

## Can Taxes Be Fair? Should They Be?

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**Abstract:** The concept of "fairness" is so frequent in modern discussions of taxation that the absence of the term in ancient and medieval discussions of taxation may seem surprising. The older literature uses such terms as "intolerable" and "confiscatory," as well as "old" and "new." Fairness seems to have entered the tax discussion in the literature on natural rights that held sway in the era of the U.S. and French revolutions. Despite the ubiquity of fairness as a criterion in the discussion, it has not led to agreement in the design of taxes. The flaws are fundamental; the concept cannot be perfected. The economic concept of "opportunity cost" is more basic, and this leads directly to the choice of the land value tax. This offers a way out of the swamp of fairness in the design of a tax system.

We hear references to fairness and taxation all the time. The President calls on the rich to pay their fair share. Organizations actively promote the "Fair Tax." If you study Public Finance you will hear much about specific versions of fairness in the form of horizontal equity (that equals should be treated equally) and vertical equity (that unequals should be treated in an appropriately unequal way). Although vertical equity has some echoes of Aristotle (bk.5, ch.3), the juxtaposition of the concepts of fairness and taxation is a recent phenomenon, beginning in the late 18<sup>th</sup> century—the intellectual climate that gave us Adam Smith, the American Revolution, and the French Revolution. That climate was, of course, the culmination of centuries of development of parliamentary control of the sovereign, as well as the evolution of Judeo-Christian concepts of natural law and individual rights.

My topic is already impossibly large, but I want to sketch out an earlier view of taxation that explains why the pre-Enlightenment references to "fairness" are so scarce. Lacking the time and knowledge to review the facts of ancient history, and in the spirit of Adam Smith and the Scottish Enlightenment, I will engage in some "theoretical or conjectural history" inspired by Mancur Olson (2000, pp.3-12):

Imagine yourself in a squalid village surrounded by wilderness a thousand or so years ago. You and your neighbors are engaged in the daily struggle to scrape together dinner. A cloud of dust appears on the horizon, followed by the thunder of galloping hooves. The villagers scramble to hide from the gang of roving bandits who kill or rape anyone they see, steal whatever they can carry, set fire to the rest, and gallop off. The surviving villagers crawl out of their hiding places and try to piece together their squalid life before winter sets in, knowing that the next gang of bandits may gallop in at any time.

Now put yourself in the position of the roving bandits. (History is written by the winners.) You ride for days through the wilderness, risk the perils of attacking and plundering, and have very little to show for the effort because squalid villages provide scant booty. Eventually, the more perceptive roving bandits realize that by settling in a village as stationary bandits and protecting the inhabitants from other marauders, they can induce the villagers to work harder, accumulate capital, produce more, and provide them with more loot than they could extract by plunder. The stationary bandits can evolve into government by providing internal order, judging disputes, defending property rights, converting indiscriminate looting into predictable taxes, and providing the public goods that increase production and, hence, tax revenues—roads, bridges, irrigation, training in useful skills, etc. Although the villagers were safer and more comfortable when the roving bandits evolved into stable government, there was no doubt that the government was an alien power extracting surplus from the people. Taxes were not described as "fair" or "unfair." but rather as "tolerable" or "oppressive." A "good king" was someone who understood that arbitrary exactions and high tax rates did not yield him as much revenue as more moderate and predictable rates that allowed his subjects to prosper.

The story with which you are probably more familiar is from I Samuel 8:5-18. Samuel judged Israel, but when he was old and his sons were corrupt, the people requested a king "like all the nations." Samuel explained what kings were like: "He will take your sons, and appoint them for himself, for his chariots, and to be his horsemen; and some shall run before his chariots. And he will appoint him captains over thousands, and captains over fifties; and will set them to ear his ground, and to reap his harvest, and to make his instruments of war, and instruments of his chariots. And he will take your daughters to be confectionaries, and to be cooks, and to be bakers. And he will take your fields, and your vineyards, and your oliveyards, even the best of them, and give them to his servants. And he will take the tenth of your seed, and of your vineyards, and give to his officers, and to his servants. And he will take your menservants and your maidservants, and your goodliest young men, and your asses, and put them to his work. He will take the tenth of your sheep: and ye shall be his servants." Again, the picture is that of an outsider who takes whatever he wants from his subjects. Fairness is not an issue.

The alien power did not always settle in the subject territory. The Roman empire, and many others, extracted tribute from weaker nations. Often local agents (the hated "publicans" of the Bible) would be granted the tax franchise for a particular area. Each agent was responsible for paying the contractual amount to the government, but could keep whatever he could squeeze out of the populace. This ancient device of "tax farming" persisted in some form for many centuries, which suggests the value of using someone with local and particular knowledge to estimate what the government could extract from taxpayers. The problems with authorizing an agent of government to squeeze an arbitrary amount from the taxpayer have led most commentators to condemn any practice that seems to put revenue agents on commission.

The details of the taxes and forms of government varied from place to place and time to time, but from the viewpoint of the mass of mankind the differences were not great. The masses could expect that nearly all of the surplus above subsistence would be extracted from them either as taxes or as rents to a landlord. When taxes became intolerable, the masses were squeezed to the point where

population would actually be decreasing from malnutrition or because people fled from the high tax civilization to refuge with the barbarians.

Even before the great invasions of Rome in the 5<sup>th</sup> century, central control of the Empire had weakened. As taxes on farmland were raised to the point where small farmers abandoned their plots, the large landowners absorbed the smaller plots and became the feudal lords who contended with each other and with kings for power and taxes throughout the Middle Ages. Much of the political history focusses on barons, dukes, princes, and kings, but the maneuverings of these folks for land and revenue made little difference to the mass of mankind. Nevertheless, the concept of justice in taxation was developing and property rights and contracts retained their force. The teachings of the Church became increasingly important. "God will certainly punish anyone who reinstitutes an old tax..." (Pope Gregory, c. 600, quoted in Adams, p. 137). New taxes, also, were forbidden by the Edict of Paris (614) and it was expected that an *exactio inaudita* (unheard-of tax) would provoke divine retribution. Kings would often have to ask the barons for special assistance to fund wars. This was generally granted for defensive wars, but not for offensive expeditions, which were expected to be self-financing through plunder and tribute. Montesquieu (Bk. XXX) cites a number of contracts between kings and cities or particular populations setting, among other matters, the taxes that could be levied on the city or group. These examples are from 7<sup>th</sup> – 12<sup>th</sup> centuries in western Europe when the king, however limited the geographic extent of his kingdom, was the highest earthly power until usurped or conquered. Yet kings did feel bound by their contracts. Whether this was evidence of a fear of eternal retribution, some innate feeling of ethics, or a pragmatic calculation of the value of being known to keep one's word, or some combination of these, the result was strengthen an ideal of justice in taxation that involved stability, predictability, and appropriateness.

Today, "just" is often used as a synonym for "fair," but the medieval concept is more closely related to the idea of being fitting, proper, and lawful. In Plato's *Republic* (p.112, "The Guardians' Duties"), the potter should not be paid either too much or too little because only the optimum pay would result in the maximum production of high quality pots. This is purely an efficiency rule. It has nothing to do with fairness. Aristotle (*Ethics*, Bk.4, ch.2) described the contributions that a man should make to his community. They should reflect his wealth and station in life, being neither too cheap and tawdry nor too extravagant. For example, a very rich man might present a well-equipped naval vessel to his city. Someone with less wealth could offer a good banquet to the poor of the city. By the time that Aquinas [1225-1274] brought the later works of Aristotle into the mainstream of western scholarship, that version of justice in taxation was firmly established. That is, the individual's contribution to the community should be somehow proportionate to the wealth and standing of the individual, but there was no thought of using taxes to change the wealth of one person relative to another.

King Louis the 14<sup>th</sup> of France [1638-1715] is reputed to have responded to reports that the people were complaining about high taxes by stating, "It is all mine anyway, I can take whatever I want." Whether he actually said that is irrelevant. The statement is a throwback to the view that taxing power is just the continuation of the plunder by the roving bandits that is justified by the power of the government. In stark contrast, the roughly contemporaneous words of John Locke (1690) define the new intellectual atmosphere: "...every man has a property in his own person; this nobody has any right

to but himself. The labor of his body and the work of his hands, we may say, are properly his" (*The Second Treatise of Government*, para. 27). That leaves no room for slavery or feudalism and room only for those taxes to which he has consented. At this stage, reached in different countries at different times, it becomes possible and seemingly useful to speak of "fairness" in taxation. The concept presupposes the existence of a surplus above subsistence for the masses—a surplus that is not considered to be rightfully the property of landowners or governments, but rather belongs to the individuals who create it by their labor.

This rough and impressionistic notion of a real divide in the way intellectuals perceived the world is borne out by a careful study by Alfani and Frigeni (2013). They analyzed manuscripts and printed documents from about 1100 to 1830 centering on Italy. They found that people were aware of the vast disparities in wealth throughout that period, but in the earlier years considered it acceptable and a natural part of a natural or God-given order. This is consistent with Aristotle, Augustine, and Aquinas. Beginning in the 16<sup>th</sup> century, they find signs of "jus naturalism" or individuals in a State of Nature with freedom and equality. This is consistent with Grotius, Hobbes, and Locke. The concept of the State of Nature reflects an abandonment of the Medieval (and earlier) concept of a natural hierarchical order. A key word count confirms the shift: "aequalitas" occurs 17 times from 1700-1785, and 334 times from 1789-1830; whereas "aequitas", which was common prior to the French revolution declined afterwards. To put it bluntly, the atmosphere shifted from the regal, "Why do they complain about taxes, it is all mine?" to the individualistic "What right do those bandits have to plunder any of my hard earned wealth?"

Regardless of shifts in intellectual climate, the practical administrators needed to raise tax revenue, especially in times of war with the increasing cost of a professional military establishment. The traditional land taxes, tariffs, tolls, and excises had been stretched to the point where everyone recognized their weaknesses. By the beginning of the 19<sup>th</sup> century, many practical tax specialists thought that "capacity" or "faculty" to earn income was the appropriate tax base. It was commonly held that property was a good measure of faculty in a primitive economy, but that it had become progressively less comprehensive as an increasing proportion of income seemed to be generated without involving much visible property.

When the British Prime Minister William Pitt was scrambling for revenue to fight the war against Napoleon, he proposed a "property tax" that was, in fact, an income tax. It was adopted in 1806. It relied heavily on "stoppage" (withholding at the source), but there were many difficulties in compliance in that era when the few written records were considered strictly confidential. One device was to establish committees of men in the same occupation and city who were charged with estimating the income for each of their competitors. The British tax was so thoroughly reviled, especially for its highly intrusive implementation, that when the wars ended and the budget stabilized in 1816 the tax was abolished and Parliament voted to destroy all of the records, as had been done with the income tax of 1404. Despite the public bonfire of destruction, the income tax administrator secretly retained a duplicate set (Adams, p.347).

In 1842 Prime Minister Robert Peel persuaded Parliament to reinstate the income tax temporarily until the budget was in balance. It never was repealed, nor was the initial 3% flat rate maintained (Seligman, p. 132; Adams, p. 349). The top rate on earned income peaked at 83% before 1979, with a surcharge of 15% on investment income above 7,100 pounds (Pechman, p.298). The U.S. had a top rate in excess of 90% in the 1950s. So much for the assertions of Seligman, the great champion of the income tax for the U.S., that, "...the moderate rate [less than or equal to 6%] has been an important factor in the success of the income tax [in Great Britain]"(p. 216) and, with respect to Italy, "Obviously an income tax running up to twenty per cent, to which all manner of other kinds of local taxes are to be added, would indeed be unendurable if enforced to the hilt" (p. 353).

The U.S. adopted an income tax to finance the Civil War in 1863. The rate was 3% on income exceeding \$600 with a 5% rate above \$10,000. Soon, the 5% rate was raised to 10%. The tax expired in 1872 when the revenue was no longer needed (Seligman, p. 437). Still, pressure was building for a permanent income tax. Enormous accumulations of wealth during the rapid growth of the post-civil war boom stirred the ire of reformers. Moreover, Lough (2013) stresses the growth of the free trade movement. If the tariffs that had traditionally supported the government, and aided northern manufacturers, were reduced, some substitute tax was necessary. Not least, the Progressive Movement, with its enthusiasm for direct government action and control of individual behavior, contributed to the pressure. An Income tax was passed in 1894 but declared unconstitutional. When the 16<sup>th</sup> Amendment was ratified in 1913, that obstacle was removed and the income tax soon followed because "wealth is escaping its due share of taxation" (Seligman, p.675). The rates were graduated, with a tax of 1% of the first taxable \$20,000 and then increasing by 1% steps to 7% over \$500,000 (equivalent to \$11.7 million today). When Justice Oliver Wendell Holmes, Jr., opined in 1904 that "taxes are what we pay for a civilized society" he was living in a world of 1% tax rates. Is a 40% rate 40 times as civilized?

The progressive rates of the new law were immediately challenged in court as a denial of "equality," but the Supreme Court allowed the law to stand. This was a significant change because legal theory and popular opinion had long supported the idea that taxing everyone an equal proportion of income (the Biblical "tithe" or 10%) was the just way to share the cost of government. In order to understand the sudden prominence of progressive taxation, it is necessary to look at what the economic theorists had been writing.

Adam Smith's *Wealth of Nations* provides a compendium of the best economic thinking circa 1776. His four Maxims of Taxation are frequently cited:

"I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."

"II. The tax which each individual is bound to pay ought to be certain, and not arbitrary."

"III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it."

"IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state."

(summarized from book V, chapter II, Part II, pp. 777-779)

Smith's advice and discussion have held up remarkably well for more than two centuries, but note that in Maxim I he slurred over the distinction between taxes as a price for the benefits received from government by the taxpayer (the benefit principle) and taxes as a measure of the ability of the individual to pay or the sacrifice that is inflicted on the taxpayer (ability-to-pay principle). He papers over the distinction by assuming that both approaches point to taxes proportional to income, although in other passages Smith suggests that additional taxes on luxury goods are acceptable because they fall only on the rich for goods they need only to display their status. A great deal of public finance literature since Wicksell (1896) has dealt with the benefit principle. Presumably, it is fair, and certainly efficient, to charge for services that can be directly or indirectly priced; e.g., charge tolls on limited access highways and finance construction of roads with a gasoline tax. After exhausting the cases where fees for service are technically feasible and politically acceptable, however, governments usually have a lot of bills to pay (e.g., the military budget and other aspects of foreign affairs, interest on the debt). This is where "ability to pay" usually becomes the standard.

Instead of making the tax strictly proportional to income, the amount of income necessary for subsistence could be exempted, with a flat rate above that. This is sometimes called a digressive tax. For example, you pay 0% on the first \$20,000 and 25% on everything above that. The marginal rate is 25% for everyone above the exemption level, but the average rate never quite gets to 25% although it approaches it for the very rich. [This is the concept underlying the "Flat Tax" advocated by Hall and Rabushka (1983).] Even this modest departure from strict proportionality raised warnings from those who forecast class warfare over the amount to be exempted.

The strong support for progressive taxes in the economic mainstream originates in two separate, but highly interrelated, developments in economic theory during the century following the publication of the *Wealth of Nations*. The first of these is "utilitarianism" and the second is the dominance of marginal analysis. Jeremy Bentham (1748-1832) coined the "utilitarian" term and adopted the slogan, "the Greatest Happiness of the Greatest Number." Bentham was a lawyer, but wrote voluminously in many fields including the design of legislation. His work influenced economics directly through writings and also through his sometime coauthor, economist James Mill (1773-1836) and participation in the education of John Stuart Mill (1806-1873), son of James. While the slogan suggests a mathematically impossible double maximization, it does convey the sentiment that has motivated much of the subsequent analysis of taxation and public expenditures, including modern cost/benefit analysis.

Although he did not use the modern words, Bentham wrote his utilitarian analyses under the assumption that the marginal utility of income is declining (see Robbins. 1965, p.62). This view starts with the plausible proposition that a dollar more or less makes a lot less difference to the rich person than does a dollar more or less to the person who has very few dollars. The extra dollar that allows the

beggar to buy a crust of bread increases his welfare (or happiness or utility) more than a decrease of a dollar would decrease the utility of Warren Buffet. Decreasing marginal utility is usually assumed in economics for most ordinary goods and services. You may value one bag of carrots or professional tooth-cleaning, but the second one that month is worth less to you and the third even less than that. But is that true for income in general?

Most economists ceased to ask that question after the "Marginal Revolution" of 1870. At about the same moment, William Stanley Jevons (1835-1882), writing in English, Leon Walras (1834-1910), writing in French, and Carl Menger (1840-1921), writing in German, adopted a form of analysis that a cynic described as "the reinvention of a crude form of differential calculus a couple of centuries after Newton and Leibniz." Nevertheless, this "marginal analysis" soon came to dominate economics and made the concept of decreasing marginal utility of income almost automatic for economists. If we assume that successive units of income have less value, and we assume that everyone is equal with respect to capacity to enjoy income, then the tax implications can be quite dramatic.

If the objective is to collect the required tax revenue while imposing the minimum total sacrifice on society, the appropriate tax is zero up to a certain point and then 100% after that. That is, depending on the revenue requirements, the government would set one annual income, for example, \$100,000. If you have less than that, you pay no tax. Anything you earn above that is sent directly to the Treasury. Of course, most people realized that this was not going to work well—at least not for long. A few extreme socialists and utopians wanted to believe in it, and even such a clever economic theorist as Edgeworth (1897) had difficulty in abandoning the spirit of it. Indeed, if one accepts the goal not just of minimizing the sacrifice of taxation, but of maximizing the utility of society, why would you not advocate continuing the leveling by transferring money from rich to poor until everyone had the same income?

A clever socialist, George Bernard Shaw (1928, p.470) put it this way: "Socialism means equality of income or nothing, and that under Socialism you would not be allowed to be poor. You would be forcibly fed, clothed, lodged, taught, and employed whether you liked it or not. If it were discovered that you had not character and industry enough to be worth all this trouble, you might possibly be executed in a kindly manner; but whilst you were permitted to live you would have to live well."

Faced with this logic, most economists retreated slightly to the goal, not of maximum utility or minimum sacrifice, but rather to the notion that everyone should endure the same proportional sacrifice of income. Opposition to progressivity was the common position even among the liberal utilitarians of the 19<sup>th</sup> century (Hutchison, 52). The opposition was based in part on the fear that progressivity would diminish incentives to work and invest and hence hobble the engine of economic growth that was essential for raising the laboring poor to a more comfortable level. Another factor was the fear that breaking the rule of proportionality would lead to continuing efforts to shift all tax burdens to the small minority of the very rich. (Adams, ch. 31). It is interesting that the economists, in general, were more caught up in the utilitarian notion that the happiness of society would be enhanced by reducing the burdens on the poor, while the lawyers retained the tradition from history and political philosophy that, in the absence of firm rules (such as proportional taxation), the problems of "faction" as discussed by Madison in Federalist 10 would tear the republic apart or turn it into a tyranny.

But John Stuart Mill, who had grown up with utilitarianism, added this caution: "For what reason ought equality to be the rule in matters of taxation? For the reason that it ought to be so in all affairs of government. A government ought to make no distinction of persons or classes in the strength of their claims on it. If any one bears less than his fair share of the burden, some other person must suffer more than his share. Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice." (Book V, Ch.I, section 2, p. 539). Despite the emphasis on sacrifice, "To tax the larger incomes at a higher percentage than the smaller is to lay a tax on industry and economy; to impose a penalty on people for having worked harder and saved more than their neighbors. It is not the fortunes which are earned, but those which are unearned, that it is for the public good to place under limitation." (pp.541-542) . Moreover, the income tax relies on self-reporting of income and, thus, "...is, in practice, unequal in one of the worst ways, falling heaviest on the most conscientious." (p. 556). Mill's comments provide a hint of the way out of the morass, but before we follow that trail, let us dig ourselves in deeper.

If one accepts the view that the marginal utility of income is diminishing, and one accepts the goal that everyone should sacrifice an equal proportion of his total utility to pay for government, then it is easy to see that rich people should pay more dollars in taxes than should poor people. Does that require a progressive tax on income? It is easy to lapse into that conclusion, but it is incorrect, as was demonstrated cogently by Cohen-Stewart in 1889. [Also see Blum & Kalven. 1953]. Briefly, if the loss of a dollar is as painful to a rich man as to a poor, then equal sacrifice would call for equal dollar taxation. That is, a lump sum tax or a head tax—each person must pay a tax of, e.g., \$1,000/year. That is the extreme of regressivity, unless one considers extremely decadent societies such as the strange world of pre-revolutionary France where, "One will hardly believe that in order to become noble it is sufficient to become rich; and to cease to pay taxes it is sufficient to become a noble. So there is only one way of escaping taxation and that is to make a fortune." [Pierre-Samuel Du Pont de Nemours, as quoted in Adams, p.218].

How quickly would the marginal utility of income have to decrease before equal sacrifice resulted in proportional taxation? The answer seems to be that proportional taxation is appropriate if, and only if, the marginal utility of income curve is a rectangular hyperbola! [See Musgrave, 1959, pp. 98-102] That is a wonderfully precise answer, but none of the assumptions can be observed to be met. We have no way to observe utility, let alone the shape of the marginal utility curve. Moreover, does anyone believe that the relationship between income and happiness is the same for everyone, or even for anyone throughout a lifetime? And we have not even inquired about the relationship between the happiness of one person and what he observes of his neighbors. In particular, if Mr. Smith is altruistic, deriving pleasure from observing that Mr. Knight is wealthy, and Mr. Knight is envious, deriving pleasure from the poverty of his neighbors, the way to improve the total happiness of society is to tax the altruist Smith and give the money to the mean-spirited Knight. Most of us would probably not vote for such a tax, even if it could be designed and administered.

Yet, the prevailing economic definition of fairness leans on such weak reeds. In the modern public finance literature, fairness (and, perhaps, efficiency), depends on horizontal equity and vertical equity. Vertical equity depends on the degree of progressivity, as discussed above. Horizontal equity requires that "equals be treated equally," but, equals in respect to what? Academic tax specialists and

reformers in the U.S. have usually begun with a bias toward a comprehensive definition of income as developed by Henry Simons (1950) and others. This amounts to whatever the person consumed during the year plus the net increase in wealth. Thus, it is the power to consume without decreasing wealth. In the purest form, consumption plus the net amount added to the accounts would be taxable income. That includes, for example, wages, interest, dividends, capital gains, rents (including the rent that an owner occupier could have received from his own house), gifts (of cash, securities, goods, and services). It would not matter where the power to consume came from or how it was used. The British debate, however, often favored the notion that wage and salary income should be discounted 25% relative to investment income because wages and salaries end when the recipient dies or loses his job. It is interesting that Andrew Mellon (1934, pp. 56-57), wealthy investor, Secretary of Treasury for Harding and Coolidge, and considered an arch conservative, stated, "The fairness of taxing more lightly incomes from wages, salaries and professional services than the income from business or from investments is beyond question."

The actual tax law, of course, is a jumble of special treatment of particular sources and uses of income. Ownership of real estate is heavily favored, as is any investment that generates capital gains. Similarly on the uses side, medical expenses, gifts to charities, child care expenses, historic preservation, energy conservation, electric cars, and saving for education and retirement are among the favored expenditures. Which is fairer, the comprehensive definition or the tax law definition? Each exception to the comprehensive base for particular sources or uses of income is defended in the name of "fairness" by its beneficiaries. It matters because it is (roughly) taxable income, rather than comprehensive income, that determines who is treated as an equal of whom.

In recent years an effort has emerged to consider consumption, rather than income, as the tax base and, thus, the fair basis for defining equality. The classical reasoning for this is that consumption measures what a person uses up from the product of the economy, whereas income should be a better measure of what he produces. John Stuart Mill arrived at consumption as the preferred tax base by an alternate route. In his view, the lower tax on earned income would allow the wage earner to accumulate savings for the years when his earning capacity had diminished. The modern pressure for consumption taxation is driven in part by belief that saving and investment should be encouraged. Some versions of consumption taxation also promise less intrusive administration (Zodrow and Mieszkowski, 2002).

Some of these problems seemed remote prior to 1930 when the federal government took less than 5% of GDP, but with total government spending now exceeding one-third of GDP, including massive redistribution, the warnings about control of a dominant faction to prevent exploitation of the rest of society become more pertinent. In the modern era, economists have continued to analyze the effects of taxation on incentives to earn income and balance these against changes in social utility, defined in some unmeasurable way. The philosopher Rawls (1971) added the twist of assuming that only the income of the person with the lowest income needed to be a concern of public policy. But economists and philosophers of the Rawlsian type do not stop to consider the Madisonian question of what will happen to a tax bill of the most sophisticated design when it is submitted to Congress. Nor do they

consider the possibility that the sovereign is a revenue maximizing entity at war with his subjects; i.e., a stationary bandit.

Because of the impossibility of defining a "fair" tax, it is worthwhile searching for a different approach. The comment by Mill, "It is not the fortunes that are earned, but the fortunes that are unearned..." provides the starting point. Of course, an income tax becomes totally arbitrary and capricious if the IRS agent has to review your return to judge each receipt for its "worthy earnedness." Spare us that intrusion! In fact, it is possible to make a distinction between earned and unearned if we are willing to give up the idea of taxing the individual on his income and turn, instead, to a tax levied on the source of the unearned income. This does require giving up progressivity as it is usually defined because the concept applies only to people.

The specific alternative to consider is the land value tax (LVT) as developed with great vigor and insight by Henry George in his best-selling book, *Progress and Poverty* (1879). LVT had antecedents in both practice and theory, including the Physiocrats, Smith, Ricardo, and Mill, but George and those inspired by George have worked out the details most fully. To put the matter in its simplest form, the LVT would replace other taxes with a single levy on the market value of the land that each person claims title to. Thus, the mechanics are similar to the existing real estate tax used by most local governments and school districts in the U.S. The difference is that the tax would apply only to the value of the land. All buildings and other improvements would be exempt.

The market value of land reflects the income you could receive just from holding title to the land. Thus, if you happened to inherit a block of vacant land in the middle of Manhattan, or any other thriving city, you could easily lease it to a developer who would do the work of arranging for a building to be built and rented out and managed. The developer would be compensated for his work, but you could just sit back and enjoy the lease payments. Those payments would be described by an economist as "economic rent." The proposed LVT would be designed to take a substantial portion (e.g., 90%) of the economic rent, but it would be levied as a percentage of the market price of the land, so that you could not avoid it by leaving the land idle. You would have a strong incentive to put the land to work at the optimum moment.

If you think of imposing a LVT today while dropping all other taxes it may seem unfair to those who have just invested their hard-earned savings into a piece of land. That is the transition problem that arises with any change in the tax law—there are winners and losers, and sometimes special transition rules can be adopted to ease the pain. Most parcels of land in the city already have buildings on them, so the taxpayer would save by eliminating the building tax while paying more for the land. The most important point is that the LVT would, over time, make the whole economy, especially the cities, function more efficiently.

The LVT is easier to justify if we think of starting with a blank slate, before anyone has laid claim to land. The words of John Locke are the starting point for the analysis of property by many in the classical liberal tradition:

26. God, who has given the world to men in common, has also given them reason to make use of it to the best advantage of life and convenience. The earth and all that is therein is given to men for the support and comfort of their being. And though all the fruits it naturally produces and beasts it feeds belong to mankind in common, as they are produced by the spontaneous hand of nature; and nobody has originally a private dominion exclusive of the rest of mankind in any of them, as they are thus in their natural state; yet, being given for the use of men, there must of necessity be a means to appropriate them some way or other before they can be of any use or at all beneficial to any particular man. The fruit or venison which nourishes the wild Indian, who knows no enclosure and is still a tenant in common, must be his, and so his, i.e., a part of him, that another can no longer have any right to it before it can do him any good for the support of his life.

27. Though the earth and all inferior creatures be common to all men, yet every man has a property in his own person; this nobody has any right to but himself. The labor of his body and the work of his hands, we may say, are properly his. Whatsoever then he removes out of the state that nature has provided and left it in, he has mixed his own labor with, and joined to it something that is his own, and thereby makes it his property. It being by him removed from the common state nature has placed it in, it has by this labor something annexed to it that excludes the common right of other men. For this labor being the unquestionable property of the laborer, no man but he can have a right to what that is once joined to, at least where there is enough and as good left in common for others. (John Locke. 1690. The Second Treatise of Government).

This analysis has a powerful appeal for the situation where land is a free good. Locke, himself, noted that significant restriction in the famous closing phrase of the quote, “where there is enough and as good left in common for others.” Although Locke tried to make the case that the world had enough good unclaimed land that men might enclose and homestead, few would try to argue that proposition today.

When land of a particular quality is no longer a free good, unregulated markets will readily generate annual rental rates for particular parcels, and those annual rents can readily be capitalized into sales prices for parcels that change hands and appraised values for parcels that do not. Land rents, like other prices, can serve to allocate inputs to their most productive uses. The rents are an opportunity cost that must be paid by the user of the land if the economy is to operate efficiently. But who should receive that rent? Henry George argued that the rent should belong to society because it either measures the natural advantage of a parcel; e.g., superior fertility of soil or location on a natural trade route, or the efforts of other people; e.g., highways, ports, and other public infrastructure, the activities of neighbors that attract business to your block, and the growth of population of the community.

The opposition to LVT often cites the unfairness of taking nearly all the rent, and hence, nearly all the value, of property in land. Most holders of land today have acquired it in legal and morally

defensible ways. That is correct and is a serious concern, but there are two sets of counterarguments. Georgists often claim that even a fully legal land title still leaves the buyer of land as the holder of stolen property. After all, British titles date to a roving bandit, "a French bastard landing with an armed banditti," as Thomas Paine (1776, p.16) so gently expressed it. U.S. titles generally date to a grant by a European monarch of land that belonged to someone else. Even in the rare case when a title does not originate in "force or fraud," --even if it originates in Locke's enclosure from the state of nature—why should that historical accident contribute to the inequality of fortunes today?

The set of arguments that I find more convincing, however, relate to the comparison of the LVT with nearly all other feasible taxes. If the LVT is theft, it is a one-time problem. The income tax robs people every year of the fruit of their labors. When this moral case is combined with the efficiency and privacy advantages of the LVT, the case, to me, seems overwhelming. So, rather than arguing about fairness or justice in taxation, let's shift the focus toward the one tax base that has a well-defined market value based on opportunity cost; i.e., what the market determines to be the rent of the land. The focus can then shift away from the utilitarian pseudo-science of minimizing unobservable "sacrifices" and maximizing unseen "utilities" or pretending that we can say anything about the "fairness" of taking from one person to give to another.

To quote Frank Choderov (1946, p.267), "Taxation is highwaymanry made respectable by custom, thievery made moral by law," while the LVT just allows the community to reclaim the value that it has produced.

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