Tutorial

Economics of Social Justice

Session 9: Fairness among tax-payers

- Musgrave, R. (1990): "Horizontal Equity Once More", National Tax Journal 43: pp. 113–23.

Goals of this session

- Distinguishing different normative roots of taxation (Tax equity in distributive justice)

- Reviewing tutorial content

- PS: Read up to page 117

Outline

- 1. Definitions and discussion: Horizontal and vertical equity
- 2. Examples:
  - 2.1 Entitlement notion of justice
  - 2.2 Ability to pay vs. Equal sacrifice
  - 2.3 Maximum welfare
  - 2.4 Towards a contractarian logic
- 3. Core messages
- 4. A (first) review of tutorial sessions

1. Definitions: Horizontal and vertical equity

- **Horizontal equity** (HE): equal treatment of equals
  - Usually accepted
  - Minimum rule of fairness (there is a consensus about it)
  - non-discrimination principle
  - how to define „equal circumstances"
    - accretion or consumption
    - annual or lifetime?

- **Vertical equity** (VE): appropriate differentiation among unequals
  - Inherently controversial
  - Matter of social taste and political debate (there isn't a consensus about it)
  - How can an appropiate pattern of differentiation be chosen?

1. Discussing Horizontal and vertical equity

- Paper critically analyzes the proposition drawn from the Pigovian tradition:
  - Horizontal equity is a derivative from vertical equity

- There may be trade-offs between HE and VE goals

- Henry Simons (1950):
  - "it is generally agreed that taxes should bear similarly upon all people in similar circumstances" (HE)
    - Again: How to define similar circumstances?

- Does compliance with VE assure compliance with HE?

- Literature on tax equity has stressed VE as primary

1. Discussing Horizontal and vertical equity

- Kaplow: meaningful measures of tax equity must be grounded in a view of:
  - Entitlement
  - Distributive justice

- Depending on how these itens are seen, tax equity will differ

- Starting point of our analysis

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2.1 Entitlement notion of justice

- "A common claim exists only to gains from natural resources, but not beyond" (Locke, 1689).
- Logic: payment in accordance with benefits received

- Entitlement to earnings (Locke, Nozick)
  - No redistribution
  - Assumptions: equal tastes, positive income elasticity of demand
  - Private goods: entitlement to welfare gained at uniform market prices
  - Social goods: marginal utility determines tax rate
    - equal income → equal value for marginal unit of public good = same tax (HE fulfilled)
    - higher income → higher value for marginal unit = higher tax

2.1 Entitlement notion of justice

- "While entitlement rules out redistribution, VE as well thus retains a place in the context of benefit taxation"

- But based on:
  - Income elasticity of demand
  - Price elasticity of demand

  - The burden distribution will depend on whether income elasticity falls short, equals or exceeds price elasticity of demand for social goods
   - Opitions: regressive, proportional, progressive

2.2 Ability to pay vs. Equal sacrifice

- **Ability to pay (Smith)**
  - Individuals should pay according to their ability to contribute to the supply of government

  - Income seen as a relevant measure of ability

  - Proportional taxation as a fair way to distribute the burden

  - Did not brake down his theory in VE and HE components

  - Mixing ability-to-pay and benefit components
    - "… that is in proportion to the revenue which they respectively enjoy under the protection of the state."

2.2 Ability to pay vs. Equal sacrifice

- Equal sacrifice (Mill)
  - Separated the expenditure side of the budget side (when talking about tax equity)
  - Premise: identical utility functions, declining marginal utility of income
  - Individuals with equal incomes should pay the same while those with higher incomes should pay more
  - Fairness required (according to Mill) equal absolute sacrifice across unequal incomes
  - Requirements of both HE and VE were met

2.2 Ability to pay vs. equal sacrifice
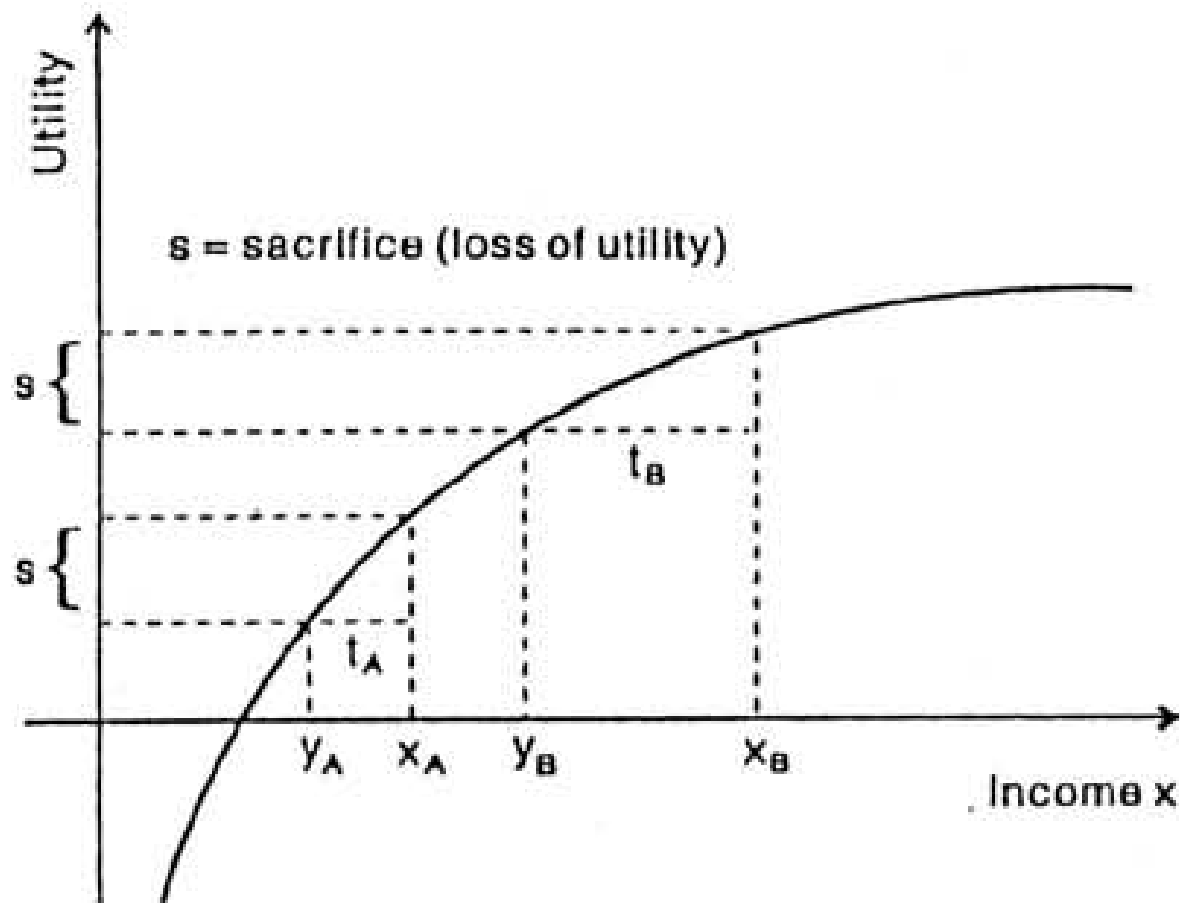
Source: Young, H.P.: Equity in Theory and Practice, Princeton 1994, p. 106.

2.3 Maximum welfare

- Bentham's utilitarian approach
  - maximizing aggregate welfare
  - no "natural right" to market income
  - Entitlement x hapiness (real goal)

- Total satisfaction would be maximized by an egalitarian distribution
  - Assumptions:
    - Fixed total income
    - Declining marginal income utility

- Edgeworth, Pigou:
  - equal marginal sacrifice rule (= least aggregate sacrifice or maximum welfare)
  - ✓ No need for HE as independent norm (implicit)

2.4 Towards a contractarian logic

- Critique on utilitarian calculus:
  - How does a utility function look like? How to measure it?
  - Do all individuals have the same function? How to aggregate?

- Contractarian view
  - No objective approach towards VE measure
  - Tax equity as a compromise between individuals → normative individualism (is back!)

2.4 Towards a contractarian logic

Theoretical postulations under the veil construct (method to restore impartiality):

- Harsanyi:
    - "neo-utilitarian" model: postulates a social contract
    - Given similar utility functions (degrees of risk aversions), individuals will maximize the mean (= sum) of individual utilities;
    - Taxation leads to substitution of leisure for income
        - Consequence: distribution will be less than egalitarian
- Rawls: Adding infinite risk aversion, the representative individual will opt for maximin rule.

- ✓ Leaves an uneasy mix between entitlement and fairness principles
- ✓ Contexts of VE (as defined by the veil models) differ from each other and from classical utilitarianism

3. Core messages

- VE tends to vast array of normative standpoints

- HE is a stronger primarly rule than VE

- Progressive taxation can be inferred from many initial viewpoints

- Economic modeling of individuals may have a significant impact on normative reasoning
  (Buchanan, 1971)

4. A (first) review of tutorial sessions

- Task: Review the content (slides) from a specific session and report in class by answering the following questions.

> - What was the essential content of the session?
> - What can we learn from that w.r.t. our superior project, an economic approach towards „justice"?
>   Please make use of generic terms (session 1): positive vs. normative justice; procedural vs. end-state-oriented; ex ante vs. ex post; endogenous vs. exogenous; theoretical vs. empirical criterion of justice
> - Where there open questions / important connections to other sessions?