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### Liberalism and Ability Taxation

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# Texas Law Review

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## Articles

### Liberalism and Ability Taxation

David Hasen\*

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*Recent tax scholarship has embraced the idea of individual endowment taxation, or taxation of human abilities, as an approach to ideal tax theory. Under endowment taxation, individuals are taxed according to their native abilities to command resources, rather than according to any actual index of goods or expenditures, such as income, consumption, or wealth, that otherwise might be thought relevant to the assignment of tax burdens. This Article argues that endowment taxation is incompatible with political theories that might broadly be described as "liberal," to the extent such theories support redistribution. It also argues that limited forms of endowment taxation may be available under liberal theories to the extent such theories operate on a payment-for-services-rendered conception of taxation. Turning to consequentialist theories, the Article suggests that under a wide array of assumptions, lump-sum taxes such as an endowment tax are not optimally efficient. Lastly, it argues that even where they represent the most efficient available alternative, lump-sum taxes generate social costs if they compel individuals to work in order to meet tax obligations.*

## I. Introduction

Recent tax scholarship has embraced the idea of individual endowment taxation, or taxation of human abilities, as an approach to ideal tax theory.<sup>1</sup> Under endowment taxation, individuals are taxed according to their native ability to command resources, rather than according to any actual index of goods or expenditures, such as income, consumption, or wealth, that otherwise might be thought relevant to the assignment of tax burdens. The individual with a greater capacity to command resources will be taxed more heavily than the individual whose capacity is low, and in both cases tax will be assessed without regard to the income or wealth that persons actually would earn or receive during their lifetimes in the absence of an endowment tax burden.

Taxation of endowments, even as a theoretical ideal, is surely counterintuitive. It would entail the imposition of tax without regard to economic resources available to the taxpayer and without the tacit consent to tax that might be inferred from an individual's engaging in activities that produce such resources. It presupposes the existence of a set of native faculties whose market value can be ascertained apart from their circumstances, yet it is not clear that this concept is coherent or defensible. And it treats each individual's talents as a kind of collective property, available for others' use without the consent of the person whose *prima facie* claim to own the talents seems clearly to be stronger than anyone else's claim. All of these theoretical problems, to say nothing of the host of practical difficulties that would attend any effort to implement the ideal, seem to suggest that endowment has little to recommend itself as either a tax base or a theory of taxation.<sup>2</sup>

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1. See Daniel Shaviro, *Endowment and Inequality*, in TAX JUSTICE: THE ONGOING DEBATE 123, 143–44 (Joseph J. Thorndike & Dennis Ventry Jr., eds., 2002) [hereinafter Shaviro, *Endowment II*] (espousing endowment taxation as a better ideal measure for underlying inequality than income, consumption, or wealth taxes); see also Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477, 1481, 1486 (1994) (arguing that under a true income tax the present value of future earnings in principle would be taxable at birth, but taking no express position on the desirability of income as a tax base); Kirk J. Stark, *Enslaving the Beachcomber: Some Thoughts on the Liberty Objections to Endowment Taxation*, 18 CAN. J.L. & JURISPRUDENCE 47, 65 (2005) (taking a neutral position on endowment taxation as an ideal but arguing that the refusal to endorse endowment taxation is inconsistent with any liberal position that accords a redistributive role to the tax system). See generally Lawrence Zelenak, *Taxing Endowment*, 55 DUKE L.J. 1145 (2006) [hereinafter Zelenak, *Taxing Endowment*] (providing a critical analysis of the state of the endowment tax discussion). The Shaviro book chapter is an updated version of his article *Inequality, Wealth, and Endowment*, 53 TAX L. REV. 397 (2000) [hereinafter Shaviro, *Endowment I*].

2. These difficulties are widely acknowledged by endowment theorists. *E.g.*, Shaviro, *Endowment II*, *supra* note 1, at 131. They include the creation of incentives to hide endowment and to play up antipathy toward work as a mitigating factor against endowment taxation, the “lumpiness” of the labor market, and of course the proper method of valuing endowments. *Id.* at 130–43. A solution to the last of these requires knowledge of the effects that universal deployment of endowments would have on the market value of any individual's endowment.

Despite these and other objections, the endowment ideal has enjoyed sustained and even expanding support across a wide spectrum of scholarly approaches to taxation. Its proponents include consequentialist theorists who have argued that it permits the most effective redistribution of the capacity to generate welfare;<sup>3</sup> those arguing from a liberal perspective who claim that differences in fairly guaranteed opportunities, and not in actual wealth or income, are the appropriate basis on which to differentiate tax burdens;<sup>4</sup> and those who find in endowment a purified form of the income concept.<sup>5</sup> While all acknowledge that endowment taxation represents a merely theoretical ideal, they also argue that it represents a highly relevant ideal—one to be taken seriously for purposes of identifying the inequalities that we believe matter in assigning different tax burdens to different persons.

As the discussion below makes clear, the implications of the argument are profound. The theory of the ideal tax base does not have ramifications only for abstract accounts of the proper scope of taxation in an ideal world; it plays a critical role in live issues of tax policy as well. For example, whether we should permit deductions for educational expenditures, or whether there should be separate rate schedules for married persons filing jointly, are just two of the questions whose answers depend on the status of endowment as an ideal. More generally, a proponent of the endowment ideal might favor forms of taxation that reach complements to leisure as a kind of second-best version of the endowment ideal. Such an approach would supplement the income tax with a potentially extensive array of commodity taxes, the effect of which would be to steer individuals into income-producing activity to the extent that the income tax creates incentives to “consume” more leisure.

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3. Stark, *supra* note 1, at 53–54; see, e.g., James Mirrlees, *An Exploration in the Theory of Optimal Income Taxation*, 38 REV. ECON. STUD. 175, 178, 201 (1971) (arguing that the optimal tax rate is one that maximizes the welfare of society, which is accomplished by imposing tax liability according to individuals’ levels of utility). The optimal tax literature starts from the proposition that an ideal tax would be lump-sum in nature but is not practicable. Shaviri, *Endowment II*, *supra* note 1, at 136.

4. See DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 154–56 (1986) (arguing for endowment taxation as an ideal on fairness grounds); LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP 105 (2002) (arguing that endowment taxation is largely consistent with the luck egalitarianism of Bradford and Dworkin, whether or not these theorists explicitly embrace endowment taxation); Shaviri, *Endowment II*, *supra* note 1, at 140–42 (arguing for endowment taxation as an ideal tax system for liberal egalitarianism, provided that the endowment can be measured); Stark, *supra* note 1, at 65 (arguing that any liberal redistributive theory cannot logically exclude endowments from the tax base without arbitrarily privileging nonmarket activity over market activity).

5. See, e.g., John A. Litwinski, *Human Capital Economics and Income*, 21 VA. TAX REV. 183, 187 (2001) (treating leisure (among other items) as income for purposes of developing a theory of true income taxation); see also Kaplow, *supra* note 1, *passim* (arguing that a true income tax would reach human capital). Kaplow does not expressly reach the endowment question because he assumes, for purposes of the argument, that available human capital will be deployed for income-producing purposes, *id.* at 1480, but the argument is congenial to endowment taxation, see *id.* (“[I]ncome is understood as the sum of consumption plus all changes in wealth (where consumption and wealth are understood as having economic values even if they involve goods, services, or assets that are not traded on a market).”).

Such a development would constitute a sweeping reform to the federal tax system.

For reasons explained more fully below, the concept of endowment as an ideal tax base fits comfortably within a consequentialist approach to questions of distribution and efficiency. From a consequentialist perspective, the usual objections to endowment taxation—that it invades autonomy and privacy, that it authorizes forced labor, or that it collectivizes what is uniquely the property of each individual—carry little force if they are taken to bar consideration of endowment in the tax base outright. These concerns, to the extent they are legitimate, can be incorporated into a consequentialist framework as items to be weighed in a more comprehensive calculus that seeks to maximize welfare, however defined.<sup>6</sup> The consequentialist framework itself, however, does not raise any principled objection to treating endowments as subject to tax.<sup>7</sup>

More puzzling is the suggestion that the endowment ideal also is compatible with what might be called a liberal approach to distributive justice in taxation. Unlike most varieties of consequentialism, liberal theories typically adopt robust commitments to the principles of respect for persons and individual autonomy and to the view that political legitimacy derives from the limited claims the government makes on its citizens.<sup>8</sup> For theorists within this tradition, the pull of the endowment ideal seems incongruous. One would expect them to resist mightily the idea that *A*'s unused potential can be pressed into service for the sake of improvements to *B*'s material circumstances. Recent scholarship on endowment taxation, however, has sought to overcome these objections, primarily on the basis that it is arbitrary for any theory that takes equality of resources or of opportunity seriously as a normative ideal to exclude ability from the pool of social resources potentially available for redistribution.<sup>9</sup>

The main argument of this Article is that the liberal case for endowment taxation largely fails. Within a liberal framework, one can make out a weak justification for endowment taxation as a means to finance some public goods, but that is the limit of its possible application. Most significantly,

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6. Stark, *supra* note 1, at 54. See John C. Harsanyi, *Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309, 315–16 (1955) [hereinafter Harsanyi, *Cardinal Welfare*], for a description of the consequentialist approach to maximizing social welfare.

7. See, e.g., John Christman, *Constructing the Inner Citadel: Recent Work on the Concept of Autonomy*, 99 ETHICS 109, 117 (1988) (“A welfarist could argue that being left free to form one’s own views and character, and being given the means to develop one’s critical capacity for this, is the surest method to ensure happiness for oneself.”).

8. See JOHN RAWLS, *POLITICAL LIBERALISM*, at xlv–xlvii (1996) [hereinafter RAWLS, *POLITICAL LIBERALISM*]; see also Russell Hardin, *Hobbesian Political Order*, 19 POL. THEORY 156, 156 (1991) (“The core value in contractarianism is consent, which is taken to be right-making.”).

9. E.g., Shaviro, *Endowment II*, *supra* note 1, at 133–34; Stark, *supra* note 1, at 55–58; Zelenak, *Taxing Endowment*, *supra* note 1, at 1154–55.

liberal theories do not authorize endowment taxation to finance redistribution—the primary reason its proponents find endowment taxation attractive in the first place.<sup>10</sup> Although a liberal theory may without contradiction promote redistributive ends through taxation, it cannot consider mere endowments as part of the pool of resources available for this purpose; it must limit the pool to already-created wealth. The reason goes to the very heart of the liberal account of political society: The political order derives its authority and its legitimacy from consent, and consent depends upon political society's having a structure that is unequivocally better, or at least unequivocally not worse, for each consenting member than is any available alternative. Once the prospect of redistributive endowment taxation enters the picture, this condition is violated and the derivation of consent fails as a result.

The unavailability of endowment taxation as a means to effectuate redistributive justice in a liberal theory has been partly obscured by the terms in which the debate has been conducted.<sup>11</sup> Proponents and even some opponents of endowment taxation have tended to conceive the liberal objection as sounding in the compulsion that any actual endowment tax would create to work.<sup>12</sup> From this perspective, the problem appears to be that taxation of endowments can compel work for individuals with great ability but little taste for it. The difficulty with this objection, as endowment theorists have gone on to observe, is that almost any tax has some effect on labor choices and in that sense can create a compulsion to work.<sup>13</sup> Since liberals do not find the effect disturbing in many other contexts, taxation of endowments seems to trouble us only because of the extent of the "compulsion," not because it exists at all. In light of the values that are thought to support redistribution (for those theories that advocate it), it therefore seems hard to exclude endowment a priori from the redistributive calculus. Thus it is not uncommon for endowment theorists to argue that nonredistributive versions of liberalism are compatible with a rejection of endowment taxation, but that redistributive versions are not.<sup>14</sup>

This line of argument misconceives the liberal objection, at least as the objection is developed here. The difficulty is not that endowment taxation has an effect on the labor–leisure decision; it is that the use of endowments

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10. BRADFORD, *supra* note 4; Shaviro, *Endowment II*, *supra* note 1, at 141–43; Stark, *supra* note 1, at 58.

11. I thank Kyle Logue for clarification on this point.

12. See, e.g., MURPHY & NAGEL, *supra* note 4, at 123 (finding the autonomy objection convincing because endowment taxation creates an excessive infringement on autonomy); Shaviro, *Endowment II*, *supra* note 1 (finding the autonomy objection unconvincing given our apparent consent to other taxes that affect the labor–leisure decision); Stark, *supra* note 1, at 52 (same); see also Zelenak, *Taxing Endowment*, *supra* note 1, at 1156–62 (discussing this criticism and rejecting it to the extent it is thought fundamental to a liberal theory of endowment taxation).

13. Shaviro, *Endowment II*, *supra* note 1, at 142–43; Stark, *supra* note 1, at 50–55; Zelenak, *Taxing Endowment*, *supra* note 1, at 1156–59.

14. E.g., Stark, *supra* note 1, at 57–58.



for redistributive purposes cannot be conceived of as consented to in a way that preserves the liberal argument for political legitimacy and, hence, for the authority of the government to tax in the first place.<sup>15</sup> The question is not one of degree but of kind, and a focus on whether some quantum of compulsion is “too much” only obscures the issue. Thus, an endowment tax that did not compel work would still count as illegitimate if the purpose were not authorized, while, conversely, an endowment tax that was used for legitimate purposes, if such a tax is possible, would not be barred even if it compelled work.

Although the argument here centers on the liberal case against endowment taxation, it has relevance for the consequentialist case as well. As the discussion in Part III makes clear, a liberal theory of taxation must offer a generalized account of the nexus between the collection of taxes and the uses to which tax proceeds are put. Consequentialist approaches to ideal taxation generally sever this link, analyzing the collection side from the perspective of efficiency and considering distributive questions separately, on the expenditure side of the equation.<sup>16</sup> Attentiveness to the relationship between tax collection and government expenditures indicates, however, that the model of efficient taxation commonly adopted within consequentialist frameworks may not be correct for a wide array of cases. This difficulty surfaces in the consequentialist account of tax distortions, which generally treats lump-sum taxes such as an endowment tax as optimally efficient, and measures the distortion of any actual tax system by the extent to which its outcomes diverge from those of a lump-sum-tax baseline.<sup>17</sup> An account of taxation that more tightly ties collection to expenditure yields a different understanding of optimally efficient tax rules.

These issues are developed as follows. Part II describes the case for endowment taxation as an ideal and demonstrates the relevance of the ideal to live issues in tax policy. Part III explores the liberal case against endowment taxation. Part IV examines the efficiency side of consequentialist arguments for endowment taxation. Part V is a short conclusion.

## II. The Theory of Endowment Taxation

### A. *The Endowment Tax Ideal*

Taxation according to personal endowments would impose tax burdens based on an individual's native ability to command resources. For convenience, and consistent with the treatment of endowment taxation by

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15. In particular, it violates the requirement that the state of society be Pareto-superior to the state of nature or to any counterfactual bargaining situation. See *infra* subpart III(B).

16. See, e.g., HARVEY ROSEN, PUBLIC FINANCE, at ix (7th ed. 2005) (stating that most of the analysis of public finance put forward in the text “follows the conventional tactic of analyzing government expenditure and revenue-raising activities separately”).

17. *Id.* at 308–10.

other commentators,<sup>18</sup> I speak of endowment taxation as the taxation of an individual's income-earning potential, or wage-rate, typically over a lifetime, and I assume that the concept of native ability apart from opportunities and other environmental factors is coherent and intelligible. I also disregard the element of risk that plays a role in returns. These assumptions, though problematic for any effort to construct a real tax system, are plausible in the context of an ideal theory.<sup>19</sup> For instance, one could reasonably say that the differences among various common tax bases collapse in the endowment tax context. Consumption potential seems to be identical to income-earning potential, since it is in principle possible to consume all one earns or receives. Similarly, the capacity to accumulate or hold wealth is more or less identical to the capacity to earn income, at least if income is understood as the net change in wealth over a given period; further, a true wealth tax is equivalent under idealized circumstances to an income tax levied at a higher rate.<sup>20</sup>

A conventional approach to ideal theory also permits one to isolate native ability, ignoring questions of implementation. An omniscient tax collector could in principle observe one's endowment at birth and assign a tax burden on that basis. Admittedly, the problem of willingness to deploy endowments remains, even at the level of ideal theory, because a distaste for work may enter in as a "cost" that would have to be addressed in a complete theory.<sup>21</sup> But the distaste also may be observable in principle and accounted for with an appropriate discount to wage rate.<sup>22</sup> And although it is possible that the idea of native endowments, apart from environment and will, ultimately breaks down, it seems reasonable to assume, as a first approximation, that such a concept is coherent.<sup>23</sup> Certainly we find coherent and useful the notions that individuals possess talents apart from their

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18. E.g., MURPHY & NAGEL, *supra* note 4, at 21–23; Kaplow, *supra* note 1, at 1506–12; Shaviro, *Endowment II*, *supra* note 1, at 131.

19. See, e.g., Shaviro, *Endowment II*, *supra* note 1, at 131–32 (discussing the issue of risk as one limitation of the wage rate hypothetical because "they treat wage rates, once drawn, as leading to determinate outcomes that are risk-free," but dismissing that issue as "beyond the scope of this chapter").

20. David A. Weisbach, *Taxation and Risk-Taking with Multiple Tax Rates*, 57 NAT'L TAX J. 229, 229 (2004).

21. See, e.g., Stark, *supra* note 1, at 54 (observing how an endowment tax imposes more severe utility costs on those with a distaste for work because the tax must be paid in cash).

22. Taking the distaste into account may turn the endowment tax into a utility tax.

23. See, e.g., MURPHY & NAGEL, *supra* note 4, at 119–21 (addressing some of the difficulties of correcting for environment to create an ideal system); Shaviro, *Endowment II*, *supra* note 1, at 131–32 (admitting that certain elements make real-world application of the wage-rate hypothetical problematic, including issues of time, risk, "lumpy" labor markets, and nonmaterial differentiators, but arguing that "[w]age rate (or endowment or ability) is still likely to be the best available measure of inequality"). The problem that the effect of assuming universal employment of endowments would have on the value of any particular individual's endowment is more difficult to resolve and has not been addressed by the literature. A workable though theoretically questionable assumption is to value each individual's endowment on the assumption that only it is introduced into the labor market.

circumstances and that the extent of a person's talents does not depend entirely upon her will to develop them.<sup>24</sup>

Finally, for purposes of ideal theory we may disregard the uncertainty of returns, a problem that poses similar issues for both ideal and actual tax systems. Uncertainty generally arises from one of two sources. It may result from unforeseeable events over which one has no control—so-called brute luck—or it may be consciously assumed in exchange for a possible benefit. Brute luck generally must be dealt with on an ex post basis under any tax system, because it will have an effect on resources but one not knowable beforehand. For example, the actual income tax generally allows deductions for casualty losses<sup>25</sup> and taxes windfall gains.<sup>26</sup> By contrast, consciously assumed risk (a category that might include unforeseen events for which insurance is available), again under both actual and ideal tax systems, may be treated as assumed and therefore may be taxed on an ex ante basis.<sup>27</sup> If it is so treated, then the effect of the assumption of the risk on returns is simply disregarded. The theory that supports this treatment is that individuals who freely exchange fixed returns for risky ones or who assume risky ones when insurance is available may be considered already to be in possession of the fair value of the expected return, no matter what its actual value turns out to be.<sup>28</sup> To simplify the analysis, I simply assume that returns are fixed, whether they result from brute luck or consciously assumed risk.

Thus we can imagine two individuals, *Attorney (A)* and *Beachcomber (B)*, endowed with identical income-earning potentials at birth but who have different cash incomes over their lifetimes.<sup>29</sup> *A* is a Wall Street lawyer who devotes her efforts to earning as much cash income as possible. *B* does not

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24. As Shaviro notes, the assumptions regarding the nature of ability are highly reductive, but they are also useful for purposes of understanding the possible role that factors apart from material circumstances have in inequality. Shaviro, *Endowment II*, *supra* note 1, at 131.

25. I.R.C. § 165(h) (2000). The relief can extend to losses for which insurance was available but not purchased. Treas. Reg. § 1.165-1 (as amended in 1977).

26. See, e.g., *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (holding treble- and punitive-damage gains as taxable income even though not expressly identified as such in the tax statute).

27. As an example, term life insurance is generally taxed under an ex ante approach under the actual income tax. Premiums generally are nondeductible personal expenses, and insurance proceeds are excluded from gross income. I.R.C. § 101 (2000).

28. For examples of this approach, see Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283, 292–97 (1981) [hereinafter Dworkin, *Equality Part II*] and ERIC RAKOWSKI, *EQUAL JUSTICE* 74–76 (1991). This approach to risk underlies much contemporary liberal political theory. See Barbara H. Fried, *Ex Ante/Ex Post*, 13 J. CONTEMP. LEGAL ISSUES 123, 131–32 (2003) [hereinafter Fried, *Ex Ante/Ex Post*] (summarizing the literature).

29. The *Attorney–Beachcomber* example is widely used in the literature. See Shaviro, *Endowment II*, *supra* note 1, at 132–34 (discussing the theoretical impact of an endowment tax base on both “a beachcomber who could have been a Wall Street lawyer” and on “an individual who actually is a Wall Street lawyer”); Stark, *supra* note 1, at 47 (explaining how the beachcomber metaphor is used in the debates about “‘endowment’ taxation, i.e., taxing people on what they *could* earn rather than what they actually do earn”).

mind work but is not particularly interested in purchasing consumable goods. He earns a comparatively small income working part-time at a fast food restaurant and spends most of his time in idle pursuits. For purposes of the discussion I assume that *A* and *B* enjoyed similar upbringings and educational opportunities and that they both have chosen their life activities freely.

Under any plausible actual income tax, *A* will pay more in lifetime tax than *B* because her real income is greater.<sup>30</sup> Under an endowment tax and assuming perfect information about *A*'s and *B*'s income-earning capacities, *A* and *B* would be subject to identical absolute tax burdens, notwithstanding their differing incomes. This result could require *B* to work just in order to pay tax. That is, the average tax rate on the income he would earn in the absence of an endowment-based burden could exceed 100%. For example, suppose a flat rate of 25% of endowment<sup>31</sup> were imposed, and it were determined that *A* and *B* each had endowments producing the equivalent of \$100,000 annually in present value terms. Suppose further that, in order to address problems of liquidity, taxes were assessed on an annual basis rather than in a lump sum at birth. Under this system, *A* and *B* each would owe \$25,000 tax annually (in present value terms). Assume for a given year *A*'s actual income exceeds \$25,000 but that in the absence of the tax *B*'s would be just \$12,500. Because *B*'s tax rate on the amount he would earn in the absence of the tax exceeds 100% (it is 200%), *B* must work just in order to pay tax.

Why might we want to adopt such a tax scheme for *A* and *B*, even assuming perfect information about their capacities and setting aside privacy and autonomy concerns? Not only is the relevance of mere earning capacity to the purposes of taxation not obvious, but the tax appears to have adverse incentive effects. As a general matter, tax consequences should not motivate behavior; rather, we tend to think that taxes should affect behavior as little as possible and that an ideal tax regime would be conduct-neutral.<sup>32</sup> From this perspective the endowment tax seems still more perplexing as an ideal.

It is appropriate to deal with these objections separately, taking the incentive argument second, since it follows as a concern only once we have established that endowment taxation represents some sort of theoretical ideal in the first instance, prior to consideration of its impact on behavior. As Daniel Shaviro and others have argued, the basic motivation for the

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30. The application of certain types of highly implausible tax schedules to earned income could result in *B*'s being more heavily taxed on monetary income than *A*. For example, a steeply regressive tax with negative marginal rates at higher incomes could produce such a result. I omit consideration of such schedules here.

31. Technically, the rate should be on endowment net of work disutility, but for ease of exposition I refer to a tax simply on endowment. See Shaviro, *Endowment II*, *supra* note 1, at 137–38 (noting the complications of weighing disutility when taste differences are taken into account).

32. See, e.g., ROSEN, *supra* note 16, at 330–31 (“The goal of optimal commodity taxation is to select tax rates . . . in such a way that the excess burden of raising the required tax revenue is as low as possible.”).

distributional point relies on the apparent nexus between endowment and the kind of inequality that we consider relevant to differences in tax burdens.<sup>33</sup> If we believe that the tax system has a redistributive role to play, we need to know on what basis redistribution will take place—from whom, to whom, and according to what principle. In considering the inequalities that make a normative difference, traditional tax bases come up short. *A* and *B* have very different incomes, but their overall levels of well being are very close, perhaps the same.<sup>34</sup> Their unequal tax burdens under an income tax result from the apparently arbitrary fact (from a normative perspective) that *B* chooses to deploy the same abilities that *A* possesses in ways that happen not to produce income. Thus, if no account is taken of endowment, mere “commodity choice” dictates redistributive policy, a result with which we may not be entirely comfortable.<sup>35</sup> The same problem can arise under consumption and wealth taxation. In each case, two individuals equally well-off in terms of the powers at their disposal are subject to different tax burdens because of the different ways in which they happen to deploy those powers.

These considerations suggest that talents no less than material resources should be subject to redistribution under a liberal theory, if the theory favors redistribution generally. For example, one strain of contemporary liberalism, sometimes referred to as “choice egalitarianism,” would seem to support redistribution of talents through taxation.<sup>36</sup> Choice egalitarians generally view individuals as responsible for the adverse consequences they suffer from risks that they choose to run, and the state as responsible for equalizing the effects of unforeseeable or brute luck.<sup>37</sup> As the distribution of talents is largely a matter of brute luck, it appears the state may ameliorate the ill effects of their unequal distribution through redistributive taxation. Similarly, John Rawls argues that arbitrariness in the distribution of talents weakens the case for an unconditional right of ownership in the fruits of one’s talents and strengthens the intuitions that support the difference principle.<sup>38</sup> Again, it becomes unclear why the resources available to satisfy the difference principle cannot include arbitrarily distributed talents.

Despite this affinity between various strains of redistributive liberalism and endowment taxation, most liberal theorists reject endowment taxation,

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33. Shaviro, *Endowment II*, *supra* note 1, at 136; *see also* Stark, *supra* note 1, at 51 (discussing Shaviro’s exposition of endowment taxation as an orienting principle for determining the distributive component of taxation).

34. The argument for this point is clearly set out in Shaviro, *Endowment II*, *supra* note 1, at 127–31. *See* Part IV, below, for a discussion of Shaviro’s derivation of this conclusion.

35. Stark, *supra* note 1, at 52.

36. *See* Fried, *Ex Ante/Ex Post*, *supra* note 28, at 131–34 (describing “choice egalitarianism,” which holds that the “just state . . . is obliged to redistribute resources to compensate individuals for any inequalities in their background resources,” thus putting individuals in positions of *ex ante* equality).

37. *Id.*

38. JOHN RAWLS, *THEORY OF JUSTICE* 74–75 (1971) [hereinafter RAWLS, *THEORY OF JUSTICE*].

principally on grounds of autonomy, consent, or both. Mark Kelman, for example, argues that endowment taxation is barred by the “simple libertarian principle that the state should not require people [absent their consent] . . . to engage in particular activities.”<sup>39</sup> Ronald Dworkin argues that endowment taxation amounts to enslavement of the able.<sup>40</sup> Liam Murphy and Thomas Nagel conclude that endowment taxation is inconsistent with choice egalitarianism because the invasion of individual autonomy that it would require is too extreme.<sup>41</sup> Rawls suggests that fair taxation requires consent that is implicit in market activities but that cannot be inferred from mere membership in a system of political association.<sup>42</sup>

These arguments have tended to leave endowment theorists cold, largely on the ground that it seems impossible to mark off the kind of compulsion under which an endowment tax places individuals from other sorts of tax compulsion that individuals routinely face and that do not seem to trouble liberals. Kirk Stark, for example, argues that once one has accepted redistribution as part of a liberal theory of justice, it becomes difficult to leave endowments out of the redistributive calculus given the acknowledged impact of taxes on all sorts of work–leisure decisions that individuals make routinely.<sup>43</sup> If high taxes force a person to work more to finance the purchase of, say, an expensive tennis racquet, then taxes compel a work decision—yet this circumstance does not seem problematic.<sup>44</sup> Why show greater solicitude for someone whose consumption choices happen not to require market income than for one whose choices do? In the end, Stark argues, the different treatment can only rest on an unmotivated decision to privilege nonmarket over market activities.<sup>45</sup>

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39. Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an “Ideal” Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831, 842 (1979).

40. Dworkin, *Equality Part II*, *supra* note 28, at 312. Dworkin objects that endowment tax would violate the envy principle. *Id.* The envy principle provides a standard by which to measure whether an arrangement is equal in the sense required by a theory of distributive justice. If it is not rational for any person to envy any other’s bundle of resources, then equality obtains. *Id.* at 285. An endowment tax could cause the more able rationally to envy the less able.

41. MURPHY & NAGEL, *supra* note 4, at 122–23.

42. JOHN RAWLS, JUSTICE AS FAIRNESS: A RESTATEMENT 157–58 (2001) [hereinafter RAWLS, JUSTICE AS FAIRNESS].

43. *See, e.g.*, Stark, *supra* note 1, at 61 (arguing that both Kelman’s and Rawls’s consent arguments are “difficult to square with liberal egalitarian principles” and “more importantly” that “under the Rawlsian framework the relevant moment for gauging consent is in the ‘original position’ when all members of society are under a ‘veil of ignorance’ regarding their position in society”).

44. *See id.* at 63–64 (arguing, contrary to some scholars’ assumptions, that one’s choice of occupation should not necessarily deserve greater protection as a fundamental liberty interest than other choices). The example Stark uses is cultivation of musical talents. If taxes make it necessary to work more to have enough resources to develop one’s musical talents, then taxes have “compelled” a labor choice. *Id.* at 64.

45. *Id.* at 65.

Shaviro takes a similar tack. He notes that many of the apparently principled liberal objections to endowment taxation boil down to administrative or practical concerns, not theoretical ones. For example, any effort to tax endowments would seem to require controversial political judgments, but these judgments may result mostly from the need to resolve the difficult empirical question of how to value endowment, not from any deep worry about the propriety of taxing it. Similarly, the fear that endowment tax is a form of “wage slavery” seems to derive in part from the practical difficulty of increasing one’s income by only the amount needed to satisfy a possible endowment tax obligation, not from any deep objection to making a tradeoff between additional work and a fair distribution of resources.<sup>46</sup>

Turning to the substantive objections, Shaviro, like Stark, questions whether any principled distinction can be made between the (acceptable) inducement to pay tax on one hand, and the (unacceptable) compulsion to do so on the other. A tax increase on one spouse’s earnings can force the other spouse to get a job, but “[n]o one seems to think that this scenario suggests a ‘libertarian constraint’ on taxing households with two or more potential earners.”<sup>47</sup> Similarly, “[d]ebates about the appropriate relative treatment of different household types . . . often turn on how to compare need or well-being in the two settings. . . . ‘[S]imple libertarian principle[s]’ apparently do not get in the way.”<sup>48</sup> The ubiquity of apparently uncontroversial tax-motivated work decisions again suggests that no nonarbitrary baseline is available to demarcate compulsion from inducement, and this means, in turn, that the autonomy–consent argument fails if it is meant to bar endowment taxation a priori. Once we accept that taxes may motivate work choices, we are unable to draw a principled line between taxes that are necessary to finance leisure time and those that are necessary to finance other activities. If we have consented to the latter, then at a minimum we have not ruled out consent to the former.

If one accepts the distributional argument, the incentive argument seems to follow without much difficulty. In describing the impact of taxation on behavior it is useful to distinguish between “income effects” and “substitution effects.” Income effects are behavioral effects that result from the fact that the taxpayer has fewer resources as a result of the tax.<sup>49</sup> These

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46. Shaviro, *Endowment II*, *supra* note 1, at 138. Shaviro calls this the problem of the lumpiness of the labor market—the fact that an individual may not have the option to work only a few more hours, but rather only twenty or forty more, if any more. *Id.*; see also Zelenak, *Taxing Endowment*, *supra* note 1, at 1150–51 (noting that the lumpiness of actual labor markets produces inefficient substitution effects under an endowment tax).

47. Shaviro, *Endowment II*, *supra* note 1, at 136.

48. *Id.* at 139 (quoting Kelman, *supra* note 39, at 842); see also Barbara H. Fried, *Left-Libertarianism: A Review Essay*, 32 PHIL. & PUB. AFF. 66, 81–82 (2004) [hereinafter Fried, *Left-Libertarianism*] (suggesting that many work decisions result from the effect of taxes).

49. ROSEN, *supra* note 16, at 311–12.

effects may lead to a reduction in the amount of a good consumed, to an increase (on a pretax basis) in the amount of a good produced, or both, but they do not result in inefficiency because they do not lead to a net reduction in overall social wealth.<sup>50</sup> For instance, the imposition of an ordinary income tax on investment returns can cause an individual subject to the tax to increase the amount of resources devoted to investment if her objective is to maintain a given target. The increase will be financed by some kind of reduction in consumption, either because the taxpayer purchases less or because she consumes less leisure, but the increase will not prevent efficient transactions from occurring.<sup>51</sup> If *B* must work more to satisfy his tax liability, all he has done is to transmute untaxed resources into taxable ones. Assuming we have factored into our endowment ideal the aversion to work, this transmutation does not result in social waste, because the resources transferred are by hypothesis better used by the transferee than the transferor. (This was the distributional argument.) Having appropriately discounted the value to *B* of additional money income, the resulting transformation of leisure to work necessary to pay the tax becomes a normatively neutral transformation of endowment into money income.<sup>52</sup>

Substitution effects, by contrast, are behavioral effects that result from the taxpayer's efforts to avoid the tax by engaging in untaxed or less-heavily taxed activities that serve as substitutes for the (more-heavily) taxed activity.<sup>53</sup> Unlike income effects, substitution effects create social waste because they induce taxpayers to engage in transactions that, by hypothesis, are inefficient on a pretax basis. If the individual subject to tax on investment earnings diverts resources into, say, equity stocks or leisure activities as a way of avoiding the tax, the resulting allocation of resources is inefficient. Less total social wealth results from her investment choice, because on an after-tax basis that choice returns more wealth to her than does the choice that produces greater social wealth overall. The extent to which this uneconomic shifting reduces overall efficiency is called the "excess burden" or deadweight loss of the tax.<sup>54</sup>

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50. *Id.* at 312.

51. *Id.* at 312 fig.13.4.

52. In effect, the tax on *B* approaches a tax on utility. Zelenak, *Taxing Endowment*, *supra* note 1, at 1151.

53. See, e.g., ROSEN, *supra* note 16, at 403-04 (explaining that when a tax reduces take-home wages there is a tendency to substitute leisure for work).

54. *Id.* at 312. For example, consider an individual faced with the choice of investing \$100 in either Asset A, generating a fixed return of 10%, or Asset B, generating a fixed return of 8%. Assume that only returns from Asset A are subject to tax and that the individual's marginal tax rate is 30%. Because her after-tax return on Asset B, \$8, is greater than her after-tax return on Asset A, \$7, she will invest in Asset B even though more total social wealth would result if she invested in Asset A. The deadweight loss is \$2, which is the difference in total wealth between the economically better investment and the investment actually made.



Endowment taxation, as a form of lump-sum taxation, appears to be maximally efficient.<sup>55</sup> Because the burden of lump-sum taxes does not depend on taxpayer behavior, they do not have substitution effects. Short of leaving the country (or suicide), there is no way to escape a lump-sum tax; it will fall on the taxpayer in the same way no matter what she does. Naturally the tax may affect her behavior by reducing consumption opportunities—that is, it may produce an income effect—but we need not be concerned with this effect because, by hypothesis, we have already determined that it is better for the government to collect the tax and use it for other purposes than for the tax to remain uncollected. Therefore deadweight loss is zero, and the welfare gains that result from the net wealth transfer that the tax effects necessarily exceed the welfare losses.

### *B. Practical Implications*

The preceding discussion lays out the argument for endowment taxation as an ideal, but it is important to bear in mind that the same considerations that support the ideal also have a bearing on real-world questions of tax policy. Because ideal theories provide a normative standard against which to evaluate actual tax systems, the theory of endowment taxation plays a role in practical tax policy similar to the roles that the theories of an ideal income and an ideal consumption tax have long played. These ideals enable us to get clear on what, exactly, we should tax under actual circumstances, taking into account administrative and other concerns that inevitably must fit into any coherent and workable system of taxation.<sup>56</sup>

As an example, consider the relationship of the theory of an ideal income tax to questions of tax policy today. An ideal income tax would tax all actual accessions to wealth, irrespective of whether they were realized and irrespective of whether they were the result of market-based activity or other sorts of activity.<sup>57</sup> From the perspective of an ideal income tax, rules limiting or deferring tax where there is economic income need to be justified on some other basis, such as administrability or political limitations. A frequently discussed case is the failure to tax imputed income. Imputed income is

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55. See JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 131 (3d ed. 2004) (stating that lump-sum taxation is perfectly neutral—it exerts no influence on economic choices since no decision can be made to affect your tax bill).

56. See, e.g., Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1415 (2006) (“[D]etermining which ideal form [of tax] is most desirable helps us design actual systems and helps us understand the flaws of actual systems—ideals matter in tax reform.”); Kaplow, *supra* note 1, at 1480 (explaining the purpose of developing a theory of ideal income taxation); Shaviro, *Endowment I*, *supra* note 1, at 410 (noting that the ideal can help orient policy decisions).

57. See, e.g., Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 723 (1990) (describing the Haig-Simons ideal income tax model); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1819 (1990) (noting that accretion taxation taxes changes in the value of an investment even if the investor is still holding the investment).

income received in the absence of an observable market transaction, typically because it is self-provided, given as a gift, or thrown off in-kind by already-owned property; examples include self-provided housework and free rent for owner-occupied housing.<sup>58</sup> Many commentators argue that an ideal income tax would reach imputed income because imputed income represents a real accession to wealth, and accessions to wealth are, by definition, income.<sup>59</sup> From this perspective, any reasons we may have for not taxing unpaid housework or the rental value of owner-occupied housing must relate to other matters, such as problems of valuation, privacy, or the problem of the second best.<sup>60</sup> If it becomes possible to resolve these problems, then, the argument goes, it appears we should tax these and other forms of imputed income if our tax system endeavors to tax true income. In short, the “ideal” theory of income purports to tell us what our tax system is an approximation of and to help us understand whether some policy rationale supports actual departures from the ideal.

Similarly, if as a theoretical matter endowment is the correct basis on which to tax, then it is appropriate to evaluate the actual tax system with reference to the extent to which it implements endowment taxation principles, again taking into account second-order concerns that may require departure from the ideal. As an example, consider the current tax system’s favoritism of many single-earner married couples over similarly situated unmarried couples (sometimes termed the “marriage bonus”).<sup>61</sup> The normative underpinning of the differential treatment is that the appropriate economic unit for taxation is the household, defined as the single head of household for unmarried persons and as the husband and wife for married persons, and therefore that each spouse’s earnings should, in effect, be averaged, or nearly averaged, for tax purposes.<sup>62</sup> An assumption of this approach is that a non-working spouse does not derive an income-like benefit from the fact that he does not work. If, however, not monetary income but personal endowment—that is, ability to earn income—is the appropriate metric for

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58. See David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793, 837–38 (1992) (describing common examples of the failure to tax imputed income).

59. *E.g., id.*

60. The problem of the second-best is the problem of piecemeal reform. Richard G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11, 12 (1956). A reform that, taken in isolation, moves toward an ideal may generate outcomes that are worse than the prereform outcome. The possibility arises because the distortion that a reform removes may have served to offset another distortion that the reform has not addressed. *Id.* at 11–13.

61. Compare I.R.C. § 1(a) (2000) (imposing tax on married individuals filing jointly), with I.R.C. § 1(c) (2000) (imposing tax with a higher rate schedule on unmarried individuals).

62. See STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., *THE INCOME TAX TREATMENT OF MARRIED COUPLES AND SINGLE PERSONS* 4–5 (Comm. Print 1980) (identifying the conflicting policy goals that result in progressivity, the “marriage penalty” and the “marriage bonus”). See generally Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 9 (2000) [hereinafter Zelenak, *Marriage Penalties*] (discussing the history and policy of the marriage penalty and the marriage bonus).

determining tax liability, then the benefit conferred on married individuals with unequal money incomes would seem unjustified. Apart from problems of valuation and assessment, we would not offer this tax benefit to married, single-earner couples, and a real-world, partial solution to the problem might be to eliminate the separate rate schedule for married individuals filing jointly. Note further that this result also would shift the terms of the related debate on the “marriage penalty.” The marriage penalty results from the fact that progressivity in tax rates subjects married couples whose members earn comparable incomes to higher tax than it does similarly situated unmarried couples.<sup>63</sup> Although the marriage penalty relates to a different comparison from the marriage bonus, the taxation of endowments is relevant because it calls into question the justification of the marriage bonus described above, and this bonus is typically weighed against the “penalty” in policy debates over the differential treatment of married and unmarried individuals.<sup>64</sup>

A second example of the relevance of the endowment ideal to current issues in tax policy is the tax treatment of education expenditures. A number of scholars have asked whether these expenditures should be amortizable, on the ground that the cost of education is not different in principle from any other cost for capital that has a finite, reasonably determinable life.<sup>65</sup> As a general matter, under the income tax such costs are capitalized and then amortized over the life of the asset,<sup>66</sup> but most educational expenses under the actual income tax are neither deductible nor amortizable.<sup>67</sup> One of the central questions in this debate is the impact of endowment. If endowment is a form of income, then the failure to tax it at birth may offset the denial of cost recovery for most education expenses, in which case the existing rules represent a reasonably good approximation of the tax ideal. If endowment is

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63. See Dorothy A. Brown, *The Tax Treatment of Children: Separate but Unequal*, 54 EMORY L.J. 755, 769 & n.55 (2005). Compare I.R.C. § 1(a) (2000) (married couples filing jointly), with I.R.C. § 1(c) (2000) (unmarried individuals).

64. Zelenak, *Marriage Penalties*, *supra* note 62, *passim*.

65. See, e.g., Joseph M. Dodge, *Taxing Human Capital Acquisition Costs—or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927, 968–82 (1993) (arguing that neither tax theory nor public policy perspectives support the proposition that taxpayers be able to amortize expenditures for higher education); John A. Litwinski, *Human Capital Economics and Income*, 21 VA. TAX REV. 183, 226 (2001) (noting that although the debate over whether educational expenses are deductible is valid, the theory of human capital economics serves is “good for much more than piddling over whether to carve out another deduction”). The problem of separating the consumption and nonconsumption components in some education raises its own difficulties, but is conceptually distinct from the question of whether to provide a deduction or amortization for the nonconsumption component.

66. I.R.C. § 167 (2000).

67. See Treas. Reg. § 1.162-5(b) (2006) (generally treating education expenses as inherently “personal” in nature, and therefore as neither deductible nor amortizable, apart from certain education expenses necessary to maintain one’s professional or business qualifications, which may be deducted). For the years 2002 and 2003, Internal Revenue Code § 222 permitted a deduction of up to \$3,000 for certain education expenses of the taxpayer or her dependent, subject to limits on adjusted gross income. I.R.C. § 222(b)(2)(A) (2000). For 2004 and 2005, the deduction was capped at \$4,000. I.R.C. § 222(b)(2)(B) (2000). The provision expired at the end of 2005. *Id.*

not income, or should not in any case be taxed, then the failure to provide cost recovery for educational expenses remains a problem for the tax system.<sup>68</sup>

More important than individual examples such as these is the fact that the endowment ideal bears significantly on the question of the optimal structure and mix of income and other taxes that make up the tax system, because it is possible to approach an endowment tax with available tax instruments. For example, Louis Kaplow suggests that an income tax capped at some (high) percentage of earned income would offer a good approximation of an endowment tax.<sup>69</sup> Kaplow puts the maximum at ninety percent, one percent below the top rate in effect during the Kennedy Administration.<sup>70</sup> There is a substantial question whether that approximation is accurate, but the more general observation that it is possible to approach an endowment tax in the real world remains valid. Thus, if one accepts, as most of the economics literature does, that some form of lump-sum taxation such as an endowment tax is optimal, then the theory of optimal taxation is much more likely to inform one's approach to actual problems of tax policy than is any theory of ideal income, consumption or wealth taxation. Optimal tax theory, as developed by Frank Ramsey, Milton Friedman, Angmar Sandmo, and others in the commodity tax context, and initially by James Mirrlees in the income tax context, attempts to formalize and operationalize the intuitions that an optimal tax in the real-world setting in which lump-sum taxation is unavailable varies tax levels on particular items or activities in ways that minimize excess burden.<sup>71</sup> If one is constrained to commodity taxation, then tax rates on particular commodities should be set so that the distortion introduced by the tax on the purchase of the marginal unit of any commodity is approximately equal, in relative terms, to the average distortion introduced by taxes on the marginal unit purchased of all commodities.<sup>72</sup> Thus, commodities for which nontaxed substitutes are readily available may be taxed lightly, whereas commodities for which such substitutes are lacking may be more heavily taxed. In each case, the object is to tax at a level that makes substitution occur at roughly the same rate.<sup>73</sup>

Similarly, where taxation may apply to income generally but not to commodities or leisure, the problem of commodity substitution disappears,

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68. See Kaplow, *supra* note 1, at 1487–90 (explaining that in seeking higher education an individual may not achieve her ideal income upon graduation, and without a method of cost recovery for educational expenses, this nondeductibility can result in a negative financial outcome).

69. Kaplow, *supra* note 1, at 1506 n.71.

70. LOUIS ALAN TALLEY, CONG. RESEARCH SERV., FEDERAL TAXATION: AN ABBREVIATED HISTORY ¶ 23 (2001), available at <http://www.taxhistory.org> (click “Readings” then select “CRS Report on History of Federal Taxes”).

71. David F. Bradford & Harvey S. Rosen, *The Optimal Taxation of Commodities and Income*, 66 AM. ECON. REV. (SPECIAL ISSUE) 94, 95–96 (1976).

72. *Id.* at 95.

73. *Id.*

but the policymaker still must address the problem that individuals substitute untaxed leisure for work when the marginal income tax rate is high enough.<sup>74</sup> In this setting, the policymaker's principal tool for minimizing excess burden is the capacity to adjust the marginal rate of tax so that the incentive to substitute leisure for labor at any given income level is minimal relative to the allocation that would take place in the absence of taxes generally. Where, however, commodity taxation is also available, an income tax and commodity taxation may operate together to approximate an endowment tax more closely, because commodity taxation, broadly understood to include taxation of certain activities (through, e.g., user fees), can approximate a tax on leisure. Thus, where it is possible to supplement a broad-based income tax with taxation on complements to leisure, such as by high taxes on televisions, or substantial fees for Internet or library usage, it may be possible to realize a reasonable second-best to a true endowment tax.<sup>75</sup>

The relevance of endowment to these and other practical tax questions demonstrates why the question of the theoretical status of the endowment ideal is not trivial. The tax treatment of single-earner married couples or expenditures for education are big-ticket policy matters that have received, and continue to receive, substantial attention in the literature.<sup>76</sup> More significantly, virtually the entire body of public finance literature considers lump-sum taxation as an ideal, and much of it is devoted to Ramsey-type solutions to the problem of deadweight loss where lump-sum taxation is not available. These issues and approaches, like the more abstract question of the nature of the inequality that is relevant to differential tax burdens, are likely to be affected by one's view of the role of endowment in taxation.

### III. Liberal Theories

The preceding Part developed the liberal case for endowment taxation and explained the relevance of the endowment ideal to live issues in tax

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74. Mirrlees, *supra* note 3, at 176–77.

75. Bankman and Weisbach note that a further refinement to commodity taxation is available. Where it is possible to identify goods the consumption of which is associated with higher levels of endowment, regardless of actual income (so-called indicator goods), it is possible for the tax system to target endowment even more accurately. Bankman & Weisbach, *supra* note 56, at 1453–55.

76. See, e.g., Bridget J. Crawford, *One Flesh, Two Taxpayers: A New Approach to Marriage and Wealth Transfer Taxation*, 6 FLA. TAX REV. 757, 759–61 (2004) (criticizing the current marital deduction allowance under the estate and gift tax schemes and proposing a “one flesh, one taxpayer” model to conform to present issues regarding marriage); Davenport, *supra* note 58, at 837–38 (analyzing the concept of economic gain and imputed taxable income to a household from the spouse “working” at home); Kaplow, *supra* note 1, at 1492–94 (noting that both the current rules and proposed alternatives fail to properly measure “ideal income” with respect to investments in human capital, e.g., educational expenditures); Angela V. Langlotz, *Tying the Knot: The Tax Consequences of Marriage*, 54 TAX LAW. 329, 332–43 (2001) (considering the economic deterrents to marriage present in the Internal Revenue Code); Edward J. McAffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983, 1014–15 (1993) (examining that, for instance, for low income earners, there is a marriage penalty and an incentive for only one spouse to work because of the relatively high marginal tax rates for the second earner).

policy. This Part examines the cogency of that case. I conclude that most forms of endowment taxation are inconsistent with what I argue are core principles of liberalism. Endowment taxation, to the extent a liberal theory may countenance it at all, must be confined to the provision of certain public goods; endowment taxation to finance redistribution is typically out of bounds, even for those liberal theories that support redistribution.

A problem that immediately confronts an effort to characterize liberalism for this purpose is the difficulty of saying anything definitive about liberalism in general. "Liberalism" is an umbrella term that encompasses a wide array of normative and positive theories of modern government and society. Its proponents include (among others) egalitarians, libertarians, and advocates of the modern welfare state,<sup>77</sup> and the understandings and approaches of theorists in each of these traditions are as varied as their derivations of and justifications for the theory or view they espouse.<sup>78</sup> Generalizations applicable to all such theories are unlikely to be substantive or helpful.

In order to orient ideas and to make the argument tractable, I confine the discussion below to the most prominent strand of philosophical liberalism, social contractarianism. The purpose of this approach is to avoid the excessive abstraction that would result from an effort to describe liberalism in terms broad enough to apply to every theory that arguably falls within the liberal tradition. This way of proceeding sacrifices some generality for a more determinate and intuitive understanding of basic principles. However, since the principles meet with wider assent than the model that is used to express them, the conclusions reached here should have intuitive appeal for liberal theorists outside of the social contract tradition as well.<sup>79</sup>

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77. See generally Fried, *Left-Libertarianism*, *supra* note 48 (canvassing both left- and right-libertarian theories of political association).

78. Normative accounts of the liberal state include, for example, BRUCE A. ACKERMAN, *SOCIAL JUSTICE IN THE LIBERAL STATE* (1980), which develops a neutral dialogue theory of liberalism; JOHN STUART MILL, *On Liberty*, in *UTILITARIANISM, ON LIBERTY, CONSIDERATIONS ON REPRESENTATIVE GOVERNMENT* 69 (Geraint Williams ed., J.M. Dent & Sons 1993) (1859), which argues for the liberal principle of noninterference on utilitarian grounds; ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* (1974), which develops a "historical" account of the minimal liberal state; and Robin L. West, *Liberalism Rediscovered: A Pragmatic Definition of the Liberal Vision*, 46 U. PITT. L. REV. 673 (1985), which advocates a pragmatic approach to developing a liberal conception of the good life. Positive accounts of liberalism include, for example, ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* (Phillips Bradley ed., Henry Reeve trans., Vintage Books 1945) (1835), which provides a sociological and historical account of American institutions that secure and threaten liberty and Richard W. Garnett, *American Conversations With(in) Catholicism*, 102 MICH. L. REV. 1191, 1195 (2004) (book review), which states "American liberalism often defined and constructed itself precisely in opposition to its image of Catholicism."

79. See, e.g., RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at xxviii–xxx (drawing out the links between generically liberal theories of political association and the contractarian tradition).

### A. Social Contractarianism

Political theories in the contractarian tradition commonly employ the device of a “pregovernmental” bargaining situation to derive basic principles of justice, including principles of distributive justice, that purport to have normative force for actual polities.<sup>80</sup> The bargaining situation contemplates individuals endowed with certain abilities who are confronted with the problem of reaching an agreement on the terms under which they interact with one another. On one hand, the individuals are understood to be complete prior to and apart from any political order, in the sense that their ultimate ends are given and in principle capable of realization outside of a political order: Political life does not constitute an end for them in any way.<sup>81</sup> On the other hand, prior to their reaching any such agreement, their material ends go largely unsatisfied because individuals lack the necessary resources—peace, the possibility of social cooperation, or both—to realize them.<sup>82</sup> Put simply, contracting individuals are poor, if not penurious, outside of a political order. Therefore they are driven to political life as a solution to the problem of finding means to realize their pregiven ends. As originally conceived and articulated, the social contract tradition thereby conceived of government as derivative of pre-existing individuals who set its terms, and who did so because they needed to for their own private purposes.

In its more recent incarnations, this approach typically has treated the bargaining situation as an idealized setting in which individuals who possess limited information about the capacities, desires, or interests they would have in any actual society deduce principles of governance that will apply to them once this information becomes known.<sup>83</sup> Rather than attempt to derive binding rules from an original state that has authority because it is somehow either natural or historically real,<sup>84</sup> contemporary contractarian approaches

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80. The progenitors of the tradition include Thomas Hobbes and most famously John Locke. See generally THOMAS HOBBS, *LEVIATHAN* (Richard Tuck ed., Cambridge Univ. Press 1991) (1651) [hereinafter HOBBS, *LEVIATHAN*]; JOHN LOCKE, *The Second Treatise of Government, in TWO TREATISES OF GOVERNMENT* (Peter Laslett ed., 1988) (1690). More recently, John Rawls, David Gauthier, and others have used the idea of a fictional social contract as a heuristic device to orient intuitions or to give specific contours to abstract principles. DAVID GAUTHIER, *MORALS BY AGREEMENT* 234 (1986); RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 17–22; Dworkin, *Equality Part II*, *supra* note 28, at 285–88.

81. See, e.g., THOMAS HOBBS, *MAN AND CITIZEN* 111 (Bernard Gert ed., Hackett Publ'g Co. 1991) (1642 & 1658) [hereinafter HOBBS, *MAN AND CITIZEN*] (“We do not therefore by nature seek society for its own sake, but that we may receive some honour or profit from it; these we desire primarily, that secondarily.”); see also *id.* at 110–13 (arguing more generally that human beings by nature are not political).

82. See *id.* at 117–18.

83. E.g., GAUTHIER, *supra* note 80, at 131–32; RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 119–20; Dworkin, *Equality Part II*, *supra* note 28, at 288–90.

84. It should be stressed that in no version of social contract theory does the argument rest on a historical account of actual consent; rather the consent is counterfactual, though the way in which it is counterfactual varies from theory to theory. See Alexander Rosenberg, *The Explanatory Role of*

use the bargaining situation as a heuristic device to give effect to basic and commonly shared ideals that are relevant to principles of justice. Rights and institutions that implement these ideals then emerge at least in part as consequences of the bargain struck. This refinement reflects a shifting conception of the role that the idea of the bargaining situation plays, but it does not fundamentally alter the nature of the justificatory enterprise. What is critical to both approaches is the assumption that rational individuals with pre-given ends set the terms on which they live together under coercive power.<sup>85</sup> This method is to be contrasted with earlier approaches, which typically justified governmental authority on the basis that it created or fostered particular ends that citizens do or should have—that is, that the good regime was the one that created the good citizen or, perhaps, the good person.<sup>86</sup>

Because of the different possible accounts both of individuals in the bargaining situation and of the bargaining situation itself, the distributional terms that emerge from it and, concomitantly, the tax systems that help to give effect to the terms, can vary widely. Some liberal theories support libertarian principles of justice,<sup>87</sup> others support some version of equality of resources,<sup>88</sup> and still others come out at various points between these two poles.<sup>89</sup> Thus, it has been remarked that where one ends up on this spectrum depends critically on contestable assumptions that go into the design of the bargaining situation in the first place.<sup>90</sup> An assumption that individuals are risk averse may push toward equality of outcome, while an assumption of

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*Existence Proofs*, 97 ETHICS 177, 181 (1986) (recounting the manner in which different theories deal with the nature of counterfactual consent).

85. RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at xxii–xxiii.

86. See, e.g., 2 ARISTOTLE, *Politics*, in THE COMPLETE WORKS OF ARISTOTLE VII.1.1323b39–1323b40, at 1986, 2101 (Bollingen Series No. 71, Jonathan Barnes ed., 1984) (Revised Oxford Translation) (“[T]he best way of life, both for individuals and states, is the life of excellence . . .”).

87. See, e.g., RICHARD A. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* 331–34 (1985) (presupposing the existence of individual rights independent of agreement and prior to the formation of the state as a basis for the eminent domain framework); GAUTHIER, *supra* note 80, at 1–20 (basing a theory of morals, in part, on the understanding that individuals fulfill their own interests); cf. NOZICK, *supra* note 78, at ix–xii (arguing for a minimal state based on a theory of justice in acquisition that begins from liberal premises about entitlements but eschews the contractarian device).

88. See, e.g., RAKOWSKI, *supra* note 28, at 1–3 (arguing that the ideal of equality requires people to start life with an equally valuable bundle of resources to be maintained over time through transfer of possessions and possibilities); Dworkin, *Equality Part II*, *supra* note 28, at 283–90 (explaining a conception of equality of resources as equality among resources privately owned by individuals); see also Fried, *Ex Ante/Ex Post*, *supra* note 28, at 133 (describing a range of views among choice egalitarians).

89. See, e.g., RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 4–6 (explaining that a characteristic set of principles for determining the proper distribution of benefits and burdens of social cooperation limits the self-interested pursuit of other ends).

90. See Don Herzog, *Externalities and Other Parasites*, 67 U. CHI. L. REV. 895, 915 (2000) (“[E]verything will depend on how we describe the choice situation. . . . So arises a powerful skepticism about contract arguments: tiny changes in the characterization of the initial situation can lead to huge changes in the principles rational agents would adopt and that are, on that ground, allegedly justified.”).



higher risk tolerance may push in the opposite direction.<sup>91</sup> A belief that market outcomes merit intrinsic respect is likely to support a libertarian social theory and a flat or even regressive tax structure, while a distrust of markets is apt to support more substantial redistribution away from market outcomes, usually effected through a progressive tax structure.<sup>92</sup>

For present purposes it is not necessary to address, much less to resolve, disagreements among the various approaches over such distributive principles. There are common themes that unite them, and it is these themes that delineate the range of views that might plausibly count as liberal. In particular, contractarian theories generally adhere to (at least) three principles that both distinguish them from consequentialist-based approaches and, it would appear, entail a commitment to a very limited role, if any, for taxation of personal endowments, no matter where on the distributive spectrum a specific theory that accepts these principles ends up. These principles are political equality; some form of autonomy, understood as the right to posit and realize one's own ends with minimal interference from others; and a certain kind of neutrality among different conceptions of the good.<sup>93</sup> A commitment to these principles is in many ways indeterminate with respect to the actual principles of justice to which bargaining parties hypothetically would agree, but it does limit the range of possible outcomes in certain critical respects.

One of these limits is given by the principle of the absolute, or "lexical," priority of the right over the good. This principle requires that basic political institutions be justified on the basis of their efficacy in realizing principles of social cooperation that follow from the moral status of persons as free, equal, and rational, not on the basis of institutions' superiority in realizing a particular conception of the good.<sup>94</sup> As explained below, the idea that the right takes priority over the good reflects the commitments to autonomy and

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91. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 474–75 (6th ed. 2003) (explicating this concept in the context of Rawls's theory that the distribution of income and wealth is only just if no other distribution would make the worst off people in society better off).

92. See, e.g., MURPHY & NAGEL, *supra* note 4, at 67 (arguing that theorists who think market-generated economic inequalities are morally illegitimate will favor tax for redistributive purposes); Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAP. L. REV. 157, 166 (1999) [hereinafter Fried, *Puzzling Case*] (purporting that most libertarians treat the division of surplus resulting from market prices as sacrosanct).

93. See RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 6 (describing "the content of a liberal political conception of justice" as including basic equality, the specification and priority of rights and liberties of individuals, and some assurance to individuals of means to make use of their ends).

94. See Samuel Freeman, *Utilitarianism, Deontology, and the Priority of Right*, 23 PHIL. & PUB. AFF. 313, 335–38 (1994) (describing the principle of the priority of the right over the good); Kevin A. Kordana & David H. Tabachnick, *Tax and the Philosopher's Stone*, 89 VA. L. REV. 647, 670 (2003) (reviewing MURPHY & NAGEL, *supra* note 4) (noting the priority of autonomy over welfare "in most liberal theories"). Rawls introduces the idea of the lexical priority of the right over the good in his discussion of the relationship between the principles of justice. See RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 40–45.

neutrality that motivate the social contractarian account of political and social cooperation.

A commitment to the priority of the right over the good has adverse consequences for endowment taxation as an ideal tax theory, because endowment taxation tends to elevate some class of conceptions of the good over the right. The reversal of priorities surfaces in the violation of the requirement that the social contract create a system of political and social cooperation that is "Pareto-superior" to available alternatives.<sup>95</sup> In general, *State of Affairs A* is said to be Pareto-superior to *State of Affairs B* if, and only if, in *A* no individual is worse off than she would be in *B* and at least one person is better off.<sup>96</sup> Pareto superiority under the social contract is critical to the contractarian account of government, because political legitimacy in a social contractarian theory rests on implied consent, and the autonomy of contracting individuals means that Pareto superiority is effectively necessary to draw the implication. Without it, consent cannot be presumed, and political authority is lacking. The next subpart explicates the connection between autonomy and the requirement of Pareto superiority. Subpart C examines the consequences that adoption of endowment taxation would have for satisfying the Pareto superiority criterion.

### *B. Autonomy in Social Contractarianism*

A notable feature of the liberal argument for endowment taxation is its proponents' acknowledgment that true endowment taxation would come at some cost to the norm of individual autonomy. For example, after criticizing the idea that endowment taxation results in "wage slavery," Shaviro states that "we do not want to force talented beachcombers to put away their surfboards, don jackets and ties, and start reviewing loan documents or arranging interest rate swaps."<sup>97</sup> Stark concedes, at the end of his article, that "all else equal," no one would opt for a greater invasion of autonomy than obtains under the actual tax system.<sup>98</sup> Similarly, Murphy and Nagel finally

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95. See Joshua Cohen, *Structure, Choice, and Legitimacy: Locke's Theory of the State*, 15 PHIL. & PUB. AFF. 301, 314 (1986) (explaining that a rational agreement will improve a person's prospects with respect to life, liberty, and goods, and thus rational individuals seek agreements that will better their own civil interest satisfaction).

96. See ROSEN, *supra* note 16, at 36. There is an ambiguity in the definition, in that "better off" may refer either to the ex ante situation or to the ex post one. If entry into the social contract has a positive expected value for every contracting party but, once the veil is lifted, results in a decline in welfare for some relative to the precontract state, it is Pareto-superior on an ex ante basis (ex ante Pareto-superior) but not on an ex post basis (ex post Pareto-superior). Except where otherwise indicated, in the following I assume that ex ante Pareto superiority must be satisfied. Where it is not satisfied, by implication ex post Pareto superiority also is not.

97. Shaviro, *Endowment II*, *supra* note 1, at 136. See also the final sentence of Shaviro's article, which reads: "The [endowment] idea deserves greater prominence and acceptance, even though we will never see, and probably do not want to see, a literal, direct endowment tax." *Id.* at 144.

98. Stark, *supra* note 1, at 68 (asking "who would prefer a tax system that results in a *greater* interference with human freedom [than the one we have now]?").

conclude that endowment taxation creates too “extreme” an invasion of individual autonomy to be compatible with choice egalitarianism, because of the constraints it would place on work choice.<sup>99</sup>

The question that these worries implicitly raise is whether endowment theorists have given due regard to autonomy as a value. The conclusion that endowment tax places too great a limit on autonomy presupposes that autonomy is appropriately weighed against other values, such as equality and efficiency, in designing a liberal theory of government. From this perspective, the idea that endowment taxation is improper in principle seems indefensible, and the only question is whether or not the appropriate place to strike the balance is one that permits some level of endowment taxation, given prevailing norms and practical realities. The endowment theorists seem to be in general agreement that it does not, though for reasons having nothing to do with the intrinsic propriety of taxing endowments. Indeed they argue that the extent to which the endowment principle should trump autonomy or other values, such as privacy, is uncertain, and different sensibilities might reach different answers to the question.<sup>100</sup> When the equally important value of equality is also at stake, some, perhaps, would feel perfectly comfortable with the conclusion that endowment tax does not exact too high a price in autonomy, or that there is nothing particularly troubling about forcing beachcombers to don jackets and work on Wall Street. In short, although any particular judgment on the question is subjective and indeterminate, what does seem certain (on this view) is, first, that some minimal forms of endowment taxation cannot be declared off limits a priori and, second, that under different conditions, more full-blown forms of endowment taxation would be appropriate—as, for example, where the administrative difficulties that Shaviro identifies could be overcome.<sup>101</sup>

In this subpart, I argue that this way of conceiving autonomy is mistaken. The notion that accommodating autonomy to other values involves making a subjective tradeoff between them betrays a misunderstanding of the role that autonomy plays in social contract theories. For such theories, autonomy does not function as a separate, limiting condition on principles of justice that derive their force from elsewhere, such as from a commitment to material equality; rather, the commitment to autonomy is one of the assumptions of the model that gives principles of justice their force in the first place. The very point of the social contract is to preserve, and perhaps to further, autonomy, and the social contract strand of

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99. MURPHY & NAGEL, *supra* note 4, at 124–25. It should be emphasized that Murphy and Nagel do not themselves endorse the liberal egalitarian theory of social cooperation, but only its compatibility (though, it seems, not full compatibility) with endowment taxation.

100. See Shaviro, *Endowment II*, *supra* note 1, at 136 (discussing the effect of the endowment principle on traditional family structures); Stark, *supra* note 1, at 68 (suggesting that assessing values and balancing interests is complicated and that critics of endowment theory should not automatically assume that autonomy trumps in all cases).

101. See *supra* notes 46–48 and accompanying text.

liberalism gives effect to this principle by building it into the derivation of political society and political legitimacy. The theory, therefore, does not tolerate some compromise of autonomy through endowment taxation in the service of other ends. Rather, the liberal case for endowment taxation, if it stands at all, must do so because at a minimum endowment taxation does not violate autonomy and, in the strongest version, because some version of endowment taxation promotes autonomy. As explained in detail below, autonomy serves as a cornerstone for a liberal theory of government because protecting autonomy is the logical implication of the possibility of irresolvable disagreement among its members that gives rise to the theory in the first place. The disagreement implies that the operative principle of government must be to provide the widest latitude possible to all of its members to pursue their ends. Moreover, even under versions of liberalism less comprehensive in the scope of their possible application, that is, where the absence of irresolvable conflict is assumed away, the principle of autonomy generally makes endowment the least favored alternative among possible schemes of taxation.

As described in the preceding subpart, social contract theories give effect to the principle of autonomy in the derivation of political obligation from a bargaining situation among individuals of a certain type. The general form of the theory treats these individuals as independent, self-interested, and rational.<sup>102</sup> They are not political by nature but rather are considered to be in possession of ends that are, from the perspective of any possible government they erect, arbitrarily given and not subject to negotiation. As one commentator has observed, in the contractarian view, "[t]he fundamental characteristics of men are not products of their social existence."<sup>103</sup> Put another way, they are possibly complete outside of politics. At the same time, however, they are individuals who, for the most part, require some form of social cooperation in order to realize their material ends. That is, they are at least relatively poor in the state of nature, but have the potential to realize tremendous gains from trade once trade becomes possible or, if conceded to be possible in the state of nature, once it becomes much easier. Whether the quantity of wealth in the presocial state is essentially zero (Hobbes) or perhaps somewhat greater (Locke; Rawls; Gauthier), the baseline of social wealth as compared to what is available under the social contract is quite low.<sup>104</sup>

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102. See generally David Gauthier, *The Social Contract as Ideology*, 6 PHIL. & PUB. AFF. 130 (1977) (presupposing a similar construct of human nature).

103. *Id.* at 138 ("What contractarianism . . . require[s] is, first of all, that individual human beings not only can, but must, be understood apart from society."); see HOBBS, MAN AND CITIZEN, *supra* note 81, at 110–13 (arguing that man is by nature not political).

104. See HOBBS, LEVIATHAN, *supra* note 80, at 86–90 (state of nature is a very uncertain state of war lacking entirely in security); LOCKE, *supra* note 80, §§ 4–5, at 269–70 (state of nature is relatively benign); GAUTHIER, *supra* note 80, at 200–01, 210 (explaining that the individual has a

Individuals so characterized face the problem of coordinating their interaction in ways that can improve their capacities to realize their ends, relative to the capacities they have before they establish a political order. Autonomy is foundational to the agreement because individuals' ends are taken to be set before they reach any agreement among themselves, and the purpose of the agreement is to further these ends. Thus, the constraints under which they place themselves are formal or instrumental in nature; they are not given by any substantive conception of the ends they should pursue. The general constraint is that each contracting party permit every other to pursue her ends, whatever they may be, as long as doing so is consistent with others' doing the same.<sup>105</sup> Apart from this requirement, no limit is placed on ends; in this sense, the widest possible rein is given to individual autonomy, which indeed is the point of the agreement, and follows from the assumption that ends are given.

It is worth pausing briefly to reflect on the generic features of this model before attempting to draw out the links between the political conception that it supports and a liberal theory of taxation. There are at least two basic reasons why the conception may be considered broadly "liberal." First, it emerges out of a general consideration of the nature of individuals as rational and equal.<sup>106</sup> Such a conception requires a justification of political obligation that does not rest on any notion that the state serves a particular substantive good (such as maximizing overall social welfare, however defined) and for that reason should be obeyed, because different individuals will have different, often conflicting conceptions of the good.<sup>107</sup> To take just two examples, maximizing one's market production is not consistent with certain forms of religious asceticism, and neither of these is consistent with a commitment to, say, the life of Socratic virtue.<sup>108</sup>

Instead, liberalism relies on the idea of consent over the means of a common life rather than over its ends as a basis for political obligation. This

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"basic endowment" that affords a "base utility not included in the co-operative surplus"). *But cf.* LOCKE, *supra* note 80, § 123, at 350 (describing state of nature as akin to a state of war).

105. See LOCKE, *supra* note 80, § 131, at 353; RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 291–94.

106. See, e.g., RAWLS, *JUSTICE AS FAIRNESS*, *supra* note 42, at 18–24 (questioning what it means to say that a citizen is free and equal); Cohen, *supra* note 95, at 311–15 (discussing these attributes in the context of Lockean political theory with sufficient generality to characterize social contract theories in the tradition commencing with Hobbes).

107. Rawls's discussion of the need for and genesis of an overlapping consensus very clearly illustrates the nature of the problem as one of reaching an accommodation among differing, and in some ways irreconcilable, substantive views of the good. RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 135.

108. See Plato, *Apology of Socrates*, in *FOUR TEXTS ON SOCRATES* 63, 92 (Thomas G. West & Grace Starry West trans., Cornell Univ. Press 1984), in which Socrates asserts that the life according to virtue involves making speeches about virtue. In the *Philebus*, Plato has Socrates argue for the priority of the pursuit of knowledge over the experience of pleasure. Plato, *Philebus*, in *STATESMAN, PHILEBUS, ION* 197 *passim* (Harold N. Fowler & W.R.M. Lamb, trans., Loeb Classical Library ed. 1925).

is what is meant by the idea that the right takes priority over the good, and it demonstrates the intimate connection between liberalism and autonomy. Agreement of the sort sought requires only a solution to the meta-problem that lack of agreement about ends (the good) presents to rational persons whose ends are given nonetheless, and whose actions may affect one another.<sup>109</sup> Political obligation under such conditions results, if at all, from the fact that even such individuals would agree to a particular kind of order, no matter what their conception of the good may be, because that order better enables them to pursue that conception—that is, to exercise autonomy—than do the available alternatives.<sup>110</sup>

A second reason why this conception is appropriately considered liberal is that it arose historically out of the effort to reorient normative political inquiry from the question of the best regime to that of the legitimate regime.<sup>111</sup> Once the idea is off the table that the best regime is the one that serves the true human good, it is no longer appropriate to speak of the good regime, except in the attenuated sense of the regime that is good as a mere means to ends that exist above and outside it. The significance of supplanting the earlier inquiry into “goodness” with the later one into legitimacy indicates why the greatest progenitor of modern liberalism is the nonliberal Hobbes, whose political theory developed in opposition to the religious conflicts of seventeenth-century England. For Hobbes, what distinguished good and bad conditions was not the presence of the right kind of regime, but the presence of any regime rather than none at all. In any regime, even the most despotic, it was possible to pursue ends; in the state of nature it was not.<sup>112</sup> Thus Hobbes rejected, for example, the notion that tyranny is bad kingship or oligarchy bad aristocracy, or more generally that a correct account of the good demonstrated the superiority of one regime over another.<sup>113</sup> For Hobbes the claim that any particular regime is bad or beneficent rests on opinion, on the extent to which the regime supports or at

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109. Bruce Ackerman makes free consent into the centerpiece of his own political theory, which is liberal but is not derived through a contractarian argument. ACKERMAN, *supra* note 78, at 4–6.

110. This idea has animated the literature since its inception. See generally HOBBS, LEVIATHAN, *supra* note 80; Mill, *supra* note 78; RAWLS, POLITICAL LIBERALISM, *supra* note 8.

111. Rawls traces this shift in describing the advent of modern political philosophy as principally a response to the problem of conflicting, comprehensive religious, philosophical, and moral doctrines. RAWLS, POLITICAL LIBERALISM, *supra* note 8, at xxiv–xxvii.

112. See HOBBS, MAN AND CITIZEN, *supra* note 81, at 118 (“[I]t cannot be denied but that the natural state of men, before they entered into society, was a mere war, and that not simply, but a war of all men against all men.”).

113. See *id.* at 192–93 (“Furthermore, what difference is there between an *oligarchy*, which signifies the command of a *few* or *grandeess*, or an *aristocracy*, which is that of the *prime* or *chief heads*, more than that men differ so among themselves, that the same things seem not good to all men?”).

least suffers the ends of the person whose opinion it is;<sup>114</sup> it does not reflect a valid judgment about the efficacy of the regime in promoting a real human good, because the real human good is, even at best, not capable of political realization.

Hobbes's refusal to ground political authority in any notion of the best regime follows from the view that the main political problem is not how to establish a regime that makes vicious people virtuous, but how to accommodate irresolvable conflicts over what virtue is.<sup>115</sup> This is why political peace cannot be had as long as the regime purports to derive its justification from its effectiveness in promoting a particular conception of the good.<sup>116</sup> In Hobbes's time these conceptions were, of course, primarily religious in nature, but the point extends as well to any case in which inconsistent and comprehensive conceptions of the good vie for supremacy. If conceptions of the good are not reconcilable and if they cannot be suppressed, then political authority will have to rest on their accommodation.<sup>117</sup> The need to rest legitimacy on accommodation is what gives rise to a government that serves means rather than ends.

For Hobbes these principles cause individuals in the state of nature, who experience complete freedom to posit their ends but no power to realize them, to establish an absolute sovereign.<sup>118</sup> The law of nature, which is really the law of rational self-preservation, commands entry into an absolutist civil order as the only solution to the problem that results from each individual's having an unlimited right to everything and everyone.<sup>119</sup> This solution, of course, is not a liberal one, but the reason is that the features of Hobbes's state of nature are particularly harsh, not that Hobbes adopts a

114. See *id.* ("[A] king, legitimately constituted in his government, if he seem to his subjects to rule well and to their liking, they afford him the appellation of a *king*; if not, they count him a *tyrant*.").

115. See generally Dana Chabot, *Thomas Hobbes: Skeptical Moralism*, 89 AM. POL. SCI. REV. 401 (1995).

116. Hobbes's definition of the commonwealth relies not at all on the extent to which it promotes any particular good but instead on the common conferral of power on one "person" (which may be a body composed of more than one individual) in order that those who confer their power can exit the state of nature. HOBBS, *LEVIATHAN*, *supra* note 80, at 120.

117. See RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 134–35 ("[P]olitical liberalism supposes that there are many conflicting reasonable comprehensive doctrines with their conceptions of the good, each compatible with the full rationality of human persons, so far as that can be ascertained with the resources of a political conception of justice. . . . So the question the dominant tradition has tried to answer has no answer: no comprehensive doctrine is appropriate as a political conception for a constitutional regime.").

118. See HOBBS, *LEVIATHAN*, *supra* note 80, at 117–21 (describing the creation of a sovereign as a means of "getting . . . out from that miserable condition of Warre, which is necessarily consequent . . . to the naturall Passions of men, when there is no visible Power to keep them in awe").

119. See HOBBS, *MAN AND CITIZEN*, *supra* note 81, at 116–17 ("[I]t appears by the right of nature those things may be done, and must be had, which necessarily conduce to the protection of life and members, [and] it follows that in the state of nature, to have all, and do all, is lawful for all.").

particular conception of the good that can only be promoted by an absolute sovereign. Thus, later philosophers working in Hobbes's tradition developed theories more congenial to modern liberalism, but they did not do so by relaxing Hobbes's guiding assumption that human ends are the starting point rather than the subject of legislation. Instead, they either began from a somewhat less conflict-ridden state of nature, or posited a bargaining situation that by its structure presupposed a more limited conception of government. Both of these modifications led to liberal conceptions because they permitted the erection of a political authority that could govern effectively with less than absolute power. The modifications did not, however, entail abandonment of Hobbes's refusal to ground political legitimacy in a conception of the good.<sup>120</sup> Pufendorf, for instance, conceived the state of nature as a state of "natural liberty [in which] every man is understood to be in his own right and power and not subject to anyone's authority without a preceding human act."<sup>121</sup> Locke asserted that the law of nature plainly gave persons a right to "as much and as good" as they could use, but not more, and that the state of nature was a state of abundance so that those who abided by the law of nature would not be in conflict.<sup>122</sup> Rawls, the most famous contemporary exponent of the social contract approach, assumes that contracts are enforceable in the bargaining situation, as do Dworkin<sup>123</sup> and David Gauthier.<sup>124</sup> Each of these theories can be usefully contrasted with Aristotle's assertion that "man is by nature a political animal," by which Aristotle meant that political life is life according to nature or that persons are not complete outside of the political order.<sup>125</sup> In Aristotle's political theory, political entities are part of the natural ends of human beings, not artifacts of human reason fashioned to serve private ends, and it therefore becomes possible (and perhaps necessary) for political philosophy to defend the best regime in terms of the natural ends of human beings.<sup>126</sup>

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120. See RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 299–301, for a particularly clear statement of this point. Dworkin's positive theory of equality of resources similarly follows his rejection of equality of welfare as the relevant kind of equality for purposes of distributive justice. See Ronald Dworkin, *What is Equality? Part 1: Equality of Welfare*, 10 *PHIL. & PUB. AFF.* 185, 244 (1981) ("[E]quality of welfare is not so coherent or attractive an ideal as it is often taken to be. We therefore have reason to consider with some care the alternative ideal of equality of resources.").

121. SAMUEL PUFENDORF, *ON THE DUTY OF MAN AND CITIZEN ACCORDING TO NATURAL LAW* 117 (James Tully ed., Michael Silverthorne trans., Cambridge Univ. Press 1991) (1673).

122. LOCKE, *supra* note 80, §§ 31–36, at 290–93. Locke later seems to change this characterization, describing the state of nature as perilous. *Id.* § 123, at 350 ("[T]hough in the state of Nature he hath such a right [of absolute control over his body and possessions], yet the Enjoyment of it is very uncertain, and constantly exposed to the Invasion of others.").

123. See, e.g., Dworkin, *Equality Part II*, *supra* note 28, at 289 (assuming, in examining the question of fair distribution, that no theft of resources occurs).

124. GAUTHIER, *supra* note 80, at 8–16. Gauthier's version does not presuppose individuals' uncertainty about their talents.

125. ARISTOTLE, *supra* note 86, 1.2.1253a3–.1253a4 at 1987.

126. *Id.*



In contrast, liberal theories of government posit individuals as whole and complete beings, if not fully realized ones, apart from and before political society comes into existence. The “social contract” that implicitly governs the society they create has authority for us because it is recognizably Pareto-superior to the nonpolitical state, however that state is conceived under any of the various state of nature theories.<sup>127</sup> But Pareto superiority, in turn, has to be derived from a hypothetical agreement of individuals over the means they create to reach their ends, not over ends themselves, because agreement over ends is lacking. In other words, the test of Pareto superiority is that no infringement of ends (other than those that themselves infringe on others’ ends) result from the agreement; individuals will be at least as able to pursue their ends under the contract as they would outside, and in most cases they will be better able to do so. Stated in the negative, if the regime were not Pareto-superior with regard to the extent to which it enables persons to pursue their ends, it would lack authority, because the prospect of being worse off would vitiate the assumption of consent and consent is the basis for political authority; it is what distinguishes legitimate governmental force from coercion.<sup>128</sup>

Within this general account of political legitimacy and obligation, the question becomes whether Pareto superiority is preserved if the original contract provides, at least in principle, for endowment taxation; the question is not whether some amount of “compulsion” under any actual endowment tax is too much. If Pareto superiority is not preserved then the liberal objection stands, no matter how minor the compulsion. If it is preserved, then it remains a further question whether and to what extent the parties can be assumed to consent to endowment taxation, given available alternative possible tax regimes that may prove a priori superior to it. The legitimacy of endowment taxation therefore does not hinge on whether any actual tax has the effect of compelling a work choice, but on the authority claimed for the tax and, by extension, for any compulsion it creates. In short, if the tax cannot be consented to in the bargaining situation, it represents a form of coercion.

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127. See LOCKE, *supra* note 80, § 131, at 353 (“But though Men when they enter into Society, give up the Equality, Liberty, and Executive Power they had in the State of Nature . . . ; yet it being only with an intention in every one the better to preserve himself his Liberty and Property; (For no rational Creature can be supposed to change his condition with an intention to be worse) . . . .”); see also, e.g., Richard A. Epstein, *The Dubious Constitutionality of the Copyright Term Extension Act*, 36 LOY. L.A. L. REV. 123, 133 (2002) (“The appeal of the social contract system is twofold. The language of contract suggests that the outcome from the use of coercion results in mutual gains across the board. Who, therefore, may complain about a system that leaves them better off?”); Hardin, *supra* note 8, at 164–66 (noting that Hobbes’s theory of government is an account of how individuals in the state of nature achieve a strongly Pareto-superior state by consenting to coercive authority).

128. See, e.g., Gauthier, *supra* note 102, at 141–42 (“[A] nonarbitrary society must improve on the natural outcome for everyone.”); see also LOCKE, *supra* note 80, § 123, at 350. The test is framed here in terms of ex post Pareto superiority, but, as argued below, the social contractarian account generally will not support endowment taxation even under the weaker requirement of ex ante Pareto superiority.

### *C. The Role of the Tax-and-Transfer System*

In both earlier and more recent social contract theories, the tax-and-transfer system has at least dual relevance to implementing the principles agreed to in the bargaining situation. Through it, individuals both satisfy their obligations to pay for the arrangement that they have established, and effectuate other transfers to which they have agreed, possibly including various kinds of redistribution. As explained below, the first type of obligation results in transfers to the government, while the second involves transfers between or among various individuals, typically though not necessarily through the government. The former transfers will, in the aggregate if not individually, reflect a benefit or benefit-like basis for taxation, while the latter generally will not, since a principle of redistribution need not be tied to benefits derived from social and economic cooperation, but can be pegged to other principles, such as formal equality of opportunity, material equality of starting point, or something else.<sup>129</sup> The question for both types of obligations is whether they plausibly attach to endowment.

As discussed in Part II, endowment theorists have sometimes suggested that the answer under a liberal theory depends on whether or not the theory is redistributive—that is, on whether the theory provides for payments of the second type described above.<sup>130</sup> The discussion of the preceding subpart indicates that this view can only be correct if Pareto superiority does not depend on whether the source of the fund for redistribution includes erstwhile nonmonetized abilities. As the following discussion shows, as a general matter the claim is wrong. Not only may some forms of benefits taxation extend to endowment (though they rarely will), but, more importantly, the fund of resources available for redistribution under a liberal theory generally cannot include unrealized endowments. In other words the claim that taxation of endowments can apply to a liberal theory if, but only if, the theory is redistributive, is exactly backwards. It is the case neither that “nonredistributive” liberal theories bar endowment taxation, nor that endowment is available under a liberal theory to finance redistribution. Rather, nonredistributive theories may permit limited forms of endowment taxation, while endowment remains off limits to the extent it might be availed of to finance redistribution. The first section of the following discussion addresses the first of these claims by examining taxation under what might be called “minimal” theories, while the second section examines the limitations on

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129. The various kinds of payments may be netted into a single payment or no payment at all. Progressive taxation might be thought of as a way to implement both a benefit principle and a redistributive principle.

130. *E.g.*, Stark, *supra* note 1, at 57–58. The view is also implicit in Shaviro’s treatment, which is confined, in its discussion of liberal theories, to those committed to some form of redistribution. *See* Shaviro, *Endowment II*, *supra* note 1, at 140–43 (comparing the relevance of endowment to liberal egalitarian and welfarist distributional arguments).

redistribution that apply to any liberal theory in the social contractarian tradition.<sup>131</sup>

*1. Minimal Theories.*—Both minimal and redistributive theories conceive of government as a cost-sharing arrangement by means of which participants take advantage of economies of scale and other features of coordinated action to supply themselves with benefits they could not obtain on their own, but minimal theories do not generally conceive of government as providing more than this.<sup>132</sup> The minimal view is typically associated with a fee-for-services, or benefits, theory of government and, by extension, of tax, according to which almost all redistribution is out of bounds.<sup>133</sup> The benefits model is consistent with theories of the minimal state because it ties legitimate government expenditures to consent, and most services can only be consented to actually, not hypothetically; they must be freely and actually purchased because they cannot be assumed as universally desired or required. For instance, under a minimal theory, taxation to pay for public utilities or education would be illegitimate absent actual consent to the tax, because neither of these goods is something that independent individuals operating in a state of nature necessarily require or desire.<sup>134</sup>

The problems that arise for the benefits theory of tax are numerous and well known;<sup>135</sup> here I mention just two. First, any such theory faces the task of rendering the notion of “benefits received” intelligible, and it is not clear that this can be done in a theory that retains theoretical elegance or even parsimony. For example, Murphy and Nagel observe that any account of benefits received depends critically on background entitlements, and these seem to depend, in turn, on the principles of justice to which the parties agree in the initial bargaining situation; normative entitlements in neither the state of nature nor society can be read off of facts.<sup>136</sup> Therefore one cannot rely on

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131. As the discussion makes clear, the terms “nonredistributive” and “redistributive” are problematic because they presuppose that a noncontroversial baseline of entitlements exists against which redistribution, if any, can be measured. See generally Fried, *Puzzling Case*, *supra* note 92, at 172–73, for a discussion of the problems with establishing such a baseline. Here I use the terms purely descriptively, to categorize theories according to whether they treat market outcomes as presumptively valid (nonredistributive) or as subject to adjustment through taxation (redistributive).

132. *Id.* at 160. Hayek develops a similar account, but he views the legitimate scope of government activity as somewhat larger, acknowledging that there may be cases in which the government is the most efficient provider of a service. F.A. HAYEK, *THE CONSTITUTION OF LIBERTY* 222–24 (1960).

133. See Fried, *Left-Libertarianism*, *supra* note 48, at 73–75 (discussing the majority of left-libertarians’ belief that self-ownership implies virtually complete control and rights over one’s property and the product of one’s labor).

134. See NOZICK, *supra* note 78, at 169–72, for an argument that compulsory taxation to finance social goods is on a par with forced labor.

135. See generally SLEMMOD & BAKIJA, *supra* note 55, at 59–62 (elaborating on the difficulty of measuring the benefits received by individual taxpayers from public goods); Fried, *Puzzling Case*, *supra* note 92, at 159–82.

136. MURPHY & NAGEL, *supra* note 4, at 104–05.

actual outcomes to provide a normative basis for any particular theory of justice in taxation. Notably, one cannot have recourse to "pretax" market outcomes as a baseline of natural entitlements to determine the extent to which taxation that invades or adjusts these entitlements is legitimate. Because the existence and financing of the market depend on the set of agreements reached in the initial bargaining situation, market outcomes can have normative significance only if they have been accorded it in that situation. They need an independent normative justification and cannot, by themselves, provide one.

A second, related objection is that it is difficult to determine the extent to which any particular individual is responsible for the costs of the benefits she derives from government, even if it is possible to identify a baseline of natural entitlements that exist in the state of nature. Many libertarians argue for proportionate income or consumption taxation on the ground that benefits derived are closely correlated with one or the other of these,<sup>137</sup> but these arguments are notably obscure.<sup>138</sup> For example, if the object of the social contract is simply to establish a cost-sharing arrangement to pay for public goods, then a flat amount of tax, that is, a head tax, might be closer than a flat rate of tax to measuring the costs of benefits derived.<sup>139</sup> Other theorists have attempted to derive the argument for proportionate taxation on analogy to a division of partnership spoils,<sup>140</sup> but this argument too seems unavailing. Under the partnership analogy, contracting parties in the state of nature each bring assets (natural talents) to the partnership, and each party agrees to receive the amount of the surplus created in the partnership that is proportionate to the value she contributes, thereby reaching a proportionate tax.<sup>141</sup> As Barbara Fried has noted, this approach presupposes the same valuation of each person's assets both in and out of the state of nature, and such an assumption would seem to hold only where alternative, equally attractive social contracts are available to contracting individuals. If alternatives are not available, then some parties may be able to extract more or less of the surplus depending on their leverage over others, much as individuals may be advantaged or disadvantaged in real bargaining,

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137. EPSTEIN, *supra* note 87, at 297–99; GAUTHIER, *supra* note 80, at 156, HAYEK, *supra* note 132, at 313–16.

138. See especially Fried, *Puzzling Case*, *supra* note 92, at 160–82, some of whose quite powerful criticisms are described in the text below.

139. The intuition is that many public goods, such as the broadcast spectrum, are goods fixed in quantity and equally consumed by all. *Id.* at 166. The price of producing or maintaining them therefore seems fixed or nearly fixed, regardless of the extent of their use or their value. Other public or quasi-public goods such as roads may exhibit some of the properties of public goods and some of those of normal goods. *Id.*

140. EPSTEIN, *supra* note 87, at 163.

141. GAUTHIER, *supra* note 80, at 134–35.

depending on whether they possess assets that are more or less marketable to other bidders.<sup>142</sup>

These difficulties are probably susceptible of resolution, but at the price of a larger and more controversial set of normative assumptions than most benefits theorists are willing to accept. For instance, Murphy and Nagel's argument illustrates that any account of what individuals have a right to on a "pretax" basis must be backed up by an explicit normative theory that would justify pretax distributions, not that any such theory would be incoherent.<sup>143</sup> (This, indeed, is Murphy and Nagel's claim.) A number of theories are consistent with a more developed benefits theory of tax, but they require their own, separate justifications.<sup>144</sup> Similarly, the problem of determining with any precision the extent to which particular individuals benefit from membership in a political order probably requires contestable assumptions that cannot be neatly associated with underlying, widely shared intuitions.<sup>145</sup>

142. See Fried, *Puzzling Case*, *supra* note 92, at 177–78. A further difficulty with the partnership model is that it seems to presuppose the existence of a market when the problem is to establish the conditions that make a market possible. See MURPHY & NAGEL, *supra* note 4, at 16–18. This problem can be overcome if one assumes, as Locke does (at times), that the state of nature is one of inconvenience and not necessity, but that assumption seems questionable enough even for Locke to abandon it when it is convenient (or necessary) to do so. Compare LOCKE, *supra* note 80, §§ 4–15, at 269–78 (inconvenience), with *id.* §§ 123–31, at 350–53 (necessity). If, as seems more plausible, the parties are to be understood as setting the ground rules for a system of fair market competition, it appears they would adopt a cost-sharing model for taxes owed if they accepted the principle of moral equality and it is assumed that they can reach binding agreements in the state of nature.

143. Kordana & Tabachnick, *supra* note 94, at 656–57.

144. For example, Locke develops a theory of property based on an initial state of abundance together with a labor theory of value. LOCKE, *supra* note 80, § 28, at 288. Under Locke's view entitlements under conditions of relative abundance are secured by the individual's laboring on them. Nozick develops a similar kind of theory though not with the aid of a labor theory of value, which he largely rejects. NOZICK, *supra* note 78, at 178.

One also could argue for a presumed equality of initial material entitlements based on the moral equality of free individuals as a basis for developing an account of benefits derived from social cooperation. Under such a view, individuals would be presumed to have a moral right to equal initial distributions, and political institutions then would operate to guarantee those distributions together with what flows from their voluntary use. Dworkin develops such a conception of equal initial entitlements, but his theory diverges from a pure benefits theory by mandating transfers to satisfy what he calls the envy principle. See Dworkin, *Equality Part II*, *supra* note 28, at 307–08 (stressing that equality of resources contemplates giving people an equal share of external resources, while a regime of equality of welfare would use resources as a set-off against people's personal attributes).

145. For example, a reasonable solution to the problem of figuring out how to value abilities in the state of nature is to assume that no better deal is in the offing, perhaps on the basis that the bargaining situation is intended to model an idealized version of the choice between any political order on one hand, and the state of nature on the other. This assumption, together with a view of government as a cost-sharing rather than a profit-making enterprise, might justify a measure of tax proportionate to the extent of money income earned—apparently an attractive intuitive result, given the breadth of its support among libertarians. See GAUTHIER, *supra* note 80, at 134–35 (reasoning that people may claim the surplus that they contributed); HAYEK, *supra* note 132, at 315–16 (stating that, because a person consumes government resources basically proportional to their income, a proportional tax is desirable); Richard A. Epstein, *Taxation in a Lockean World*, in PHILOSOPHY AND LAW 49, 74 (Jules Coleman & Ellen Frankel Paul eds., 1987) (concluding that a proportional

A bare-bones theory is unlikely to specify in any unique way how the surplus from political association is to be divided up,<sup>146</sup> while a more detailed theory may be up to the task but is less likely to meet with general assent.

Fortunately, the question whether a minimal theory can overcome these problems can largely be set aside for present purposes. The task here is not to defend a particular version of minimal liberalism, but only to understand what conception of taxation follows for it, assuming that some version of minimal liberalism can be defended. As a general matter, if a minimal theory treats native abilities and the actual market outcomes that flow from their exercise as entitlements, then the tax system's scope would extend only to paying for the public goods that protect these abilities and make market transactions possible, including any defense necessary for the maintenance of the political order.<sup>147</sup> Taxation to finance additional expenditures, such as those for public services that only some may want, or to equalize or adjust market outcomes, would not find a place in such a theory.

Thus, and more or less by definition, the minimal state's tax system will satisfy Pareto superiority as long as the state of nature game is worth the candle, which is to say, as long as one freely consents to membership in the social order. One can imagine two general cases: where the parties view the social contract as the outcome of rational and uncoerced dialogue among moral equals, and where it is viewed as the result of market transactions among the members. For the reasons noted above, the latter seems less plausible as an account of the origin of political society,<sup>148</sup> but it seems clear that on either view, Pareto superiority is achieved. In the former case one would expect the parties to adopt a cost-sharing model of taxation, according to which individuals' tax burdens bear some proportionality to the costs their activities create;<sup>149</sup> in the latter case one would derive tax burdens as the

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tax is desirable because it minimizes distortions and is practical). It comes, however, at the price of adopting a more controversial view of the role of the state of nature. Similarly, a reasonable assumption on true public goods might be that they are shared equally, since their supply is not limited, but this assumption tends to the intuitively unattractive result of a head tax for these goods.

Barbara Fried notes that welfarist-based approaches to ascertaining the true marginal benefit of public goods to individuals yield results that are inconsistent with those of most benefit theories. Fried, *Puzzling Case*, *supra* note 92, at 171.

146. *Id.* at 174–75.

147. *See, e.g.,* LOCKE, *supra* note 80, §§ 127, 140–42, at 352, 362–63 (describing a theory of government whose main purpose is to preserve the property of its members and in which its members, who enjoy its protection, should pay to maintain that government); NOZICK, *supra* note 78, at 26–27 (describing a minimum state that protects its citizens against violence and enforces contracts).

148. The notion that the social contract is not grounded upon a market but itself secures a market clearly underlies Hobbes's theory, *see* HOBBS, *MAN AND CITIZEN*, *supra* note 81, at 127, and at the end of the day would seem to be what motivates even those in the Lockean state of nature to exit, *see* LOCKE, *supra* note 80, § 123, at 350 (describing the enjoyment of property rights in the state of nature as “very unsafe, very insecure”).

149. Rawls's theory, even though it is not a minimal theory, is in the spirit of the cost-sharing model because the bargaining parties are unaware of the attributes of those for whom they negotiate. RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 305. Because they seek to minimize prospective

market price for social benefits purchased.<sup>150</sup> In this scenario, tax levels would be considered the outcome of some negotiation, taking into account the availability of alternative social contracts and the value that prospective members place on the resources that any individual brings to the table.<sup>151</sup> In both cases, tax burdens will be agreed to only if they do not make entry into the social contract a pointless exercise. The difference is that in the latter case, some individuals will pay less, and others more, than the pure cost of producing the benefits they derive, because of the leverage or lack thereof that their talents afford relative to the talents of others.

It thus appears that, under both scenarios, there are some situations in which endowment taxation is possible, because the benefits that an individual derives from entry into the contract include both the possibility of realizing economic wealth and enhanced security. In particular, where the benefit of defense or protection is sufficient to motivate entry, endowment taxation could follow if the costs of financing the benefit exceed the market wealth of a contracting party (or were not financed with a tax on economic income in the first place but with, say, a military draft). If we consider even the beachcomber with zero income to have exited the state of nature voluntarily, then she must have viewed the security bargain as worth the cost. Where provision of security has costs, endowment taxation may result, again under the proviso that the amount of the tax not be greater than the value of the benefit derived. This is all that is necessary to satisfy the requirement of Pareto superiority. While it remains a further question whether endowment taxation would be adopted in any specific case (such as that of the military draft), there is no a priori ban on the use of endowment taxes even under a minimal

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disutility to those parties, the outcome of the contract should be a cost-sharing approach (apart from redistributive aims) under the assumption of the declining marginal utility of money income. In the case of true public goods the outcome of the agreement could be a head tax, though Rawls somewhat incongruously appears to support a flat tax. RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 278. *But see* Fried, *Puzzling Case*, *supra* note 92, at 184–86 (criticizing Rawls's view on this point).

150. As indicated above, Epstein (implicitly in the partnership theory of social cooperation) and Gauthier offer examples of such theories. The problems with generating a coherent account of how that pricing mechanism would operate have been noted. *See supra* text accompanying notes 134–41.

The somewhat different problem of deriving market prices of true public goods for actual (rather than hypothetically contracting) individuals is the subject of an extensive economics literature. *See* Fried, *Puzzling Case*, *supra* note 92, at 168–72 (summarizing the literature). The problem arises because consumption of such goods is generally equal in quantity for each individual, and consumption is nonrival. As a result, it is not possible for individuals to vary their consumption in order to equate their marginal rates of substitution among all commodities, leading to efficient allocation and optimal levels of production. The general solution involves varying the cost each individual pays, rather than the quantity she consumes, so that the marginal rate of substitution is equalized. *Id.*; *see also* Richard A. Musgrave, *Social Contract, Taxation and the Standing of Deadweight Loss*, 49 J. PUB. ECON. 369, 372–73 (1992).

151. *See, e.g.*, NOZICK, *supra* note 78, at 192–93 (considering a person's benefit from a noncooperative scheme versus a general social cooperative scheme versus a limited intragroup cooperative scheme).

theory, as long as the cost of the benefit financed does not exceed its value to each contracting member. What is critical, however, is that the tax result from the need to cover a cost to which the contracting parties implicitly assent.<sup>152</sup>

2. *Redistributive Theories.*—Redistributive theories differ from minimal theories in that they include, in addition to a taxation scheme designed to pay for public goods purchased, a scheme of distribution that involves transfers of wealth from some members of society to others. Rawls's *Theory of Justice* is the most prominent contemporary example of a redistributive liberal theory, but it is by no means the only one.<sup>153</sup> In Rawls's case, resources resulting from the exercise of *A*'s talents may be transferred to *B* in certain circumstances, even after *A* and *B* have fully paid for the benefits they have derived from the system of social cooperation.<sup>154</sup> Dworkin similarly supports redistribution, both to reflect the material wealth effects that result from the unequal distribution of talents and as a way to counteract the adverse effects on consumer choice that he believes result from production and exchange in a free market.<sup>155</sup> Although Dworkin and Rawls offer different justifications for the different forms of redistribution, they are united in identifying a principle of redistribution that extends beyond an effort to account for benefits received.

Redistributive liberal theories might seem more congenial to endowment taxation because they are committed to transfers of wealth that do more than pay for security and a system of free market production and exchange. They also include transfers that seem to be designed to reduce or eliminate the inequality of holdings as a way to ameliorate the arbitrariness of fortune. Now once one accepts a principle of adjustment of "natural" entitlements to accord with some notion of justice or fairness, it may appear arbitrary to limit redistribution to socially created wealth, inasmuch as the

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152. Technically the imposition of endowment taxation to finance defense would seem to suppose either an exit option or the availability of conscientious objector status for individuals who do not want even defense. Most state of nature theories assume that defense is universally desired, but one could imagine individuals who eschew it. See, e.g., LOCKE, *supra* note 80, §§ 117–20, at 346–49.

153. See, e.g., RAKOWSKI, *supra* note 28, at 19–20 (establishing the groundwork for a theory of redistributive justice based on the idea that resources should be distributed equally, as opposed to distributed by the community on the basis of utility considerations); Dworkin, *Equality Part II*, *supra* note 28, at 313–14 (arguing for "the redistribution of resources through some form of income tax . . . that will neutralize the effects of differential talents, yet preserve the consequences of one person choosing an occupation . . . that is more expensive for the community than the choice another makes").

154. This is the effect of Rawls's difference principle. RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 75–83.

155. See Dworkin, *Equality Part II*, *supra* note 28, at 311–14 (talents), 307–08 (market effects). As to the latter, Dworkin asserts that the increased purchasing power of one productive member may limit the choice set of other members in ways that violate the equality of initial entitlements, as he develops this idea. *Id.* at 307–08.



vagaries of fortune have as much to do with one's natural endowments as with one's material wealth. This observation underlies the view held by both Stark and Shaviro that a liberal theory committed to some form of redistribution cannot consistently limit the pool of wealth to material holdings.<sup>156</sup>

An examination of the role that redistribution must play, if it forms a part of a liberal theory, discloses why the Stark and Shaviro view is mistaken. The redistribution that a liberal theory authorizes must be thought of as coming out of the pie of wealth actually created in political society, not from material wealth that is called into being for the purpose of redistribution itself. If the pool of wealth includes attributes, then Pareto superiority is threatened. Indeed, even if Pareto superiority is conceived in less-demanding *ex ante* terms and the theory by hypothesis is limited to individuals whose ends are not possibly lexically ordered, endowment taxation still remains the least favored of available alternatives. The first part of the following discussion addresses redistributive theories that must satisfy *ex post* Pareto superiority.<sup>157</sup> The next part addresses redistributive theories that (1) need satisfy only the weaker *ex ante* version of Pareto superiority, and (2) apply to individuals whose ends are not lexically ordered.

*a. Ex Post Pareto-Superior Theories.*—Under a social contractarian model, what is called “redistribution,” measured against a baseline of tax burdens correlated with benefits received, generally may be thought to stem from either of two kinds of principles, depending on the theory. In one type of theory it results from the contracting parties’ decision to take advantage of the benefits that membership in a political order offers as a way to ameliorate the effects of bad brute luck. Examples of theorists who fall into this group are Rawls, Dworkin, and Eric Rakowski. In a second type of theory it results from an account of the bargaining situation that permits individuals to bargain on the basis of some knowledge of their actual abilities and certain assumptions about available alternatives. Here the divergence from market outcomes results because market outcomes are thought to reflect incompletely the entitlements that would be negotiated in the bargaining situation on the basis of known attributes. Gauthier is an example of a theorist who falls into this group.<sup>158</sup>

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156. See *supra* subpart II(A). Lawrence Zelenak offers a view largely sympathetic to Stark’s and Shaviro’s. See Zelenak, *Taxing Endowment*, *supra* note 1, at 1154–62. Zelenak also offers a critique of the views expressed in a working paper version of this Article. See *id.* at 1169–72. In the composition of the present version, I accordingly have had the benefit of Zelenak’s critique.

157. See *supra* note 36 (defining *ex ante* and *ex post* Pareto superiority).

158. GAUTHIER, *supra* note 80, at 154–56. Gauthier purports to derive proportionate income taxation from his principle of minimax relative concession (MRC), even though proportionate taxation does not seem to follow under a pure benefits theory. Under MRC, the bargaining parties divide the surplus from social cooperation so as to leave each with the same percentage increase in utility over the state of nature. *Id.* at 136–40. For a criticism of Gauthier’s derivation of MRC, see Barbara H. Fried, *Why Do Libertarians Love Proportionate Taxation? The Case of Gauthier’s*

For both types of theories, as for what I have called “minimal theories,” redistribution must be derived from the fact that it is in the parties’ self-interest to agree to it. This follows from the basic requirement of Pareto superiority that animates the social contractarian approach. Therefore it must be the case that adding redistribution to the mix does not possibly make entry into the political order worse than staying out. In other words, a social contractarian theory does not derive redistribution by adding a supervening moral or ethical obligation to the participants in the bargaining situation, even if actual individuals—the persons for whom the theory has relevance—find moral considerations highly relevant.<sup>159</sup> Rather considerations of this sort find expression in the overall design of the bargaining situation as it is constructed or modeled, in the facts both that individuals in it have the characteristics they do and that they reach an agreement under the particular circumstances of the bargaining situation.<sup>160</sup> The theory does not ascribe moral considerations to the contracting parties directly, because doing so would sacrifice the guarantee of consent that makes the agreement binding. If moral considerations are assumed, then individuals who do not share them cannot be presumed to consent.

Therefore we are to test the actions of individuals within the bargaining situation against the standard of instrumental rationality applied to serve their own self-interest. It is easy to see that in the case of theories such as Gauthier’s, endowment taxation fails except in those limited situations in which it might also be appropriate for a minimal theory. Gauthier’s theory differs from a minimal theory in that it purports to offer an explicit justification for a principle of division of the “social surplus,” or the net benefit from exiting the state of nature, that diverges from simply respecting

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Morals by Agreement (Stanford Pub. Law & Legal Theory Working Paper Series, Paper No. 12, 2000), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=232641](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=232641) [hereinafter Fried, *The Case of Morals by Agreement*].

159. See RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 128 (clarifying that, in the original position, Rawls assumed that the parties were not bound by prior moral ties to each other as they attempted to advance their conception of the good).

160. See, e.g., GAUTHIER, *supra* note 80, at 1–20 (arguing that morality emerges, and overcomes an initial presumption against morality, as rational persons, seeking the greatest satisfaction of their own interests, mutually agree to constraints that result in mutually beneficial and cooperative ventures); RAWLS, *JUSTICE AS FAIRNESS*, *supra* note 42, at 95–96 (comparing social contract theory with utilitarianism and describing social contract theory as a “fair system of social cooperation between citizens regarded as free and equal” and as “quite naturally specified so as to include the ideas of equality (the equality of basic rights, liberties, and fair opportunities) and of reciprocity”); RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 304–05 (noting that the “original position” as a whole represents the two powers of moral personality, but that the representative parties in the original position only have the “capacity to be rational,” while the remaining power, “the capacity to be reasonable,” is represented by the restrictions placed upon representative parties in the original position and by the conditions imposed upon their agreement). The point is to include moral considerations in a way that preserves the basic account of individuals as free, rational, and autonomous. See GAUTHIER, *supra* note 80, at 6–10 (describing a person as an “independent centre of activity” who acts rationally “if and only if she seeks her greatest interest or benefit” and then deriving morals by agreement from these principles of personhood).

market outcomes. This principle, “minimax relative concession” (MRC), requires taxes to be set at a level that provides for uniformity in the percentage increase in utility that each contracting member experiences as a result of agreement to the contract.<sup>161</sup> The details of, and problems with, Gauthier’s argument need not detain us here.<sup>162</sup> What matters for the question of endowment taxation is that the problem for which MRC is intended as the solution is how to divide the actual surplus that results from exiting the state of nature; MRC has nothing to do with unrealized capacities, and in fact is expressly limited to deciding the question of dividing up what is left *after* each has recouped the goods that she would have had in the state of nature anyway.<sup>163</sup> At all events, because the utility that is to be equalized is that resulting from the social surplus, pre-existing utility from nonmonetized endowments does not figure into the calculus and therefore cannot be said to be a source of utility subject to sacrifice in order to satisfy MRC.<sup>164</sup> In other words, MRC as a principle of division of the surplus represents little more than a modification of the minimal theory view that taxes for a contracting individual will be correlated with the actual cost of supplying public goods to that individual. MRC requires modification of the benefits principle, but subject always to the rule that the pool of wealth from which tax is collected is the actually created social surplus.

The case for endowment taxation under the first type of redistributive theory is not much better. As previously noted, in a Rawlsian theory, the reason that contracting parties agree to redistribution is that they conclude it furnishes a desirable form of insurance.<sup>165</sup> The main difference between this kind of redistributive theory and a minimal theory concerns the way in which the contracting parties consider risk, uncertainty, or both in their evaluation of the benefits that society offers. Under a minimal approach the contracting parties are prepared to run the risk of poor native abilities or meager resources; under this type of redistributive approach they hedge their bets.<sup>166</sup>

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161. GAUTHIER, *supra* note 80, at 154–56.

162. See generally Fried, *The Case of Morals by Agreement*, *supra* note 158.

163. GAUTHIER, *supra* note 80, at 200–10.

164. *Id.* at 154–56.

165. See, e.g., Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis?*, 53 TAX L. REV. 51, 76–77 (1999) (noting that if wage uncertainty is introduced into the optimal tax model, then a new rationale for redistributive taxation arises—namely, insurance against low wages).

166. A problem with the view is that whether hedges are taken depends on the risk profile of the parties to the agreement, and this would seem to depend partly on taste. See John C. Harsanyi, *Can the Maximin Principle Serve as the Basis for Morality? A Critique of John Rawls’s Theory*, 69 AM. POL. SCI. REV. 594, 595–604 (1975) [hereinafter Harsanyi, *Maximin*] (criticizing Rawls’s use of maximin as a decision principle in the original position). But see RAWLS, JUSTICE AS FAIRNESS, *supra* note 42, at 97–98 (arguing that complete ignorance of probabilities in the original position precludes rational analysis of risks and leads to the maximin decision principle). This problem goes to whether a minimal or a redistributive theory is a more plausible outcome of the bargaining situation; it does not affect the basic consideration at issue here, which is whether the parties can be

In Rawls's theory, the hedge leads the contracting parties to adopt the difference principle as the second principle of justice. The difference principle requires that social and economic institutions be arranged so that resulting social and economic inequalities are to the greatest advantage of the least advantaged class of persons.<sup>167</sup> The effect of the operation of this principle is a possible reduction in overall social product in exchange for a guarantee of first consideration to those who, because of bad brute luck, turn out to be at the bottom of the socio-economic ladder.<sup>168</sup> Similarly, the distinction between option luck and brute luck that informs both Rakowski's and Dworkin's theories can be framed in terms of the rationality of insurance against unforeseeable hardships.<sup>169</sup> In each case the redistribution authorized represents an exchange of a portion of anticipated upside benefit of membership in the system of social cooperation for a reduction in downside risk. What is key is that what is traded off is a portion of the benefit that membership creates. What is not traded off are the benefits one derives from powers one has prior to entry, or "naturally."

Several considerations indicate why this is so. First, recall that the ex post Pareto superiority criterion requires individuals to be no worse off from actual entry into the political order than they would be if they remained in the state of nature, no matter what their ends may be (assuming the ends are compatible with others' pursuit of their ends).<sup>170</sup> That is, once the veil is lifted, they must not be worse off than they were in the state they exited. But the prospect of endowment taxation could be so onerous that even entry into the social contract could have a negative value ex ante. The failure to limit taxation to benefits derived causes Pareto superiority, both ex ante and ex post, not to hold. Here the situation is different from that of an endowment tax used to finance defense that may result in compulsory labor. Even after such a tax a contracting party is better off, at least in an ex ante sense, whereas that may not be the case in a redistributive scheme under which the proceeds of the labor in fact benefit another.<sup>171</sup> By contrast, in the absence of redistributive endowment taxation, the parties know ex ante that they will enjoy gains from entry into the social contract even under a scheme of extensive distribution away from market outcomes. The only questions are whether such a scheme will operate and, if so, how extensive it will be. In

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understood to trade off advantages they would have in the absence of membership in society for some level of economic security should they suffer bad brute luck.

167. RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at 6–7.

168. It might be thought reasonable on both equity and incentive grounds to require individuals to whom the state supplies primary goods to work for the state.

169. RAKOWSKI, *supra* note 28, at 74–76; Dworkin, *Equality Part II*, *supra* note 28, at 292–93 (casting his theory in insurance terms).

170. See *infra* text accompanying notes 205–06.

171. Technically the result presupposes that, under actual conditions, individuals have an exit option, since it is possible that some individuals would rather remain in the state of nature than not pay for defense. Perhaps the absence of an actual exit option explains the availability of conscientious objector status.

this case Pareto superiority continues to hold, and the assumption that individuals have consented to the political order that results from the bargain remains viable.<sup>172</sup>

It may be helpful to contrast this result with the result under an income, a consumption, or a wealth tax. Recall that state of nature theories generally suppose that actual wealth in the pre-governmental state ranges anywhere from zero (Hobbes), to negligible (Locke), to merely substantially less than wealth that exists after the contract has been concluded (Gauthier). In other words, actual wealth is entirely, or in any event mostly, the result of social cooperation that is first made possible by the social contract. A tax limited to actual resources, or at least to those that only become available because of social cooperation made possible by the social contract, therefore will not violate Pareto superiority, because it will not come out of wealth that persons would have “anyway,” that is, in the absence of a social contract.

*b. Ex Ante Pareto-Superior Theories.*—While some form of Pareto superiority is necessary to derive the consent that underlies liberal theories of obligation, the superiority need not be of the ex post sort if one is willing to limit the possible scope of application of the theory. Under a theory requiring only ex ante Pareto superiority, there need be simply a positive expected value to entry into the contract, not a positive actual value. Under this less-demanding standard, whether any particular individual enjoys an actual gain once the veil is lifted is an open question, and it may well be that some individuals do not. Nonetheless, the resulting situation remains Pareto-superior to the precontract situation because, on an ex ante basis, all enjoy gains from entry.

It remains the case that for individuals whose ends are lexically ordered, even ex ante Pareto superiority will not be satisfied under endowment taxation, because such persons’ ends may be so ordered that performance of work beyond what one would do “anyway” has an infinitely negative value; it is noncompensable in principle. In such a case, much more is at stake than a commitment to a more comprehensive scheme of social insurance than would result if redistribution were limited to “already-created” social product. Unlike a regime drawing on this more limited pool of resources, a regime potentially making use of untapped resources cannot be rationally agreed to if it is possible that one will turn out to be a Socratic philosopher, a religious ascetic, or, indeed, anyone for whom an endowment tax would force one to labor in a way that violates what might be considered his or her ultimate ends. For any such person it is not a question of weighing, in the

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172. Whether the assumption is reasonable is the subject of extensive debate about the specific agreement that parties to the contract would reach. See, e.g., Harsanyi, *Maximin*, *supra* note 166, at 594–95 (arguing that parties would reach different contracts depending on which decision rules they chose and rejecting the Maximin decision rule adopted by Rawls in favor of a Bayesian expected-utility maximization decision rule).

bargaining situation, the benefits of an extensive scheme of insurance against the finite costs of providing such insurance where one otherwise would not have to. Rather it is a question of potentially agreeing to a life *ex ante* that is categorically barred by the ends one turns out to have. If I turn out to have a conception of the good that requires me, on pain of damnation, to abjure all market activity, then I will have willed my own destruction in the bargaining position by consenting to my own market activity once the veil is lifted.<sup>173</sup> In terms of expected value, one could frame the analysis as requiring the contracting parties to contemplate the possibility of a result having infinite negative value, multiplied by a finite, nonzero probability. No matter how remote the likelihood, the requirement of Pareto superiority, whether *ex ante* or *ex post*, is violated. If individuals in the state of nature can have ends of this type, then redistributive endowment taxation seems to be fatal to any social contract theory because it is not possible to make even the weak assumption that it is better on an expected value basis to exit the state of nature than to remain in it.

Therefore, one must make the further assumption that individuals in the bargaining situation are such that all their ends can, in principle, be traded off. In this setting, it is at least possible to substitute *ex ante* Pareto-superiority for *ex post* without vitiating entirely the case for entry in the first place. Of course, by limiting in this way the range of persons for whom the theory has validity, one surrenders much of the power of the liberal argument because one no longer can infer consent for all actual persons. Moreover, such a theory can say nothing to the individuals whose ends in fact are lexically ordered, as in the strong case. Finally, from a historical perspective, such a theory seems to assume away the problems that liberalism was designed to address, inasmuch as liberalism represents an effort to deal with just this problem of incompatible ultimate ends.<sup>174</sup>

Setting all of these difficulties aside, one can readily conclude that even here the model is not congenial to endowment taxation, because it is quite unlikely that contracting individuals would agree to it in the face of alternative arrangements to which they could agree instead. In particular, one can imagine two general cases. In the first case, endowment taxation is possible but limited to those for whom the prospect of an endowment burden does not create infinite disutility. The question that such individuals would face in the bargaining situation is whether the prospect of an endowment burden to fund redistribution is better or worse than one limited to already created wealth. On one hand, the pool of potential taxpayers is larger if

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173. Note that the possibility of certain lexically ordered ends can even lead to exceptions to endowment taxation to finance security, as is provided for conscientious objectors in many countries.

174. See RAWLS, *POLITICAL LIBERALISM*, *supra* note 8, at xxix–xxxi (arguing that political liberalism attempts to explain how people interact in a free society even though they disagree about the moral purpose of society); *supra* subpart III(B).

endowment taxation is permitted than if not, which means that the average rate of redistributive tax will be lower. On the other hand, the expected disutility from the prospect of being compelled to monetize otherwise unrealized talents is greater than the expected disutility of paying tax from already created wealth. That is, under the usual assumptions about the declining marginal utility of any good, be it money or leisure, an individual will suffer more disutility from being forced to work just to pay a redistributive tax than she would from being forced to pay the redistributive tax out of income that she would have earned even in the absence of the redistributive tax.<sup>175</sup> It therefore appears that the answer to the question whether the parties will agree to an endowment tax in this setting requires knowledge of potentially unknowable, and contingent, facts. If the proportion of contracting parties that comprises talented beachcombers is very high, then it might appear that the parties would choose an endowment tax. If the proportion is low, the parties would not choose an endowment tax.

The idea, however, that it is an open question which circumstance is likely to obtain seems to rely on the untenable assumption that the parties to the contract would agree to finance redistribution to talented beachcombers, or more generally to individuals who are capable of meeting their material needs but choose not to. The assumption is untenable because the relevant question is not how many people choose not to work, but how many merit receipt of resources through redistribution. Recall that a theory of the Rawlsian type views the inclusion of a redistributive component as insurance against bad brute luck, that is, the inability to meet one's needs. The purpose of the redistribution is not to create a lottery that favors those who are able but do not want to produce what they desire for their material well being; it is to provide for those whose talents are insufficient for this purpose.<sup>176</sup> Therefore, it seems more reasonable to suppose that the number of people to whom resources will be distributed is relatively low. This assumption pushes in the direction of resource- rather than talent-based taxation. That is, the contracting parties would have to perceive a very substantial likelihood that total social product absent endowment taxation would not suffice to ensure that individuals would have adequate resources as measured by whatever

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175. See Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1947 (1987) (exploring the assumption in optimal tax models that individuals have identical utility functions). In the endowment context the basic intuition is that, by hypothesis prior to any tax, income actually earned was more valuable than the leisure forsaken. Even though a tax on actual income might make the marginal income less valuable than leisure, the overall reduction in utility would seem to be less than if the pretax point was one at which the leisure time was already more valuable than the work, as would occur when an endowment tax forced one to work.

176. It follows that individuals capable of work but who choose not to would not be net recipients of redistributive transfer payments.

standard was adopted for this purpose. Apart from a largely untenable story about adverse incentive effects run rampant, this likelihood seems remote.<sup>177</sup>

To illustrate the point, consider the case in which the parties assume that there are three relevant groups, but they do not know to which one of them they will belong: (1) those with low abilities who need transfer payments; (2) those with pre-redistributive-tax incomes sufficient to support their allocable portion of those in need of transfer payments; and (3) those with the ability, but not the pre-redistributive-tax income, sufficient to make any transfer payments. The relevant question is, assuming that one would be a member of Group (2) or Group (3), would one in the bargaining situation assent to endowment taxation to fund the redistribution, or not? If one did, then members of both groups would be forced to make transfer payments and members of Group (3) would be forced to work to do so; if one did not, then only members of Group (2) would be forced to make transfer payments, but their payments would be higher.

If we assume, implausibly, that Groups (2) and (3) are of the same size,<sup>178</sup> and concomitantly that the average dollar amount of the redistributive tax would be twice as high on Group (2) if only they pay the tax than it would be if both Groups (2) and (3) did, it still should be the case that the expected utility of an individual in the bargaining situation would be higher where the redistributive tax burden is confined to Group (2) than where it is not. This result follows if we assume, as seems reasonable, that the disutility caused to the Group (3) member from having to work to satisfy an endowment burden that is \$X greater than her income in the absence of a redistributive tax obligation exceeds the disutility to a Group (2) member from having to meet a \$2X redistributive tax burden rather than a \$X one, where (by hypothesis) her income available for redistribution exceeds \$2X. The assumption is reasonable because individuals in Group (3) must forsake leisure to pay the tax that already was more valuable than the income they would have earned prior to the imposition of the redistributive tax burden. Such is not the case for individuals in Group (2), who therefore can be expected to suffer less disutility from having \$X less because only Group (2) is subject to the redistributive tax, than would Group (3) members from having to generate an additional \$X because both Group (2) and Group (3) members are subject to the tax. In other words, the expected value of a 50% prospect of a tax of \$2X if you have more than \$2X of income available for redistribution and a 50% prospect of a tax of \$0 if you have no income

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177. Daniel Markovits argues that the parties in this setting might opt for limited endowment taxation, as long as it would not involve "talent slavery." Daniel Markovits, *How Much Redistribution Should There Be?*, 112 YALE L.J. 2291, 2307-09 (2003). While the argument that the parties would not opt for talent slavery is plausible, the further claim that they would nonetheless adopt an endowment tax capped on realized wealth is less so, as discussed in the text immediately below.

178. At all events it is reasonable to assume that Group (1) is of small size, for the reasons set forth in the preceding paragraph.



available for redistribution (in both cases prior to the imposition of a redistributive tax) is greater than the expected value of an  $\$X$  tax where it is equally likely you will have either more than  $\$2X$  income or  $\$0$  income. The plausibility of this result would seem greater where  $\$X$  constitutes a relatively small portion of a Group (2) member's total income, as would be expected where, as assumed here, Group (1) is relatively small.

The result does not change once we make the more realistic assumption that Group (2) will exceed, indeed that it will vastly exceed, Group (3) in size. A relatively small increase in tax on erstwhile earned income of Group (2) members will cause them much less disutility than will a concomitant increase in tax cause Group (3) members that forces them to work to pay tax. On the other hand, the likelihood of membership in Group (2) is much greater. The two changes should roughly balance each other, leading to the same result as in the case where the groups are of equal size.

In the second general case, the endowment tax still applies, but it is limited to realized gains from entry into the social contract (or to a percentage of such gains).<sup>179</sup> This case differs from the previous one in that tax-compelled work, measured against a baseline of the work that would occur in the absence of any redistributive burden, is ruled out by hypothesis. In this scenario the requirement of Pareto superiority would still be satisfied and so-called "wage slavery" would be eliminated. For example, consider an upper bound on endowment tax liability equal to the amount of money income that the individual earns prior to the imposition of the endowment tax, after allowing for a subsistence wage. Under such a scheme, tax burdens would be keyed in part to endowment, but no work would be "compelled" in the sense that one would have to work more than one would absent any redistributive tax obligation solely to satisfy a tax liability.<sup>180</sup> Such a scheme would essentially collectivize realized endowments but leave in private hands control over the decision whether to realize them in the first place.

It is implausible to suppose that the contracting parties would agree even to this modified endowment scheme. In the first place, an endowment tax with a limit threatens to become a 100% tax on earnings above

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179. See Shaviro, *Endowment II*, *supra* note 1, at 134–35 (suggesting that administrative concerns could limit an actual endowment tax to income earned before the tax was calculated).

180. For example, consider two individuals, *Attorney A* and *Attorney B*. *Attorney A*'s wage rate is \$400 per hour and *Attorney B*'s is \$100 per hour, but *Attorney A* enjoys leisurely pursuits much more than *Attorney B* does. Each earns \$110,000 annually, which represents 25% of *Attorney A*'s maximum possible income and 100% of *Attorney B*'s. Assume further that \$9,000 equals the value anyone would have in the state of nature and that the annual cost of running the minimal state is \$1,000 for someone with \$110,000 of income, leaving each of the attorneys with \$100,000 of net cash gains resulting from entry into the social order. A flat-rate endowment tax capped by the excess of one's actual earnings over what one would have in the state of nature plus the tax cost of running the society, or \$10,000 for each attorney in this case, would not violate Pareto superiority. For example, under a flat rate equal to 30% of endowment but subject to the cap, *Attorney A*'s endowment tax would be \$33,000 and *Attorney B*'s would be \$100,000 (the lesser of 30% of \$440,000 and \$100,000).

subsistence, because the high effective tax rate on the actual income of highly endowed, leisure-preferring individuals creates very large incentives to reduce output if doing so also reduces the level of tax. The result for such persons is an endowment burden that approaches earned income (above the subsistence amount) and for society a very large deadweight loss. More importantly, under the standard assumption that individuals exhibit some degree of risk-aversion,<sup>181</sup> the expected utility of a contracting party faced with the prospect of such an endowment tax is lower than the expected utility of a contracting party in which redistributive taxation is pegged to (and not merely limited by) actual wealth earned. It therefore becomes irrational to consent to the possibility of such a tax in the bargaining situation.

The point can be illustrated by considering the question that the parties in a Rawlsian-type bargaining situation face when deciding on possible tax arrangements. To simplify, suppose the parties are ignorant of their own (or their constituents') actual attributes, but that they know there are two categories of persons, high-ability and low-ability, and that each individual has a 50% chance of turning out to be either. Low-ability persons are net recipients of transfer payments and high-ability persons are net transferors. If we assume that resources under either a standard actual-resource-based tax or the limited endowment tax under consideration here will suffice to meet any redistributive burden, then, as in the previous case, low-ability persons will be treated the same no matter which tax base is chosen, and the only question for the contracting parties is which base high-ability persons prefer. Assume further that the parties know there are two types of high-ability individuals, leisure preferring and income preferring, and again that each individual knows she has a 50% chance of being either if she is a high-ability person.<sup>182</sup> By hypothesis the average rate on all real resources is the same under the two tax bases,<sup>183</sup> but there will be greater variance in the rate on actual resources under the endowment tax.<sup>184</sup> If the parties are risk-averse, then for reasons similar to those discussed above, they would choose a tax base pegged to actual income, because even under the endowment tax limited to erstwhile earned income they will suffer more utility loss from the higher

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181. See, e.g., S.L. Hurley, *The Unit of Taxation Under an Ideal Progressive Income Tax*, 4 OXFORD J. LEGAL STUD. 157, 167 (1984) (discussing the Von Neumann-Morgenstern theory of risk-aversion).

182. The argument applies under the probabilities given and, more importantly, under the assumption that individuals have no knowledge at all of the probabilities that they will be one type of person or another. This assumption is a more reasonable one for purposes of a redistributive theory. See RAWLS, *JUSTICE AS FAIRNESS*, *supra* note 42, at 106-07 (contrasting risk with uncertainty).

183. The absolute size of the redistributive burden is fixed and incentive effects are disregarded, which together imply that the quantity of resources produced is also fixed.

184. Where tax burden is randomly associated with resources available to pay the tax (subject to a cap on resources owned pretax), the variance in tax rate necessarily exceeds that where tax burden is directly correlated to resources.

tax on earned income if they are leisure-preferring than they will enjoy utility gain from the lower rate on earned income if they are income-preferring.<sup>185</sup>

*D. Conclusion on the Liberal Case Against Endowment Taxation*

In his abbreviated discussion of endowment taxation, Rawls observes:

The difference principle does not penalize the more able [through endowment taxation] for being fortunately endowed. Rather, it says that to benefit *still further* from that good fortune we must train and educate our endowments and put them to work in socially useful ways that contribute to the advantages of those who have less.<sup>186</sup>

Endowment tax proponents, arguing that it is arbitrary to exempt nonmarket leisure activities, but not other leisure activities, from “tax compulsion,”<sup>187</sup> seem to have missed the thrust of this observation. The different treatments of the two types of leisure activity do not rest on an unmotivated judgment that nonmarket activities are morally superior to market-based ones, but on the motivating assumption of liberal theories generally that we already consider ourselves to be in possession of the capacity to engage in nonmarket-based activities, before we ever come to the social contract bargaining table. That is, we begin at a presocietal “baseline” that includes certain abilities. What we lack is the capacity, or at least the fully realized capacity, to use these abilities to engage in economically productive activity. We therefore need not make any concessions to others with respect to nonmarket activities in agreeing to establish a system of redistribution under social cooperation. The same cannot be said of leisure activities that do require market income. Engaging in these activities presupposes that one take advantage of the system of economic and social cooperation that also specifies the terms on which one may do so. In Rawls’s terms, one who requires money income to pursue an activity benefits “still further” from the system of cooperation, and it is this “still further” that may come with strings attached in the form of additional taxation.

Finally, in this connection note that it is just this distinction between what we require in order to engage in solitary, or at least pre-political society, activities and what we require in order to engage in activities made possible by social cooperation in a political order that explains the difference between acceptable inducement and unacceptable compulsion. Indeed, Rawls implicitly relies on the distinction in characterizing endowment taxation as a

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185. As an example, suppose that under the endowment tax, ex ante the high-ability individual faces an equal likelihood of a 10% redistributive tax on actual income and a 30% redistributive tax on actual income, whereas under the income-based redistributive tax she faces a 100% likelihood of a 20% redistributive tax on actual income. For risk-averse individuals, the expected value of the former arrangement is lower than that of the latter.

186. RAWLS, *JUSTICE AS FAIRNESS*, *supra* note 42, at 158 (emphasis added). In his discussion Rawls uses the term “head tax” rather than “endowment tax,” but it is clear that he intends thereby to distinguish lump-sum taxation generally from the more standard tax bases. *See id.* at 157.

187. *See supra* subpart II(A).

“penal[ty].”<sup>188</sup> The endowment theorists’ skepticism toward the distinction, it will be recalled, lay in the apparent arbitrariness of any line between the compulsion imposed on the beachcomber and that imposed on the secondary earner or on one who requires market income to finance leisure activities, coupled with the fact that many choices between work and leisure that individuals actually face seem to be driven by taxes already.<sup>189</sup> What the argument of this Part demonstrates, however, is that implicit consent furnishes the basis for distinguishing between compulsion and inducement, between endowment taxation for redistributive purposes and other forms of taxation that are pegged to socially created wealth. Taxation based on the latter can be presumed consented to, while taxation based on the former cannot.<sup>190</sup> Because consent provides the basis for the government’s authority to tax in the first place, taxation of endowments, other than for the limited purposes of defense and security, generally represents a form of compulsion or “wage slavery”—whether or not it compels additional work and however minor it may be—because individuals have not consented to it.

#### IV. Consequentialist Theories

The main purpose of this Article is to argue against the view that endowment taxation is generally compatible with liberalism. Nonetheless, the argument has relevance to the consequentialist case for endowment taxation, and in particular to the efficiency portion of that case. This Part focuses on the latter through an examination of the concept of a tax distortion.

##### A. *The Distortion Argument*

For theorists who adopt total social utility, welfare, efficiency, or some similar aggregative approach to normative tax questions, the basic justification for a particular tax base or system has two parts. The first part identifies the thing that one wishes to maximize, and then tests which form of taxation, incentive effects aside, best conduces to maximizing that thing. The second part determines the extent of the tax’s excess burden—that is, the “cost” of the tax in social welfare—by examining the incentive, or substitution, effects that taxation along the chosen dimension set up. The first part operates from an ex post perspective, and the second from an ex ante one.<sup>191</sup>

The initial task for endowment tax theorists, then, is to show that taxation of endowment—and not of actual income, wealth, or consumption—

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188. RAWLS, JUSTICE AS FAIRNESS, *supra* note 42, at 158.

189. Fried, *Left-Libertarianism*, *supra* note 48, at 81; Shaviro, *Endowment II*, *supra* note 1, at 142–43; *see supra* subpart II(A).

190. *See supra* subpart III(A).

191. *See generally* ROSEN, *supra* note 16, at ix–x (noting that the division of the text is such that the efficiency of taxation is evaluated separately from the use of tax proceeds).

maximizes along the relevant dimension. All that needs to be added to the argument for endowment taxation developed in Part II is a demonstration of the connection between endowment and the relevant maximand. The argument Shaviro offers is, again, instructive.<sup>192</sup> Given two individuals with equal endowments, free choice over their exercise, and differing chosen allocations of their time among available alternatives, it seems more reasonable to assume that they are idiosyncratic in choosing what maximizes their welfare than to assume that they enjoy different levels of welfare.<sup>193</sup> On this assumption, the different composition of work and leisure that each chooses reflects the different ways in which each rationally achieves the same utility, through the satisfaction of his or her particular tastes, with the means available. These means are not primarily income, but primarily ability. Income is second-order (if even that), just in that it reflects the decision to deploy abilities in a given way.<sup>194</sup>

In light of (a) the presumed equality of welfare between equally endowed individuals who choose different leisure and commodity bundles, and (b) the normative goal of maximizing welfare under the relevant social welfare function (SWF),<sup>195</sup> personal endowment taxation would follow under the further assumption of the declining marginal utility or benefit of cash income (assuming that the SWF does not accord greater weight to the utility of the more advantaged). In effect, under a welfarist approach, endowment taxation follows from the monetization of endowment as income-earning capacity. Once we monetize ability, taxation of endowments results because we redistribute income in order to maximize welfare under the SWF. Having established, it would seem, an equivalence between dollars and income-earning capacity, it becomes possible and indeed necessary to sweep that capacity into the calculation of a welfare-maximizing distribution of resources.

Turning to the distortion question, the issue—as we have seen—is not whether taxes have an effect on behavior by virtue of the fact that they reduce consumers' choice set, but whether they induce tax avoidance by encouraging the substitution of intrinsically less desirable but more favorably

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192. See Shaviro, *Endowment II*, *supra* note 1, at 128–32 (noting that an individual with a high-wage rate may earn less income than an individual with a low-wage rate due to differing preferences in allocating time between productivity and leisure).

193. See *id.* at 132 (arguing that, for the purpose of measuring welfare differences among individuals, a “beachcomber who could have been a Wall Street lawyer is ideally grouped . . . with the individual who actually *is* a Wall Street lawyer, not with the one for whom beachcombing is the only option”).

194. See *id.* at 124–25 (contending that income, as a tax base, is useful only as a “crude proxy for some set of attributes that are relevant to distributive justice”).

195. The SWF is assumed to be that set of preferences that society, or more accurately, the policymaker, has decided should be maximized. See Harsanyi, *Cardinal Welfare*, *supra* note 6, at 315 (observing that the social welfare function should be based on “the . . . subjective preferences . . . of *all* individuals;” “a kind of ‘fair compromise’ among them”). There are many possible SWFs, including maximizing overall utility, equalizing utility, and Rawls’s maximin principle (requiring all changes to be to the advantage of the least advantaged, viewed as a class). RAWLS, *THEORY OF JUSTICE*, *supra* note 38, at 75–78.

taxed goods for intrinsically more desirable but less favorably taxed ones. And here the superiority of an endowment tax to any actual tax system seems to be undeniable. An endowment tax, like any lump-sum tax, has no substitution effects, because it applies to the same extent no matter what the taxed person does.<sup>196</sup> Endowment tax thus represents a kind of tax holy grail, because it seems to permit optimal distribution with no efficiency costs. It is ideal from both the ex ante (efficiency) and the ex post (distributional) perspectives.

### *B. Observations on the Distortion Argument*

Although the welfarist analysis of the ex ante effects of lump-sum taxation is descriptively accurate, it is not clear that these effects should be labeled with the normatively loaded term “nondistortive.” To conclude that an effect on behavior constitutes a distortion, one requires a neutral baseline against which the distortion can be measured. In order for the lump-sum-tax efficiency analysis to hold, one must assume, among other things, that taxes are not pure cost-internalizing arrangements. A cost-internalizing tax, sometimes referred to as a “Pigouvian tax” (named for the economist A.C. Pigou), is designed to make the person who engages in an activity bear all and only the costs associated with the activity.<sup>197</sup> Cost internalization may be accomplished by assessing tax in an amount equal to the marginal social damage that production of a good causes at the optimal level of output.<sup>198</sup> If it is possible to assess tax at this level, then the tax is maximally efficient, even though the tax will influence (indeed is designed to influence) behavior.<sup>199</sup> This follows for the simple reason that when taxes function like any other costs, producers will efficiently bear them in the same way they efficiently bear other costs. As we have seen, minimal liberal theories conceive of the tax system very much along Pigouvian lines, because a benefits tax devoted solely to the provision of public goods is designed to assess each contracting individual an amount equal (or at least close) to her share of the burden that social cooperation creates. Redistributive liberal theories add a further layer of tax that typically functions like insurance.

Pigouvian taxes may be contrasted with revenue-raising taxes, the purpose of which may bear little or no clear relationship to regulation of or payment for the taxed activity.<sup>200</sup> The model of taxes as revenue-raising is dominant in most economic approaches to taxation and underlies the

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196. See ROSEN, *supra* note 16, at 309 (noting that “because the tax base [of an endowment tax] is potential, an individual’s tax burden would not depend on behavior”).

197. Olof Johansson, *Optimal Pigovian Taxes Under Altruism*, 73 LAND ECON. 297, 297 (1997).

198. *Id.*

199. See ROSEN, *supra* note 16, at 92–94 (discussing the use of Pigouvian taxes to influence damaging behavior, e.g., pollution).

200. *Id.* (discussing the desirability of aligning Pigouvian taxes as closely as possible with the activity meant to be burdened).

efficiency analysis described above. Under the revenue-raising approach, the question of how best to tax is disaggregated from the question of how tax proceeds are used. We can represent the limit of this disaggregation in an intuitive way using Blum and Kalven's metaphor of tax assessment as a common disaster in which the proceeds of the tax are thrown into the sea.<sup>201</sup> Here we consider taxes as needed to satisfy some specified revenue target, and the question is how best to achieve the target. The point of this approach is not to assume that taxes are useless, but to consider the spending side in isolation from the taxing side, in order to separate incentive from distributional and other effects of the tax. The method of tax collection that minimizes the tax disaster is the desired method, with lump-sum taxes representing the limit, since they induce no substitution from pretax outcomes.

This separation of the taxing and spending sides of the budget equation under the revenue-raising model tacitly underlies the treatment of the failure to tax leisure under an actual tax as distortionary.<sup>202</sup> A consideration of revenue-raising fully in isolation from tax expenditures invites the questionable supposition that the activities giving rise to the revenue exist independently of the use of the revenue. That is, we may imagine and treat the market as a self-subsistent reality, wholly apart from the taxes that fund the institutions that actually make it possible.<sup>203</sup> Within the (impossible) world of a no-tax efficient market, it is of course the case that there will be more work and less leisure than there will be in a world where the costs of being able to do the work are actually charged to those who do it. The non-tax world, unmoored in this way from the conditions of its possibility, furnishes an illusory baseline of undistorted—that is, natural—activity against which changes wrought by taxes appear as distortions. The problem with such an account, of course, is that taxes are needed to finance the world that is supposed to operate as a baseline against which to measure the distorting effects of taxes in the first place.

One might counter this observation by noting that it is in fact possible to model the production side of the world as though there were no taxes in a

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201. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 517 (1952).

202. For a treatment of these issues that expressly addresses the assumptions discussed here, see Musgrave, *supra* note 150, at 373.

203. Within the economics literature, this assumption has been challenged at various times. See, for example, Earl A. Thompson, *Taxation and National Defense*, 82 J. POL. ECON. 755 (1974), which argues that efficient taxation to fund defense expenditures is Pigouvian because the costs of such expenditures rise with the quantity of capital that nations seek to protect. Treating defense expenditures in this way, Thompson concludes that the U.S. income tax system is remarkably close to the optimal tax system. *Id.* at 781; see also Robert J. Barro, *Government Spending in a Simple Model of Endogenous Growth*, 98 J. POL. ECON. S105, S116 (1990) (noting that “the amount of [many public services] that an individual receives is roughly proportional to the amount of property that the person has to protect” and that “[t]hese cases can be approximated by assuming that each individual holds constant his ratio of public services to output . . . rather than his level of public services”). I thank Jim Hines for the reference to this literature.

way that does include taxes. If taxes are assumed to be of the lump-sum variety, such as an endowment tax, then, apart from income effects,<sup>204</sup> the same quantum of economic production and exchange takes place in the lump-sum world as would in the imagined nontax world. It therefore becomes possible to construct a hypothetical world that is both possible and not different from the nontax world that is intended to function as a baseline, suggesting that the revenue-raising model provides a baseline after all. The difficulty with this argument is that it is circular to assert that a lump-sum tax world functions as a baseline for assessing distortions in the real world on the basis that the lump-sum tax world gets to the same result as the (impossible) nontax world. The concept of a distortion implies a neutral baseline against which the distortion present under any particular state of affairs can be measured. The notion of the nontax world only derived its force as a neutral baseline from the fact that it appeared to be what happens naturally, in a world of efficient market exchange, before taxes are "added on." But, of course, the actual nontax world is not the world of efficient market exchange, but, judging from history, something between a tentative market of rudimentary barter exchange and a war of all against all. That, indeed, is why taxes are added on. If a smoothly functioning market economy is not something found in nature, then still less is one financed by lump-sum taxes. Lump-sum taxes, like all taxes, must be adopted.

The fact that neither the nontax world nor the world financed by lump-sum taxes is natural still does not imply that these worlds fail to provide an uncontroversial baseline against which to measure distortion. It shows only that to establish their status as a baseline, a normative argument demonstrating their superiority, or at least their non-inferiority, to all other baselines is required. That is, one must demonstrate that the world in which taxes are levied in a way that does not affect market transactions is Pareto-superior to any other tax world.<sup>205</sup> Stated in the negative, it would suffice to call into question the use of the nontax-lump-sum tax world as an uncontroversial baseline, to show that there is some real doubt about the non-inferiority of that world to all worlds in which taxes are tethered to market activity.

It is fair to say that the status of the nontax-lump-sum-tax world as Pareto-superior to any other tax world is anything but uncontroversial. In the

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204. Strictly speaking, income effects are not desired, but they do not introduce inefficient distortions on the production side. See Terrence Chorvat, *Taxing Utility*, 35 J. SOCIO-ECON. 1, 3 (2006) (noting that lump-sum taxes force those least able to bear the tax burden to increase their earning activities to afford the tax).

205. See A. ATKINSON & J. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 343 (1980) (comparing the Pareto efficiency of the competitive equilibrium in a world with competitive households and firms, a full set of markets, and perfect information with the Pareto efficiency achievable through lump-sum transfers and taxes). Technically the nontax world must be merely non-Pareto-inferior to any other tax world, the only difference being that non-Pareto inferiority is also satisfied when no one is made better off and no one is made worse off. I use "Pareto-superior" for simplicity.



end the claim rests on the doubtful proposition that leisure forsaken can always be made good in additional dollars earned. The truth of this proposition, however, presupposes empirical assumptions that may well be false.

To see the point, consider a simplified social order in which, in the absence of any taxes whatever (but assuming a well functioning market), total social product would be  $X$ . Suppose that the cost of running the social order at this level of output is  $Y$ , where  $0 < Y < X$ , assuming the assessment of these costs has no effect on behavior. In other words,  $Y$  is the revenue target. If the planner adopts some form of lump-sum tax to raise  $Y$ , and no taxes for any other purpose are assessed, then total social product net of taxes is  $X - Y = Z$  (treating administrative costs as 0).

Now consider the same social order operating under a Pigouvian-type benefits tax, in which the cost of running the social order is fully internalized so that each member bears all and only the costs for which she is responsible. Assume further that the prospect of bearing the tax has substitution effects, so that total social product (gross of taxes) is  $X'$ , the cost of running the social order at this level of production is  $Y'$ , and the net social product is  $Z'$ , where  $0 < Y' < X'$ ,  $X' < X$ , and  $Z' < Z$ . Net wealth produced under the two arrangements differs by  $Z - Z' = \Delta Z$ . There is a correspondingly greater quantity of leisure time in the Pigouvian world.

In order to say that the  $Z$  of net output in the lump-sum world is the quantity of output produced with no tax distortions, one must be able to conclude that everyone in the two states either would be indifferent between having the portion of  $\Delta Z$  that represents her additional work and having the leisure, or would prefer this portion of the  $\Delta Z$  to the leisure.<sup>206</sup> In other words, it must be true that in every case the extra dollars are at least as desirable as the leisure forsaken. It is easy enough to show that this relationship will not hold under plausible assumptions.

To keep things simple, assume that costs are a linear function of income no matter what the level of production<sup>207</sup> and that all time is devoted to either work or leisure. Individual  $J$  earns an income of \$10 per hour. The social cost she thereby creates is \$2 per hour. Her utility function is such that she values the first thirteen hours of leisure each day at \$11 per hour, the fourteenth hour at \$9, and the fifteenth through the twenty-fourth hours at less than \$8 per hour. In a world of Pigouvian taxes  $J$  works ten hours and takes home \$80 after tax, and her utility is  $\$80 + \$9 + 13 \times \$11 = \$232$ . In a world of lump-sum taxes, she works eleven hours and takes home \$88 after tax, and her total utility is  $\$88 + 13 \times \$11 = \$231$ . Because she is forced to work the eleventh hour under the lump-sum tax, she has \$1 less of utility. Thus it

206. This simply states the criterion of Pareto superiority. Sen, *supra* note 96, at 217.

207. This assumption is likely to be false in any real case, but the result generally obtains whenever the costs of market production rise with the quantity of market production.

cannot be said that the lump-sum tax world is not Pareto-inferior to any other tax world.

This argument demonstrates that the concept of a tax distortion, critical to the consequentialist evaluation of the welfare effects of an endowment tax, cannot be defined by treating the nontax world as a neutral baseline, at least not where social costs are positively correlated with wealth production. The argument also illustrates, however, the relevance for efficiency analysis of the difference between benefit and redistributive taxation. For though it appears that an ideal Pigouvian tax is more efficient than a lump-sum tax, where the object of the tax is to internalize costs, it remains the case that a maximally efficient *redistributive* tax is lump-sum in nature.<sup>208</sup> This result follows intuitively once we recognize that the model of taxes as revenue-raising, as a common disaster in which the proceeds are dumped into the sea, functions perfectly well for solely redistributive taxes, which by definition are not used to finance the goods that make the system of production possible. Therefore, from a social-welfare perspective a maximally efficient ideal tax system that contains a redistributive component should incorporate lump-sum taxes as add-ons to Pigouvian taxes.

I take no position here on whether social welfarist approaches are normatively superior to so-called fairness approaches, a question that has been the subject of a vast literature.<sup>209</sup> I note only that the relevance of ideal Pigouvian taxes to modeling taxation to pay for public goods suggests that there may be further adverse efficiency consequences even to reserving lump-sum taxes for redistributive purposes. These consequences can arise when the lump-sum tax has the effect of causing individuals to work solely to pay the tax, but not otherwise. In that case, overall social costs will also increase whenever benefits derived are an increasing function of social production. These increased social costs must be accounted an efficiency loss.

Returning to the previous example, assume that a redistributive lump-sum tax is adopted as an add-on to the ideal benefits tax. (The kind of lump-sum tax is immaterial.) Suppose that in *J*'s case, the total tax (benefits plus lump-sum) comes to \$120 per week. Before the lump-sum tax, *J* worked ten hours and took home \$80. Now she must clear an additional \$40 to meet her tax burden. In order to ensure that the social costs of her additional work are covered, she will have to work five additional hours and pay \$10 additional tax, rather than just four additional hours. This \$10 is deadweight loss.

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208. Musgrave, *supra* note 150, at 376–77.

209. Compare Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 967 (2001) (championing policymaking based almost exclusively on maximizing social welfare and disregarding notions of fairness), with Ward Farnsworth, *The Taste for Fairness*, 102 COLUM. L. REV. 1992, 1993 (2002) (arguing that “justice and fairness have a legitimate . . . place in the making of legal policy”).

Contrast this case to the case in which the lump-sum tax does not exceed erstwhile after-tax income under an ideal benefits tax. Suppose for example that *J*'s redistributive tax burden is \$40 rather than \$120. Now the tax does not compel any further work. It is true that she may choose to work more because of the income effect of the lump-sum tax, and this choice will create additional social costs that must be paid. But this additional cost cannot be accounted an efficiency loss, since, by hypothesis, she gains more on an after-tax basis from the additional income than she creates in social costs (which only she bears) to produce it.

## V. Conclusion

The case for a liberal theory of endowment tax must be considered very weak if one takes seriously the commitments to equality, neutrality and autonomy that, I have argued, are foundational for liberal political theories. The weakness stems from the fact that for such a theory, the point of political association is to enhance individuals' capacity to realize ends that are assumed to be given and for which the system that is created, with all that it offers, functions in the main as a means. What follows from these assumptions is only a very limited governmental authority over individuals' actions that do not arise from the relations that the agreement itself makes possible. This conclusion follows whether one believes in a minimal state or a more redistributive one. Redistribution is compatible with many forms of liberalism, but only if the redistribution does not extend beyond resources that would be created in the system of social cooperation that citizens establish, prior to the imposition of any redistributive tax burden.

The same concerns that give rise to the commitments described above bear on the consequentialist case for endowment taxation. On its face endowment taxation appears to satisfy optimally the two basic aspirations of any tax system grounded in a consequentialist theory: to distribute resources in a way that maximizes social welfare, and to do so with the least social cost. But this result presupposes a questionable set of assumptions about the relationship of taxes to the system of production and exchange that they finance. A lump-sum tax is maximally efficient only if it is uncontroversial that forgone leisure can be made good with dollars at the margin. That condition is less likely to hold once the social costs of producing social wealth are taken into account. When it does not hold, there are efficiency costs to ideal lump-sum taxation, even when lump-sum taxes are confined to financing redistribution, if the lump-sum taxes compel work to pay the tax.

