Compounding Errors: Why Heightened Regulation and Taxation Are Bad Antidotes for Recessions and Income Inequality

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The current concerns with laggard growth and income inequality have led to a widespread set of demands for more regulation and higher taxation to reverse the trend. These two approaches move matters exactly in the wrong direction. The correct response is to find ways to reduce tax burdens and barriers to entry, and to reduce the political uncertainty associated with new government measures. It may well be too late, worldwide, for a substantial rollback in the welfare state. But the current proposals will only prolong the dismal results on both fronts in any arena in which they are tried.

Introduction

There is little question today that the two greatest challenges on the contemporary legal and economic scene are the efforts to combat recession and inequalities of income and wealth. These two issues do not know any clear jurisdictional boundaries, for they arise in virtually all Western democracies that work within the general social democratic tradition, which is to say all Western democracies. To be sure, these countries all have different local institutions, laws, and practices, so that there is no easy transfer of insights or solutions from one area to another. Yet, as so often happens with comparative questions, it is too easy to stress the differences and to ignore the similarities across these legal

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Citation: 17 Theoretical Inquiries L. 711 (2016)

systems. The point is not only true with respect to standard private law issues, but also with respect to larger questions of social planning and control that all modern societies must face. Many of these matters are handled by legislative or administrative means, which can easily be copied in one jurisdiction from schemata developed in another. It is also the case that the basic intellectual disputes that help determine the direction of policy are now conducted on a global level, much of it in English, and much of it on the web, so that the transmission of ideas, both good and bad, takes place in record time.

These conditions hold here, and in my brief stay in Israel it was clear that policy discussions were couched in language that is common in the United States and the European Union. I do not know that much about the particular parties involved in Israel, but have consulted on some major policy statements that have come out of the OECD. Many of the examples that I use come from the United States. These often refer to actions at the state level, which in a federal system allows for comparisons of performance across state lines within the larger union. The point is critical because one of the best ways to discipline government is through the exit option that is far easier to exercise within a federalist system than in the international arena.

A quick survey of some of the responses indicates that common mode failures have produced generally unsatisfactory results. The unsuccessful responses to challenges of slow growth and income inequality are all too evident in the European Union, where growth has stagnated for years, bringing with it the massive dislocations from prolonged unemployment, not to mention the imminent exit of Greece from the European Union. In these situations, the most vulnerable are hurt the most. The situation is much the same in Japan, where the flickering signs of economic progress are quickly snuffed out by another round of high taxes and protective tariffs. In the United States, the overall numbers are somewhat better than they are in the European Union, but the declining rates of labor market participation coupled with the increase in part-time employment and persistent wage decline tell much the same story. The median income (inflation adjusted) in the United States has fallen about nine percent from its 1998 high ($56,000) and eight percent from its 2007 prerecession peak ($55,500) to about $52,000 in 2013, notwithstanding sustained efforts to reverse that trend.[1] The average rate of growth in labor productivity in the United States is about 1.4% since 2007, compared to 2.6% for the previous seven years.[2]

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1 Carmen DeNavas-Walt, Bernadette D. Proctor & Jessica C. Smith, U.S. Census Bureau, Income, Poverty, and Health Insurance Coverage in the United States: 2012 (2013), http://www.census.gov/prod/2013pubs/p60-245.pdf.

2 *Labor Productivity and Costs*, U.S. Bureau of Labor Statistics, http://www.bls.gov/lpc/prodybar.htm (last visited Aug. 17, 2015).

The rate of formation of new businesses is down by about twenty percent since 2007, with only tiny gains in 2013.[3] The period of formal recession has been left behind. The period of the no-growth non-recession is here with us, perhaps to stay, and so too the problem of income inequality.

The current situation is undesirable in the long run, and the question is how best to attack it. In Part I, I make the case for market liberalization as the best way to undo the logjam. In Part II, I examine the dangers of high taxes and extensive regulation. In Part III, I challenge the dangerous optimism that political institutions can reach some optimal level of redistribution through coercive redistribution. Part IV then looks at some of the empirical evidence that casts a negative light on that coercive redistributive process.

I. The Need for Market Liberalization

Situations like this call out for prompt remedial action. The burning question is the form it should take. The antidote to this situation is in my view a reduction in the barriers to effective trade within and across countries. This requires undoing most of the new taxes and regulations put in place over the last five or ten years. The explicit assumption for this program is that the additional taxes and regulations impede the robust competition in markets for goods and services that offers the surest road to economic expansion. The argument here depends on no novel conclusion, but merely rests on the view that the highest level of social output comes from competition, rather than monopoly, which raises prices, reduces output, and creates social losses. In general, it is important to make sure that selective systems of taxation and regulation do not create the monopolies that competition policy in Europe and antitrust policy in the United States seek to avoid. There is no reason to deviate from this desirable framework in developing a sensible response to the challenges of recession or inequality.

Growth in all cases turns out to be the key, with huge consequences from keeping output growth at 2.6% as opposed to 2.0%.[4] It is hard to think of

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3 *Business Employment Dynamics*, U.S. Bureau of Labor Statistics, http://www.bls.gov/bdm/entrepreneurship/entrepreneurship.htm (last visited Aug. 17, 2015).

4 Since the 2007 U.S. downturn, keeping yearly output growth at 2.6% would have led to a 26% increase in productivity, relative to a 19.5% growth level at 2% yearly output. That extra 7.5% works out to an increment of about 1.35 trillion dollars in the final year (using 2015 real GDP numbers). *See Current-Dollar and "Real" GDP*, U.S. Bureau of Economic Analysis, http://www.bea.gov/national/index.htm#gdp (last visited April 10, 2016). The wider the gap, the greater the cumulative differences.

a system of transfer payments that could do better with a far smaller base. Lower administrative costs and higher growth should prove to be a winning combination. On this view, we should look with suspicion at any program that raises transaction costs or otherwise pushes us further from the competitive equilibrium. High taxes and regulation, much of which are intended to prop up cartels in labor and agricultural markets, should be regarded as serious mistakes and removed whenever possible.[5] The point of all government intervention should be to encourage positive-sum social projects, which typically arise by the creation of public goods that ordinary private transactions cannot create.[6] Under this view, those forms of taxation that facilitate the creation of public goods are welcomed. So long as the benefits of a particular tax exceed its costs, it will not dampen private incentives to create. Indeed, to the extent that the public expenditures offer at the margin higher rates of return than can be had by private investment, they should stimulate production and growth. Regulation, always a close substitute for taxation, should be evaluated through the same lens: encourage it when it corrects for market failures, but be suspicious of it when it does not.

Yet this view is very much in retreat, as the current view is that increased levels of taxation and regulation are the best way to shake slow economies out of their lethargy. That view is strongly championed by the OECD in its recent publication, *In It Together: Why Less Inequality Benefits All*.[7] In this Article, the preferred remedies for ending inequality consist of a set of interventionist prescriptions that cannot be made operational without massive government control. These include policies that are intended to increase the role of women in economic life; to encourage widespread employment in top-quality jobs that are stepping-stones to better careers; to increase the level of education with early childhood development; and to develop an efficient

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5 *See* Agricultural Adjustment Act of 1933, Pub. L. No. 73-10, 48 Stat. 31 (enacted May 12, 1933); Agricultural Adjustment Act of 1938, Pub. L. No. 75-430, 52 Stat. 31 (enacted Feb. 16, 1938). These two statutes were challenged in the recent Supreme Court decision in *Horne v. Dep't of Agric.*, 135 S. Ct. 2419 (2015). For an estimate of the welfare losses, see Harold L. Cole & Lee E. Ohanian, *New Deal Policies and Persistence of the Great Depression: A General Equilibrium Analysis*, 112 J. Pol. Econ. 779, 781 (2004) ("Our main finding is that New Deal cartelization policies are a key factor behind the weak recovery, accounting for about 60 percent of the difference between actual output and trend output.").

6 The standard reference on the point is still Mancur Olson, The Logic of Collective Action (1965).

7 OECD, In It Together: Why Less Inequality Benefits All (2015), http://www.keepeek.com/Digital-Asset-Management/oecd/employment/in-it-together-why-less-inequality-benefits-all_9789264235120-en#page1.

system of wealth-transfer programs. The notion that these programs benefit all, including those who are net losers, rests on the dubious proposition that the indirect benefits of these initiatives will be positive, even if the programs themselves will further reduce output. But growth is not the object of this program. Neither is knocking down barriers to entry, saving on administrative costs, or providing better incentives any part of this one-sided picture.

In dealing with these issues, there is no examination of the source of the inequality, to ask whether it derives from the market naturally or from current regulatory policies that have increased the gap between winners and losers, thereby contributing to the inequality they are meant to control. The workers who get jobs over the minimum wage are now in the job market with prospects for advancement. Those who are kept out are shunted to the back burner, unable to acquire on-the-job skills that will facilitate the growth of their human capital. The point here is not to oppose initiatives that are directed to providing financial support, such as jobs programs, to spur the inclusion of underrepresented groups in the economy. Yet it is to say that these initiatives are likely to do a lot better when taken by private parties, rather than through state commands.

The former programs are likely to generate positive-sum games, because the participants will act in their own joint best interest. That conclusion holds even when the gains to one party come from the satisfaction seen in having other individuals better off, rather than from profit. The same cannot be said for the latter, where the transfer payments are forced on individuals who, especially when levels become high, regard them as antithetical to their own best interests. The OECD title — *In It Together: Why Less Inequality Benefits All*,[8] which declares that controlling inequality is in the interest of presumed universal benefits — takes a paternalist stance that is wholly inconsistent with the view of revealed preferences. It eases the path toward reform by making it appear that coerced transfers should be treated as Pareto improvements when they are not. It is always a mistake for any analyst to assume that all that matters is some programmatic social objective, not the parties who introduce it, or how it is implemented.

On this score, the contemporary concern with inequality goes hand in hand with a deep suspicion of private markets, and a strong plea for more government intervention, especially in labor, education, and housing. None of the modern foes of inequality champion deregulation or reduced taxation as a means to increase overall levels of economic opportunity. Nor, on the educational question, where the state role is substantial, do the contemporary critics support the expansion of charter schools — privately operated but

8 *Id.*

funded, at least in part, publicly — to improve educational opportunity. Their strong support for teachers' unions often stands in the way. Nor is there the slightest recognition that the expanding state role in taxation, regulation, and transfer payments may increase the inequality in wealth and income, by snuffing out opportunities for low-wage workers, for whom regulatory and tax compliance constitutes a larger fraction of their income. Indeed, on this score, it is clear that Israel and the United States do have one feature in common. They rank at or near the top in economic inequality: "The U.S. and Israel Have the Worst Income Inequality in the Developed World."[9] But at the same time, it is risky business to think that the stagnant French economy should be the model for developed nations.[10]

These general pronouncements on inequality in hard times have found a voice in the Obama administration, which drives and recycles much of the conventional wisdom that the best path out of the doldrums lies in such measures as stronger labor unions, increased minimum wages, and enhanced restrictions on foreign trade.[11] A similar note, stressing wage stagnation, is a

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9 *The U.S. and Israel Have the Worst Income Inequality in the Developed World*, Truth Dig (May 21, 2015), http://www.truthdig.com/eartotheground/item/the_us_and_israel_have_the_worst_income_inequality_in_the_developed_world_. For the critical counterpoint, noting the complexity in Israeli labor and educational markets, see Steven Plaut, *The Myth of Ethnic Inequality in Israel*, 21 Middle E.Q., Summer 2014, http://www.meforum.org/3839/israel-inequality.

10 *See, e.g.*, Paul Krugman, *What's the Matter with France*, N.Y. Times, Aug. 27, 2014, http://krugman.blogs.nytimes.com/2014/08/27/whats-the-matter-with-france/?_r=0. His tables, which show high levels of French growth, do not correspond to those reported by the World Bank, which reveal a growth rate for Great Britain that is seven times the size of France, driven in part by a contraction of its public sector. *See* Louis Rouanet, *Paul Krugman's Love Affair with France*, Mises Daily, Apr. 27, 2015, https://mises.org/library/paul-krugman%E2%80%99s-love-affair-france. Indeed, the job growth in Yorkshire exceeded that in all of France: "Between 2010 and 2013, the number of people employed in Yorkshire increased by 76,400 — while over the same period, employment in France increased by 66,000, data from Eurostat show." Emily Gosden, *Budget 2015: Yorkshire 'Created More Jobs Than France', Chancellor Claims*, Daily Telegraph, Mar. 15, 2015, http://www.telegraph.co.uk/finance/budget/11481637/Budget-2015-Yorkshire-created-more-jobs-than-France-Chancellor-claims.html.

11 For one expression of this view, see *Where Have All the Raises Gone*, N.Y. Times, Mar. 2, 2014, http://www.nytimes.com/2014/03/03/opinion/where-have-all-the-raises-gone.html?module=Search&mabReward=relbias%3Aw&_r=0. I have critiqued these proposals in Richard A. Epstein, *Why Income and Wealth Equality Cannot End Wage Stagnation*, 48 Creighton L. Rev. 1 (2014).

central portion of the Hillary Clinton presidential campaign.[12] This position has its strong supporters in the press,[13] and the same position is taken in many learned volumes, by such public intellectuals as Paul Krugman,[14] Joseph Stiglitz,[15] and Anthony Atkinson,[16] who think that high taxes on the rich, strong unions, high minimum wage laws, and strong government control over the economy offer the best way to get out of the current stagflation that grips much of the world. Needless to say prominent presidential aspirants such as Hilary Clinton[17] and Bernie Sanders[18] have rallied to the cause.

This mindset is also reflected in California's recent Fair Pay Act, effective January 1, 2016,[19] which essentially introduces a comprehensive form of public utility regulation for competitive markets by requiring "the employer

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12 *See* David Leonhardt, *Trying to Solve the Great Wage Slowdown*, N.Y. Times, Jan. 15, 2015, http://www.nytimes.com/2015/01/15/upshot/trying-to-solve-the-great-wage-slowdown.html?_r=0&abt=0002&abg=1.

13 *See* Nicholas Kristof, *Inequality Is a Choice*, N.Y. Times, May 2, 2015, http://www.nytimes.com/2015/05/03/opinion/sunday/nicholas-kristof-inequality-is-a-choice.html?_r=0. For my response, see Richard A. Epstein, *The "Income Inequality Warriors,"* Hoover Inst., Defining Ideas (May 19, 2015), http://www.hoover.org/research/income-inequality-warriors.

14 *See, e.g.*, Paul Krugman, *Economics and Inequality*, N.Y. Times, Jan. 8, 2016, http://krugman.blogs.nytimes.com/2016/01/08/economists-and-inequality/?_r=0. The point has an obvious political resonance.

15 Joseph Stiglitz, The Great Divide (2015) (defending higher taxes on the rich and corporations, investment in education, science and infrastructure, and steps to aid a return to full employment).

16 Anthony Atkinson, Inequality: What Can Be Done? (2015).

17 For one of many references, see Benjy Sarlin, *Hillary Clinton Slams Inequality in Populist Speech*, MSNBC, May 16, 2014, http://www.msnbc.com/msnbc/hillary-clinton-goes-populist ("Economists have documented how the share of income and wealth going to those at the very top, not just the top 1 percent but the top 0.1 percent, the 0.01 percent of the population, has risen sharply over the last generation . . . . Some are calling it a throwback to the Gilded Age of the robber barons.").

18 Bernie Sanders, *Income and Wealth Inequality*, Bernie 2016, https://berniesanders.com/issues/income-and-wealth-inequality/ (last visited April 8, 2016) ("The issue of wealth and income inequality is the great moral issue of our time, it is the great economic issue of our time, and it is the great political issue of our time.").

19 California Fair Pay Act, Cal. Lab. Code § 1197.5. For my critique, see Richard A. Epstein, *Rethinking "Gender Discrimination at Work,"* Hoover Inst., Defining Ideas (Oct. 5, 2015), http://www.hoover.org/research/rethinking-gender-discrimination-work.

to affirmatively demonstrate that a wage differential is based upon one or more specified factors, including a seniority system, a merit system, a system that measures earnings by quantity or quality of production, or a bona fide factor other than sex."[20] The California measure is one of many based on the belief that some form of pay equality is the best way to respond to pressing problems of income inequality. The statute notes, for example, that Latina women earn on average forty-four percent of the wages of white males, and then attributes the entire wage gap — $33,650,294,544 — to differentials driven by discrimination, as if the statutory defenses did not explain any portion of the wage gap in individual cases. No mention is made of the administrative costs or allocative distortions that a statute of this magnitude can impose. The law of unintended consequences is ignored, as the legislation is sold as the first step toward the restoration of a healthy economy, partly on the grounds of interpersonal equity and partly on the grounds that higher levels of wealth in the hands of low-income individuals will spur consumption, which in turn will drive economic growth under some form of trickle-up economics as per the conclusions of the OECD. The Keynesian prescriptions on recovery have been tightly fused with the concerns over income inequality.

I think that the full range of these interventionist approaches is deeply flawed in principle, and that their anti-market bias and dubious logic should be exposed and rejected. In order to make out the case against government intervention, I shall begin with some analysis of the *proper* role of both taxation and regulation, for it is all too easy to dismiss parties who are in favor of deregulation and lower taxation as scholars who favor no regulation and no taxation at all. But the correct position should strike at excesses in both areas, rather than simply ban both these government tools. I wish to shrink the current size of government because present governments are too large, not because there should be virtually no government at all. Put otherwise, I think that there is a clear theory that helps point to an *optimal* level of regulation, which should be set at far greater than zero. Accordingly, the conceptual frame that I outline in this Article does apply across time and national borders. But as to the particular prescription, I am only making the more *contingent* claim that currently, in all too many places around the world, there is far too much regulation and far too much taxation, both of which need to be curbed. In order to find out what counts as an "excess," it is important at least to give the broad outlines of a defensible theory of taxation and regulation.

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20 *An Act to Amend Section 1197.5 of the Labor Code, Relating to Private Employment*, Legislative Counsel's Digest, http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0351-0400/sb_358_bill_20150831_enrolled.htm (last visited Oct. 29, 2105) (referring to section 2 of the Act).

II. The Proper Scope of Taxation and Regulation

A. Taxation

For the purposes of this analysis, taxes include any levies imposed by the government on a wide range of productive activities. In saying that taxation cannot lead nations out of a recession, I do not make the preposterous claim that the ideal state works with a zero level of taxation. Instead, the claim is that, given the current downturn, any constant effort to introduce various new forms of taxation, to increase progressivity, to raise the capital gains taxes, or to raise the estate tax, will only make things worse. We cannot reverse the current malaise or increase the overall level of wealth by raising taxes and investing their proceeds in some combination of transfer payments and supposed infrastructure improvements — especially today, when these programs are primarily intended to facilitate a targeted redistribution of wealth.[21]

On this score, I take the now unfashionable Lockean view that the first and major object of taxation is to fund the creation and maintenance of public (i.e., indivisible) goods that cannot be supplied through voluntary transactions.[22] Ideally the incidence of the tax should reflect the benefits that each person or group receives from the public expenditures, which in the case of general income or consumption taxes points to a flat rate that allows the government to raise whatever level of revenue it sees fit, so long as it keeps within the flat tax constraint. The object of taxation should not be to fund new, often covert, forms of redistribution. Rather, it should be to facilitate a political situation, to the extent possible, where all persons are left better off because, in their own subjective estimation, the benefits received from public programs exceed the costs of the taxes that they are forced along with everyone else to contribute.

To be sure, this principle is not capable of systematic implementation today given the massive level of transfer payments already built into the fabric of every modern Western democracy. Indeed, the defenders of progressive taxation take the case for redistribution as a moral imperative, and then confine their

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21 These multiple efforts are evident in looking at such statutes as the American Recovery and Reinvestment Act, Pub. L. No. 111-5 (2009), http://www.gpo.gov/fdsys/pkg/PLAW-111publ5/pdf/PLAW-111publ5.pdf, which is a smorgasbord of ad hoc transfer and taxation programs.

22 For my defense, see Richard A. Epstein, *Can Anyone Beat the Flat Tax?*, 19 Soc. Phil. & Pol. 140 (2002); and Richard A. Epstein, *Taxation in a Lockean World*, 4 Soc. Phil. & Pol'y 49 (1986) (arguing that the flat tax outperforms all other income or consumption taxes).

inquiry to asking how steep the tax could rise without drying up revenues.[23] This calculation is strictly instrumental insofar as the high-income taxpayers who are subject to the tax have no moral veto right against the increased exactions of their wealth under any generalized tax regime. The declining marginal utility of wealth is said to justify the high rate of transfer payments, although the steepness of that decline is difficult to measure.[24]

It is, however, hard to implement this program. In any given period, the simplest models find it difficult to address the major complications that arise from trying to measure the rate of substitution of (nontaxable) leisure for (taxable) income. And over time, it is difficult to measure the impact of deferred taxation plans for pension contributions, which are taxed only after a person has passed his or her peak earning years. Should progressivity be thought of in lifetime or single-period terms? Should assignments of income be allowed within or across generations? Serious lawyers who look at this problem are all too aware of the daunting technical problems that arise in any effort to increase the tax burden on the rich, assuming that group can be defined with precision.[25] But for the modern progressive, these systematic queries do not unfurl red flags about the soundness of their overall program, but instead are technical problems that can be met with technical fixes that should be able to mend the system at tolerable costs. Given that mindset, any effort to cut back on existing levels of redistribution through the tax system will be met with stout political resistance, on both symbolic and practical grounds. That reality taken as a given, a more modest variation on the basic theme should be accepted — which is that it is unwise to follow the clarion call to *increase* the current levels of progressivity as a way to combat persistent slow growth, given the current high rates of progressivity.

This last, strictly prudential, concession does not undermine the basic thesis. Now the more modest charge is that once the first level of redistribution is in place, going forward growth, not redistribution, should be the object of tax policy. In dealing with future changes, ideally the task is to design each future tax modification, up or down, that every person will support if given the all-or-nothing choice. At this juncture, it must be recognized that in any

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23 For technical discussions, see, for example, Peter Birch Sørensen, *Optimal Tax Progressivity in Imperfect Labour Markets*, 6 Lab. Econ. 435 (1999); and Joel Slemrod, *Fixing the Leak in Okun's Bucket: Optimal Progressivity When Avoidance Can Be Controlled*, 55 J. Pub. Econ. 41 (1994).

24 For discussion, see *infra* pp. 729-31.

25 *See, e.g.*, David Kamin, *How to Tax the Rich*, 146 Tax Notes 119, 119 (2015) ("As a purely practical matter raising taxes for the richest Americans is harder than it might seem."). Indeed it is.

scheme of tax containment or reduction, the bulk of the direct reductions will still necessarily be received by the rich who today pay the vast bulk of current taxes, as took place in the United States under the 1986 Tax Reform Act.[26] The Act (with one technical "bubble" exception) had only two tax brackets: the maximum bracket was set at twenty-eight percent, down from fifty percent, and the bottom bracket was raised from eleven percent to fifteen percent. The greater growth that this system can produce should offset any increase in taxes or reduction in direct benefits.

In principle, I believe that there is no decisive objection to moving toward a flatter tax system, with fewer loopholes. But even if that approach is rejected, one clear implication of this approach is that whether we think in terms of instituting a new system of taxation, or in terms of modifying an existing system of taxation, we should reject categorically the full range of special taxes, such as the notorious 2.3% excise tax on medical devices, which is intended to plug the financial gap in the Patient Protection and Affordable Care Act (ACA),[27] and was subject to a two year moratorium in December 2015.[28] The multiplicity of tax bases only increases the political competition of interest groups to impose selective tax burdens on someone else. But those extra degrees of freedom are never needed to meet any particular revenue target, which can always be reached by altering one single instrument — the rate on a single tax base on income, or preferably consumption (so as to avoid the relative over-taxation of savings and the endless puzzles in taxing capital appreciation). The use of that single variable reduces the need for painful changes in taxation regimes. When should these take place? In which direction should they move? And why? The change of a single variable avoids all of these uncertainties, none of which produce allocative gains. The modern effort to increase redistribution through taxation and ad hoc regulations will not succeed in reversing the trend, which has intensified with those policies in place. Indeed, the position that I take here follows from one that I took seven

26 Tax Reform Act of 1986 (TRA), Pub. L. No. 99-514, 100 Stat. 2085.

27 26 U.S.C. § 4101. For an account of the tax, see *Medical Device Excise Tax: Frequently Asked Questions*, IRS, http://www.irs.gov/uac/Medical-Device-Excise-Tax:-Frequently-Asked-Questions (last visited April 10, 2016). For the politics, see Jason Millman, *How Killing the Medical Device Tax Became One of Washington's Top Priorities*, Wash. Post, Nov. 7, 2014, http://www.washingtonpost.com/blogs/wonkblog/wp/2014/11/07/how-killing-the-medical-device-tax-became-one-of-washingtons-top-priorities/.

28 Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (2015).

years ago in writing for *Theoretical Inquiries in Law*: consider redistribution last, only after correcting the allocative mistakes that slash productivity.[29]

B. Regulation

A similar story applies with respect to regulation. The first point again is to make clear what counts as a form of regulation. On this score, I do not follow the all too common view that any system for the enforcement of common law rights of contract, property and torts constitutes government regulation for the purposes of this debate, even though that contention is often made on the grounds that no system of regulation is "prepolitical." In some cases, it has been claimed, dating back to Pierre-Joseph Proudhon, that all property is theft because private ownership necessarily prevents other individuals from moving freely about in an unregulated common.[30] But the argument to the contrary rests on the empirical claim that unless exclusive rights are given, no one will sow where they cannot reap, so that the exclusion is justified by the overall gains that it produces.

In its modern form, the position is championed most notably by Cass Sunstein, who in defense of New Deal regulation attacks the view that "[w]hen government protected existing distributions, it was not really acting at all, but only permitting free market choices to determine wages and hours. When the government altered the existing distributions — for example, imposing a minimum wage — it would be seen as 'acting,' thus raising constitutional doubts."[31] It is indeed true that the pre-New Deal view had deep reservations about minimum wage laws. But it was not for the reason Sunstein stated. The gist of the distinction is that minimum wage laws block voluntary transactions in a competitive market, while the use of simple contractual formalities, like a writing or recordation system, tends to facilitate such transactions. These formalities impose no substantive limits on price or wages, but essentially give an *ex ante* roadmap of the deal that reduces the likelihood of future disputes and increases the ease with which they can be resolved. The minimum wage of course reduces the possible terms of exchange and if left to go high enough,

29 *See* Richard A. Epstein, *Decentralized Responses to Good Fortune and Bad Luck*, 9 Theoretical Inquiries L. 309 (2008). For a later exposition of the same theme, see Richard A. Epstein, Design for Liberty, Private Property, Public Administration, and the Rule of Law 141-48 (2011).

30 *See* Pierre-Joseph Proudhon, What Is Property? An Inquiry into the Principle of Right and of Government (1840).

31 Cass R. Sunstein, *Is Free Speech the Enemy of Democracy?*, Boston Rev., Mar.-Apr. 1993, http://new.bostonreview.net/BR18.2/sunstein.html.

could close down a market altogether. This is no atavistic yearning for a set of common-law rights that have outlived their usefulness. It is the utilitarian justifications of the earlier natural law system, bolstered by a sensible set of formalities, which account for its continuing value.[32]

This same incautious claim has been made recently with respect to intellectual property,[33] by insisting that intellectual property rights necessarily interfere with the rights of other people to use their real and personal property as they see fit. But a system of intellectual property rights rightly allows for decentralized innovation. Inventions are privately generated and are then filtered through an examination and recordation system to establish rights good against the world. The strong property rights are justified, again on empirical grounds, by the belief that front-end inventions would falter if all inventions were left in the commons for others to use as they chose. Once intellectual property rights are protected, gains from trade are possible through an active licensing market, whose operation benefits patent-holders and licensees alike.

With all forms of property, the claim is necessarily made that some property rights are necessary for the maintenance of a competitive economy. If people do not have property rights, i.e., rights good against the rest of the world in labor, land, goods, inventions and writings, it is not possible to organize voluntary transactions in any of these markets. Nobody could figure out who counted as a permissible seller without a clear identification of ownership that would let potential buyers and lenders know with whom they should deal. It is for this reason that virtually every modern legal system adopts detailed recordation statutes for land (and some other large assets, like motor vehicles), and of course intellectual property, such as patents or copyrights, as a means to structure future transactions.

To include these basic building blocks in the definition of regulation makes it quite impossible to ask sensibly whether regulation is the route out of the current economic malaise, now that it becomes necessary to describe every

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32 For a longer justification, see Richard A. Epstein, *The Utilitarian Foundations of Natural Law*, 12 Harv. J.L. & Pub. Pol'y 713 (1989).

33 *See, e.g.*, Mark A. Lemley, *Faith-Based Intellectual Property*, 62 UCLA L. Rev. 1328, 1330-31 (2015):

> IP rights are a form of government regulation of the free market designed to serve a useful social end — encouraging innovation and creation. IP rights represent government interventions in the marketplace that seek to achieve that desirable social end by restricting the freedom of some people (consumers, reusers, critics) to do what they want with their own real and personal property in order to improve the lives of other people (inventors and creators). My freedom to make art or build a new phone is constrained by a government requirement that my art or my phone not be too similar to someone else's.

competitive market as a regulated industry. Of course, various requirements for formality and recordation of contracts and deeds count as regulation insofar as they entail that only some proper subset of agreements or transfers will be enforced in a court of law. For example, the definition of a contract in its broad signification is "an agreement by which two parties reciprocally promise and engage, or one of them singly promises and engages to the other to give some particular thing, or to do or abstain from doing some particular act."[34] This definition covers both unilateral contracts, such as the Roman contract of stipulation, as well as all the standard bilateral contracts, such as those dealing with sale or hire. It is also easily generalizable from two to more than two individuals. What is key for these purposes is that the definition specifies no formalities of any kind for either the performance of a contract or the transfer of a thing, from which it could be inferred that all promises constitute contracts and all deliveries constitute a transfer of title if so intended.

But it is commonly understood that many contracts are enforceable only if in writing or subject to other formalities, and that any transfers are sufficient to transfer ownership only if they are done in accordance with such forms. In the absence of these formalities, the difficulties of deciding whether an agreement has been formed, or a transfer has been made, can be subject to divisive and uncertain litigation. The *ex post* cost of litigation functions like a tax, which is factored into the *ex ante* decision on whether to conclude the transaction. These costs of litigation must be subtracted from the gains from trade. Once that is done, it could well be that high costs of dispute resolution could either kill the transaction or render it more modest in scope: the quantities exchanged could be reduced; the time period for the agreement could be shortened; and the terms of payment could be simplified. The use of those limitations in effect reduces the gains from trade. There is no question that the addition of formality also reduces the gains from trade — relative to what they would be in a world in which the cost of contract enforcement were zero. But our world is marked by high transaction costs. In that setting the case for formalities rests on the common view that cheap *ex ante* precautions *expand* the possibilities for trade beyond what they would be in a world without formalities.

Instead, in this context, I use the definition of "regulation" that is often used in connection with courses on regulated industry: any effort on the part of the government to set terms and conditions on which various contracts for goods and services may be exchanged. To sharpen the discussion still further, I do not include in my per se attack on regulation those various devices that

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34 Robert Joseph Pothier, Treatise on Obligations, or Contracts pt. I, c.1, art. I at 5 (Francois-Xavier Martin trans., The Lawbook Exchange, Ltd. 1998) (1802).

are intended to control the use, and abuse, of monopoly power. The argument for both rate regulation of natural monopolies, and the antitrust imposition on otherwise competitive industries, is that these forms of regulation are intended to bring the industries in question closer to some competitive norm. In the rate regulation cases, the effort is to find some rate that is below the monopoly rate but above the competitive rate, which can be imposed at a cost sufficiently low that it does not swamp the benefits that the regulator hopes to obtain from controlling this monopoly risk.

Stating this purpose does not mean that all regulations based on this view are necessarily sound. Many in fact are flawed in their design details. In some cases, these flaws can be corrected, and in other cases it is on balance better to do without regulation and rely instead on strong market forces to counter the dangers at hand. It is difficult to offer a strong generalization as to when this form of rate regulation works, as that often depends on the peculiar characteristics of given industries. In general, those industries with rapid technological transformation, such as the internet, should be left unregulated, as programs such as net neutrality, which insist that all persons have equal access to the internet, do little to contain monopoly power but do much to block technical innovation.[35] But rate regulation in electricity and gas may well work better given the difficulty of entry into these markets, the slow rate of technological change, and the small number of firms that are subject to regulation.

The reason to exclude these regulations from any categorical disapproval is that they function to bring markets closer to competition and not away from it. Unfortunately, many forms of rate regulation do not have this function, but are intended to create various kinds of cross-subsidies between different groups, and those forms of regulation are included in the overall mix. These include comprehensive systems of healthcare regulation in which individuals with different risk profiles are charged the same rate for services, or, more generally, where a key feature of the system is to create a disguised system of transfers, which happens all the time in insurance, mortgage, and healthcare markets, among others. The account of regulation that I use is therefore parallel to the account that I use for taxation. These systems are welcome to the extent that they create, or seek to create, Pareto improvements. They are suspect to the extent that they have other ambitions in mind.

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35 *See, e.g.*, L. Gordon Crovitz, *Liberals Mugged by Obamanet: Buyer's Remorse Is Already Setting in for Google and Other 'Net Neutrality' Proponents*, Wall St. J., Mar. 1, 2015, http://www.wsj.com/articles/gordon-crovitz-liberals-mugged-by-obamanet-1425252804; Richard A. Epstein, *Hands Off the Web*, Hoover Inst., Defining Ideas (Nov. 17, 2014), http://www.hoover.org/research/hands-web.

III. Dangerous Optimism on Redistribution

Once these preliminaries are completed, it becomes possible to drill down on the various taxation and regulatory schemes that are the central source of concern here. Initially, it is clear that *none* of the discussion of tax and regulatory policy involved in the fight against the recession addresses the traditional forms of taxation and regulation that I have exempted from this discussion. Instead the programs that are involved are those that have very different objectives. One set of arguments is that we need various forms of stimulus that are intended to break some supposed liquidity trap that makes people unwilling to invest in the creation of new goods and services because there is an insufficient demand by others for the goods that they might well create. The theory is that a stimulus package, backed by deficit financing, can overcome this obstacle by putting new money into the economy, in the hands of low-income people who are most likely to spend it, which will accordingly overcome the reluctance of other individuals to invest. To that extent, this program involves a form of deficit financing: it seeks to marry stimulus programs with fighting inequality. Of course, the money that is created will have to be paid off at some future time, whether by inflation (which is a hidden tax) or by the belated imposition of taxes on private labor or capital to pay off the deficit. The gamble is that future growth, nowhere provided for, will do that job. It should be evident that none of these tax programs is intended to secure the creation and maintenance of public goods in the sense mentioned above. It is one thing to use public funds to purchase assets that can be paid off out of future revenues from the project. It is quite another to assume that expenditures that create no long-term assets will have a positive economic impact. The Keynesian models are largely oblivious to the difference, which is why growth levels continue to lag.[36]

The question then arises as to whether these programs can produce any kind of benefit. The first point is that the supposed Keynesian payoff in this regard is that a higher fraction of the money spent will go to the consumption of goods. But there are at least two difficulties with this basic proposition. The first is that it is hard to know the extent to which special, i.e., nonrecurring payments, will be treated the same as ordinary income flows. There is at least some chance that the extra dividend, so to speak, will be either saved or used to pay off past debts, which is fine as far as it goes, but which has no connection with the stimulus. The second point is that there is no abstract principle that

36 For a further critique, see Richard A. Epstein, *How to Clear the Path to Growth*, Nat'l Affairs, Summer 2015, at 34; and Richard A. Epstein, *Why I Will Never Be a Keynesian*, 33 Harv. J.L. & Pub. Pol'y 387 (2010).

confidently suggests the fraction of social wealth that should go to investment or consumption. There is no reason to resort to *aggregate* determinations. Individuals using their own money are more likely to make good judgments as to whether consumption or investment fits their particular needs, so that the aggregates in question are built up from decentralized individual decisions that are likely to make better tradeoffs than any centralized government system. The second point follows from the first. Neither consumption nor investment counts as waste, so it is hard in the abstract to decide which to prefer at any moment. In contrast, the reduction of uncertainty on long-term patterns of taxation and regulation works well on both sides of the market. It hardly matters whether demand or supply comes first.

Similar objections can be raised to other arguments for using income and wealth transfers to stamp out the rising level of social inequality in society. This position is most closely associated today with the work of Thomas Piketty, who starts from an assumption that the rate of capital appreciation, *r*, is always greater than the growth rate, *g*, which leads to the conclusion that capital will always consume a larger portion of the capital.[37] Right off the bat, this proposal cannot be right. It first assumes that all forms of capital are homogenous, so that venture capital and treasury bills fall into the same class, and further, that capital investments are not subject to diminishing rates of return. More technically, it has recently been observed that Piketty does not take into account the depreciation of capital assets when he makes his calculation, which is an error tantamount to assuming that the gross revenues from the use of a capital asset should be treated as income to the asset holder, without first taking depreciation into account.[38] There is no inherent tendency

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37 Thomas Piketty, Capital in the Twenty-First Century (2013).

38 *See, e.g.*, Matthew Rognlie, *A Note on Piketty and Diminishing Returns to Capital*, http://www.mit.edu/~mrognlie/piketty_diminishing_returns.pdf ("[M]ost evidence suggests diminishing returns powerful enough that further capital accumulation will cause a decline in net capital income, rather than an expansion."); *see also* Lawrence Summers, *The Inequality Puzzle: Piketty Book Review* (Spring 2014), http://larrysummers.com/2014/05/14/piketty-book-review-the-inequality-puzzle/#sthash.vQX6l0gp.dpuf. Economists have tried forever to estimate elasticities of substitution with many types of data, but there are many statistical problems. Piketty argues that the economic literature supports his assumption that returns diminish slowly (in technical parlance, that the elasticity of substitution is greater than 1), and so capital's share rises with capital accumulation. But I think he misreads the literature by conflating gross and net returns to capital. It is plausible that as the capital stock grows, the increment of output produced declines slowly, but there can be no question that depreciation increases proportionally.

for capital to gain a larger fraction of the overall social pie, as it is much more likely that *g* is greater than *r*, precisely because there has been no massive contraction of consumption expenditures that this theory predicts. The exact ratio between *g* and *r* will vary from case to case, but there is no systematic push that justifies the massive forms of social redistribution, worldwide, that he advocates. Far better it is to get rid of the current midlevel imperfections in labor and capital markets that do deal with wealth.

Wholly apart from this conceptual failure, the approach must overcome practical obstacles. It is very difficult to get an accurate measure of the level of social inequality that takes into account earnings on the one hand and transfer payments on the other. One approach to this question is to focus on the incomes of the top one percent. These have surely garnered a larger fraction of the wealth (see Figure 1), especially in the last ten years, the last portion of which has taken place under the Obama administration, which favors the progressive policies — high progressivity and a large estate tax — that writers like Peter Diamond and Emmanuel Saez, on the one hand, [39] and Piketty on the other support[40]. Neither the graph in Figure 1 or in Figure 2 covers the total tax contribution of the top one percent, which is close to twice its share of wealth, and which fuels the entire transfer system. Nor does it make any estimate as to whether higher tax rates will lead to a reduction in income levels that could reduce the amount of transfer payments — most particularly, whether an increase of capital gains rates will result in the reduction of taxable capital transactions. Nor does it offer any explanation for the tepid growth rates during this period.

39 *See* Emmanuel Saez & Gabriel Zucman, *Exploding Wealth Inequality in the United States*, Wash. Ctr. for Equitable Growth, Oct. 20, 2014, http://equitablegrowth.org/research/exploding-wealth-inequality-united-states/.

40 Piketty, *supra* note 37 (proposing an annual global wealth tax of up to two percent, coupled with a progressive income tax of up to eighty percent.)

Figure 1: The Return of the Roaring Twenties: The Share of Total U.S. Wealth Owned by the Top 0.1 Percent of Families, 1913-2012[41]

Nonetheless, these considerations drive strong recommendations on policy, most notably the conclusion of Diamond and Saez that the optimal level of progressivity could be as high as seventy-three percent,[42] a huge increase over current levels. Their paper cannot be called empirical in the sense that there are no available systems of taxation that reach anything close to that level, which suggests that working politicians who wish to stop inequality are leery of such a dramatic shift. And well they should be. The key assumption of this model rests on strong assumptions about diminishing marginal utility of wealth. In their view,

> if the social value of utility is logarithmic in consumption, then social marginal welfare weights are inversely proportional to consumption. In that case, the social marginal utility at the $1,364,000 average income

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41 Saez & Zucman, *supra* note 39.

42 Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Police Recommendations* (CES ifo, Working Paper No. 3548, 2011), http://eml.berkeley.edu//~saez/diamond-saezJEP11opttax.pdf. For criticism, see Aparna Mathur, Sita Slavov & Michael R. Strain, *Should the Top Marginal Income Tax Rate Be 73 Percent*, On Margin (Nov. 9, 2012), http://www.aei.org/wp-content/uploads/2012/11/-should-the-top-marginal-income-tax-rate-be-73-percent_085518416524.pdf.

> of the top 1 percent in 2007 is only 3.9% of the social marginal utility of the median family, with an income of $52,700.[43]

It is clear that the marginal utility of particular items declines steeply, but there is no empirical evidence this makes the twenty-five to one ratio hold, especially over the full range of the distribution, which is several orders from people who earn around $400,000 per year (not all that much in New York City) to over ten or fifty million dollars.

Nor, to question another of their assumptions, is there any reason to believe that the optimal top tax rate is one that "maximizes revenue from top bracket taxpayers." Within this framework, it is critical to ask about the counterstrategies that these taxpayers will take to avoid this system, which starts with various devices for income splitting, to moving income (or themselves) offshore, or finding new tax shelters (which were very much a part of the landscape when maximum nominal tax brackets (virtually never paid) reached ninety-one percent in the 1950s).[44] At no point, for example, do they mention the real possibilities for tax evasion by the formation of business partnerships with fancy allocations of income and loss between partners, which in turn take advantage of the depreciation of borrowed capital and the forgiveness of taxable gain at the time of death.[45] Indeed, more generally, the key source of tax evasion among many people is the avoidance of taxation on income altogether, not the differential rates on taxable income.

Another way to attack the inequality problem is to look at the entire distribution in light of the Gini coefficient, which varies from zero to one, where zero represents perfect equality and one represents perfect inequality, i.e., one person with all the money. But it tells a different story insofar as

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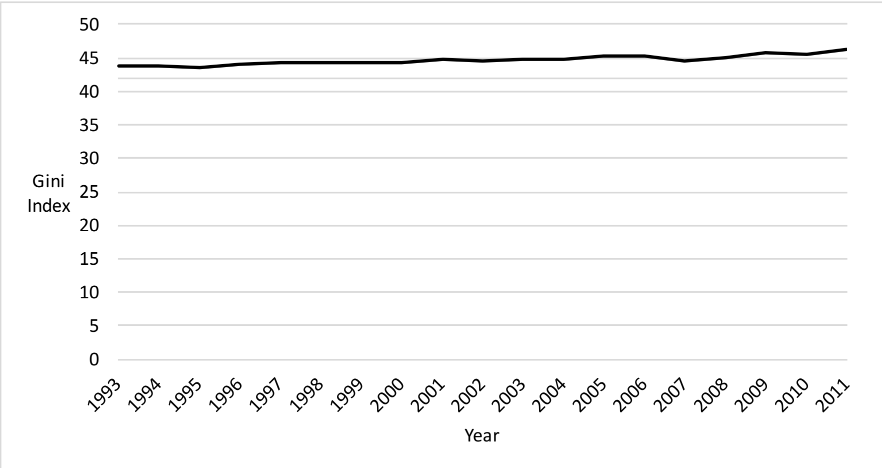
43 Diamond & Saez, *supra* note 42, at 5.

44 Here is one pattern of immense value to high-income taxpayers. The current U.S. law gives an implicit subsidy to investments made with borrowed capital by allowing persons to take depreciation deductions in excess of their equity contribution (i.e., based on the total cost of the asset). *See* Internal Revenue Code (I.R.C.), 26 U.S.C. § 101. The partnership code gives high-income taxpayers the right to claim the bulk of the depreciation deductions for any common project, so long as they agree to pay back those deductions when the project is closed and there is sufficient nonrecourse debt in the partnership. *See id.* § 704. Nonetheless, those future gains will be forgiven at death when the property receives a stepped-up basis equal to its market value, without paying any gain. *See id.* § 1014. This mechanism, which keeps vast amounts of income out of the tax base, is far more important than the tax imposed on taxable income. It is easy to support a progressive tax if huge portions of economic income are out of the taxable income base.

45 For these relationships, see *id.* §§ 704, 1012, 1014.

the Gini coefficient has not moved much in the last twenty or so years in the United States: it remains at around 0.45, with a slight uptick under the Obama administration.

Figure 2: Gini Index of Income Inequality for U.S. Households, 1993-2012



This result holds even if particular individuals move up and down the scale as a function of their own personal situation. Nor is it clear how much we should care about this index, as there are many situations in which Pareto improvements can expand the level of inequality by giving disproportionate gains to the rich relative to everyone else. Yet should the poorer individuals worry that more of the gain goes to richer individuals, so long as they gain themselves, especially if the alternative is cuts across the board? There is little sense in praising a system of inequality that narrows the gap by reducing income at the top without increasing it at the bottom. At this point, the basic relationship still holds in taxation as elsewhere: an increase in transaction costs will translate into a loss in social welfare. The measurement of the first is far more reliable than an effort to build complex models and data sets to evaluate the second.

The third element of concern involves the public-choice dynamic that sets in whenever the definitions of the tax base and the rate structure are up for grabs. One reason why I have long defended the flat tax on a broad income base is that these two moves limit the degrees of freedom in defining taxation, and in so doing decrease the scope for political maneuvering and wasteful rent-seeking activities. The flat tax is not a full answer to all the relevant problems because it does nothing to control for skews in the distribution of government benefits, many of which today do not go to the formation of public goods. But the constraint should still reduce the scope of political intrigue and thus serve as an added benefit.

The imposition of regulation is subject to much the same dynamic. General rules for market behavior are all too good, but the regulation becomes much more onerous when it involves the regulation of specific industries under ad hoc rules. I have worked extensively with the complex regulation of the debit card markets under the Durbin Amendment, which essentially places maximum caps on the interchange fees that merchants are required to pay to customer banks through the credit card platforms that major credit card companies, like Visa and MasterCard, supply.[46] The litigation was a genuine nightmare. First, the Court of Appeals for the Eighth Circuit upheld the statute against charges that its artificially low rates were confiscatory.[47] Thereafter, the Circuit Court for the District of Columbia upheld the Federal Reserve Board when it allowed the banks to recover some of the fixed costs of running the system, even though the statutory language excluded them from the rate base.[48]

The price fixing has snuffed out the enormous level of innovation that drove this market from virtually nothing in 1995 to being the dominant source of cash for most people.[49] Prior to the adoption of the amendment, debit card companies took some of the revenues that they received from the merchants and used them to lure customers into the system by supplying them with free miles on various airlines. The price caps led to elimination of these benefits. The same consumers that saved some sums on interchange fees lost them when the terms on their debit cards became more expensive, as the banks had to raise fees on other portions of their business — both for general checking accounts and ATM withdrawal fees — to make up for the lost revenues that

46 *See* 15 U.S.C. § 1693o-2.

47 *See* TCF Nat'l Bank v. Bernanke, 643 F.3d 1158 (8th Cir. 2011).

48 15 U.S.C. §§ 1693o-2(a)(4)(B)(i)-(ii); NACS v. Bd. of Governors of the Fed. Reserve Sys., 746 F.3d 474 (D.C. Cir. 2014):

> [D]istinguish[ing] between . . . the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular debit transaction, which cost shall be considered . . . , [and] other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered.

The decision treated the fixed costs of running the system as incremental costs. *See NACS*, 746 F.3d at 484-85.

49 For discussion, see Richard A. Epstein, *Dunwody Distinguished Lecture in Law, The Constitutional Paradox of the Durbin Amendment: How Monopolies Are Offered Constitutional Protections Denied to Competitive Firms*, 63 Fla. L. Rev. 1307 (2011).

they received under the earlier consensual arrangements.[50] It is only a matter of time before debit card rewards, like bonus airline miles, become a thing of the past.[51] The adoption of Sarbanes-Oxley in 2002[52] increased the responsibilities on the boards of directors and executives of public corporations, and surely slowed down the conversion of private to public corporations and spurred a reprivatization movement.[53] Indeed, it is hard to think of any industry in which the regulatory burden has lightened in the last ten or so years. In light of these particulars, the grim figures quoted in the Introduction start to make sense.

IV. Empirical Studies

In dealing with this material thus far, I have introduced only a few gross statistics that have indicated the slowdown of business activity throughout the United States. In general, the simplest explanation for this slowdown is the set of policies that I talk about, which form a complex network that exerts force on varying sectors. It is exceedingly difficult to think of a thought experiment that isolates one variable nationwide and then tries to measure the input of any given statute on a particular program. It is just for that reason that the global statistics are in a sense preferable because they do not require the isolation of particular causal chains, but instead rest on the more or less a priori theoretical approach that opposes all taxes and regulations that are on net an impediment to trade (which is why a statute of frauds is not like a rent control law). The weakness in this case is that it makes the particular mechanisms for change obscure, which in turn makes it harder to decide where to begin on a complex agenda of piecemeal reform, which will be difficult to do anyhow given the large confidence intervals that surround particular studies. Indeed, if the gaps between the sophisticated studies of scholars like Piketty, or Diamond and Saez, depend on heroic or untestable assumptions, it is hard to know exactly what looks like empirical data in this field. And the matter only gets harder with complex schemes of regulation whose details

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50 Jonnelle Marte, *ATM Fees Soar to New High*, Wash. Post, Oct. 5, 2015, http://www.washingtonpost.com/news/get-there/wp/2015/10/05/atm-fees-soar-to-new-high/.

51 Hal Bundrick, *Will Debit Card Rewards Become a Perk of the Past?*, U.S. News Money (July 21, 2014), http://money.usnews.com/money/blogs/my-money/2014/07/21/will-debit-card-rewards-become-a-perk-of-the-past.

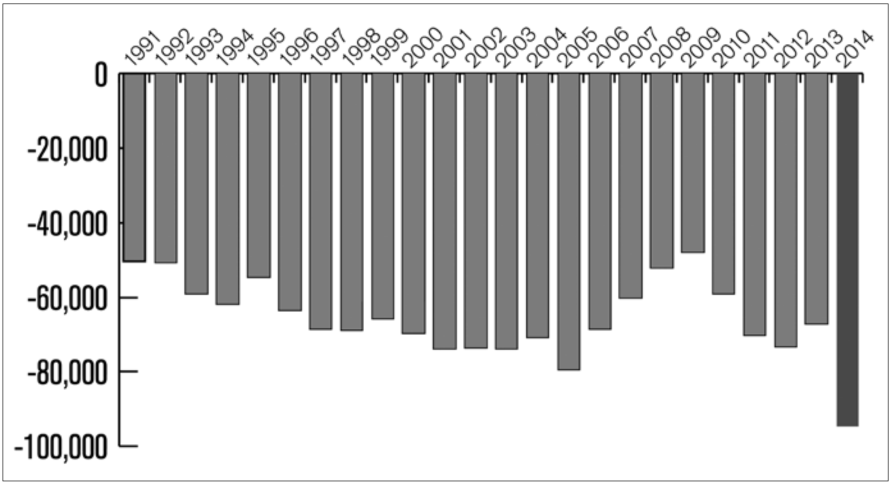
52 Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).

53 Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. Acct. & Econ. 116 (2007) (reporting an increase in going-private transactions after passage of Sarbanes-Oxley).

are difficult to master and whose key provisions are hard to isolate by people who do not have intimate knowledge of the particular field.

One other way to look at this within the American context is to examine state data, where the key question is the rate of exit of individuals from one state to another. That exit is a lot easier than exit from a country, so that local changes should be expected to exert a greater effect. Exit itself is a complex phenomenon that depends on a constellation of variables that do not work with equal force on all segments of the population. The nice point about exit is that, all things considered, it is relatively easy to measure. In addition, it is an aggregate measure that takes into account all the factors of taxation and regulation that can influence the net flows of people. In this connection, I assume that both high taxation and extensive regulation are key elements, and in many instances they go together. Nonetheless, there are states like Illinois and Massachusetts that have flat state income taxes and extensive regulation of various markets, so it is hard to treat these in lockstep progression. To give one example of how potent the point can be, look at the numbers presented in Figure 3, which describe the exit option from Illinois over the last twenty-five years.

Figure 3: Illinois' Record Exodus: Illinois' Net Loss of Residents to Other States, 1991-2014[54]



54 Michael Lucci, *If Illinois Had Simply Broken Even on Domestic Migration, There Likely Wouldn't Be Much of a Budget Problem*, Ill. Pol'y (June 15, 2015), https://www.illinoispolicy.org/hey-speaker-madigan-illinois-no-1-budget-problem-is-taxpayers-fleeing-the-state/.

The key point to understand about this chart is that it does not stand alone. As the Illinois Policy Institute tables report,[55] Illinois has had huge job losses, dropping from about 6,700,000 employees in June 2008 to 6,510,000 employees in December 2014. It has seen its unfunded pension liability increase from about 62.5 billion dollars in 2009 to over 111 billion dollars in 2014.[56] It has the highest real estate property taxes in the region, and the highest workmen's compensation premiums in high-risk industries — about three times those of Indiana — and no right to work laws.[57] This puts it at a disadvantage vis-à-vis neighboring states, and, most tellingly, there is no willingness of the state legislature to mend its ways.

Put this chart into context, and the exit figures look dramatic. More systematically, the electoral college map of 1940 relative to that of 2010 shows some stunning changes in relative population levels. The three largest gains in population over that period have been California, Florida, and Texas, which are reflected in the increase in their number of electoral votes out of a constant total of 535: thus California moved from 22 to 55; Florida from 7 to 29; and Texas from 23 to 38.[58] It is not easy to run a clear political litmus test on these states because their politics have changed over that period. California has gone from Republican to Democratic; Texas has done the reverse; and the directional changes in Florida are not all that clear. But it is striking to note that three of the largest losers have strong long-term, Democratic traditions: Illinois (29 to 20), Massachusetts (17 to 11) and New York (47 to 31).[59]

Similarly, the current rankings of friendliness to business by the Small Business & Entrepreneurship Council[60] offer a snapshot of the overall picture,

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55 *See id.*

56 *See* Ted Dabrowski, *More Revenue Can't Fix a Fundamentally Flawed System: Illinois Lawmakers Should Know This; They Tried That Approach and Failed*, Ill. Pol'y (May 19, 2015), https://www.illinoispolicy.org/think-tax-hikes-will-fix-illinois-pension-crisis-think-again/?utm_source=Illinois+Policy%3A+Opens&utm_campaign=c6a8871057-utm_source%3Dmailchimp&utm_medium=email&utm_term=0_9471dd8540-c6a8871057-12878649.

57 *See* Lucci, *supra* note 54.

58 *Compare Election of 1940*, The American Presidency Project, http://www.presidency.ucsb.edu/showelection.php?year=1940 (last visited Aug. 17, 2015), *with Distribution of Electoral Votes*, U.S. Nat'l Archives & Records Admin., http://www.archives.gov/federal-register/electoral-college/allocation.html (last visited Aug. 17, 2015).

59 *See* sources cited *supra* note 42.

60 *SBE Council Ranks the 50 States in "Small Business Policy Index 2014,"* SBE Council (Dec. 11, 2014), http://www.sbecouncil.org/2014/12/11/sbe-council-ranks-the-50-states-in-the-small-business-policy-index-2014/.

in which Illinois (35), Massachusetts (31) and New York (48) are laggards, along with California (50), which in recent years has taken on a high-taxation, high-regulation approach. The SBE Council uses its own measure of forty-two inputs, so that no one point dominates the analysis. And there is little doubt that the movement of capital and labor across state lines corresponds closely to these various measures. The message of the SBE study bears scant resemblance to those of Diamond, Piketty, and Saez. I quote it in full:

> Policies clearly affect the environment for investment, entrepreneurship and small business growth. In order to compete for capital, business and human capital, many Governors and state legislatures are pushing forward with policies to improve their tax and regulatory climates. This competitive policy environment is a big plus for small business. States like Arizona, Indiana, Kansas, New Mexico, North Carolina, North Dakota, and Ohio have really stepped up their game on the policy front. In each of these cases, tax reform and relief were undertaken, which reduces the costs of risk taking and doing business. Meanwhile, top-tier policy states like Texas, Nevada, South Dakota, Florida and Wyoming continue to leverage their long-standing policy advantage, and are doing things to get better," said SBE Council President and CEO Karen Kerrigan.[61]

The most entrepreneur-friendly states under the "Small Business Policy Index 2014" are: 1) South Dakota, 2) Nevada, 3) Texas, 4) Wyoming, 5) Florida, 6) Washington, 7) Alabama, 8) Indiana, 9) Colorado, 10) North Dakota, 11) Ohio, 12) Arizona, 13) Utah, 14) Michigan, and 15) Virginia.

In contrast, according to the Index, the most negative policy environments for entrepreneurs are: 40) Rhode Island, 41) Connecticut, 42) Maine, 43) Iowa, 44) Oregon, 45) Vermont, 46) Minnesota, 47) Hawaii, 48) New York, 49) New Jersey, and 50) California.

As for the best policies, it must be noted that five (South Dakota, Nevada, Texas, Wyoming, and Washington) of the top six states on the Index impose no income taxes whatsoever, that is, no personal or corporate income and capital gains taxes. And the other state in the top six (Florida) has no personal income or individual capital gains taxes. Clearly, enhancing the incentives for entrepreneurship and investing by not taxing the returns on such critical activities makes for sound, pro-growth, pro-entrepreneurship policymaking.[62]

I think that these figures are instructive because they suggest that the common assumption, namely, that it is difficult to find strong allocative effects

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61 *Id.*

62 *Id.*

from changes in levels of taxation and regulation, is incorrect in light of the major movements across state lines in accordance with standard measures of business friendliness. It has to be understood that all these effects are at the margin, in the sense that businesses in all states are subject to a largely uniform system of federal regulation, which tends to blunt the impact of state regulation. Thus, if the net burden of federal regulation is 50 and that of state A is 10 and that of state B is 30, the overall difference is not 300% but 33%. Yet even though these differences are marginal, they are still large, which points out once again the importance of competitive federalism as a check on government power, and provides for an empirical check to prefer one economic model over another.

Conclusion

In this Article I have sought to outline the basic response to the claim that massive increases in taxes and regulation should be used to offset the rising inequality of income. In my view, the strategy is likely to prove counterproductive if tried. In making this claim, I try to delineate the wealth-enhancing kinds of taxation and regulation that should be retained wholly without regard to inequality. In staking out that position, I am content to work from the status quo as it existed before the new surge against inequality, including some programs for redistribution (which as a matter of first principle I often oppose). While I support a reversion to a flatter tax system, the key point is to at least reject the countless recommendations to further steepen the curve, to raise taxes on capital gains, to impose higher estate taxes, and to make comparable changes in regulatory systems, especially labor markets.

In dealing with these issues, the basic principle is, reduce transaction costs and uncertainty in order to create stable competitive markets. Modern proposals, however, move in the opposite direction. They often do so, moreover, on the assumption that the impact of redistribution programs on overall social welfare will be low (given the steeply declining marginal utility of wealth) and that the impact on growth will be modest as well. It is very difficult to get strong information on these matters, but what information we can gather from between-state comparisons is highly instructive, and it points to a picture in which private responses to changes in tax and regulatory policy are far more elastic than commonly supposed. There are no free lunches in trying to work out of a recession, while trying to redress perceived gaps in inequality. In the end, the best way to improve both economic growth and inequality is to return the current system of taxation and regulation to one built around facilitating positive-sum games, not one that continues to expand for its own sake.