# And Equal (Tax) Justice for All? (Part 3 of 8)

## Part Three: Progressivity versus Individual Equity

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Progressivity or vertical equity is a principle that stresses how the rights and obligations of individuals are related to their ability or their well-being. Although often applied formally to government finance and expenditure programs, a similar standard applies in the ordinary affairs of the family and community. For example, within the family those who can work are expected to contribute more financially than those who cannot. Dependents often have obligations, but less than those that are placed on working-age adults with greater maturity and ability. Thus common sense, not just philosophy, leads us to accept progressivity as a principle with wide application to the affairs of humans.

Vertical equity often competes head-on against another principle: individual equity, which emphasizes the freedom of each individual to partake in transactions with others without interference by third parties, including the government. In general, each voluntary transaction involves an exchange between two individuals, both of whom would not have made the exchange if each did believe he or she would be better off because of the transaction. For the government to interfere in that transaction involves taking away from one or both individuals the gains they honestly sought (at least when there is no harm to any third party). Moreover, by interfering, government can affect the nature of the transaction, perhaps even deter it altogether.

In practice, actions by government to promote vertical equity usually involve taking from someone on the basis of some transaction such as selling labor, the employment of capital, or the purchase of some good or service. That is, it is the tax side of the governmental efforts that is most likely to arouse claims that individual equity has been violated.

At times it is possible to tax in a way that either does not violate the principle of individual equity or at least minimizes the extent of the violation. In the former case, the transaction between the individual and the state is voluntary and the individual would not pay unless he receives a benefit that is worth the price paid. In the latter case, the benefits of government action are designed to be approximately equal to, or closely related to, the taxes or contributions made.

The public finance literature distinguishes between "benefit taxation" and taxation according to ability to pay. With benefit taxation, the tax paid to the government can be considered roughly equivalent to a price paid in the market—only in this case the good or service is furnished by government rather than the private sector. Tolls for using public highways are a common example. With a higher ability to pay, one pays taxes independently of what one receives in return, e.g., regardless of whether she uses the highway.

Adam Smith, the father of economics, is often accused of confusing benefit taxation and ability to pay when he argued that individuals should be taxed "according to their ability to pay, that is, benefits of governmental action." But it is not so clear that he was inconsistent, at least for his day and time. Consider what the activities of government were when he wrote in the latter part of the 18th century. The defense of the state and its people, the maintenance of order and police protection, the sponsorship of trade and new industry, and the enforcement of contracts were among the primary uses of government revenues. Since the benefits from many of those items could not be calculated easily to each individual, it would not take much of a leap of faith to argue that the benefits were closely related or even proportional to ability to pay. Hence for some public goods and services it is possible for benefit taxation and ability to pay taxation to come to the same result.

If purely voluntary, benefit taxation would not appear to violate the principle of individual equity—assuming that the government did not run a monopoly that distorted prices or otherwise restricted choices as to what could be purchased. Many governmental transactions, however, are involuntary, and the value of those public goods and services cannot easily be attributed to each individual. Some, like defense, are required to be provided collectively for order within the polity and the maintenance of the state. As a practical matter, taxpayers are compelled to share in these costs simply to avoid problems of "free riders"—those who could avoid paying but get the benefit anyway. There is a related "moral hazard" in that citizens don't really have to reveal voluntarily their preferences as to how much they value a government service that will be provided in any case.

Of course, when government is largely engaged in making transfers, as opposed to providing other public goods, it is unlikely that the benefits to transferors are exactly equal to the involuntary taxes each of them pay. Still, the moral hazard and free rider problems do not go away. If there are benefits to the social order, or if most people in society do want to engage in collective action, say, to prevent poverty, then some form of coercion is still required to deal with the moral hazard. Democracy tries to limit this coercion by requiring at least that a majority of people favor such enforced action, but majorities can still reduce the freedom of minorities.

If it is mandated, then benefit taxation—even where people get back what they put into a system—can be considered a violation of individual equity. If I give up a dollar and get back a dollar in some mandated benefit, I have less freedom than if I am left with my dollar in the first place. For example, considerable debate arises today over the establishment of mandated individual saving accounts within or outside of social security. Interestingly, when suggested as a carve-out from existing taxes, individual accounts are supported by many libertarians as a move toward individual equity. On the other hand, when recommended as an add-on tax, such accounts are often opposed by those same libertarians as another form of government interference.

Yet when all the money mandated from an individual is put into an account owned by the individual, the mechanics of the mandate do not differ between a carve-out and an add-on. The difference is that in a carve-out the total amount of mandated tax plus contribution (for example, the new social security tax plus the mandated individual account deposit) does not change (relative to the old social security tax). At least according to one line of thinking, then, there is no net additional reduction in individual freedom on the tax side, and there may be greater freedom on the benefit side. In the case of the add-on, however, interference increases because mandated taxes plus contributions rise.

With the rise of social insurance in the 20th century, new thinking has been required to try to achieve a balance between vertical equity and individual equity in the presence of a substantial moral hazard problem. Elsewhere I have described social insurance as more of a problem of who should pay than who should benefit when society decides that it is going to provide for some minimum level of well-being. Take the case of preventing poverty in old age. A traditional welfare approach—as opposed to social insurance—would simply grant benefits only to those with low incomes. The problem is that it is very easy for the old and near-old to drop out of the labor force or give their assets to their children so as to achieve low income even in the presence of substantial ability to pay. In addition, two people with equal incomes all their working lives may differ in their saving patterns so that one ends up better off in old age than the other. Most people would consider it unfair to force the saver to transfer to the nonsaver when both had equal ability throughout their working lives. Yet assistance to the nonsaver would force such a result.

Social insurance attempts to deal with this problem by mandating contributions on the part of individuals—in the example above, for their own retirement. At the same time, most social insurance programs try to achieve some redistribution from those with greater lifetime ability to those with lesser lifetime ability. Once government mandates that people partly take care of themselves—for example, by contributing to their own retirement—it is difficult then to come in the back door and phase out benefits entirely when income rises—as would a welfare system.

On the other hand, transfers are also being made, so not everyone is going to get back his own taxes. (Here I skip over many other issues related to social insurance, such as whether rising levels of transfers from future generations can somehow protect earlier generations and whether mandated contributions are really saved.) The point is simply that social insurance is a good example of an approach that combines a type of benefit taxation—mandated because of a moral hazard problem—and taxation according to ability to pay within the same overall program structure.

In many public debates, advocates will approach equity issues only from the standpoint of vertical equity or individual equity. Think tanks are set up to argue only for more progressive or more libertarian government. Redistributional policy is viewed as being always good or always bad. Such views reflect a lack of balance. The tension between the two equity principles is healthy. That government programs reflect ability and need is only natural, but, at the same time, there are true costs to restricting the freedom of individuals to act.

## Other Publications by the Authors

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