

Introduction

In a capitalist economy, taxes are not just a method of payment for government and public services: They are also the most important instrument by which the political system puts into practice a conception of economic or distributive justice. That is why they arouse such strong passions, fueled not only by conflicts of economic self-interest but also by conflicting ideas of justice or fairness.

A graph showing the variation in marginal tax rates, or the percentage of income paid in taxes by different income groups, or the percent of the total tax burden carried by different segments of the population, is bound to get a rise out of almost anybody. While people don't agree about what is fair, there is a widespread sense that tax policy poses the issue of fairness in an immediate way. How much should be paid by whom, and for what purposes, what should be exempt from taxation or deductible from the tax base, what kinds of inequalities are legitimate in after-tax income or in the taxes paid by different people—these are morally loaded and hotly disputed questions about our obligations to one another through the fiscal operations of our common government.

Yet while it is clear that these questions have to do with justice, they have generated less sophisticated discussion, from a moral point of view, than other public questions that

have a moral dimension—questions about freedom of expression, pornography, abortion, equal protection, affirmative action, the regulation of sexual conduct, religious liberty, euthanasia, and assisted suicide. While there has been a great deal of debate over socioeconomic justice at the most abstract level in recent years, since John Rawls's *A Theory of Justice* returned the scholarly world's attention to the subject, those arguments about general theories of justice have made relatively little contact with the ideologically loaded battles over tax policy that are the bread and butter of politics.

This is partly because fiscal policy involves large empirical uncertainties about the economic consequences of different choices, and it is hard to disentangle the disagreements about justice from the disagreements about what will happen. A theory of justice cannot by itself approve or condemn a tax cut, for example; it requires some estimate of the effects of such a change on investment, employment, government revenue, and the distribution of after-tax income. With the prominent issues of individual rights, by contrast, the moral dimension can be more easily distinguished, even if empirical questions are also involved.

Another reason for the difference may be that tax battles are fought out in electoral politics, where rhetorical appeals are overwhelmingly important, rather than in the courts, where detailed and time-consuming argument is more welcome. Certainly the role of U.S. courts, in defining individual rights through constitutional interpretation, has had a large influence on the introduction of moral and political theory into those other areas of public debate.

Whatever the reason, there seems to us to be a gap or at least an underpopulated area in philosophical discussion of the ethical dimensions of public policy, and this book is intended to make a start at occupying it. This is especially important at a time when serious public discussion of economic justice has been largely displaced by specious rhetoric about tax fairness. We want to describe the important issues, criticize some previous approaches, and defend conclusions to the extent that we can arrive at them.

Many of the issues that crop up in political debate have to do with the design of the tax system, but there is also a large

question about its purpose—about what kinds of things a government should be levying taxes to pay for. Public goods like defense and domestic order or security are uncontroversial, but beyond that minimum there is controversy. To what extent should education be financed out of tax revenues, or health care, or mass transportation, or the arts? Should taxation be used to redistribute resources from rich to poor, or at least to alleviate the condition of those who are unable to support themselves adequately because of disability or unemployment or low earning capacity?

There are questions about the best form of taxation—whether it should be levied on individuals or businesses or on particular economic transactions, as by a sales tax or value-added tax. Should the base be wealth and property or the flow of resources over time—and in the latter case, should the measure be income or consumption? How should the tax system treat the transfer of resources within families and across generations, particularly at death?

There are issues about what should not be taxed—what level of minimum income, if any, should be exempt from taxation, for example, and what types of expenditures should be tax deductible or yield tax credits. There is the perennial issue of proportional or “flat” versus progressive taxes and of the appropriate degree of progressivity. And there are familiar questions about differences in the treatment of different categories of taxpayers—the married and the unmarried, for example, or homeowners and renters—and about what is required to justify such differences.

Finally, there is the question whether a general presumption has to be overcome against taxation and in favor of leaving resources in the private hands of those who have created or acquired them—a presumption against “big government” and in favor of allowing people to do what they want with the resources that they have acquired through participation in a free market economy. If there were such a presumption, or *prima facie* case against, it would mean that the case for supporting various projects and aims out of tax revenue would have to be that much stronger.

Many of these questions arise about taxes at every level—national, state, and local—so taxes are at the heart of mor-

ally charged politics wherever elections are held, and sometimes they even form the subject of direct referenda. There are other ways of raising money that complicate the picture, such as import duties, license fees, tolls, state-run lotteries, and of course borrowing, but we will leave them aside. In a nonsocialist economy, without public ownership of the means of production, taxes and government expenditures are the primary focus of arguments over economic justice.

These arguments take us into the territory of more abstract controversies of political and social philosophy, and it is the bearing of those philosophical controversies on tax policy that we will explore. They all come out of the attempt to describe the rights and duties of a democratic state with respect to its citizens, and the rights and duties of those citizens with respect to the state and to one another.

Limited democratic government constrains individuals in certain respects, leaves them free in others, and provides them with certain benefits, both positive and negative. It usually creates those benefits by means of constraints, whether it is keeping the peace or maintaining public safety or raising revenue for child care, public education, and old-age benefits. Disagreements over the legitimate scope of government benefit and constraint, and over the way that scope is affected by individual rights, are likely to underlie differences over taxation, even when they are not made explicit. These are disagreements about the extent and limits of our collective authority over one another through our common institutions.

It is now widely believed that the function of government extends far beyond the provision of internal and external security through the prevention of interpersonal violence, the protection of private property, and defense against foreign attack. The question is how far. Few would deny that certain positive public goods, such as universal literacy and a protected environment, that cannot be guaranteed by private action, require government intervention. There are political differences about the appropriate level of public provision of such goods. But what arouses the most controversy is the use of government power not only to provide what is good

for everybody but also to provide extra resources for those who are worse off, on the ground that certain sorts of social and economic inequality are unjust or otherwise bad, and that we have an obligation to our fellow citizens to rectify or alleviate those problems.

Much of the controversy has to do with the justice or injustice of outcomes produced by a market economy—the relation between market outcomes and reward for productive contribution, the degree to which the determinants of economic success or failure are arbitrary from a moral point of view. What is the moral basis for a right to hold on to one's earnings? Where the economy is largely private and the government democratic, tax policy will be the site where moral disagreements about these matters are fought out.

Since each of us is both a private individual, entering as a participant into the market economy, and a citizen who participates, at least potentially, in the process of public choice through politics, we have to combine our convictions about social justice and political legitimacy with our more personal motives, in arriving at a stable view of what we want government to do. When we decide whether to favor or oppose a tax cut, we think about its effect on our own disposable income, as well as about its broader social and economic consequences. The fact that tax policy is not set by forces outside the society but must be in some way chosen by those within it, as the political outcome of inevitable deep disagreements, makes the subject all the more complicated. The accommodation between personal and public motives in democratic politics is therefore an important part of the discussion.

Before getting to moral and political philosophy, however, we need to say something about the way evaluative questions have been treated, and to a considerable extent still are treated, in the traditional tax policy literature. Certain concepts have been developed specifically for application to the evaluation of tax policy: vertical equity, horizontal equity, the benefit principle, equal sacrifice, ability to pay, and so forth. We will begin by examining these concepts and will try to explain why they do not adequately capture the con-

siderations that ought to enter into the normative assessment of tax policy.

If there is a dominant theme that runs through our discussion, it is this: Private property is a legal convention, defined in part by the tax system; therefore, the tax system cannot be evaluated by looking at its impact on private property, conceived as something that has independent existence and validity. Taxes must be evaluated as part of the overall system of property rights that they help to create. Justice or injustice in taxation can only mean justice or injustice in the system of property rights and entitlements that result from a particular tax regime.

The conventional nature of property is both perfectly obvious and remarkably easy to forget. We are all born into an elaborately structured legal system governing the acquisition, exchange, and transmission of property rights, and ownership comes to seem the most natural thing in the world. But the modern economy in which we earn our salaries, own our homes, bank accounts, retirement savings, and personal possessions, and in which we can use our resources to consume or invest, would be impossible without the framework provided by government supported by taxes. This doesn't mean that taxes are beyond evaluation—only that the target of evaluation must be the system of property rights that they make possible. We cannot start by taking as given, and neither in need of justification nor subject to critical evaluation, some initial allocation of possessions—what people originally own, what is theirs, prior to government interference.

Any convention that is sufficiently pervasive can come to seem like a law of nature—a baseline for evaluation rather than something to be evaluated. Property rights have always had this delusive effect. Slaveowners in the American South before the Civil War were indignant over the violation of their property rights that was entailed by efforts to prohibit the importation of slaves into the territories—not to mention stronger abolitionist efforts, like helping runaway slaves escape to Canada. But property in slaves was a legal creation, protected by the U.S. Constitution, and the justice of such forms of interference with it could not be assessed apart from the justice of the institution itself.

Most conventions, if they are sufficiently entrenched, acquire the appearance of natural norms; their conventionality becomes invisible. That is part of what gives them their strength, a strength they would lack if they were not internalized in that way. For another pervasive example, consider the conventions governing the different roles of men and women in any society. There may be good or bad reasons for the existence of such conventions, but it is essential, in evaluating them, to avoid the mistake of offering as a justification precisely those ostensibly “natural” rights or norms that are in fact just the psychological effects of internalizing the convention itself. If women are always treated as subordinate to men, the perception inevitably arises that submissiveness is a natural feminine trait and virtue, and this in turn is used to justify male dominance. Aristotle mistook the consequences of an institution for its natural basis in this way when he argued that certain people were natural slaves, and also in his claims about women.¹ To appeal to the consequences of a convention or social institution as a fact of nature which provides the justification for that convention or institution is always to argue in a circle.

In the case of taxes and property, the situation is more complicated, and it can be even more absurd. The feeling of natural entitlement produced by an unreflective sense of what are in fact conventionally defined property rights can encourage complacency about the status quo, as something more or less self-justifying. But it can also give rise to an even more confused criticism of the existing system on the ground that it violates natural property rights, when, in fact, these “natural” rights are merely misperceptions of the legal consequences of the system itself. It is illegitimate to appeal to a baseline of property rights in, say, “pretax income,” for the purpose of evaluating tax policies, when all such figures are the product of a system of which taxes are an inextricable part. One can neither justify nor criticize an economic regime by taking as an independent norm something that is, in fact, one of its consequences.

This is, as we have said, completely obvious, but as we will try to show, it is easy to forget. The appropriate form of a system of property rights and its shaping by tax policy is a

difficult question, and to address it requires that we take up a number of ethical issues about individual liberty, interpersonal obligation, and both collective and personal responsibility. Property rights are not the starting point of this subject but its conclusion.

While we hope the theoretical questions we discuss will have general application, we are going to conduct the discussion with reference to more or less familiar American examples. And we will talk mostly about federal rather than state and local taxation, and about taxes on individuals rather than corporations—even though the federal personal income tax plus Social Security and Medicare taxes amount to only about half of total tax revenues in the United States. Specific taxes must, of course, be assessed in the context of the whole economic picture, including other taxes. But the general issues we are concerned with arise everywhere.

The book is organized as follows. In the next two chapters we discuss general principles, first as they have been understood by tax theorists and then as they have been understood by philosophers. Chapter 2 examines the main criteria proposed in the tax policy literature to evaluate the fairness of taxes. This work comes from the disciplines of economics and law, and it has by now a considerable history. Chapter 3 then provides a critical survey of the diverse theories of social, political, and economic justice, developed in discussion among moral and political philosophers over a still longer history, that have implications for how tax policy should be evaluated—even if those implications have not always been explicitly drawn. The two approaches are quite different, in spite of the variety to be found within each of them. In chapter 4, we explain a fundamental distinction between two functions of taxation, which is important in identifying the values that should bear on its multiple effects. Chapters 5, 6, and 7 take up from the standpoint of justice three central issues about the design of the tax system: the tax base (what should be taxed); whether taxes should be progressive, and if so to what degree; and taxation of inherited wealth. Chapter 8 discusses some specific charges of discrimination among taxpayers by certain forms

of tax. Throughout the book we try to present fairly a range of competing views about all these questions, without concealing our own sympathies. In the concluding chapter, we draw together the results of the preceding discussion, summarize our views, and say what practical policies we think they imply under the political constraints of the real world.

and it is a way of looking at the issue that continues to have a large influence on political discussion (see, for example, President Bush's insistence that when there is a tax cut, everyone's taxes should be cut by roughly the same proportion).

From early on, there have also been dissenters from this approach, and at the present time, a number of the most prominent tax theorists reject it. Nevertheless, we will begin by explaining in detail what we think is wrong with an exclusive focus on the distribution of tax burdens, and why other political values must play a role in any adequate discussion of justice in taxation. This will also serve to distinguish our objections from those of other contemporary critics of the traditional approach.

There are also decisive objections to the traditional discussion of fairness even on its own terms. Still, an examination of those traditional ideas is an excellent way to bring out the nature and complexity of the issues of political morality that tax policy must address.³ So we will start our discussion from inside the traditional framework.

II. Vertical Equity: The Distribution of Tax Burdens

Everyone agrees that taxation should treat taxpayers equitably, but they don't agree on what counts as equitable treatment. It is standard practice in addressing the question to distinguish between vertical and horizontal equity. According to this conception, vertical equity is what fairness demands in the tax treatment of people at different levels of income (or consumption, or whatever is the tax base), and horizontal equity is what fairness demands in the treatment of people at the same levels. Vertical equity is analytically more fundamental, since sameness of income takes on significance for policy purposes only if we believe that persons with different levels of income should be taxed differently.⁴ Accordingly, we address vertical equity first.

As a limiting case, consider the simplest form of tax, which is a poll or head tax: each person pays the same dollar amount of tax, regardless of income. In addition to being simple, a

Traditional Criteria of Tax Equity

I. Political Morality in Tax Policy: Fairness

It has been recognized for a long time that tax policy must take account of political morality, or justice.¹ Though economic theory provides essential information about the likely effects of different possible schemes of taxation, it cannot by itself determine a choice among them. Anyone who advocates the tax policy that is, simply, "best for economic growth" or "most efficient" must provide not only an explanation of why the favored policy has those virtues, but also an argument of political morality that justifies the pursuit of growth or efficiency regardless of other social values.

Apart from economic efficiency, the social value that has traditionally been given weight in tax design is fairness; the task of the tax designer is to come up with a scheme that is both efficient and fair.² Fairness, in the traditional conception, is thought of specifically as a standard for evaluating differences in the tax treatment of different people: the principle that like-situated persons must be burdened equally and relevantly unlike persons unequally.

Historically, much of the discussion of justice in taxation has taken the form of attempts to interpret this requirement,

head tax has a formal, if superficial, claim to being equitable, since it treats everyone literally the same. If this were fair, the question of vertical equity would be easily resolved—people with different incomes should not pay different amounts of tax, they should pay the same. But even the most virulent opponents of redistribution away from pretax incomes balk at the head tax; it is almost never defended as the appropriate form of a national income tax.⁵

Given the superficial equity of a scheme that takes the same amount of money from each person, why is a head tax almost universally regarded as obviously unjust? One answer is that there are relevant differences between taxpayers that make it fair to treat them differently—indeed, unfair to treat them the same.⁶ This is where the topic of vertical equity begins—by asking what the relevant differences are between taxpayers that justify differential tax burdens.

We will review some traditional answers to this question. Our purpose, however, is to explain why the question itself is misguided. The injustice of the head tax has a more fundamental source.

It will be helpful to sketch in advance two main themes of our discussion. First, theories of vertical equity are frequently myopic, in that they attempt to treat justice in taxation as a separate and self-contained political issue. The result is not a partial account of justice in government, but rather a false one.⁷ For what counts as justice in taxation cannot be determined without considering how government allocates its resources.

Myopia afflicts the contemporary legislative process in the United States in a simple and dramatic way, in the form of tables that set out the distribution of tax burdens associated with various tax reforms.⁸ Most government transfers are excluded from these burden tables, including, most importantly, Social Security and Medicare payments.⁹ This practice has been strongly criticized; as David Bradford writes, “economists have long recognized the essential equivalence between taxes and transfer payments.”¹⁰ It seems clear that a tax burden that is matched by an equivalent transfer is not, in the relevant sense, a burden at all.

But the problem would not be solved even if all money transfers were included in the burden tables. That too would

be arbitrary, so long as we excluded in-kind benefits such as roads, schools, and police, not to mention the entire legal system that defines and protects everyone’s property rights. If literally all government benefits were taken into account, however, we would notice that almost no one suffers a net burden from government. We would be forced to conclude that there is no separate issue of the fair distribution of tax burdens, distinct from the entirely general issue of whether government secures distributive justice.¹¹ This might be described as a question about the allocation of different *benefits* of taxation, expenditure, and other government policies to different individuals; but that looks very unlike the original question.

The only way to avoid this conclusion would be to assume some morally privileged hypothetical distribution of welfare or resources as the baseline against which to assess the burdens of government. And our second main objection to theories of vertical equity is that they commonly do just that. Implicit in those theories is a vision of government as a provider of services whose demands for payment intrude on a *laissez-faire* capitalist market economy that produces a presumptively legitimate distribution of property rights. Justice in taxation is then seen as the fair sharing out of tax burdens among individuals *as assessed from that baseline*.

The assumption that pretax market outcomes are presumptively just, and that tax justice is a question of what justifies *departures* from that baseline, appears to flow from an unreflective or “everyday” libertarianism about property rights. Though a consistent application of sophisticated libertarian political theory leads to deeply implausible results that hardly anyone actually accepts, in its naive, everyday version libertarianism is taken for granted in much tax policy analysis. We attempt a diagnosis of this situation in section VII, where we will present our most general theoretical objections to the tax burden approach.

Though our main aim is to explain that with the demand for a principle of vertical equity, the question has been wrongly posed from the start, in the following four sections we elaborate these criticisms of the idea of vertical equity by examining several traditional answers to the question—several views, that is, about which characteristics of taxpayers

should be used to determine their differential tax burdens. Section III considers the principle that taxes should correspond to benefits received from government, and sections IV, V, and VI take up three interpretations of the principle that taxes should depend on ability to pay.

III. The Benefit Principle

One difference among taxpayers that certainly seems relevant is how much they benefit from government services. Many have thought that fairness in taxation requires that taxpayers contribute in proportion to the benefit they derive from government.¹² The implications of the benefit principle are usually said to be very unclear, on the ground that we lack even a roughly accurate measure of the benefits each individual receives from the government. But in fact, once we interpret the idea of benefits from government properly, the rough assessment of those benefits does not seem terribly problematic.

To come up with a measure or even an understanding of any kind of benefit (or burden) we need to ask, "Relative to what?"—we need to settle on a baseline. The magnitude of a benefit received is the difference between a person's baseline or prebenefit level of welfare and that person's level of welfare once the benefit has been conveyed. In this case, the baseline for determining the benefits of government is the welfare a person would enjoy if government were entirely absent; the benefit of government services must be understood as the difference between someone's level of welfare in a no-government world and their welfare with government in place.

What sort of life would be led in the total absence of government? It would be wrong to imagine life roughly as it is now, with jobs, banks, houses, and cars, and lacking only the most obvious government services such as Social Security, the National Endowment for the Arts, and the police. The no-government world is Hobbes's state of nature, which he aptly described as a war of all against all. And in such a state of affairs, there is little doubt that everyone's level of welfare

would be very low and—importantly—roughly equal.¹³ We cannot pretend that the differences in ability, personality, and inherited wealth that lead to great inequalities of welfare in an orderly market economy would have the same effect if there were no government to create and protect legal property rights and their value and to facilitate mutually beneficial exchanges. (We leave aside the fact that without government, the earth would sustain only a tiny fraction of its present human population, so that most of us wouldn't even exist in Hobbes's state of nature.)

If the relevant baseline for the assessment of benefit is the very low level of welfare, roughly the same for everyone, that people would have in the absence of government, then we can use people's actual levels of welfare, with government in place, as a rough measure of the benefit conveyed to them by government. And if income (somehow defined) were an acceptable measure of people's welfare, the benefit principle might seem to yield the following simple principle of vertical equity for an income tax: People should pay tax in proportion to their income, which is to say at the same percentage—a flat tax.¹⁴

Even leaving aside doubts about whether income is an acceptable measure of welfare, this conclusion does not follow. For the claim that justice is served by taxing in proportion to benefit must mean, not that each person should pay dollar amounts in proportion to benefits received, but rather that each person should be burdened, in real terms, in proportion to benefits received.¹⁵ And once we take into account the familiar fact of the diminishing marginal utility of money, it is not at all clear what kind of rate structure for the income tax is recommended by the benefit principle. Depending on the way in which the marginal utility of money diminishes, the principle may recommend progressive, proportionate, or even regressive taxation.* The benefit principle would therefore be faced with a practical problem, even if it were ac-

*Taxation is progressive if the average rate increases with income (or whatever is the tax base), proportionate if the average rate remains constant as income increases, and regressive if the average rate decreases with income. (The term "progressive taxation" is sometimes used in a different sense in the tax policy literature, to refer to rising marginal rates.)

cepted as an ideal: Its implementation requires knowledge of how steeply marginal utility of income declines, and of how much the rate of decline varies from person to person.¹⁶ That is a problem faced by many measures of vertical equity; we will return to it in a different context below.

But there is a more fundamental problem with the benefit principle: Whether or not it recommends proportional taxation, the benefit principle gives us no guidance on what the tax rate or rates should be, because it gives us no guidance as to the appropriate level of government expenditure. It takes expenditure as given, and allocates taxes in proportion to the resulting benefit. That is an example of what we mean by myopia.

At first glance, it is easy to overlook this problem. Shouldn't the rate be set at the level sufficient to pay for the government services that the democratic process deems desirable? Ordinary politics determines what government should provide; the benefit principle tells us how to fund government provision in a fair manner. But the trouble with this line of thought is that it pretends that the issue of the nature and extent of government services does not itself raise questions of justice. Once we acknowledge those questions, it is clear that the benefit principle cannot serve as a standard of tax justice.

The confusion is particularly apparent if we consider that on most accounts of social justice one of the aims of government is to provide (at least) minimal income support and health services to the otherwise indigent.¹⁷ But if that is part of the aim of just government, it conflicts with the benefit principle. For though the very poor benefit less from government than the rich, they still benefit greatly as against the baseline of the war of all against all—especially in a country with at least a minimal welfare system. According to the benefit principle, then, the poor must pay for this benefit in proportion to its size. But it would be entirely pointless to provide minimal income support and then demand payment for the service.* The benefit principle is, in fact, incompatible,

*Noah Feldman has suggested that this absurdity could be avoided by a broader benefit principle understood not merely as a principle of tax policy but rather as a general principle of justice, according to which indi-

as a matter of political morality, with every account of social justice that requires government to provide any kind of income support or welfare provision whatsoever to the destitute (let alone more strongly egalitarian distributive aims).

Now there are accounts of social justice that reject all support for the destitute as illegitimate redistribution away from market returns. And so it might seem that the benefit principle is not myopic at all, but rather flows from a wider libertarian theory of political morality according to which the distribution of welfare produced by the market is presumptively just and should not be disturbed by government.

But the benefit principle is actually inconsistent with any such theory of justice. For if we assume that the pretax baseline is one of market outcomes undisturbed by government, and assume further that the resulting distribution is presumptively just, because people are entitled to what they get out of the market, then we will regard the benefit principle of taxation as unfair because it distorts that distribution. The benefit principle would have to take much more, in real terms, from those who do very well in the market than from those who do badly.¹⁸ If market outcomes are presumptively just, that is unwarranted, and some other, less inequitable method must be found to pay for the costs of government and the legal protection of the market economy. We will examine such a standard—the principle of equal sacrifice—in section V below. The benefit principle, however, cannot be saved from incoherence by embedding it in a market-oriented theory of property rights. It is inconsistent with every significant theory of social and economic justice.

viduals are obligated to repay the benefits they receive from government not only through taxes, but by a combination of loyalty, legal obedience, and willingness to serve the state (by accepting conscription in wartime, for example). Then even those who receive income support from the state and pay no taxes would still be expected to repay their benefits in kind, so to speak. We will not attempt to evaluate this interesting proposal as a theory of distributive justice. In any event, it is not clear whether it could be worked out in a way that had definite implications for the allocation of tax burdens.

IV. Ability to Pay: Endowment

Historically, the main alternative to the benefit principle has been the principle that tax should be levied in accordance with taxpayers' "ability to pay." This is now the most commonly invoked criterion of vertical equity; in Germany, Italy, and Spain it has achieved constitutional status.¹⁹

On this view, what is inequitable about the head tax is that it ignores the fact that people differ in their ability to pay the burden of a tax payment. The notion of ability to pay is of course vague, and it has been interpreted in different ways. One initial ambiguity is this. Does it mean people's ability to pay tax by virtue of their actual economic situation—given the choices they have made and the income and wealth they now have? Or does it mean their ability to pay given the choices that they *could* make and the possibly higher income and wealth they therefore have the *ability* to earn? On the latter interpretation, the idea of ability to pay leads to the idea of *endowment taxation*: People should pay tax according to their endowment, which is defined as their ability to earn income and accumulate wealth. It is clear that potential income may be higher than actual income. Someone who abandons a successful business career to become an unsuccessful writer thenceforth earns below potential. Under an endowment tax, that person's tax bill would not decline along with income.

No one proposes the actual implementation of an endowment tax—the difficulty of measuring a person's maximum potential income is one obvious problem.* But among economists it is not unusual to employ the idea of taxation according to endowment as the fundamental principle of justification for tax policy. The thought is that an ideal or first-best taxation scheme would implement the endowment principle; actual proposed tax schemes are second best in that they aim toward the ideal but must deviate from it because of various practical considerations.²⁰

The origin of the endowment principle lies in the earliest versions of the ability to pay approach. As originally understood, people's ability to pay tax, also called their "faculty," was understood to be a function of property or wealth.²¹ This is natural enough—a person who has more wealth is in a literal sense able to transfer more money to the state. But in addition to ordinary property, people have what economists call "human capital": the resources of knowledge, ability, personality, connections, etc. that enable them to act productively—the most important case being the earning of wages in a market economy. So it is not surprising that by the nineteenth century some analysts began to suggest that the proper understanding of ability to pay was endowment in the full sense that includes a person's potential income.²²

Since "liquidation" of human capital requires labor, however, the endowment interpretation of the idea of ability to pay has only an indirect relation to the value of fairness. It is one thing to believe that differences in actual income are relevant to the distribution of tax burdens because a higher-income person has more money available—and to believe that taxing everyone the same is unfair because people with more money should pay more. This simple and imprecise idea can hardly suffice as the basis for a theory of just taxation, as we shall see, but it certainly has initial intuitive plausibility. The same cannot be said for the very different idea that *potential* income should determine the distribution of tax burdens.

If two people, Bert and Kurt, earn the same amount, in fact, but Bert is earning at his full capacity and Kurt below his capacity, why might it be thought unfair to tax them the same absolute amount? We cannot say that Kurt has more money available, since he does not. Perhaps he has more leisure and is for that reason better off than Bert.²³ But this is not necessarily so: Perhaps Kurt and Bert work the same hours, but Kurt is earning less than he might because he has chosen to be a teacher rather than a lawyer.

But whether he takes it in the form of leisure or a lower-paying occupation, there is an advantage Kurt has over Bert, when it comes to the normal tax system: Something he cares

*Another is the potential for interference with taxpayers' autonomy—see further chapter 5, section VIII.

about costs him income, but only income that he doesn't earn. So if taxes are levied only on actual income, Kurt will enjoy those advantages tax-free, so to speak. He won't be taxed on the income he forgoes by working less or by being a teacher rather than a lawyer—whereas Bert will be taxed on the income he has to earn to buy a BMW. This may seem an inequitable and arbitrary distinction. Equitable treatment might be thought to require that this difference be taken into account in the tax scheme, and that taxes not be assessed merely on cash earnings, in order to deny Kurt a free ride that he doesn't deserve.*

Equity is not, however, the main reason contemporary economists offer for endowment as the ideal principle of taxation. That case usually turns not on fairness or moral obligation²⁴ but rather on the fact that a tax on endowment, unlike a tax on actual income, attaches no disincentive to further labor.**

A tax on actual income has two kinds of behavioral influences that pull in opposite directions. The first is that it encourages people to choose more or more highly paid work; this is due to what economists call the income effect—taxes leave you poorer and thus reduce your opportunity to consume. The second, called the substitution effect, is that the tax encourages people to work less, by reducing the reward per unit of labor. Without the tax, an additional hour of work may be worth more than an hour of leisure; with the tax, the extra hour of work may be worth less than the hour of leisure. The tax on endowment or potential income, by contrast,

*Another reason why fairness might be thought to demand a higher absolute amount of tax from Kurt is that in falling short of his potential income he is in some sense evading his responsibilities. Walker (1888), making essentially this argument, concludes, about the likes of Kurt: "His social and industrial delinquency, so far from excusing him from any portion of his obligation, would, the rather, justify heavier burdens being laid upon him, in compensation for the injury which his ill example and evil behavior have inflicted upon the community" (15). Walker was the first president of the American Economic Association from 1885.

**We discuss justice-based arguments for an endowment tax in chapter five, section VIII.

is a lump-sum tax and therefore has only an income effect. There is no substitution effect because the same tax must be paid whether the additional hour is worked or not.

Why is a tax with no substitution effect preferable? The answer has nothing to do with fairness. Rather, it turns on an essentially utilitarian argument.²⁵ As a moral theory utilitarianism requires each person to do whatever it is that will best promote the aggregate welfare of everyone. But utilitarianism as applied to tax policy is not at all concerned with whether people do their duty, as such, and indeed gives no role whatsoever to considerations of individual moral responsibility. Instead, it focuses on institutional design as a way of affecting people's behavior.

The utilitarian has a purely instrumental interest in people's behavior. As applied to the problem of tax design, utilitarianism tells us that the best tax system is the one that is most effective in promoting aggregate welfare, through incentives and in other ways: The aim is to design a tax scheme that will encourage people to act in the way that will best serve this aggregate good. The substitution effect is always bad from that point of view, as it may lead a person not to work an extra hour who would otherwise choose to do so, thus discouraging a mutually beneficial exchange. So a lump-sum tax is ideal in terms of its effects on behavior. Of course, a head tax is a lump-sum tax as well, but it is easy to see why utilitarians would prefer an endowment tax: it gives more productive people greater incentives to work than less productive people. From a utilitarian point of view, leisure is better forgone by those who produce more for the price.²⁶ As has often been noted, utilitarianism is consistent with Marx's dictum from "The Critique of the Gotha Program": "from each according to his ability, to each according to his needs."

We can conclude that the standard economic case for embracing the endowment principle as the ideal principle of tax policy should not be understood as an interpretation of "ability to pay," since that phrase is meant to suggest an answer to the problem of vertical equity—the problem of determining what is a fair distribution of tax burdens among differently situated people. The standard justification is aggregate utility, not fairness.

V. Ability to Pay: Equal Sacrifice

We have seen that if the tax base is actual income, there is a straightforward sense in which it can seem equitable to ask for more tax from those who have more income: Those who have more money are better able to pay. Though it sounds plausible enough, this idea remains ambiguous. There are at least two different senses in which a richer person might be thought better able to pay than a poorer person. First, we might think that people with more money can afford to give away more in the sense that additional money is worth less to them in real terms, so they can pay more money than a poorer person—sometimes much more—with no greater loss in welfare. Alternatively, we might think that people with more money can afford to give away more because even if they sustain a larger real sacrifice they will be *left* with more: they will still have, in some sense, enough—and will still be better off than those who started out with less. John Stuart Mill took a clear stand in favor of the first of these possibilities; it is to him that we owe the influential principle of equal sacrifice.²⁷ (We return to the second possibility in the next section.)

According to the equal-sacrifice principle, a just tax scheme will discriminate among taxpayers according to their income, taking more from those who have more, so as to ensure that each taxpayer sustains the same loss of welfare—so that the real as opposed to monetary cost to each is the same. The key factual assumption here is again that of the diminishing marginal value of money; whether the equal-sacrifice principle leads to a proportional or a progressive tax scheme depends on the rate at which the marginal utility of income diminishes.

We do not know how steeply marginal utility declines, but the fact that the equal-sacrifice principle may require empirical speculation to implement does not show that it is incorrect. Rough guesswork will be a part of any plausible account of tax justice, and it is a serious mistake to prefer one account of justice to another *solely* because it seems easier to implement. As the economist Amartya Sen has said, “it is better to be roughly right than precisely wrong.”

At this stage our question is the more fundamental one of whether the principle of equal sacrifice is plausible as a matter of political morality. A sacrifice is a burden; as with benefits, our understanding of the nature of a burden depends on the baseline we use for comparison. It is clear that the baseline envisaged for the principle of equal sacrifice is not the world without government and a war of all against all. That would be the right baseline if the principle concerned equality of *net* sacrifice—the burdens of government minus its benefits. However, as we know, government does not in fact impose a net sacrifice on anyone; assuming that we are talking only about governments that do not enslave, murder, or persecute parts of the population, each person is better off, post-tax, with government in place than without it. So equal net sacrifice relative to the miserable level of the no-government world is clearly not what advocates of the equal-sacrifice principle of tax fairness have in mind. Their idea has been that fair taxation will extract an equal sacrifice as measured against a baseline of pretax incomes, where those incomes are possible only in the presence of government.

Our principal objection to this approach is that it treats the justice of tax burdens as if it could be separated from the justice of the pattern of government expenditure—what we called earlier the problem of myopia. This is to treat “the collection of taxes as though it were only a common disaster—as though the tax money once collected were thrown into the sea.”²⁸ In fact, taxes are imposed for a purpose, and an adequate criterion of justice in their imposition must take that purpose into account. What matters is not whether taxes—considered in themselves—are justly imposed, but rather whether the totality of government’s treatment of its subjects, its expenditures along with its taxes, is just.

Taxes are not, in general, like criminal fines, which may be understood to impose symbolic or moral costs over and above their monetary costs. So understood, criminal fines *should* be fairly imposed considered in themselves, since improper fines harm or wrong a person even if they are easily “affordable,” or are canceled out in financial terms by funds transferred from the state. There are, it is true, certain

possible tax practices that are intrinsically unjust because of their discriminatory aims or effects; cash transfers would not adequately compensate the victims of this kind of tax injustice. But such exceptional cases—we discuss them in chapter 8—must not be taken as representative of our topic; as far as its purely economic impact is concerned, the justice of taxation is an issue that must be considered as part of the general subject of social justice.

Since taxation is not an entirely independent realm of justice, one cannot pronounce confidently that the state should extract an equal tax sacrifice from each person as measured against pretax incomes while remaining agnostic on the question of what a just expenditure policy would be. As Pigou wrote, more than fifty years ago:

People's economic well-being depends on the whole system of law, including the laws of property, contract and bequest, and not merely upon the law about taxes. To hold that the law about taxes ought to affect different people's satisfactions equally, while allowing that the rest of the legal system may properly affect them very unequally, seems not a little arbitrary.²⁹

However, the equal-sacrifice principle cannot be rejected as quickly as the benefit principle for, unlike the latter, it does make sense if embedded in a wider theory of justice that rejects all government expenditure or taxation to alter the distribution of welfare produced by the market. Such a libertarian theory of justice, typically based on either some notion of desert for the rewards of one's labor, or of strict moral entitlement to pretax market outcomes, limits the role of the state to the protection of those entitlements and other rights, along, perhaps, with the provision of some uncontroversial public goods. If (and only if) that is the theory of distributive justice we accept, the principle of equal sacrifice does make sense.

It makes sense because the theory limits government services to those that are needed to secure everyone's rights, in ways that can only be accomplished by state action. Paying

for these minimal services that benefit everyone is then naturally understood as a matter of sharing out the cost of a common burden.

On this view, government should not be in the business of altering the distribution of welfare, but its services (police, roads, financial regulation, etc.) have to be paid for nevertheless. How should the burden be distributed? The equal-sacrifice principle would seem to provide the natural solution to this problem of fair taxation for a libertarian—what could be fairer, if we assume that the distribution of welfare produced by the market is just, than that everyone contribute the same amount in real (as opposed to monetary) terms?

As we saw, the benefit principle is less plausible from this perspective. By assessing everyone the same proportion of their total benefit from the existence of government, it exacts far more in real cost from the better-off and thus alters the presumptively just distribution produced by the free market. And the head tax could hardly be defended as a fair way to fund a government that is imposed on everyone, regardless of their wishes, since it hurts some people more than others and indeed hurts more those who are already worse off. Thus, the equal-sacrifice principle—taxing people differently so that everyone shares the same proportion of the common burden in real terms—has some initial claim to be taken seriously since there is a theory of justice in which it can be embedded.

However, it is important to emphasize that this approach cannot be generalized to other theories of justice. The separate treatment of justice in taxation as a sharing out of common burdens among the citizenry depends on the libertarian assumption that there is no comparable question of distributive justice in public expenditures or the provision of government services. If one rejects that assumption, the treatment of taxes as a “common disaster” has no further application.

An unreflective form of libertarianism casts a shadow over much discussion of tax policy; we will later discuss the severe damage this has done. For now we note that very few people are consciously committed to the libertarian theory of justice. Hardly anyone really believes that market out-

comes are presumptively just and that justice does not require government to provide welfare support to those of its subjects who are destitute, without access to food, shelter, or health care. Thus, though the principle of equal sacrifice has been widely avowed over the past 150 years, the theory of justice it depends on has not been.

That dissonance at the level of first principles typically disappears at the level of concrete proposals for tax reform. When that stage is reached, the principle of equal sacrifice is in practice always abandoned: no one proposes a tax scheme that does not provide for a substantial personal exemption or tax-free level of income. And practically everyone supports some level of transfer payments to those who are genuinely unable to provide for themselves. Nevertheless, the dissonance at the level of first principles has important political consequences; we discuss it at length in section VII.

In the meantime, we must review some other interpretations of the general idea that taxes should be levied in accordance with ability to pay—interpretations that lack the radical implications of the equal-sacrifice principle.

VI. Ability to Pay as an Egalitarian Idea

As it has so far been understood, the principle of equal sacrifice requires that taxes impose the same real loss of welfare on each taxpayer. In the tax policy literature, this is sometimes referred to as the principle of equal *absolute* sacrifice, in order to contrast it with two other principles, those of equal proportional and equal marginal sacrifice.³⁰ The practice of presenting these three principles as interpretations of a common basic idea of equal sacrifice is misleading, as the latter two principles in fact have nothing to do with the idea that a fair tax scheme should impose the same sacrifice on everyone; rather, they are best understood precisely as rejections of that idea and its radical implications.

We need not here discuss the principle of equal marginal sacrifice, since it represents an essentially utilitarian approach and has nothing to do with the fair distribution of tax

burdens.³¹ The principle of equal proportional sacrifice, by contrast, is important in the current context, since it expresses an egalitarian interpretation of the idea of ability to pay. Even though this principle is rarely invoked explicitly any more, it corresponds to a very common way of thinking about tax fairness.

The principle of equal proportional sacrifice stipulates that individuals should sustain tax burdens in proportion to their level of welfare.³² That means that the better off a person is, the greater the real sacrifice that should be exacted through taxation. The only thing equal about this pattern of taxation is the proportion of welfare each person loses. And an equal proportion, of course, is not an equal amount; if all give up the same proportion, the better-off give up more, in real terms (though they are also left with more). So the word “equal” is redundant in the label “equal proportional sacrifice”—“proportional sacrifice” denotes the same idea.

As we noted at the start of the previous section, one might interpret the idea of ability to pay not just in terms of the diminishing marginal utility of money, but rather as the political claim that better-off people can “afford” to sacrifice more, in real terms, than worse-off people, because they will still be left with more. This interpretation of the notion of ability to pay, which is required by the principle of proportional sacrifice, is dramatically at odds with the principle of equal sacrifice. The claim that those who are better off can afford a greater real sacrifice embraces taxation as a legitimate means of redistribution away from market outcomes, to the benefit of the worse-off at the expense of the better-off. The principle of proportional sacrifice thus rejects the libertarian theory of justice that implicitly lies behind the principle of equal sacrifice.

Since the underlying idea of the principle of proportional sacrifice must simply be that fair taxation will extract more, in real terms, from those who are better off, there should be no special magic in the formula of strict proportionality.³³ The same general idea could lead, for example, to the even more strongly egalitarian view that taxes should be levied at progressively *higher* proportions of real sacrifice as welfare rises.

That suggests what might seem to be an appealingly flexible way of thinking about tax justice: fair taxation imposes greater real burdens on those who are better off, but the exact rate of increase in the burdens is a matter to be settled by intuitive political judgment. Some such view—we could call it “the principle of increasing sacrifice”—is no doubt implicitly held by many people of an egalitarian disposition and draws them to favor progressive tax schemes.

Once again, however, this entire approach is flawed in its foundations. If the distribution produced by the market is not presumptively just, then the correct criteria of distributive justice will make no reference whatever to that distribution, even as a baseline. Distributive justice is not a matter of applying some equitable-seeming function to a morally arbitrary initial distribution of welfare. Despite what many people implicitly assume, the justice of a tax scheme cannot be evaluated simply by checking that average tax rates increase fast enough with income. Moreover, as we have seen, once we reject the assumption that the distribution of welfare produced by the market is just, we can no longer offer principles of tax fairness apart from broader principles of justice in government. If the distribution produced by the market is not presumptively just, then government should employ whatever overall package of taxation and expenditure policies best satisfies the correct criteria of justice; it is meaningless to insist that tax policy be fair in itself while ignoring the fairness of expenditures.

We can summarize this section and the previous one with two observations: (1) If the idea of taxation in accordance with ability to pay is made concrete through the principle of equal sacrifice, it depends on the radical view that the distribution of welfare produced by the market is presumptively just. (2) If, on the contrary, the idea of taxation in accordance with ability to pay is understood to mean that redistribution away from market returns is required by justice, then the goal of the vertical equity of taxation, considered apart from the justice of government expenditures, has been abandoned. And the vague idea of “ability to pay” will not help us when we move to the different question of what distributive aims a just government should have.

VII. The Problem of Everyday Libertarianism

We have said that the principle of equal sacrifice depends on the idea that the distribution of welfare produced by the market is presumptively just. That idea in turn implies that justice does not require a government to alleviate even the most serious inequalities that the market might produce, or to provide minimal subsistence for those who lack food, shelter, access to health care, or the means of buying those things.

Hardly anyone actually holds this radical view on distributive justice, but a muted version of it infects much everyday thinking about tax policy. Even those who believe that the principle of equal sacrifice is insufficiently egalitarian in its implications may persist with the notion that justice in taxation is a matter of securing a fair distribution of sacrifice as measured against a market-outcomes baseline. The mismatch between this way of thinking about tax policy and what people actually believe about distributive justice (let alone what it is most plausible to believe) is not just a harmless intellectual confusion. Unfortunately, it has great political significance.

Let us take a closer look at the market-oriented view of distributive justice required by the equal sacrifice approach. (The issues raised here are discussed in greater depth in the next chapter.) Libertarian views come in a variety of different forms, but the two that are most important for current purposes can be referred to as the rights-based and the desert-based.³⁴ The former turns on a commitment to strict moral property rights; it insists that each person has an inviolable moral right to the accumulation of property that results from genuinely free exchanges.

The implication for tax policy of rights-based libertarianism in its pure or absolute form is that no compulsory taxation is legitimate; if there is to be government, it must be funded by way of voluntary contractual arrangements.³⁵ On this extreme version of libertarianism we should never reach the issue of the fair distribution of mandatory tax burdens, because all such burdens are illegitimate. However, as ex-

plained in the previous section, a less absolute libertarian position would authorize compulsory taxation to support a government that permits the market to operate, and that would justify sharing out the burden equally.³⁶

According to desert-based forms of libertarianism, on the other hand, the market gives people what they deserve by rewarding their productive contribution and value to others. Such a view would imply that the market-based distribution is presumptively just without raising any objection to compulsory taxation—provided, again, that the burden is shared out equally.

We discuss desert-based theories of justice in chapters 3 and 5. Here we note just one point. The notion of desert entails that of responsibility; we cannot be said to deserve outcomes for which we are not in any way responsible. Thus, to the extent that market outcomes are determined by genetic or medical or social luck (including inheritance), they are not, on anyone's account, morally deserved. Since nobody denies that these kinds of luck at least partly determine how well a person fares in a capitalist economy, a simple and unqualified desert-based libertarianism can be rejected out of hand.

Both forms of libertarianism have implausibly radical consequences. But there is a still more fundamental problem with this approach to tax justice—a conceptual problem. Our use of libertarianism to make sense of the equal-sacrifice principle has relied so far on the following assumption: That so long as government does not pursue redistributive expenditure policies, the pretax distribution of resources can be regarded as the distribution produced by a free market. But, in fact, this is deeply incoherent.

There is no market without government and no government without taxes; and what type of market there is depends on laws and policy decisions that government must make. In the absence of a legal system supported by taxes, there couldn't be money, banks, corporations, stock exchanges, patents, or a modern market economy—none of the institutions that make possible the existence of almost all contemporary forms of income and wealth.

It is therefore logically impossible that people should have any kind of entitlement to all their pretax income. All they

can be entitled to is what they would be left with after taxes under a legitimate system, supported by legitimate taxation—and this shows that we cannot evaluate the legitimacy of taxes by reference to pretax income. Instead, we have to evaluate the legitimacy of after-tax income by reference to the legitimacy of the political and economic system that generates it, including the taxes which are an essential part of that system. The logical order of priority between taxes and property rights is the reverse of that assumed by libertarianism.

This problem could not be avoided by moving from a baseline of actual pretax incomes to a hypothetical baseline of incomes in a government-free market world. There is no natural or ideal market. There are many different kinds of market system, all equally free, and the choice among them will turn on a range of independent policy judgments.

A flourishing capitalist economy requires not only the enforcement of criminal, contract, corporate, property, and tort law. (Those laws themselves are not natural but include evolving and contested accounts of limited liability, bankruptcy, enforceability of agreements, contract and tort remedies, etc.) In addition, most economists assume, it requires at a minimum a regime of anti-trust legislation to promote competition, and control over interest rates and the money supply to alternately stimulate or retard economic growth and control inflation. Then there are such matters as transport policy, regulation of the airwaves, and the way government alleviates so-called negative externalities of the market, such as environmental degradation.

All these functions of government are taken for granted by even the most ardent market enthusiasts. The problem for the sacrifice view here is that the choices government makes in discharging these functions affect market returns. How much profit an iron-ore smelter can generate will depend on the prevailing regime of environmental law. A person's fortunes on the bond market depend on government-influenced interest rate fluctuations. The upshot is that even if the desistitute are left to fend for themselves, it still cannot be said that pretax outcomes are simply market outcomes. They are, instead, the returns generated by a market regulated in accordance with a certain set of government policies.

Choices about these matters cannot be made without appeal to substantive social values that go beyond whatever internal logic there is to the idea of a competitive market. Since that is so, the idea of a politically neutral market world that can serve as the baseline required by the sacrifice approach to taxation is a fantasy. Any pretax distribution—real or imaginary—is already shaped in part by judgments of political morality, and it is impossible to address questions of tax fairness without evaluating those judgments.

Altogether, the case against using pretax outcomes as the baseline against which fairness in the distribution of tax burdens can be assessed is so strong as to make it puzzling how anyone could have been attracted to this way of thinking about tax justice. The answer lies in the enormous appeal of what we have called everyday libertarianism. Even though the two ideas of strict, unqualified moral property rights and desert in market rewards may not survive cursory critical reflection, they are hard to banish from our everyday thinking. In both cases, we believe, the illusion is supported by the illegitimate extension of more restricted concepts beyond the boundaries within which they actually apply.

Consider first the idea of moral property rights in pretax income. We all know that people have full *legal* right to their *net* (post-tax) income; subject to contractual or family obligations, their money is legally theirs to do with as they wish. A legal property right to net income is obviously not an absolute moral property right to anything (let alone to pretax market returns), but in daily life it is hard to prevent the strong sense of legal rights from sliding into a sense of a much more fundamental right or entitlement.

From this point of view, it isn't just that it makes good pragmatic or economic sense for government to protect our current legal entitlements; it isn't even that, having once created these legal rights, government is morally required to protect the legitimate expectations that those rights generate. At the everyday level of what it feels like to live and work in a capitalist economy, the sense of entitlement to net income is firmer than that—we are inclined to feel that what we have earned belongs to us without qualification, in the strong sense that what happens to that money is morally speaking

entirely a matter of our say-so. Though everyone knows that even our right to spend the money in our pockets is circumscribed, for example, by the obligation to pay applicable sales taxes, the instinctive sense of unqualified ownership has remarkable tenacity.

If people intuitively feel that they are in an absolute sense morally entitled to their net incomes, it is not surprising that politicians can get away with describing tax increases (which diminish net income) as taking from the people what belongs to them. It is then a short step to the thought that tax cuts give us back "our money"* and indeed that all taxation takes what belongs to us; what we are fundamentally entitled to is our *pretax* incomes.

Of course, virtually no one really believes that all taxation is illegitimate because it takes what belongs to us without our consent. Everyday libertarianism is, as we have said, a muted or confused version of the real thing. Nevertheless, the confused idea that net income is what we are left with after the government has taken away some of what *really* belongs to us certainly helps explain the conviction that the pretax distribution of material welfare is presumptively just (how could a distribution that gives people precisely what they are morally entitled to be unjust?), and that the question of justice in taxation is therefore properly a question of determining what is a fair distribution of sacrifice as assessed from that baseline.

We can comment more briefly on the other powerful influence, the idea of desert. Market returns are to a certain extent affected by a person's effort and willingness to take risks. Since that is so, it can seem preposterous to those who are both better-off and very hard-working to suggest that they do not deserve to be paid more than others who may be lazy and unadventurous. And, perhaps because people care more about what unjustly harms them than about what unjustly benefits them, they can easily ignore the fact that some of the other factors contributing to their economic success are not in any sense their responsibility and therefore can be said to

*As George W. Bush has often said of the federal budget surplus: "The surplus doesn't belong to the government, it belongs to the people."

have produced advantages that are not deserved. The natural idea that people deserve to be rewarded for thrift and industry slides into the much broader notion that all of pretax income can be regarded as a reward for those virtues. Here too, a normative concept is being taken beyond the context in which it legitimately applies.

So the unreflective ideas that we have unqualified moral entitlement to what we earn in the market and that higher market returns are in some sense deserved as a reward arise naturally within the everyday outlook of participants in a capitalist economy. It is true that almost nobody follows through on the idea that a market-generated distribution of welfare is intrinsically just—nearly everyone accepts the need for *some* kind of public assistance to the destitute, and not even the most radically antiegalitarian politicians argue for a tax scheme without a significant personal exemption. Nonetheless, everyday libertarianism has a distorting effect, for these exceptions to the libertarian outlook tend to be regarded as charitable gestures that do not challenge the basic approach to distributive justice. By placing the burden of proof on departures from market outcomes, everyday libertarianism skews the public debate about tax policy and distributive justice.

Tax policy analysis needs to be emancipated from everyday libertarianism; it is an unexamined and generally non-explicit assumption that does not bear examination, and it should be replaced by the conception of property rights as depending on the legal system that defines them. Since that system includes taxes as an absolutely essential part, the idea of a *prima facie* property right in one's pretax income—an income that could not exist without a tax-supported government—is meaningless. There is no reality, except as a book-keeping figure, to the pretax income that each of us initially "has," which the government must be equitable in taking from us. It isn't that there are no questions of equity here—justice is central to the design of property rights—only that this is the wrong way to pose them.

The tax system is not like an assessment of members of a department to buy a wedding gift for a colleague. It is not an incursion on a distribution of property holdings that is al-

ready presumptively legitimate. Rather, it is among the conditions that *create* a set of property holdings, whose legitimacy can be assessed only by evaluating the justice of the whole system, taxes included. Against such a background people certainly have a legitimate claim on the income they realize through the usual methods of work, investment, and gift—but the tax system is an essential part of the background which creates the legitimate expectations that arise from employment contracts and other economic transactions, not something that cuts in afterward.

There is no default answer to the question of what property system is right—no presumptively just method of distribution, deviations from which require special justification. The market has many virtues, but it does not relieve us of the task of coming to terms with the real values at stake in tax policy and the theory of distributive justice. There are no obvious answers to the range of questions about distributive justice we will pose in the next chapter, but one thing that should be obvious is that those questions must be faced by tax theory.

VIII. Horizontal Equity

Whereas the label "vertical equity" refers to a normative question, the label "horizontal equity" states a normative conclusion: People with the same incomes (or other relevant economic measure) should pay the same amount of tax. However, these two dimensions of tax equity are not really distinct. 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.

The reason so much attention has been devoted to issues of horizontal equity by tax theorists is that there are many apparent violations of the norm of equal tax from equal income in most actual tax regimes, and many possible violations that are not apparent, but need to be rooted out. A cen-

tral question in this literature has been whether apparent violations of horizontal equity show themselves as true violations once the issue of tax incidence has been properly taken into account.

To take a standard example, the preferential tax treatment of state and municipal bonds in the United States is not regarded as a violation of horizontal equity, since the bond market adjusts by bidding up the price of the tax-exempt bonds. As a result, there is no inequity at the level of tax-paying purchasers of bonds (but rather instead a question about why state and local governments should receive this economic benefit courtesy of the tax code).³⁷ In other cases of apparent horizontal inequities, however, the issue of incidence is not so easy to determine.

A further reason for scholarly attention to horizontal equity is that it is a controversial question in economics just what the appropriate operational measure of degrees of horizontal equity might be. As Alan Auerbach and Kevin Hassett write: "From Musgrave . . . on, there is general agreement that horizontal equity is important, but little agreement on quite what it is."³⁸

But if what we have said about the traditional criteria of vertical equity is right, there is a fundamental objection to the traditional concern with horizontal equity as well. For we have argued precisely that tax justice cannot be fully captured by a criterion that simply directs government to tax certain incomes at certain rates (based on some principle of sacrifice or benefit). Tax justice must be part of an overall theory of social justice and of the legitimate aims of government. Since that is so, there can be no blanket rule that persons with the same pretax income or level of welfare must pay the same tax.³⁹ The strong pull of such a rule seems again to be due to everyday libertarianism; if we assume that the pretax distribution provides the moral baseline from which taxation must begin, it is natural to think that it would be unjust for people with the same incomes or welfare not to pay the same amount in tax.

Once we abandon the presumption of the moral significance of the pretax world, we see that differential treatment of people with the same income may or may not be warranted

depending on our overall theory of justice. If it is a legitimate social goal to encourage home ownership, for example, by exempting imputed income from owner-occupied housing and allowing a deduction for mortgage interest payments, and if this practice is innocent from the point of view of distributive justice (both contestable premises), then the unequal treatment of buyers and renters raises no further issue of justice.

That is not to say, however, that anything goes in tax policy. Some forms of discrimination among taxpayers will count as unjust even if they do serve other legitimate goals. The familiar suspect categories of race, sex, sexuality, and religion come to mind. But a ban on invidious discrimination through the tax system is not the same as a blanket ban on taxing differently those who earn the same. We discuss the topic of tax discrimination in detail in chapter 8.