

Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange

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Over the past several years, Professors Richard Musgrave and Louis Kaplow have engaged in an exchange over the question whether the concept of horizontal equity has any independent significance apart from vertical equity.¹ Kaplow answers that question in the negative, Musgrave in the affirmative. The purposes of this comment are (1) to sort out the issues raised in the Musgrave-Kaplow exchange, and (2) to set forth a somewhat different perspective from which to view those issues.

I. CONCEPTUAL ISSUES

A. *The Definitions*

Kaplow and Musgrave define horizontal equity (HE) as the requirement that equals be treated alike. Both define vertical equity (VE) as requiring an "appropriate" pattern of differentiation among unequals.²

B. *Synopsis of the Arguments*

The starting point was a statement by Musgrave in 1959 that the requirements of horizontal and vertical equity are but different sides of the same coin. Musgrave asked rhetorically "[i]f there is no specified reason for discriminating among unequals, how can there be a reason for avoiding

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1. Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 Nat'l Tax J. 139 (1989) [hereinafter Kaplow I]; Richard A. Musgrave, *Horizontal Equity, Once More*, 43 Nat'l Tax J. 113 (1990) [hereinafter Musgrave I]; Louis Kaplow, *A Note on Horizontal Equity*, 1 Fla. Tax Rev. 191 (1992) [hereinafter Kaplow II]; Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 Fla. Tax Rev. 354 (1993) [hereinafter Musgrave II].

2. Kaplow I, *supra* note 1, at 140-41; Musgrave I, *supra* note 1, at 113.

discrimination among equals.”³ His rhetorical question can be rephrased as a statement: If we cannot explain why we discriminate among unequals, then we cannot explain why we fail to discriminate among equals. Thus, in 1959, Musgrave viewed HE and VE as inextricably linked. He explained:

Without a scheme of vertical equity, the requirement of horizontal equity at best becomes a safeguard against capricious discrimination—a safeguard which might be provided equally well by a requirement that taxes be distributed at random. To mean more than this, the principle of horizontal equity must be seen against the backdrop of an *explicit view of vertical equity* (emphasis added).⁴

Musgrave also felt in 1959 that HE and VE, by themselves, were inadequate for formulating tax policy because they are dependent upon the determination of some measure for distinguishing equals and unequals. He stated: “An objective index of equality or inequality is needed to translate either principle into a specific tax system.”⁵

Subsequently, in 1989, Kaplow examined the current use of HE in tax policy analysis.⁶ He concluded, like Musgrave in 1959, that HE is not a useful tool because it has no normative content and has no significance apart from VE.⁷ Compliance with VE will always assure compliance with HE, Kaplow stated, “because whatever reasons motivate a particular treatment of one individual will require the same treatment of another individual who is equal in all relevant respects.”⁸

In response to Kaplow’s critique of HE, Musgrave reexamined his own 1959 critique of HE.⁹ He surveyed various formulations of distributive justice and concluded that HE has a normative basis of its own that is more firmly planted than VE.¹⁰ He stated:

the requirement of HE remains essentially unchanged under the various formulations of distributive justice, ranging from Lockean entitlement over utilitarianism and fairness solutions. That of VE, on the contrary, undergoes drastic change

3. Richard A. Musgrave, *The Theory of Public Finance* 160 (1959).

4. *Id.*

5. *Id.* at 161.

6. Kaplow I, *supra* note 1, at 139-40.

7. *Id.*

8. *Id.* at 143.

9. Musgrave I, *supra* note 1.

10. *Id.* at 117.

under the various approaches. While HE is met by the various VE outcomes, this does not mean that HE is derived from VE. If anything, it suggests that HE is a stronger primary rule.¹¹

As discussed below, Musgrave argued that it is necessary to compare proposed tax changes that differ in their VE and HE outcomes. Where VE results are similar, then the change that produces better HE results is to be preferred.¹²

But Kaplow then responded: "Musgrave does not attempt to offer an example involving HE violation that any relevant distributive theory would count as decisive against an otherwise desirable policy."¹³ As an example of the insignificance of HE, Kaplow stated:

[A]ssume that the only administratively feasible way to redistribute wealth from the rich to the poor involves omitting some of the rich from the tax base or excluding some of the poor from receiving transfers (perhaps because some individuals live in remote areas). Clearly, neither a maximum welfare perspective nor a Rawlsian approach (derived from a veil construct) would oppose such redistribution because it violated HE. (They would indicate that the distributive objective is satisfied incompletely.)¹⁴

In a subsequent response, Musgrave agreed with Kaplow that in an ideal world, arrangements which satisfy VE also satisfy HE.¹⁵ Moreover, in the real world, Musgrave stated that it is unreasonable "to limit considerations of departure from HE to individuals with identical incomes only, while disregarding the relative treatment of individuals with more or less similar incomes."¹⁶ Musgrave argued, however, that this did not mean that HE is a useless concept since HE and VE concerns must be traded off in assessing proposed tax changes in the less than ideal world in which those changes must be considered.¹⁷

11. *Id.* at 116-17.

12. Musgrave II, *supra* note 1, at 356-58.

13. Kaplow II, *supra* note 1, at 192.

14. *Id.* (footnote omitted).

15. Musgrave II, *supra* note 1, at 355.

16. *Id.* at 358.

17. *Id.* at 359.

C. Analysis of the Exchange

In analyzing the above exchange, it is necessary to return to the HE and VE definitions employed both by Musgrave and Kaplow. Recall that HE is the requirement that equals be treated alike. One might think that VE, then, simply is a requirement that unequals be treated differently. Stated in this way, it is clear that neither concept has any normative content. The response to each definition is "why"? Neither definition, in itself, provides any answer.

Thus, both Kaplow and Musgrave use a definition of VE which is different from the above, i.e., for both it is a requirement that there be an "appropriate" pattern or system of differentiating among unequals. The word "appropriate" is not self-defining, so where do the two go to provide it with content?

Theoretically, VE could apply to a tax system that is progressive, proportional or regressive. Which of these designs is chosen depends upon one's underlying theory of justice and decisions about some key economic assumptions.

For example, one can be a thoroughgoing utilitarian and reach any of the three tax equity designs noted above. The reason for this is that the utilitarian must make a decision about the slope of the marginal utility of income. If she thinks that the slope declines, the tax paid will rise with income. However, whether the rate schedule should be regressive, proportional or progressive will depend on the rate of decline of the slope (i.e., the elasticity of the marginal utility of income with respect to income).¹⁸

Perhaps somewhat surprisingly, the same conclusion about possible tax system designs (i.e., progressive, proportional or regressive) is true for a believer in distributive justice as articulated by Rawls. For Rawls, the demands of justice are met by a society that provides maximum liberty for everyone and in which the advantages of the more fortunate promote the well-being of the least fortunate.¹⁹ In the context of taxation, Rawls concluded that the best tax system for his theory of justice may be a flat tax rate on consumption.²⁰ By design, a tax on consumption only exempts capital income from tax and capital income is concentrated in the upper income levels. Economists commonly argue that, under certain assumptions,

18. The tax design will be progressive, proportional, or regressive depending on whether the elasticity of the marginal utility of income with respect to income is, respectively, greater than, equal to, or less than one. Richard A. Musgrave & Peggy B. Musgrave, *Public Finance I, Theory and Practice*, 200 (1973). Although most economists agree that the slope of the marginal utility of income declines, there is far less agreement about its rate of decline (its elasticity).

19. See John Rawls, *A Theory of Justice* 60-61, 83 (1971).

20. *Id.* at 278-79.

such a tax is the equivalent of a tax on wage income only.²¹ Given the facts that lower income earners have mostly wage income and that they consume a higher percentage of total income than do upper income individuals, the optimal tax design favored by Rawls is regressive to income (although not to consumption).

With this background, what is the VE to which Kaplow refers? Kaplow infuses VE with content by adopting a progressive income tax system as the "appropriate" differentiation in the tax treatment of unequals. For example, in his analysis of various HE indexes, he suggests that VE favors moving individuals closer together.²² Similarly, he subsequently states that "VE objects to inequality and favors equality."²³ and that "gains from moving individuals closer together are already encompassed in VE."²⁴

Kaplow's appeal to progressivity in defining VE is entirely understandable. VE lacks normative content and is derivative, because in order to determine what the "appropriate" differential among unequals should be, one has to refer to economic assumptions and some theory of distributive justice.²⁵ For example, if one believes that the marginal utility of income declines in such a manner as to permit the use of a progressive tax rate in order to impose equal burdens on taxpayers, then a tax provision based on the belief that marginal utility *increases* is "bad." It is not "bad" because it failed to make a distinction among unequals. It is "bad" because one disagrees as to whether it is an "appropriate" distinction. In order to determine what is "appropriate," one has to refer to additional concepts. Thus, the concept of VE, as defined, is itself entirely derivative.

21. Musgrave, *supra* note 3, at 262, 266-67. Rawls would use progressive rates to prevent excessive accumulations of wealth that could impair the liberty of others. Rawls, *supra* note 19, at 279. For some, this concession might consume the rule for the reasons described in the text. To make sure that no one would think he was making use of any of the tools of utilitarianism (which he rejects totally), Rawls added:

It is evident also that the design of the [system of taxation] does not presuppose the utilitarian's standard assumptions about individual utilities. . . . The aim of [tax] is not, of course, to maximize the net balance of satisfaction but to establish just background institutions. Doubts about the shape of utility functions are irrelevant.

Id. at 280.

22. Kaplow I, *supra* note 1, at 143. He states: "Hence, the central defining characteristic of HE—and its central force in policy applications—is that it also condemns moving individuals closer together in the income distribution . . . directly contrary to VE." See also *id.* at 144 (stating that the impact of moving two individuals closer together in income distribution as a result of a tax reform is measured under VE).

23. Kaplow I, *supra* note 1, at 147.

24. *Id.* at 148.

25. Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 Cal. L. Rev. 1905, 1910 (1987).

With respect to HE, given the economic and justice judgments which Kaplow appears to make, he clearly is correct that HE will always merge into VE and will not survive as an independent normative criterion. A system which seeks to impose equal burdens on all taxpayers should, by definition treat equally the subset of taxpayers that have equal income. Similarly, a system that seeks to equalize the income of all taxpayers will, of course, treat taxpayers with equal income equally.²⁶

Thus, Kaplow correctly asserts that HE never will prevail to prevent enactment of a provision that would otherwise be appropriate on grounds of administrative efficiency or VE. As Kaplow has noted, Musgrave has not provided any such example and indeed he cannot. The reason Musgrave cannot, however, has nothing to do with his defense of HE. The reason is that Musgrave has accepted Kaplow's definition of VE and, in that definition, HE is subsumed into VE. Thus, neither Musgrave nor anyone else can respond to Kaplow's challenge on his terms. Musgrave properly, in our view, subsequently pointed this out by observing that Kaplow is correct only "if the relevant norm is defined in [prescribed] VE terms."²⁷

Even where the "appropriate" form of differentiation among unequals for VE purposes does not involve a progressive rate structure, HE will lack normative content.²⁸ In order to determine whether equals are treated equally, the measure of equality has to be defined, i.e., in tax terms the tax base must be determined. Once that definition is properly articulated, it necessarily follows they will be treated alike. In a different, but relevant, area of the law, Professor Westen stated:

The formula "people who are alike should be treated alike" involves two components: (1) (sic) a determination that two people are alike; and (2) a moral judgment that they ought to be treated alike. The determinative component is the first. Once one determines that two people are alike for purposes of the equality principle, one knows how they ought to be treated.²⁹

26. Musgrave II, *supra* note 1, at 358.

27. *Id.* at 356.

28. There has been a debate over whether equality has any normative content in the context of the administration of justice. That discussion is relevant to our analysis. See, e.g., Peter Westen, *The Empty Idea of Equality*, 95 Harv. L. Rev. 537 (1982); Erwin Chemerinsky, *In Defense of Equality: A Reply to Professor Westen*, 81 Mich. L. Rev. 575 (1983); Anthony D'Amato, *Comment: Is Equality a Totally Empty Idea*, 81 Mich. L. Rev. 600 (1983); Kenneth L. Karst, *Why Equality Matters*, 17 Ga. L. Rev. 245 (1983); Kenneth W. Simons, *Equality As a Comparative Right*, 65 B.U.L. Rev. 387 (1985).

29. Westen, *supra* note 28, at 543.

The first component is satisfied in the context of taxation by a selection and definition of a tax base. Thus, with respect to HE, once one has decided on the tax base (say, income), then all that is required is a definition of income.³⁰ However, once income is defined, those with equal amounts of income will, by definition, be taxed equally. If a particular item which constitutes "income" is not taxed or a consumption cost is allowed to be deducted, we know that the provision is "bad" and applying HE adds nothing to that analysis.

Musgrave resorts to external resources to support his assertion of the independence of HE. For example, he refers to the fact that it reflects "a basic premise of social mores"³¹ and is "almost universally accepted."³² And, in his assertion that it is necessary to conceive of a "meta principle" by which trade-offs between VE and HE may be weighed in assessing a particular tax revision, he relies on "the public's sense of equity."³³ We do not imply that Musgrave is inappropriately calling on these principles to justify HE. We only point out that in this process, he is doing exactly what both he and Kaplow do in asserting a normative content for VE.

In summary, we believe that Musgrave/Kaplow exchange reveals the following: (1) Musgrave in 1959 demonstrated that there is no independent content to VE and resort must be had to economic assumptions and a theory of justice to provide that content; (2) we read Kaplow as agreeing with that view and he, in fact, does infuse VE with just such content; and (3) given Kaplow's now content-infused VE, he has demonstrated (and Musgrave agrees in an ideal world) that HE is subsumed within it and has no independent normative content

For us, however, both HE and VE at best become surrogates to describe consistency with or departures from the underlying decisions about the tax base and rate structure. The question is whether they are useful surrogates or whether they confuse or obscure the real issues that should be addressed in assessing proposed or actual changes in tax structure. We address those issues in III, below. But first we turn to the indexes of HE discussed by Kaplow and Musgrave.

30. Musgrave, *supra* note 3, at 161.

31. Musgrave II, *supra* note 1, at 355.

32. *Id.* at 356.

33. *Id.* at 358.

II. MEASUREMENT ISSUES

A. *The Kaplow/Musgrave Exchange*

If one agrees with our conceptual analysis, it follows that any attempt to develop an index to measure the extent to which a tax change violates HE or VE is futile. However, economists, including Musgrave,³⁴ have sought to develop such indexes.

Kaplow asserts that the inadequacies of HE as an independent normative concept become apparent when one seeks to measure it. He states that two major problems exist. First, unless HE is viewed as an absolute constraint, it is necessary to assign some measure of the degree to which it is violated.³⁵ Second, since by definition HE applies only to equals, it does not address individuals whose positions initially differ.³⁶ Thus, Kaplow observes, that "even an infinitesimal difference in treatment beyond whatever range is deemed 'equal treatment' counts as a violation, while further deviations, no matter how significant, are ignored."³⁷

Kaplow analyzes the efforts of investigators who have sought to deal with these problems by measuring changes in HE. He states that several economists have sought to measure the HE impact of a tax law change by comparing the pre-change ranking of taxpayers to the post-change ranking of taxpayers.³⁸ If the rankings change, HE is said to be violated.³⁹ For example, assume that prior to a tax law change the ranking of individual⁴⁰ taxpayers A, B, and C, based on after-tax income is:

34. See Musgrave I, *supra* note 1, at 117-20; Musgrave II, *supra* note 1, at 357-58.

35. Kaplow I, *supra* note 1, at 140.

36. *Id.*

37. *Id.* at 140-41.

38. The rankings are based on measures of economic well-being. See, e.g., Robert Plotnick, *A Comparison of Measures of Horizontal Equity*, in *Horizontal Equity, Uncertainty, and Economic Well-Being* 239, 246-47 (Martin H. David & Smeeding Timoth eds., 1985). Economists have suggested or actually employed various definitions of income or utility in ranking the economic well-being of taxpayers. See, e.g., A.B. Atkinson, *Horizontal Equity and the Distribution of the Tax Burden*, in *The Economics of Taxation* 3-19 (Henry J. Aaron & Michael J. Boskin eds., 1980); Martin Feldstein, *On the Theory of Tax Reform*, 6 *J. Pub. Econ.* 77 (1976); Mervyn A. King, *An Index of Inequality: With Applications to Horizontal Equity and Social Mobility*, 51 *Econometrica* 99 (1983); Harvey S. Rosen, *An Approach to the Study of Income, Utility, and Horizontal Equity*, 92 *Q. J. Econ.* 307 (1978).

39. See Kaplow I, *supra* note 1, at 141, 146-48. See also King, *supra* note 38 at 99-115; Robert Plotnick, *The Concept and Measurement of Horizontal Equity*, 17 *J. Pub. Econ.* 373, 373-91 (1982).

40. Usually, individual taxpayers are not ranked but rather groups of similar taxpayers are ranked. This example uses individuals for illustrative purposes.

<u>Ranking</u>	<u>Taxpayer</u>	<u>Income</u>
1	A	100
2	B	99
3	C	50

while after the tax change the ranking of taxpayers based on their after-tax income is:

<u>Ranking</u>	<u>Taxpayer</u>	<u>Income</u>
1	B	99
2	A	98
3	C	50

HE is deemed violated by the change because B and A have changed ranks.

Kaplow argues that the ranking studies suffer from essentially the same defects as the concept of HE itself because a small change in income (A's income dropped only by 2 in the above example) as a result of a tax law change may result in a rank change while a large change in income might result in no rank change.⁴¹ This is illustrated by the following example.

Consider again taxpayers who have the following after-tax income and rankings prior to a tax law change:

<u>Ranking</u>	<u>Taxpayer</u>	<u>Income</u>
1	A	100
2	B	99
3	C	50

As discussed above, if A's after-tax income were to decrease by 2 to 98 as the result of a tax law change, while the income of B and C remain the same, the ranking studies would show a violation of HE because A and B have switched ranks.

Contrast this result with the consequences where the tax change causes A's income to increase to 147, B's income to decrease from 99 to 51, and C's income stays at 50.

<u>Ranking</u>	<u>Taxpayer</u>	<u>Income</u>
1	A	147
2	B	51
3	C	50

41. Kaplow I, *supra* note 1, at 141.

Note that the rankings have not changed and, therefore, that no change in HE would be registered by the ranking analysis although the disparity between A's and B's income has increased markedly. Also note that Kaplow correctly states that the indexes are not measuring the treatment of equals (HE), but really are measuring the treatment of unequals (VE) since the ranking process begins with individuals (or groups) with different incomes.⁴²

Lastly, Kaplow asks why the ranking of taxpayers prior to the tax law change is the starting point for this form of HE analysis.⁴³ The use of changes in the ranking of taxpayers to measure the impact of a tax law change on HE must in effect assume that the pre-change ranking achieved HE. Yet, Kaplow observes, the pre-change ranking is itself the result of several prior tax law changes that may or may not have achieved HE.⁴⁴

Musgrave also proposes an index that seeks to measure HE. Rather than using a ranking system such as that described above, Musgrave devised an index with two parts. The first part, the HE component, would measure the difference between the welfare cost of the tax system if equals were treated equally and the welfare cost of the system when equals are not treated equally.⁴⁵ The second component, the VE component, would measure the difference between the welfare costs of the tax system assuming that VE had been achieved and the welfare costs of the tax system where VE is not achieved.⁴⁶ Musgrave uses the term welfare costs to represent the burden imposed on all taxpayers by the tax system. In his examples, he calculates welfare cost by assuming that the marginal utility of income declines as income increases.⁴⁷ He argues that his system of employing two components to isolate the welfare costs arising from the failure to achieve HE or VE is superior to ranking studies because his system measures changes in the allocation of tax burdens that might be considered significant but that might not result in a rank shift.⁴⁸

42. *Id.*

43. *Id.* at 146-47.

44. *Id.* Kaplow notes that some authors have attempted to deal with this problem by determining what the distribution of income would be if the ideal tax system were in effect and then comparing the effect of the tax reform on the distribution of income to the ideal distribution. *Id.* at 147-48. However, Kaplow argues that the distribution analysis is really focusing on VE since it is analyzing the impact on unequals.

45. Musgrave I, *supra* note 1, at 117-18; Musgrave II, *supra* note 1, at 357-58.

46. Musgrave I, *supra* note 1, at 117-18; For this purpose, Musgrave assumes that VE has been achieved with a tax distribution that minimizes aggregate welfare costs.

47. Musgrave assumes a social welfare function that assigns a value of 10 to the first dollar of income, of 9.1 to the second dollar of income, of 8.19 to the third dollar of income, etc., with the social welfare of each successive dollar of income declining by 10%. Musgrave I, *supra* note 1, at 119.

48. *Id.* at 118.

A simple version of Musgrave's index will illustrate Musgrave's thesis. Consider four individuals L1, L2, H1, and H2. L1 and L2 have low incomes, each receiving \$5, and are grouped together in the low rank category L. H1 and H2 have high incomes, each receiving \$10, and are grouped together in the high rank category H. Two proposals to implement an income tax for the first time ever are being considered. The impact of the two proposals on the after-tax income and rankings of the individuals is illustrated below.

	Initial	Initial	<u>First Tax Proposal</u>			<u>Second Tax Proposal</u>		
	Income	Group Rank	Tax	Net Income	Group Rank	Tax	Net Income	Group Rank
H1	10	1	4	6	1	2.5	7.5	1
H2	10	1	4	6	1	3.8	6.2	1
L1	5	2	0	5	2	.4	4.6	2
L2	5	2	0	5	2	1.3	3.7	2

Note that although the two tax proposals have a disparate impact on the members of the two groups, L and H, the reforms do not register a rank change so long as only two ranking groups are used because H1 and H2 still have after-tax incomes that place them in the highest ranking group and L1 and L2 still have incomes that place them in the lowest group. Thus, using the ranking analysis, each proposal is consistent with HE although after-tax incomes differ markedly depending upon which proposal is adopted.

Musgrave's index attempts to capture the HE movement which the ranking studies miss. In addition, Musgrave's index attempts to measure VE differences. Thus, under Musgrave's approach, the two systems would register different welfare impacts, as illustrated below.⁴⁹

	Initial Income	<u>First Tax Proposal</u>		<u>Second Tax Proposal</u>	
		Tax	Net Income	Tax	Net Income
H1	10	4	6	2.5	7.5
H2	10	4	6	3.8	6.2
L1	5	0	5	.4	4.6
L2	5	0	5	1.3	3.7

VE Welfare costs
as result of not
achieving VE

0

6.4

49. This example is obtained from Musgrave II, *supra* note 1, at 357.

HE welfare costs as result of not achieving HE	0	2.3
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Note that the first tax proposal has no excess welfare cost under Musgrave's approach,⁵⁰ but the second tax reform registers both excess HE and VE costs.⁵¹ Thus, the first tax proposal would be preferable.

Kaplow criticizes Musgrave's two-component index because it devotes one entire component (the HE component) to the few persons who just happen to be equal while all other persons are lumped together in the VE component. In terms of the above example, if L1 and L2 had not started with identical incomes of 5 but had instead had initial incomes of 5 and 4.9, and H1 and H2 had not started with initial incomes of 10 each, but had initial incomes of 10 and 9.9, no HE measure would be applied to the treatment of H1, H2, L1, and L2. Instead, the treatment of H1, H2, L1, and L2 would be measured solely by the VE index. Kaplow asks why a separate index, the HE index, should be devoted solely to the measurement of the impact of individuals who start out as equals when all other taxpayers are lumped into the VE index.⁵² Moreover, Kaplow asks what weight should be assigned to VE and HE costs. For example, if one proposed tax law change results in an excess VE cost of 6 and HE cost of 0 while the other result in an excess VE cost of 3 and HE cost of 3, both will have the same aggregate welfare cost of 6. Kaplow queries which tax proposal should be selected. He asserts that since both HE and VE derive from the same normative base,⁵³ it is difficult to see why they should have a different normative import.

In a subsequent article, Musgrave admits that in a complex world it is unrealistic "to limit considerations of departure from HE to individuals with identical incomes only, while disregarding the relative treatment of individuals with more or less similar incomes."⁵⁴ But he maintains that this does not mean that HE is a useless independent concept.

B. Analysis

In our view, Kaplow's analysis of the defects of ranking studies to analyze HE is correct. As noted above, to the extent that ranking studies use

50. That is, equals are treated equally, and there is an "appropriate" differentiation between H and L.

51. That is, equals are not treated equally, and there is not an "appropriate" distinction in the treatment of unequals.

52. Kaplow II, *supra* note 1, at 195.

53. See *supra* text accompanying notes 3-7.

54. Musgrave II, *supra* note 1, at 358.

the distribution of income existing prior to a tax law change as a base to measure the HE impact of the change, the studies are in effect assuming that the pre-change distribution achieved HE, an assumption that appears to be extremely weak. Moreover, because in the real world the ranking studies compare the impact of the change on taxpayers or groups of taxpayers who start with different incomes, Kaplow is correct in asserting that ranking studies really involve a VE analysis.

We also believe that Musgrave's effort to defend the vitality of his indexes for measuring HE and VE ultimately must fail. We believe that his concession quoted above that the HE component cannot be limited to taxpayers with identical incomes is in fact a reversion to his 1959 assertion that HE folds into VE once a system that makes appropriate distinctions among unequals is adopted. Moreover, the VE component gives no information in addition to the economic assumption made by Musgrave that the marginal utility of income declines. Finally, it follows that the index will not assist in identifying relevant trade-offs in assessing proposed tax changes because VE and HE both are derivative concepts. Because HE and VE derive their normative base from economic judgments, values based on some theory of justice and efficiency concerns, the relevant trade-off is between or among those potentially conflicting fundamental judgments and values.

If it is agreed that objective indexes of HE and VE are not likely to be developed, the question remains as to whether HE and VE concepts may have some utility in the real world.

III. HE AND VE AS SURROGATES FOR BASIC ECONOMIC AND JUSTICE DECISIONS

A. *Kaplow's Suggestions*

Although Kaplow rejects both the proposition that HE contains any normative content and the validity of indexes of measures of HE, he nonetheless concludes his 1989 article by suggesting some practical, if limited, uses for which HE may be employed. Two of those uses are:

(1) HE analysis may reveal provisions (or the absence thereof) that are the source of inefficiencies or which need adjustment in order that VE norms may be applied properly.⁵⁵

55. Kaplow I, *supra* note 1, at 149.

(2) Repeated violations of HE could have adverse effects on (presumably labor and investment) incentives and undesirably impose the element of risk.⁵⁶

B. Analysis

Kaplow concludes that none of these uses demonstrates any normative content to HE (and, we would add, the same is true for VE). Instead, according to Kaplow, they serve as signals that something is amiss that needs investigation. The question is whether attention to HE in the above situations (and others he describes) adds anything to the analytical process.

To take Kaplow's first example, would application of HE analysis have added anything to the analysis of the need for the time value of money rules enacted in 1984? Indeed, the more troubling question is whether a focus on HE concerns would have masked the source of the problems and hence the need for the changes. That is, were not principles of income definition and allocation of income and expenses to proper accounting periods sufficient to indicate the need for changes?⁵⁷ After applying the principles, what further could HE analysis have provided that would have led to any different conclusions about the appropriate legislative responses?

In the case of Kaplow's second example, if legislative changes impose undesirable elements of risk, it is the identification of the undesirable risk effects (undesirability measured in terms of risk, not HE) that will be determinative. HE adds nothing to the analysis and waiting for HE analysis to reveal the risk effects may postpone identification of problems that would have been revealed if risk analysis were used to begin with.

Similar lines of analysis lead to the conclusion that Kaplow's other suggested uses of HE are better served by an examination of the fundamental concerns that underlie each problem.

Because Musgrave sees a broader role for HE than the practical uses suggested by Kaplow, he presumably does not object to these lesser suggestions. We suggest, however, that the questions raised as to the more limited uses require further exploration. In the end, we believe, any use of HE is going to be driven by more fundamental concerns. The question for advocates of even limited use of HE is why should analysis not begin and end in terms of those more fundamental concerns. The risk is that relying on HE or VE analysis might lead policymakers and the public astray if those

56. *Id.*

57. In 1959, Musgrave observed that once the appropriate income definition is agreed upon, most of the HE concerns have been resolved. Musgrave, *supra* note 3, at 161.

concepts in fact do not accurately or adequately reflect underlying principles in a given situation.⁵⁸

C. The Effect of Tax Expenditure Analysis on HE and VE

Even if one believes that HE and VE analyses do or should have a role to play, it is important to keep in mind the kind of provision being assessed. If the provision is a tax expenditure, HE and VE notions should not play a role in assessing a change. As McDaniel demonstrated in an earlier article,⁵⁹ the introduction or removal of a tax expenditure has no impact on tax equity, whether HE or VE. This counter-intuitive result flows from the tax expenditure construct itself: a taxpayer is deemed to pay tax based on economic income and is then given a Treasury check in an amount equal to the subsidies run through the tax system for which he or she qualifies. Obviously, in the real world two checks are not exchanged. Instead, the taxpayer nets his or her "economic tax check" amount with the "tax subsidy" check amount and remits the difference (or gets a refund). But focusing on the economic tax check portion of the analysis reveals that a tax expenditure is not the object of traditional tax HE or VE concerns. Indeed, if those concerns are applied to tax expenditures (as frequently they are), policy-makers can be led astray (e.g., "no new taxes" as a call to oppose repeal of a tax expenditure). Of course, there are equity concerns to address in assessing tax expenditures. But those concerns are those that are involved in assessing the outlay side of the budget (which may or may not be identical to tax notions of HE and VE).

Use of tax expenditure analysis also is consistent with our criticisms of HE and VE. That is, tax expenditure analysis avoids HE and VE altogether and focuses directly on the issues of why, for example, an item of income is untaxed and what the economic and distributional effects of that omission are.

IV. CONCLUSION

The Kaplow/Musgrave exchange has raised issues of considerable theoretical and practical interest. Our analysis of this exchange leads us to the following conclusions: (1) neither HE nor VE has any independent normative content, and that content must be supplied by reference to economic assumptions and a theory of justice; (2) Kaplow has demonstrated convincingly the inadequacies of efforts to develop indexes that will measure

58. See Westen, *supra* note 28 (making a similar point in his broader analysis of equality).

59. Paul R. McDaniel, Identification of the "Tax" in "Effective Tax Rates," "Tax Reform" and "Tax Equity," 38 *Nat'l Tax J.* 273, 277 (1985).

movements in HE as a result of tax law changes; and (3) it is not likely that HE and VE add anything to the need to analyze tax changes in terms of basic tax policy objectives and indeed may conceal problems or lead policymakers astray as particular tax changes are considered.