

CHALLENGING THE OLD WARHORSE: IS THE FLAT TAX A PLAUSIBLE ALTERNATIVE TO THE PROGRESSIVE SYSTEM?

**PAPER BY MARTIN PEROLD
UNIVERSITY OF JOHANNESBURG**

1. INTRODUCTION

Personal income taxation is a concept that is resented by many, as it involves handing over a percentage of their hard-earned money to the government. Some people object to this type of meddling into their financial affairs and despise paying taxes. Furthermore, taxation is not voluntary, as it can be enforced by the laws of a state, and there are severe penalties for tax evasion in many countries. This has led to the tax collectors often being portrayed in a negative light as odious and abhorrent people who come to confiscate much-needed income from citizens, such as the Sheriff of Nottingham in the famous story of Robin Hood.

Despite their inherent aversion to income tax, however, most people would acknowledge that taxation is a necessary evil. It allows the state to raise the revenue it needs to provide essential government services such as roads, health care and education. These services benefit the population in general, but they would not be possible without taxation. John S. Coleman (quoted in Roux, 2005: 79) sums up the situation well: “[t]he point to remember is that what the government gives it must first take away”.

The focus of this paper is on how the state “takes away” the income from its citizens. Traditionally, personal income tax revenue has always been collected via a progressive system, whereby those who earn the highest incomes are taxed at the highest marginal rates. Recently, however, some economists (such as Hall and Rabushka, 1995) have proposed and defended alternative systems whereby all incomes above a specific exemption level are taxed at the same, flat rate. It is the aim of this paper to show that South African policymakers should give the flat tax due consideration as a plausible alternative to the progressive system.

To achieve this aim, the paper is divided into three parts, followed by a conclusion. The first section will describe the traditional arguments for progressive taxation, pointing out the economic thought that has made this “old warhorse of taxation” so popular throughout history. These arguments will be critically examined to show that they are not indubitable, and that the progressive system is not necessarily the obvious choice for fiscal policy.

The next section will focus on the three main justifications for a flat tax – its political responsibility, its simplicity and its predicted incentive effect. Here, the most important theoretical and empirical arguments for and against a flat tax will be discussed and evaluated.

Finally, the last section will examine the thirteen countries that have, so far, rebelled against the established system and adopted a flat tax in reality. Their experiences will be described briefly and it will be shown that the flat tax has been quite successful in these countries. It will be concluded that there may be enough reason for the South African government to put the flat tax into operation in this country, even if it is not able to redistribute wealth as efficiently as the progressive system. Further quantitative research will need to be done in order to identify the likely effects of a switch to a flat tax.

2. ARGUMENTS FOR PROGRESSIVE TAXATION

In their detailed review of the traditional arguments for progressive taxation, Blum and Kalven (1953) divide them into four main categories, namely benefit theory, the argument from stability, sacrifice theories and the equality argument. In this section, these four types of argument will be considered in turn and it will be shown that none of these defences of progressive taxation are ultimately convincing.

Benefit Theory

The central postulate of the benefit theory is that taxpayers ought to pay taxes in proportion to the benefits they receive from the government. Hobbes (1651: 184) provides one of the first statements of the benefit principle, saying that the equal imposition of a tax depends “not on the [e]quality of riches but on the [e]quality of the debt, that every man oweth to the Commonwealth for his defence”.

This leads us to the justification of progressive taxation. Since those with the highest incomes have the most to lose if the state does not protect them, they ought to contribute the most in taxes. Tax, according to this theory, is a type of insurance premium paid to the state for the protection of one’s property and earning power – as the rich own more, their premiums should be the highest. Furthermore, wealthy entrepreneurs require the labour of skilled workers and a good infrastructure for their profits. As a result, they depend on the state to provide education for the workforce and to maintain and upgrade infrastructure; therefore, they ought to pay more for these benefits than other citizens who depend on the government in a lesser degree. In this way, “every man payeth equally for what he useth” (Hobbes, 1651: 184).

This principle has been questioned by many writers, however. Mill (1852) provides an important criticism, claiming that all citizens benefit equally from government spending in most cases. For instance, everyone in the country benefits equally from government spending on national defence, as the entire nation is protected by the army. It is a feature of public goods that they are non-excludable, so “no-one is debarred from using” them (Mazolla, 1890: 37). Therefore, as nobody can be prevented from consuming them, it makes sense that everyone should pay for them equally – thereby justifying proportional taxation instead of progressive taxation. As Mill (1863: 76) says, it is just for a business to charge all its customers “the same price for the same article, not a price varying according to their means of payment”.

The benefit principle has even been criticised on the view that it leads to *regressive* taxation. According to Mill (1863) and Seligman (1908), one may argue that it is the poor who benefit most from government expenditure. They make use of unemployment benefits, state-subsidised housing, healthcare and education while the wealthy generally have the resources to provide for themselves in the absence of government spending. Then, if benefit theory is correct in claiming that taxes should be levied in proportion to benefits received, it leads to regressive taxation: since the poor benefit more, they should pay more.

Furthermore, some government expenditure such as interest on the national debt does not benefit anyone (Wicksell, 1896) and the state may spend money on public goods that benefit one group but not another (Lindahl, 1919). It is also difficult to measure exactly how much a particular benefit is worth to a taxpayer (Seligman, 1925 and Manwell, 1967). Thus, as Seligman (1908) notes, “this defence of progressive taxation is not very strong”.

The Stability Argument

Progressive taxation has also been defended on the grounds of stability. It is claimed that the effects of economic shocks such as depressions are minimised under a progressive tax system, because taxpayers are shifted from one bracket to another (Blum and Kalven, 1953). During a recession, the wages of workers may have to be reduced, moving them into a lower tax bracket. In this new bracket, they are taxed at a lower marginal rate and are, therefore, able to retain more of their income – and this reduces the impact of the recession on their income. The opposite would occur during a boom and, as such, aggregate consumption will remain relatively constant despite macroeconomic shocks. Progressive taxation therefore acts as an automatic stabiliser in the economy.

The ability of progressive taxation to act as an automatic stabiliser is seen to be relatively unimportant, however. Blum and Kalven (1953: 34) note that it is “a part time case”, applicable only in a recession – instead, the state can stimulate the economy by other, more effective means. Mishan and Dicks-Mireaux (1958) attempt to measure to what extent tax rates affect inflation. They conclude that “[b]uilt-in stability is built small into the system, not large” (Mishan and Dicks-Mireaux, 1958: 604), and the stabilising effects of a passive fiscal policy that maintains expenditure and progressive rate structure constant are found to be “disappointing”. Thus other means of achieving stability may be more effective than progressive taxation and this argument is unconvincing.

Sacrifice Theories

The starting point for the sacrifice theories is that taxes are compulsory payments to the state. Since taxation can be enforced by law, the question is not how much the individual ought to pay the state; instead, what should be asked is how much the state is rightly entitled to confiscate from the taxpayer (Carver, 1904). Taxation reduces the wealth of the taxpayers and, therefore, results in a sacrifice on their part, causing disutility. The legislator ought to design a tax that imposes this disutility as fairly and efficiently as possible.

According to the sacrifice theorists, progressive taxation is the best method of achieving this objective. This is because the confiscation of one unit of income from a wealthy individual represents a smaller sacrifice than taking the same unit of income from a poorer individual (Edgeworth, 1897). The argument is that those with low incomes have barely enough to satisfy their basic needs. Taxing away even a small part of this low income forces a significant sacrifice upon these people – they may have to forgo certain essentials that they can now no longer afford. In contrast, those with high incomes would merely have to give up some or other luxury if the same amount of income were taken away from them, and they would still have more than enough to live on. Consequently, it is justified to take more income from the rich taxpayers than from the poor, as the disutility imposed upon the high-income earner is the lowest.

From this description of the sacrifice theories, it is clear that they assume that the marginal utility of money declines as income increases (Fagan, 1938). A further assumption common to all sacrifice theories is that it is possible to measure sacrifices and to compare them for different taxpayers – “[t]o speak of aggregate sacrifice or satisfaction... implies that satisfactions are... capable of being summed” (Pigou, 1947: 41).

The assumption that sacrifice can be measured has been questioned by scholars such as Nicholson (1894) and Kendrick (1939). They claim that sacrifice cannot be quantified in mathematical terms and using income as a measurement is a poor substitute. Seligman (1908) makes the same point, saying that sacrifice is something subjective and psychological and so cannot be identified with income, which is material. Furthermore, it seems difficult to see how the sacrifices between two different individuals may be compared, as some people value a certain good more highly than others – “[s]acrifices are relative to the individuals that experience them” (Kendrick, 1939: 99).

The other assumption, that the marginal utility of money declines as income increases, has received considerable attention in the literature. Chapman (1913) provides a detailed theoretical critique of this assumption. One of his points is that it is more realistic to hold that there are some points of discontinuity in the marginal utility of money curve. The curve may, for example, decline up to a point but then rise steeply – for instance, there may be a minimum income level required to own and maintain an important asset such as a motor vehicle. The marginal utility of money may decline up to a point just below this income level but, *ceteris paribus*, it could easily increase significantly once this income level is attained. The person who would be able to afford a car with a small increase in income would value that income extremely highly, because it would make a dramatic improvement in lifestyle possible (Chapman, 1913).

Cohen Stuart (1889) notes that, even if the marginal utility of money declines with income, this does not automatically entail progressive taxation. Instead, one needs to know what the precise shape of the utility of money curve is. Cohen Stuart’s investigation shows that, while some declining utility curves justify progressive taxation, there are just as many other possible declining curves that justify proportional and even regressive taxation – in fact, progressive taxation is justified only if the utility curve is a rectangular hyperbola.

Some other theorists have attempted to derive the true shape of the utility curve mathematically, but their results have not been convincing. Pigou (1947) claims that it is impossible to determine the exact shape of the curve, while Preinreich (1948) notes that there are a number of difficulties associated with this problem and that all the practical attempts to solve it have, so far, been unsatisfactory. Harrod’s (1930) investigation shows the curve to be steeper than a rectangular hyperbola, but Fagan (1938) questions the assumptions that he uses in arriving at this result. Thus it is by no means obvious that the curve is indeed declining, as is maintained by sacrifice theorists.

It has been shown that two of the key assumptions of sacrifice theories are dubious and controversial. Fagan (1938) lists several further assumptions of this theory and also calls them into question. The defence of progressive taxation on the grounds that it minimises disutility does not appear to be convincing, therefore, and one would have to justify progressive taxation on other grounds, such as that it promotes equality.

The Equality Argument

The argument from equality is probably the most satisfactory justification for progressive taxation. It stems from the view that economic differences between citizens need to be redressed by transferring wealth from the rich to the poor. This view is advanced by, among others, Marx and Engels (1848), Wagner (1883) and Lyons (1969) and it is claimed that progressive taxation is desirable because of its effectiveness in redistributing wealth.

According to Gide (1924), economic inequalities are pervasive and it is the duty of the state to reduce them. Steps are being taken to eliminate racism and sexism from our society, and there ought to be a similar requirement for governments to eradicate economic inequalities. Wicksell (1896: 109) summarises the view well by saying that society has “both the right and the duty to revise the existing property structure.”

It is clear how this view leads to progressive taxation. Essentially, the wealthy will pay over a greater percentage of their incomes to the state than the poor, and this revenue will be redistributed to those with the lowest incomes via means such as welfare payments. In this way, economic inequalities will be reduced (or even eliminated). This argument is especially valid for a country like South Africa, with its history of racial discrimination and preferential treatment. Furthermore, the incomes of the rich may be obtained through the unfair exploitation of low-income labourers (Marx and Engels, 1848). This provides a further reason for the view that some of the wealth of the rich ought to be redistributed.

The main objection to this type of argument is that a progressive rate is unfair because it penalises some “people for having worked harder and saved more” than others and that it is, therefore, “a tax on industry and economy” (Mill, 1852: 371). As Sidgwick (1901) explains, certain professions require time and effort to learn, so if inequalities in income reflect this additional time spent studying, they are justified. There may, then, be no incentive to be productive or to save if marginal tax rates increase with income. Economic agents may decide to work less, master simpler trades and spend more time at leisure as a result of increasing marginal tax rates – this is detrimental to economic growth.

Also, high marginal tax rates may cause capital flight to lower-tax countries, as Sidgwick (1901) points out. Greater equality may, therefore, be achieved only at the expense of capital flight and disincentives to work, save and invest; and these disincentives may inhibit economic growth. Even if progressive taxation is highly successful at redistributing wealth, it may have costs that cannot be justified.

Rawls' (1971) "difference principle" summarises the issue well – he claims that a certain level of inequality is acceptable if society as a whole is better with these inequalities than it would be without them. Many of the arguments for the flat tax rest on this principle, as will be seen in the next section. While supporters of the flat tax accept that progressive taxation is the best system for achieving equality, they argue that everyone would be better off under a flat tax despite the inequalities. Aaberge, Colombino and Strøm (2004) liken the redistribution to the division of a cake, and, using their analogy, it may be that the progressive system would result in a more equal distribution of the slices, but that the cake itself would be bigger under a flat rate.

Some theorists argue that redistribution and equality are not goals that are worth pursuing at all. Nozick (1974), for instance, believes that no type of government redistribution of wealth is ever justified. He argues that redistributive taxation is on a par with slavery – if the state confiscates any income over and above that which is needed to fund public goods and services, it is essentially forcing the taxpayer to work for the benefit of the poor, which is akin to slavery.

Furthermore, says Nozick, it is futile to seek equality as, even if perfect equality could somehow be attained, this state of affairs will be temporary because market forces will create new inequalities. Consumers have different tastes and will spend varying amounts of their income on different goods, creating inequalities between those who have spent and those who have saved. It is impossible for the government to intervene on a regular basis to eliminate these inequalities, as this would involve too much intrusion by the state into the private lives of citizens.

There does, however, seem to be a great deal of merit in the view that the state should redistribute wealth, particularly in South Africa. It is also clear that progressive taxation achieves this objective well, and that the arguments from equality are the most successful at defending progressive taxation. Thus a flat tax will certainly entail some sacrifices in terms of equity as compared to progressive taxation; what we need to ask, however, is whether its benefits outweigh the costs. In the next section, therefore, the purported advantages of the flat tax will be considered.

3. ARGUMENTS FOR THE FLAT TAX

Supporters of a flat tax commonly defend it on three main grounds – it is a more politically responsible system than progressive taxation, it is simple, and it stimulates productivity and economic growth by providing greater incentives to work than progressive taxation does (Blum and Kalven, 1953). These three types of argument will be examined critically in this section.

The Argument from Political Responsibility

The first type of argument for a flat tax is based on what may be called political responsibility. Blum and Kalven (1953: 19) point out that progressive taxation is irresponsible because “higher surtax rates are almost certain to apply only to a minority of voters”. This means that the majority (low-income earners) are able to vote on and set the high tax rates that the minority pay. According to Blum and Kalven (1953: 19), this is unfair because “[n]o majority... can pass fairly or responsibly on an issue so infected with its own immediate self-interest.”

Epstein (2004) emphasises this point, noting that there is no definitive, mathematically determined answer to the question of what the progressive rate structure should be. As a result, a progressive tax schedule is necessarily determined politically, leading to certain special interest groups being advantaged. Supporters of a flat tax claim that their system is better because, since everyone pays the same flat rate, this unfair advantaging of special interest groups cannot occur.

A flat tax supporter, Armev (1996), summarises the arguments from political responsibility well. He claims that a flat tax is the fairest system because it treats everyone the same, avoiding the problem of having “fallible politicians decide, for their own reasons, which groups should render more or less of their earnings to the government” (Armev, 1996: 100). Instead, the flat tax does not discriminate between any economic group or agent, setting a single, objectively determined rate.

This kind of argument for a flat tax seems to have little force, however. As Blum and Kalven note, any system of majority rule will encounter this type of problem. There will always be those who disagree with a decision taken by the majority, and this is a logical and necessary consequence of a democracy, which is “superior to any other principle for resolving group decisions” (Blum and Kalven, 1953: 19). The advantages of a free and fair decision-making process will surely outweigh the relatively small disadvantage of the majority’s “getting its own way”. Besides, it may be said that the view of the majority best reflects the desires and wishes of the society and that there is nothing unfair in submitting to their suggestions.

Furthermore, one might object that the flat tax would support the wishes of the minority instead, and that this would be even more unfair. If a flat tax is adopted and it results in less revenue available for redistribution to the poor, it is the wishes of the rich that are granted at their expense. This essentially represents minority rule, which is surely a greater injustice than majority rule. Also, as majority rule is consistent with utilitarianism, it is intuitively more attractive to economists.

Blum and Kalven (1953) also note a second possible reply to this criticism of progressive taxation. They point out that “membership in the majority is not a permanent matter” (Blum and Kalven, 1953: 20) because individuals will earn more income and shift to higher tax brackets throughout their careers. Thus, in voting on a tax system, rational individuals would consider its possible effects on them in the future as they move into a higher-income group.

In conclusion, it seems as though the argument from political responsibility does not provide a compelling reason to adopt a flat tax. Blum and Kalven (1953) appear correct in thinking that this argument is overstated, even though it provides an additional consideration that legislators must bear in mind when deciding on a tax system.

The Argument from Simplicity

A second argument is that the flat tax is extremely simple compared with the progressive system. Advocates of a flat tax often claim that their tax return could be completed on a postcard (Hall and Rabushka, 1995; Forbes, 2005). This would save taxpayers hours of unproductive time spent completing complicated forms and finding ways in which to take advantage of tax loopholes (Blum and Kalven, 1953). But is the progressive system truly that complicated?

Studies have found that, although the majority of citizens regard progressive taxation as an inherently fair system (Porcano, 1984), few understand its complexity in practice (Roberts, Hite and Bradley, 1994). Edwards (2006) points out that a complicated tax system can impose four types of costs on the economy: there are compliance costs (the unproductive time and effort expended by taxpayers in completing a long and burdensome tax return), efficiency costs (where tax considerations interfere with the decisions of economic agents), administrative costs (the costs incurred by the state in collecting the tax and in identifying tax evaders) and increased incentives and opportunities for tax avoidance (a complicated system allows taxpayers to take advantage of loopholes in the income tax code). All these costs will be considered here.

Blumenthal and Slemrod (1992) provide a comprehensive discussion of compliance costs. They explain that, apart from the time spent in reading the instructions and completing the return and the money spent in hiring a tax consultant, there are other costs that are incurred regularly. These include the process of keeping detailed and accurate records of sources of income and of possible tax deductions, as well as researching the tax literature for better ways of organising a business to reduce its tax liability.

Studies of the compliance costs of the current tax system in the United States (such as Slemrod and Sorum, 1984) indicate that they are substantial, in terms of time as well as money. Blumenthal and Slemrod (1992) estimate that American taxpayers devoted 21.7 hours of their own time, on average, to complying with tax regulations in 1982. This figure increased to 27.4 hours in 1989, according to their analysis. Edwards (2006) finds that 61% of all American tax filers in 2005 made use of paid tax preparers, which is unproductive expenditure.

This is consistent with Blumenthal and Slemrod's (1992) finding that, on average, completing a tax return cost the American tax payer \$66 spent on professional assistance in 1989. Kaplow (1994) claims that compliance costs run into billions of dollars each year, and another estimate by Bevan (2006) puts the total cost at 6.4 billion hours in time and \$265 billion in money. Forbes' (2005) estimate is also at 6 billion hours for the American taxpayer. Proponents of flat tax systems claim that their tax code will avoid these high compliance costs by being simple and comprehensive.

Bankman and Griffith (1987) question the validity of these arguments. They claim that there are methodological flaws in some of the studies, and that the conclusions are misleading. Although they admit that compliance costs are high because of a complex tax system, they argue that only a small percentage of this complexity is due to progression, concluding that “[r]eforming certain deductions that require record-keeping or simplifying tax returns... would do far more to reduce compliance costs than would changing to a flat tax rate” (Bankman and Griffith, 1987: 1934).

A second cost of complex tax systems is that they interfere with economic decisions of taxpayers (Edwards, 2006). This is because taxpayers will factor their potential tax liabilities into the decision-making process, thereby making decisions that would not necessarily be optimal in the absence of such a tax. For instance, an entrepreneur may turn down a profitable business opportunity on the basis that its tax cost is likely to be high. Such practices are economically inefficient.

This point may be explained in more detail by using a hypothetical example. Suppose a South African farmer is entitled to make certain deductions on his tax return for the cost of fertilizer for his crops. The farmer may decide to take advantage of this tax saving by purchasing large quantities of fertilizer, which stands unused in his storage facilities. However, if this fertilizer is unused and if the farmer has cash flow difficulties in the next year, he may be forced to sell it to recoup some cash. Clearly, this is an inefficient decision, and a complex tax system may lead individuals to make more of these decisions than a simpler system.

Poterba (2001) also shows that differential taxation has a significant effect on the types of assets households will hold in their investment portfolios, confirming that a complicated, progressive tax system leads to economic inefficiencies. He finds that a progressive rate structure reduces risk-taking by households, a result confirmed by Taylor (1986), who highlights progressive taxation as an important (though neglected) source of risk aversion among investors.

Bankman and Griffith (1987) claim that these arguments are also not entirely convincing. They point out that tax-motivated transactions are not necessarily undesirable – instead, they simply reflect the wishes of society, being those transactions “that society has explicitly decided to favour with tax incentives” (Bankman and Griffith, 1987: 1940). Tax laws can be used to achieve other desirable goals and stimulate investment in sectors that are favoured by the legislator – and there is nothing inherently wrong with this principle. Proponents of a flat tax, however, point to these kinds of inefficiencies in defending their systems nonetheless.

The third of Edwards’ (2006) costs is that a complicated tax system imposes administrative costs on the government as it is required to take costly steps to collect the tax and enforce all its rules, as well as investigating and prosecuting tax evaders. Edwards (2006: 2) calls this “an invasion of privacy” by the state.

There seems to be a general consensus among economists that the current taxation system entails high administrative costs. Alm (1996) stresses that governments ought to take the costs of administration into account when evaluating proposals for tax reform. Mayshar (1991) makes one attempt to do so, providing a model to solve the problem of costly administration using a tax technology. In South Africa, too, the costs of administration are high – Visser (2006) reports that 1.33% of the total tax revenue collected by the South African government was spent in efforts to collect the tax, which is clearly wasteful and inefficient.

Some scholars have attempted to show that administrative costs, though undesirable, should nevertheless be tolerated. Kaplow (1994) points out that it is important for all tax liabilities to be assessed as accurately and fully as possible. According to Kaplow, a system that contains

numerous inaccuracies is inefficient, firstly because taxpayers will usually waste resources in attempting to prove that they have been over-assessed and secondly because a system that forces taxpayers to pay too much in tax is inherently unfair. There is also the problem that taxpayers have no incentive to prove that they have been under-assessed, so the inefficiency is exacerbated.

Some administrative costs may, therefore, be acceptable according to Kaplow. These costs represent, for Kaplow, the risk premium that an individual is willing to pay to prevent an inaccurate tax assessment. However, this argument fails if the benefits gained from greater accuracy are not worth the costs paid in administration. In reality, the administrative costs appear to be extremely high, so it seems as though the risk premium argument is unsuccessful in practice. The flat tax proposals claim to be administratively efficient as a result of their extreme simplicity, having only one tax rate that needs to be administered.

Edwards' (2006) final cost of a complicated tax system is that it increases the likelihood of error by the taxpayer or by the collection agency, and also provides incentives for tax avoidance. Taxpayers may actively seek out ways of manipulating the many rules and regulations of the tax code to their own advantage. Edwards cites the Enron scandal as an example of such "aggressive tax avoidance", as he calls it (Edwards, 2006: 2).

Gelfand (1958) argues that progressive taxation provides both the motive for tax avoidance (because high-income earners resent the fact that they have to hand over a larger portion of their incomes than others) as well as one of the principal means for avoiding taxes. In the United States, it is acknowledged that a great deal of revenue is lost each year through tax avoidance (Goetz, 1976; Clotfelter, 1983 and Feldstein, 1999).

The South African system also lends itself to abuse, as taxpayers can reduce tax liability by "taking advantage of loopholes in the Income Tax Act" (Jordaan, Boonzaier and Troost, 1988: 1). One strategy to reduce tax liability, which Gelfand (1958: 105) calls "fractioned income", exploits the weaknesses of the progressive system. In short, "fractioned income" involves one or both of two tactics: either "splitting income among related entities or deferring income to another period when the marginal tax rate is expected to be lower" (Gelfand, 1958: 105).

A proponent of a flat-rate tax system would argue that fractioning income is entirely due to the progressive nature of the current tax system. Under a flat system, all taxable units will be taxed equally, so no income-splitting would have to occur. Furthermore, there is no need to defer income to another financial year because all levels of income are taxed at the same flat rate. It is

likely to be those citizens with the highest incomes who are best able to exploit the complexity of the tax system, as they are the ones who can afford to employ tax specialists.

Slemrod and Yitzhaki (1985) note several possible solutions to the problem of non-compliance. They claim that changing the tax law to reduce incentives and opportunities to avoid taxes is one possible response, but show that the state could also increase the size of the tax collection agency or increase penalties for tax evasion. These alternatives would result in additional administrative costs, however. Thus the policy-maker should determine all the possible effects of tax reform and adopt “an integrated approach to the optimal government policy” (Slemrod and Yitzhaki, 1985: 14). The flat tax might therefore not be the best solution to this problem, as there are other possibilities – however, its simplicity indeed appears to be attractive.

It is important to note that the results of studies of tax avoidance must be interpreted with some caution. Economics is unlike other sciences in that experiments with different policies are impossible to perform unless the policy is actually implemented. These studies have used data from progressive tax systems to reach their conclusions – however, it is quite possible that tax avoidance would be just as prevalent under a flat tax system.

For instance, Bankman and Griffith (1987) make the important point that deferral of income would probably occur under any tax system, because deferral provides benefits to individuals (and losses to the state) due to the time value of money. Although a progressive rate structure may increase the advantages of deferral, the latter is “valuable independent of the rate structure” (Bankman and Griffith, 1987: 1937).

It is therefore impossible to say with certainty what the effects of adopting a flat tax will be until one has been introduced in reality. However, it seems reasonable to claim that progressive taxation appears to provide more incentives to avoid taxes, mainly because splitting income will not provide any advantage under proportional taxation.

The Argument from Economic Incentives

The third and final type of argument that is often advanced for a flat tax is that it creates better economic incentives than a progressive system. Supporters of this view claim that progressive taxation provides disincentives to work and impediments to capital formation. This therefore reduces labour supply and inhibits production and economic growth.

Economists generally agree that there is a trade-off between equity and efficiency in taxation (Black, Calitz and Steenekamp, 2003; Myles, 1995). A redistributive system such as progressive

taxation may lead to greater equality of holdings of wealth, but it comes at the cost of economic growth because of its inherent disincentive effects. It may be that the costs to society of lost productivity and inhibited economic growth are not worth the reduced inequalities and perceived fairness resulting from progression.

This trade-off is studied in detail in Browning and Johnson (1984: 175), who find that “income redistribution is not a socially costless endeavour”. They find that the costs of reducing income inequality through redistribution are “surprisingly high” (Browning and Johnson, 1984: 201), and note that their investigation considers only the effects of redistribution on labour supply, ignoring other possible costs such as the administrative and compliance costs discussed previously. Auerbach, Kotlikoff and Skinner (1981: 2) find that even a small degree of progression “imposes a very large efficiency cost” in comparison with an equal-revenue proportional tax. Thus there may be an argument against progression in terms of inefficiency.

Blum and Kalven (1953) note that this disadvantage of progression has received a great deal of attention by economists. They point out that many of the theorists that support progression, such as Carver (1895) and Pigou (1947), recognise the adverse effect of progressive taxes on productivity as a shortcoming of the system. For Blum and Kalven, there are two separate factors that contribute to the lessening of incentives for production.

The first such factor is that “a minority of the population” who are “likely to be of special importance economically” will be subject to disproportionately high taxes (Blum and Kalven, 1953: 21). In short, a progressive tax will curtail the production of precisely those individuals who are able to put capital to the best use, having the resources needed for productive investment opportunities. This principle may be likened to the Biblical parable of the talents (Matthew 25: 14-30), in which the servant who proves himself to be the most able to produce is entrusted with the greatest quantity of talents.

The second factor that Blum and Kalven identify is that accelerating marginal tax rates will reduce work effort. This is because workers are likely to think in terms of costs and benefits when deciding how much time and effort to expend on their labour. With progressive taxation, the ratio of rewards to costs decreases with higher levels of income, so workers supply less labour than they would under a flat tax system.

Several scholars have attempted to demonstrate the effect of progressive taxation on the labour supply. In an early study, Break (1957) interviews 306 solicitors and accountants in London,

selected at random, asking them questions to determine to what extent progressive taxation affects their economic decisions.

One feature of this study must be carefully noted. The subjects are all workers “whose business commitments to others... were sufficiently limited and flexible to allow a good deal of freedom of action” (Break, 1957: 548). Of course, it makes no sense to attempt to demonstrate a disincentive effect among workers whose hours of work are fixed and who cannot realistically change their labour supply in response to a tax.

Furthermore, many members of the workforce are in the middle of an income tax bracket, so progression may play no role in their decisions because additional hours of work may not push them into a higher bracket. Only workers whose additional supply of labour would result in a higher marginal tax rate can truly experience the full disincentive effects of progression. Thus subjects of such surveys must be chosen with care, and Break’s choice of respondents seems to meet these criteria.

Contrary to expectations, his results fail to show the existence of a strong disincentive effect. Although his respondents made “a chorus of complaints, vehement and eloquent” against the evils of high and progressive taxation, these complaints seldom resulted in changes in their behaviour (Break, 1957: 548). It was found that the workers continued to provide, on average, the same hours of work despite their professed antagonism toward progressive taxation. However, Break notes that this antagonism may be translated into less productive work as employees, though they work the same number of hours as before, put less effort into their work as a result of the high taxes. This effort is difficult to measure accurately.

The reason for this result may be that the income effect of earning more money through more hours of labour dominates the substitution effect that leisure becomes cheaper at high marginal tax rates. These workers continue supplying labour because the tax rate is not high enough to discourage them, although they lament their loss of income. Bankman and Griffith (1987) explain that workers may value income so highly that even a steeply progressive tax will result in little or no effect on their labour supply.

In fact, higher tax rates might even result in greater labour supply because workers desire to maintain a given lifestyle and level of consumption (Break, 1957). Thus they will work more hours in response to a tax that reduces their disposable income in order to obtain the same after-tax income as before. It is therefore not so obvious that progressive taxation will necessarily result in a lower supply of labour than a different tax system.

Grubel and Edwards (1964) adapt Break's survey to attempt to determine to what extent tax considerations influence the decisions of young men in choosing a profession. If progressive taxation plays a major role in determining what career young workers will follow, it may reduce "the supply of bright young people into the socially valuable high-risk and high-return entrepreneurial professions" by reducing the returns involved while leaving the risks unchanged (Grubel and Edwards, 1964: 158).

This is clearly a disincentive effect on the labour supply. However, none of Grubel and Edwards' subjects list progressive taxation as a factor influencing what career they would choose, leading them to conclude that tax considerations do not have a significant effect on choice of profession.

Apart from conducting interviews, Bankman and Griffith (1987) note three other ways of estimating the effect of taxes on labour supply: cross-section studies, controlled experiments and time-series studies. In each case the problem amounts to estimating the compensated elasticity of the labour supply (Bankman and Griffith, 1987). The higher the compensated elasticity, the greater is the effect of the wage rate on work effort and, therefore, the greater the disincentive effect will be ("individuals will work fewer hours if their effective wage rate is reduced by an income tax", Bankman and Griffith, 1987: 1921).

In a comprehensive survey of twenty-one studies that attempt to estimate the compensated elasticity of the labour supply, Bankman and Griffith (1987: 1923) find that these estimates "cluster around a reasonably narrow range". Most of the studies put the compensated elasticity of the labour supply for males (which Bankman and Griffith recognise as the main wage-earner group) between 0.1 and 0.3. These figures imply that a 10% decline in wages because of a progressive income tax will be translated into a decrease in labour supply of between 1% and 3%, which is relatively small. From this, Bankman and Griffith (1987: 1924) conclude that work is "conditioned more by social forces" than by wages – therefore, the predicted disincentive effect of progressive taxation does not appear to be large.

Some later studies confirm this result. Using a detailed econometric analysis, Triest (1990) reaches the conclusion that the labour supply of men is invariant to changes in tax rates. Moffitt and Wilhelm (1998) estimate the effect of the 1996 American Tax Reform Act, which significantly reduced marginal tax rates for the wealthy, on the labour supply of high-income men. They find that there is no responsiveness to this reduction.

In his survey of the literature, Feldstein (1995) also states that the majority of earlier studies find that the working hours of men are not responsive to changes in tax rates. However, Feldstein adds the important warning that labour supply should not be seen as being identical with hours worked. Instead, “the amount of ‘labo[u]r’ that an individual supplies depends also on the intensity of work effort, the nature of the occupation, the assumption of risk and responsibility” and similar factors (Feldstein, 1995: 5).

Feldstein points out that all these other factors can also be affected by changes in tax rates. It is therefore incorrect to claim that there is no responsiveness of labour supply to tax changes simply because working hours remain constant with the imposition of a tax. Hours of work are an incomplete measure of labour supplied, because a worker may, for example, work the same hours but put less effort into his job as a result of steeply progressive taxes. Thus these results should be interpreted with some caution.

Importantly, several of the studies show that the labour supply of *women* is responsive to changes in tax rates. Hausman and Ruud (1984) point out that, especially among married couples, labour supply behaviour is very different among women than among men. Bankman and Griffith (1987) find that twelve of the fourteen studies that they review estimate the compensated elasticity of labour supply of women above or near 1. Later studies by Triest (1990) and Feldstein (1995) confirm this result, though Triest claims that his conclusion depends critically on the method used to estimate the labour supply function.

Bankman and Griffith (1987) also note that the labour supply of elderly people is found to be responsive to changes in tax rates. Both the elderly and women face “social indifference or disapproval” when they choose to enter the workforce, according to Bankman and Griffith (1987: 1926). As a result, they will do so only when the economic rewards are high.

Furthermore, Bankman and Griffith claim that the work that these individuals take is often part-time, enabling them to exit easily – thus they may have greater opportunities to respond to tax changes than men, who generally have little flexibility of hours and work primarily to gain social approval. Thus one could argue that greater economic efficiency could be attained by providing tax relief to these groups, such as a reduction in taxes for retirees and married women who take on part-time jobs.

A study by Carroll, Holtz-Eakin, Rider and Rosen (1998b) shows how progression may also affect labour from the demand side. They investigate how tax rates influence entrepreneurs’ decisions to hire more labour and find that, when the entrepreneur is taxed at high rates, he is

less likely to hire labourers. Furthermore, the study reveals that “taxes on high-income entrepreneurs may be shifted in part to lower-income employees” (Carroll *et al.*, 1998b: 25) through lower wages.

The progressive tax therefore provides a disincentive to job creation and simultaneously fails to achieve its goal of redistribution if the tax is shifted by entrepreneurs to their workers. However, the study does not show whether this effect is due to the progressive rate structure or simply because of high tax rates in general.

Gentry and Hubbard (2002) investigate the effects of progression on job turnover. In their study, they show that workers are unlikely to engage in activities to search for better employment because progression taxes away many of the benefits that could be obtained if the job search is successful. Thus these workers will simply stay in their current employment, where they may be under-employed. This is a further disincentive cost of progression.

It seems as though a flat tax is not necessarily the most effective way of increasing incentives to work. Levitt (1964), for instance, shows that, under certain conditions, a progressive tax could result in more labour supply than an equal-yield proportional tax. The literature does not, therefore, seem to provide overwhelming evidence that a flat tax would increase economic incentives. Similarly, there do not appear to be good reasons for thinking that progressive taxation causes serious disincentives to work. It is not clear that the disincentives that do exist are necessarily caused by progression – they may, instead, be caused by *high* tax rates.

Apart from its predicted effect on the labour supply, some scholars believe that progressive taxation discourages savings and investment. A study by Engen and Gale (1997) shows that a proportional tax would encourage savings compared to a progressive one. Carroll, Holtz-Eakin, Rider and Rosen (1998a) find that tax considerations, especially high tax rates, play a significant role in entrepreneurs’ decisions to invest in new capital. In a later, related study, the same authors find that the growth rates of entrepreneurs’ businesses are also inhibited by high tax rates (Carroll, Holtz-Eakin, Rider and Rosen, 2000). These effects can reduce economic growth for the entire nation, if the growth rate depends on investment and capital formation.

This type of argument attempts to negate the redistributive benefits of a progressive tax. It has been shown that progressive taxation achieves redistribution far more efficiently than proportional taxation (Saez, 2002). However, if progressive taxation inhibits economic growth, it may well be that the poorest members of society would have more resources under a flat tax than under a progressive one.

Then, even if there is a large degree of inequality, the flat tax is clearly preferable because GDP is higher and the poor have more wealth. The benefits from increased economic growth may well outweigh the costs of greater inequality. Altig and Carlstrom (1994) provide support for this argument, finding that a system with fewer tax brackets is far more conducive to economic growth, efficiency and welfare than a system with many brackets.

It is once again not clear whether these effects are due specifically to progression or simply as a result of high tax rates (whether progressive or flat). Milesi-Ferretti and Roubini (1995) point out that any taxation of factor incomes reduces economic growth. Thus care must be taken in interpreting these results.

There is also evidence that progressive taxation discourages people from becoming entrepreneurs in the first place. Cullen and Gordon (2002) show theoretically that the treatment of profits and losses via a progressive rate structure has the potential to discourage entrepreneurship as individuals prefer low-risk, fixed salaries. Their empirical investigation into this phenomenon finds that this type of disincentive effect of a progressive tax is large. However, one could argue that this problem could be combated by providing tax subsidies to entrepreneurs – a flat rate system is not the only possible solution.

A further result of a progressive income tax is that it fosters the use of tax shelters. Blunden's (1895: 528) discussion of two centuries ago recognises this point, claiming that high-income citizens are best able to avoid the payment of a progressive tax as "[t]heir incomes are often drawn through secret channels from diverse and distant sources, of which the most vigilant assessors can have no suspicion". Progressive tax rates shift productive investment into areas where lower tax is payable, and this may be inefficient.

Hall and Rabushka (1995) as well as other scholars listed in Bankman and Griffith (1987) highlight the point that progressive taxation leads to capital flight. Bakija and Slemrod (2004) find that individuals in America often change their state of residence in order to avoid high state taxes. Kirchhof (2005: 55) laments the capital flowing out of Germany to low-tax countries like Slovakia, claiming that Germany's high taxes put it at a disadvantage as a business location". Sadly, it is the high-income earners who have the resources required to shift their income into tax shelters, and this reduces the success of a progressive system as a means of redistribution.

Bankman and Griffith (1987) claim that this argument is defective. Firstly, they point out that "[d]uring the last twenty years, the top marginal rates have declined dramatically" (Bankman and

Griffith, 1987: 1940) without a corresponding decrease in the use of tax shelters – instead, studies show that there has been a significant increase in tax shelters. Thus it is not clear that there is a strong relationship between progressive taxation and tax shelter investments.

Secondly, Bankman and Griffith note that the cause of tax shelter activity is more likely to be high marginal rates than progression. It is difficult to separate the effect of high tax rates from the effect of a graduated rate structure, and the level of tax shelter activity could well be the result of the former rather than the latter. This is a defect common to all the arguments that progression limits economic activity – instead, it may be the level of tax rates that provides disincentives, not the mere fact that a progressive system is in place.

Other studies confirm the view that high tax rates inhibit economic growth. Many authors attempt to determine the optimal tax system and find that tax rates should be lower than they are. The pioneering study in this field is that by Mirrlees (1971) who uses optimal control theory to arrive at an optimum income tax schedule. He finds that the desirable tax schedule “depends on the distribution of skills within the population” and on society’s “labour-consumption preferences in such a way that it is impossible to say whether marginal tax rates should be higher for high-income, low-income or intermediate-income groups” (Mirrlees, 1971: 186). Thus Mirrlees finds little empirical reason to support either progressive or proportional taxation.

However, Mirrlees does find that an optimum income tax should have low rates – he confesses that he “had expected the rigorous analysis of income- taxation... to provide an argument for high tax rates” but that “[i]t has not done so” (Mirrlees, 1971: 206). Instead, he shows that optimality demands lower rates than expected. This provides evidence for the view that it is primarily high tax rates - not progressive taxes - that inhibit economic growth.

Despite claims that progressive taxes can limit economic growth through their effects on labour supply and incentives to form capital, there appears to be little conclusive empirical evidence that this is indeed true. The results of studies are ambiguous and are not without their defects. Although disincentives certainly exist, it is not certain in what degree and measure these are the results of progression – instead, they could well be caused by other factors such as high tax rates.

As such, the existence of disincentives does not provide an uncontroversial reason to adopt a flat tax. However, it may be the case that a flat tax provides further incentives for saving, labour supply, capital formation and economic growth that are not present under a progressive system. These possibilities need to be studied further. One way of doing so is to examine the experiences of the various countries that have, so far, adopted a flat tax.

4. THE FLAT TAX PIONEERS

To date, thirteen countries have adopted some type of flat tax system. The flat tax systems that have been adopted are all characterised by a single positive marginal tax rate on personal income and some kind of allowance, such as a minimum exemption level. Of course, the tax rate and allowance differs between these economies. The table below is a summary of the different flat tax countries with their tax rates before and after the reform as well as the year in which the flat tax was implemented¹:

Table 1: The Flat Tax Pioneers

Country or region	Year in which flat tax was adopted	Personal income tax rates before reform	Current flat tax rate
Jersey (UK)	1940	10% to 40%	20%
Hong Kong	1947	2% to 20%	Optional 16%
Guernsey (UK)	1960	10% to 40%	20%
Estonia	1994	16% to 33%	26% ²
Lithuania	1994	18% to 33%	33%
Latvia	1997	25% to 10% ³	25%
Russia	2001	12% to 30%	13%
Serbia	2003	N/A ⁴	14%
Ukraine	2004	10% to 40%	13%
Slovakia	2004	10% to 38%	19%
Iraq	2004	Up to 45%	15%
Georgia	2005	12% to 20%	12%
Romania	2005	18% to 40%	16%

The table shows that all the flat tax economies with the exceptions of Latvia and Lithuania were able to implement their flat tax at a lower rate than the highest marginal rate that existed before the reform. Georgia's flat tax rate is equal to the lowest pre-reform marginal rate, resulting in a considerable tax cut for most citizens, while Romania set its flat tax rate at an even lower rate

¹ This table is adapted from data and similar tables given in *The Economist* (April 14, 2005: 70), Grecu (2004), Keen, Kim and Varsano (2006: 6), Mitchell (2003) and Teather (2004: 1).

² Estonia first set its flat tax rate at 26% but it has since been reduced to 23% at the time of writing, with a further reduction to 20% planned for 2009.

³ Before the 1997 reform, Latvia had a regressive tax schedule with a 25% marginal rate levied on low incomes and a 10% marginal rate levied on the highest incomes!

⁴ Serbia did not exist as an independent country before reform, being part of the old Yugoslavia.

than the lowest rate before the reform. On the face of it, therefore, the change to a flat tax was generally accompanied by a lowering of rates for the wealthiest citizens.

While a detailed examination of the experiences of these thirteen countries is a subject for further research and beyond the scope of this paper, two important points should be noted. Firstly, we may divide the flat tax pioneers into two main categories – there are the first world island economies of Jersey, Guernsey and Hong Kong. These islands have small populations and have traditionally been used as tax havens by investors all over the world. In contrast, we have the former communist economies that have recently converted to a free market. South Africa cannot be placed in either category, which means that comparisons between the countries must be undertaken with caution.

Secondly, the literature reveals that all the Eastern European countries have experienced significant economic growth since the adoption of the flat tax (Keen, Kim and Varsano, 2006). However, this may well be due to other factors such as their conversion to capitalism or the lowering of the tax rates. Furthermore, the implementation of a flat tax rate has been only one component in an extensive reform of the tax system in most of those countries. For example, the Russian and Slovakian flat taxes were accompanied by a dramatic revision of the welfare system (Ivanova, Keen and Klemm, 2005; Keen *et al*, 2006) and it is difficult to consider the effects of the flat tax on these economies in isolation.

Despite these two considerations, however, there are eight lessons that may be learned from the experiences of these countries, according to Keen *et al* (2006):

The first point is that, in countries where the flat tax rate is low, the tax reforms have been associated with a reduction in revenue collections from personal income tax. Russia is the exception to this trend, but Keen *et al* claim that its increased revenue is due to other macroeconomic factors. Thus it would appear as though the state will need to sacrifice some revenue in order to implement a flat tax. However, as Hall and Rabuska (1995) note, a tax system may be designed so as to be revenue neutral by adjusting the tax rate so that it will collect the same amount of revenue as the present system – but this may involve a flat tax rate that is too high to be desirable.

Secondly, the flat tax systems are generally associated with increased compliance – especially in Russia (Keen *et al*, 2006). Since a flat tax removes incentives to avoid taxes through loopholes in the tax system, this may be a reason for this effect (especially among the highest income groups). The South African economy will certainly benefit from reduced tax evasion and avoidance.

However, there is not enough evidence to say with certainty that increased compliance is due to the flat tax – it may, instead, be a result of better enforcement by the tax authorities (Keen *et al*, 2006).

The third lesson is that there is no evidence that the flat tax systems have improved labour supply (Keen *et al*, 2006). There has been only one study (that of Ivanova *et al*, 2005) that examines labour supply responses to tax changes in these countries that is based on empirical evidence. Even though future studies might have different findings, it appears far from certain that the flat tax provides incentives to work. If the goal of adopting a flat tax in South Africa is to reduce unemployment, it seems as though this will be unsuccessful.

Keen *et al* make the fourth point that the distributional effects of moving to a flat tax are not certain. In some countries, the flat tax seems to increase progressivity via its effects on compliance and benefits to the lowest incomes. In fact, Keen *et al* note that most of the studies of the effects of the flat taxes show that they do actually increase progressivity. However, there are several complexities involved in estimating what the likely distributional effects of the flat tax should be.

Because the Eastern European countries that have adopted the flat tax were all previously communist countries, an ideology of common property and community was supposed to have been instilled in the population. A progressive tax is consistent with the communist worldview that property should be communal, because it takes more from the wealthy to redistribute it to the poor. In contrast, the flat tax seems to attach more importance to property rights, as it allows each citizen to keep the same proportion of her income. Thus the adoption of the flat tax supports the move toward capitalism by these countries and heralds a new attitude toward distribution.

This notion is captured in the next point that Keen *et al* make: the flat taxes have been adopted by countries that are “anxious to signal a fundamental regime shift, toward more market-oriented policies” (Keen *et al*, 2006: 37). In these cases the flat tax is used partially to indicate that the state is committed to free markets and property rights, in contrast to the communist past that these countries have experienced, and this is responsible for a great deal of its appeal to the general public. However, this may not be the case in other countries “[w]here no such reputation needs to be acquired” on the part of the government (Keen *et al*, 2006: 37).

It is certain that, given South Africa’s history of unequal distribution of resources among its population, the flat tax may not receive universal support from South Africans. Progressive

taxation may well be seen as an important policy measure to right past wrongs. Furthermore, a central aspect in the African philosophy of ubuntu is that community is more important than the individual.

As summarised by Desmond Tutu, the concept of ubuntu is the belief that “a person is a person through other people” (Tutu, 1999: 35) and people demonstrate ubuntu by sharing what they have. Certainly, progressive taxation forces people to share more of what they have than a flat tax system, provided the tax revenue is used for redistribution. A government that is committed to the principles of ubuntu and that wishes to show its desire to help the poor should perhaps adopt a progressive tax system instead. Of course, it is not obvious that the South African government does wish to acquire such a reputation, but it is reasonable to think that a flat tax might be criticised by some sectors in society who would like to see ubuntu in practice.

The sixth point that Keen *et al* make is that the flat rate is not solely responsible for greater simplicity in the tax code after the reforms in these countries. It is acknowledged that a flat tax eliminates practices such as income shifting that take advantage of a progressive rate structure to reduce tax liabilities, but the authors point out that much of the complexity in tax systems is due to exemptions and deductions, as well as other factors. This means that greater simplicity can be achieved through other means too, so the flat tax should not be seen as a miracle solution to complexity. For successful tax reform, the South African policy-maker should therefore investigate several possible ways of simplifying its tax code.

Keen *et al* emphasise the importance of removing exemptions in their seventh observation. They claim that the elimination of these exemptions and deductions has broadened the tax base significantly in many countries, notably in the Ukraine, and that this has increased tax revenue considerably. Furthermore, removing exemptions contributes to greater horizontal equity.

Finally, Keen *et al* claim that there is some evidence that the automatic stabilisers have become more effective in the flat tax countries than they were before. This is contrary to the argument that progressive taxes automatically stabilise the economy, and further weakens the case for progressive taxation on those grounds. However, this hypothesis has not been studied empirically, so it should not be taken as true.

One further point is worth noting. Some of the developed countries that are considering the introduction of a flat tax, such as France, Germany and Spain, are doing so not for greater simplicity or to increase economic incentives, but to become more competitive as business

locations. The German proposal is summarised by Kirchhof (2005) who makes the point that Germany is losing investment to the flat tax countries as capital moves to lower-tax countries.

This point appears to be an important one. A study by Klassen, Lang and Wolfson (1993) finds evidence that global, multinational corporations routinely shift income to low-tax countries in order to reduce their tax bills. In an era of increased globalisation, competitive tax rates are becoming more and more essential to attracting foreign investment. However, there is no reason why a simple lowering of high marginal rates in a progressive system cannot achieve the same goal.

It seems as though all the flat tax economies have grown quite impressively and that their implementation of the system has been successful up to now. However, the recurring theme of this section has been that one cannot isolate the effect of the flat tax, as all the tax reforms that have been discussed were comprehensive, with the flat tax being only one aspect in a thorough revision of the tax system. It should not be concluded, therefore, that the flat tax is the sole reason for these countries' successes.

Contrary to predictions by flat tax theorists, there has been no marked increase in labour supply in these countries following the tax reform. Thus there appears to be no significant incentive effect associated with the flat tax. However, one may nevertheless conclude that, firstly, the improved compliance following the flat tax (perhaps because of its greater simplicity) is an advantage to any economy and, secondly, that tax competition is important in the global economy. Together with reduced administrative costs of collecting this tax, it may have enough advantages over the current system to be implemented in South Africa.

5. CONCLUSION

This paper has presented a detailed discussion of the various arguments that have been advanced for and against progressive taxation, as well as for its alternative, the flat tax. It seems as though progressive taxation cannot be defended on the grounds of benefits received, sacrifice theory or stability – however, its redistributive advantages cannot be denied. Thus the only serious defence of progressive taxation is that it redresses economic inequalities.

In opposition to this are the arguments for a flat tax system. The argument from political responsibility seems to be unimportant, but the flat tax does indeed have the advantage of simplicity over its rival. As far as the argument that the flat tax will increase productivity and boost economic growth goes, however, the empirical evidence has been mixed and inconclusive.

Any incentive effects on labour supply, saving and investment seem to arise from lower tax rates rather than from flat rates. Thus a gradually progressive system where the top marginal rate is low may have greater incentive effects than a flat tax with a higher rate. As a result, the flat tax is probably best defended on the grounds of its simplicity.

The question whether the flat tax would be successful in South Africa has not yet been answered in this paper. Tax reforms have taken place at regular intervals in our history, but the principle of progressive taxation has never been questioned. Instead, the South Africa reforms have implemented base-broadening measures and altered the progressive rate structure and the number of brackets. However, this paper has shown that there are some good arguments for taking the challenge of the flat tax seriously. Further research still needs to be done on what the likely effects on the South African economy might be, and certain methods such as the computerised general equilibrium approach or econometric time-series analysis could be used for such a quantitative analysis. Such research may well find that a flat tax might greatly improve economic growth and that the old warhorse of progressive taxation should be displaced by a better candidate, but the question still needs to be settled.

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