A Taxation Policy to Make John Stuart Mill Weep

By DAVID CAY JOHNSTON

The income tax returns filed by President Bush and Vice President Dick Cheney last week highlight in stark detail several new tax issues that subtly affect all Americans and that will become increasingly significant in the next few years.

What's more, their returns demonstrate how far American tax policy has veered from two classic philosophical insights about how to finance government: "horizontal equity" and "vertical equity."

Horizontal equity means that people with similar incomes and family structures pay similar amounts of tax. Vertical equity means those who have the greatest capacity to pay taxes bear the greatest burden.

The idea of basing taxes on the ability to pay dates to ancient Athens, Maureen B. Cavanaugh, a professor of tax law at Washington and Lee University, wrote recently. Athens was a tyranny when it had a flat tax, she wrote, but democracy flourished once taxes were based on one's ability to pay. Sylvia Nasar, a journalism professor at Columbia University who is writing a history of 20th-century economic philosophers, said that in the 18th and 19th centuries, "Adam Smith, John Locke, James Mill and John Stuart Mill all supported the broad tax principles of horizontal equity, vertical equity, transparency and efficiency."

Today, Professor Cavanaugh said, the debate on tax policy largely ignores these principles. A look at the tax returns filed by Mr. Bush and Mr. Cheney demonstrates that shift. Mr. Bush and his wife, Laura, paid 27.7 percent of their total income in federal income taxes, about the same as the average taxpayer earning $500,000 to $1 million a year. Mr. Cheney and his wife, Lynne, however, paid 19 percent, far below the average of more than 29 percent for those in the $1 million to $2 million income group.

Even more striking, when their interest from tax-exempt bonds is added, the Cheneys paid just 12.7 percent of their total income in federal income taxes. The Cheneys paid such a low rate because in recent years Congress has cut tax rates - more so on dividends than on wages. Horizontal equity is the critical concept that motivates Americans to comply with the tax laws, according to John O. Fox, who teaches tax policy at Mount Holyoke College. And as horizontal equity is reduced, he said, more cheating is encouraged. "We have more and more cheating not because we are bad people, but because people have concluded that the system does not treat equals fairly," he said.

Daniel J. Mitchell, a tax policy specialist at the Heritage Foundation, which favors lower taxes on investments, said recent changes in tax policy have increased horizontal inequity. He said classic tax theory is virtually absent from corporate tax policy, too, such as the administration's energy bills and proposals to change how exports are taxed. He said few tax bills are "based on what politicians think is good policy." Rather, he said, "it is all just special interests and who is whining the most."

The Bush and Cheney returns also show the collapse of vertical equity, under which one's tax burden rises with income and which the libertarian Cato Institute calls a "bedrock American principle."

The Cheneys had more than twice the income of the Bushes, yet the amount of income tax they paid was about the same, a result of the growing trend by Congress to tax different sources of income differently. For example, to encourage more savings and investment, Mr. Bush and Mr. Cheney persuaded Congress to lower the tax on most corporate dividends to 15 percent from as much as 39.6 percent when they took office. That decision saved Mr. Cheney and his wife almost $21,000 last year.

Over all, the Cheneys saved $36,000 in taxes because of the Bush cuts, but two-thirds of that savings was wiped out by another measure: the Alternative Minimum Tax, a separate, parallel income tax law with its own rules on deductions and its own rates.

The A.M.T. was adopted in 1969 to make sure that all very high-earning Americans (those making more than $1 million today) pay some income tax. In this alternate calculation, people lose their exemptions for themselves and their dependents, and their deductions for state income and local property taxes. But even with the A.M.T., the Cheneys' tax burden was far below the average for people in their income group.

One thing's for sure: Judging from the Cheney and Bush returns, we've come a long way indeed from the classic tax policies of ancient Greece.