Horizontal equity

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A principle used to judge the fairness of taxes, which holds that taxpayers who have the same income should pay the same amount in taxes.

The principle of horizontal equity is a basic yardstick used to gauge whether tax burdens are fairly distributed. On the one hand, the idea that tax policy should strive for horizontal equity is uncontroversial (Musgrave 1990). It protects taxpayers against arbitrary discrimination, and also seems consistent with basic principles of equal worth. Some might also argue that horizontal equity comports with the principle of "equal protection under law" set forth in the United States Constitution.

On the other hand, some tax scholars maintain that the property of horizontal equity is not really an independent principle of tax fairness, but instead is subordinate to the concept of vertical equity, which holds that people with different incomes should pay different amounts of tax (Kaplow 1989). As a matter of logic, a tax system that assigned different tax burdens to people with different incomes should assign the same tax burden to people with the same income. Viewed in this way, equal treatment of equals in taxation is not an end in itself, but rather a means to ensuring that tax burdens are distributed in a way that is vertically equitable.

As Musgrave (1990) notes, however, horizontal equity can lay claim to being an independent standard of tax equity because it is consistent with a number of different underlying conceptions of tax fairness, although application of the vertical equity standard will differ. For example, the benefit principle of taxation holds that tax burdens should be assigned according to the benefits that taxpayers receive from government goods and services. If one assumes that the benefits taxpayers receive from government spending vary with their income level, a case can be made that taxation according to the benefit principle would require that taxpayers with the same income pay the same amount of tax. Under the benefit principle, vertical equity would require that taxpayers with different incomes pay different amounts of tax. But, depending on how benefits varied with income, vertical equity could require that benefit tax burdens be distributed regressively, proportionately, or progressively, depending on whether benefits from public goods and services rose less than proportionately, proportionately, or more than proportionately as income increased.

Under the ability-to-pay principle, people with the same incomes have the same ability to pay, and thus should pay the same amount in taxes. In contrast to the benefit principle, however, regressive taxes would not be deemed fair under the ability-to-pay principle, and there is a general presumption that vertical equity under the standard of ability to pay would require some degree of progression in tax burdens.

The point is that while different standards of tax fairness may give different answers about how people with different incomes should be taxed (e.g., regressively, proportionately, or progressively), in theory or in practice, they generally give a similar answer about how people with the same incomes should be taxed—namely, that tax burdens should be distributed in a manner that is horizontally equitable.

Horizontal equity and consumption versus income taxation

Several conceptual issues should be kept in mind when applying the horizontal equity principle. One has to do with the measure of income that is used to group taxpayers as equals. The most commonly used yardstick is annual income, comprehensively measured. Many economists, however, believe that a taxpayer's lifetime income is a better measure. One's judgment about whether taxing income or consumption is consistent with horizontal equity depends on which definition of income one uses.

Consider, for example, the case of two people, Taxpayer A and Taxpayer B, who, for purposes of illustration, are assumed to live for only two periods of time. In the first period, both taxpayers work and earn $50,000; in the second, they retire and live from the proceeds of savings they collected in the first period. Assume that Taxpayer A saves $20,000 of income earned in the first period, and invests it at a return of 10 percent, while Taxpayer B saves only $10,000, also invested at 10 percent.

The question is do Taxpayers A and B have "equal incomes"? The answer depends on whether one measures income annually or over a taxpayer's lifetime. If annual income is used as the standard, then Taxpayers A and B would be seen to have the same income in period one ($50,000), but Taxpayer A would have a higher income in period two because of investment income of $2,000 compared with only $1,000 of income for Taxpayer B. Applying the principles of horizontal and vertical equity would require that Taxpayers A and B pay the same tax in period one, and that Taxpayer A pay more taxes than Taxpayer B in period two.

Clearly, in this case, taxing income meets the standard of horizontal equity, but taxing consumption would not. The reason is that in period one, taxpayers A and B would pay taxes only on the amount of their income that is consumed, so that Taxpayer A would pay less in tax than would taxpayer B, even though they have the same amount of annual income.

If, however, one believes that lifetime income should be used to compare taxpayers, the answer changes. The reason is that from a lifetime perspective, Taxpayers A and B have the same lifetime income. They each earn $50,000 of income in period one, and this means that they have the same possibilities for consumption over their lifetimes. How they decide to allocate their consumption between present and future is a matter of personal preference. Taxpayer A would rather have more consumption in period two, and so saves more than does Taxpayer B. As a byproduct of these choices, the two taxpayers wind up with different amounts of *annual* income in period two, but this simply reflects the fact that Taxpayer A would rather consume less in period one and more in period two than would Taxpayer B. If lifetime income is the standard of comparison, it can be shown that taxing based on consumption achieves horizontal equity, while taxation of income imposes a heavier tax burden on people who have the same lifetime incomes as others, but who prefer to shift more of their lifetime consumption to later years through saving.

Horizontal equity and implicit taxes

There are also situations in which horizontal "inequities" may be more apparent than real. Income received from tax-exempt bonds is a case in point. Suppose that Taxpayers A and B are identical in all respects save for the fact that Taxpayer A receives $7,000 in interest from tax-exempt bonds, while Taxpayer B receives $7,000 in fully taxable interest. Assume for purposes of illustration that the tax rate is 30 percent. It might seem that horizontal equity is violated because both taxpayers have the same measured income, even though Taxpayer B will pay $2,100 on his or her interest income, while Taxpayer A owes no tax on his or her tax-exempt interest.

But, as Bittker (1980) notes, the two taxpayers are not really in the same position. The reason is that tax-exempt bonds will pay a lower rate of interest because of their tax-free status. For example, if the interest rate on fully taxed bonds were 10 percent, and the tax rate 30 percent, the interest on tax-exempt bonds would be 7 percent. This means that in order to earn $7,000 in tax-exempt interest, Taxpayer A must have bought $100,000 of tax-exempt bonds, whereas Taxpayer B needed to buy only $70,000 worth of bonds to earn the same income. Many economists would say that Taxpayers A and B are really in the same position, because while Taxpayer B faces an explicit tax of 30 percent on interest earnings, Taxpayer A faces an implicit tax, levied in the form of the lower return received on the tax-favored investment.

Cases in which horizontal equity does not apply

The standard of horizontal equity will have limited applicability when taxes are levied to account for the presence of external costs. For example, smokers and nonsmokers will face sharply different tobacco tax burdens, even when their incomes are the same. To the extent, however, that tobacco taxes are intended to force smokers to bear the external costs of smoking, the apparent violation of horizontal equity would not be seen as problematical.

Application to tax policy

The concept of horizontal equity plays an important role in the evaluation of tax policy. For example, treating taxpayers with equal incomes equally was one of the central organizing principles of the landmark reform of the federal income tax that took place in the Tax Reform Act of 1986.

Additional readings

Bittker, Boris. "Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?" In *The Economics of Taxation*, edited by Henry Aaron and Michael Boskin. Washington, D.C.: The Brookings Institution, 1980.

Kaplow, Louis. "Horizontal Equity: Measures in Search of a Principle." *National Tax Journal* 42 (2) (1989): 139–55.

Musgrave, Richard. "Horizontal Equity Once More." *National Tax Journal* 43 (2) (1990): 113–23.

Cross references: ability to pay; benefit principle; fairness in taxation; progressivity, measures of; tax reform, federal; tax reform, state; vertical equity.