

Horizontal Equity as a Principle of Tax Theory

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I. INTRODUCTION

The principle of horizontal equity demands that similarly situated individuals face similar tax burdens.¹ It is universally accepted as one of the more significant criteria of a "good tax." It is relied upon in discussions of the tax base,² the tax unit,³ the reporting period,⁴ and more.⁵ Violation of horizontal

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1. Cf. THOMAS HOBBS, *LEVIATHAN* 238 (Richard Tuck ed., Cambridge Univ. Press 1996) (1651) ("To Equall Justice, appertaineth also the Equall imposition of Taxes."); JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY* 155 (Donald Winch ed., Penguin Books 1970) (1848) ("For what reason ought equality to be the rule in matters of taxation? For the reason, that it ought to be so in all affairs of government."); see also HENRY SIDGWICK, *THE PRINCIPLES OF POLITICAL ECONOMY* 562 (London, MacMillan 1883). However, references to equality made before the twentieth century were generally in the context of what is referred to today as vertical equity, the principles by which the tax burden should be spread out over the entire population. The above writers were considering the meaning of equality when distributing the tax burden among those not equally well-off.

The idea that the tax structure should impose similar burdens on equally well-off individuals was apparently first mentioned by Henry C. Simons and A.C. Pigou in the first half of the twentieth century. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 30 (1938) ("[W]e may say that tax burdens should bear similarly upon persons whom we regard as in substantially similar circumstances . . ."); *id.* at 106 ("[T]axes should bear similarly upon persons similarly situated."). Pigou explicitly differentiated between those principles of equality applicable to equally well-off individuals and those relevant to unequally well-off individuals—i.e., between horizontal equity and vertical equity: "[E]qual sacrifice among similar and similarly situated persons is an entirely different thing from equal sacrifice among all persons." A.C. PIGOU, *A STUDY IN PUBLIC FINANCE* 44 (3d rev. ed. 1949).

The term "horizontal equity," as referring to equal treatment of equally well-off taxpayers, came into common usage during the 1960s and 1970s, having been coined in R.A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 160 (1959). Adoption of the term "horizontal equity" nevertheless took several years. For instance, in 1965, when writing of the principles of tax theory, Joseph T. Sneed referred to equity and to mitigating economic inequality as two of those principles. When discussing mitigating social inequality, he used the term "vertical equity." However, the principle that similarly situated individuals should pay the same tax was referred to merely as "equity." Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 *STAN. L. REV.* 567 (1965). Musgrave may also have been the first to use the term "horizontal equity" in a law review article. R.A. Musgrave, *In Defense of an Income Concept*, 81 *HARV. L. REV.* 44, 45 (1967).

2. For the celebrated debate on this subject between William D. Andrews and Alvin Warren, see William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 *HARV. L. REV.* 1113 (1974); Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 *HARV. L. REV.* 931 (1975); William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 *HARV. L. REV.* 947 (1975); Alvin Warren, *Would a Consumption Tax Be Fairer*

equity, while not necessarily fatal, is nevertheless considered a serious flaw in any proposed tax arrangement.

Why should framers of the tax structure seek, as a matter of policy, to impose similar tax burdens on similarly situated taxpayers? Although horizontal equity is considered one of the more important principles of tax theory, scant attention has been paid to the question of its normative foundation.⁶ Ordinarily, theorists take for granted that the tax system should treat similarly situated taxpayers similarly, and turn their attention instead to the implementation of the principle: how well-being should be measured, or whether specific provisions of the tax structure violate horizontal equity.⁷ The lack of attention given to the theory of horizontal equity stands in marked contrast to the vast literature dealing with the other two linchpins of contemporary tax theory: vertical equity and economic efficiency.

It is important to emphasize that horizontal equity is concerned with individuals who are "similarly situated," not with those who are "identically situated." Tautologically, any conceivable tax arrangement will treat identically situated taxpayers equally. If the tax burden, for instance, falls more heavily on one group of taxpayers because their income, consumption patterns, marital status or place of residence is different than those of another group, then, by definition, the members of the two groups are not identically situated.

Taxpayers are similarly situated when their situations are considered to be equivalent. While identically situated taxpayers are always similarly situated,

than an Income Tax?, 89 YALE L.J. 1081, 1092 (1980). See generally David F. Bradford, *The Case for a Personal Consumption Tax, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE?* 75 (Joseph A. Pechman ed., 1980) [hereinafter WHAT SHOULD BE TAXED]; Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961 (1992); Richard Goode, *The Superiority of the Income Tax, in WHAT SHOULD BE TAXED, supra*, at 49; Mark G. Kelman, *Time Preference and Tax Equity*, 35 STAN. L. REV. 649 (1983); William A. Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461 (1977).

3. See, e.g., THE STRUCTURE AND REFORM OF DIRECT TAXATION: REPORT OF A COMMITTEE CHAIRED BY PROFESSOR J.E. MEADE 14-16 (1978) [hereinafter MEADE].

4. See, e.g., Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509.

5. See, e.g., William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Thomas Chancellor, *Imputed Income and the Ideal Income Tax*, 67 OR. L. REV. 561 (1988); Mark A. Haskell & Joel Kauffman, *Taxation of Imputed Income: The Bargain-Purchase Problem*, 17 NAT'L TAX J. 232 (1964); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979); William D. Popkin, *Household Services and Child Care in the Income Tax and Social Security Laws*, 50 IND. L.J. 238 (1974).

6. But see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990); Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993).

7. One English tax reform committee wrote that "[t]he following point[] [is] clear: A good tax system should be horizontally equitable, i.e., should treat like with like." MEADE, *supra* note 3, at 12. The committee did not clarify why like should be treated with like. See also ERIC RAKOWSKI, *EQUAL JUSTICE* 1 (1991) ("No one would deny that equals deserve equal treatment . . .").

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similarly situated taxpayers are not necessarily identical. If, for example, savers and consumers are similarly situated, horizontal equity demands that they face equal tax burdens *despite* their different circumstances.⁸

The fact that the tax system treats taxpayers similarly does not, of course, mean that they are similarly situated.⁹ Every tax respects horizontal equity in terms of its own base: a tax based on shoe size imposes an equal burden on all taxpayers who wear the same size shoe. For horizontal equity to be an effective tool of tax theory, it needs to be understood as requiring that *equally well-off* taxpayers be taxed equally.¹⁰ Consumption tax proponents, for example, do not claim that the income tax discriminates among taxpayers with similar incomes;¹¹ their claim is rather that income tax violates horizontal equity because income is not a true measure of well-being.

While the justification for horizontal equity is often ignored, the question of how well-being should be measured for the purpose of horizontal equity has attracted a great deal of attention. One example is the debate as to whether well-being should be expressed in terms of income or of consumption—i.e., whether horizontal equity should concern itself with equal earners or with equal consumers.¹²

8. A comment here on the distinction between vertical and horizontal equity is perhaps appropriate. For practical purposes, we cannot limit the realm of horizontal equity to taxpayers with precisely identical levels of well-being. It makes little sense, for example, to argue that horizontal equity requires two taxpayers, each of whom earns \$100,000, to face similar tax burdens, but that horizontal equity is indifferent to the relative tax burdens faced by two individuals, one of whom earns \$100,000 and the other of whom earns \$100,001. Since, at a sufficient level of specification, there are no two individuals who are perfectly similarly situated, horizontal equity might be thought an imaginary concept, inapplicable in the real world. Some commentators argue that horizontal equity requires respect for the ranking of taxpayers: one who is better off in the market distribution should remain better off after paying taxes. See A.B. Atkinson, *Horizontal Equity and the Distribution of the Tax Burden*, in THE ECONOMICS OF TAXATION 3, 4-7 (Henry J. Aaron & Michael J. Boskin eds., 1980); Martin Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 83 (1976); Fried, *supra* note 2, at 1009; Mervyn A. King, *An Index of Inequality: With Applications to Horizontal Equity and Social Mobility*, 51 ECONOMETRICA 99, 101 (1983); Robert Plotnik, *The Concept and Measurement of Horizontal Inequity*, 17 J. PUB. ECON. 373, 375 (1982). Alternatively, the definition of horizontal equity could perhaps be modified to require that taxpayers who are approximately similarly situated bear approximately the same tax burden.

In shaping the appropriate contours of horizontal equity, it would seem that one should initially focus on the extreme, if purely hypothetical, case of perfectly similarly situated individuals, and then search for the normative foundation of a rule requiring them to be subject to identical tax burdens. If there is no such normative justification, then determining the limits of horizontal equity would be a meaningless exercise. If, on the other hand, horizontal equity *stricto sensu* can be normatively grounded, the grounding itself would serve to define the contours of the principle—for example, forbidding the disruption of rankings or requiring the imposition of almost identical burdens on almost similarly situated individuals. This Article argues that horizontal equity could include whatever is justified by reference to the market distribution for reasons other than those of economic efficiency.

9. Cf. Chancellor, *supra* note 5.

10. Musgrave, *In Defense of an Income Concept*, *supra* note 1, at 45-48.

11. Although proponents do also raise this argument, in particular with reference to unrealized capital gain. *But cf.* STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 198-99 (1985) (claiming that the tax base of an income tax is not income but realized income).

12. See in particular the various articles by Andrews and by Warren, *supra* note 2. Another

This Article will not concern itself with the question of when the situations of different taxpayers should be considered similar.¹³ Those who debate whether equal earners or equal consumers should be similarly taxed, whether the existence of dependent minor children is a factor in computing well-being, or whether imputed income should be included in the tax base all assume that those who were similarly situated in the pre-tax distribution should remain so in the post-tax distribution. The focus of this Article is more basic: why should similarly situated taxpayers necessarily face the same tax burden?

Part II investigates the possibility of viewing horizontal equity as a function of economic efficiency. We will see that this is impossible, and that efficiency in the tax structure is not necessarily horizontally equitable.

Part III will examine the possibility of basing horizontal equity on accepted notions of vertical equity. The analysis will show that the social theories upon which most contemporary conceptions of vertical equity are based do not require respect for horizontal equity. Part IV will go further and will prove the independence of horizontal equity as a principle of tax theory by demonstrating that it is possible, in theory, to design a tax structure that is both economically efficient and highly redistributive, and yet blatantly violates horizontal equity.

Part V will consider whether horizontal equity can be viewed as an application of the constitutional guarantee of equal protection or of the philosophical principle of equality before the law. This Part will conclude that as a constitutional principle, equal protection does not prohibit horizontal inequity. It will further show that the philosophical imperative to treat people equally does not necessarily require respect for horizontal equity, although certain conceptions of equality might do so.

Part VI will show that horizontal equity can only be justified within the framework of a theory of social justice that accepts the morality of the market distribution. However, such an approach may undermine the very foundations of tax theory, by implying that the state may not disturb the market distribution through taxation—what the market hath joined, let no man put asunder. The normative foundation of horizontal equity as a principle of tax theory will, therefore, depend upon the simultaneous moral justification of both the market

example is the issue of medical deductions. Suppose that taxpayer *A*'s state of health necessitates large medical outlays. Is taxpayer *A* similarly situated to taxpayer *B*, whose income is the same, but who has no significant medical expenses? Or is taxpayer *A* similarly situated to taxpayer *C*, who also has no significant medical expenses and whose income is equal to what taxpayer *A* has left over after paying his medical bills? Horizontal equity requires that similarly situated taxpayers pay similar taxes. Thus, medical expenses should be deductible if the situations of taxpayers *A* and *C* are similar, but not if the situations of taxpayers *A* and *B* are similar. *Cf.* Andrews, *supra* note 5, at 334; Kelman, *supra* note 5, at 862-63.

13. See, e.g., MEADE, *supra* note 3, at 15 (comparing two taxpayers, one of whom is a bachelor, and the other of whom has a family to support); Schmalbeck, *supra* note 4 (comparing taxpayers with steady income streams to those whose incomes fluctuate).

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distribution and the taxing authority of the state. Accordingly, Part VI will investigate attempts by Robert Nozick and by Ronald Dworkin to integrate taxation into a market oriented social philosophy.

Part VII will summarize the findings and suggest some of their implications for the future of tax theory.

II. HORIZONTAL EQUITY AS A FUNCTION OF ECONOMIC EFFICIENCY

The first question to be examined is whether horizontal equity can be justified as a function of economic efficiency.

A. *The Apparent Congruence of Horizontal Equity and Economic Efficiency*

In an efficient market, the marginal rates of substitution of any two products, of work for leisure, and of present for future consumption will equal their marginal cost of transformation.¹⁴ Taxes create inefficiencies in the market through what is known as the substitution effect. By encouraging taxpayers to choose lower-taxed options—for example, leisure over work, or present over future consumption—taxes create a deadweight or net loss to society. The greater the deadweight loss, the greater the economic inefficiency.

Reducing deadweight loss involves moderating the substitution effect. The substitution effect, in turn, results from the ability of taxpayers to reduce their tax burden by choosing low-tax courses of action that differ from what they would have chosen in a no-tax world. The way to combat the substitution effect is therefore to impose an identical tax burden on every course of action available to the taxpayer. An efficient tax system would impose the same tax burden whether the taxpayer chose to work, rest, or perform services for herself. If the tax burden is the same whatever she chooses to do, her choice will be unaffected by tax considerations, and economic resources will be directed by market forces to their most efficient uses.

Here lies the apparent connection between economic efficiency and horizontal equity. Horizontal equity demands that similarly situated individuals pay the same amount of tax, without regard to what they choose to consume or how they choose to invest. A taxpayer who chooses to work should pay the same tax as another, equally well-off individual who chooses leisure, and one who consumes presently should pay the same tax as a similarly situated taxpayer who chooses to delay consumption. In general, horizontal equity demands that equally well-off taxpayers should pay the same amount of tax regardless of how they choose to act. Imposing different tax burdens on alternative courses of action violates both the principle of horizontal equity and

14. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 61 (1989).

the principle of economic efficiency.¹⁵

Nonetheless, society's interest in putting economic resources to their most productive use is insufficient to justify horizontal equity. This argument will proceed in two stages. The first stage will show that where economic activity involves significant externalities, an efficient tax would violate horizontal equity. The second stage will consider the argument from a more general perspective.

B. *Externalities*

The argument that taxation introduces inefficiencies into the market by disrupting the free flow of goods and services assumes the existence of a perfect pre-tax market. In practice, however, the market contains a number of flaws—neighborhood effects or externalities—which existing market incentives do not take into account. To achieve a higher level of efficiency, the state may exploit the tax system in order to internalize these externalities. A pollution tax, for instance, would ideally quantify the environmental damage of the production process, and by causing previously hidden costs to be taken into consideration by the market, actually contribute to economic efficiency. If the polluting activity were no longer economical after the imposition of the tax, the factors involved in its production would be better put to some other use.¹⁶

Where the economic activity concerned produces beneficial externalities, a negative tax (i.e., a subsidy) may be offered.¹⁷ A classic example of such a beneficial activity is education. Society as a whole, not just the individual student, benefits from a high level of education. Even if investing in education is uneconomic from the student's narrow viewpoint, society's overall interests might be better served by directing economic resources toward her education. When the subsidy correctly quantifies society's interests, it actually contributes to the efficiency of the market.

In both the aforementioned cases—the pollution tax and the education subsidy—horizontal equity is violated in order to further economic efficiency.

15. Note that the present analysis concerns horizontal equity and not vertical equity. The claim made here is not that anyone who chooses to act in a certain way should pay the same tax; the claim is that equally well-off individuals should pay the same tax whatever they choose to do. Under a progressive tax regime, for instance, two taxpayers who invest the same amount of money at the same rate of return, and who consequently receive the same gross interest, will not necessarily pay the same amount of tax, because they may be in different tax brackets due to other income. Neither horizontal equity nor economic efficiency is thereby violated. These two principles require only that taxpayers in the same tax bracket be taxed identically whether they save or consume.

16. Cf. Chester N. Mitchell, *Taxation, Retribution, and Justice*, 38 U. TORONTO L.J. 151 (1988) (arguing that the tax system should replace the criminal law as the primary means of regulating social behavior).

17. For our purposes, subsidies include both direct grants and tax breaks. See SURREY & MCDANIEL, *supra* note 11, at 2-3; Yoseph Edrey & Howard Abrams, *Equitable Implementation of Tax Expenditures*, 9 VA. TAX REV. 109 (1989).

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Equally well-off individuals will pay unequal amounts of tax because of the nature of their productive activities or their preferences for education. Efficiency is thus produced by the violation of horizontal equity.

C. *General Considerations of Efficiency and Horizontal Equity*

What happens when we shift our attention from specific, efficiency-producing taxes to the issue of general taxation? Although horizontal equity and economic efficiency do occasionally overlap, the concerns of each are fundamentally different. Whereas horizontal equity considers the relative well-being of the individual, economic efficiency analyzes the elasticity of the tax base. Elasticity here refers to the ease with which individuals can avoid tax by changing their behavior. In general, the narrower the tax base, the more elastic it is and the easier it is for the prospective taxpayer to avoid the tax. For example, a tax imposed on a particular unessential product or service (say, yachts) would be subject to the substitution effect, as the taxpayer can avoid the tax by purchasing a different product or service.¹⁸

A broader, and consequently less elastic, base is overall consumption. A tax imposed on consumption—whether indirectly as in a value-added type tax or directly through a cash-flow type tax¹⁹—cannot be avoided by purchasing product *A* as opposed to product *B*; it is therefore efficient with regard to the choice between different consumer products. Nevertheless, consumption as a tax base normally includes only purchased consumption. Self-provided services, including leisure, are not ordinarily included in the tax base, meaning that individuals may reduce their tax burden by avoiding remunerated work and engaging instead in self-provided services. The economic effects of using consumption as a tax base thus depend on the elasticity of the labor supply. The more sensitive the labor supply is to changes in net compensation, the less efficient consumption is as a tax base.²⁰

The elasticity of the labor supply is relevant, for example, in the ongoing dispute regarding income and consumption as alternative tax bases. A tax on income—defined theoretically as the sum of consumption and the change in the net value of assets²¹—reaches both consumption and investment. Because income is a broader tax base than consumption,²² collecting a similar amount of

18. See MUSGRAVE & MUSGRAVE, *supra* note 14, at 299-301.

19. See Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, *supra* note 2; Bradford, *supra* note 2, at 75.

20. See generally Jerry A. Hausman, *Labor Supply*, in HOW TAXES AFFECT ECONOMIC BEHAVIOR 27 (Henry J. Aaron & Joseph A. Pechman eds., 1981).

21. SIMONS, *supra* note 1, at 50; Robert Murray Haig, *The Concept of Income*, in THE FEDERAL INCOME TAX 1, 1 (Robert Murray Haig ed., 1921).

22. Income is a broader tax base provided that net investment is positive. When net investment is negative, consumption is a wider tax base. Nicholas Kaldor, in particular, relied on the capacity of the consumption tax to reach the dis-saving practiced by the upper classes of English society as an argument

revenue through a consumption tax would require higher rates than would an income tax. Thus, while return on investment is taxed only under an income tax, earned income is subject to a higher rate of tax under an equal-revenue consumption tax. As far as efficiency is concerned, the choice between the two taxes centers on the relative elasticity of investment and labor. If labor supply is more sensitive to net compensation than investment is sensitive to net return, an income tax will be more efficient.²³

The efficiency of a tax is thus a function of the elasticity of the tax base, and the search for an efficient tax is nothing other than an attempt to find an inelastic tax base. The most efficient tax base may be a head tax, because the tax base is the taxpayer's very existence, which few individuals would change for fiscal reasons. Similarly, a tax on the minimal income required for survival is highly efficient: when the tax structure makes achieving such a level of income difficult, poor individuals may have no option but to intensify their economic activity (the "income effect"). The higher one's income—and, consequently, the lower its marginal utility—the more elastic it becomes. High rates of tax on large incomes may cause wealthy individuals, who have already satisfied their basic needs, to prefer leisure to taxable income or to invest less due to lower net return. Due to the relative inelasticity of the tax base at lower levels of income and its increasing elasticity as income rises, efficiency considerations dictate a regressive tax.

Even when considering a narrow tax base, efficiency considerations would dictate imposing tax on inelastic bases. For example, a tax on essential medical services might be considered efficient if it could be demonstrated that the demand for this type of service is insensitive to its cost. A similar argument could be made for monopoly profits or windfalls. Even extremely high taxes on income of this type would not greatly affect behavior. A person who finds money lying in the street would generally not refrain from picking it up for tax reasons, as long as her marginal tax rate were less than 100 percent.

What, then, is the relationship between efficiency and horizontal equity? Whereas efficiency is concerned with elasticity of the tax base, horizontal equity examines the well-being of the individual taxpayer. Consider two equally well-off taxpayers, of whom one earns a salary, while the other finds money in the street. Since they are equally well-off, horizontal equity requires imposing the same tax burden on each.²⁴ Nevertheless, efficiency

in favor of the consumption tax. NICHOLAS KALDOR, AN EXPENDITURE TAX 91-96 (1955).

23. See, e.g., DANIEL C. MORGAN, JR., RETAIL SALES TAX: AN APPRAISAL OF NEW ISSUES (1964); Hausman, *supra* note 20, at 27; B. Douglas Bernheim & John B. Shoven, *Taxation and the Cost of Capital*, in THE CONSUMPTION TAX 61 (Charles Walker & Mark Bloomfield eds., 1987); E.P. Howrey & Saul Hymans, *The Measurement and Determination of Loanable-Funds Saving*, in WHAT SHOULD BE TAXED, *supra* note 2, at 1.

24. Assume here that the psychic costs of earning the money were already taken into account when determining that the two taxpayers were equally well-off.

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considerations might demand imposing a higher tax on the latter, as labor income is more subject to the substitution effect than are windfalls.

Horizontal equity cannot, therefore, be seen as flowing from economic efficiency. A tax can be efficient and still violate horizontal equity.

III. HORIZONTAL EQUITY AS A FUNCTION OF VERTICAL EQUITY

Vertical equity is concerned with the distribution of the tax burden along society's socio-economic spectrum. While past conceptions of vertical equity justified the imposition of heavy tax burdens on wide segments of society for the benefit of the better-off,²⁵ in modern times, vertical equity is often construed as requiring reductions in existing economic inequality.²⁶ While the extent to which economic inequality should be mitigated is heavily debated, current conceptions of vertical equity hold that the degree of economic inequality after taxes should be less than that which prevailed previously.

Vertical equity would therefore reject outright the creation of inequality from a state of pre-tax equality.²⁷ In other words, where the market itself generates economic equality among taxpayers, those who favor vertical equity would require maintaining that equality. An argument could therefore be made that horizontal equity is rooted in this duty to preserve pre-existing equality.

This Part argues that the derivation of horizontal equity from vertical equity is problematic when one considers the underpinnings of redistributionary theories of vertical equity. As will be shown, the major justifications of redistributionary taxation are end-state theories of social justice—theories that assign values to particular distributions without regard to how those distributions came about. However, as end-state theories do not consider the pre-tax market distribution when evaluating post-tax distributions, they are incapable of serving as a normative foundation for horizontal equity. Other theories of vertical equity—those that attach weight to the market distribution for reasons other than those of economic efficiency—raise the question of *why* the market distribution should be relevant to a moral evaluation of the post-tax distribution. That question will be considered in Part VI.

A. Utilitarianism

Since its inception, Utilitarianism has been relied upon to justify the

25. See, e.g., SIMONS, *supra* note 1, at 3-4.

26. See MEADE, *supra* note 3, at 12; Sneed, *supra* note 1, at 581; Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, *supra* note 2, at 943.

27. LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 37 (2002) ("Horizontal equity is just a logical implication of any traditional answer to the question of vertical equity. If tax justice is fully captured by a criterion that directs government to tax each level of income at a certain rate, it simply follows that people with the same pretax incomes should be taxed at the same rate."); MUSGRAVE, *THE THEORY OF PUBLIC FINANCE*, *supra* note 1, at 160; PIGOU, *supra* note 1, at 44-45.

redistribution of economic resources in order to reduce inequality. Nevertheless, in its classic formulation Utilitarianism does not consider equality to have intrinsic value at all. There are, in fact, those who argue that Utilitarianism is the antithesis of equality: should some individuals be more capable of transforming resources into pleasure, society's total utility would be increased by transferring additional resources to those individuals, until the marginal utility they derived from their additional resources equaled that of the rest of the population. Equality would demand the redistribution of resources in the opposite direction.²⁸

Equality in Utilitarianism is therefore not an end in itself, but at most is a means to maximizing society's total utility. Nevertheless, if people are equally capable of transforming resources into pleasure—or if, being incapable of proving otherwise, we assume that they are—and if resources have declining marginal utility, then a more equal distribution would result in a greater overall level of satisfaction. The striving for equality would, of course, need to be tempered by considerations of efficiency; otherwise the increase of total utility achieved by the more equal distribution of resources would be more than offset by the decreased amount of resources available for distribution. Nevertheless, Utilitarian thinkers normally held that, subject to requirements of efficiency, society should strive for a more equal distribution of resources.

A Utilitarian redistribution would not, however, be obligated to respect horizontal equity. To use a term coined by Robert Nozick, Utilitarianism is an “end-state” theory.²⁹ End-state theories are not concerned with how a particular distribution came about: they consider only the final, post-redistribution state of affairs under whatever criteria the particular theory expounds. In the case of Utilitarianism, for example, that criterion is the maximization of total welfare. What is significant for our purposes, however, is not the criterion chosen but the very fact that we are dealing with an end-state theory. When the comparison considers merely the distribution inherent in the various end-states, the relationship between the original market distribution and the redistributed end-state is irrelevant. Consequently, end-state theories are insensitive to any particular individual's position in the original distribution.

For example, assume that a society composed of nine members (named *A* through *I*) is considering the following redistributions, which can be achieved through alternative tax structures:

28. ROBERT NOZICK, *ANARCHY, STATE AND UTOPIA* 41 (1974); SIMONS, *supra* note 1, at 14.

29. NOZICK, *supra* note 28, at 155.

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Individual	Pre-tax Income	Redistribution I	Redistribution II
<i>A</i>	150	135	100
<i>B</i>	150	135	125
<i>D</i>	125	115	125
<i>C</i>	100	100	75
<i>E</i>	100	100	100
<i>G</i>	100	100	125
<i>F</i>	75	85	75
<i>H</i>	50	65	75
<i>I</i>	50	65	100
Total	900	900	900

Even though Redistribution I respects horizontal equity (similarly situated taxpayers remain so after taxation), Utilitarians would no doubt prefer Redistribution II.³⁰ As noted, the prior distribution is irrelevant for proponents of end-state theories. The fact that two individuals were equally well-off beforehand, and that the redistribution created inequality between them, is completely irrelevant so long as the redistribution conforms to the principles underlying the theory.

This does not, of course, indicate that as a matter of policy, Utilitarians will specifically seek to violate horizontal equity; they are simply indifferent to it. Horizontal equity would be of interest only if its violation, by affecting market efficiency, threatens to reduce the total amount of satisfaction or the total amount of resources available for distribution.

It could, however, be argued that Utilitarians would seek to respect horizontal equity for fear that doing otherwise would conflict with the taxpayers' perceptions of fairness, and that the consequent feelings of insult and frustration would negatively affect their happiness. Furthermore, if citizens were to lose faith in the framers of social policy, the consequent acrimony might well reduce society's welfare by affecting the functioning of social institutions, anywhere from encouraging individuals to cheat on their taxes ("which aren't fair anyway") to bringing about civil unrest.³¹

Two responses can be given to this argument. The first is that the question raised is empirical and not normative. It is impossible theoretically to predict or quantify the effect on social welfare of a particular violation of horizontal equity. Moreover, issues other than horizontal equity might be foremost in

30. Assuming that the marginal utility of income diminishes as income rises, and that all persons are equally capable of converting resources into pleasure, total utility would be greater under a more equal distribution than under one allocating a greater share of the same fixed income to some rather than others.

31. See R.M. HARE, *The Argument from Received Opinion*, in *ESSAYS ON PHILOSOPHICAL METHOD* 117, 134 (1971); Rolf Sartorius, *Utilitarianism and Obligation*, 66 *J. PHIL.* 67 (1969).

taxpayers' minds when they evaluate the fairness of the tax structure. Historically, "tax revolts" have almost always centered on issues of vertical equity, the level of taxation, or the method by which taxes were imposed, not on violation of horizontal equity.³²

Second, this disadvantage of horizontal inequity is dependent on the popular sense that horizontal equity should be respected; otherwise its violation would not be upsetting. The point of the present study, however, is to examine whether horizontal equity has an independent theoretical justification. While Utilitarians would perhaps want to consider the symbolism of the tax system and its impact on individual welfare, answering that horizontal equity should be respected because people feel that it should be respected involves a certain amount of circular reasoning. Furthermore, such reasoning would make all of tax theory superfluous, as one could make do with public opinion polls.

The problem inherent in relying on popular perception for the normative grounding of horizontal equity can be further demonstrated by noting that undiscovered violations of horizontal equity would be unobjectionable: the public's ignorance of the inequity would preclude any negative impact. Accordingly, should a scholar of tax theory discover by means of deep and sophisticated analysis that an accepted tax arrangement violates horizontal equity,³³ he would best refrain from publishing his findings. As long as the violation were not widely recognized, it would be unobjectionable.

B. *Rawls*

As opposed to Utilitarianism for which equality is at best a means, John Rawls considered equality to be an end in itself, and used it as his starting point in the development of his "difference principle."³⁴ The difference principle holds that any deviation from absolute equality in the distribution of primary social goods is justified only if the least well-off in the unequal distribution are

32. Consider, for instance, the resistance displayed by the American colonies to taxes imposed by the British Parliament. This resistance did not result from any supposed inequality between the taxes imposed on the colonies and those in force in England at the time, but from the colonists' assertion that Parliament had no right to impose taxes on people lacking representation. EDMUND S. MORGAN & HELEN M. MORGAN, *THE STAMP ACT CRISIS: PROLOGUE TO REVOLUTION* 53-63 (1953). Other examples include the French Revolution, brought on in part by the taxation of the masses for the benefit of the aristocracy and clergy, SIMONS, *supra* note 1, at 3-4; California's Proposition 13, which limits property taxes to a percentage of the property's purchase price, despite the violation of horizontal equity inherent in its discrimination against more recent purchasers during periods of rising land values, (*see infra* discussion at note 59); and the fall of the Thatcher Government in England following an attempt to impose a head tax, which respects horizontal equity but violates accepted notions of vertical equity.

33. For example, consumption tax advocates often argue that the income tax violates horizontal equity by discriminating against future consumers.

34. JOHN RAWLS, *A THEORY OF JUSTICE* 75 (1971); *see id.* at 62 ("All social values—liberty and opportunity, income and wealth, and the bases of self-respect—are to be distributed equally unless an unequal distribution of any, or all, of these values is to everyone's advantage.").

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better off than they would have been under a more equal distribution.³⁵ The preferred structure is one in which the welfare level of the least well-off is maximized. The wealth of the rich, then, is justified only to the extent that it contributes to the welfare of the poor.

Rawls' difference principle, like Utilitarianism, can be viewed as an end-state theory. Should a different distribution be possible that would be more beneficial to the poor, such a distribution should be adopted. It is immaterial whether one wealthy individual in the first distribution might be worse-off in the second, while another might survive the redistribution with her wealth intact. In other words, horizontal inequity would not reduce the justice of such a redistribution.

Consider an attempt by society to design a tax structure based on Rawlsian concepts. If the revenue raised by imposing taxes on certain wealthy individuals would benefit the poor, while taxing other, equally rich individuals would worsen the situation of the least well-off due to detrimental economic effects, the difference principle would approve taxing the former but not the latter. The blatant violation of horizontal equity is irrelevant as far as the difference principle is concerned. The point is that in Rawlsian philosophy, no person is morally entitled to his current wealth. Inequality is justified only when the advantages enjoyed by the rich contribute to the welfare of the poor. In effect, every wealthy individual—indeed, anyone not occupying the bottom rung of the socio-economic ladder—has the burden of proving that transferring part of her wealth to others who are less well-off than she would not improve their economic situation. Whoever succeeds in so doing may retain her wealth. With regard to whoever cannot, society has both the right and the obligation to redistribute their wealth in conformity with the dictates of the difference principle.

The difference principle, it should be noted, is not the only possible outcome of Rawlsian methodology. Rawls proposed examining conceptions of justice by asking which principles would be adopted by reasonable people who were ignorant of their social position and their talents. Rawls argued that behind this "veil of ignorance," risk aversion would dominate all other considerations, and that rational individuals would therefore strive to maximize the welfare level of the most disadvantaged segment of society.³⁶ Nonetheless, while it is generally assumed that risk-aversion would be one of the factors determining the final outcome, it could be argued that rational individuals

35. In Rawls' theory, justice in the distribution of basic liberties is lexicographically prior to justice in the distribution of goods. *Id.* at 61-64. Thus, the optimal state is not necessarily the one in which the distribution of goods conforms to the difference principle. However, as the tax burden concerns the distribution of goods and not the distribution of liberties, it is enough for our purposes to show that the difference principle would not respect horizontal equity.

36. *Id.* at 152-56. Were there no aversion to risk, the participants would presumably agree upon a welfare-maximizing arrangement, consistent with Utilitarian principles.

behind the veil of ignorance would be willing to sacrifice some of the welfare of the least well-off if the advantages to other segments of society would be sufficiently great.

Whether conforming to the difference principle or not, however, a Rawlsian redistribution would not seek to respect horizontal equity. Rawlsian philosophy is based upon the principle that talents and positions in society are distributed by a natural lottery; individuals have no moral claim to what they received in the natural distribution, and society has both the right and the obligation to effect a redistribution of wealth. The fact that *A* may have been similarly situated to *B* in the natural distribution does not mean that she has a greater claim than anyone else to be equal to *B* in the redistribution.

C. *Sacrifice Theory*

Sacrifice theory, which once dominated discussions of vertical equity and ostensibly provided support for progressive taxation, is not an end-state theory. By demanding that each individual suffer an equal sacrifice in paying her taxes, sacrifice theory would appear to respect horizontal equity: when two individuals are equally well-off in the pre-tax distribution, an equal sacrifice would leave them equally well-off in the post-tax distribution. Conversely, a violation of horizontal equity would indicate that equally well-off individuals were called upon to make dissimilar sacrifices. However, sacrifice theory cannot be offered as a justification for horizontal equity without considering its origins and purposes.

Sacrifice theory is the stepchild of classic Utilitarianism,³⁷ and it was devised as a method to achieve Utilitarian goals. Sacrifice theory was introduced to the world with these words of John Stuart Mill:

Whatever sacrifices [the government] requires from them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole.³⁸

This statement contains a goal and a proposal of how to reach that goal. The goal set by Mill is minimum total sacrifice, a goal wholly compatible with Utilitarian ends. "Sacrifice," meaning negative utility or negative welfare, must be minimized in order that total utility may be maximized.

The means by which Mill proposed to achieve this end is equal sacrifice, a standard he claims would also minimize total sacrifice. But Mill did not prove or even attempt to prove this claim. Moreover, as subsequent Utilitarian

37. But see Klaus Vogel, *The Justification for Taxation: A Forgotten Question*, 33 AM. J. JURIS. 19, 27-28 (1988). Vogel claims that sacrifice theory was adopted in the nineteenth century by German philosophers who endowed the state with theological attributes. The concept of "sacrifice" as a description of the gift offered the god-state by the citizen correlated well with this outlook: the state, entitled to demand the blood of its citizens, can also demand their wealth.

38. MILL, *supra* note 1, at 155.

thinkers discovered, the claim is simply false. Whether two given taxpayers suffer similarly in paying taxes proves nothing with respect to the total utility loss. Indeed, if the individuals are not equally well-off, then in accordance with the axioms of classic Utilitarianism, their marginal utility is also unequal. Placing a greater share of the tax burden on the shoulders of the wealthier individual with lower marginal utility would raise the same amount of revenue while reducing overall sacrifice.

Those who followed in Mill's footsteps attempted to interpret his statement as proposing not equal sacrifice, but rather something else which might perhaps justify his conclusion.³⁹ For example, "equal sacrifice" was occasionally interpreted as sacrifice proportional to one's well-being. Edwin R.A. Seligman claimed that "[w]hen economists speak of equal sacrifice they mean relatively proportional sacrifice . . . 'Equal' sacrifice is thus merely a rough way of expressing the idea of 'proportional' sacrifice."⁴⁰ Nonetheless, the question remains why equal proportional sacrifice, any more than equal absolute sacrifice, would result in minimum overall sacrifice. Were the goal minimal overall sacrifice, taxes would not be imposed equally, but upon those who would suffer the least from them. If we assume that marginal utility always decreases and that the utility curve is identical for all individuals, minimum sacrifice would be achieved by taxing only the wealthiest individuals and exempting everyone else. Henry Sidgwick recognized this fact when he noted that

[t]he common sense of mankind, in considering these inequalities, implicitly adopts, as I conceive, two propositions laid down by Bentham as to the relation of wealth to happiness: viz. (1) that an increase of wealth is—speaking broadly and generally—productive of an increase of happiness to its possessor; and (2) that the resulting increase in happiness is not simply proportional to the increase in wealth, but stands in a decreasing ratio to it. . . . And from these two propositions taken together the obvious conclusion is that the more any society approximates to equality in the distribution of wealth among its members, the greater on the whole is the aggregate of satisfactions which the society in question derives from the wealth it possesses.⁴¹

However, Sidgwick refrained from proposing that this conclusion be implemented. He felt that equalizing wealth would reduce the incentive to work or invest; would cause wealth to be inefficiently managed; would lead to an increase in population; and would interfere with the role of the wealthy in creating culture. The Utilitarian ideal of minimal sacrifice was impractical. The critical question then became the limits beyond which a redistributionary tax system should not go. Sidgwick was of the opinion that if complete

39. See WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* 51 n.128 (1953) ("An amusing study could be written on the many efforts of those who came after Mill to save him from error in this passage.").

40. E.R.A. SELIGMAN, *PROGRESSIVE TAXATION IN THEORY AND PRACTICE* 135-36 (Baltimore, American Economic Assn. 1894).

41. SIDGWICK, *supra* note 1, at 518.

redistribution were impossible, then no natural stopping point exists:

[I]f the principle of redressing inequalities is applied at all, any limit to its application seems quite arbitrary; if the burden of the rich is to be twice as great as that of the poor, there seems no clear reason why it should not be three times as great, and so on. I hold therefore that the general aim of a statesman in distributing taxation should be to impose, as nearly as possible, equal sacrifices upon all.⁴²

According to Sidgwick, equal sacrifice—and perhaps the same can be said for equal proportional sacrifice—is nothing more than an identifiable, although totally arbitrary, point on the continuum stretching from an unjust head tax to an impractical egalitarianism.⁴³

Moreover, as Walter J. Blum and Harry Kalven, Jr. point out:

Any theory of equalizing the sacrifice of taxpayers implicitly assumes that the taxes are a necessary evil falling upon a distribution of money, and therefore upon a distribution of satisfactions, which is otherwise acceptable. With this assumption the problem is not to use the tax system to adjust existing inequalities in that distribution but simply to leave all taxpayers equally “worse off” after taxes.⁴⁴

Can, then, sacrifice theory serve as a possible normative justification of horizontal equity? I believe that doing so would leave horizontal equity without a solid normative justification. If sacrifice theory is none other than a means of achieving Utilitarian goals, the theory must necessarily yield whenever the two conflict. Thus, no objection could legitimately be raised to a tax structure that promoted Utilitarian goals while violating horizontal equity. Alternatively, sacrifice theory might be seen as a compromise between complete equality in distribution of wealth and the dictates of economic efficiency, which reject too great a disruption of market incentives. As efficiency considerations do not allow for equal distribution of wealth, the process of redistribution must be stopped at some point on the continuum stretching from the market distribution to total equality. In identifying the optimal resting point, however, one must consider all the economic and social effects of the choice, and there is no

42. *Id.* at 562.

43. This line of reasoning, it should be noted, appears to contradict Mill's poignant (although unsubstantiated) depiction of equal sacrifice as the Platonic ideal that a practical tax structure can only hope to approach:

For what reason ought equality to be the rule in matters of taxation? For the reason, that it ought to be so in all affairs of government. As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole. If any one bears less than his fair share of the burthen, some other person must suffer more than his share, and the alleviation to the one is not, *caeteris paribus*, so great a good to him, as the increased pressure upon the other is an evil. Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his. *This standard . . . cannot be completely realized; but the first object in every practical discussion should be to know what perfection is.*

MILL, *supra* note 1, at 155 (emphasis added).

44. BLUM & KALVEN, *supra* note 39, at 43-44.

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evidence that either equal or proportional sacrifice are optimal policies in this sense of the word.⁴⁵

If, on the other hand, sacrifice theory is justified because it retains the absolute or relative disparities inherent in the existing distribution, the question arises as to why society would be interested in retaining existing inequalities for reasons other than economic efficiency. This question will be analyzed in Part VI.

IV. THE INDEPENDENCE OF THE PRINCIPLE OF HORIZONTAL EQUITY

We have seen that horizontal equity is not a function of economic efficiency; nor can it be considered a function of those conceptions of vertical equity that require use of the tax structure to mitigate economic inequality. It is possible to establish tax structures that advance the cause either of economic efficiency or of vertical equity while blatantly violating horizontal equity. With regard to economic efficiency, we have seen that imposing tax burdens relative to the inelasticity of the base—i.e., taxing income from inelastic sources more heavily than income from elastic ones—minimizes the substitution effect and thus minimizes the detrimental economic effects of the tax. This type of tax structure entails a small deadweight loss, yet violates horizontal equity.

A similar argument can be made with regard to vertical equity. Those social theories that would use the tax structure to mitigate economic inequality are concerned with the distribution of income. The situation of any particular individual before or after taxes is irrelevant. The demand is merely that the post-tax distribution be more just than the pre-tax distribution, or than other redistributions available under alternate tax structures. Here, too, it is possible to imagine a tax structure that would advance the cause of vertical equity while representing a wholesale violation of horizontal equity.

These two examples prove that horizontal equity is neither a function of economic efficiency nor of vertical equity. Note, however, that the latter two principles are not always compatible: achieving economic efficiency may entail

45. If equal sacrifice—whether absolute or relative—is nothing other than an arbitrary compromise between the desire to redistribute wealth and the fear of interfering with market efficiency, why did sacrifice theory dominate tax theory for so many years? No one, after all, has yet shown that equal sacrifice, located somewhere on the continuum between maintaining the status quo and a complete redistribution, is the optimum compromise. What, therefore, is the attraction of sacrifice theory? The impression one generally gleans from reading analyses of equal absolute or equal relative sacrifice is that these theories are means by which to achieve redistribution without openly admitting such a goal. It is entirely possible that political constraints, in particular the hesitation at certain times and in certain places to advocate “socialist” ideas, led to the adoption of sacrifice theory. Sacrifice theory allows one to advocate, under the banner of equal taxation, a regime that taxes the rich more heavily than the poor. When the social and political climate began to allow open discussion of redistribution, sacrifice theory lost a great deal of its *raison d’être*. In other words, we may be dealing with a phenomenon of first determining the result and then structuring a theory to justify it. Perhaps this is why sacrifice theory is not as popular now as it once was; today, one who supports redistribution may openly say so, relying, for example, on Rawlsian principles, and need not hide behind the broad back of sacrifice theory.

a violation not only of horizontal equity but also of vertical equity, as wealthier individuals can more easily modify their economic activity to take account of the dictates of the tax structure. Similarly, in achieving vertical equity, the post-tax distribution may be more just than the pre-tax distribution, but the redistribution itself might create serious disincentives for work and investment.

One might wonder, then, whether horizontal equity, while a function neither of vertical equity nor of economic efficiency, is nevertheless a function of the two combined. In other words, it may be argued that horizontal equity contains elements both of efficiency and of vertical equity, and that it is therefore not an independent principle of tax theory, but rather a side effect caused by the implementation of these other principles. This hypothesis can be tested by attempting to design a tax structure that respects both vertical equity and economic efficiency, but nevertheless violates horizontal equity.

This approach can be illustrated by noting that it is possible to construct a tax structure conforming to horizontal and vertical equity but which is economically inefficient (e.g., a confiscatory tax of all incomes above a certain level), or one conforming to horizontal equity and economic efficiency but which is not vertically equitable (e.g., a head tax). These examples prove the independence of vertical equity and of economic efficiency as principles of tax theory.

Is it possible to prove the independence of horizontal equity by constructing a tax system which is both vertically equitable and economically efficient, but is nevertheless horizontally inequitable? It turns out that such a structure is possible. Take, for instance, a tax imposed according to certain objective criteria, bearing a statistical, although not absolute, relationship to income or economic well-being. Examples of such criteria might include racial or ethnic background, height, gender, etc. As there is almost no way for individuals to reduce their tax burden by modifying their behavior, such a tax would be economically efficient. Administrative and compliance costs would also be reduced to a minimum, as the criteria of the contemplated tax base are fairly difficult to hide. Furthermore, such a tax would be vertically equitable, in the sense that the post-tax distribution would be more equal than the pre-tax distribution. Nevertheless, the proposed tax structure would clearly violate the principle of horizontal equity.

Suppose that in certain societies there exists a statistical correlation between income and physical height: tall people tend to earn more than shorter people, although the relationship between income and height is not absolute. Consider the members of a nine-individual society whose heights and incomes are presented below:

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Individual ⁴⁶	Height	Pre-tax income
<i>A</i>	6'4"	150
<i>B</i>	6'0"	150
<i>C</i>	5'8"	125
<i>D</i>	6'0"	100
<i>E</i>	5'8"	100
<i>F</i>	5'4"	100
<i>G</i>	5'8"	75
<i>H</i>	5'4"	50
<i>I</i>	5'0"	50

The society in question is not satisfied with this distribution of income; particularly unacceptable is the fact that some earn three times as much as others. On the other hand, a tax on higher incomes would create disincentives to work—both for the rich, who would be required to hand over part of their earnings to the government, and for the poor, who by virtue of their poverty would be entitled to transfer payments. The policymakers, therefore, propose to impose a tax not on income but on height—such that the taller the individual, the more tax they would pay—in accordance with the following table:

Individual	Height	Pre-tax Income	(Tax Paid) / Transfer Payment Received	Post-Tax Income
<i>A</i>	6'4"	150	(50)	100
<i>B</i>	6'0"	150	(25)	125
<i>C</i>	5'8"	125	0	125
<i>D</i>	6'0"	100	(25)	75
<i>E</i>	5'8"	100	0	100
<i>F</i>	5'4"	100	25	125
<i>G</i>	5'8"	75	0	75
<i>H</i>	5'4"	50	25	75
<i>I</i>	5'0"	50	50	100

The contemplated tax structure would not affect the efficiency of the market; because the tax base is height rather than income, the effective marginal rate of taxation on income would be 0%. The same considerations that determined individuals' behavior in the pre-tax world would continue to control

46. As in the table in Section III.A, *supra*, the individuals are ranked in descending order of pre-tax income.

their behavior after the tax.⁴⁷ As there is no way to avoid taxes by modifying one's behavior—assuming that height cannot be manipulated or that no one would do so for fiscal reasons—the substitution effect would be inoperative.

Moreover, the contemplated tax structure is vertically equitable, in the sense of mitigating economic inequality. In the pre-tax world, the richest segment of the population earned three times as much as the poorest. After imposition of the tax, the richest would earn just 67% more than the poorest. The standard deviation from absolute equality would be reduced from 12.5% to 4.2% of the average income. Furthermore, if the poverty level were defined as 60% of the average income, the contemplated tax structure would succeed in eliminating poverty altogether. What we have here is an impressive feat of mitigating inequality that any redistributionary tax system would be proud to achieve. And yet this goal was achieved without distorting economic incentives.

On the other hand, horizontal equity is nowhere to be found. Taxpayer *A* would be required to pay twice as much as *B*, despite the fact that their pre-tax incomes are the same. *D* would pay 25% of his income to the treasury, *E* would pay no tax at all and *F* would receive transfer payments, even though all three have identical pre-tax incomes. In fact, there is not a single instance in which similarly situated taxpayers pay the same tax.

The facts presented are admittedly simple, as they include only nine individuals and a strong correlation between height and income. In practice, it is probably impossible to achieve such an extensive redistribution of wealth along with such a clear violation of horizontal equity by means of a tax on unmodifiable, objective criteria. Nevertheless, what we are presently concerned with is theory and not its direct practical implementation. The fact that there exists an arrangement that is vertically equitable, economically efficient, and yet horizontally inequitable is sufficient to prove the independence of horizontal equity.

If there is a normative justification for horizontal equity, it is not to be found in vertical equity, in economic efficiency, or in any combination of the two. In other words, if the proposed height tax has an objectionable flaw, the grounds for such an objection have not yet been uncovered. Our search for the underpinnings of horizontal equity must therefore lead us through other legal and philosophical byways.

V. HORIZONTAL EQUITY AS A FUNCTION OF EQUAL PROTECTION OR EQUALITY BEFORE THE LAW

The present Part will consider whether horizontal equity can be viewed as

47. The possible income effects of the tax are ignored, as the income effect does not create inefficiencies in the market mechanism.

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an application of constitutional principles of equal protection or of philosophical principles of equality before the law. Principles of equality ostensibly require the equal treatment of individuals who are equal in all respects relevant to the legal rule in question. If similarly situated taxpayers are equal in this sense, the tax structure would be prohibited from discriminating among them by imposing different tax burdens. The argument could therefore be made that horizontal equity is an application of the requirement of the principle of equality.

A. *Equal Protection: Procedure and Substance*

The nature of equal protection as a constitutional principle depends upon the constitutional structure of the country concerned. In England, for example, the unwritten constitution does not limit the power of Parliament.⁴⁸ Under such a constitutional regime, legislative enactments are not subject to judicial review. Should the law treat different people differently, the principle of equality requires merely that the law be applied as written. Equal protection here is procedural, and is violated when a rule intended for members of one group is applied to the other. As Lord Wright stated with reference to equality before the law:

That maxim is true enough, but all the same the law may impose inequalities: it would be true to say that all persons are equally subject to the law, though the law to which some are subject may be different from the law to which others are subject.⁴⁹

Such procedural equality does not imply respect for horizontal equity. If the law treats consumers differently than it does savers, or if it imposes varying tax rates on incomes derived from different sources, procedural equality is satisfied when the laws are applied as written. The fact that equally well-off taxpayers may face unequal tax burdens is irrelevant.

In countries where the legislature is subject to formal constitutional restraints, equal protection often takes on a substantive aspect. Substantive equal protection demands that the legislative branch itself, in establishing the rules by which the other branches operate, respect the principle of equal protection. A law that fails to do so may be unconstitutional.⁵⁰

48. Although by joining the European Community, Britain agreed that domestic law incompatible with European Community law is invalid. See Paul Craig, *Britain in the European Union*, in *THE CHANGING CONSTITUTION* 61 (Jeffrey Jowell & Dawn Oliver eds., 4th ed. 2000).

49. Lord Wright, *Liberty and the Common Law*, 9 CAMBRIDGE L.J. 2, 4 (1945).

50. It is interesting to note in this context the case of *Powell v. Pennsylvania*, 127 U.S. 678 (1888), in which the petitioner challenged the constitutionality of a Pennsylvania statute forbidding the sale of margarine. The Court rejected the argument that dealers in margarine were discriminated against:

The objection that the statute is repugnant to the [Equal Protection Clause] . . . is untenable. The statute places under the same restrictions, and subjects to like penalties and burdens, all who manufacture, or sell . . . the articles embraced by its prohibitions; thus recognizing and preserving the principle of equality among those engaged in the same business.

The question, then, is whether the principles of substantive equal protection require respect for horizontal equity in the tax system, and whether horizontal equity can thus be justified as an application of those principles.

B. *Suspect and Non-Suspect Classification*

Laws, by their very nature, classify individuals into categories and accord them different treatment. The law distinguishes between adults and minors and between those who have a driver's license and those who don't. It distinguishes between those who kill intentionally and those who cause death negligently or in self defense. It classifies people as judges, as police officers, and as civil servants. In fact, it is difficult to imagine a legal system that would not constantly classify people and bestow upon them different rights, privileges, obligations, and punishments.

The central question, therefore, is not whether a law distinguishes among individuals. Almost all laws do. The question is how the particular law concerned classifies individuals and why. Under American law, for example, race is the standard suspect classification. Laws that distinguish among persons on account of their race are subject to strict scrutiny in order to determine whether there exists a compelling need for the racial classification. In theory, racial classifications are permitted when the legislative interest is compelling and when there is no other reasonable way to achieve that purpose. In practice, however, strict scrutiny almost always leads to the invalidation of the law in question; this type of scrutiny has therefore been described as not strict but fatal.⁵¹ It is, therefore, safe to assume that a law imposing taxes based upon the race of the taxpayer would be unconstitutional.

A similar argument might apply to a tax that, although ostensibly neutral with regard to suspect categories, primarily impacted a politically marginalized group.⁵² An example could be an excise tax on a product or service whose

Powell, 127 U.S. at 687. The challenge to the law's constitutionality was based upon a principle of substantive equal protection, and contended that the law discriminated among different groups in society. The Court, however, examined the law according the principle of procedural equality and determined that the law applied equally to all those belonging to the class the law itself delimited. Obviously, no law applied as written could ever violate the principle of procedural equality. *Cf.* Joseph Tussman & Jacobus tenBroek, *The Equal Protection of the Laws*, 37 CAL. L. REV. 341, 345 (1949) ("What is striking about this statement is the easy dismissal of the equal protection issue on the grounds that the law applies equally to all to whom it applies. . . . By the same token a law applying to red-haired makers of margarine would satisfy the requirements of equality.").

51. LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* 1451 (2d ed. 1988). For discussions regarding the justification of suspect classification theory, see JOHN HART ELY, *DEMOCRACY AND DISTRUST* (1980); Bruce A. Ackerman, *Beyond Carolene Products*, 98 HARV. L. REV. 713 (1985); and Laurence H. Tribe, *The Puzzling Persistence of Process-Based Constitutional Theories*, 89 YALE L.J. 1063 (1980).

52. *Cf.* *United States v. Carolene Products Co.*, 304 U.S. 144, 153 n.4 (1938) (refraining from enquiring "whether prejudice against discrete and insular minorities may be a special condition, which tends seriously to curtail the operation of those political processes ordinarily to be relied upon to protect

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primary consumers are members of such a group.

Tax theorists, however, are not normally concerned with laws of this sort. The issue of horizontal equity arises in discussions which focus, for example, on the taxing of saving while exempting consumption, on the taxing of consumption requiring monetary outlay while exempting the consumption value of leisure, or on the taxing of domestically generated income differently than foreign-source income.⁵³ Do distinctions of this sort, which violate horizontal equity, run afoul of the constitutional requirement of equal protection?

In *Allied Stores of Ohio, Inc. v. Bowers*,⁵⁴ the Supreme Court affirmed the constitutionality of an Ohio law that exempted from property taxes any inventory stored in Ohio by non-residents of the state. The taxpayer, an Ohio resident to whom the exemption did not apply, argued that the law in question discriminated against residents of Ohio and thereby violated the Fourteenth Amendment's guarantee of equal protection. The Court rejected the argument, reasoning as follows:

The States have a very wide discretion in the laying of their taxes. When dealing with their proper domestic concerns, and not trenching upon the prerogatives of the National Government or violating the guarantees of the Federal Constitution, the States have the attribute of sovereign powers in devising their fiscal systems to ensure revenue and foster their local interests. Of course, the States, in the exercise of their taxing power, are subject to the requirements of the Equal Protection Clause of the Fourteenth Amendment. *But that clause imposes no iron rule of equality, prohibiting the flexibility and variety that are appropriate to reasonable schemes of state taxation. The State may impose different specific taxes upon different trades and professions and may vary the rate of excise upon various products.* It is not required to resort to close distinctions or to maintain a precise, scientific uniformity with reference to composition, use or value.⁵⁵

Equal protection does not therefore require the imposition of an equal tax on

minorities, and which may call for a correspondingly more searching judicial inquiry”).

53. This is not, of course, to say that tax theorists would condone discriminatory taxes such as those described in the text. However, this may merely represent an area of overlap of the two principles. To demonstrate that horizontal equity is independent of equal protection, one need only show that horizontal inequity can exist even when the laws concerned do not violate equal protection—not that there is no overlap between them. As will be shown, a tax arrangement may be illegitimately discriminatory even when horizontal equity is not an issue—which proves that equal protection is not itself a function of horizontal equity.

54. 358 U.S. 522 (1959).

55. *Id.* at 526-27 (emphasis added). *But cf.* *Hooper v. Bernalillo County Assessor*, 472 U.S. 612 (1985) (voiding a property tax exemption granted to Vietnam veterans who were already New Mexico residents by a certain date prior to the law's enactment); *Williams v. Vermont*, 472 U.S. 14 (1985) (declaring unconstitutional a law exempting Vermont residents, but not others, from a use tax on automobiles purchased out-of-state and taxed in the state of purchase); *Metro. Life Ins. Co. v. Ward*, 470 U.S. 869 (1985), *reh'g denied*, 471 U.S. 1120 (1985) (overturning an Alabama law imposing higher taxation on out-of-state insurance companies). Note, however, that the invalidated laws discriminated against residents of other states, while the law in *Allied Stores of Ohio* discriminated in their favor. The different outcomes might therefore reflect the Court's sensitivity to unfair discrimination against foreign residents, who have no voting rights in the state. Discrimination against or among local residents raises no such concern.

equally well-off individuals. It does not, in other words, demand respect for horizontal equity.⁵⁶

In one of the few cases in which the Court decided to strike down a tax arrangement on equal protection grounds, it did so only after characterizing the issue as one of executive rather than of legislative arbitrariness. *Allegheny Pittsburgh Coal Co.* concerned property taxes in West Virginia, the assessments for which, as a matter of administrative convenience, were based largely on the price paid.⁵⁷ The Court held that an arrangement that would severely burden more recent purchasers in periods of rising land values violated the Equal Protection Clause.⁵⁸ Nonetheless, the fact that the arrangement was administrative and not statutory might indicate that the ruling concerned procedural, rather than substantive, equal protection.⁵⁹

56. See also *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540 (1983) (holding that Congress has wide discretion in fiscal legislation, and may deny tax-exempt status to organizations engaged in lobbying while permitting tax-exempt veterans' organizations to lobby). The Court followed a line of reasoning similar to that of *Allied Stores in Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973) (upholding against an equal protection challenge a property tax imposed on chattels owned by corporations, but not on chattels owned by individuals), and *Charleston Fed. Sav. & Loan Ass'n v. Alderson*, 324 U.S. 182, 191 (1945) ("It is plain that the Fourteenth Amendment does not preclude a state from placing notes and receivables in a different class from personal property used in agriculture and the products of agriculture, including livestock, and taxing the two classes differently . . .").

In an early case, *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1 (1916), the Court discussed the general issue of horizontal equity (or lack thereof), in the tax system. Considering the issue under the terms of the Due Process Clause of the Fifth Amendment, the Court stated, in no uncertain terms, that the constitution does not ordinarily bar provisions of tax legislation that violate horizontal equity. In the words of the Court:

Discrimination and want of due process result, it is said, from the fact that the owners of houses in which they live are not compelled to estimate the rental value in making up their incomes, while those who are living in rented houses and pay rent are not allowed, in making up their taxable income, to deduct rent which they have paid, and that want of due process also results from the fact that although family expenses are not as a rule permitted to be deducted from gross, to arrive at taxable, income, farmers are permitted to omit from their income return, certain products of the farm which are susceptible of use by them for sustaining their families during the year.

.....

So far as the due process clause of the Fifth Amendment is relied upon, it suffices to say that there is no basis for such reliance since it is equally well settled that such clause is not a limitation upon the taxing power conferred upon Congress by the Constitution . . .

240 U.S. 1 at 23-24.

57. *Allegheny Pittsburgh Coal Co. v. County Comm'n of Webster County*, 488 U.S. 336 (1989).

58. But see Robert J. Glennon, *Taxation and Equal Protection*, 58 GEO. WASH. L. REV. 261 (1990). Glennon examined the factual background of the case, arguing that the real reason for the difference in the assessments was not the date of purchase, but rather the recent discovery of commercial quantities of coal, which of course caused the value of the properties concerned to skyrocket. Glennon attributed the coal companies' success in defining the issues to the fact that they were represented by the country's top law firms, while the tax assessor was represented by the county attorney of one of the poorest counties in one of the poorest states of the Union.

59. See *Allegheny*, 488 U.S. at 344 n.4 ("We need not and do not decide today whether the Webster County assessment method would stand on a different footing if it were the law of the State, generally applied, instead of the aberrational enforcement policy it appears to be."). In a subsequent decision, *Nordlinger v. Hahn*, 505 U.S. 1, 14-15 (1992), the Court distinguished *Allegheny* in upholding the constitutionality of California's Proposition 13. In contrast, Justice Thomas, concurring in *Nordlinger*, 505 U.S. at 18, argued that the two decisions were incompatible.

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C. *Horizontal Equity and Equal Protection*

A statute differentiating among taxpayers according to a suspect classification would almost certainly be unconstitutional.⁶⁰ A tax that primarily impacted members of a politically marginalized group, although stated in neutral terms, might also run afoul of the constitutional guarantee of equal protection, although such instances would probably be rare. These rules, however, have nothing to do with horizontal equity. Equal protection is not concerned with whether or not the individuals concerned are similarly situated in any sense relevant to tax theory.

Assume, for example, that members of a politically marginalized group tended to have fluctuating income patterns while members of the politically dominant group had fairly constant income. In such circumstances, a progressive income tax with no provision for multi-year averaging might come under constitutional scrutiny. On the other hand, were individuals with fluctuating income streams scattered randomly throughout the population, no constitutional issue would likely arise. Nonetheless, horizontal equity, on the assumption that individuals with the same multi-year incomes are similarly situated,⁶¹ would be equally offended whether or not a suspect classification were involved.

A tax that merely violates horizontal equity does not necessarily violate the constitutional guarantee of equal protection. However, the demands of equality are not necessarily exhausted by constitutional requirements; one need not go so far as to challenge the constitutionality of a fiscal provision to argue that it does not conform to the criteria of a “good tax.” A legislature, acting within its constitutional limits, is charged with promoting the interests of the public and applying principles of equality. Indeed, each lawmaker will likely attempt to gear the legislation according to her—and her constituents’—view of what equality requires. The various branches of philosophy addressing the question of equality—political theory, jurisprudence, ethics—may assist in framing such a viewpoint.

Thus, while a law that violates horizontal equity may still be constitutional, it might nevertheless constitute a breach of the legislature’s moral duty to uphold principles of equality. Analyzing this argument for horizontal equity requires an investigation of equality as a philosophical concept rather than a legal or constitutional one.

60. See *supra* note 52. Such a tax may be unjust as well; see, for example, MURPHY & NAGEL, *supra* note 27, at 39 (“Some forms of discrimination among taxpayers will count as unjust even if they do serve other legitimate goals.”).

61. See Schmalbeck, *supra* note 4.

D. *Equality as a Philosophical Concept*

While the legal literature described above is principally concerned with illegitimate discrimination, the literature of political philosophy is more concerned with the question of what kind of equality society should seek. Among the more widely held views are equality of opportunity and equality of results; others hold that society should strive neither for equal results, nor for equal opportunity, but rather for treatment as equals.⁶²

Those who argue for equal results hold that every individual should ideally end up with an equivalent package of economic resources.⁶³ When the market leads to an unequal distribution of resources—as markets tend to do—the government's job is to redistribute wealth to more closely approach the goal of equality.⁶⁴ A tax system which was crafted with the goal of achieving a radical equalization of wealth would apparently conform to the principle of horizontal equity. If all taxpayers were similarly situated in the post-tax distribution, it would necessarily follow that taxpayers who were similarly situated in the pre-tax distribution would continue to be similarly situated after the imposition of the tax.

Nevertheless, it is apparent that in practice, every tax system must allow some degree of inequality in order to encourage beneficial economic activity. Otherwise, everyone might be equal, but that equality would provide only the equal right to starvation. Whoever views equality of result as a value must therefore decide on the level of his aversion to inequality; in other words, to what extent he is willing to forgo an equal division of the pie in order to increase the size of that pie.⁶⁵ Rawls' willingness to do so was minimal. Others may allow greater inequality in exchange for an increase in the amount of total resources. As a result, our previous analysis regarding the place of horizontal equity within a difference-principle tax structure is valid here. If an individual has no moral entitlement to his wealth—and this is the basic assumption of the equality-of-result worldview—then he has no moral right to retain, in the post-tax distribution, either the same absolute or the same relative level of well-being he enjoyed before. The fact that two individuals were equally well-off carries no moral weight.

The right to equal opportunity, on the other hand, is a right to compete

62. While these views are perhaps the most prevalent, the list is certainly not intended to be exhaustive. Nevertheless, the analysis regarding the place of horizontal equity in these views is probably applicable to most other worldviews of equality.

63. See Milton Friedman & Rose Friedman, *FREE TO CHOOSE* 134 (1979) (describing such views without adopting them).

64. As we saw in Section III.A, equality may also be desirable as a means to other sorts of ends (for instance, Utilitarian ends). Here, however, we are considering equality as an end in its own right.

65. See Menahem E. Yaari, *A Controversial Proposal Concerning Inequality Measurement*, 44 J. ECON. THEORY 381 (1988).

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fairly. If the competition is fair and the judging impartial, the losers have no claim to redistribution. The function of the state is to ensure procedural fairness and not to strive for a predetermined distribution.

Among supporters of equal opportunity, the central area of disagreement concerns the legitimacy of the various factors influencing a competitor's chances. Does a disadvantaged child have an equal opportunity for economic success? Consider a sports analogy. Physical differences between contestants are occasionally taken into consideration: wrestlers and boxers, for example, are classified by weight. In most cases, however, physical differences are not considered relevant; a basketball player of less-than-average height cannot legitimately argue that he is unfairly discriminated against. Each player competes according to his or her own strengths and weaknesses. On the other hand, a contestant who is forced to wear ankle weights would normally be considered to be competing under unfair conditions. In considering an individual's upbringing and economic success, which circumstances should be viewed as violating equal opportunity? In other words, when is the playing field level?

There are no universally agreed-upon answers to these questions, even among those who accept equal opportunity as a goal. The competing models of equal opportunity each characterize some factors as impediments to fair competition, the influence of which should be neutralized as much as possible, and others as strengths and weaknesses that each competitor legitimately brings to the playing field.

The Libertarian model of equal opportunity, for example, holds that individuals should be allowed to compete to the best of their own abilities. The Libertarian state limits itself to preventing violence and fraud, much the same as umpires at a race pay attention to unsportsmanlike behavior. Beyond this limited role, the state has no right to compensate for unequal abilities, whether by supporting individuals' efforts directly or by imposing handicaps on their competitors.⁶⁶

The Libertarian model of equality—assuming it accepts the authority of the state to impose taxation⁶⁷—would seem to require that taxes be imposed so as to avoid disturbing the market distribution. The options available would be a head tax, which would maintain absolute gaps, and a proportional tax, which

66. This philosophical outlook can be traced back at least as far as Kant: "[E]very member of the commonwealth must be entitled to reach any degree or rank which a subject can earn through his talent, his industry and his good fortune." IMMANUEL KANT, *On the Common Saying: "This May Be True in Theory but It Does Not Apply in Practice,"* in KANT'S POLITICAL WRITINGS 61, 75 (Hans Reiss ed., H.B. Nisbet trans., Cambridge Univ. Press 1970). Rawls refers to this conception of equality as a "system of natural liberty," in which positions are distributed according to qualifications and without attempting to compensate for inequality in social circumstances or natural talents. RAWLS, *supra* note 34, at 72.

67. See *infra* Part VI.

would maintain relative gaps. A tax system based upon either of these options would respect horizontal equity: individuals equally well-off before the imposition of taxes would remain equally well-off after taxes are imposed. Note, however, that this model, although respecting horizontal equity, nevertheless requires a justification of the market distribution.⁶⁸

The Liberal conception of equality—to use Rawls' term⁶⁹—results from the feeling that arbitrary social circumstances should not be allowed to influence a person's ability to exploit fully his or her natural talents. This conception of equality requires state action to neutralize the influence of social standing on a person's ability to compete in the market. Whereas all modern worldviews hold that social position should not be a formal barrier, the Liberal conception of equality claims that social position should not even indirectly influence individuals' abilities fully to develop their natural talents. Thus, while both Libertarians and Liberals would reject a formal barrier limiting admission to a profession to the children of guild members, only Liberals would disapprove of a situation in which certain individuals, due to the social or economic standing of their parents, are better trained for desired professions and thus enjoy an advantage over their competitors.

Liberal equality thus requires the neutralization of environmental influences in order to allow individuals to compete according to their natural talents. In distributing positions, society must consider natural abilities only and ignore the degree to which the development of those abilities was affected by other factors.⁷⁰

A Liberal tax system would therefore result in a tax system similar to the Libertarian model, but would also include relief for those who had confronted environmental obstacles to the development of their natural talents. A privileged upbringing, on the other hand, might justify an increased tax burden in later years to compensate for environmental factors that influenced the development of natural talents, and this tax burden need not respect horizontal equity. For example, if Betty, with an elite background, were only able to earn the same income as the highly talented but disadvantaged Bernie, a Liberal tax system would attempt to mitigate Betty's social advantage and ameliorate Bernie's social disadvantage, despite the fact that they were equally well-off in

68. Justifications of the market distribution and their implications for horizontal equity will be considered in Part VI, *infra*.

69. RAWLS, *supra* note 34, at 73-74.

70. Liberal equality is, nevertheless, susceptible to the argument that it too allows distribution according to what Rawls calls "the natural lottery" of individual talent, whose results are no more morally justified than the advantages owing to wealth, social position or other environmental factors. *Id.* Equal opportunity, egalitarians argue, should be afforded to all, regardless of either social position or natural talents. However, once equal opportunity is defined so as to neutralize both environmental factors and natural talents, the line separating equality of opportunity from equality of results becomes exceedingly thin.

the pre-tax distribution.

An alternative model of equality was presented by Dworkin, who distinguished between "equal treatment" and "treatment as an equal."⁷¹ Equal treatment is the right to an equal distribution; treatment as an equal, on the other hand, is the right to the same degree of care and respect as others receive: "An individual's right to be treated as an equal means that his potential loss must be treated as a matter of concern, but that loss may nevertheless be outweighed by the gain to the community as a whole."⁷²

Thus, for example, universities may discriminate in their admissions policies in favor of more intelligent candidates, simply because society has an interest in intelligent doctors, lawyers, scientists and so on.⁷³ Moreover, while rejecting the legitimacy of a racist society's discriminating against a particular race, Dworkin nevertheless claimed that where the preferential admission of minority members could contribute to the integration of society, root out prejudice, and serve as inspiration for minority youth, such treatment is justified.⁷⁴ The preferential admission of minority candidates in such a case may contribute to society's welfare more than admitting others, even those more qualified by traditional standards.⁷⁵

In a tax structure based on the Dworkinian principle of treatment as an equal, it would not be necessary to accord each taxpayer equal treatment. Rather, it would be necessary only to treat each taxpayer's needs and desires with the same degree of respect. Two equally well-off taxpayers, one of whom

71. RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* 227 (1977); see also RONALD DWORKIN, *A MATTER OF PRINCIPLE* 293-303 (1985).

72. See DWORKIN, *TAKING RIGHTS SERIOUSLY*, *supra* note 71, at 227.

73. Dworkin's theory can be challenged, as can Utilitarianism, on the grounds that it ignores persons and sees only goals. It might be argued that Dworkin's approach violates the Kantian imperative to view people as ends and never just as means, as well as the widespread intuition that a person's moral desert should be considered apart from the utility which society can extract from that individual. Cf. MICHAEL J. SANDEL, *LIBERALISM AND THE LIMITS OF JUSTICE* 141 (1982) ("[T]o regard 'my' abilities and endowments as mere instruments of a wider social purpose is to use me as a means to others' ends, and thus violate a central Rawlsian and Kantian moral injunction.").

74. See DWORKIN, *TAKING RIGHTS SERIOUSLY*, *supra* note 71, at 239 ("Racial criteria are not necessarily the right standards for deciding which applicants should be accepted by law schools. But neither are intellectual criteria, nor indeed, any other set of criteria. The fairness . . . of any admissions program must be tested in the same way. It is justified if it serves a proper policy that respects the rights of all members of the community to be treated as equals, but not otherwise.").

75. See *id.* Dworkin distinguishes here between the good of society in his ideal sense and the good of society in a Utilitarian sense by noting that under Utilitarianism, the treatment an individual receives may depend partly on what others think of him. Thus, racist policies might increase society's overall welfare if the pleasure afforded the majority, due to their larger number, outweighed the pain caused the minority. Dworkin countered by arguing that the good of society in an ideal sense takes into account only an individual's "personal preferences" for the pleasure and opportunities afforded by given situations, and not his "external preferences" for situations by virtue of the pleasure and opportunities (or lack thereof) they afford someone else. *Id.* To Dworkin, an individual is treated as an equal when the treatment he receives contributes to the good of society in this particular sense. Accordingly, it would seem that Dworkin's theory of treatment as an equal is actually an end-state theory, to which the analysis in Part III, *supra*, would apply.

engages in activity which society values more highly, are still being treated as equals in a Dworkinian sense even if they face different tax burdens reflecting the usefulness of their activities. Similarly, in attempting to redistribute wealth, society may impose little or no tax on certain wealthy individuals to prevent particular economic consequences, while other, equally well-off individuals might encounter heavy tax burdens. Despite the violation of horizontal equity, each would be treated with the same degree of care and respect. Equal treatment requires equal tax; treatment as an equal does not.

Horizontal equity, therefore, is not necessarily a function either of equal protection or of the philosophical dictate of equality before the law. Nevertheless, it would appear that certain models of equality, specifically those that prohibit disturbing the market distribution, could potentially serve as normative justifications for horizontal equity. Those worldviews which give the market moral weight now deserve our attention.

VI. HORIZONTAL EQUITY AS A FUNCTION OF THE JUSTIFICATION OF THE EXISTING DISTRIBUTION

A. *Introduction: Aristotle, Justice and Merit*

Horizontal equity recognizes the right of each individual to the same post-tax welfare level as those enjoyed by others who were similarly situated in the pre-tax distribution. Thus, the right to demand equality in the post-tax distribution is conditional upon equality in the pre-tax distribution; those who did not achieve a given welfare level in the pre-tax distribution have no right, under the principle of horizontal equity, to demand post-tax equality with those who did. Note, therefore, the important distinction between horizontal equity, on the one hand, and those conceptions of vertical equity which require redistribution to mitigate inequality on the other: Vertical equity, in determining the just distribution of resources in society, considers the consequences of alternative distributions in terms of their impact on society's overall utility,⁷⁶ not in terms of the degree of departure from the market distribution. The distinction between horizontal equity and Rawlsian conceptions of vertical equity is even more striking. Rawlsian principles recognize each individual's fundamental right to equality by virtue of her humanity and limit the implementation of this right only for utilitarian reasons (i.e. economic efficiency), whereas horizontal equity recognizes a right to equality only for those who were equal in the pre-tax distribution.

Horizontal equity and vertical equity are two conceptions of justice. Both

76. The term "utility" here can be considered either in its classical Utilitarian sense of "the greatest good for the greatest number" or in its Dworkinian sense of contributing toward the ideal good of society. See *supra* Sections III.A and V.D.

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meet the Aristotelian definition of distributive justice yet differ regarding its application. Aristotle defined distributive justice as distribution by merit.⁷⁷ Those of equal merit should receive equal shares, while those of unequal merit should receive shares proportional to their merit. According to Aristotle, an unjust distribution is one in which shares are not proportional to merit. Unjust distributions, therefore, include both unequal treatment of equals and equal treatment of unequals.

However, the Aristotelian definition is merely formal, as Aristotle did not define the term “merit.”⁷⁸ He himself asserted that different conceptions of merit would lead to different conceptions of distributive justice, with all such formulae fulfilling the formal requirements.⁷⁹ Thus, distribution according to achievement, according to need, according to popularity or according to intelligence would all be just in a formal sense. This is not, of course, to say that a distribution which is just in the Aristotelian sense of the term is necessarily fair or moral; the moral basis of any conception of distributive justice is dependent upon the morality of its conception of merit.⁸⁰ The Apartheid regime, for example, assigned benefits according to race; it was thus “just” in the formal sense of the term. Its moral standing, however, was dependent upon the conception that certain races are more worthy than others; whoever did not accept that premise could not accept the morality of the system.

Horizontal equity requires that those who had equal shares in the pre-tax distribution receive equal shares in the post-tax distribution. Thus, horizontal equity can be seen as an application of Aristotelian justice in which “merit” is defined as well-being in the pre-tax, or market, distribution. Those whose shares in the market distribution were equal are entitled to equal shares in the post-tax distribution. As the moral basis of any conception of Aristotelian justice depends upon the fairness or morality of its definition of merit, the moral basis of horizontal equity depends upon the moral standing of the market distribution.⁸¹ One who denies that the market distribution has any moral

77. ARISTOTLE, *NICOMACHEAN ETHICS* 112 (David Ross trans., Oxford Univ. Press 1972).

78. Cf. CH. PERELMAN, *THE IDEA OF JUSTICE AND THE PROBLEM OF ARGUMENT* 15 (John Petrie trans., 1963) (“The question is to find a formula of justice which is common to the different conceptions we have analysed. This formula must contain an indeterminate element—what in mathematics is called a variable—the determination of which will give now one, now another, conception of justice. The common idea will constitute a definition of *formal* or *abstract* justice. Each particular or *concrete* formula of justice will constitute one of the innumerable values of formal justice.”).

79. ARISTOTLE, *supra* note 77, at 112-13 (“[F]or all men agree that what is just in distribution must be according to merit in some sense, though they do not all specify the same sort of merit, but democrats identify it with the status of freeman, supporters of oligarchy with wealth (or with noble birth), and supporters of aristocracy with excellence.”).

80. PERELMAN, *supra* note 78, at 45 (“Formal justice tells us that an act is just when it is the result of applying a certain rule. But when can it be said of the rule that *it* is just? Formal justice does not teach us.”).

81. References to the market distribution include the state of any particular person within the

standing, such as Rawls,⁸² would not recognize the moral imperative of considering it when formulating the redistribution.⁸³

Moreover, when considering the justification of the market distribution, efficiency-based arguments are unsatisfactory.⁸⁴ If the market distribution is justifiable for reasons of economic efficiency, then an individual's entitlement to her socio-economic position is grounded, not in a moral entitlement to her share in the distribution, but in the benefit to society of allowing her to remain in that position. However, those very considerations which are used to justify the market distribution can also justify disturbing it; if considerations of economic efficiency dictate, in certain circumstances, disturbing an individual's economic ranking, she cannot defend herself with reference to the sanctity of the market. And while in many cases, economic efficiency implies respect for horizontal equity, it does not always do so.⁸⁵

Arguments attempting to justify pre-tax economic standing with reference to the efficiency of the free market are incapable of serving as a basis for horizontal equity. The normative justification of horizontal equity requires, therefore, a justification of the pre-tax distribution, not as a means of advancing utilitarian aims, but as an expression of the moral entitlement of each individual to his share.

B. *Nozick*

This section will examine horizontal equity in the light of Nozick's theories of the state and of entitlement. It will begin by describing Nozick's view of the emergence of the state from a state of nature and the legitimate functions of such a state. It will proceed to analyze the tax structure which such a state would adopt, assuming it operated under the constraints which Nozick imposed. Finally, it will consider the place of horizontal equity in such a scheme.

1. *The Emergence of the State*

In his monumental work, *Anarchy, State and Utopia*,⁸⁶ Nozick set for

market distribution. Where the market distribution has moral standing, it is not the distributive pattern per se—which would not be disturbed by randomly switching the places of various individuals—but rather the entitlements of each particular individual that are significant.

82. See RAWLS, *supra* note 34, at 73-74.

83. See MURPHY & NAGEL, *supra* note 27, at 38-39.

84. For efficiency-based arguments for a free market, see LAWRENCE C. BECKER, PROPERTY RIGHTS 57-74 (1977); MILTON FRIEDMAN, *Market Mechanisms and Central Economic Planning*, in THE ESSENCE OF FRIEDMAN 18 (Kurt R. Leube ed., 1987); F.A. HAYEK, *Two Pages of Fiction: The Impossibility of Socialist Calculation*, in THE ESSENCE OF HAYEK 53 (Chiaki Nishiyama & Kurt R. Leube eds., 1984); and JEREMY WALDRON, THE RIGHT TO PRIVATE PROPERTY 9-12 (1988).

85. See *supra* Part II.

86. NOZICK, *supra* note 28.

himself two principal goals. The first was to prove the legitimacy of the minimal state—a state whose sole function is to protect the “natural rights” of its subjects,⁸⁷ protecting them from physical assault, guarding their property, enforcing their contracts and so forth—and to counter arguments by anarchists who contend that the state violates the natural rights of those subject to its power. The second was to show that the minimal state is the most extensive state that can be morally justified. In particular, Nozick attempted to refute the claim that a more extensive state is justified in order to redistribute society’s wealth.

As we have seen, only a theory which morally justifies the existing distribution of wealth can serve as a normative basis for horizontal equity. It is therefore interesting to examine the principles of a just tax according to Nozick. Nozick wrote that income taxation is unacceptable because it is in effect a form of slavery: an income tax at a rate of x percent requires the taxpayer to work for the state x percent of the time, and for himself during the time that remains. This situation is similar to one in which each individual would be conscripted into forced labor for x percent of the year.⁸⁸

Nozick did not, however, deny the legitimacy of the state; he merely claimed that it has no right to redistribute wealth. How, then, is the state supposed to finance its activities if it has no right to tax? In order to answer this question, we need to examine briefly Nozick’s conception of the moral justification of the state and its legitimate functions.

In discussions of distributive justice, attention is normally focused on the second part of the book. It was here that Nozick presented his theory that holdings are justified as long as they result from a series of justified acquisitions and transfers, as opposed to the Rawlsian view that justice demands the redistribution of resources. However, in order to understand the Nozickian conception of a just tax, we must focus instead on the first part of Nozick’s book.

The task Nozick faced in the first part of the book was to confront the anarchist argument that the state—including the “night-watchman state” of Liberal literature—violates the rights of those subject to its authority.⁸⁹ The anarchist argument rests on two attributes of the state. First, the state claims for itself the exclusive right to authorize the use of violence within the territory it controls and is supposed to punish anyone who uses force contrary to the rules

87. *Id.* at 74.

88. *Id.* at 169. Nozick raises another objection to the income tax, namely that it discriminates between taxpayers who prefer consumption requiring a monetary outlay and those who prefer consumption that does not. This argument, which concerns the tax base, is irrelevant to our present discussion.

89. *Id.* at 25.

it establishes.⁹⁰ The state thus prohibits self-enforcement of rights. Second, the state affords physical protection to all its subjects and finances this activity through the levying of taxes. Here the state violates property rights because it forces some to pay for the protection of others.⁹¹

Liberal philosophers have attempted to justify the existence of the state by means of social contract theory, in which every individual, in his own name and that of his descendants, supposedly waived his natural rights in exchange for protection by the state.⁹² Nozick rejected the social contract and tried to show how the state could come about through an “invisible hand” process.⁹³ He attempted to prove that one could move from a state of nature to a minimal state (or more precisely a “state-like entity,” as he describes it)⁹⁴ in a number of steps, none of which violates anyone’s natural rights.

Nozick contended that natural rights include the right to self-defense and the right to enforce substantive natural rights. These procedural rights are assignable; it would therefore be reasonable that in a state of nature, there would arise mutual protection societies, which, for a fee, would protect the natural rights of their clients. When a dispute arose between a client of the agency and a third party, or between two clients of the agency, the agency would need to judge the merits of each side’s arguments.⁹⁵

Should there be more than one mutual protection agency, disputes could arise between clients of different agencies, disputes that would require each of the agencies to adjudicate the claims of the parties involved. Should each agency determine that its client is right,⁹⁶ the two agencies would fight against each other, in the same way as two individuals in a state of nature would fight when in disagreement regarding their natural rights.⁹⁷ Several such skirmishes would determine which agency was stronger in each geographical area.⁹⁸ Other agencies would soon find it hard to attract clients in that region. Thus, in each geographical area, one mutual protection agency would become dominant.

90. *Id.* at 23-24.

91. *Id.* at 24-25.

92. See, e.g., HOBBS, *supra* note 1; Jean-Jacques Rousseau, *The Social Contract*, in SOCIAL CONTRACT 167 (Ernest Barker ed., 1962).

93. NOZICK, *supra* note 28, at 18; cf. David Hume, *Of the Original Contract*, in SOCIAL CONTRACT, *supra* note 92, at 145 (rejecting the concept of an original contract based on freely given consent).

94. NOZICK, *supra* note 28, at 118.

95. *Id.* at 12-15.

96. This situation may be the most prevalent, as each agency, for obvious commercial reasons, would tend to favor its own clients.

97. NOZICK, *supra* note 28, at 16. Another possibility is that each agency would determine that the client of the other is right and refuse to protect the position of its own client. It would seem that in this case each party would be able to attempt private right-enforcement, as would be the case in a state of nature. Another, more reasonable, outcome is that each party would join the other’s agency.

98. *Id.* Nozick also considers the possibility that two (or more) equally powerful agencies would form a federal system. *Id.*

Residents of that area would face the choice of joining that agency or not joining any agency at all (becoming “independents”).⁹⁹

Whoever does not join an agency retains his natural right to self-enforce his rights, and in theory the agency would not be entitled to protect its clients from the just use of force by independents. Nevertheless, it need not accept the procedure by which the independent determines whether his rights have been violated and by whom.¹⁰⁰ The agency may protect its clients against what it considers to be an overly risky procedure. However, in doing so, the agency in effect prevents independents, who are helpless against the power of the agency, from enforcing their rights. Clients of the agency would be able to infringe the rights of independents with impunity, knowing that the agency would protect them against any countermeasures undertaken by the independent. The situation of the independents would thus be worsened relative to what it was in the state of nature. As a result, they are entitled to compensation in the form of free limited protection—the agency would not be required to protect against violation of rights by other independents—or transfer payments with which to purchase a protection policy, financed by additional charges imposed on clients.¹⁰¹ This compensation, in cash or services, would not be based on a principle of redistribution, but rather on compensatory justice, or the “principle of compensation.”¹⁰²

Nozick, as noted, argued that this structure is the most extensive which can be morally justified. Because of the differences between it and the normal conception of a minimal state (in particular the monopoly claimed by the state on authorizing the use of violence, as opposed to the non-interference of the mutual protection agency in disputes between independents), Nozick often referred to the dominant protection agency not as a state but as a “state-like entity,” although he was not entirely consistent in this regard.¹⁰³

Nozick attempted to blur the difference between a minimal state and a dominant protection agency. For example, he raised the following question: if independents receive free protection by virtue of the principle of compensatory justice, what would move people to join the agency and pay not only for their

99. *Id.* at 54.

100. *See id.* at 96-108. Nozick touched here upon one of the most problematic aspects of natural law theory: the issue of procedural rights. In a state of nature, no forum exists to determine whether natural rights have been violated. Each individual is the judge in his own case, and in practice might makes right.

101. *See id.* at 57-78 (extensively analyzing the issue of violating rights subject to payment of compensation); *see also* Robert Paul Wolff, *Robert Nozick's Derivation of the Minimal State*, 19 ARIZ. L. REV. 7, 9 (1977).

102. NOZICK, *supra* note 28, at 83.

103. *Id.* at 118 (“We therefore conclude that the protective association dominant in a territory, as described, is a state. However, to remind the reader of the slight weakening of the Weberian condition, we occasionally shall refer to the dominant protective agency as ‘a state-like entity,’ instead of simply as a ‘state.’”).

own protection but for the protection of others as well? He responded that the free protection afforded independents covers them only against violation of their rights by clients, not against violation of their rights by other independents. As the number of independents rises, the value of the free protection diminishes, which would cause more independents to join the agency. Nozick argued that equilibrium would be reached at close to universal membership in the agency. Thus Nozick attempted to blur the distinction between involuntary taxes and voluntary premiums by assuming that (almost) all residents of an area would join the dominant protection agency.¹⁰⁴

This short summation of Nozick's argument is sufficient to allow us to examine the principles of taxation in the Nozickian minimal state. Nozick himself, as noted, objected to taxation and viewed it as a form of forced servitude. One who reads Nozick literally would not even consider discussing the principles of a just Nozickian tax. Only voluntary payments to the state could possibly be justified.

Let us stop for a moment and consider our discussion up to this point. We began with a search for a normative basing of horizontal equity. We discovered that horizontal equity can be justified only by a theory, such as that of Nozick, which justifies the market distribution on moral grounds. In the world according to Nozick, however, only voluntary transfers are justified; taxes are intrinsically unjust. It would therefore appear that the justification of horizontal equity as a principle of tax theory would require upsetting the moral basis of the very imposition of tax in the first place.

Nevertheless, Nozick's theory is normally seen as a justification of the minimal state, a state that taxes its subjects for the sole purpose of protecting their natural rights. Nor is it entirely clear whether Nozick himself would object to such a state: his aim, after all, was to justify "[t]he night-watchman state of classical liberal theory" or the "minimal state,"¹⁰⁵ and he claimed that having brought us to the dominant protection agency which compensates independents in its midst,¹⁰⁶ he had achieved his goal. Apparently, for Nozick, the difference between an organization which collects voluntary payments and compensates independents and one which taxes its subjects and in return protects their rights

104. See *id.* at 113. Nozick's estimation may be overly optimistic. Just as the value of free protection decreases as the number of clients decreases, its value increases as the number of clients increases. Equilibrium may be reached at a point far short of universal membership. Moreover, Nozick discussed extensively the question of compensation due to independents in return for limiting their procedural right to enforce their substantive rights privately. Obviously, the advantages of joining the agency before the introduction of compensation are immeasurably greater than the advantages of joining after the introduction of compensation. If after the introduction of compensation almost everybody would join the agency, the number of those who would refrain from joining before the compensation was introduced would be insignificantly small.

105. *Id.* at 26.

106. Compensation of independents is what distinguishes a minimal state from an "ultra-minimal state."

is insignificant. As further support for this conjecture, it is interesting to note that, when claiming that the dominant protection agency is in effect a state, Nozick nevertheless qualified his claim and pointed out that, as opposed to a state, a dominant protective agency does not claim a complete monopoly on the use of force in its territory.¹⁰⁷ For this reason, and “to remind the reader of the slight weakening” of the Weberian definition of a state, Nozick occasionally used the term “state-like entity” instead of the word “state.”¹⁰⁸ Nozick’s qualification is interesting for present purposes because of the omission of the other difference between a state and a dominant protection agency: that a state imposes taxes while an agency collects voluntary premiums. This difference, it seems, is not sufficiently serious to lower the dominant protection agency from the status of a state to that of a state-like entity.¹⁰⁹

2. *Principles of Taxation in the Nozickian State*

Thus far, we have reviewed Nozick’s theory of the emergence of the state from a mutual protection agency. We may now turn our attention to the principles of taxation which should guide the Nozickian state and, in particular, to whether those principles would include horizontal equity.

The starting point of our discussion would appear to be the policies offered by the dominant protection agency. Nozick did not state how the premiums on such policies should be computed. Specifically, he did not mention whether the agency would collect a standard premium from all its clients (subject, perhaps, to the level of protection requested) or would suit the premium to the particular circumstances of each client. If we assume that the agency is a private organization guided by normal commercial considerations,¹¹⁰ the premium would likely reflect the expense of granting protection to the client. From the client’s point of view, these anticipated expenses would quantify what he expects to receive by joining the agency.

Moving from the dominant protection agency to a minimal state, we might consider viewing the state as forcing its subjects to purchase from it a protection policy in return for the premium that would have been agreed upon

107. NOZICK, *supra* note 28, at 117 (“One additional necessary condition for a state was . . . that it claim to be the sole authorizer of violence. The dominant protective association makes no such claim.”).

108. *Id.* at 118; see also *supra* note 103.

109. Even though Nozick would reject imposition of taxes in any context, the question still remains: how would the dominant protection agency determine its premiums? As long as several agencies are competing among themselves, premiums would be determined by the laws of supply and demand. However, what happens when one of the agencies becomes a monopoly? Nozick says nothing about the premiums which the dominant protection agency may legitimately charge, but it is hard to believe that he would agree to monopolistic prices in these circumstances. See NOZICK, *supra* note 28, at 179-82. It is therefore possible that even under a dominant protection agency, there would be rules to determine when a “tax” is just and when it violates the property rights of the clients.

110. Nozick does not, as noted, consider how to keep the premiums reasonable once the agency becomes, in effect, a monopoly.

in a voluntary commercial transaction. This premium would reflect the anticipated cost of services provided by the agency. We seem, in effect, to have backed into benefit theory, whereby each individual pays taxes according to the services he receives from the state. However the benefit theory we are considering here differs slightly from the usual formulation. Benefit theory normally considers the taxpayer's life and property, both of which are protected by the state, as the benefits she receives in exchange for her payment of taxes.¹¹¹ On this basis, it has been argued, benefit theory leads nowhere.¹¹² If, on the other hand, the basis for computing the benefit is not the value of the life and property protected but the cost of protecting them, the problem of just taxation under benefit theory might be solvable, at least in principle.

The question, however, remains as to how the level of risk presented by each taxpayer would be determined. Would risk be computed as a function of the taxpayer's property, or perhaps of her income? Should private measures taken by the taxpayer to protect herself be taken into consideration? Would the taxpayer's lifestyle—where she lives, where she works, how she spends her free time—be relevant? Insurance companies are in the business of estimating risk. They are, however, incapable of considering all the various factors that determine the risk level of each client. They normally rely, therefore, on certain objective criteria. It is reasonable to assume that a protection agency, and by extension a minimal state, would operate similarly. There is no reason to believe that equally well-off individuals would necessarily pose similar risks. Similarly situated taxpayers may find themselves, therefore, subject to different tax burdens.

Nozick also considered individuals who cannot afford to purchase a protection policy.¹¹³ As previously noted, he argued that the dominant protection agency must finance protection for these independents in order to prevent their natural rights from being violated by clients of the agency. The sum of money that the agency is obliged to spend protecting independents is the cost of its basic policy (which does not include protection from other independents) minus the expenses the independent would have had to incur to protect his rights in a state of nature.¹¹⁴

111. BLUM & KALVEN, *supra* note 39, at 35-39; HOBBS, *supra* note 1, at 238; MURPHY & NAGEL, *supra* note 27, at 16-17; SELIGMAN, *supra* note 40, at 79-126; ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 777 (Edwin Cannan ed., Random House 1937) (1776) ("The subjects in every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue they respectively enjoy under the protection of the state.").

112. See SIMONS, *supra* note 1, at 3-4 ("It is fair to say . . . that this principle, with reference to the allocation of the whole tax burden, is now of interest only for the history of the doctrine . . . [and] has been repudiated as completely by students as by legislatures.").

113. NOZICK, *supra* note 28, at 111-12.

114. Nozick fails to consider the case of independents who, having received the difference between the cost of the basic policy and what they would otherwise have spent on rights protection, prefer to

As before, here too it is interesting to consider the details which Nozick omitted. How would the ability of each independent to contribute to his own protection be determined? Would the criteria only include his property and income, or also his needs? If needs are relevant, what do these needs include? Family? Health? Emotional state? Tastes and personal preferences? Nozick apparently discriminated in favor of independents who can work but prefer leisure: the agency may subtract from the due compensation those funds actually available to the independent, but not those which the independent could have earned had he chosen to work.¹¹⁵ This point is quite interesting, given that one of Nozick's arguments against the income tax (in addition to its resemblance to forced labor) is that it discriminates against those who prefer purchased consumption.¹¹⁶

Until now, we have discussed the most onerous tax the minimal state could legitimately impose, both on "clients" and on "independents." Let us now consider the effect of imposing such a tax structure. An individual who, due to his financial situation, cannot pay the tax which would normally be required of him, would be entitled to a partial exemption equal to the difference between the full tax and what he can afford to pay (one who cannot afford to pay anything would be entirely exempt from taxes). The better off the taxpayer is, the less the exemption and consequently the greater the tax burden. Obviously, granting a total or partial exemption to some taxpayers would increase the tax burden on that segment of the population able to pay the full tax (equal to the full premium on a protection policy). Transferring part of the tax burden from the poorer to the richer strata of society is justified, according to Nozick, by virtue of the principle of compensatory justice.

It is worth pointing out, therefore, three distinct groups created in the population: (1) those paying full taxes, (2) those entitled to a partial exemption, and (3) those entitled to a full exemption. According to Nozickian principles, those located in the second group would in effect face a 100% marginal income tax, since every dollar of extra income would be accompanied by a one dollar reduction in their compensation from the agency. In such circumstances, there

pocket the compensation and not purchase a policy. They would, apparently, constitute a third social standing, in addition to "clients" entitled to full protection and "independents" entitled to protection from infringement of their rights by clients: "complete independents," who receive no protection whatsoever from the agency. Complete independents would in effect be helpless against the whims of clients, as the dominant protection agency would prevent them from enforcing their rights against clients should it judge the procedure employed by the complete independents too risky. In disputes between complete independents, as in the case of disputes between them and ordinary independents, the agency would not interfere. The fact that Nozick did not consider such a situation constitutes additional evidence of the hazy distinction between the dominant protection agency and the state, and of the lack of importance which Nozick attaches to the difference between taxes and voluntarily paid premiums. This haziness adds further support to the thesis that Nozick would not oppose taxes per se, and that Nozickian principles of taxation can be derived from analysis of the protection agency premiums.

115. NOZICK, *supra* note 28, at 111-12.

116. *Id.* at 170.

would be no incentive for those located in the second group to increase their incomes or indeed to maintain any income level above the full-exemption line. Also, many of those located in the first group might conclude that maintaining their gross income level is not worth the effort, due to the 100% “tax bracket” below the full-tax line.

This situation is untenable, both for the protection agency and for the minimal state. The 100% tax bracket between the lines would cause the number of clients—or full tax payers—to decrease and would increase the burden on those who remained. The agency or state, therefore, would have an interest in lowering the tax bracket, or the amount by which it offsets the compensation, to a level far below 100%. For example, the agency might declare that it will deduct from the independents’ compensation only 40% of their income above the lower line. Without question, the agency is morally entitled to do so, and commercial considerations dictate that that is what it would do. What we have, therefore, is an “invisible hand” process, explaining the imposition of tax as a function of monetary well-being.

In determining the “tax” rate, two contradictory considerations would operate. On the one hand, the higher the tax rate, the greater the disincentive to earn and to rise above the level of the lower line. The agency’s income, computed as a function of the independents’ income, would suffer. On the other hand, too low a “tax” rate would also result in a shortfall in income for the agency. The point of optimal balance between these two competing influences would be determined by empirical economic analysis. Furthermore, nothing rules out the possibility of non-proportional (e.g., progressive or even regressive) “tax.”

The tax structure would reflect the desire of the protection agency or of the minimal state to ease the burden imposed on those located above the upper line: the clients or the full tax payers. In establishing the tax base, the tax rates, and so forth, the agency or state would be mindful of the following efficiency question: To what extent would a given change in the tax structure affect the payments of the clients or full tax payers, and consequently the number of clients or full tax payers in the future. Nevertheless, the agency or state would not be free to adopt any tax structure it saw fit. Principles of justice (in this case compensatory justice) set an upper limit to the amount of tax which may be imposed. The limit is the premium of the basic protection policy (or the “full” rate of taxation) less the money which the “taxpayer” has and could use to finance his own protection.

3. *The Nozickian Tax Structure and Horizontal Equity*

Our analysis has now reached the stage where we can consider the position of horizontal equity within a Nozickian tax structure. Recall that the starting point for the present analysis was the demonstration that only a social

philosophy which attaches moral weight to the market distribution can serve as a normative basis for the principle of horizontal equity. Nozick's theory is widely considered the most convincing argument for a free market on moral—as opposed to utilitarian—grounds. The question, therefore, is whether a Nozickian tax structure would respect horizontal equity.

As we have seen, the framers of a Nozickian tax structure—or, more precisely, that section of the tax structure below the level of the “full tax”—would be guided by two key considerations. The first consideration would be whether the tax structure would maximize the income of the state's (or the dominant protection agency's) coffers. The higher the tax rate, the more tax will be collected, assuming the tax base (e.g. income or consumption) remains constant. However, the imposition of tax also tends to cause the tax base to shrink (due to the substitution effect), and the higher the tax rate, the greater the effect. The designer of a Nozickian tax structure would need to locate the optimal rate to maximize revenue. Furthermore, different tax rates could be imposed on income from different sources or on different types of taxpayers. Here, too, efficiency would prevail. As we saw earlier,¹¹⁷ pure efficiency considerations, which dictate, *inter alia*, that the more elastic the tax base the lower the rate of taxation, do not necessarily conform to the principle of horizontal equity. The fact that two taxpayers are equally well-off is not sufficient reason to impose equal tax burdens upon them.

The second consideration a Nozickian tax structure must take into account is compensatory justice—a principle similar in many ways to what is more commonly referred to as “vertical equity” or “distributional justice.” Compensatory justice, according to Nozick, permits taking from the taxpayer the same amount of money he would have dedicated to private enforcement in the absence of protection.¹¹⁸ The exact relationship between a taxpayer's economic status and the taxes that may be demanded of him—whether the tax would be progressive, proportional or regressive—is an empirical matter which cannot be determined normatively, for wealthier individuals may or may not spend a greater share of their income on protection. Nor may be it assumed that equally well-off individuals would necessarily spend equal amounts of money on protection. For example, those who are less attached to their place of residence (for personal or business reasons) and are more willing to leave at the first sign of trouble might spend less money on rights protection than others. Physically powerful individuals might also spend less. Individuals with families who rely on them for support might be more diligent in protecting their rights than those who do not. In any case, while well-being might be an important consideration in determining the limits of a Nozickian tax, it is clearly not the

117. See *supra* Part II.

118. See *supra* note 101 and accompanying text.

only consideration which would be taken into account. Two equally well-off taxpayers could find themselves faced with differing tax burdens.¹¹⁹

What is the relationship between efficiency and compensatory justice in Nozickian tax theory? The principle of compensatory justice sets an upper limit on the taxes that may be demanded from an individual. According to Nozick's conception of individual rights, utilitarian considerations can never justify a violation of rights.¹²⁰ Within the limits imposed by compensatory justice, efficiency will determine the exact outlines of the tax.

Nozick's theory of justice in holdings and the relationship between the state and the individual therefore cannot serve as a normative basis for horizontal equity. In the first place, justification of the existing distribution—an essential first step in the theoretical justification of horizontal equity—could undermine the moral authority of the state to impose tax at all. Even if we were to recognize the right—or obligation—of the state to impose taxes to finance the protection of others for reasons of compensatory justice, horizontal justice would not play a part in the design of the tax structure: the principles which would dominate such a structure would be compensatory justice or vertical equity on the one hand, and economic efficiency on the other.

C. *Dworkin*

As compared to Nozick, who justified the free market distribution and described any attempt to redistribute wealth (outside the framework of compensatory justice) as an illegitimate violation of property rights, Ronald Dworkin set off on a more ambitious course: he sought moral justification for both the market distribution and a redistributionary tax structure.¹²¹ Dworkin undoubtedly warrants our attention, since as we have seen, any justification of horizontal equity would have to attach at least some moral weight to the market distribution without undermining the moral basis of the entire tax structure itself.

Dworkin began his analysis by noting that while the free market is known to be an efficient means for achieving economic prosperity and a high level of welfare, it is nevertheless a widely held belief that the market—which tends to lead to great disparity in the distribution of wealth—is incompatible with the principle of equality. Dworkin disagreed and argued that a free market is an

119. It is not correct to claim that horizontal equity is respected because those individuals who would have spent similar amounts of money to protect their rights in a state of nature are similarly taxed. Recall that all taxes are horizontally equitable in terms of their own base. Horizontal equity demands that taxpayers who are equally well-off face similar tax burdens.

120. NOZICK, *supra* note 28, at ix ("Individuals have rights, and there are things no person or group may do to them (without violating their rights).").

121. Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283 (1981).

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essential element in any arrangement aiming at equal distribution of resources.¹²²

Individuals, Dworkin argued, have choices regarding how to live their lives. All things being equal, those who prefer to work and save will, in time, control more resources than those who prefer leisure or current consumption. However, the disparity in wealth between the two does not necessarily indicate any breach of equality. One who preferred leisure to work, or current consumption to savings, may indeed envy the resources of another who chose to work and save; however, given that he would not have chosen to live his life in such a way, we may conclude that he does not envy the other's distribution of resources over the course of his lifetime.¹²³

People, during their lives, voluntarily take chances, and Dworkin referred to situations in which individuals voluntarily assume risks as "option luck." The losers in cases of option luck may well envy the winners. However, Dworkin claimed, if we redistribute resources from the losers to the winners, we infringe upon people's rights to decide to lead risky lives.¹²⁴

Equality is apparently violated by what Dworkin referred to as "brute luck," such as being struck by lightning or being injured in a hit-and-run accident. However, Dworkin claimed, where one can purchase insurance against incidents of this sort, brute luck in effect becomes option luck. One who neglects to purchase insurance is voluntarily gambling against the occurrence of the uninsured event.¹²⁵

The only justified complaint that can be made on the grounds of equality is that one lacks the talent necessary to obtain the resources one desires. The presence or absence of economically valuable talents is a matter of brute luck. Dworkin proposed, therefore, the introduction of an imaginary insurance policy, similar to a policy obtainable against ordinary risks of brute luck, to protect against the possibility of being born without the talents necessary to achieve a certain level of income.¹²⁶

What we have here is, apparently, a theory that could justify horizontal equity within a framework of a redistributionary tax structure. Dworkin justified the morality of the market distribution by providing that there be compensation for disparities in initial conditions. Under his insurance scheme, the premium payable by equally well-off individuals would be identical. However, as usual, the devil is in the details, as Dworkin himself showed when

122. *Id.* at 284.

123. *Id.* at 285-88, 292-93; *cf.* JULIAN LEGRAND, *EQUITY AND CHOICE* 87 (1991) ("[A] distribution is equitable if it is the outcome of informed individuals choosing over equal choice sets.") (emphasis omitted).

124. Dworkin, *supra* note 121, at 293-95.

125. *Id.* at 293.

126. *Id.* at 298.

he contemplated the form such a policy would take.

The first issue to address is what level of insurance would be purchased by an individual who is aware of her talents but unsure of their market value.¹²⁷ Of course, the higher the level of protection requested, the higher the premium would be. It would not, therefore, be reasonable to insure oneself against the risk of being unable to earn the highest income in society. The premium for such a policy would be so high that the income left over after paying the premium would be minimal. The average level of protection requested must be much lower.

The second point is that evaluating the economic worth of talents is nearly impossible. As a result, Dworkin suggested the practical solution of viewing actual incomes as a substitute for potential incomes.¹²⁸ What happens, then, to respect for the market as a means of achieving equality? Dworkin's starting point was that market distributions conform to the principle of equality, provided that there are no significant differences in talent among those concerned. The market distribution should, therefore, in the name of equality, be respected. Those who work more or who postpone expenditures are not economically better off because of their choice; in the terminology of tax theory, they are similarly situated to those who enjoy leisure or the gratification of immediate consumption. Those who live risky lives, whether their gambles pay off or not, are similarly situated to those who, facing the same option, refrain from gambling. Horizontal equity rejects the imposition of a more onerous tax burden due to that choice. Dworkin ostensibly agreed. Yet his proposed tax structure, in the final analysis, transfers wealth from those who prefer work to those who prefer leisure, from savers to spenders and from those who gambled and won to those who gambled and lost. In the final analysis, the Dworkinian tax scheme violates horizontal equity and creates inequality where equality had previously prevailed.

VII. SUMMARY AND CONCLUDING THOUGHTS

The normative grounds of horizontal equity are problematic. Several possible justifications for horizontal equity—the equality-mindedness which serves as a foundation for prevalent conceptions of vertical equity; the goal of limiting the economic inefficiency created by the tax system; the principle of

127. Dworkin allows individuals to be aware of their talents, as talents constitute an integral part of one's personality. *Id.* at 315-16. Compare this approach to Rawls's veil of ignorance, behind which individuals are unaware of their talents, their social position or even their conception of the good. RAWLS, *supra* note 34, at 12.

128. As Dworkin notes, such an arrangement exposes the company to what is known in the insurance trade as the "moral hazard" of insurance, namely the increased tendency of insured risks occurring. Dworkin, *supra* note 121, at 325. In tax theory moral risk is referred to as the substitution effect.

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equal protection or equality before the law—were examined; all proved ultimately unsuccessful.

In the final analysis, justification of horizontal equity depends upon the moral entitlement of each individual to his free-market holdings, without such entitlement undermining the moral authority of the State to impose taxation. We considered, therefore, two attempts—Nozick's and Dworkin's—to justify the State's taxing power within the framework of social theories which require, for moral reasons, respect for the market distribution.¹²⁹ Neither, it turns out, respects horizontal equity.

One could, therefore, conclude that horizontal equity is unjustifiable as a principle of tax theory. Nevertheless, it is perhaps prudent to frame the conclusion more conservatively, taking into account the possibility that social theory may produce a new justification. A more moderate conclusion is that horizontal equity, if justifiable, must derive from the conception that a person is morally entitled to his or her pre-tax level of well-being, and that the state, through its tax structure, must respect that position. Only an approach providing that people are morally entitled to their holdings can serve as the basis for a normative justification of horizontal equity.

Vertical equity is based on a different, indeed incompatible, worldview.¹³⁰ Prevalent conceptions of vertical equity hold that wealth should be redistributed more equally. Society is willing to suffer inequality in distribution of economic resources only for considerations of efficiency, because an efficient market operates to the benefit of society as a whole. Nevertheless, society need not ratify all of the distributional dictates of the market. When the benefit to society is insufficient to justify the inequalities produced, society is obligated to interfere with the market mechanism and to effect a redistribution. The extent to which it redistributes will reflect the importance that it attaches to equality on the one hand and to efficiency on the other—or, in other words, its willingness to suffer inequality for the sake of achieving alternative economic and social goals.

It should be strongly emphasized, however, that respect for an individual's holdings as necessary to counterbalance the negative utility of the effort it took her to acquire them and her desire not to see those holdings redistributed, do not contradict this description of vertical equity. The argument that holdings thus acquired should not be redistributed is based on the view that the individual concerned is similarly situated to another who did not make the

129. Recall that in Nozick's philosophy, the line dividing taxes from voluntary payment is exceedingly thin. See *supra* text accompanying note 104.

130. See, e.g., MURPHY & NAGEL, *supra* note 27, at 32-33 ("It is . . . logically impossible that people should have any kind of entitlement to all their pretax income . . . [W]e cannot evaluate the legitimacy of taxes by reference to pretax income.").

effort and did not acquire the holdings.¹³¹ Vertical equity is concerned with individuals who are deemed unequally well-off after all relevant factors are taken into account.

Both of the principles of equity—vertical and horizontal—may therefore be grounded in various strains of modern social philosophy. However, as the axioms upon which the various philosophies are based are contradictory, so too horizontal and vertical equity are fundamentally incompatible. Because of this fundamental contradiction, it is inconsistent to demand respect both for horizontal and for vertical equity.

Tax theory is today based upon the conception that both horizontal equity and vertical equity are principles to which the tax structure should ideally conform. Such a dual goal is irrational. Tax theory must design varying principles for different tax structures: those aiming at redistribution and those aiming to maintain the existing distribution. Some issues may be common to both tax structures: both, for example, need to confront the question of how to measure well-being.¹³² With regard to other issues, however, the paths of the different tax structures will diverge. Here tax theory will need to design new principles, some principles specifically geared to achieve redistribution, others designed specifically to avoid it.

Any proposal regarding the tax structure must first clarify its approach to distributional justice. If the tax structure is supposed to preserve the existing distribution, one must explain how it avoids the slippery slope into redistribution. The key question here is not whether and to what extent horizontal equity should be sacrificed for the sake of vertical equity. On the contrary, a dilemma would arise only when preserving horizontal equity requires what appears to be redistribution. For example, preserving the existing distribution of incomes might be considered redistribution from the point of view of consumption, since the rich tend to consume less relative to their

131. In Dworkinian terms, the two individuals are similarly situated over their lifetimes. *See supra* Section VI.C.

132. Tax structures seeking to maintain the existing distribution need to measure well-being so as to compare welfare levels before and after taxes (e.g., whether spenders and savers are similarly situated). Redistributive tax systems need to measure well-being in order to determine the degree of inequality in the redistribution. (If some have more money because they consumed less in the past and saved more than others, is this distribution equal? Would transferring wealth from the savers to the consumers advance the cause of equality or detract from it?)

Nevertheless, each type of tax structure may use the conclusions differently. A vertical equity tax structure may adopt any efficient tax base. For example, even if consumption is the best proxy for welfare, due to the declining marginal propensity to consume, an income tax may help mitigate differences in consumption levels without requiring prohibitively high tax rates. *Cf.* Ronald Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191, 195 (1980) (examining the possibility of viewing wealth as a surrogate for welfare). Horizontal equity, on the other hand, must choose the proxy for welfare as its base. The declining marginal propensity to consume is merely a statistical average, and the fact that two individuals earn the same amount of money does not prove that their consumption level is also the same. Were consumption the correct proxy, an income tax would violate horizontal equity by imposing a greater tax burden on one whose consumption level is low relative to his income.

Horizontal Equity

incomes.¹³³ A possible solution to such a dilemma could be a demonstration that consumption is simply not a legitimate basis for comparison so that redistribution in terms of consumption is normatively meaningless. Another might be a demonstration that the proper measure is some composite of consumption and income and while there might be redistribution along one of the axes, the market distribution is respected when considering the composite. Alternatively, one could admit that consumption and income are both legitimate, independent bases for measuring well-being and that preserving the existing distribution according to one base involves a certain amount of redistribution from the perspective of the other.¹³⁴ In such a case, from the point of view of a proponent of horizontal equity, a compromise may be in order. Note, however, that the conflict—and the possible compromise—is not between the desire to respect the existing distribution and the need to redistribute, but between the desire to respect the existing distribution and the need to *avoid* redistribution.¹³⁵

On the other hand, if the tax structure seeks to redistribute economic resources more equally, the only relevant question would be whether the post-tax distribution is better than the pre-tax distribution—or, more precisely, whether the post-tax distribution is the best possible distribution given the particular theory of vertical equity. Success in the market does not justify a claim to a greater share of society's resources. Horizontal equity would have no place within such a structure.

Thus, horizontal equity may not be a proper goal of tax theory; there may be nothing wrong with imposing unequal tax burdens on similarly situated individuals. If, on the other hand, horizontal equity is a goal to strive for—a claim which has yet to be proven—then its normative grounding would be in direct conflict with that of vertical equity.

Even assuming that horizontal equity is a legitimate goal, it appears that contemporary tax theory, by viewing both horizontal and vertical equity as goals worth attaining, is mired in conceptual confusion. Tax theory needs to be divided into different streams: one that adopts horizontal equity and seeks to preserve the existing distribution, and another that ignores the existing distribution and seeks optimally to redistribute wealth. Tax theorists must clarify within which framework they are operating and the underlying goal of

133. Cf. Stanley H. Turner, Book Review, 19 ECON. J. 244, 245 (1909) (reviewing E.R.A. SELIGMAN, *PROGRESSIVE TAXATION IN THEORY AND PRACTICE* (2d ed. 1908)) ("[A] scale which is progressive relative[] to a particular base, may yet be no more than proportional relative[] to income . . .").

134. Similarly, one could argue that while some composite of income and consumption is the correct basis of comparison, we are incapable of computing the function and must therefore analyze each component separately.

135. Noteworthy in this context is Nozick's attempt to prove that a non-redistributionary system may nevertheless require individuals to pay for the protection of others. See *supra* Section VI.B.

their theories, whether redistribution or preservation of the existent order—for readers who do not share their framework will have no interest in the methods of achieving their goals.