note 17, at 79.

<sup>40</sup> Most of these demand-revealing solutions are traceable back to Theodore Groves, *Incentives in Teams*, 41 *ECONOMETRICA* 617 (1973).

<sup>41</sup> In some models, the supplementary tax is not paid in dollars at all, but instead in scarce voting points; in others, it is paid in dollars, but the dollars are wasted, or at least not returned in any systematic fashion to the individual voters (if they were, that would undermine motives for honest revelation).

<sup>42</sup> See MUELLER, *supra* note 32, at 145.

per capita basis, a solution that would obviously be highly regressive. For some schemes, the per capita charge is a necessary feature, while for others, it is not. In the latter cases, it is theoretically possible that, once optimal output, and hence full costs, are determined, one could distribute that tax burden by income class or other measurable and taxable voter characteristics in a fashion that approximates what Lindahl taxes for that group would look like.<sup>43</sup> That decision, however, is independent of the efficiency concerns that are driving the models, and would be dictated by wholly external distributive concerns, which require independent justification.

### C. Epstein's "Tale of Two Pies"

These and all other attempts to solve the problem of optimal output and pricing in the true public goods context are concerned only with efficiency. Thus, they take the background distribution of wealth as just, and disregard whatever incidental distributive effects their solution might entail. In recent years, some prominent libertarians have directly addressed the question of the just distribution of surplus from public goods and the tax costs of financing them. Two notable recent examples are Richard Epstein's *Takings*<sup>44</sup> and David Gauthier's *Morals by Agreement*. Both arguments attempt to develop a theory of the just distribution of surplus value created by the existence of an organized society, and both purport to derive proportionate taxation from that theory. Many of the intuitions that drive these two pieces seem to be widely shared in libertarian defenses of proportionate taxation, including Hayek's quoted above.<sup>45</sup>

I have explored both arguments in greater length elsewhere.<sup>46</sup> In the interests of economy, I will limit discussion here to Ep-

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43 For such a suggestion, see Tideman, *supra* note 38, at 74. The logic here is that, while taxpayers might still have a mild incentive to depress their income levels to avoid Lindahl taxes, they have no incentive to lie about their true preferences, since their individual, truthful revelation has virtually no effect on aggregate output, and hence on the absolute amount of the Lindahl share their income class will bear.

44 Epstein's arguments in *TAKINGS* (*supra* note 5) are prefigured in an earlier piece, *Taxation in a Lockean World* (*supra* note 5).

45 See *supra* note 28 and accompanying text.

46 Barbara Fried, *Why Do Libertarians Love Proportionate Taxation? Epstein's Tale of Two Pies and Other Puzzles* (draft manuscript) (copy on file with *Chapman Law Review*). Gauthier's convoluted theory of just distribution is not easy to summarize. In brief, he argues that the surplus value from society ought to be divided among all the cooperators who produced it in accordance with his principle of "minimax relative concession" (MRC). MRC requires that surplus be divided among members of a society so as to equate the ratio of (1) the total amount of surplus that each person actually gets from any cooperative venture in which he is a participant, to (2) the largest amount of surplus he could have plausibly claimed from that cooperative venture. Gauthier's verbal formulation is different, but amounts mathematically to the same thing. GAUTHIER, *supra* note 14, at 136-40. The largest amount he could have plausibly claimed, in turn, is the amount left over after fellow cooperators' costs are covered; that is, after cooperators are left no worse off than under

stein's, the more conventional of the two. Epstein, consistent with conventional libertarian premises, limits the state's taxing powers to raising funds to finance true public goods, explicitly precluding any spending motivated by redistributive intent.<sup>47</sup> That constraint, however, leaves open the question of how precisely that revenue is to be raised, and hence how any surplus value generated by the existence of the minimal state—with surplus implicitly defined here as the total value of society net of the tax costs of providing it—is to be distributed among citizens.

For Epstein, all roads, whether constitutional, Lockean rights theory or utilitarian, lead to the same two-part answer to the question, "Who gets the surplus?"<sup>48</sup> First, the surplus should be divided in proportion to the value of each citizen's "private holdings," which Epstein defines as the property she would have held in a state of nature (SON), under just (Lockean) principles of acquisition.<sup>49</sup> Second, such proportional division of surplus will naturally, if not definitionally, lead to proportionate taxation.

Both halves of the argument have some surface plausibility. At least so one is led to conclude by the long list of people who have subscribed to them. The more one ponders them, however, the less plausible they seem. I take up each half in turn.

1. Why Should the Surplus Value Created by the Existence of Organized Society Be Distributed in Proportion to the Value of Rights Individuals Have Brought into Society?

As noted above, Epstein purports to defend this proposition from three different vantage points: constitutionalism, utilitarianism, and a Lockean, natural rights, perspective. For present purposes, I want to set the first two to the side, and examine the

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noncooperation. *Id.* at 137-39. As Gauthier ultimately acknowledges, this formula dictates an equal division of surplus among all participants in each cooperative venture, assuming each makes the largest plausible claim he could. *Id.* at 151-54, 277. In Gauthier's view, this equal division may be deviated from, under a Rawlsian minimax principle, where all will be benefitted by the deviation. What it implies about the division of surplus at the societal level is much less clear. Gauthier argues that it logically leads to proportionate taxation. For reasons I have explored elsewhere, that argument must rest on assumptions about the distributive effects of pretax prices that are wildly implausible on their face, and impossible to reconcile with other aspects of Gauthier's argument. *See id.*

In the end, proportionate taxation is such an implausible expression of Gauthier's view of distributive justice that his enthusiasm for it, like Rawls's, is interesting chiefly as an illustration of the strength of the irrational pull proportionality exerts on the imagination.

<sup>47</sup> TAKINGS, *supra* note 5, at 163-64.

<sup>48</sup> *Id.* at 162.

<sup>49</sup> *Id.* at 3-5, 163-64. See also *Taxation*, *supra* note 5, at 52-53, "noting that the *baseline* against which 'being better off' is measured gives to each person only his natural rights to liberty and property, and not the fruits acquired by theft, aggression, or deception." For Gauthier's similar conclusion, see GAUTHIER, *supra* note 14, at 254, arguing that each share in the joint gains from society should be "proportioned to the contributions of its recipients."

question only from the third; the perch shared by most of his fellow libertarians.<sup>50</sup>

Locke's state, like Hobbes's, Epstein argues, gets its legitimacy from the strict pareto-superiority of the deal it offers its members: give up the formal freedom you possessed when locked in your war of each against all, in return for constraints of law that will leave all of you at least as well off, and some of you better off, than you were in the SON. For Hobbes, that guarantee of strict paretianism defined the full extent of the sovereign's obligations to its citizens. For Locke, however, it merely set a floor on those obligations. While Hobbes's sovereign was free to appropriate virtually all the surplus value of civilization, Locke's was not: "[i]n the Lockean world, . . . the sovereign is to be fully constrained, so that the lives, liberties, and estates of the citizens may be preserved. The tangible measure of that constraint is that principled . . . limits are placed upon the appropriation of surplus by the sovereign."<sup>51</sup>

As Epstein acknowledges, Locke himself did not supply those principled limits. Epstein does so in his stead, concluding that the surplus "should be divided among all citizens, pro rata in accordance with their private holdings."<sup>52</sup> Why? Epstein, along with nu-

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<sup>50</sup> Epstein's idiosyncratic constitutional argument for dividing surplus in proportion to rights in a state of nature, in brief, is as follows: (1) the just compensation clause extends to taxation as well as conventional takings; (2) the "public use" requirement in the just compensation clause mandates proportionality between the benefits and burdens of any public taking; and (3) the requirement of proportionality mandates that all surplus value created by the state be distributed in accordance with the value of assets people bring into the state. His utilitarian argument for pro rata division of the surplus, in brief, is that such division "does not skew the incentives of private parties in the choice between public and private control over human affairs. For example, if each person received an equal portion of the general gain, there would be an incentive for persons with smaller shares to force matters into the public arena, where they would be relative gainers." *TAKINGS*, *supra* note 5, at 163. The utilitarian argument fails for the same reasons that the Lockean one does: the private market does not reward individuals in proportion to the value of their rights in the state of nature, and such pro rata division of the surplus would not, in any event, give rise to a proportionate tax.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* For those familiar with *Takings*, that conclusion is presented in the pie chart of two concentric circles that opens the book. *Id.* at 3-6. The view that the surplus value created by a Hobbesian state ought to be divided pro rata in accordance with individuals' SON holdings is fundamental to Epstein's view of a just society. *See id.* at 3, 5: "The implicit normative limit upon the use of political power is that it should preserve the relative entitlements among the members of the group, both in the formation of the social order and in its ongoing operation. . . . Each gain from public action therefore is uniquely assigned to some individual, so that none is left to the state, transcending its citizens." Epstein asserts it largely as fiat in *Takings*. In *Bargaining with the State*, he defends it with a number of arguments, including that a vastly unequal division of surplus will be an unstable solution and a pro rata division a stable one, an argument reminiscent of Gauthier's game-theoretic arguments for pro rata division; that it minimizes the chance that some party will be left in a pareto-inferior position by the taxes-for-civilization deal, and that it (tautologically) "leads to the *automatic* proration of the surplus among all contenders." *EPSTEIN*, *supra* note 27, at 90-91, 95-97. The first two arguments rest on empirical premises that seem doubtful, or at the very least in need of some defense.

merous others with libertarian leanings going back to Adam Smith, appears to derive that conclusion from an unexamined analogy to private partnerships.<sup>53</sup> The general line of argument goes as follows. Think of society as an n-person joint venture, in which we all bring to the table our SON assets, which we agree to pool in this collective venture called the state in return for our aliquot share of the returns to investment, or surplus, that our cooperation generates. If this were a private partnership between two persons, one putting up \$60,000 of capital and one putting up \$40,000, it is perfectly clear that the two partners would and should agree to split the profits from their venture 60/40, in accordance with their contributions. There is no reason for that conclusion to change when we move from a two-person private partnership to an n-person public one.

There are a number of serious problems with the analogy.<sup>54</sup> The first is: how do we value SON assets for purposes of calculating what would be a fair (pro rata) return on them? As Epstein concedes, his two-pie structure “presupposes that we have a very clear sense of what counts as individual rights.”<sup>55</sup> Much of the criticism of Epstein’s *Takings*, along with Nozick’s *Anarchy, State, and Utopia* and other libertarian schemes, has sought to argue that such a “clear sense” is impossible to come by, and that what Epstein et al. take to be the boundaries simply reflects conventional Anglo-American property arrangements that would be impossible to deduce from any deep-seated theory of natural rights. I want to set those objections aside for the moment, and suppose

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Some notion of equal proportionate division of surplus is fundamental to Gauthier’s view of a just society as well, although the precise notion is less clear. As noted below, Gauthier suggests in passing the standard solution by analogy to partnerships—returns-in-proportion-to-investment—proposed by Epstein and others. But the version he develops in depth in *Morals by Agreement*, under the rubric “minimax relative concession” (MRC), rejects that model entirely. For further discussion of these matters, see FRIED, *supra* note 46.

<sup>53</sup> See SMITH, *supra* note 16, at 945: “The subjects of every state ought to contribute towards the support of the government . . . in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation, is like the expence [sic] of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate.” Among contemporary libertarians, see, for example, GAUTHIER, *supra* note 14, at 140-41, 152, 254. “[T]he ratio between the benefit [each member of society] receives and the contribution she makes is, so far as possible, constant, the same for all.” *Id.* at 152. Gauthier’s actual scheme for dividing the surplus value generated by society, however, abandons that principle entirely. See *supra* note 46.

<sup>54</sup> For these purposes, I accept the conventional libertarian premise that individuals are entitled to what they have acquired by Lockean principles in the SON. To the extent one rejects that premise, because, for example, one does not regard as just the natural distribution of talents, or the distribution of resources by grab in the SON, SON entitlements lack justificatory significance, and as a consequence, arguments for distributing surplus pro rata in accordance with those entitlements will lack justificatory weight as well.

<sup>55</sup> TAKINGS, *supra* note 5, at 5.

that we could come up with some formal boundaries on such natural rights. The question is: what are they worth in the SON?

Epstein concedes that the value of rights in the SON may be low, due to uncertainty and insecurity.<sup>56</sup> That concession, however, is hardly damaging to his argument. The real problem is, how would we determine the value in the SON to begin with? Rather than hazarding an answer—a daunting thought experiment—Epstein simply assumes that the value of rights in the SON are a scaled-down version of the value of rights in society. Thus, if Brains is earning 100 times more than Brawn in America circa 1999, we are to assume that the use value of Brains's human capital in the SON was 100 times higher than the use value of Brawn's. As discussed below, this assumption that people's endowments retain the same relative values in moving from SON to society is critical to Epstein's argument for proportionate taxation; it also seems completely unfounded.

The second problem is, what portion of the surplus value generated by civilization is subject to division by collective decision-making? In the typical private joint venture envisioned in the 60/40 partnership example above, the answer is relatively clear. First, the boundaries between the partnership's activities and the separate activities of each partner are typically clearly demarcated, and hence that portion of social wealth attributable to the returns to the partnership's activities clearly demarcated as well. In committing their respective \$60,000 and \$40,000 to their joint venture, each partner implicitly commits to dividing those returns by some collectively agreed-to decision rule.

The answer to the question, however, is far from clear in the context of the Lockean social contract. What exactly are the boundaries of the partnership we are embarked upon here? Does it extend only to the creation and operations of the formal state, or does it extend to social organization in any form? Epstein and others appear to make the latter assumption, in assuming that the entire (aggregate) increase in wealth we all realized in moving from the SON to America circa 1999 is subject to division by collective decisionmaking. That broad view, of course, implies that the enormous gains society bestows on those whose natural talents have little use value on their Crusoeian island are all up for grabs. One *could* take this view of our implicit (Lockean) social contract, pursuant to which all the gains that, say, Wayne Gretsky realizes by moving from being Wayne Gretsky alone on a desert island, thinking of inventing a game called hockey if he could ever find ice, eleven other players, and an audience to pay to watch, to being Wayne Gretsky in late twentieth-century America

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<sup>56</sup> *Id.* at 3.

earning \$20 million a year, are thrown into a common pool for division in accordance with some norm of just distribution. This is certainly a plausible moral view, with a number of respectable adherents.<sup>57</sup> But it seems like an odd concession to collectivist ethics for libertarians to make. One would expect them to insist that a smaller portion of the gains to Gretsky from civilization is fair game for redivision among all citizens.<sup>58</sup> Limiting what is up for grabs to that portion of private gains directly attributable to the provision of specific, costly, public goods, is one possibility—a view that implicitly limits the scope of the social contract to the operations of the formal state. Nozick and others have suggested another: that the only thing that should be up for grabs is that portion of income that exceeds what the best endowed could have gotten, *not* by staying in the SON, but instead by seceding from the existing state and forming a new state whose membership was limited to the best endowed.<sup>59</sup>

Third, assuming that America circa 1999 represents one great joint venture, with each participant entitled to some share of the aggregate returns to civilization, how are those returns to be divided among the participants? A pro rata division, in accordance with the value of assets contributed, is an obvious solution only if one is dealing with inputs that have an opportunity cost (expected return outside the partnership) equal to their value inside the partnership. That condition is presumably met in the 60/40 partnership example above, if we assume the partners' only contributions are (fungible) cash, which is receiving a marginal (competitive) return. In such a case, the constraints of the market—the opportunity cost of capital—dictate a pro rata division of the partnership's income, whatever justice might require, and most people would take that result to be consonant with what justice in fact requires.

But in the Lockean social contract, the value of each person's assets is (by hypothesis) greater if exploited within the joint venture of civilization than it is outside of that joint venture in the SON. That is to say, the Lockean social contract resembles an *n*-person multilateral monopoly rather than a competitive equilibrium. Imagine, for example, that in our two-person partnership, partner A contributes a really good idea, which requires \$100,000 in ready cash to exploit, and partner B contributes the \$100,000—the only person, as it turns out, that was willing to come up on the

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<sup>57</sup> See, e.g., RAWLS, *supra* note 4, at 520-29; KENNETH J. ARROW, SOCIAL CHOICE AND JUSTICE 188 (1983).

<sup>58</sup> This position is, of course, just a variant of the point made above, concerning the level of aggregation at which to test the pareto-superiority of civilization.

<sup>59</sup> NOZICK, *supra* note 24, at 192-93. For a similar argument implicit in his parable of the greens and the purples, see GAUTHIER, *supra* note 14, at 284-86.

spot with the required cash. Now, there are gains from cooperation in excess of the returns available to either partner from her next best available opportunity. To that extent, they are, with respect to each other, locked in a bilateral monopoly. How should returns from our grand joint venture be divided now?

The problem presents one instance of the allocation-of-common-costs problem that has been subject to extensive analysis in the game theory literature. The question is, how should the common costs of a value-enhancing cooperative venture be allocated among the cooperating parties? While a detailed treatment of the issue is beyond the scope of this paper, a brief overview may be helpful in framing the problem.

In game-theoretic analyses, the possible solutions ("core") of the common-costs problem are taken to include all allocations that give each player in the cooperative game a payoff at least as great as the greater of (1) what she could have secured through a non-cooperative strategy, and (2) what she could have achieved as a member of the most profitable coalition of players that could secede from the group to pursue their own cooperative strategy.<sup>60</sup> Clearly, condition (1) requires that each person get a return from civilization (net of taxes) at least equal to the value of her assets in the SON—that the choice be individually rational. (This, of course, correlates with the minimal pareto condition imposed at the maximum level of aggregation.) Condition (2) adds the additional requirement of group rationality; it just restates in a slightly different form Nozick's secession thought experiment, described above.<sup>61</sup> Nozick is concerned with defining the extent of private gains that are up for grabs at all; condition (2) is concerned with defining how such gains should be divided. But the two are just different paths to the same conclusion: the best endowed group in society (and by extension each lesser endowed group in turn) will claim for itself, at a minimum, that portion of the gains from social cooperation that it could have achieved by seceding from America circa 1999 and forming a new state whose membership is limited to the best endowed.

What if anything do the above conditions imply about the appropriate division of surplus from society? First, the strict requirement of individual or group rationality holds as a descriptive matter—that is, predicts the actual outcomes in allocating common costs—only where exit from the group is possible and

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<sup>60</sup> For a discussion of this "stand alone property," see Lewis Kornhauser, *Fair Division of Settlements: A Comment on Silver and Baker*, 84 VA. L. REV. 1561, 1568-72 (1998); HERVE MOULIN, AXIOMS OF COOPERATIVE DECISIONMAKING, 89-95 (1988). I am indebted to Lewis Kornhauser for pointing out the relevance of the standard allocation-of-common-costs analysis to the problem at hand.

<sup>61</sup> See *supra* note 59 and accompanying text.

costless. To the extent that it is costly for the best endowed members of society (and by extension any other subgroup) to secede from America circa 1999 to form their more perfect union, the gains they could have realized in that more perfect union are, as a purely positive matter, expropriable by the less well-endowed majority. This, of course, describes to a considerable extent the situation facing the very rich in this society.<sup>62</sup> In such a case, what, if any, normative force does condition (2) carry? Are we required to abide by the distributive results the best endowed could have obtained for themselves were exit costless, even though it is not, and if so, why?

Assuming that we are, in fact, morally required to abide by condition (2) (the results of the Nozickean thought experiment), what does it imply about the appropriate division of surplus from society? As Kenneth Arrow has argued, if there are no increasing returns to scale for society and no externalities, in a large enough economy where no individual is large on the scale of the economy, "the core shrinks to the competitive equilibrium."<sup>63</sup> That is to say, condition (2) leads to whatever division of surplus happens to result from market prices, and there is, as Arrow states, no problem of social justice left at all.<sup>64</sup> In such a world, taxation is presumably relegated to a pure benefits tax, with rates set to mimic (as far as possible) the prices the market would itself set for publicly provided goods or services.

If there *are* increasing returns to scale from organized society, generating significant gains from nonsecession for any subgroup, including the best-endowed, the range of solutions in the core is less clear.<sup>65</sup> Contrary to Epstein's, Gauthier's, and others' apparent assumption, however, there is unlikely to be any unique solution to the problem, and an allocation that assigns surplus (net of taxes) in proportion to the value of SON assets is not necessarily even in the core of the game.<sup>66</sup>

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<sup>62</sup> Given the inherent administrative limitations of an income tax, which does not tax leisure, the rich do of course have a less costly means of exit available to them if tax rates get high enough: to trade off productive labor for (untaxed) leisure. As a practical matter, that form of exit is likely to constrain political choice far more than the more extreme sort of exit contemplated here.

<sup>63</sup> ARROW, *supra* note 57, at 188.

<sup>64</sup> *Id.*

<sup>65</sup> For the thoughtful argument that there *are*, in a deep sense, such increasing returns to scale from organized society, see ARROW, *supra* note 58, at 188. I am indebted to Marvin Chirelstein for bringing this passage to my attention.

<sup>66</sup> For a proof of the latter proposition in the context of joint litigation costs, see Lewis Kornhauser, *Control of Conflicts of Interest in Class Action Suits*, 41 PUBLIC CHOICE 145 (1983).

2. Would Pro Rata Division of the Surplus Value of the Social Contract, in Proportion to the Value of Individual Rights in a SON, Lead to Proportionate Taxation to Finance the Cost of Public Goods?

Epstein, along with numerous others, presumes the answer to the above question is yes. In fact, the answer is no, unless two conditions are met: everyone must derive utility from the creation of the minimal state in proportion to the value of his or her rights in an SON, *and* the utility each person derives must all be reflected in income (or whatever other tax base we use). It is extremely unlikely that *either* of these conditions will be met, let alone both.

A simple example will illustrate the problem. Suppose we have a two-person SON society. Person A, a hunter, has rights, in the form of human capital, with a market value of \$10. Person B, a gatherer, has rights, in the form of human capital, with a market value of \$20. The two enter into a compact to create a Nozickian/Lockean minimal state, pursuant to which they forswear Hobbesian aggression against each other, agree to hire a mercenary police force and army to enforce their Hobbesian contract against mutual aggression and to defend themselves jointly against outside aggression, and agree to create a variety of pure public goods, including a lighthouse, a TV broadcasting system, and roads. All of these goods and services together cost \$100 to supply.

Due to the advances that civilization has brought, person A is now able to give up hunting and become a taxi driver for visiting tourists. She spends her spare time watching television. The total subjective value to her of her rights in civilization is equal to \$230, of which \$140 is attributable to income generated by driving a cab and \$90 to the pleasures of watching TV. Person B, in the meantime, becomes a television technician. He works all the time, generating a total subjective value to him of \$260, equal to the total market earnings he realizes.

Thus, in our simplified example, the total costs of civilization are equal to \$100, and the total benefits of civilization are \$460 (\$490 total utility in civilization, minus \$30 total utility in the SON), yielding a net surplus value from civilization of \$360. How is the \$100 cost of producing that \$460 benefit to be divided through the tax system? Epstein would argue it should be divided such that A ends up with one-third of the total \$360 surplus value, or \$120, and B ends up with the remaining \$240. But, as the chart below indicates, that result would mean that A must bear the entire \$100 cost of public goods, and B nothing. In con-

trast, a proportionate tax on earned income (which in this example totals \$400) would take 25% of the earned income from each of the two, producing a \$35 tax bill for A (.25 x \$140) and a \$65 tax bill for B (.25 x \$290).

EPSTEIN'S TALE OF TWO PIES

	A Hunter Turned Taxi Driver	B Gatherer Turned TV Repairman
SON (wealth)	\$10	\$20
LS (wealth)	\$230	\$260
	(\$140 income and \$90 imputed income)	(income)
Epstein tax allocation	\$100	\$0
After-tax wealth	\$130	\$260
Net of rights in SON	-\$10	-\$20
After-tax share of surplus	\$120	\$240
Tax allocation under 25% proportionate tax on income	\$35	\$65

Thus, Epstein's "proportionate division of the surplus" rule clearly produces results that are wildly removed from a proportionate tax on income. In this particular example, it produces a tax scheme in which 100% of the tax burden falls on the person with the lower earned income. While that particular result is an artifact of the numbers chosen, the more general conclusion is not. Indeed, only by the most implausible coincidence would Epstein's rule *ever* produce something approximating proportionality.

To drive the point home, imagine we expand the example to a four-person SON society, in which, in addition to A and B above, we also have C, a wily but puny hunter, whose brains compensate only partially for her absence of brawn, leaving her slightly worse off than A; and D, a 7 foot 6 inch gatherer whose freakish height is on the whole a disadvantage for his chosen profession in the SON economy, leaving him slightly worse off than B. In the Hobbesian minimal state circa 1999, C becomes a well-paid law professor, the income from which far outstrips A's or B's, and D becomes a basketball superstar, the income from which dwarfs A's, B's and C's. The relative gains to C and D—whose distinguishing talents were completely worthless in the SON—from entering into civilized society are wildly disproportionate to their relative positions in the SON. As a consequence, a tax designed to return C and D to their same SON positions relative to A and B must necessarily fall in a confiscatory manner on C and D.

### III. SOCIAL WELFARIST/CONSEQUENTIAL THEORIES OF DISTRIBUTIVE JUSTICE

The intuition that tax burdens should be set in a fashion that minimizes the aggregate burden they entail has long held appeal. For the latter part of the nineteenth century and first half of the twentieth, that intuition was most frequently embodied in the notions that tax burdens ought to be allocated in accordance with "ability to pay," or to "minimize sacrifice." For reasons thoroughly rehearsed elsewhere, neither "ability to pay" nor "minimum sacrifice" theories have moral coherence as freestanding principles of distributive justice.<sup>67</sup> They are incomplete intuitions of a deeper, unarticulated (social welfarist) theory of distributive justice, in which the state has an obligation to use its fiscal powers to further the aggregate welfare of society, aggregated in accordance with some implicit or explicit social welfare function.

Viewed in that larger context, the social welfarist case for *any* tax structure judged in isolation is inherently unsatisfactory, for reasons that critics of "ability-to-pay" and "equal sacrifice" theory on the right and the left have long recognized. Once we admit that the redistribution of income for social welfarist ends is a legitimate role for the government, it is morally incoherent to isolate the tax side from the transfer/expenditure side of the fiscal ledger. As Wicksell commented many years ago, there is no point in achieving "a just part in an unjust whole."<sup>68</sup> It is operationally incoherent to isolate the tax side of fiscal affairs as well, for the simple reason that we can undo any tax distribution on the transfer side. Take the following, simple example. Suppose we have a two-person society in which Poor earns \$1000 and Rich earns \$10,000. Suppose we impose a flat tax of 45% on both Poor and Rich, thereby reducing Poor's after-tax income to \$550 and Rich's to \$5500. Suppose we then take the resulting \$4950 in tax revenues, and distribute them in-kind and in cash entirely to Poor. One would be hard-put to disagree if Rich is heard to complain that the net result of all this fiscal legerdemain is a confiscatory tax on Rich for the purpose of achieving absolute income equality between Rich and Poor.<sup>69</sup>

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<sup>67</sup> See MUSGRAVE, *supra* note 17, at 90-115.

<sup>68</sup> KNUT WICKSELL, *FINANZTHEORETISCHE UNTERSUCHUNGEN UND DAS STEUERWESEN SCHWEDEN'S* 143 (Jena 1896) *quoted in translation in* MUSGRAVE, *supra* note 17, at 72. See also Edgeworth's and Pigou's observations to the same end, both *cited in* MUSGRAVE, *supra* note 17, at 111; discussion in FRIED, *supra* note 30, at 154-55.

<sup>69</sup> The potential for undoing any tax distribution on the transfer side has not been lost on the right, although proponents of proportionality on libertarian grounds probably have underestimated the extent to which it undercuts any fairness arguments for proportional tax rates judged in isolation. See, e.g., HAYEK, *supra* note 1, at 307 (recognizing the potential for effecting radical redistribution through use of proportionate tax and differential transfers to the lower classes, but assuming that potential is limited in practice by the

What an optimal tax-and-transfer scheme would look like under a plausible range of social welfare functions giving priority to the needs of the worst-off has been much debated. The central problem, of course, is how to balance welfare gains (assuming a declining marginal utility of income) from redistributing income to the poor, against welfare losses from the distortionary effects of taxes required to finance the redistribution. It has been suggested that a degressive tax, or even a tax rate structure that declines slightly at the top, may well be optimal *if combined with* substantial lump-sum transfers (so-called demogranants).<sup>70</sup> The intuition behind flattening rates at the top is that the last, or marginal, incremental decision to work or save is *most* sensitive to tax rates. In a world with perfect information, each person would have her own optimal tax schedule, with rates set very high on inframarginal earnings, and declining, ultimately to zero, on the last (marginal) dollar earned. In our actual world, where we cannot observe people's true preferences, a degressive tax structure might best approximate that ideal result. More recent work has cast doubt on the efficiency arguments for a degressive tax, suggesting that, at least in some contexts, in particular, in winner-take-all markets and contexts where work and savings decisions are driven by a desire for relative status, steeply graduated rates may well be *more* efficient than flat rates.<sup>71</sup> The larger point, however, remains clear. The case for any tax structure on social welfarist grounds is purely derivative of prior moral commitments to a particular social welfare function, and empirical hunches about the combination of tax and transfer schemes that will best effect it.

Notwithstanding the foregoing, many thoughtful people, proceeding on social welfarist premises, have found it irresistible to assess the desirability of a given tax arrangement in isolation from the transfer side of fiscal affairs. This approach is perhaps an inevitable occupational hazard for professional tax types, whose habitual frame of reference and claims to expertise both push toward that partial view. It may also, in some cases, sensibly reflect political exigencies. If a decisionmaker is limited, as a political matter, to affecting the distribution of tax burdens, then it is perfectly sensible for her to take all other variables as given.

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inflexibility of in-kind transfers as a tool for income redistribution). Of course, once one admits the possibility of straight cash transfers, that problem goes away.

<sup>70</sup> See Bankman & Griffith, *supra* note 21, at 1955-58.

<sup>71</sup> For a very suggestive treatment of these issues, see ROBERT H. FRANK AND PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY* (1995), and Robert H. Frank, *Progressive Taxation and the Incentive Problem*, Working Paper no. 98-4 (Off. Tax Pol'y Res., U. of Mich. Bus. Sch., 1998). For a much earlier treatment of the relative status problem along the same lines in a slightly different context, see A.C. PIGOU, *A STUDY IN PUBLIC FINANCE* 90 (3d rev. ed. 1947).

The tendency for social welfarists to assess the fairness of tax burdens, divorced from the government's other fiscal functions, extends far beyond the foregoing situations, however, to include those who are trying to work out a just scheme of income distribution *de novo*. Perhaps the most recent striking example is Rawls.

In *A Theory of Justice*, Rawls suggests that the fairest tax scheme for raising funds to "provide for the public goods and make the transfer payments necessary to satisfy the difference principle" would be a proportional consumption tax.<sup>72</sup> Rawls offers the suggestion in passing, as a part of a hodgepodge of proposed fiscal arrangements to effect a just state, and it seems doubtful that he has thought through the implications of any of these institutional arrangements very clearly.<sup>73</sup> At any rate, one suspects he would think better of many of them on further reflection.

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<sup>72</sup> RAWLS, *supra* note 4, at 278-79.

<sup>73</sup> Following Musgrave, Rawls divides the government into four functions: the allocative, stabilization, transfer, and distribution branches. For our purposes, only the latter two are relevant. The transfer branch Rawls defines as concerned with guaranteeing a social minimum, provided either piecemeal by family allowances, special payments for sickness, and employment, or more systematically by a negative income tax. RAWLS, *supra* note 4, at 275. He subdivides the distribution branch into two functions: (1) regulating intergenerational transfers, through gift and estate taxes and restrictions on rights of bequests, in order to "prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity," *id.* at 277; and (2) raising tax revenues necessary to "provide for the public goods and make the transfer payments necessary to satisfy the difference principle," *id.* at 278.

There are a number of peculiarities here. First, it would seem that the guaranteed minimum income that is the focus of the transfer branch should be subsumed under transfers necessary to satisfy the difference principle, the task of the second leg of the distribution branch. Rawls himself seems to concede as much, in stating that "[o]nce the difference principle is accepted, however, it follows that the minimum is to be set at that point which, taking wages into account, maximizes the expectations of the least advantaged group." *Id.* at 285.

Second, it is not clear why the first and second legs of the distribution branch should be treated as distinct. Why single out intergenerational transfers as a unique violation of the just state that need to be dealt with through their own institutions, rather than simply treating them as one of many possible sources of inequality that all require governmental correction in accordance with the difference principle? One customary reason for distinguishing intergenerational gratuitous transfers from other sources of wealth, such as labor income and returns to one's own lifetime savings, is because the former is regarded as uniquely "unearned" and hence undeserved. See FRIED, *supra* note 30, at 97-99; ERIC RAKOWSKI, *EQUAL JUSTICE* 158-62 (1991). Whatever the problems with this view—and they have been much debated over the centuries—the view is clearly not one congenial to Rawls. Rawls, consistent with his broad view of undeserved privilege, explicitly states that "[t]he unequal inheritance of wealth is no more inherently unjust than the unequal inheritance of intelligence," and that "as far as possible inequalities founded on either should satisfy the difference principle." RAWLS, *supra* note 4, at 278. This statement suggests that wealth from inheritance should be treated like wealth from any other source, presumably all under the second distribution branch. The second danger that Rawls suggests is posed by inherited wealth—that when it creates inequalities in wealth that exceed a certain limit, it threatens "the fair value of political liberty and fair equality of opportunity" in society, *id.* at 277—likewise suggests no ground for separating inherited wealth from any other source of wealth. If the concentration of wealth is what matters, the source should not.

Finally, Rawls's hostility to intergenerational transfers is hard to reconcile with the solicitude he shows to savers in supporting a consumption tax in place of an income tax.

In defense of a proportional rate structure—the element of the scheme of relevance here—Rawls notes only that “it treats everyone in a uniform way (. . . assuming that income is fairly earned).”<sup>74</sup> At the outset, Rawls’s argument runs smack into the same difficulty faced by most libertarian defenders of a flat-rate tax: the tax rate structure Rawls supports is, in fact, not a proportionate one, but a degressive one, since Rawls, like most other proponents of proportionality, would permit the “usual exemptions for dependents.”<sup>75</sup> Whatever other merits such a scheme might have, it surely lacks the virtue of “uniformity” as that word is used here. Setting that difficulty aside, the form of uniformity or equality that Rawls implicitly champions here, equal percentages of income taken, is hardly an obvious solution to the question, “equality of what?,” a matter to be returned to shortly. That point is underscored by noting that the difference principle Rawls would use in setting transfers adopts a quite different notion of uniformity: uniformity of absolute income levels after tax and transfer, subject to the exception for inequalities that help the least well off.

That last observation brings us to what is surely the greatest oddity of Rawls’s championing of a flat-rate tax. In the context of the overall Rawlsian scheme, the right not to have one’s income taxed at a higher marginal rate than one’s neighbor’s stands as an island of deontological rights swamped by a sea of redistribution. As the above example of Rich and Poor illustrates,<sup>76</sup> if the proceeds of a Rawlsian tax are used to finance the transfers to the least well off required by the difference principle, the fact that the rich are treated “uniformly” with the poor on the tax side should be cold comfort to them, and a matter of total moral indifference to a Rawlsian.

Indeed, the same criticism Rawls rightly makes at “traditional criteria” for fair taxation, ability to pay and benefits theory, can be made of Rawls’s proposed tax scheme: it does not “take a

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The salient difference between a consumption tax and an income tax is the treatment of savings: a consumption tax exempts from taxation at least some forms of capital income currently taxed under our income tax. See Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 540-42 (1998). In defense of a consumption tax base, Rawls appeals to the “common sense precepts of justice,” precisely the ones that appealed to Hobbes some three hundred years ago, that “it imposes a levy according to how much a person takes out of the common store of goods and not according to how much he contributes (assuming here that income is fairly earned).” RAWLS, *supra* note 4, at 278. Whatever the merits of this position, the statement is hard to reconcile with Rawls’s position on intergenerational transfers. Given that a significant portion of lifetime savings, at least among the wealthy, is destined for intergenerational transfer through inter vivos gifts and bequests, the choice to protect the return to savings, via a consumption tax, during a taxpayer’s lifetime, while burdening the same decision heavily upon death, seems to require some justification.

<sup>74</sup> RAWLS, *supra* note 4, at 278-79.

<sup>75</sup> *Id.* at 278.

<sup>76</sup> See *supra* note 69 and accompanying text.

sufficiently comprehensive point of view" of the government's role in securing a just distribution of income.<sup>77</sup>

As a final oddity in Rawls's defense of proportionality, Rawls suggests that flat rates are obviously fair only in an already just world. Given the injustice of existing institutions, Rawls argues, there may be a role for "even steeply progressive income taxes."<sup>78</sup> By "injustice," Rawls appears to mean here a world in which not all income is "fairly earned."<sup>79</sup> It is hard to figure out what this essentially Nozickean principle of rectification is doing in a Rawlsian world. Given Rawls's view that talents, including a taste for hard work, are undeserved, and hence the income derived from those talents undeserved, what could it mean to Rawls for a person to earn income fairly, such that it was *not* up for grabs under a steeply progressive income tax?

In the end, the impossibility of making any logical sense, in the context of his larger aims, of Rawls's positions on tax policy in general, and rate structures in particular, makes those positions of more than common interest—not in justifying those positions, but in appreciating the breadth and strength of the irrational pull they exert. If Rawls, of all people, could think a flat tax a just tax because "it treats everyone in a uniform way," surely there is some powerful instinct at work here that resists logic. What is it?

#### IV. EQUALITY OF TAX BURDENS AS A PERCENTAGE OF INCOME AS A DEFAULT POSITION

Rawls may be the most surprising expositor of the view that a flat tax is the fairest tax of all, but he is hardly alone. Many people believe (1) that one can assess the fairness of a tax system in isolation from government expenditures or any other government policies affecting the distribution of wealth, and (2) that viewing our tax system from such a perspective, a proportionate tax scheme is the self-evidently fairest one, because, in the words of Rawls, "it treats everyone in a uniform [that is, equal] way."<sup>80</sup> Indeed, for many, flat rates (or more precisely a degressive rate structure) appear to be the *only* feature of the tax system that is mandated on fairness grounds.<sup>81</sup>

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<sup>77</sup> RAWLS, *supra* note 4, at 280.

<sup>78</sup> *Id.* at 279.

<sup>79</sup> Or so I infer from his repeated insistence on this qualification on his support for a flat-rate consumption tax in the preceding passage. *Id.* at 278-79. Rawls doesn't state explicitly what injustices he has in mind here.

<sup>80</sup> *Id.*

<sup>81</sup> Epstein, for example, treats all other fundamental choices in tax system, including the choice of a taxable base, double taxation at the corporate level, the realization requirement, the home mortgage interest deduction, and the preferential treatment of capital gains, as normatively discretionary calls, on the empirical assumption that the resolution of each of these questions will have little systematic impact on the distribution of surplus.

Everyone is in favor of equality. The question, of course, is "equality of what?" Why this particular version of equality, taking an equal percentage of everyone's income, has had such widespread and persistent appeal is something of a mystery. It has history on its side, of course, in the biblical tradition of tithing, but that merely pushes the mystery one step back.

To take the case for proportionality in its most sympathetic posture, let us assume that the beneficiaries of public expenditures are absolutely impossible to trace, thereby precluding any benefits-theory-based defense for any rate structure. We can invoke here Blum and Kalven's helpful suggestion that we treat the collection of taxes "as though it were only a common disaster—as though the tax money once collected were thrown into the sea."<sup>82</sup> Let us also assume that the state has no legitimate, social welfarist interest in redistribution, and that we take the background distribution of pretax incomes as just. In this limited context, in which the fairness of tax burdens is to be judged completely in isolation, can we say anything at all about their just distribution?

For most people, the default assumption in such a case, where taxes are, in Blum and Kalven's words, "a necessary evil falling upon a distribution of money . . . which is otherwise acceptable,"<sup>83</sup> is that the tax burden ought to be shared equally by all taxpayers. This view is obviously reflected in the longstanding argument, going back at least to Mill, for "equal sacrifice" in taxation.<sup>84</sup> That argument, however, simply raises the question adumbrated above, equality of what?

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TAKINGS, *supra* note 5, at 300-02. That assumption is almost certainly wrong with respect to many of these items, given the highly skewed distribution of capital income in this country. The only other tax policy choice attracting constitutional scrutiny from Epstein is industry-specific tax breaks like percentage depletion for oil and gas.

Others, of course, notably including Rawls, have argued that the choice of tax base (consumption versus income) raises fundamental issues of fairness. That argument is conspicuously absent, however, from most contemporary defenses of the so-called Hall/Rabushka flat tax championed by Steve Forbes and adopted as the model for the Arme/ Shelby plan now pending before Congress. The Hall/Rabushka plan, along with most so-called flat tax schemes, adopts a consumption tax base in place of an income tax base, in addition to shifting from a graduated to a degressive rate structure. Notwithstanding that fact, as Larry Zelenak argues at length in his piece for this symposium, most proponents of the plans on fairness grounds are conspicuously silent about the former change. Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Base and Rate*, 2 CHAP. L. REV. 197 (1999). Hall and Rabushka themselves, for example, completely ignore the consumption tax feature of their proposal in their 30-page defense of the fairness of their flat tax. HALL & RABUSHKA, *supra* note 7, at 23-51.

<sup>82</sup> Blum & Kalven, *supra* note 6, at 517.

<sup>83</sup> *Id.* at 460.

<sup>84</sup> For typical expressions of that view, see *Taxation*, *supra* note 5, at 73-74 (where the benefits and other costs of government are hard to assess, "a test of equal treatment across taxpayers becomes the next best alternative"); Blum & Kalven, *supra* note 6, at 460 (if taxes are a necessary evil falling on a distribution of income otherwise just, the object is "to leave all taxpayers equally 'worse off' after taxes").

Now, we are plunged into a long-running dispute, well-documented elsewhere, and I do not propose to rehash it at length here.<sup>85</sup> In brief, commentators have disagreed about the proper meaning of both equality and sacrifice, in interpreting "equality of sacrifice." Two principal measures of equality have been proposed: equal absolute sacrifice, and equal proportionate sacrifice (in proportion, that is, either to income or to any substitute taxable base).<sup>86</sup> Two principal measures of sacrifice have been proposed: that sacrifice should be measured by the *utility of dollars* relinquished, and that it should be measured by *dollars* relinquished.

The resulting four-cell matrix obviously yields four different interpretations of "equality of sacrifice." Of the four, only one—equal *proportionate* sacrifice measured by *dollars* relinquished—unambiguously (indeed, definitionally) leads to a flat-rate tax. Equal *proportionate* sacrifice measured by the *utility of dollars* relinquished under most plausible utility schedules for money would yield a progressive rate structure. Equal *absolute* sacrifice measured by *dollars* relinquished obviously yields a highly regressive head tax. Equal *absolute* sacrifice measured by the *utility of dollars* relinquished is the most ambiguous: under differing but plausible assumptions about the declining marginal utility of income, it could imply a regressive, proportionate, or progressive rate structure.<sup>87</sup>

What, then, explains the apparently widely shared intuition that the equality principle should be interpreted to require equal proportionate sacrifice, measured by dollars relinquished? The choice to use dollars, rather than the utility of dollars, as a measure of sacrifice, does not seem hard to defend. Indeed, the contrary choice, adopted by numerous tax theorists over the last century, is much harder to understand.<sup>88</sup> We customarily measure the price exacted for goods or services by nominal dollars paid, not by the subjective disutility to the payor of relinquishing those dollars. Opting for the latter measure here—a measure

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<sup>85</sup> See Blum & Kalven, *supra* note 6, at 455-65; MUSGRAVE, *supra* note 17, at 90-98; FRIED, *supra* note 30, at 153-54.

<sup>86</sup> The third measure proposed by Mill, equimarginal sacrifice, was rightly dismissed by friends and foes alike as nothing more than a stand-in for utilitarian concerns. See FRIED, *supra* note 30, at 154-55.

<sup>87</sup> See MUSGRAVE, *supra* note 17, at 99-100; Blum & Kalven, *supra* note 6, at 458-59. David Gauthier, to take one recent example, assumes that the measure (which he supports in a convoluted fashion) would result in a flat-rate tax. GAUTHIER, *supra* note 14, at 272. There is clearly no more empirical, or even strong intuitive, support for that conclusion, however, than for the alternative Friedmanesque assumption, which Gauthier rejects, that the *quantity* of public goods people consume is proportionate to their income. *Id.* at 271.

<sup>88</sup> See, e.g., Antonio de Viti de Marco, *cited in* MUSGRAVE, *supra* note 17, at 73; FRIED, *supra* note 30, at 154-55, 301 nn.261-62. For a more recent defense of utility as a measure of sacrifice, see GAUTHIER, *supra* note 14, at 271-72.

that, under conventional assumptions of the diminishing marginal utility of wealth, is inversely correlated with initial wealth—is hard to explain except as an indirect way to smuggle in the very redistributive objectives that we ruled out of bounds at the start of this inquiry, when we took the background pretax distribution of incomes as just.<sup>89</sup>

The former choice, however—the choice of *proportionate* over *equal absolute* sacrifice—seems much harder to defend. Probably the most famous, albeit indirect, brief for proportionate taxation, Blum and Kalven's "Uneasy Case," has only two things to say on behalf of the fairness of flat rates in the course of its 100-page assault on graduated rates. The first is that "[a]s a principle of justice [proportionate sacrifice] is intuitively attractive."<sup>90</sup> The second is that the "virtue of the proportionate sacrifice formula is that it remains neutral as to the relative distribution of satisfactions among taxpayers."<sup>91</sup> Virtually all defenses of proportionality ultimately boil down to some variant of the former "I know fairness when I see it" claim, or the latter tautology. In the tautological vein, for example, consider Hall and Rabushka's argument that "[t]he principle of equity embodied in the flat tax is that every taxpayer pays taxes in direct proportion to his income."<sup>92</sup> Or consider Hayek's: while progression represents "discrimination against the wealthy,"<sup>93</sup> proportionality "raises no problem of a separate rule applying only to a minority."<sup>94</sup>

Can we do no better than this? The usual starting point for implementing equality-based norms is that people who are identical *in relevant respects* should be treated identically. The case for

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<sup>89</sup> Gauthier attempts to justify a utility measure of sacrifice as not redistributive in intent here by reference to his notion of "minimax relative concession" (MRC). GAUTHIER, *supra* note 14, at 271-72, and note 46, *supra*. In brief, MRC requires an equal division of the joint gains from cooperation, including gains from the cooperative provision of public goods. Gauthier argues that a head tax will violate the requirements of MRC, because under a head tax "a person with fewer resources will lose a greater proportion of the gain he would realize were he to obtain the good at no [tax] cost." *Id.* at 272. Presumably, this result follows in Gauthier's mind from the declining marginal utility of income: since dollars are worth more to the poor, a head tax strips from them more absolute utility, and hence a greater absolute share of the surplus. But if the utility of tax dollars given up to purchase public goods is greater, so also, presumptively, is the utility of public goods retained, net of taxes (that is, the poor's share of the surplus from cooperation less their share of the tax costs). If so, Gauthier's requirement that surplus be divided equally, in utility terms, seems more plausibly to lead to a steeply regressive tax than a flat tax. At any rate, it requires some odd assumptions about the shape of marginal utility curves over the relevant ranges to conclude otherwise. In the end, Gauthier's inclination to measure gain by utility, like his inclination to equalize the division of surplus under MRC, seems hard to explain except as an expression of egalitarian impulses that are uneasily reconciled with the libertarian premises of his project.

<sup>90</sup> Blum & Kalven, *supra* note 6, at 460.

<sup>91</sup> *Id.*

<sup>92</sup> HALL & RABUSHKA, *supra* note 7, at 27.

<sup>93</sup> HAYEK, *supra* note 1, at 313.

<sup>94</sup> *Id.* at 314-15.

any tax rate structure that is tied to the level of income, be it progressive, proportionate or even regressive, thus depends on showing that income levels are morally relevant in setting differential tax burdens. In the case of benefits theory or social welfarist approaches, the claim for moral relevance of income levels is obvious. In the case of benefits theory, income is taken as a proxy for benefit levels; in the case of social welfarist approaches, whether embodied in inchoate form in "ability to pay" arguments or full-blown optimal tax analyses, income (or capacity to generate income, as reflected in actual income) is taken as the prime measure of welfare. If the justice of tax burdens is really to be judged in isolation from either the distribution of government benefits or the desired end-state distribution of income, however, it is difficult to see why income levels would ever be relevant in measuring equal treatment. The far more plausible measure of equality under those conditions would seem to be equal treatment of individuals, a premise that would seem to lead to a head tax. Indeed, Blum and Kalven argue as much in another context, in attacking Mill's "equimarginal sacrifice" as a plausible interpretation of equality. If we are really confining discussion to how we should allocate a burden, and are ignoring benefits and distributive concerns, Blum and Kalven argue, the principle of equimarginal equality "seems not a little absurd. . . . [I]t is strange indeed to have [two men] share a common burden by putting all of it on the wealthier man."<sup>95</sup> It is no less absurd in principle, although less extreme in degree, to put more of it on the wealthier man than the poorer one just because he is wealthier. At least, it is hard to see how the absurdity could ever be removed, except by reference to either benefits theory or social welfarist concerns.

#### V. TAXES SHOULD BE LEVIED SO AS TO LEAVE PEOPLE'S CHOICES UNDISTORTED

A number of commentators with libertarian sympathies have argued for proportionality on the ground that it would leave people's choices undistorted from what they would have been in a no-tax world.<sup>96</sup> Minimizing tax-induced distortion in behavior is, of course, the goal of much of public economics, on efficiency grounds. For Epstein, Gauthier and others, that ideal appears to have libertarian roots, of a Randian/personalist sort. As Epstein put it:

The creation of a system of government should strive not to reduce the scope of permissible individual choice from what it was before. Accordingly, no person or group should be able to use the tax system to change the pattern of preferences of other in-

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<sup>95</sup> Blum & Kalven, *supra* note 6, at 470-71.

<sup>96</sup> See *Taxation*, *supra* note 5, at 74; GAUTHIER, *supra* note 14, at 272-73.

dividuals. If A ranks a set of (noncoercive) alternatives 1 to n before taxation, then A's ranking of those alternatives should remain 1 to n, without alteration, after the tax is imposed.<sup>97</sup>

This statement is hardly a universally shared interpretation of the requirements of libertarianism. It treats individual liberty as residing in undistorted individual choice among actions, rather than, for example, the utility any particular choice generates. Thus, nothing in Epstein's example would preclude a near-confiscatory tax on earnings from any source, provided only that it did not reverse rank orderings of choices. Be that as it may, contrary to Epstein's assumption, the requirement that we preserve the rank orderings of choices—including both the choice among kinds of work and the choice between work and leisure—does not lead in the first instance to either proportionate taxation or, what Epstein erroneously takes to be the same thing, a tax system that leaves the relative wealth of taxpayers constant.<sup>98</sup> It leads to a highly regressive head tax, endowments tax, or some other form of pure lump-sum taxation. As a second-best alternative, where lump-sum taxation is politically infeasible or distributionally undesirable, it leads to a Ramsey-type optimal tax on labor or capital, in which tax rates are set in inverse proportion to the elasticity of supply, in order to have the tax burden fall, as far as possible, on suppliers' rents. As discussed above, what precisely such an optimal tax scheme implies about the rate structure in a broad-based income tax has been much debated, without any definitive conclusion. A case can be made for a degressive, or even a regressive rate structure at the top of the income scale, on efficiency grounds.<sup>99</sup> But the choice to opt for any broad-based income tax in preference to lump-sum taxation in the first instance must be driven by distributional concerns that are hard to reconcile with the Randian libertarianism driving Epstein's argument here, or the more conventional, property rights-based libertarianism reflected in benefits theory.

## VI. POLITICAL ECONOMY ARGUMENTS FOR A FLAT TAX

Proponents of proportionate taxation have offered a variety of political economy arguments on behalf of flat rates. Perhaps the most prominent is an argument, chiefly associated with Hayek but espoused by many others as well, that proportionality, as a rule of

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<sup>97</sup> *Taxation*, *supra* note 5, at 55. For similar comments from Gauthier, see GAUTHIER, *supra* note 14, at 272-76.

<sup>98</sup> "If tax neutrality [in this sense] could be perfectly achieved, the laws would act as a prism which magnified equally all preexisting endowments. The nature of private activities would not change, nor would the relative endowments of private persons." *Taxation*, *supra* note 5, at 56. The former conclusion is true; the latter is decidedly not.

<sup>99</sup> See *supra* note 70 and accompanying text.

general application, precludes the majority from imposing upon "a minority a rule which it does not apply to itself."<sup>100</sup> Such an imposition, Hayek argues, "is an infringement of a principle much more fundamental than democracy itself, a principle on which the justification of democracy rests."<sup>101</sup>

Hayek's argument for proportionality here, of course, depends on the fact that in raising rates on the minority rich, the majority also raises rates on themselves. Whatever merits the argument might have as an empirical or normative matter, however, the property Hayek seizes on here is hardly unique to proportionate taxation. It is even more true of a head tax, in which any rate increase imposed on the minority rich will fall on the majority even more heavily than in a proportionate scheme, a fact Epstein inadvertently surfaces, in mistakenly defending a flat tax on the grounds that "[a] rule that says you must pay a dollar for the dollar that you wish to exact from your neighbor" is an important constraint on political intrigue.<sup>102</sup> Indeed, the same property holds for *any* rate structure, including a highly progressive one, in which the rates of each income group are a positively correlated arithmetical function of the rates imposed on others. With little ingenuity, one could accommodate virtually any level of progression within that constraint.

There is, however, a further problem with Hayek's argument. It presumes, as Epstein argues, that "[t]he flat tax gives the government only one degree of freedom: what is the level of the revenues and, hence, of [the tax rate]?"<sup>103</sup> That conclusion is true, however, only if a flat tax, once enacted, cannot be repealed. If it can—and unless constitutionalized, it formally can as easily as the progressive rate structure it has hypothetically replaced—then at any time after a flat-rate structure has been enacted, the government has not one degree of freedom, but as many as it ever had, since enactment of a flat-rate structure does not itself preclude the bottom 51% of the population from sticking it to the top 49% at any time, simply by voting to abandon flat rates in favor of progressive ones. The Hayekian argument, to make any sense, must therefore depend upon a further assumption: that if one can persuade people to go for a flat-rate structure to begin with, one has a higher than (politically) customary chance of persuading

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100 HAYEK, *supra* note 1, at 314. For similar sentiments, see sources cited in Blum & Kalven, *supra* note 6, at 435 n.60; *Taxation*, *supra* note 5, at 70.

101 HAYEK, *supra* note 1, at 314. Epstein trumpets the same property of proportionality for a different reason, arguing that by limiting political choices to one tax rate that applies to all, proportionality reduces the opportunities for, and hence transactions costs of, factional fighting. *Taxation*, *supra* note 5, at 53, 57.

102 *Taxation*, *supra* note 5, at 70.

103 *Id.*

people to adhere to it going forward. On what could such an assumption be based?

#### VII. FLAT RATES AS A SCHELLING-LIKE FOCAL POINT

One possible answer lies in the suggestion that the broad appeal of proportionate taxation is attributable less to any easily explicable moral theory than to its operating as a Schelling-like focal point for people; that is, a solution that is psychologically prominent because of its apparent mathematical certainty, along with its apparent properties of equality.<sup>104</sup> I say apparent mathematical certainty and simplicity, because one can achieve equal or greater simplicity with other schemes—a head tax, for example—and equal mathematical certainty from *any* mathematically determinate function that correlates the tax rates of different income groups. But that logical quibble is in a sense beside the point here—the point being that, for *whatever* psychological or historical reasons, this particular relationship among tax burdens has a strong pull on the popular imagination.

There is much, particularly in Hayek's writings, to support the focal-point explanation. It may explain why people as divergent in their political commitments as Rawls and Hayek might fix on such a solution in good faith to begin with, as unselfconscious participants in a Schelling-like convergence. It also explains why proponents of less progressivity than now exists would fix on it as a strategic matter, as a political solution that is both obtainable and sustainable. Hayek himself seems to concede as much, when he acknowledges that he is seeking a principle "which has [a] prospect of being accepted and which would effectively prevent those temptations inherent in progressive taxation from getting out of hand," and rejects as an alternative solution "setting an upper limit which progression is not to exceed."<sup>105</sup> The problem with such a solution, notes Hayek, is that "[s]uch a percentage figure would be as arbitrary as the principle of progression and would be as readily altered when the need for additional revenue seemed to require it."<sup>106</sup> Of course, as noted above, a flat-rate scheme could be altered at will as well, to revert back to a progressive rate structure. But Hayek has perhaps got hold of a psychological truth here: a flat-rate structure has a psychological prominence that may make it easier to sell to voters in the first instance than many other possible rate structures that are less progressive than

<sup>104</sup> See Bankman & Griffith, *supra* note 21, at 1914. The certainty of a proportionate rate structure is a recurrent argument offered in its favor. See, e.g., HAYEK, *supra* note 1, at 313-14; Blum & Kalven, *supra* note 6, at 430-35, 511; LUTZ, *supra* note 15, at 70, 73-76.

<sup>105</sup> HAYEK, *supra* note 1, at 323.

<sup>106</sup> *Id.*

the current one, and may make it more likely, once enacted, to stick.

### VIII. POLITICAL FRAMING

Finally, the convergence on proportionate taxation seems to be, in significant part, a product of political framing. Benefits theory, at least under the strict construction of benefits that seems most congenial to libertarian premises, would almost certainly lead to a highly regressive tax structure. Most opponents of progressivity on fairness grounds specifically reject that outcome as politically unpalatable and hence infeasible. Blum and Kalven, for example, take a regressive tax off the table, as they took off the table a tax that does not exempt basic income, not because it is unpersuasive, but because “[i]t is so clear no one today favors any tax because it is regressive . . . [that] a regressive tax on income is not a serious [policy] alternative.”<sup>107</sup> Richard Epstein takes a head tax off the table without any justification whatsoever.<sup>108</sup>

That decision permits opponents of a graduated rate structure to narrow and restate their position as follows: “[o]n what grounds is a progressive tax on income to be preferred to a proportionate tax on income?”<sup>109</sup>—or more precisely, for the overwhelming majority of flat-rate proponents who also support an exemption for basic income, “[o]n what grounds is a progressive tax on all incomes over a minimum subsistence exemption to be preferred to a proportionate tax on all incomes over a minimum subsistence exemption?”<sup>110</sup> Once regressivity is off the table as a viable alternative, along with a true proportionate tax, a degressive tax becomes the best available alternative to those who are hostile to the degree of income redistribution effected at the top of the income scale by a graduated rate structure. Indeed, the whole structure of Blum and Kalven’s implicit argument for proportionality depends on getting regressive taxes off the table, because almost all of the arguments they make against progressivity, to the extent they are persuasive, would more naturally lead to a highly regressive tax structure than a degressive one. (It might also be noted that once a regressive tax and a true flat tax are off the table, proponents of a degressive, rather than graduated, rate structure have narrowed the choice to two alternatives that are so close to each other in so many respects that it seems implausible that the differences between them will be dispositive under most theories of distributive justice.)

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<sup>107</sup> Blum & Kalven, *supra* note 6, at 419.

<sup>108</sup> *Taxation*, *supra* note 5, at 68: “(I ignore here capitation taxes that call for all persons to pay a fixed amount of taxes, regardless of income.)”

<sup>109</sup> Blum & Kalven, *supra* note 6, at 419.

<sup>110</sup> *Id.* at 420.

We have lived with a progressive tax rate structure for so long that we are all accustomed to think regressivity unthinkable. As Thatcherite England makes clear, however, the unthinkable can become thinkable. If it did here—if the political landscape changed enough to make a regressive tax rate structure, or at the extreme even a head tax, a politically plausible alternative—then there is every reason to expect that the odd convergence on a flat tax as “the fairest tax of all” would dissipate. Whatever Rawls and other social welfarist participants in that convergence might make of their inexplicable enthusiasm on second thought, one would surely expect defection in the libertarian ranks. For libertarians, a regressive tax seems the more likely logical outcome of their philosophical precommitments.