State Tax Reform:

General Principles and Lessons from Prior Efforts

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I) A Definition and General Principles of Tax Reform

A. Working definition of "tax reform"

1) It is useful to have a definition of tax reform that defines the goals of reform. If we do not know where to aim, we're likely to miss our target. But there is no single set of necessary and sufficient conditions commonly used to distinguish what is, from what is not, tax reform. Tax policy analysts are not lexicographers with authority to dictate usage. Nevertheless, many tax policy analysts with practical experience in tax reform arenas follow a common approach that provides a working definition that establishes criteria, or principles, of an economically desirable tax system. This section reviews some well known descriptions of tax reform, some objections, and the tax policy analyst working definition.

2) Former Louisiana senator Huey Long famously stated tax reform means "don't tax you, don't tax me, tax the fellow behind the tree." The advantage of this definition is that it includes a measure of success: Tax reform is accomplished when the tax system shifts the tax burden to others outside the relevant tax jurisdiction. The difficulty with this approach is that the others have an economic incentive to resist the effort. The 1930 Smoot-Hawley tariff, an example of 'beggar-thy-neighbor' policy, provides an example.[1] Other countries retaliated by increasing tariffs on U.S. exports. World trade seized up, making all countries involved worse off.[2]

3) Wikipedia (the online encyclopedia) defines tax reform as the process of changing the way taxes are collected or managed by government. The advantage of this definition is that it is easy to know when reform has been achieved: Nearly every change in the tax system fits this definition. For example, in 1991 the Texas Legislature "eliminated" that state's tax on corporate income. More precisely, Texas relabeled its corporate tax a 'franchise tax.' The problem with this definition is that if everything is tax reform, the term is meaningless, providing no useful guide to improving the tax system.

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[1] Beggar-thy-neighbor policy is designed to improve one's own lot at the expense of someone else's.
[2] After imposition of Smoot-Hawley U.S. imports from Europe declined from $1.3 bi. in 1929 to $0.4 bi. in 1932. U.S. exports to Europe fell from $2.3 bi. in 1929 to $0.8 bi. in 1932. World trade declined about 66%. Source - http://www.state.gov/r/pa/ho/time/id/17606.htm.

4) The tax cut advocacy group Americans for Tax Reform defines reform as a change in taxes that reduces the level of tax revenue. However, there is no necessary relationship between the level of revenue and the ability of a tax system to attain desirable social goals: Small governments can have poorly designed tax systems, and large governments can have well designed tax systems. What is needed is a set of criteria for good design.

5) Major changes in federal taxes legislated in the early 1960's and the early 1980's often are referred to as tax reform. In the 1960's the Kennedy Administration enacted an Investment Tax Credit on machinery and equipment (*ITC*), and reduced the highest marginal tax rate on personal income from 91% to 70%. In the early 1980's, among other things, the Reagan Administration reduced the highest marginal tax rate on unearned income from 70% to 50%, and introduced many changes in the tax system that permitted taxpayers to shelter income from taxes.[3]

6) The reported goal of the Kennedy Administration was to use deficit-finance to "get the country moving again." That is, the goal was a short term increase in the rate of economic growth.[4] A problem with using growth as the goal of tax reform is that doing so tends to give the misleading impression that tax reform has only benefits. But growth has costs, such as congestion, the need for new infrastructure, and possible environmental impacts. Second, it is very difficult to identify an empirical relationship between taxes and growth, so it is impossible to know if the reform achieves its goal. Third, this says nothing about other important social impacts taxes have, for example on equity and economic efficiency. The Urban Institute's Eugene Steuerle, one of the architects of the Tax Reform Act of 1986 (*TRA86*), says that when growth is used to justify tax changes, it tends to dominate the debate, pushing all other laudable tax reform objectives out of the discussion.[5]

7) Early in the Reagan Administration tax reform appeared to be identified with tax cuts. The advantage of this position is that achievement of reform is clear: the tax rate is lower than before. However, if tax cuts were a viable goal, the optimal reform would cut the rate to zero. Because no true economic goal of reform was articulated by proponents of the 1981 Economic Recovery and Tax Act (*ERTA*) confusion over goals was widespread. One faction argued the tax cuts would increase growth, thereby increasing revenues: tax cuts would pay for themselves. Other participants suggested *ERTA's* true goal was to reduce revenue, and force a reduction in the size of government. 'Tax cuts' overpowered every other goal of true tax reform. The result has been described as a tax cut feeding frenzy. Effective tax rates on some activities became negative, creating economic incentives to undertake those activities for no purpose other than to shelter income from taxes. Such special treatment ends up treating equals differently, and encourages

[3] For example, *ERTA* increased opportunities for safe-harbor leasing, allowing firms with no taxable income to benefit from accelerated depreciation allowances by selling their capital to profitable firms, and leasing it back. *ERTA* also increased opportunities for investors to use capital losses on passive investments (where the principle is not actively involved in a business) to reduce ordinary taxable income, and thereby reduce tax liability.
[4] James Tobin, a principle advisor to the Kennedy Administration, suggested the tax cut was unlikely to produce substantial change in long run growth.
[5] Steuerle, 1999, "Tax Reform, Federal," *The Encyclopedia of Taxation and Tax Policy* (Urban Institute Press: Wash. DC).

taxpayers to divert resources and energy away from productive activity toward activities designed to reduce tax bills.[6]

8) As early as Adam Smith's *The Wealth of Nations*, tax policy analysts enumerated criteria, or principles, of an economically sound tax system.[7] Smith's list included equity and simplicity. He did not include economic efficiency as a separate principle: however, Smith's discussion makes clear that he regarded efficiency as a fundamental principle of sound taxation.[8] Thus, tax policy analysts Donald Bruce, Steven Gold, and Eugene Steuerle, define tax reform as a change in the tax system designed to improve ***equity***, ***economic efficiency***, and ***simplicity***.[9]

9) Equity, Economic Efficiency, and Simplicity

a) Equity: Two fundamental principles govern most tax analysts' discussions of equity. These are, first, the benefits principle, and second, the ability-to-pay principle. When the benefits principle is applied, citizens pay taxes according to identifiable benefits each receives from government services. This can work for a small set of specific services, such as transportation. The benefits principle cannot be implemented where individual benefits are hard to identify, such as in the cases of criminal courts and prisons. The ability-to-pay principle is applicable in the hard-to-identify cases. When the ability-to-pay principle is applied, citizens who have equal abilities are taxed equally, ('horizontal equity'), and citizens with higher abilities are taxed relatively heavily ('vertical equity').

b) Economic Efficiency is the least intuitive principle of taxation, and usually requires some explanation. It is best understood by considering its opposite, inefficiency.

i) Inefficiency occurs when taxes alter taxpayer choices, reducing economic value. For example, colonial England imposed a tax on windows. Afterward, the English built houses with fewer windows. Houses with fewer windows have lower value. The decrease in economic value is a "deadweight loss;" that is, a cost to some taxpayers not offset by benefits to anyone. This is worse than taxing Peter to pay Paul, which at least makes Paul better off. Deadweight tax loss is economic value flushed down the drain. It has been likened to burning money. Tax inefficiency occurs because taxes provide incentives for taxpayers to spend time and other scarce resources to avoid taxes, rather than in

[6] According to Frederick Mishkin, a current member of the Board of Governors of the Federal Reserve, *ERTA's* special treatment of real estate investment contributed to a real estate boom, which, in turn, contributed to the Savings and Loan Crisis. See Mishkin's *The Economics of Money, Banking, and Financial Institutions.*
[7] An economically sound tax system is one that adheres, as closely as possible, to the principles that: 1) individuals trading in markets are the best judges of their own interests, 2) markets fail in important ways, and 3) the government has a potential to correct market failures, and improve social welfare.
[8] In fact, economic efficiency is the central them of *The Wealth of Nations*.
[9] Bruce is a University of Washington tax policy analyst and author of *Public Finance and the American Economy*. Gold and Steuerle are tax analysts for The Urban Institute in Washington DC.

production and consumption. For example, a sufficiently high payroll tax could discourage work effort or may encourage payment to professionals expert at shifting salary into tax shelters.

ii) A relatively efficient tax system would reduce deadweight tax losses to the minimum amount consistent with achievement of the other principles.

c) Simplicity means ease in compliance with, and administration of, the rules governing taxation.

10) Steuerle uses the term "*systematic*" tax reform to distinguish the tax analysts' definition of tax reform from other views. He points to the Tax Reform Act of 1986 (*TRA86*) as an example of systematic tax reform. *TRA86* was designed to improve equity, reduce inefficiency, and simplify the federal tax system. It was not designed to encourage economic growth, cut taxes, change the system for the sake of change, or increase or decrease the level of revenue (in fact, it was designed to be revenue neutral).

*B. Principles of **state** tax reform*

1) Bruce, Gold, and Steurele define tax reform in terms of fundamental principles of a sound tax system, namely equity, efficiency, and simplicity. These are core principles that apply to taxes at all levels of government. But state and local finance faces many knotty issues not faced at the federal level. Therefore state and local tax policy analysts cite additional principles of sound state tax policy that can usefully guide state tax reform.

2) Revenue sufficiency is an additional principle that is fundamental in a well designed state tax system. A sufficient revenue system grows with the economy in the long run. Sufficiency is fundamental because none of the other economic goals of reform is likely to be achieved if the tax system does not provide sufficient revenue to meet state and local funding requirements. If the tax system is insufficient, the state budget will experience periodic or persistent financial crises. During financial crises, the need to balance the budget dominates debate and tends to sweep aside other laudable goals of a sound tax system.

3) Sharing of fiscal responsibilities between state and local authorities is another principle important at the state and local level. State governments have a comparative advantage in collecting some forms of revenue, such as income taxes, which would be prohibitive for an individual local government. And local governments appear to have the advantage collecting real property taxes. Many observers suggest a similar dichotomy on the spending side of the balance sheet. The way revenue responsibility is shared between state and local governments must be a paramount concern in design of a sound state tax system.

4) The competitiveness of a state's industries and workers is an additional important issue in tax reform.[10] A competitive revenue system promotes long-run economic development, job creation, and growth.

5) Many additional goals of state and local finance design have been cited.[11] However, there is no consensus on the additional goals. For example, the Advisory Commission on Intergovernmental Relations (*ACIR*) argues that balance among tax bases (property tax, income tax, sales tax) should be a goal of tax reform: that is, each tax base should raise approximately the same fraction of total revenue. Against this, Duke University economist Helen Ladd argues that if balance is an objective at all, it should be balance between the other goals (mentioned above) not between tax bases.[12] In contrast, setting taxes so that each base contributes equally to revenue could impair the ability to meet more fundamental economic goals of reform.

6) Many tax analysts and the *Final Report* of the 2002 Governor's Commission to Modernize State Finances suggests the following set of principles:[13]

> i) Sufficiency: A revenue system that provides funds over time to satisfy government requirements, with minimum variation in the level of funds, year to year.
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> ii) Appropriate Federalism: A division of state/local revenue, and an allocation of taxing authority, consistent with each government's abilities, needs, and responsibilities.
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> iii) Competitiveness: A tax system that promotes long-term, sustainable, economic development, job creation, and growth.
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> iv) Equity
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> v) Economic Efficiency
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> vi) Simplicity

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[10] I believe an economically efficient tax system will be competitive, and an inefficient system will not be. However, many thoughtful tax policy analysts argue that competitiveness and efficiency should be treated as separate principles.

[11] The National Conference of State Legislatures (*NCSL*) describes no less than ten goals (http://www.ncsl.org/programs/fiscal/fpphqsrs.htm). Long lists are unwieldy and violate the principle of simplicity. The principle of parsimony suggests a focus on fundamentals.

[12] Ladd, 1988, "The Meaning of Balance for State-Local Tax Systems," in *The Unfinished Agenda for State Tax Reform*, edited by Steven D. Gold (NCSL: Wash. DC) pp. 31-46.

[13] With apologies to *Final Report* authors, I have changed the order and description of some goals, for the sake of this article. The *Final Report* is available at http://www.osbm.state.nc.us/files/pdf_files/final_rpt_gov_comm.pdf.

7) These considerations suggest the following definition of state tax reform:

> ***State Tax reform is a change in a state's tax system designed to improve sufficiency, advance federalism, and improve competitiveness, equity, economic efficiency, and simplicity***

8) Unfortunately, no single tax base can achieve all these goals simultaneously: A tax reform that moves the system closer to one goal often moves it away from others. For example, many tax policy analysts argue that shifting from an income tax base to a consumption tax base would increase economic efficiency, because the former tends to discourage savings and investment and the latter does not. However, it also is argued that shifting from an income to a consumption tax base could tend to reduce equity because consumption taxes tend to be regressive. Inconsistent goals create a (taxing) dilemma:

a) There is at least one major exception to the dilemma, namely broadening the tax base and reducing tax rates. Everything else constant, lower tax rates are relatively efficient. Financing rate reduction by broadening the tax base could improve fairness by reducing tax discrimination against some activities, and by increasing progressivity. For example, eliminating some itemized income tax deductions would broaden the income tax base, allowing revenue to be raised at lower tax rates. At the same time, progressivity would be increased because relatively well off taxpayers tend to benefit most from itemized deductions.

b) The fact that some changes improve performance in one dimension while reducing it in others suggests that the principles should be applied to the tax *system* as a whole, not to each part separately. For example, if a reformer adamantly resists any single change in the tax system that would impair a favored principle, there would seem to be no room for compromise. However, it is possible to move the *system* closer to both goals at once by trading off movements toward goals. For example, broadening the sales tax base would tend to improve efficiency, but might reduce progressivity. As well, increasing the income tax's standard deduction would make the system more progressive, but would necessitate higher tax rates (to achieve a given level of revenue) reducing efficiency. Neither of these reforms by itself is capable of making the tax system more equitable and efficient. However, by carefully calibrating the two reforms simultaneously the *system* could be made more equitable and efficient.

II) Lessons From Prior Efforts

A. Comprehensive versus partial tax reform

1) Once goals have been established, the question remains how far should tax reform actually be implemented. Some tax policy analysts argue in favor of comprehensive tax reform. Bruce (2001) defines comprehensive reform as change in the tax system that alters the entire structure of the system, or replaces it entirely. Tax structure includes the tax base, that is, the economic activity or benefit taxed (E.G., consumption, income, or

property), as well as permitted exemptions, exclusions, deductions, and special provisions. For example, *TRA86* often is referred to as a comprehensive tax reform because it reduced exclusions of saving and investment, thereby shifting the tax base toward income.

2) Others analysts argue in favor of partial reform. Partial reform is a targeted change in details of the existing tax structure that leaves the basic structure intact. For example, the 2003 federal tax reductions for capital gains and dividends decreases tax rates on capital income without altering the basic structure of the federal tax system.[14]

3) Note that highly respected tax analysts, such as William Fox, Director of the Center for Business and Economic Activity, and John Mikesell, an Indiana University professor of public and environmental affairs, suggest comprehensive reform has not often succeeded at the state level. I respectfully submit that this point of view may be restricted to the recent past (since WWII). Otherwise, the 1913 federal income tax, and North Carolina's shift from property taxes to state income taxes in the early Twentieth Century would not qualify as successful comprehensive reform.

B. An example of comprehensive federal tax reform

TRA86 has often been held up as a paradigm of comprehensive implementation of tax reform. Among other things, *TRA86*

1) increased personal exemptions and the standard deduction sufficiently to remove millions from the federal income tax roles.

2) reduced the highest federal individual marginal income tax rate from 50% to 28%.

3) reduced the highest federal corporate income tax rate from 46% to 34%.

4) eliminated or reduced many exclusions, deductions, and tax shelters.[15]

C. Steurele's guidelines

Eugene Steuerle served as economic coordinator of the *TRA86* effort. Here are his guidelines for systematic tax reform, along with brief notes:[16]

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[14] The title of the act is Jobs and Growth Tax Relief Reconciliation Act of 2003.

[15] Among other things, *TRA86* eliminated the *ITC* for machinery and equipment, eliminated a 60% exclusion of capital gains, rolled back accelerated depreciation schedules instituted in 1981, reduced depletion allowances for oil and gas, eliminated the 10% income exclusion for dual-earner households, reduced opportunities for safe-harbor leasing, and reduced the ability some investors had to use capital losses on passive investments (where the principle is not actively involved in a business) to reduce ordinary taxable income.

[16] Steurele's article is short but full of insight. See Eugene Steuerle, Dec. 12, 2002, "Ten Guidelines for Systematic Reform, *Tax Notes* (Wash DC: Urban institute), www.urban.org/Template.cfm?NavMenuID=24&template=/TaggedContent/ViewPublication.cfm&PublicationID=8330

1) *Listen* (take the observations, insights, and objections of staff seriously because the tax system is too complicated for any one person to understand.)

2) *Know the Forces at Play* (know and deal with the major difficulties facing the tax system)

3) *Have an Overall Vision* (the tax system and individual interests are so complicated that it is easy to become distracted with minor side issues. Reform should begin with a view of what is achievable and most important to pursue).

4) *Start with Principles* ("only principles can provide a guiding beam, allowing people to judge whether they are on course or not")

5) *Balance Principles* ("…legitimate principles compete with each other. The trick is establishing and maintaining some reasonable balance. Without this balance, reform will get shot down for its failure on one front even if it is successful on another.")

6) Seek some Bipartisan Consensus ("major reform almost always requires some bipartisan consensus… ")

7) *Plan your Snapshots* ("Often a few pictures or symbols in the public's mind will sell or kill reform.")

8) *Acknowledge Reform Involves Losers* (Systematic reform can't dodge the tax goal balance sheet. Achievement of some goals tends to make some people worse off. "One of the ways systematic reform gets killed is the unwillingness to acknowledge this unpleasant fact of economic calculus…. The only way to avoid this downward spiral is to beat the naysayers to the punch…" So admit up front that that there will some losers among those unduly favored by current tax provisions.)

9) *Work Bottom Up and Top Down* (starting with and sticking to principles works from the top down. It also is vital to work from the bottom up, going through the tedious detail of the tax system to get things right.)

10) *When Stuck Between Camps, Work on Common Concerns* (The *TRA86* tax reform effort often got stuck, and at one point ground to a halt for lack of direction. Steuerle says it regained momentum when the divisive issues were momentarily set aside, and attention was shifted to areas where there was common ground.)

More than one observer has noted that many of the 1986 reforms have been eroded by subsequent legislation. For example, special treatment of capital gains eliminated by *TRA86* was resurrected by the 1997 Taxpayer Relief Act. Any realistic assessment of past tax reforms must acknowledge that reforms do not last forever. This should not be surprising. First, special interests that create the need for tax reform in the first place remain after reform is achieved: but the enthusiasm and energy level of reformers often falls off and is hard to sustain. Second, even if the special interests were permanently defeated, the tax system must change because the economy evolves. Natural evolution in the economy inevitably transforms the state-of-the-art into obsolescence. These observations suggest an additional guideline:

11) Anticipate self-interested as well as evolutionary pressure on reforms, and describe mechanisms to periodically monitor tax law changes for conformance to principles and to modernization of the economy. In a democratic society with a technologically advancing economy, eternal vigilance may be a price of a sound tax system.[17]

D. An example of state comprehensive tax reform

1) I believe the principles of state tax reform enumerated above provide a strong argument in favor of sales taxation of services. However, Florida attempted a comprehensive extension of its general sales tax to services in 1987, and failed. This section describes two accounts of Florida's experience. These accounts can be instructive, first, because they offer insight into what a tax on services could look like. Second, and more generally, these accounts offer insight into how and why a well initiated state tax reform can fail.

2) James Francis, past Director of Research in Florida's Revenue Department, helped construct Florida's sales tax on services.[18] Walter Hellerstein helped draft Florida's sales tax law and served as legal counsel to Florida's Department of Revenue.[19] Here is my rendition of their discussions about what transpired. To aid interpretation of the flow of events, they are presented in rough chronological order:

a) Francis: In *June 1986* Florida's legislature expressed its intent to extend the sales tax base, beginning in 1987. At first, the legislation garnered surprisingly little resistance. Francis argues there were three reasons for this: First, the idea of closing sales tax loopholes had been discussed in Florida's General Assembly for the preceding two years, so the public was educated about the issue, which became popular. Second, increased demand for government services, stemming from economic growth, tended to reduce resistance. Third, the June 1986 legislation was written as a sunset provision, which disarmed reform opponents.

b) Hellerstein:

i) Bob Martinez campaigned for Governor on an anti-tax platform, and was elected in 1986. However, as governor Martinez changed his position, and supported comprehensive extension of Florida's general sales and use taxes to services. In April 1987 Governor Martinez signed legislation extending the sales and use tax to services. The tax took effect July 1, 1987.

[17] Hawaii's tax laws include a provision requiring a tax commission to re-examine the tax system every five years.
[18] Francis, 1988, "The Florida Sales Tax on Services: What Really went wrong," in *The Unfinished Agenda for State Tax Reform*, edited by Steven D. Gold (NCSL, Wash. DC), pp. 129-152.
[19] Hellerstein, 1988, "Florida's Sales Tax on Services," *National Tax Journal*, pp. 1-18.

ii) The Florida sales tax reform extended the sales and use tax to accounting, advertising, contracting, and legal services. In general, services were taxable if sold in Florida. The use of services was taxable if the services were sold outside the state, but used in state, and if the sale or use was not taxed in another state. Services performed in state for use outside the state were exempt. The sale or use of multistate firm services used partly in Florida was apportioned. There were exemptions for agriculture, education, government, health, local and suburban personal transportation, occasional or isolated sales by persons not engaged in business, and sanitary, social, and religious services.

iii) After the legislation passed, the sales tax extension became embroiled in controversy. Media groups claimed that taxing advertising services violated the First Amendment. Lawyers' associations argued that taxing legal services violated constitutional rights to assistance of counsel. "Out of state purchasers of services claimed that the tax violated the Due Process and Commerce Clauses." (page 10) National advertisers and advertising media launched a vigorous, well-financed, campaign against the tax. Large advertisers reduced advertising in Florida. And media trade associations canceled conventions there.

iv) By September 1987 the Governor's position again turned one-hundred and eighty degrees. In December 1987 Florida's legislature repealed the tax, and Governor Martinez immediately signed the repeal.

c) Francis again:

When vigorous resistance arose, the most heavily criticized feature was the use tax on services. The real bone of contention for multi-state business was not the tax per se, but compliance costs. Services would be apportioned. This startled taxpayers accustomed to the all-or-nothing delivery rules for sales taxation of goods. And apportionment of the sales tax on business services may have implied a widening of "nexus" in some minds.

Francis concludes the tax eventually failed to stick for the following "logistical" reasons: First, the governor's campaign rhetoric handed opponents an anti-tax message. Second, the media was aggravated by inclusion of taxation of advertising services, and bombarded the public with that message (advertisers commissioned a study claiming sales tax extension would eliminate 46,000 jobs). Third, poorly conceived responses by leaders of both parties caused the reform coalition to dissolve.

E. Lessons

1) As a result of the Florida experience, Francis offers the following advice:

a) Two ways to extend sales tax to more services are i) enumerate each specific service to be taxed, or ii) extend the sales tax comprehensively to all services, and enumerate services to be exempted from the tax. Francis argues that the first "piecemeal" approach does not work because the politically tough measures won't be taken.

b) Reformers wishing to extend sales tax comprehensively to services should seek a way to make the media's self-serving anti-tax message be seen for what it is.

c) The pro-reform coalition must proceed on a consensus basis before and after enactment.

2) Many careful observers of tax reform efforts suggest that the principles should be applied to the whole tax system, not its individual tax bases. This is because each and every tax base fails to satisfy one or more principles. Together, however, the combination of all tax bases is capable of moving the system closer to all goals. This is consistent with Ladd's and Steuerle's admonitions that balance be sought in achieving principles. Just as a well designed portfolio of assets balances risk and return, a sound portfolio of tax bases balances equity, efficiency, simplicity, et al. I believe this approach favors comprehensive reform.

3) Martin Feldstein, President of the National Bureau of Economic Research, and Joseph Stiglitz, Nobel prize winning economist, argue that reform tends to be difficult to achieve because taxpayers have already adjusted many economic decisions, and have committed resources, on the basis of the existing tax system.[20] Thus, tax reform always produces economic losses for some taxpayers. Feldstein and Stiglitz suggest that reforms be introduced gradually, so taxpayers have time to adjust, and that reforms should be as transparent as possible, so taxpayers can understand their economic consequences.

4) Steuerle's Guideline 3 is Have an Overall Vision. I suggest the vision could be a revenue neutral systematic tax reform that broadens the tax base and lowers tax rates. Declaring the change will be revenue neutral can soften the charge that tax reform is a smokescreen for increasing the amount of revenue. As well, base broadening with lower rates may be the single reform with potential to improve both equity and efficiency, two of the most divisive issues in tax reform.

5) Ability-to-pay often is held up as the appropriate basis for equitable taxation. Taxation according to ability-to-pay sets two standards. Horizontal equity holds that citizens with equal resources should be taxed equally. Vertical equity holds that citizens with relatively greater economic resources should be taxed relatively heavily. Almost all

[20] Feldstein, 1976, On the Theory of Tax Reform, *Journal of Public Economics*, pp. 77-104; Stiglitz, 2000, *Economics of the Public Sector* (New York: WW Norton & Company).

stakeholders and analysts agree about what horizontal equity requires. However, there appears to be a thoroughgoing lack of consensus on what vertical equity requires. Therefore well-meaning tax reformers often disagree strongly about what is required for a tax system to achieve vertical equity. In this case, Steurele's Guideline 10, (When Stuck Between Camps, Work on Common Concerns) could be an aid to progress. One approach would be to focus initial discussions of fairness on horizontal equity. Construct tax reform on this basis. Leave discussion of vertical equity, namely tax exemptions and the gradient in tax rates, until after the basic tax structure has been agreed upon.

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