P.O. BOX 247
Wingate, NC 28174
Ph: (704) 233-1776
www.jessehelmscenter.org

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THE FLAT TAX – HAS ITS TIME COME? LESSONS FROM EASTERN EUROPE

By

Dr. Joseph M. Ellis and Dr. Peter M. Frank

Our present tax system is the ugly stepchild of the Congress and advocates of special interest legislation – Jesse Helms, 1982

The tax structure in Russia is exemplary in many ways… – George W. Bush, 2001

The 2012 election season is revealing the ongoing tension in electoral politics over "fair" and "just" taxation and the proper recipe for sustained economic growth. During the Republican primary debates, the GOP distinguished their position on taxes between the libertarian wing represented by (Ron Paul), the social conservative wing (Rick Santorum, Rick Perry and Michelle Bachmann) the "mainstream" Republican wing (Mitt Romney), and the "outsider" wing (Newt Gingrich, Jon Huntsman and Herman Cain). Yet, one of the more curious developments to come out of the primary cycle was the proliferation of a number of flat tax policies proposed by the candidates. While the idea of a flat tax is not new – as a concept it dates back to the 1950s – the sheer number of proposals seen this election cycle was stunning. Of the eight Republican candidates that stumped during the primary season at one point or another, only Mitt Romney and Ron Paul did not have a thoroughgoing flat tax plan, yet tax reform is still at the heart of candidate Romney's agenda.

This paper will explore the creation and development of the flat tax idea both in the United States and abroad, and it will address the need for tax reform as a central issue in the current presidential campaign. Though the flat tax was championed by Americans like Milton Friedman, Robert Hall and Alvin Rabushka, Steve Forbes, and even Jesse Helms, it has gained little traction in the United States as public policy. While there are seven states with flat income taxes in the United States there is still a progressive tax with six graduated rates at the federal level. Moreover, progressive taxation is the norm for most of the World particularly Western industrial democracies in Europe. However, beginning in 1994 with the tiny Baltic country of Estonia, the flat tax policy came to fruition at the international level. Within a year neighbors

Latvia and Lithuania jumped on board by implementing their own flat tax, and in little more than 15 years later, 24 countries in the world have adopted a flat tax.

The paper will proceed in four parts. First, we will examine the history of income taxes in this country. Second, we will examine the various calls for flat taxes within the United States. Third, we focus on Eastern Europe, examining the implications and spread of the flat tax policy there, and lastly we analyze the economic impact of significant tax reform in the United States. In short our goal is to demonstrate the reasons for the ease with which Eastern Europe adopted flat tax policy while discussing the possible outcome of a flat tax system in America.

Income Taxation in the United States

Progressive income taxation has only been common place for about the past one hundred years, but the idea is found in a few classic texts. Some have interpreted progressive taxation to have sources in Adam Smith's *Wealth of Nations*, where he argues for taxation that is in "proportion" to one's income (Smith as cited in Cahn 2004, 348-349). In Karl Marx's *The Communist Manifesto*, Marx argues that a "heavy progressive or graduated income tax" is a mechanism to redistribute wealth quickly (Marx 1978, 490). The most obvious source for progressive taxation in practice was found in Western European governments, in particular Germany, who enacted a progressive income tax in 1891. Few, however, realize that the United States has a longer history than even Germany with progressive taxation.

As far back as 1861, income taxes had been tinkered with in the United States. During the Civil War period, the federal government sought to raise $320,000,000 to effectively run the country and stage a war. Of this figure, it was surmised that about $30,000,000 would be raised by a direct tax whose burden would be distributed among the "loyal" states based on population. The rest would be drawn from borrowing and increasing tariffs (Hill 1894, 417). There was a

problem with taxing based on population size. States in the northeast, say Connecticut for example, had very small populations but a heavy concentration of wealth in comparison to a state like Wisconsin, which doubles the population of Connecticut but lacked wealth. The decision to shift away from this state-centered tax was to capture more effectively the actual "location" of wealth: personal income (Hill 1894, 419). When the first income tax was passed and went into effect in August 1861, it taxed all incomes over $800 at a *flat* rate of 3%. But by 1864, Congress had already started creating rates for various incomes, 5% for any income below $5000 and a 10% tax for incomes over this amount (Hill 1894, 425). In short, the income tax took on a progressive character.

The income tax died down in peacetime but calls for income taxation increased during the late-1800s and during the auspices of the Progressive Movement. Republican Theodore Roosevelt was the first American president to openly stump for a graduated income tax (Yarborough 2003, 542). Democrat Woodrow Wilson continued to push the progressive tax agenda while Congress worked on crafting an amendment to foster a peacetime income tax. The result was the passage of the 16th Amendment to the US Constitution in 1913 and Wilson subsequently signed an income tax law in October of the same year. It read: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration" (16th Amendment to US constitution). While marginal rates were initially very low and not very graduated (1%-7% on income) in time those rates would get very high and very graduated. For example, by the end of Wilson's term the highest marginal rate was 73%, and by Eisenhower's first term in office in the 1950s the highest marginal rate was 90%. Not until the tax cuts of

Ronald Reagan and George W. Bush did the margins look comparable to what we have today, with 35% the top marginal rate.

Alternatives to the progressive income tax started to emerge in the 1950s. Economists like F.A. Hayek and Milton Friedman began to doubt the political motivations of highly progressive taxation. Hayek noted that high marginal rates on income were punitive, reflecting "an expression of the dislike of the majority of the idea that anybody should enjoy the command of such large incomes" (Hayek 1956, 272). Friedman argued in *Capitalism and Freedom* that progressive taxation was an instance of government coercion that negated human liberty. He states thusly: "All things considered, the personal income tax structure that seems to me best is a flat-rate tax on income above an exemption" (Friedman 1965, 174). Friedman was especially influential to practitioners of the flat tax in Eastern Europe. For example, Mart Laar, Estonia's Prime Minister in 1994 and main flat tax spokesperson, first learned about the flat tax by reading about it from Friedman (Laar 2007).

The most developed and rigorous flat tax blueprint to date was drawn up by Hoover Institution scholars Robert Hall and Alvin Rabushka. Hall and Rabushka argued that flat taxes could solve five problems that had plagued United States' revenue collectors: a) the problem of complexity; b) the problem of taxpayer cost; c) the problem of wasteful government investment; d) the problem of tax cheating and loopholes; and e) the problem of cronyism among the taxation bureaucracy (Hall and Rabushka 1995, 3). The flat tax would tax all incomes – with the exception of the poor, who would not be taxed at all – across the same 19% rate (Hall and Rabushka 1995, 58). The second major aspect of the flat tax is that it eradicates tax deductions because, for Hall and Rabushka, deductions are loopholes that can lead to massive tax tinkering (Sease and Herman 1996, 27). Moreover, with one "flat" rate deductions themselves would not

be meaningful, since the whole purpose of a deduction is to lessen the tax burden by erasing income. This second point is crucial and something many flat tax advocates – including those running for President – have not considered in depth.

In the United States there have been a number of flat tax proposals and plans created, but thus far with limited success. Jesse Helms himself was a flat tax advocate who tried to push through three different 10% flat tax plans – in 1982, 1991 and 1993. Helms believed a flat tax would promote economic growth by doing away with the disincentive of wealth-making harbored by progressive taxation. He also impressed upon the Congress his belief that flat taxes were efficient, frequently citing that under flat taxation tax season would require the effort of filling out "the back of a postcard" (Congressional Record 97th Congress, June 1982). Of those three plans not one even came to the floor for a vote. More recently the flat tax was lauded by former presidential candidate Steve Forbes as a response to the "complex nightmare" of gradual income tax schemes (Forbes 2005, 3-4). He ran an entire presidential campaign centered around the flat tax in 1996 and 2000 and wrote a book titled *The Flat Tax Revolution* – which detailed his proposal -- in 2005. Other politicians, namely former US representative Dick Armey and former presidential candidate and California governor Jerry Brown have supported the flat tax. The most recent proposal for a flat tax in Congress, dubbed H.R. 1040 "The Freedom Flat Tax Act" was another attempt at achieving a flat tax in the United States.

The Flat Tax in Eastern Europe

The takeaway from the American experience with the flat tax is apparent: the idea is present but the political support is lacking. Even George W. Bush who has spoken admiringly about the flat tax made little effort to push for one during his time in office, choosing instead to cut rates rather than truly flatten rates. However, if we turn our attention toward Eastern Europe,

the success with implementing the flat tax has been astounding, and we learned from Ronald Reagan's tax reforms during the 1980s that radical changes are possible. In 1994 Estonian Prime Minister Mart Laar came to power behind a strict policy of liberalization of the economy and an adherence to the principles of neoliberalism. Laar's first order of business was to figure out a way to solve Estonia's tax revenue and collection problems (Smith 2002, 119). He answered by eliminating Estonia's gradual, or progressive, taxation structure in favor of a 26% flat rate on incomes, a rate that is now just 21%. Since the adoption of the flat tax the fortunes of Estonia have greatly changed. Estonia gained admission into the European Union and has become a showcase country for economic growth and acquiring foreign direct investment. This is not to argue that flat taxes were the only contributors to these positive economic changes; however, straightening out Estonia's budget and revenue woes went a long way toward signaling to others that Estonia was at least serious about reforming their country. All told, fifteen countries in Eastern and Southeastern Europe have adopted flat taxes in the last fourteen years (See Table 1).

Table 1. Tax adoption and rates (personal)

COUNTRY	ADOPTION YEAR	INCOME TAX RATE
Estonia	1994	21%
Latvia	1995	25%
Lithuania	1995	24%
Russia	2001	13%
Serbia	2003	14%
Ukraine	2004	15%
Slovakia	2004	19%
Georgia	2005	12%
Romania	2006	16%
Macedonia	2006	10%
Montenegro	2007	15%
Albania	2007	10%
Czech Republic	2008	15%
Bulgaria	2008	10%
Hungary	2010	16%

The adoption of the flat tax was a surprising development that caught not only practitioners, but also scholars, off guard. It is surprising because the flat tax had little real world use, and also because Eastern Europe was in disarray and would be one of the last places to look for policy innovation. The problems were serious. "Postcommunist governments [in Eastern Europe] suffered from both tax evasion and weak control over the use of resources that were collected," noted political scientist Linda Cook (2007, 21-22). What made it more difficult was the rapid switch to privatize formerly state-led economies. The tax bureaus had no way to track financial transactions and outflows. Governments lost revenue, could not fund basic social services and corruption was rampant. As Cook also stated, governments would go on to cut public sector salaries, increasing the incentive for bribery and under-the-table operations (Cook 2007, 22). One of the foremost experts on Eastern Europe's transition, Anders Aslund, argued that the socialist economy had "no real tax system" to begin with. "At the end of each year, the state simply confiscated the remaining profits from state enterprises" (Aslund 2007, 116). The personal income tax – which is at the heart of this study – did not have a Soviet equivalent. Most of Eastern Europe adopted a model of progressive taxation which was unfamiliar to them. Combine that with the problems of economic shock therapy, bureaucratic inefficiency, and corruption, and many in those states believed their tax system needed an overhaul. The idea of the flat tax appeared to be a solution to a pressing budgetary problem facing Eastern European economies.

A noticeable dimension of flat tax adoption in Eastern Europe has been the presence of committed elites who serve as "carriers" of new ideas (See Table 2). In Estonia, Laar became the most vocal and prominent carrier for the flat tax. Other elites like Ardo Hansson and Heiki Kranich served in advisory roles that helped articulate the specifics of the tax. Laar saw the flat

tax as part of a package of free market ideas that were fundamentally pro-growth and anti-communist. In Slovakia, appointing the right people went a long way towards achieving a flat tax. Mikulas Dzurinda, a right-of-center prime minister, nominated Ivan Miklos as his Finance Secretary. Even in the face of early criticism, Miklos took on the flat tax and shepherded it through to adoption. Martin Bruncko, Miklos' chief economic advisor, became the international spokesperson for the plan. The Czech Republic's spokespersons included Prime Minister Mirek Topolanek and Finance Minister Vlastimil Tlusty. In Hungary, Janos Koka became a vocal advocate despite being shut out from his own party. And though Poland does not yet have a flat tax individuals within the country have been advocating for its adoption. Former Finance Minister Miroslaw Gronicki stumped for the flat tax and Zbigniew Chlebowski worked for the flat tax in his position as finance minister.

Table 2. Elite carriers

NAME	COUNTRY	POSITION (at time of adoption or idea)	YEAR
Mart Laar	Estonia	Prime Minister	1994
Ardo Hansson	Estonia	Economic Advisor	1994
Kalev Kukk	Estonia	Economic Advisor	1994
Heiki Kranich	Estonia	Finance Minister	1994
Mikulas Dzurinda	Slovakia	Prime Minister	2004
Ivan Miklos	Slovakia	Finance Minister	2004
Martin Bruncko	Slovakia	Economic Advisor	2004
Mirek Topolanek	Czech Republic	Prime Minister	2008
Martin Riman	Czech Republic	Trade Minister	2008
Vlastimil Tlusty	Czech Republic	Finance Minister	2008
Janos Koka	Hungary	Economic Minister	2009
Laszio Bekesi	Hungary	Finance Minister (Retired)	2009
Donald Tusk	Poland	Prime Minister	2009
Zbigniew Chlebowski	Poland	Finance Minister	2009
Miroslaw Gronicki	Poland	Finance Minister (Retired)	2009

A second critical piece of the flat tax puzzle in Eastern Europe has been political parties. By gaining power through a ruling coalition the flat tax became a much more viable policy choice. In countries like Estonia, Slovakia, the Czech Republic, Hungary and Poland, political parties were major players on the flat tax scene. (See Table 3). Estonia's Pro Patria and Reform Party, Slovakia's Slovak Democratic Coalition (SDK), the Czech Republic's Civic Democratic Party (ODS), Hungary's Alliance of Free Democrats (SZDSZ) and Poland's Civic Platform (PO) all were openly supportive of the flat tax and pushed for its adoption. For these parties the flat tax was part of a free market, neoliberal framework adopted throughout Eastern Europe. Transnational groups like the Liberal International became a place where like-minded parties could come together and discuss policy issues. Parties in Hungary, Estonia and Latvia were all Liberal International members.

Table 3. Political parties aligned with the flat tax

COUNTRY	PARTY	YEAR FORMED
Estonia	Reform Party	1994
Estonia	Pro Patria Union	1995
Estonia	Res Publica	2001
Slovakia	Slovak Dem. Coalition	1997
Czech Republic	Civic Dem. Party	1991
Hungary	Alliance of Free Democrats	1988
Poland	Civic Platform	2001

Finally, knowledge communities served as a third channel for the dissemination of the flat tax idea. This includes think tanks like Lithuania's Free Market Institute, Slovakia's MESA-10, Stanford's Hoover Institute, and the Heritage Foundation. The composition of the think tanks includes major players in the flat tax community. Slovakia's MESA-10 was founded by none other than former finance minister Miklos, for example. The Hoover Institute's Alvin Rabushka and then Heritage Foundation fellow Daniel J. Mitchell have traveled throughout

Eastern Europe speaking in favor of the flat tax. Additionally, international meetings of flat tax advocates at places like the CATO Institute – where Laar and Leszek Balcerowicz were featured speakers – and academic conferences like Topolanek's "Flat Tax" conference bring together like-minded individuals for the purposes of promoting the benefits of the flat tax.

The Economic Implications of a Flat Tax

The rationale for adopting a flat tax may not be consistent across all counties. Taxation systems are obviously designed to provide revenue for the Federal government, and the bureaucrats who administer any tax system seek to maximize compliance within whatever system policy makers adopt. Thus, evaluating a tax system is often measured first on what system will maximize revenue to the national government coffers and second on designing a system that the majority of citizens will comply with. Two questions arise from these goals: 1) Should revenue maximizing be the first goal of a tax system? 2) Do questions of "fairness" or "justice" play a role in designing the tax system? In evaluating these questions, we must first examine the economic outcomes of flat taxes in Eastern Europe.

First, research suggests that under a flat tax system there is greater compliance. While the data may not be as strong as some advocates of a flat tax would hope for, even incremental increases in compliance is telling. In the Eastern European examples, the flat tax was adopted within governmental regimes where corruption (at times) has been commonplace. Lack of trust in government is widespread in the former Soviet Union, so any increase in compliance should be noted as significant. In one study of the Russian flat tax reform, compliance was said to increase by about one-third due to both the policy change and enforcement changes (Ivanova, Keen, and Klemm 2005). According to the Center for American Progress, $400 to $500 billion in taxes go uncollected annually in the United States, and it is possible that compliance may

improve more dramatically in America (where the distrust in government is not as profound as in Eastern Europe). One powerful contributor to compliance is tax code simplification, and a significant portion of uncollected taxes each year is due to the complexity of the system (rather than outright evasion).

The second important factor in adopting a flat tax is the overall economic impact. When examining the economic effect of a flat tax two important changes must be measured. First, to what degree does tax code changes impact the incentives to earn and produce within an economy, and second to what extent does an economy become more attractive to foreign direct investment. Again, looking at the examples discussed in Eastern Europe there is clear evidence that changing incentives impacts economic performance. In Slovakia, both foreign and domestic companies report that the tax code changes improved the overall business environment and spurred growth to more than 6% (from 4%) after the tax code reforms (Miklos 2006). More complex analysis conducted to determine the potential economic growth effects of a flat tax within the U.S. demonstrate modest, yet permanent, increases in per capita growth after tax code changes (Cassou and Lansing 2004). These increases in growth are contingent on changes in labor supply behavior which are harder to measure, but it is reasonable to assume (based on previous comparative research) that incentives to enter and remain in the labor force would improve if penalties (i.e. higher marginal tax rates) for earning higher levels of income were removed (Prescott 2002).

Third, it is necessary to consider the issues of fairness and equity within the tax code. The question of fairness is often considered the most subjective, yet to evaluate whether public policy is fair, objective criteria must be considered. One consideration on fairness is whether every income earner pays some portion of Federal income tax. Currently, approximately half of

all earners paid no income tax in 2011. Is this fair? Under any tax system the more you earn the more you pay, but is it not progressive enough to have rates constant across all income levels? The problem with these questions is they become subjective and ideologically driven, when policy should be focused on how to get the institutions right that then create the right incentives where individual decisions provide the highest benefits to all. Penalizing higher income levels with higher tax rates does not directly provide more income/resources for those with lower incomes, and this is a highly inefficient means of wealth transfer with the aim of reducing inequality.

Evidence suggests that acceptance of the fairness of taxation likely derives from a general confidence that the system treats everyone equitably (Picciotto 2007). The two factors that create the most significant perception of unfairness are penalties for higher income levels and the complexity of the tax code. Thus, "unfairness" is a significant contributor to tax avoidance. Also, the case for progressive taxation is most prominently argued based on the principles of sacrifice theory (i.e. citizens should be taxed based on an equal level of "sacrifice") (Hagopian 2011). Sacrifice theory argues that taxes are not levied based on services provided by the government, but taxes are simply a burden to be shared. This concept of sacrifice is predicated on the marginal utility curve for money (the more one earns the less satisfaction will be derived from the last dollar earned), and for progressive taxation to hold based on fairness the marginal utility curve for all persons must be essentially the same. This assumption simply does not hold. What results is a vastly complex system where attempts are made to alter the progressive tax code in order to equalize marginal utility curves across various individuals (through myriad deductions, credits, shelters, and the like).

Fourth, a flat tax would significantly reduce the cost and resources necessary to comply with the tax code. Public choice economists likely consider the costs to manage, administer, and influence the current tax system in the U.S. a compelling reason for large-scale reform. According to the Tax Foundation, the overall cost of resources spent by Americans to file their taxes in 2011 was $338 billion. In addition, the Internal Revenue Service (IRS) has a budget over $13 billion which is necessary due to the administrative complexity of dealing with the federal tax code currently at approximately 13,500 pages (depending on how many words constitute a single page).

Finally, in evaluating the implications of flat tax reforms the overall level of revenue sent to Federal government is important to examine. This is perhaps one of the more controversial elements of a flat tax proposal, which is similar to the recent critiques of simply cutting marginal tax rates, and that is whether a flat tax system will provide enough revenue to fund Federal government programs and will there be a supply-side response when implementing a flat tax. While some studies of countries with flat tax systems in Eastern Europe have not demonstrated a significant boost in economic performance, there is reason to believe that the American economy would see a boost in the form of business investment. A flat tax would certainly make America more attractive for existing firms and foreign firms. Again the high rate at which U.S. firms are currently taxed (the second highest rate in the world), creates ample incentives for firms to leave the U.S. or choose not to invest in American projects.

Tax Reform in the United States

The Eastern European examples noted above demonstrate some of the parallels of policy implementation as well as the challenges with adopting a flat tax system in the United States. The U.S. has had plenty of “carriers” of the flat tax; after all, it was an American idea to begin

with. And though party platforms are less coherent in the United States than in European-style parliamentary systems, Republicans have generally supported a less progressive tax system, whether that means by cutting taxes and reducing rates or by promoting flat taxation. Moreover, American think tanks have been frequently waving the flat tax banner. So why, then, does the United States not have a flat tax? There are three important reasons for this.

First, if you look at the first flat tax adopters in Eastern Europe, you see a number of countries who three years earlier were under communist rule. With the fall of the Soviet Union a transfer of power occurred that put authority in the hands of relative newcomers willing to try out new ideas. In the United States any change to a tax policy alters some vested interest, whether that means changing the rates, eliminating or adding deductions, or scrapping a policy altogether. Just as a point of comparison, Lithuania's income tax laws are roughly 56 pages, and an abbreviated summary of that law is 12 pages. The United States federal tax code in its entirety is over 13,500 pages long and growing by the year. Obviously Lithuania is a much smaller country than the United States but the basic point still stands: the United States tax code has become unmanageable.

Second, there is also a fundamental misinterpretation about what the flat tax *really* is. Most plans are not quite as simple as Hall and Rabushka detailed almost twenty years ago, for example the flat tax plans proposed during the Republican primary season included limited deductions. Yet, what makes the flat tax simple is not that there is necessarily one rate (though that helps) but that the environment for manipulating the tax code with endless deductions and credits is effectively eroded. As economist Robert Frank noted in a New York Times op-ed: "The complexity of the current system has nothing to do with its multiple income brackets" (Frank 2011). Instead, he argues, calculating your adjusted gross income in a world of

exemptions, deductions and other inducements is the real culprit. Frank himself is not in favor of a flat tax, but agrees that the tax code has become unworkable. Or as conservative commentator John Podhoretz argued in the New York Post -- “The intellectual virtue of the flat tax… is its coherent simplicity: no deductions. Keep deductions, and the tax is no longer flat” (Podhoretz 2011).

Last, the flat tax has suffered from a lack of leadership at the executive level. In Eastern Europe Prime Ministers were extensively involved in policy-making. This is common in parliamentary systems as Prime Ministers are not only the chief representative for the executive branch but also the most important member of parliament and their party. Despite numerous attempts in Congress to flatten the tax code there has been a marked silence from the White House on this issue. Ronald Reagan’s persistent call to reduce taxes in the 1980s went a long way toward the passage of Tax Reform Act of 1986, and he demonstrated that radical reform is possible if championed by the executive branch. A similar commitment to reform would be needed from a sitting President in order to accomplish the change to a flat tax.

Conclusion

In addition to the economic benefits noted above, it is clear that the tax system in America has become the go-to means of policy implementation. Congress loves to provide incentives using the tax code. Any problem it wants to solve, use the tax code. Any behavior it wants to change, use the tax code. Any industry it wants to prop up or diminish, use the tax code. President Obama’s stimulus package which passed early in his presidency added 300 pages to the tax code. Manipulation of the tax code has simply become de facto government regulation. This is not a new practice for Congress or the President. Ever since the 16th Amendment, the federal government has increasingly used income taxes (on individuals and

businesses) to regulate, but the ever-increasing complexity created by using the tax code for basic policy purposes has reached a critical stage.

It is hard to contend against Robert Frank's claim that the "current tax system is profoundly dysfunctional" (Frank 2011). The Eastern Europeans have taught us that with serious leadership at the presidential level, with a coherent party platform, and with continued research and communication by think tanks and other policy centered organizations it would be possible to advance substantial and beneficial tax reform.

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