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Journal
UCLA Law Review, 51

Author
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Publication Date
2004

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Kirk J. Stark

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FISCAL FEDERALISM AND TAX PROGRESSIVITY: SHOULD THE FEDERAL INCOME TAX ENCOURAGE STATE AND LOCAL REDISTRIBUTION?

Kirk J. Stark*

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* Professor of Law, UCLA School of Law. I would like to thank Reuven Avi-Yonah, Steve Bank, David Bradford, Victor Fleischer, Bill Klein, Kyle Logue, Dan Shaviro, Joel Slemrod, Dennis Ventry, and Eric Zolt for helpful comments on earlier drafts of this Article. I also wish to thank participants at the University of Michigan Tax Policy Workshop and the NYU Colloquium on Tax Policy and Public Finance.

INTRODUCTION

For more than a half century following World War II, U.S. fiscal policy has been characterized by "fiscal activism and federal leadership."[1] During this period, the federal government has dominated almost every major category of social spending, and federal law (especially federal tax law) has served as the primary vehicle through which income and wealth were redistributed in the United States.[2] Over the past several years, however, the political consensus sustaining this basic framework has begun to shift, and significant structural changes with broad implications for American fiscal federalism are beginning to emerge.

The first change, which has its origins in the early Reagan years and Republicans' persistent call for a smaller role for the federal government, involves the devolution of fiscal responsibilities to states and localities.[3] Programs that were previously handled by the federal government, including welfare, housing and job training, are increasingly becoming the responsibility of the states.[4] The second change, which is more recent but potentially more significant, is an emerging political consensus against the redistribution of wealth. The pending repeal of the federal estate tax and the recent flattening of the federal income tax rate structure are two examples of this nascent trend.[5]

These changes have called into question longstanding institutional arrangements, forcing scholars and policymakers to reexamine several basic questions concerning the division of fiscal responsibilities between the

1. Richard A. Musgrave, *Devolution, Grants, and Fiscal Competition*, 11 J. ECON. PERSP. No. 4, 1997, at 65, 65, 1997.

2. This is not to suggest, however, that the federal income tax has had a significant impact on the distribution of income. In fact, the data appear to suggest that taxes have had a minimal impact on the distribution of income. *See* Benjamin A. Okner & Joseph A. Pechman, *Who Paid the Taxes in 1966?*, 64 AM. ECON. REV. 168 (1974).

3. On devolution, see Musgrave, *supra* note 1; Richard A. Musgrave, *Reconsidering the Fiscal Role of Government*, 87 AM. ECON. ASS'N PAPERS & PROC. 156, 157 (1997); Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120 (1999); C. Eugene Steuerle & Gordon Mermin, *Devolution as Seen From the Budget*, NEW FEDERALISM: ISSUES AND OPTIONS FOR THE STATES (Urban Institute, January 1997).

4. Oates, *supra* note 3, at 1120.

5. On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) which, among other things, accelerates the reductions in individual income tax rates first enacted in 2001, reduces the maximum capital gains tax rate to 5 and 15 percent (from 10 and 20 percent), and reduces the tax rate on dividend income to 15 percent. Pub. L. 108-27. The first major Bush tax legislation, enacted in 2001, initiated a phased-in repeal of the federal estate tax. Absent any change in the law, the federal estate tax will be repealed completely in 2010. In 2011, however, it is scheduled to revert to pre-2001 law due to a controversial sunset provision. Pub. L. 107-16.

national and subnational governments. Which governmental responsibilities should be undertaken by the federal government and which by the states? What is the effect of interjurisdictional competition on the provision of public goods or the level of public spending? Which level of government should redistribute wealth? Is it even possible for state and local governments to redistribute wealth? Should the federal government encourage or discourage redistributive policies by state and local governments?

The answers to these questions, which fit broadly within the field of "fiscal federalism," implicate a wide spectrum of public policy concerns, including several areas of federal tax reform.[6] But the "rubber hits the road," so to speak, in section 164 of the Internal Revenue Code, which allows individuals who itemize their deductions when filing their federal income tax returns to claim a deduction for certain tax payments made to state and local governments.[7] Existing literature on the deduction for state and local taxes has tended to focus on two basic questions: (1) Is the deduction an appropriate refinement to the tax base in order to implement a theoretically "pure" or "ideal" tax on income? (2) What effect does the deduction have on the size of state and local budgets and the mix of taxes used?[8] My analysis differs from this literature by asking a third question

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6. For a brief overview of the field of "fiscal federalism," see Richard M. Bird, *Fiscal Federalism*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 127, 127–29 (Joseph J. Cordes et al. eds., 1999).

7. 26 U.S.C. § 164 (2004). In relevant part, section 164 provides as follows:

> (a) General rule. Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: (1) State and local, and foreign, real property taxes. (2) State and local personal property taxes. . . .
>
> (b) Definitions and special rules. For purposes of this section—(1) Personal property taxes. The term "personal property tax" means an ad valorem tax which is imposed on an annual basis in respect of personal property. (2) State or local taxes. A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

Id.

8. While not without exceptions, as a general rule legal scholars have addressed the first question, while public finance economists have focused more on the second question. *See, e.g.*, Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 418 (1996) ("Most of the analysis in this Article and much in the literature address whether deductibility is appropriate to implement a conceptually pure tax on 'income.'"); *see also* Edward A. Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 6 AM. J. OF TAX POL'Y 9 (1987); Brookes D. Billman & Noël B. Cunningham, *Nonbusiness State and Local Taxes: The Case for Deductibility*, 28 TAX NOTES 1107 (1985). Regarding the fiscal effects of deductibility, see

that, to date, has gone largely unexamined: *Should Congress use the federal income tax deduction for state and local taxes to influence the amount of income redistribution undertaken by state and local governments?*[9]

In setting tax and spending levels, state and local officials face a wide range of competing pressures, two of which are of special concern here. First, as a general proposition, state and local officials will attempt to minimize the after-tax cost of the public services they provide to their residents. That is, where possible (and subject to competing pressures), state and local officials attempt to "export" the cost of funding state and local public goods to nonresidents. One of the primary means of tax exporting for state and local governments is to use taxes that are deductible for purposes of the federal income tax.[10] For every dollar of state or local taxes that is deductible for federal income tax purposes, the taxpayer, in effect, receives a rebate from the federal government. This rebate, the amount of which depends upon the taxpayer's federal marginal tax rate, reduces the tax price that local residents face for public goods provided by state and local governments.[11] As a result, state and local policymakers will prefer, *ceteris paribus*, to finance public goods with taxes that are deductible for federal income tax purposes.[12]

Martin S. Feldstein & Gilbert E. Metcalf, *The Effect of Federal Tax Deductibility on State and Local Taxes and Spending*, 95 J. POL. ECON. 710 (1987).

9. Some economists have studied the related empirical question of whether federal deductibility does in fact lead state and local governments to adopt more steeply progressive tax structures. *See* Howard Chernick, *A Model of the Distributional Incidence of State and Local Taxes*, 20 PUB. FIN. Q. 572 (1992); Charles E. Scott & Robert K. Triest, *The Relationship Between Federal and State Individual Income Tax Progressivity*, 46 NAT'L TAX J. 95 (1993). It also appears that Martin Feldstein and Marian Vaillant once began a paper on this topic; however, the authors appear to have abandoned that project. *See* MARTIN FELDSTEIN & MARIAN VAILLANT, CAN STATE TAXES REDISTRIBUTE INCOME? (Nat'l Bureau of Econ. Research, Working Paper No. 4785, 1994).

10. *See* Gilbert E. Metcalf, *Deductibility and Optimal State and Local Fiscal Policy*, 39 ECONOMICS LETTERS 217 (1992) ("Deductibility is a form of tax exporting which reduces the cost to residents of using a particular tax.").

11. For useful discussions of the concept of "tax price," see RONALD C. FISHER, STATE AND LOCAL PUBLIC FINANCE 371 (1996) and JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 133, 152 (2d ed. 1988). *See also* Walter Hettich, *Tax Price*, *in* THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY, *supra* note 6, at 391 (Joseph J. Cordes et al. eds., 1999) (describing tax price as "[a] concept developed in analogy to price as observed in private markets); Kirk J. Stark, *The Right to Vote on Taxes*, 96 NW. L. REV. 191, 217–19 (2001).

12. It should be noted that the cost to the federal government (in terms of foregone revenue) arising from a state government's use of deductible taxes is, of course, borne in part by residents of that state. Moreover, these residents share in the burden of other states' use of deductible taxes. In some sense, therefore, one might observe that there is no aggregate advantage for states to use deductible versus nondeductible taxes. For present purposes, however, this observation is misplaced. What matters here is not whether states come out ahead in the

A second pressure that state and local policymakers face when devising tax policies is the mobility of the tax base. As has long been recognized in the literature on fiscal federalism, subnational governments are constrained in their ability to impose redistributive taxes because taxpayers may simply choose to leave the jurisdiction to avoid the tax.[13] This is the key insight of the familiar Tiebout hypothesis,[14] which holds that under certain extreme assumptions (for example, costless mobility, an infinite number of jurisdictions from which to choose) the provision of local public goods will have efficiency properties similar to a private market. While no one suggests that Tiebout's assumptions represent a strictly accurate portrayal of reality, the Tiebout theory usefully highlights the constraints that state and local public officials face in crafting fiscal policies. Thus, for example, with respect to high-income taxpayers who are mobile and can choose among several different jurisdictions, state and local governments face pressure not to let tax levels deviate too significantly from the value of benefits received.[15] In effect, by threat of exit, mobile taxpayers can demand price-like "benefit taxes" and thereby avoid becoming the subjects of state or local efforts to redistribute income. One normative prescription flowing from this analysis is that, in a federal system of governments, redistributive policies should be undertaken exclusively by the most central level of government.[16]

The purpose of this Article is to highlight and critically examine the ways in which the current federal deduction for state and local taxes may encourage the adoption of suboptimal redistributive state and local tax structures. As presently designed, the federal deduction for state and local taxes encourages subnational redistribution in a variety of ways. First, state and local taxes are deductible only for taxpayers who itemize their deductions—a population that consists primarily of high-income, high-wealth taxpayers. By contrast, taxpayers who claim the standard deduction—which in 2001 consisted of 66 percent of all taxpayers—derive

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aggregate, but rather the fact that in deciding among different tax instruments, states face differential marginal cost because some taxes are deductible while others are not.

13. Charles E. McLure, *Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?*, 39 NAT'L TAX J. 341, 342 (citing an example involving a property tax on the fishing fleet docked in Gloucester, Massachusetts to fund school lunches).

14. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 419–23 (1956).

15. Michael I. Luger, *Federal Tax Reform and the Interjurisdictional Mobility Impulse*, 23 J. URB. ECON. 235, 236 (1988) ("In the past, selective out-migration of higher income households caused serious fiscal problems for high-tax jurisdictions.").

16. *See* discussion *infra* at Introduction subpart A.

no federal tax benefit from the payment of state and local taxes.[17] Second, because of changes in the law made in the Tax Reform Act of 1986, deductions are no longer allowed for sales taxes. Thus, current law favors income and property taxes, which tend to have a more progressive distributional effect, over sales taxes, which tend to be more regressive.[18] Third, because of the progressive marginal rate structure of the federal income tax, the dollar value of the deduction for state and local taxes rises with the taxpayer's income. Thus, a deduction for state and local taxes is more valuable to a taxpayer with a higher federal taxable income than a taxpayer with a lower taxable income.

Together, these features of the deduction for state and local taxes give state and local governments an incentive to raise revenues through property and income taxes on high-income taxpayers—an outcome that is exactly contrary to the central normative prescription of fiscal federalism regarding the assignment of redistributive policies to the national government. Working from this insight, this Article represents an attempt to make the normative case against the deduction for state and local taxes as currently designed. The principal argument is that the state and local tax deduction should be "distributionally neutral" or, more precisely, the amount of the SALT (state and local taxes) subsidy flowing to residents of any state or local government should not vary based upon the distributional properties of that government's tax burden.[19]

The easiest and most obvious means of implementing this principle would be to repeal the deduction for state and local taxes. Thus, the

17. Of course one might argue that the standard deduction incorporates some hypothetical state or local tax payment. The point here, however, is a different one. That is, taxpayers who claim the standard deduction derive no marginal federal tax benefit from an increase in their state and local tax payments. This point is discussed in further detail *infra* Part III.A.

18. There is some debate regarding the distributional properties of the state sales tax. At least one author has found that from a lifetime perspective the sales tax is "in fact equally progressive as the income tax." *See* Gilbert E. Metcalf, *The Lifetime Incidence of State and Local Taxes: Measuring Changes During the 1980s*, *in* TAX PROGRESSIVITY AND INCOME INEQUALITY 59, 60 (Joel Slemrod ed., 1994).

19. Throughout the Article, I will use the term "subsidy" to describe the federal income tax deduction for state and local taxes. Note, however, that there is considerable debate among academics regarding whether this deduction is properly characterized as a "subsidy" or "tax expenditure." For a recent treatment of the issues raised in the tax expenditure debate, see Leonard E. Burman, *Is the Tax Expenditure Concept Still Relevant?*, 56 NAT'L TAX J. 613 (2003). Importantly, the arguments presented here regarding the incentive effects of the deduction for state and local taxes do not depend upon a characterization of the deduction as a "tax expenditure." That is, even if one believes that a deduction for state and local taxes is conceptually appropriate in order to implement a "pure" income tax, one should still be concerned with the incentive effects discussed here.

analysis presented here provides an additional argument in support of repealing the SALT deduction not previously recognized in the literature. However, there may be legitimate tax policy reasons for retaining a federal tax subsidy for state and local taxes. As Feldstein and Metcalf have argued, for example, the SALT deduction may be a cost-effective means of stimulating additional spending by state and local governments, which may be artificially low due to the effects of interjurisdictional competition.[20] Therefore, this Article considers alternative methods of subsidizing state and local taxes that satisfy the principle of distributional neutrality. One such possibility is a refundable federal tax credit, equal to some percentage of the jurisdiction's total tax revenues, to be divided among taxpayers of the taxing jurisdiction on a per capita basis. It is estimated that such a change in the law would alter the distribution of the federal income tax burden, making it more progressive. But by removing the current incentives for state and local governments to impose a greater tax burden on high-income, high-wealth taxpayers, this change would also likely result in less progressive state and local tax systems. I argue that this outcome—a more progressive federal tax structure and a less progressive state and local tax structure—is more consistent with basic principles of fiscal federalism than current law.

This Article is organized as follows: Part I begins with an overview of the debate over the deduction for state and local taxes and argues that the question of proper "income measurement" is unlikely to produce meaningful guidance for lawmakers in deciding whether to retain or repeal the deduction. The remainder of the Article makes the case for designing the SALT subsidy according to the normative principles of fiscal federalism. Part II offers a brief discussion of the Tiebout hypothesis and then reviews the public finance literature concerning which level of government should redistribute wealth. Part III discusses the features of the current deduction for state and local taxes that encourage subnational governments to increase the progressivity of their tax systems. Part III also reviews a handful of empirical studies which have generally found that state and local governments do in fact alter the distribution of their tax burdens in response to changes in the relative tax prices of their residents. Part IV makes the case for a "distributionally neutral" subsidy for state and local taxes and discusses some concerns that might be raised by such a change in policy. Finally, the conclusion offers an overview of the argument and some summary comments.

20. Feldstein & Metcalf, *supra* note 8.

I. THE DEBATE OVER THE DEDUCTION FOR STATE AND LOCAL TAXES

One of the principal features of American fiscal federalism is the federal income tax deduction allowed for taxes paid to state and local governments.[21] The total cost for this deduction, measured in terms of forgone revenues, is estimated to be $73 billion for fiscal year 2003.[22] This is more than twice the amount currently expended on the earned income tax credit,[23] the nation's largest income-transfer program, and three times the annual budgetary outlay for the Department of Justice.[24] Given these figures, it is no surprise that controversy over the deduction for state and local taxes has figured prominently in tax policy debates over the past two decades.[25] In this part, I briefly examine the history of the deduction for state and local taxes and provide a summary overview of the debate regarding whether to repeal or retain the deduction.

A. Public Consumption Under an Ideal Income Tax

The deduction for state and local taxes first became part of the income tax laws of the United States in the mid-nineteenth century,[26] and has since undergone various modifications. Although Congress has periodically eliminated deductions for different types of taxes, a wide variety of legislative rationales has sustained the deduction over time.[27] To

21. *See* 26 U.S.C. § 164.

22. This figure is derived by adding the amounts of the deduction for real property taxes ($22.1 billion) and the deduction for income and personal property taxes ($50.9 billion). *See* JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003–2007, at 20, 27 (2002).

23. 26 U.S.C. § 32.

24. *See* OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT: MID-SESSION REVIEW, FISCAL YEAR 2002 at 39 (2001), tbl. 14 (Outlays by Agency).

25. For a general discussion of the "tax expenditure" concept and the federal tax expenditure budget, see JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2001–2005, at 2–14 (2001).

26. *See* William J. Turnier, *Evaluating Personal Deductions in an Income Tax—The Ideal*, 66 CORNELL L. REV. 262, 264–65 (1981) ("The Revenue Act of 1864, as amended in 1865, provided the first personal deduction for taxes.").

27. *See id.* at 264–69; JB McCombs, *Refining the Itemized Deduction for Home Property Tax Payments*, 44 VAND. L. REV. 317, 323–24 (1991) (summarizing changes in state and local tax deductions from 1913 to 1986). Academic debate over the deduction has ebbed and flowed; the real flood of analysis began in the mid-1980s, when public finance economists responded to the proposal by the Reagan Administration to eliminate all deductions for state and local taxes. The proposal was first put forth by the Treasury Department in 1984. *See* U.S. DEP'T OF TREASURY,

understand the traditional justification for a deduction for state and local taxes in an income tax, it is first necessary to give some substance to the concept of an "income tax" and exactly what such a tax should be designed to reach. It is hard to do justice to these complex issues in a summary format, but it will be useful to lay out a basic framework in order to set the stage for the ensuing analysis.[28]

Tax scholars interested in pursuing a "normative" or "ideal" income tax typically begin with the "Haig-Simons" conception of income,[29] which is generally defined to include the market value of the taxpayer's rights exercised in consumption plus (or minus) any change in the taxpayer's net wealth during the relevant accounting period.[30] As this formulation reveals, a tax on income may be viewed as consisting of two separate taxes—a tax on consumption and a tax on the net yield (positive or negative) to capital. For present purposes, the most relevant insight is that a broad-based normative income tax (or consumption tax) should arguably reach *all* types of consumption—whether private or public.[31] That is, the fact that consumption is accomplished through the means of *public* taxing and spending decisions does not detract from the fact that it is consumption and thus appropriately included in the tax base. After all, the argument goes, a family that pays property taxes and sends its kids to public schools cannot

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TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH, Vol. 1, at 78, Vol. 2 at 62 [hereinafter TREASURY I]. The public finance literature on the elimination of the deduction is massive. The following list is by no means exhaustive: George F. Break, *Tax Competition and Federal Tax Deductibility*, 39 NAT'L TAX J. 349 (1986); Feldstein & Metcalf, *supra* note 8; Henry W. Herzog, Jr. & Alan M. Schlottmann, *State and Local Tax Deductibility and Metropolitan Migration*, 39 NAT'L TAX J. 189 (1986); Douglas Holtz-Eakin & Harvey Rosen, *Federal Deductibility and Local Property Tax Rates*, 27 J. URB. ECON. 269 (1990); Luger, *supra* note 15, at 235; Nonna A. Noto & Dennis Zimmerman, *Limiting State-Local Tax Deductibility: Effects Among the States*, 37 NAT'L TAX J. 539 (1984); Janet G. Stotsky, *The Effect of the Elimination of Sales Tax Deductibility on State Fiscal Decisions*, 18 PUB. FIN. Q. 25 (1990).

28. For a comprehensive analysis, see HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 139, 139–54 (1921). A useful summary of the Haig-Simons theory and its history in tax scholarship can be found in Yoshihiro Masui & Minoru Nakazato, *Personal Income Taxation*, *in* ENCYCLOPEDIA OF LAW & ECONOMICS (Boudewijn Bouckaert & Gerrit De Geest eds., 2000), *available at* http://encyclo.findlaw.com/.

29. For a critical analysis of arguments for a "comprehensive" income tax, see Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

30. For an interesting discussion of the Haig-Simons view in the context of local government services, see Charles R. Hulten & Robert M. Schwab, *A Haig-Simons-Tiebout Comprehensive Income Tax*, 44 NAT'L TAX J. 67 (1991).

31. For an alternative view, see William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 361 (1972) (developing the concept of "private, preclusive consumption").

be said to have "consumed" any less than a family that pays tuition to send its kids to private schools. In both instances, the family has "exercised rights in consumption," and thus has "income" in the Haig-Simons sense.[32]

Several arguments have been offered in response to the contention that state and local taxes should be treated as "ordinary consumption" under the Haig-Simons theory. For example, it is sometimes noted that taxes are "involuntary" and that the consumption procured by the payment of taxes should therefore be treated differently than private market consumption.[33] In other words, the argument goes, public goods may be viewed as a type of "forced consumption." It is easy enough to see the intuitive appeal of this argument. The elderly widow with no school-age children may be taxed to pay for local public schools, but few would argue that her payment generates direct consumption benefits. Still, various counterarguments cut against considering tax-financed public goods as a type of forced consumption that should be excluded from the Haig-Simons tax base.

First, the amount and type of public goods are determined by a democratic process in which the taxpayer has an opportunity to participate. The taxpayer's choice may be diluted by this process, but it is not completely eliminated. Therefore, in the same sense that, say, country club dues are not made deductible because the payor does not have ultimate control over the disposition of the funds, it may be argued that state or local tax payments do not represent strictly involuntary consumption.

Second, because taxpayers may choose among several state and local governments, they cannot be said to have had taxes "forced" upon them

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32. SIMONS, *supra* note 28, at 50. For an alternative view based upon a detailed examination of the nature of public goods and services financed with state and local taxes, see Zelinsky, *supra* note 8. Zelinsky argues that "the concept of income is best understood by reference to its disparity-assessing function. . . ." *Id.* at 11. Thus, in order to appropriately measure income, we must ask whether the public expenditure at issue is one that (i) restores the taxpayer to some minimally acceptable standard of living (not income); (ii) benefits a discrete segment of the population (not income); or (iii) generates benefits for the general community (income). Using this analytical framework, Zelinsky argues for a "partial, functional deductibility" approach for state and local taxes. *Id.* at 10. Under Zelinsky's approach, whether a tax should be deductible depends upon the nature of the services the tax finances. *Id.* Zelinsky states:

> In my estimation, the most appropriate formulation is that the [income] tax ought to assess economic disparities above the socially accepted minimum standard of living when such disparities yield a particularized benefit for the individual taxpayer or when such disparities yield a generalized benefit for the taxpayer as great as received by anyone else.

Id.

33. *See, e.g.*, Billman & Cunningham, *supra* note 8, at 1119 ("The payment of state and local taxes . . . involves only a limited degree of voluntariness.").

without their consent.[34] After all, the choice was theirs to reside in the jurisdiction—by selecting a residence the taxpayer has signed on to the particular mix of taxes and services offered by that state or local government. In other words, choice of residence operates as a type of constructive consent to the taxes imposed by that community. In response to this consent theory, one might argue that an individual's choice of state or locality in which to reside is not typically made based upon the particular tax-service package offered.[35] Individuals typically determine their residence based on a variety of non-tax factors, including job opportunities, family ties, and commuting distance. Thus, to suggest that an individual "shopped" among several tax-service packages and then "chose" the one that most closely matched her preferences admittedly has an air of unreality about it.

Yet even if the tax-service package offered by state and local governments deviates from the taxpayer's preferences, a deduction may still not be warranted under a "Haig-Simons" conception of income. In the state and local setting, government services are, in effect, bundled with private amenities (most notably housing) and "sold" together. In the most common case, the taxpayer chooses a place to live and enters into a private market transaction, either renting or owning a home, which carries with it certain state and local government benefits (in the form of governmental services) and obligations (in the form of taxes). To the extent that the tax-service package of a taxpayer's chosen jurisdiction does not match her preferences, the taxpayer has not necessarily suffered a loss in the Haig-Simons sense.[36] Rather, she has decided to tolerate a suboptimal tax-service

34. U.S. DEP'T OF TREASURY, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985) (hereinafter Treasury II).

35. Billman & Cunningham, *supra* note 8, at 1119 ("such a move is a very complicated matter in a world in which taxpayers clearly do not enjoy perfect mobility.").

36. As an example, consider a taxpayer, Dr. Seuss, who is considering whether to buy two products, Thing 1 and Thing 2, which can only be purchased together in a bundle. Assume that Seuss's reservation price for Thing 1 by itself is $100, but that the bundle is being offered on the market for $90. Seuss will purchase the bundle because the total price is less than his reservation price for Thing 1. We can now ask the tax question: Should Seuss be allowed a deduction for that portion of the $90 purchase price that is allocable to the cost of Thing 2? There are at least two reasons why a deduction should not be allowed.

First, it seems clear enough that Seuss has not experienced any sort of loss from the transaction as a whole. Given that his reservation price for Thing 1 is $100 and that he paid $90 for Thing 1 and Thing 2 together, it would seem that, if anything, Seuss is ahead by *at least* $10—even more if Seuss places any positive value on Thing 2. Thus, allowing a deduction of any amount would seem to overcompensate Seuss. Second, it is not clear that the tax system should ever allow deductions for loss of consumer surplus. If Seuss were able to buy Thing 1 by itself for $100 but then later finds out that he could have purchased it elsewhere for $80, should he be

package in order to gain access to her preferred bundle of private amenities. In the language of economics, she has merely surrendered some portion of the consumer surplus attributable to her consumption of those private goods. The Haig-Simons measure of income does not normally recognize consumer surplus (or its loss); it is not clear why a different approach should apply to the consumption of local public goods.

In any event, whether public consumption is viewed as "voluntary" or "forced" consumption, there is still the issue of the extent to which any given taxpayer's consumption of public goods matches the amount that she pays in taxes. That is, even if we conclude that the consumption of state and local public goods is in some relevant sense a type of "forced" consumption, our conclusions regarding whether to allow a deduction are still likely to be guided, at least in part, by the relationship between the amount of taxes paid and the value of benefits received. It is to that question that I now turn.

B. The Relationship Between Taxes Paid and Benefits Received

The relationship between state and local taxes paid and benefits received was most recently explored by Louis Kaplow in a 1996 article on the subject.[37] Kaplow develops a basic framework for considering the deduction for state and local taxes, using two "benchmark cases" to highlight the circumstances in which deductibility is appropriate or inappropriate from an income measurement perspective. In the first, taxes paid to the jurisdiction are presumed to be equal to the amount of benefits received. In the second, taxes are unrelated to benefits received.[38]

1. Deductibility Where Taxes Equal Benefits

According to Kaplow, most commentators would agree that in the first benchmark case (taxes equal benefits) a deduction would not be appropriate.[39] Here the argument seems explicitly grounded in a Haig-Simons conception of income: "if one wishes to tax income—equal to

entitled to deduct the $20 difference? More broadly, must the tax system keep a constant accounting of how much consumer surplus a taxpayer's transactions *could have* generated? In effect, allowing such a deduction would provide the taxpayer with insurance for bad deals or buyer's remorse. Neither the actual tax system nor the Haig-Simons approach allows deductions for the loss of consumer surplus for all the obvious reasons.

37. *See* Kaplow, *supra* note 8.

38. *See id.* at 420–30.

39. *Id.* at 422.

consumption plus accumulation—one must allow no deduction for consumption expenditures of any kind."[40]

Kaplow's statement here seems to reflect a particularly broad interpretation of the Haig-Simons theory. In fact, there may be instances where, because of the nature of the taxpayer's consumption, it would not be appropriate to include a particular expense in the taxpayer's Haig-Simons tax base. Consider, for example, an individual who pays $2000 in state taxes and receives $2000 of state-funded medical care. Allowing a deduction in this case might be appropriate because of the nature of the consumption involved. If, as Bill Andrews has suggested, personal consumption should be used to "provide an index of relative material well-being on the basis of which to distribute tax burdens,"[41] then the inclusion of a particular expense in the tax base should turn on whether it enhances the taxpayer's material well-being (in which case we include it) or whether it merely restores the taxpayer to a standard level of well-being (in which case we exclude it).[42]

Whatever merit these alternative views may have, current law reflects Kaplow's basic point in a variety of ways: Where state or local taxes are linked in some concrete way to a specific consumption benefit, SALT deductions are generally denied. For example, the Internal Revenue Code presently disallows the deduction for "taxes assessed against local benefits of a kind tending to increase the value of the property assessed."[43] In addition, user charges, such as university tuition, hunting license fees, etc . . . , have always been nondeductible on the grounds that the taxpayer is receiving something equivalent in value to the amount he has surrendered to the government.[44] Finally, the deduction for gasoline taxes—which many view as a type of user charge—was eliminated in 1978.[45] In short, there appears to be a broad consensus among academics and policymakers that when government charges either match or are closely related to the provision of specific services, a deduction for those amounts is not warranted.

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40. *Id.*
41. Andrews, *supra* note 31, at 335.
42. *Id.*
43. *See* I.R.C. § 164(c).
44. Boris Bittker, *Income Tax Deductions for Personal Expenditures*, 16 J. LAW & ECON. 193, 200 (citing I.T. 3511, 1941–1942 Cum. Bull. 90).
45. Pub. L. No. 95-600, Section 111(a), 92 Stat. 2763, 2777 (1978). The legislative history of the 1978 Tax Reform Act indicates that Congress repealed the deduction for nonbusiness gasoline taxes in part because the tax is regarded as a "user charge." *See* S. Rep. No. 1263, 95th Cong., 2d Sess. 57 (1978) ("The bill repeals the deduction for nonbusiness State and local gasoline taxes in order to . . take account of the fact that these taxes really represent user charges for the use of highways.").

2. Deductibility Where Taxes Are Unrelated to Benefits

The more difficult questions relate to Kaplow's second benchmark case—where taxes paid do not equal benefits received.[46] In these situations, theorists committed to a Haig-Simons normative income tax must confront two separate questions. First, with respect to those taxpayers for whom taxes exceed benefits, there is the question of whether a deduction should be allowed to the extent of that excess.[47] Here the intuition is that the taxpayer has suffered a net loss from the exchange and that his taxable income should therefore be reduced to reflect his diminished ability to pay.[48] Second, with respect to taxpayers whose benefits exceed the amount of taxes paid, it may be appropriate to require income to be recognized in an amount equal to the excess to reflect the taxpayer's increased ability to pay.[49]

To determine the appropriate amount of the deduction or inclusion, as the case may be, it would be necessary to measure both taxes paid and benefits received for each individual taxpayer. One approach suggested by Kaplow would be to allow each taxpayer a deduction equal to the excess of T_i-T (or an income inclusion where T_i-T < 0), where T_i represents the amount of taxes paid by the individual and T represents the taxpayer's per capita share of total taxes paid in the community.[50] Thus, as Kaplow explains, in a community with only two individuals, Resident 1 (who pays $4000 in taxes) and Resident 2 (who pays $2000), T would be equal to $3000. Consequently, Resident 1 would be entitled to a $1000 deduction, while Resident 2 would be required to include $1000 in income. By contrast, if both individuals paid $3000 in taxes, neither a deduction nor an inclusion would be appropriate.[51]

46. *See* Kaplow, *supra* note 8, at 423–30.

47. Various commentators have expressed the view that deductibility is warranted in this situation. *See id.* at 423 n.27 (citing numerous sources).

48. *Id.* at 424–25 ("Those who pay taxes have lower economic well-being to the extent of their payments, so a deduction is necessary if ability to pay is to be measured properly.").

49. *Id.* at 425 (noting that under an ability-to-pay theory, residents who receive benefits in excess taxes "should be required to include the difference in income").

50. *Id.* at 426.

51. Recognizing the possibility that any given taxpayer's benefits may not be equal to her per capita share of total taxes, Kaplow suggests that it may be appropriate to reduce the amount of allowable deductions and inclusions (where benefits are skewed in favor of those who pay more than a per capita share) or to increase the amount of allowable deductions and inclusions (where benefits are skewed in favor of those who pay less than a per capita share). *Id.* at 490–92. Thus, ultimately Kaplow's second benchmark case depends upon the precise distribution of benefits and taxes within communities, a point on which, Kaplow notes, "[r]eliable empirical evidence is difficult to obtain." *Id.* at 427.

Assuming that the objective is a proper measurement of "income," Kaplow's suggested approach seems to fall short. In many cases, an individual taxpayer's T_i will bear little or no relationship to the amount of that taxpayer's *actual* consumption objectively measured. In the example from the previous paragraph, there is no reason to assume that Residents 1 and 2 will split the value of public services equally. In fact, casual empirical observation suggests residents of a community often consume quite different shares of public services. For example, parents with school-age children are likely to consume more of a school district's services than will an elderly widow. Low-income households may benefit more from state-provided health insurance than do high-income households. While there may be some legal and political pressures preventing a severely skewed distribution of public services,[52] it seems problematic to simply assume that all residents will consume an equal share of services.

Second, even if we knew with certainty that residents consumed equal shares of state and local public services, it is still not clear that the per capita figure is the appropriate figure to use in determining the taxpayer's Haig-Simons income. Recall that the Haig-Simons definition of income includes the market value of all consumption. In private markets, the aggregate amount of an individual's consumption will equal the quantity consumed multiplied by the market price. For example, a taxpayer has $29.98 of Haig-Simons income when she purchases two Coldplay CDs for $14.99 each. In these market transactions, we know with certainty that the consumer derived *at least* as much utility as she was willing to spend on those private goods.[53] With regard to public goods, however, we have no such assurance, because it is possible that the consumer may actually have consumed less if she had been given that choice. Thus, the Haig-Simons conception of income, already imperfect in conceptualizing the value of

52. *See* Stark, *City Welfare*, *supra* note __, at n.18 (describing legal and political pressures that "make it much harder for a taxpayer who has paid more than average via the property tax to be compensated by a greater receipt of local services. In effect, these equity rules help cement the redistribution generated by property taxation.")

53. The phrase "at least" is used here because the taxpayer may experience more subjective utility in the form of the "consumer surplus" (that is, the excess of her reservation price over the market price). Indeed, this is one of the principal criticisms of the Haig-Simons conception of income—that is, that it does not accurately capture the full measure of economic utility that an individual experiences from consumption. *See* Jeff Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 STAN. L. REV. 1023, 1094 n.157 (1985); *see also* RICHARD W. TRESCH, PUBLIC FINANCE: A NORMATIVE APPROACH 268 (1981) (criticizing the Haig-Simons income measure as "not a very good surrogate for utility" and noting that "[o]nly if people have identical tastes, equal abilities, and equal opportunities in the marketplace is income (or consumption) a perfect surrogate for utility").

consumption in private markets because of its failure to include consumer surplus, is even more imperfect in the context of public goods and services because it overlooks the possibility of "consumer deficit."

Finally, there is the more fundamental question of why we should want to reform the tax system to make it more consistent with the Haig-Simons "ideal" in the first place. It seems clear enough that Congress has not chosen that path—no one has ever suggested that the Internal Revenue Code has ever looked anything like the theoretical Haig-Simons model.[54] Moreover, for as long as the Haig-Simons idea has been in existence, academic theorists have been debating whether it serves as a useful guidepost in formulating concrete tax-reform proposals. If there is no political or academic consensus that the Haig-Simons ideal is what we should be aiming for in reforming our tax system, then it is not clear why Haig-Simons principles should play any role in the debate over the deduction for state and local taxes.[55]

C. Legislative Activity Concerning the SALT Deduction

Not surprisingly, political activities surrounding the deduction for state and local taxes have largely bypassed the theoretical debates described above. Congressional interest in the SALT deduction reached its zenith in 1985, when the Reagan Treasury Department proposed repealing the deduction completely.[56] This recommendation triggered a substantial popular and academic reaction. Recognizing the threat this proposal represented for their budgets, states and localities responded in full force. One New Jersey mayor termed the proposal "an absolute disaster," and (then) Governor of New York Mario Cuomo declared the elimination of the deduction to be "a regional death sentence."[57] Their concern sprang from a recognition that eliminating the deduction would raise the tax price of public goods for itemizing taxpayers, thereby reducing their demand for state and local government services and "impairing cities' ability to provide public services."[58] In response to these concerns, Congress in 1986 repealed

54. Douglas A. Kahn & Jeffrey S. Lehman, *Tax Expenditure Budgets: A Critical View*, 54 TAX NOTES 1661, 1662 (1992).

55. Bittker, *supra* note 29, at 925 (arguing that "a neutral, scientific measure of income is a mirage").

56. TREASURY I, *supra* note 27.

57. Luger, *supra* note 15, at 235.

58. *Id*. (quoting U.S. Conference of Mayors); *see also* Julie Roin, *The Consequences of Undoing the Federal Income Tax*, 70 U. CHI. L. REV. 319, 332 (2003) ("A commonly expressed fear

the deduction for sales taxes, but retained the deduction for state and local income and property taxes.[59]

Section 164 has not been amended since the 1986 Tax Reform Act; however, a separate development with even greater potential significance has crept up on the SALT deduction in recent years. The alternative minimum tax (AMT), first enacted in 1969, does not allow a deduction for state and local taxes.[60] For years, the fact that the AMT disallowed the deduction was only relevant for a small number of taxpayers, as the AMT applied to only a small subset of the super-rich.[61] However, the various parameters used in determining AMT liability (the exemption level, the amounts at which the higher rate applies, etc.) are not indexed for inflation, a fact that inexorably subjects more and more taxpayers to AMT liability over time.[62] In fact, the AMT has become even more of an issue in the past three years, as regular tax rates have been cut by the Bush tax legislation of 2001 and 2003.[63] One recent study suggests that by 2010, up to 33 million taxpayers—one-third of all individual filers—could be subject to the AMT.[64] The implications of the AMT problem for the SALT deduction are potentially significant. As more taxpayers become subject to the AMT, fewer taxpayers will benefit from the SALT deduction. In effect, the AMT is gradually accomplishing what Reagan's Treasury Department

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is that the elimination of the deduction for state and local taxes will reduce subordinate governments' ability to generate tax revenue.").

59. Tax Reform Act of 1986, Pub. L. No. 99-514, § 134, 100 Stat. 2085, 2116 (1986). Interestingly, states have not appreciably reduced their reliance on the retail sales tax in the years following the 1986 Tax Reform Act. For a discussion of this issue, see *infra* Part III.A.3.

60. 26 U.S.C. § 56(b)(1)(A)(ii). For a useful discussion of the history of the alternative minimum tax, see Leonard E. Burman et al., *The AMT: Out of Control*, TAX POLICY ISSUES AND OPTIONS, Sept. 2002, *available at* http://www.brook.edu/dybdocroot/views/articles/gale/20020918.pdf.

61. Burman et al., *supra* note 60, at 1–2.

62. *Id.* at 2–3 (describing the development of the AMT from a "class tax" to a "mass tax").

63. Not surprisingly, AMT participation rates are highest in the high-income range. IRS data show 16 percent of filers with AGI over $200,000 paying AMT in 2001. That's down from 18 percent in 2000. Data for 2002 and 2003 haven't come out yet but the percentages will jump due to Bush's cuts in the regular income tax. The figures are significantly lower in the $100,000–$200,000 range (only 9 percent). Most projections show the AMT exploding in 2005 because that's the year the newly enlarged AMT exemption amount will sunset, but most people think Congress won't just sit around and let that happen. And if you assume that Congress will do nothing and the AMT will explode, then you also have to assume it will do nothing again in 2011 when the pre-2001 tax code springs back to life and the AMT will once again recede in importance. Leonard E. Burman et al., *The AMT: Projections & Problems*, 100 TAX NOTES 105, 105–117 (2003) (providing projections on the expansion of AMT coverage, given changes enacted in 2001 and 2003 tax legislation).

64. *See* Burman et al., *supra* note 60, at 1.

had proposed in 1985: the outright repeal of the deduction for state and local taxes.[65]

II. FISCAL FEDERALISM AND SUBNATIONAL REDISTRIBUTION

The analysis in Part I above, like much of the existing literature on the deduction for state and local taxes, has focused on the SALT deduction in isolation—without regard to the effects that the deduction might have on the fiscal behavior of state and local governments. Yet these effects are potentially significant. With as much as $73 billion per year at stake, it is difficult to believe that the SALT deduction does not exert a significant influence on both the level and distribution of state and local taxes. Put differently, because of its influence on both federal and state and local tax receipts, the SALT deduction may be viewed as one of the principal regulatory devices within the field of fiscal federalism.

A. The Tiebout Hypothesis

As many authors have noted, the starting point for any discussion of issues relating to fiscal federalism or subnational public finance is the well-known Tiebout hypothesis.[66] Writing in 1956, economist Charles Tiebout

65. Note, however, that simply becoming an AMT taxpayer does not completely negate the value of the SALT deduction. A brief example will illustrate this point. The AMT has a broader base and lower rates than the regular income tax. For simplicity, assume that the regular income tax rate is a flat rate of 35 percent and the AMT rate is a flat rate of 30 percent. Assume further that a taxpayer's base would be $100,000 under the regular tax rules and $120,000 under the AMT. Finally, assume that the only AMT adjustment is that the taxpayer's $20,000 of state and local taxes are nondeductible under the AMT. Under these assumptions, the taxpayer's regular tax owed would be $35,000 ($100,000 x 35 percent) and the AMT would be $36,000 ($120,000 x 30 percent). Because the taxpayer pays the higher of the two figures, he owes $36,000 in federal income tax. The point here is that the taxpayer still "benefits" from the existence of the SALT deduction because without the deduction, his regular income tax liability would have been $42,000 ($120,000 x 35 percent). So the more precise statement would be to say that the AMT reduces the value of the SALT subsidy in an amount equal to Q, where Q = (AMT rate – Regular rate) x Amount of SALT Deduction. In the example above, Q = (35 percent - 30 percent) x $20,000 = $1000. Perhaps more importantly, once a taxpayer is an AMT taxpayer, he derives no additional benefit by increasing his state and local taxes.

66. *See* Tiebout, *supra* note 14; Bruce W. Hamilton, *Property Taxes and the Tiebout Hypothesis: Some Empirical Evidence*, *in* FISCAL ZONING AND LAND USE CONTROLS 13 (Edwin S. Mills & Wallace E. Oates eds., 1975) (describing Tiebout's work as "the most significant article on the theory of state and local public finance"); John D. Donahue, *Tiebout? Or Not Tiebout? The Market Metaphor and America's Devolution Debate*, 11 J. ECON. PERSP., No. 4, 1997, at 73 (describing Tiebout's paper as "among the most-cited publications in economics"). *But see* Bird, *supra* note 6, at 127 (noting that the Tiebout theory is better understood as not falling within the

set out to challenge the idea, traditionally associated with economists Paul Samuelson and Richard Musgrave, that public goods cannot be provided on an efficient basis because of the absence of any effective preference-revelation mechanism.[67] The Tiebout hypothesis posits that, under certain assumptions, *local* public goods may in fact be provided at efficient levels.[68] In the local setting, individuals can shop among multiple jurisdictions, selecting membership in the community that most closely matches their preferences for the appropriate mix of taxes and services. Local political entrepreneurs will compete to attract mobile consumer-taxpayers, offering distinct tax-service packages to suit consumer demand. This combination of mobility and interjurisdictional competition results in a quasi market for public goods—consumer-taxpayers have an incentive to reveal their preferences for the type and amount of public goods by opting into the jurisdiction their choice.

Tiebout recognized, of course, that the assumptions required for his conclusions to be valid were not even "a first approximation at reality."[69] Nevertheless, Tiebout's model demonstrated that two core features of private markets—consumer choice and producer competition—were also evident in the provision of local public goods and thus would exert similar pressures. Thus, the Tiebout hypothesis highlights the parallels between the provision of local public goods and a market for private goods, where consumers shop for those goods which most closely match their preferences.[70] The Tiebout theory has served as both a positive and normative guidepost, spawning an enormous literature in the field of state and local public finance.[71]

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field of fiscal federalism "because it is concerned only with governmental relations at the same jurisdictional level").

67. *See* Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. STAT. 387, 389 (1954). The Samuelsonian perspective may be understood in part as a response to theories of voluntary fiscal exchange from nineteenth-century European economists (for example, Knut Wicksell) who argued that an efficient level of public goods was possible with appropriate voting rules. *See* Knut Wicksell, *A New Principle of Just Taxation*, *in* CLASSICS IN THE THEORY OF PUBLIC FINANCE (Richard A. Musgrave & Alan T. Peacock eds., 1958).

68. Tiebout, *supra* note 14, at 419–23.

69. *Id.* at 421.

70. For a summary discussion, see Kirk Stark & Jonathan Zasloff, *Tiebout and Tax Revolts: Did* Serrano *Really Cause Proposition 13?*, 50 UCLA L. REV. 801 (2003).

71. For a sampling of this literature, see THE ECONOMICS OF FISCAL FEDERALISM AND LOCAL FINANCE (Wallace E. Oates ed., 1998).

B. Which Level of Government Should Redistribute Wealth?

Working from the core insights of the Tiebout hypothesis, public finance economists have traditionally asserted that all redistributive policies should be concentrated at the most centralized level of government.[72] The reasons behind this central canon of fiscal federalism are straightforward. One concern is that redistribution undertaken by state and local governments creates pecuniary incentives for strategic migration. Where state and local governments redistribute wealth, there is a fear that both the rich and the poor will relocate to escape or take advantage of redistribution. From an efficiency perspective, the costs incurred in these movements represent a deadweight loss.[73] Another concern is that relying on subnational governments to redistribute wealth will result in too little redistribution. In effect, redistributive policies undertaken by state or local governments are likely to create spillover benefits for other jurisdictions, causing the redistributing jurisdiction, which is unable to internalize all of the policy's benefits, to provide too little redistribution.[74] These problems may be avoided by centralizing redistributive policies at the highest level of government. This federal assumption of redistributive policies, centralists argue, would not only avoid the pitfalls described above but would also help to foster a more efficient provision of local public goods.

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72. *See, e.g.*, RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 454–55 (1989); WALLACE E. OATES, FISCAL FEDERALISM 8 (1972) ("A unitary form of government is . . . likely to be far more effective in achieving the redistributional objectives of the society than is a governmental organization at the opposite end of the spectrum."); Helen F. Ladd & Fred C. Doolittle, *Which Level of Government Should Assist the Poor?*, 35 NAT'L TAX J. 323 (1982) ("Most economists assert that income redistribution should be a function of the highest possible level of government and therefore urge a greater federal role in public assistance programs for the poor."); Charles C. Brown & Wallace E. Oates, *Assistance to the Poor in a Federal System*, 32 J. PUB. ECON. 307, 328 (1987) ("[T]he analysis in this Article points to a basic source of inefficiency in decentralized systems stemming from the mobility of the poor.").

73. Mark V. Pauly, *Income Redistribution as a Local Public Good*, 2 J. PUB. ECON. 35, 35 (1973) ("If migration is costly, movement itself involves social cost, and the resultant spatial distribution of population may also differ from that compatible with least-social-cost production of goods and services. Since any distribution of income is Pareto optimal, the cost associated with migration represents a dead-weight welfare loss.").

74. Consider the following example from Professor Ellickson: "[I]f Miami fed and clothed a flood of refugees, it would be relieving a problem also of concern to non-Miamians. Whenever such benefit spillovers occur from a city activity, public-finance scholars suggest, a city is likely to carry out too little of that activity." Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519, 1554 (1982).

C. Income Redistribution as a Local Public Good

In 1973, economist Mark Pauly published a paper challenging the centralists' reasoning and arguing that subnational redistribution is not necessarily inconsistent with the Tiebout theory.[75] Pauly's chief contribution was to introduce a spatial component to the principle of "utility interdependence," contending that individuals "value positively income gains by at least some other individuals. . . ."[76] As Pauly explained, when utility interdependence has a spatial dimension, one's appreciation of the income gains of others fluctuates according to those others' geographical proximity. In other words, we are more likely to want to help the neighboring poor than those far away.

According to Pauly, there are two reasons why utility interdependence may have a spatial dimension.[77] First, communities may want income redistribution at least in part because of pure altruism. Because seeing others suffer is likely to give rise to such altruism, poverty which is nearby and actually experienced by taxpayers is likely to trigger a local response. Second, communities may want redistribution in order to help minimize crimes against property and persons. If that is the case, it seems logical to assume that taxpayers are more likely to care more about local crime, or potential crime against themselves or their loved ones, than crime elsewhere. Again, this phenomenon would create pressures for local action. Thus, through a combination of "genuine concern for poverty close at hand with a 'selfish' dislike of its manifestations . . . ,"[78] localities are likely to undertake some level of redistributive outlays. To the extent that people have different demands for such outlays, communities will sort themselves out according to their redistributive preferences. At least some degree of local redistribution can continue without necessarily disrupting the efficiency properties of the Tiebout model.

D. The Ongoing Debate Over Subnational Redistribution

The Pauly theory has had important implications for economic theories of subnational redistribution. Other economists have incorporated

75. *See* Pauly, *supra* note 73.
76. *Id.* at 37.
77. *Id.*
78. *Id.* at 38.

Pauly's assumptions into their economic models,[79] and even those economists who dissent from the Pauly view seem to acknowledge the importance of Pauly's contribution. Moreover, at least some empirical evidence seems to support Pauly's conclusions. Several studies have measured state-by-state variations in welfare benefit levels and, consistent with Pauly's conclusions, this research has provided "substantial evidence that tastes for redistribution vary across jurisdictions."[80] Nonetheless, it appears that few economists have adopted Pauly's assumption of spatially limited altruism as gospel.[81]

The apparent reluctance among economists to see a spatial dimension in utility interdependence has several possible explanations. Despite the cited evidence for variations in jurisdictions' tastes for redistribution, there are still strong factual bases for clinging to the more traditional public finance theory of centralism. Available data continue to suggest that households do relocate according to differentials in levels of income redistribution.[82] Moreover, there seems to be little argument over the evidence of local taxpayers' sensitivity to tax price differentials among communities.[83] Thus, even if there is some locally manifested altruism and concern for crime, these factors are likely outweighed by public officials'

79. *See, e.g.*, James M. Buchanan, *Who Should Distribute What in a Federal System?*, *in* REDISTRIBUTION THROUGH PUBLIC CHOICE 22 (Harold M. Hochman & George E. Peterson eds., 1974).

80. *See* David E. Wildasin, *Income Redistribution in a Common Labor Market*, 81 AM. ECON. REV. 757, 757 n.3 (1991) (citing fact that AFDC benefits in California are five times the level of benefits in Mississippi).

81. *See, e.g.*, MUSGRAVE & MUSGRAVE, *supra* note 72, at 455 (noting that the Pauly assumptions are "tempting" but that they "break down in an important respect").

82. *See, e.g.*, Edward M. Gramlich & Deborah S. Laren, *Migration and Income Redistribution Responsibilities*, 19 J. HUM. RESOURCES 489, 510 (1984) ("Our tentative conclusion is that migration of AFDC beneficiaries does appear to be an important phenomenon, though only in the very long run."); Paul E. Peterson & Mark Rom, *American Federalism, Welfare Policy, and Residential Choices*, 83 AM. POL. SCI. REV. 711, 725 (1989) ("[T]he data do suggest that over time, as people make major decisions as to whether they should move or remain where they are, they take into account the amount of welfare provision a state provides and the extent to which it is increasing.").

83. *See* John Shannon, *Federalism's Invisible Regulator: Interjurisdictional Competition*, *in* COMPETITION AMONG STATE AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM 117, 118–19 (Daphne A. Kenyon & John Kincaid eds., 1991) ("Although liberals and conservatives differ sharply on both the need for and efficacy of interjurisdictional tax competition, they agree on its effects . . . . Both sides believe that competitive taxation can put a damper on the growth of the state and local sector in general and on the adoption of progressive tax policies in particular."); Wallace E. Oates & Robert M. Schwab, *The Allocative and Distributive Implications of Local Fiscal Competition*, *in* COMPETITION AMONG STATE AND LOCAL GOVERNMENTS, *supra*, at 127 ("There can be little doubt that state and local jurisdictions actively compete against one another for jobs, investment, and other assets that promote economic growth.").

fear of attracting welfare recipients, driving away taxpayers, or losing the battle to attract business investment.

III. DEDUCTIBILITY AS A "TAX SYSTEM WITHIN A TAX SYSTEM"

Given the extensive literature on fiscal federalism, subnational redistribution, and the deductibility of state and local taxes, it is somewhat surprising that scholars have yet to address a central question at the intersection of these fields: Should Congress use the deduction for state and local taxes to influence the amount of redistribution undertaken by state and local governments? The lack of attention to this question in the literature on subnational redistribution may be due in part to that literature's general focus on state and local policies—for example, the provision of local welfare assistance—rather than federal policies. As for the literature on deductibility, it is perhaps relevant that incentives for or against redistribution are not a *necessary* feature of the deduction for state and local taxes.[84] Because those incentives arise from the specific manner in which the deduction is implemented, such as the limitation of the deduction to itemizing taxpayers, commentators may not have considered them relevant to the threshold question of deductibility. In his lengthy article on SALT deductibility, for example, Louis Kaplow observes that "[w]hether the deduction should be available only to itemizers is an administrative concern that will not be considered here."[85]

Yet in the context of current U.S. tax policy, these "administrative" details will determine the parameters of who is entitled to the deduction and how much the deduction will be worth. Indeed, these administrative details function as a sort of "tax system within a tax system"—that is, they provide a set of rules governing the amount and allocation of the federal subsidy for state and local taxes. Under this system, certain tax structures are "rewarded" or "subsidized" (and therefore encouraged) while other tax structures are "penalized" or "taxed" (and therefore discouraged). In Subpart A below, I briefly examine this tax system within a tax system by highlighting the design features of the current SALT deduction that determine a taxpayer's subsidy rate for state and local taxes. These include: (1) the limitation of the deduction to itemizers; (2) the impact of the federal progressive rate structure on the value of the deduction; and (3) the nondeductibility of sales taxes. Subpart B then reviews the empirical

84. I explore this point further *infra* Part IV.
85. *See* Kaplow, *supra* note 8, at 415 n.4.

literature looking at the question of whether state and local tax systems are more progressive as a result of the state and local tax deduction. Subpart C addresses the question of whether deductibility-induced redistribution is qualitatively different than other types of subnational redistribution.

A. Determinants of the SALT Subsidy Rate

1. SALT Subsidy Limited to Itemizing Taxpayers

Under current law, the deduction for state and local taxes is available only to those taxpayers who elect to itemize their deductions.[86] It is well known that the vast majority of U.S. households do not itemize their deductions for the federal income tax but rather claim the standard deduction.[87] For the tax year 2001, only 32.9 percent of taxpayers itemized their deductions.[88] By contrast, 66.2 percent of individual filers claimed the standard deduction.[89] The percentage of taxpayers who itemize their deductions has fluctuated over the past five decades, ranging from a low of 19 percent in 1950 to a high of 48 percent in 1970.[90] For the past twenty years, however, the figure has remained fairly stable. For each of the years from 1980 to 2000, roughly one-third of taxpayers itemized their deductions.[91]

These nationwide figures disguise the substantial variation in state and local itemization rates. On a state-by-state basis, itemization rates range from a high of 48 percent in Maryland to a low of 17 percent in South Dakota.[92] Regionally, itemization rates appear to be the highest on the West coast (California, Oregon) and the Eastern seaboard (Maryland, Delaware, New Jersey, Connecticut). Itemization rates are the lowest in the South (Texas, Louisiana, Mississippi) and the North Central plains

86. 26 U.S.C. § 63(e) (election to itemize); 26 U.S.C. § 63(c) (standard deduction). For 2000 tax returns, the standard deductions were $4400 for single filers, $7350 for married couples filing jointly, $6450 for head of household filers, and $3675 for married couples filing separately.

87. Martin A. Sullivan, *The Average Tax Return: $ 25,000 and No Deductions*, 71 TAX NOTES 1409 (1996).

88. *See* IRS Statistics of Income, Table 7: Standard, Itemized, and Total Deductions Reported on Individual Income Tax Returns, Tax Years 1950–2000, *at* http://www.irs.gov/pub/irs-soi/01in07td.xls.

89. *Id.* Together, those who itemize and those who claim the standard deduction account for 99.1 percent of all tax returns filed. The remaining 0.9 percent of returns presumably claim neither the standard deduction nor itemized deductions. *Id.*

90. *See id.*

91. *Id.*

92. For a detailed listing of itemization rates for all fifty states, see Appendix I.

(North Dakota, South Dakota). These differences in itemization rates are largely traceable to differences in income and housing values, which are of course the primary determinants of the two most significant itemized deductions—home mortgage interest and state and local taxes.[93]

Variation is even greater at the local level. Although the IRS does not publish itemization rates for cities, counties or other political subdivisions of states, it is possible to get some sense of the variation by examining itemization rates by zip code.[94] For the tax year 1998, itemization rates by zip code ranged from a low of 0 percent in several zip codes to highs in the 80 percent range. For example, two adjacent zip codes in San Antonio, Texas—98237 and 98207—both had itemization rates of less than 1 percent.[95] By contrast, several zip codes in Manhattan had itemization rates in excess of 60 percent,[96] the highest being zip code 10020, home to the world famous Rockefeller Center, where 84 percent of individual federal income tax returns featured itemized deductions.[97] Although it is always difficult to generalize, one would assume that itemization rates would be highest in high-income homogeneous municipalities and lowest in low-income homogeneous communities, whereas itemization rates in larger, income-diverse jurisdictions (for example, large urban areas) would fall somewhere between these two extremes.

This spatial heterogeneity in itemization rates suggests that there is wide variation in the distribution of the SALT subsidy among state and local governments. In addition, where there is substantial heterogeneity within a single taxing jurisdiction, it would be expected that the itemizing population would bear a larger portion of the local tax burden. In effect, nonitemizers face a federal subsidy rate of 0 percent (that is, payment of state and local taxes generates no additional marginal benefit for them),

93. IRS zip code level data for 1998 show a very strong simple correlation (r = .803) between a zip code's median household income and the percentage of individual income tax returns that were itemized. The correlation between median housing value and percentage itemizing is also strong (r = .648).

94. *See* IRS, Individual Tax Statistics - Zip Code Data, *at* http://www.irs.gov/taxstats/article/0,,id=96947,00.html.

95. More specifically, there were 19,265 returns filed in zip code 78207, of which 197 were itemized. In zip code 78237, there were 15,181 returns filed, of which 150 were itemized.

96. These include the following Manhattan zip codes: 10004 (73 percent), 10005 (69 percent), 10280 (72 percent), 10017 (62 percent), 10021 (64 percent), 10022 (68 percent), and 10023 (62 percent).

97. In zip code 10020, there were a total of 870 individual federal income tax returns filed, of which 730 were itemized. It appears that this zip code is assigned exclusively to Rockefeller Center. I was unable to determine who, if anyone, actually resides in Rockefeller Center. Although Form 1040 asks the filer to indicate his or her "home" address, it is possible that these data are based upon individuals who filed federal income tax returns using their work addresses.

while itemizers face a federal subsidy rate equal to their federal marginal tax rate. The message to state and local policymakers is clear: A tax system that burdens federal itemizers more than nonitemizers will enjoy the largest possible federal subsidy.

2. SALT Subsidy Rate Rises With Taxable Income

In addition to being limited to itemizers, the dollar value of the SALT subsidy rises with the taxpayer's income. This is a familiar effect of any deduction allowed in the calculation of an income tax base where the tax rates applied to that base are progressive—that is, where marginal rates rise with income. Thus, for example, a high-income itemizer whose last dollar would be taxed at a marginal rate of 40 percent would face a 40 percent subsidy rate, while a low- or middle-income itemizer whose last dollar would be taxed at a 20 percent rate would face a subsidy rate of half that amount.[98]

Tax commentators have frequently objected to this feature of federal tax deductions, especially where the deduction under consideration is most appropriately considered a subsidy or "tax expenditure."[99] In distributing federal dollars, it is not clear why the government should offer a higher subsidy rate to high-income earners as compared to low-income earners.[100] Indeed, the late Nobel prize winning economist William Vickrey once attributed this feature of the U.S. tax system to "plutocratic bias."[101] Whatever objections one might have to this method of subsidizing taxpayer activities, the incentives it creates seem clear: Because the value of the deduction for state and local taxes rises with income, the federal subsidy is

98. *See* MUSGRAVE & MUSGRAVE, *supra* note 72, at 346 (providing an example in the case of charitable contributions). Note, however, that taxpayers who are subject to the alternative minimum tax face a subsidy rate of zero because payment of additional state and local taxes will not reduce their federal income tax liability.

99. *See* WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 131 (1947). Break and Pechman seem to endorse the effect, but only where the deduction is justified as "an appropriate refinement of income in judging relative tax liabilities." *See* GEORGE F. BREAK & JOSEPH A. PECHMAN, FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM? (1975). As Richard and Peggy Musgrave once commented in the context of charitable contributions, "a philosopher-economist might observe that the opportunity cost of virtue falls as one moves up the income scale." MUSGRAVE & MUSGRAVE, *supra* note 72, at 346. *See also* Susann Loeb & Miguel Socias, *Federal Contributions to High-Income School Districts: The Use of Tax Deductions for Funding K–12 Education*, 23 ECON. EDUC. REV. 85, 86 (2004) (describing effect of variable subsidy rates in the context of state and local taxes used to pay for education).

100. One possibility for the different subsidy rates is that high-and low-earners have a differential responsiveness to the subsidy. With regard to a charitable contribution, for example, one might argue that a differential subsidy rate is appropriate because high-income taxpayers are more likely to increase their giving in response to a subsidy than low-income taxpayers.

101. *See* VICKREY, *supra* note 99, at 353, 366.

maximized by shifting the tax burden to those with the highest federal taxable income.

3. SALT Subsidy Depends on Type of Taxes

Finally, the subsidy rate for state and local taxes depends upon the type of state or local tax paid. As noted above, the Tax Reform Act of 1986 repealed the deduction for state and local sales taxes, while retaining the deduction for state and local income and property taxes.[102] Perhaps the most obvious distinction among these three taxes is that the retail sales tax is widely considered to be regressive, while property and income taxes are probably better described as "ability to pay" taxes.[103] Consequently, to the extent that state or local governments favor deductible taxes over non-deductible taxes, one predictable effect of the 1986 amendments would be a shift away from sales taxes to income and property taxes—that is, a shift away from a mostly regressive tax to taxes more consistent with notions of ability to pay.

Surprisingly, it does not appear that states reduced their reliance on the sales tax in response to the 1986 amendments.[104] If anything, state reliance on sales taxes has *increased* in the years following the repeal of the deduction for sales taxes.[105] What explains this paradox? One possibility is that secular trends in the composition of the state tax base are driving the continued reliance on sales taxes. During the late 1970s and early 1980s, unrelated developments limited the extent to which state and local governments could turn to property and income taxes to replace sales taxes. First, popular initiatives in several states limited the property tax.[106] In California, for example, the famous Howard Jarvis initiative Proposition 13 pushed property tax assessments back to 1975–1976 levels and capped the

102. 26 U.S.C. § 164 (2004).

103. *See* MUSGRAVE & MUSGRAVE, *supra* note 72, at 403 ("Imposed as a personal tax, seeking to meet the taxpayer's ability to pay, the income tax was ranked highly in equity terms. The same cannot be said for sales and excise taxes. Imposed in an imperial fashion, it makes no such allowance for ability to pay."). *But see* Metcalf, *supra* note 18.

104. *See* Gilbert E. Metcalf, *Tax Exporting, Federal Deductibility, and State Tax Structure*, 12 J. POL'Y ANALYSIS & MGMT. 109, 111 (1993) (noting that "there does not appear to be any perceptible movement away from the use of sales taxation").

105. Robert D. Ebel, *Comment on "Tax Exporting, Federal Deductibility, and State Tax Structure"*, 12 J. POL'Y ANALYSIS & MGMT. 127 (1993) ("[D]uring the past five years [that is, 1988–1993], 25 states increased their general sales tax rates, and there was a general trend toward expansion of the sales tax base.").

106. *See* ARTHUR O'SULLIVAN ET AL., PROPERTY TAXES AND TAX REVOLTS: THE LEGACY OF PROPOSITION 13 (1995).

property tax rate at 1 percent.[107] Second, several states followed the federal government's lead in the early 1980s of indexing income tax rates for inflation.[108] This change had the effect of eliminating the automatic revenue increases that resulted from inflation prior to the adoption of indexed tax rates. To shift from sales to income taxes, therefore, would have required explicit increases in tax rates, which is always a politically difficult proposition.

Perhaps more relevant to the present discussion is the so-called "incomplete deductibility" theory.[109] According to this explanation, the deduction for sales taxes prior to 1986 was so incomplete that its repeal had little or no effect on the level of sales taxes collected by state governments. The deduction for sales taxes was "incomplete" for a number of reasons. First, only itemizers were entitled to claim the deduction; those who claimed the standard deduction were not entitled to deduct their sales taxes. Second, the method by which itemizers calculated the amount of the deduction often understated the amount of sales taxes actually paid. Because retail sales taxes are collected on a transaction-by-transaction basis, it is administratively burdensome for taxpayers to keep a running tab of how much they have paid in sales taxes over the course of the year. Recognizing this, the IRS allowed taxpayers to use tables to determine an approximate amount of sales taxes that would be deductible. For taxpayers with income in excess of $100,000, the amount allowable under these tables was capped. As a result of these provisions, the percentage of total sales taxes that was deducted on federal tax returns was actually quite low. According to one estimate, only 22 percent of all sales taxes paid in 1986 were deducted—compared to 90 percent for income taxes.[110]

Another factor limiting the value of the sales tax deduction prior to 1986 was the income composition of the population that claimed sales tax deductions. Recall that the value of any federal deduction is equal to the amount of the deduction multiplied by the taxpayer's marginal tax rate. Because a larger share of sales taxpayers were low- and middle-income households, the value of the sales tax deductions was not as high as the value of deductions for certain other taxes. For 1986, it is estimated that

107. For a general discussion of Proposition 13, see Stark, *supra* note 11, at 197–201.

108. The Citizens for Tax Justice web site contains a useful discussion of the states' efforts at indexing their income taxes for inflation. *See* Citizens for Tax Justice, FAQ, *at* http://www.ctj.org/html/faq.htm.

109. Metcalf, *supra* note 104, at 112–15.

110. Stephen H. Pollock, *Mechanisms for Exporting the State Sales Tax Burden in the Absence of Federal Deductibility*, 44 NAT'L TAX J. 297, 298–99 (1991).

the average federal marginal tax rate for taxpayers claiming a sales tax deduction was 28 percent—as compared to 33 percent for taxpayers claiming a deduction for income taxes.[111]

Using these figures, it is possible to calculate a "tax price" for sales tax and income taxes and then to show how the 1986 legislation altered the relative tax prices for sales and income taxes. In its simplest form, the tax price is a number ranging from 0 to 1, showing what percentage of an increase in taxes will be borne by residents of the taxing state (as compared to the federal government). Algebraically, this simplified tax price can be stated as 1 – (D * R), where D is the percentage of taxes paid that was actually deducted and R is the average federal marginal tax rate faced by taxpayers who were able to deduct those taxes.

As noted above, prior to 1986, both D and R were relatively low for sales taxes—22 percent and 28 percent, respectively. Thus, the tax price for sales taxes prior to 1986 was .936 (that is, 1 – (.222 * .288)). After 1986, the tax price was 1 because D was equal to zero. By contrast, the tax price for state income taxes was .696 prior to 1986 and .800 after tax reform.[112] Put differently, while the Tax Reform Act of 1986 increased the tax price of state income taxes by 14.9 percent, it increased the tax price of state sales taxes by only 8.2 percent.[113] Thus, quite counterintuitively, the 1986 legislation actually increased the attractiveness of state sales taxes relative to state income taxes.

B. Does Deductibility Result in More Progressive State and Local Tax Systems?

As demonstrated above, there are reasons to believe that the deduction for state and local taxes encourages state and local governments to adopt more steeply progressive tax systems than they otherwise would. For example, consider a city with four residents—Moe, Larry, Curly, and Bill Gates—that needs to raise $1 million in revenue. Assume that all taxpayers face a federal marginal tax rate of 20 percent except for Bill Gates, whose marginal rate is 50 percent. In the absence of a deduction for

111. *Id.*

112. For state income taxes, the tax price is derived as follows. Before 1986, the tax price was 1-(.903 x .337) or .696. After 1986, the tax price was 1-(.756 x .265) = .800. For a discussion, see Pollock, *supra* note 110, at 298–99.

113. For state sales taxes, the 8.2% figure is derived by taking into account not only sales taxes paid directly by individuals but also the consumer's share of sales taxes paid by businesses. For more detail, see Pollock, *supra* note __, at 299.

state and local taxes, the city may choose to impose a $250,000 tax on each resident that will be used to finance local public goods of an equivalent per capita amount.

The introduction of a deduction for state and local taxes fundamentally changes the incentives for structuring this fictional community's tax burden. If each resident continues to pay $250,000 in taxes, then the total federal SALT subsidy flowing to the city residents would be $275,000: (1) Moe, Larry and Curly receive a federal SALT subsidy of $50,000 each, while (2) Bill Gates receives a federal SALT subsidy of $125,000. Another way of looking at the distribution of the city's tax burden is to say that while all residents face a nominal burden of $250,000, Moe, Larry and Curly face an effective burden of $200,000, while Bill Gates faces an effective burden of $125,000. However you look at it, it is clear that the city is leaving money on the table, so to speak, by not altering the distribution of its tax burden to take account of the differential availability of the federal tax subsidy to its residents. More specifically, the city should shift a greater portion of its burden to Bill Gates in order to take maximum advantage of the fact that his federal SALT subsidy rate is the highest.

There are several alternatives for how the city might rearrange its tax burden in the presence of deductibility. The maximum federal subsidy is assured if the *entire* $1 million tax burden is imposed on Bill Gates. In this case, the total federal SALT subsidy flowing to city residents would be $500,000—all of it going to Bill Gates. Alternatively, the city could rearrange the tax burden so that all four residents face an equal effective tax burden.[114] As yet another alternative, the city might change the overall level of tax revenues it raises. For example, it could raise $1.5 million in revenues instead of $1 million, again through a tax exclusively on Gates. Gates could be "compensated" by receiving half the tax proceeds ($750,000) in benefits, and the other three residents could receive $250,000 each.

In short, the federal deduction for state and local taxes introduces a wide range of distributional possibilities, all of which involve some shifting of the jurisdiction's tax burden to those individuals best positioned to receive the federal tax subsidy. Yet simply making this observation leaves unanswered a very important question: Have state and local governments *in*

114. This would involve imposing a tax of roughly $217,500 on Moe, Larry, and Curly, while imposing a tax of $347,500 on Gates. The result would be an equal effective burden of (roughly) $174,000 on each taxpayer.

fact adjusted the distribution of their tax burdens to account for the differential value of the SALT deduction?

Anecdotal evidence suggests that the answer is yes. For example, consider a recent tax-reform proposal in the state of Texas. Texas, like Florida and a handful of other states, does not have a personal income tax.[115] Yet the ongoing legal controversy in the state over public funding for education has required the legislature to consider new sources of revenue.[116] David Thompson, a Houston attorney and member of the state's Joint Select Committee on School Finance, recently floated an intriguing proposal. Thompson proposed that the state adopt a "voluntary" income tax that Texas residents could choose to pay. This voluntary tax would have one very important feature: Those taxpayers who choose to volunteer to pay the income tax would receive a rebate of some portion of their sales taxes. To the uninitiated, the idea sounds truly ridiculous—until one stops to consider that income taxes are deductible for the federal income tax while sales taxes are not. In effect, what the Texas voluntary income tax proposal promises to do is to raise more revenue for the state, while also cutting taxes for taxpayers.[117] As with the example above involving Bill Gates, the only loser would be the federal government, whose income tax receipts would decline by the amount of income taxes "volunteered" to be paid.[118]

The Texas proposal for a voluntary income tax suggests that states do in fact respond to the incentives created by section 164, but is the effect more systematic? Several studies have examined this empirical question.

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115. The Texas Constitution provides as follows:

> A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax.

TEX. CONST. art. VIII, § 24(a).

116. The most recent developments in this ongoing saga, which traces back to the landmark U.S. Supreme Court decision in *San Antonio v. Rodriguez*, can be accessed on the Texas Department of Education web site, at http://www.tea.state.tx.us/school.finance/.

117. For additional proposals to shift from sales to income taxes, see Harvey Lapan, GianCarlo Moschini, and Brad Caruth, *Are All Taxes Equally Bad? Replacing Iowa's Sales Tax Could Save Iowans More Than $100 Million per Year*, WORKING PAPER 02-WP 312, CENTER FOR AGRICULTURAL AND RURAL DEVELOPMENT (Sept. 2002); Kirk J. Stark, *Smart Tax Laws Would Put More Money in California's Pocket*, L.A. TIMES, B13 (Dec. 2, 2003).

118. As a side note, it is not clear that a "voluntary" tax would even qualify as a tax within the meaning of section 164. Most of the jurisprudence in this area derives from the foreign tax credit and it is clear under that case law that a "voluntary" tax paid to a foreign government does not qualify as a creditable tax for purposes of the U.S. foreign tax credit. However, the question has not been directly addressed in the context of section 164.

In a 1993 study, economists Charles Scott and Robert Triest examined the extent to which states modified the progressivity of their income taxes in response to the tax reforms of the 1980s.[119] Among other things, the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 substantially reduced marginal tax rates.[120] Whereas in 1980 the top marginal rate for individual filers was 70 percent, by 1988 the top marginal rate had dropped to 28 percent.[121] These changes in the federal income tax rate structure dramatically reduced the value of the deduction for state and local taxes for many high-income taxpayers. In the absence of any changes in state tax structures, this decline in the SALT subsidy rate for high-income earners would increase the effective progressivity of state income taxes—that is, the progressivity net of the federal offset. Thus, a state tax system that was already progressive would be made more progressive by the flattening of the federal tax rates—because the value of the deduction to high-income earners had declined.

Scott and Triest hypothesized that states would respond to the increase in *effective* progressivity by reducing *statutory* progressivity.[122] The rationale for doing so would be that the high-income earner's tax price had increased substantially (due to the decline in the subsidy rate) relative to the tax price faced by low-to middle-income earners. Faced with this new reality, state and local policy would, according to Scott and Triest's hypothesis, reduce the tax burden on high-income earners. Scott and Triest's results show that states did in fact reduce statutory progressivity in response to the tax reforms of the 1980s, but not enough to eliminate the increase in effective progressivity.[123] One interpretation of these results offered by the authors is that by 1989 states had only partially adjusted their tax systems to the federal changes.[124] Whether the results would be the same if measured over

119. *See* Scott & Triest, *supra* note 9.

120. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

121. Individual income tax rate brackets for all years from 1944 onward may be viewed by clicking on "Tax Facts" on the Urban-Brookings Tax Policy Center web site (located at http://www.taxpolicycenter.org).

122. Scott & Triest, *supra* note 9, at 97 ("Suppose states act to maintain constant effective progressivity following federal tax reforms. Following a federal reform which lowers marginal tax rates, states would then reduce the statutory progressivity of their tax systems in order to maintain constant effective progressivity.").

123. This can be seen on page 99 of the Scott and Triest article by looking at the "State-actual payments" row in Tables 1 and 2. Scott & Triest use two measures of progressivity. *Id.* at 97. The Suits measure looks at the before-tax distribution of income and compares that figure with actual tax payments. The Reynolds-Smolensky measure subtracts the after-tax Gini coefficient from the before-tax Gini coefficient—a higher figure indicating greater tax progressivity.

124. Scott & Triest, *supra* note 9, at 102, 103–104.

a longer adjustment period is not known, in part because federal tax rate progressivity began to increase again throughout the 1990s.[125]

In a separate study published in 1992, economist Howard Chernick reached results similar to those presented by Scott and Triest. Chernick examined cross-sectional distributional data for state and local taxes for 1985.[126] Among other things, Chernick sought to gauge the discrete effect of deductibility on the overall progressivity of state and local tax systems.[127] To do this, Chernick regressed a measure of state and local tax progressivity against tax prices—determined for each jurisdiction based on estimates of the percentage of itemizers and average marginal tax rates—while controlling for several additional variables, including things such as welfare benefits, per capita income, and an index of "political liberalism."[128] Like Scott and Triest, Chernick found that "the deductibility incentive exerts a significant effect on the progressivity of state and local tax systems. A higher tax price—fewer itemizers and/or lower marginal tax rates—leads to a substantial decline in progressivity."[129]

Finally, it appears that Martin Feldstein, Marian Vaillant, and Daniel Altman have also examined the relationship between deductibility and state tax progressivity. Although a final study has not been published, in a recent paper Feldstein and Vaillant reported that "preliminary results provide some support for [the possibility that] state taxes are more progressive where deductibility is more common or where the federal marginal tax rate of itemizers is greater."[130] As with the Scott/Triest and Chernick studies, this finding supports the intuition that subnational governments adjust the distribution of their overall tax burdens to take account of changes in the value of the federal income tax deduction.

As these studies demonstrate, there is at least some preliminary empirical support for the proposition that the progressivity of state and local tax systems is influenced by federal deductibility. Importantly, however,

125. The top individual income tax rate rose to 31 percent in 1990 and 39.6 percent in 1993. For a brief history of the tax brackets over this period, see Leonard Burman & Deborah Kobes, *Income Tax Brackets Since 1985*, 100 TAX NOTES 557 (July 28, 2003). *See also* Adam Carasso & Gene Steuerle, *A Brief History of the Top Tax Rate*, 97 TAX NOTES 1093 (2002).

126. Chernick, *supra* note 9, at 576.

127. Chernick calculated tax prices using itemization figures from the NBER/TAXSIM model. *Id.* at 577. These tax prices then served as one of seven independent variables in an ordinary least-squares regression model designed to explain the variance in state and local tax progressivity. Progressivity was measured using a ratio of the average tax burden imposed on the top 5 percent of the income distribution to the bottom quintile. *Id.* at 576.

128. Chernick, *supra* note 9, at 578 tbl. 1 (describing variables).

129. *Id.* at 579.

130. *See* FELDSTEIN & VAILLANT, *supra* note 9, at 7.

none of these studies has examined the question of whether the effect of deductibility varied depending upon the degree of income heterogeneity of a jurisdiction's residents. Yet in considering the effect of deductibility on subnational redistribution, this would appear to be a potentially significant factor. The reason is that deductibility—at least as currently designed—alters the relative tax prices of residents in an income-heterogeneous jurisdiction, but does not alter the relative tax prices of residents in an income-homogeneous jurisdiction.

For example, consider two jurisdictions, each of which has three residents. In jurisdiction *A*, the three taxpayers have incomes of 10, 50 and 100 each. In jurisdiction *B*, each of the three taxpayers has income of 100. If deductibility is introduced to this world subject to a rule limiting the deduction to taxpayers with income of, say, 75 or greater, then jurisdiction *A* would face an incentive to alter the distribution of its tax burden in response to the differential subsidy rates faced by its residents. By contrast, deductibility does not influence the relative tax prices of the residents of jurisdiction *B*. This suggests that deductibility-induced progressivity is more likely to take place in income-heterogeneous jurisdictions and less likely to occur in income-homogeneous jurisdictions. Accordingly, one would expect the degree of income heterogeneity in a community to be correlated with the degree to which that community would alter its tax structure in response to federal deductibility. To my knowledge, however, no study has examined this effect.

C. Is Deductibility-Induced Redistribution Different?

To this point in the analysis, I have examined the ways in which the differential reduction in the local resident's tax price created by the SALT deduction is likely to induce state and local governments to adopt a more progressive tax system than it otherwise would. In addition, I have reviewed empirical evidence supporting the claim that subnational governments do in fact respond to deductibility in the manner suggested. However, I have not addressed whether this increase in state and local tax progressivity is likely to lead to deleterious effects of the sort anticipated by those who advocate centralizing all redistribution at the highest level of government.[131] There are two reasons why deductibility-induced redistribution may have different substantive effects than redistribution not resulting from the influence of deductibility.

131. *See* discussion *supra* Part II.

The first reason is that deductibility itself blunts the effect of subnational redistribution. The reason, of course, is that where federal marginal tax rates increase with income, federal deductibility makes *effective*—that is, after-tax—state and local average tax rates less progressive. Thus, for example, a state flat-rate income tax is actually regressive in the presence of federal deductibility and progressive federal marginal tax rates.[132] Similarly, progressive state income tax rates are made less progressive by the federal SALT deduction. This point is obvious enough, but a brief example will help to clarify. Consider an income tax imposed by the State of Michiana, which has three residents: *A*, *B*, and *C*. If the federal subsidy rates for these three taxpayers are 0 percent, 20 percent and 50 percent, respectively, then the effective progressivity of the state's income tax will be reduced in the manner illustrated below:

TABLE 1
ILLUSTRATION OF HOW DEDUCTIBILITY REDUCES
EFFECTIVE STATE TAX PROGRESSIVITY

	A	*B*	*C*
Statutory Tax Burden	10	50	100
Federal Subsidy Rate	0%	20%	50%
Effective Tax Burden	10	40	50

As these figures demonstrate, the statutory tax burden is substantially more dispersed than the effective tax burden. Moreover, it should be clear that the magnitude of this difference in dispersion is a function of how steeply progressive the federal income tax is. Thus, as federal income tax rates become more progressive, effective state tax progressivity declines even further. For example, if Taxpayer C above faced a federal subsidy rate of 60 percent, his effective state tax burden would be 40, equal to that of

132. For example, under current law, if a state adopts a 10 percent flat-rate income tax, the *effective* rate of taxation for residents of the state would actually be 6.5 percent (for those in the 35 percent tax bracket), 6.7 percent (for those in the 33 percent tax bracket), 7.2 percent (for those in the 28 percent tax bracket), 7.5 percent (for those in the 25 percent bracket), 8.5 percent (for those in the 15 percent tax bracket), 9 percent (for those in the 10 percent tax bracket—who are unlikely to itemize), and 10 percent for those who do not itemize. In other words, effective state income tax rates actually *rise* as income declines, with rates ranging from 6.5 percent for those with the highest incomes (for example, married couples with taxable income in excess of $250,000) to 10 percent for those with the lowest incomes (for example, a worker who makes $20,000 and does not itemize). *See* 26 U.S.C. § 1 (2004).

Taxpayer *B*. One might conclude, therefore, that the federal deduction for state and local taxes actually works to minimize the (potentially) deleterious effect of progressivity, rather than to eliminate it, because the federal government effectively shares in the cost of subnational progressivity to high-income taxpayers.

In considering the efficiency consequences of subnational redistribution, however, what matters is not the *absolute* level of redistribution undertaken by any one jurisdiction, but rather the *relative* effect of redistribution. For any given state tax burden, deductibility has no effect on the relative disadvantage of redistribution as compared to benefit taxation. Consider, for example, another jurisdiction where Taxpayers *X*, *Y*, and *Z* each pay $100 and receive the same amount of public goods. Assuming that Taxpayer C above consumes an amount of public goods less than his $100 share of the tax burden—say, $60—he faces the same incentive to migrate with or without the deduction. In both cases the potential "payoff" from migrating is the $40 increment in public goods to be had by joining *X*, *Y*, and *Z*. The reason, of course, is that the deduction promises to reduce C's tax burden from $100 (statutory) to $50 (effective) regardless of the amount of services that he consumes.[133]

A second reason why deductibility-induced redistribution may have different substantive effects is that while states may increase the progressivity of their taxes in response to deductibility, they may also consciously attempt to reverse the distributive effects of these changes by making spending programs more regressive. In fact, in a world without frictions and transaction costs, this would appear to be the optimal strategy for an income-diverse jurisdiction in the face of deductibility. On the one hand, the jurisdiction should respond to deductibility by shifting the tax burden to high-income itemizers. At the same time, however, the jurisdiction should manipulate the benefit side of the equation to remain attractive to mobile high-income itemizers. Put differently, because deductibility constrains the taxing decision, the spending side of the equation is the only remaining margin that the jurisdiction can adjust in order to reach its preferred distributional outcome.

133. Of course it is also true that the subsidy is more generous (in an absolute sense) as a taxpayer's total tax bill increases. Thus, a taxpayer who pays $100 in taxes but receives only $50 in benefits does face a different incentive to migrate (under deductibility versus under non-deductibility) if the option is a jurisdiction that offers $50 in benefits for $50 in taxes. Without deductibility the taxpayer faces a $50 payoff by migrating. With deductibility the payoff for migrating (assuming a 50 percent subsidy rate) is $25. Thus, deductibility may have the effect of inhibiting migration by high-income itemizers out of high-tax jurisdictions.

Importantly, however, there are reasons to believe that state and local governments will not be able to successfully engage in this strategy. First, because of the federal constitutional restriction of "one person/one vote," there is political pressure in the direction of an equitable distribution of public services.[134] In addition, various legal requirements limit a state or local government's ability to provide a differential level of public services. These include, for example, state constitutional requirements that free public education be provided to all children[135] and the constitutional doctrine that race-related disparities in the provision of generally financed local services violate the federal Equal Protection Clause.[136] While not ensuring perfect household equity, these requirements make it harder for a taxpayer who bears a disproportionate share of the tax burden to be compensated in the form of a greater receipt of local services. In effect, these legal rules on the spending side of the equation help to cement the effect of redistribution undertaken on the tax side of the equation.

IV. THE CASE FOR A DISTRIBUTIONALLY NEUTRAL SALT SUBSIDY

In the previous parts of this Article, I have attempted to demonstrate that the federal income tax deduction for state and local taxes operates as a "tax system within a tax system," rewarding certain tax structures and penalizing others. To summarize, the current SALT deduction rewards and therefore encourages state and local tax structures that place the heaviest tax burden on high-income itemizing taxpayers. Correspondingly, federal tax laws currently penalize and discourage state and local tax structures that impose a heavier tax burden on nonitemizing low- and middle-income households, as well as those states and localities that rely heavily on retail sales taxes. Moreover, several empirical studies confirm the predicted effect, namely, that the SALT deduction skews state and local tax structures in favor of deductible taxes and away from nondeductible taxes.[137] Thus, it appears that the progressivity of state and local tax systems may be at least partly attributable to the influence of the SALT deduction.

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134. For a discussion, see Richard Briffault, *Who Rules at Home?: One Person/One Vote and Local Governments*, 60 U. CHI. L. REV. 339 (1993). *See also* Ellickson, *supra* note 74, at 1538.

135. *See* Julie K. Underwood & William E. Sparkman, *School Finance Litigation: A New Wave of Reform*, 14 HARV. J. L. & PUB. POL'Y 517, 533 n.54 (1991) (listing education articles of state constitutions).

136. *See* Hawkins v. Town of Shaw, 437 F.2d 1286 (5th Cir. 1971), *aff'd en banc*, 461 F.2d 1171 (5th Cir. 1972).

137. *See supra* Part III.B.

The overall effect of current law, therefore, is that the federal tax burden has been made more *regressive* (because the SALT deduction is most valuable to high-income taxpayers) while state and local tax systems have been made more *progressive* (because of the incentive to shift the state and local tax burdens to high-income tax taxpayers). As I have argued, this combination of a more regressive federal tax structure and a more progressive state and local tax structure is precisely contrary to one of the central normative prescriptions of fiscal federalism—that is, that the government's redistributive function should be assigned to the most central level of government.[138] The question remains, however, whether it is possible to reform the SALT deduction in order to bring it in line with this normative prescription.

In this Part, I attempt to answer this question by making the case for a "distributionally neutral" federal SALT subsidy—that is, a federal tax subsidy for state and local taxes that does not have the incentive effects described in Part III above. Subpart A below provides a definition of the term "distributional neutrality" as used in this context. Subpart B explains that while repealing the section 164 deduction would be consistent with this principle, there may be valid reasons to retain some sort of subsidy for state and local government spending. Subpart C discusses three specific design alternatives for a federal SALT subsidy that are consistent with the principle of distributional neutrality. Finally, subpart D addresses a concern with policies that are consistent with the principle of distributional neutrality—namely, that such policies may have the effect of inducing the migration of wealthy taxpayers from high-tax jurisdictions.

A. The Principle of Distributional Neutrality

The principle of "distributional neutrality" as applied to the design of a SALT subsidy may be stated as follows: A "distributionally neutral" subsidy for state and local taxes is one in which the absolute amount of the subsidy to taxpayers in a jurisdiction does not vary depending upon the distribution of the tax burden among those taxpayers. Where the subsidy is distributionally neutral, there is no incentive for state and local lawmakers to alter the distribution of the state and local tax burden to increase the amount of the subsidy.

Consider, for example, State *X* that has two taxpayers, *A* and *B*, who earn $20,000 and $200,000 of federal taxable income respectively. If State

138. *See supra* Part III.A for a discussion of this point.

X imposes a 10 percent income tax, but federal law provides that *only those who earn more than $100,000 may deduct state taxes*, then the total SALT subsidy flowing to citizens of State X will be $20,000 (*B*'s State-X tax burden) multiplied by the higher-earning taxpayer's federal marginal tax rate. Assuming for the moment a flat federal income tax rate of 50 percent, the amount of the SALT subsidy flowing to citizens of State X, in this case only taxpayer *B*, would be $10,000.[139] Put differently, the effective SALT subsidy rate for the state as a whole is 45.5 percent (that is, $10,000 divided by $22,000). Here the SALT subsidy is *not* distributionally neutral because the state could increase the aggregate amount of the subsidy flowing to its citizens by altering the distribution of its tax burden. For example, if State X were to impose its entire $22,000 tax burden on taxpayer *B*, then the amount of the SALT subsidy flowing to citizens of State X would increase to $11,000 for a subsidy rate of 50 percent (that is, $11,000 divided by $22,000).[140] As demonstrated in Part III above, the current deduction for state and local taxes has a similar effect in that it is structured to give state and local governments the incentive to shift the tax burden to high-income taxpayers.

By contrast, consider a regime identical to the one described above (again, assume a flat federal income tax rate of 50 percent) except that there is *no limitation on persons who may deduct state and local taxes*. Here the SALT subsidy satisfies the principle of distributional neutrality. The aggregate amount of the subsidy flowing from the federal government to State X taxpayers *A* and *B* will be $11,000. This is true whether the entire tax burden is placed on taxpayer *B*, whether it is divided equally between the two taxpayers or divided unequally between them. In all cases, the total amount of the subsidy is the same; thus, there is no incentive for the state to alter the distribution of its tax burden to increase the amount of the subsidy.[141]

139. That is, B's federal tax burden is reduced from $200,000 x 50 percent ($100,000) to $180,000 x 50 percent ($90,000). Thus, the subsidy to B is $200,000–$190,000 = $10,000.

140. Note that the community's aggregate tax burden, $22,000, remains the same. The only difference is that Taxpayer *B* now bears 100 percent of the nominal tax burden, rather than the previous 91 percent (that is, 20k/22k). Importantly, however, Taxpayer *B*'s after-tax contribution increases by only $1000 because the additional $2000 tax payment is offset by a federal income tax deduction (at a rate of 50 percent) of the same amount. The community as a whole gains $1000 by shifting the $2000 tax burden from *A* to *B*. That $1000 is paid for by the federal government in the form of reduced federal income tax receipts.

141. Note that in order for the principle of distributional neutrality to hold, the deduction must have the same value for all taxpayers, including those taxpayers that have no income.

The principal value of a distributionally neutral SALT subsidy from the perspective of fiscal federalism is that it would not encourage state and local governments to adopt redistributive tax policies. As noted above, efforts by subnational governments to redistribute income invite strategic migration by both the potential subjects and beneficiaries of the redistribution.[142] When subnational tax progressivity has its roots in the redistributive preferences of the state or local community, there is less reason for concern because, as Pauly suggested, redistribution may be viewed in some sense as a type of local public good.[143] Individuals can be expected to sort themselves out into different communities with different levels of redistribution based on their preferences.[144] However, where federal tax law creates incentives for subnational redistribution, there is no reason to think that the observed tax progressivity is a product of local preferences; rather, the degree of redistribution undertaken by a state or local government may simply reflect that government's effort to contort its tax structure to fit the "preferred" structure of section 164 in order to maximize the federal subsidy.

To be consistent with the basic normative prescriptions of fiscal federalism, federal tax policy should be neutral with respect to the degree of redistribution undertaken by state and local governments, while at the same time respecting Pauly-type interjurisdictional variations. Put differently, subnational redistribution should be a function of differences in the "taste" for redistribution, not a function of the influence of federal tax laws on the state and local tax structure.

B. Nondeductibility as a Distributionally Neutral Option

The cleanest and most obvious means of satisfying the principle of distributional neutrality in the design of the SALT subsidy would be to repeal the deduction for state and local taxes. If the subsidy rate is zero in all instances, then no jurisdiction can increase the amount of the subsidy it receives by altering the distribution of its tax burden. However, there may be valid reasons for wanting to subsidize state and local taxes. For example, one prominent argument in the literature on fiscal federalism is that decentralized government results in an artificially small public sector.[145] To

142. *See supra* Part II.A.
143. *See* discussion of Pauly *supra* Part II.C.
144. *See* discussion of Pauly *supra* Part II.C.
145. This is the argument at the heart of the so-called "Leviathan" debate among political economists. At issue in this debate is the empirical question of whether decentralized

the extent that one views this effect as a negative consequence of interjurisdictional competition,[146] a case can be made for some sort of federal subsidy for state and local spending to counter the government-shrinking effects of decentralization. Moreover, if history is any guide, it seems likely that outright repeal would face (insurmountable) political opposition from state and local governments, especially at a time of budget crises.[147]

C. Flat-Rate Credits and Variants

There are several options, short of outright repeal, that would be consistent with the principle of distributional neutrality. Various design features of the SALT subsidy could be modified to reduce or eliminate the incentive to shift state and local tax burdens to high-income taxpayers. For example, one relatively minor change in the law would involve allowing a deduction for state and local taxes even to those taxpayers who do not currently itemize their deductions—that is, allowing an "above the line" deduction for state and local taxes. In recent years, Congress and the Bush administration have considered such a change for charitable contributions.[148] Of course, simply allowing an above-the-line deduction would not address the issue of the differential treatment of different types of taxes (sales v. income or property), nor would it change the effect of the progressive federal rate structure. Nonetheless, allowing a SALT deduction to nonitemizers might have some effect in mitigating the incentive to shift state and local tax burdens to itemizing (typically high-income) taxpayers.

A second option would be to eliminate the effect of the progressive rate structure on the value of the deduction for state and local taxes. This could be done in conjunction with a policy change giving nonitemizers a SALT deduction or, alternatively, simply as a modification to the deduction within the population of itemizing taxpayers. What would be

government, and the competition that it necessarily entails, results in a smaller public sector than centralized government.

146. The debate over interjurisdictional competition is usefully explored in ADVISORY COMM. ON INTERGOVERNMENTAL RELATIONS, INTERJURISDICTIONAL TAX AND POLICY COMPETITION: GOOD OR BAD FOR THE FEDERAL SYSTEM? (1991), *available at* http://www.library.unt.edu/gpo/acir/Reports/information/m-177.pdf.

147. See the discussion in Part I.C of the politics surrounding the proposals made in 1985 and 1986 to repeal the deduction for state and local taxes.

148. *See* Cordes et al., *Extending the Charitable Deduction to Nonitemizers: Policy Issues and Options*, CHARTING CIVIL SOCIETY (May 2000); JANE GRAVELLE, CONG. RESEARCH SERV., ECONOMIC ANALYSIS OF CHARITABLE CONTRIBUTION DEDUCTION FOR NON-ITEMIZERS (2001), *available at* http://www.ombwatch.org/npadv/2002/Documents/31302crsstudy.pdf.

required for such a change would be the conversion of the subsidy from a deduction to a credit. A deduction reduces taxable income and thus has a value that depends upon the rate at which that income would have been taxed. As noted above, in a progressive income tax that value rises with income. By contrast, a credit is a reduction in the amount of tax owed and is taken into account after the progressive rate structure is applied to the taxpayer's income.[149] The value of a credit depends upon the statutorily specified "credit percentage"—that is, the percentage of expenditures that the credit is designed to reimburse.[150] For example, if a credit is allowed for state taxes at a credit percentage of 25 percent and the taxpayer pays $10,000 of state taxes, then she would be entitled to a credit in the amount of $2500. In effect, the credit percentage serves the same function for credits that the marginal tax rate serves for deductions—it sets the dollar value of the subsidy.

The value of a credit may also be limited by the amount of expenditures that are considered to be "creditable" under the statute. Most commonly, credits will feature floors or ceilings that have the effect of reducing the amount of the credit depending upon the relationship between the expenditures incurred by the taxpayer and the trigger points for the ceiling and/or floor. In the case of a floor, the credit will only be allowed with respect to expenditures in excess of a threshold amount.[151] By contrast, a ceiling specifies a maximum amount up to which the taxpayer's expenditures will be counted in calculating a credit. Assume, for example, that a credit for state taxes is allowed at a credit percentage of 25 percent but that taxes are creditable only to the extent that they exceed $1000 and that no taxes over $51,000 may be used in determining the amount of the credit. Under such a scheme, a taxpayer who has paid $21,000 of state taxes will be entitled to a credit of $5,000 (that is, ($21,000 – $1,000) x .25). In addition, because of the ceiling, no taxpayer would be entitled to a credit in excess of $12,500 (that is, ($51,000 – $1000) x. 25).

149. For a discussion, see William J. Turnier & Douglas G. Kelly, *The Economic Equivalence of Standard Tax Credits, Deductions and Exemptions*, 36 U. FLA. L. REV. 1003 (1984).

150. Credit percentages vary widely, depending upon the credit. For example, the Dependent Care Tax Credit has a credit percentage that ranges from 20 percent to 35 percent, depending upon the taxpayer's adjusted gross income, *see* 26 U.S.C. § 21(a)(2) (2002 Amdmts.), while the Earned Income Tax Credit has a credit percentage that ranges from 7.65 percent to 34 percent, depending upon the number of children and the taxpayer's adjusted gross income, *see* 26 U.S.C. § 32(b) (2002 Amdmts.).

151. For a discussion of the use of floors in the U.S. income tax, see Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 TAX L. REV. 1 (1995).

Importantly, each of the approaches discussed above—the above-the-line deduction for state and local taxes, the conversion of the subsidy from a deduction to a credit, and the use of ceilings and/or floors—relies upon the *actual* amount of state and local taxes paid by a taxpayer in order to determine the amount of the subsidy. Assuming for the moment that anything is possible (politically), it should be emphasized that this limitation is one that we impose upon ourselves and, at least as a thought experiment, may be worth disregarding in the design of a SALT subsidy. Unburdened by political limitations, one could imagine a SALT credit to be paid to each resident of a state or locality the amount of which depends upon some credit percentage of that taxpayer's per capita share of total taxes paid. This approach would involve an explicit decoupling of the credit from the amount of taxes actually paid by individual taxpayers. Under such a scheme, the federal subsidy begins to look more like an intergovernmental grant, albeit one that is paid directly to taxpayers rather than to the government itself.[152]

D. Concerns with Moving to a Distributionally Neutral SALT Subsidy

As I have argued above, a distributionally neutral SALT subsidy would be superior to the current structure of section 164 in that it would not encourage suboptimal subnational redistributive tax structures. There is, however, a concern that critics might raise in opposition to adopting distributional neutrality as a design principle. More specifically, some might contend that moving from the current system to a distributionally neutral subsidy could encourage high-income taxpayers to migrate away from high-tax jurisdictions.[153] Critics of a distributionally neutral subsidy might argue, for example, that the current deduction insulates high-income taxpayers from the adverse effects of local redistribution. In effect, the argument goes, the current SALT deduction shields high-income taxpayers from some portion of their state and local tax burdens, giving them less incentive to migrate out of high-tax jurisdictions (typically large urban centers) in response to increased taxes. Under this view, a SALT subsidy that favors the wealthy (as the current deduction does) has the laudable

152. For a discussion of intergovernment grants, see David F. Bradford & Wallace E. Oates, *Towards a Predictive Theory of Intergovernmental Grants*, *61* AM. ECONOMIC REVIEW 440–48 (1971).

153. This concern was raised in connection with the proposal to eliminate deductibility in 1986. *See* Henry W. Herzog, Jr. & Alan M. Schlottmann, *State and Local Tax Deductibility and Metropolitan Migration*, 39 NAT'L TAX J. 189 (1986).

effect of making progressive state and local taxes more like benefit taxes—that is, the receipt of the federal subsidy reduces the disparity (brought about by progressive state and local taxes) between the high-income taxpayer's state and local taxes and benefits. Moreover, eliminating the progressivity bias in the SALT deduction would, according to this argument, result in an out-migration of high-income taxpayers from income-heterogeneous communities.[154]

There are two possible responses to this line of argument. First, it is important to remember that when it comes to the question of interjurisdictional mobility and competition, what matters is not the *absolute* level of taxes and benefits offered by a particular jurisdiction, but rather the *relative* levels imposed by competing jurisdictions. Because the SALT subsidy is made available to *all* high-income taxpayers—not just those who are on the giving end of redistributive state and local tax structures—it does not affect the *relative* attractiveness of fiscal packages offered by two jurisdictions. To illustrate, consider a wealthy taxpayer choosing between two jurisdictions—one that offers $4000 of benefits and an equivalent amount of taxes, and another that offers only $3000 of benefits for the same $4000 of taxes. The federal subsidy for state and local taxes is the same in both jurisdictions: $4000 multiplied by the taxpayers' top federal marginal tax rate. Put differently, *for any given level of state or local taxes*, the SALT deduction does not alter the relative attractiveness of one jurisdiction's tax-service package over that offered by other jurisdictions.[155] It cannot be said, therefore, that the progressivity bias of the current SALT deduction reduces the high-income taxpayer's incentive to migrate.

Second, the criticism takes an inappropriately static view of the governmental response to a redesigned SALT subsidy. At the heart of the analysis set forth in Part III above is the assumption that state and local governments will respond to a distributionally neutral SALT subsidy by

154. *Id.* at 197 (contending that "incremental five-year outmigration from metropolitan areas triggered by nondeductibility will range from nominal amounts in many southerns MSAs to 9.7 percent of present labor outmigration (16 per thousand of the resident labor force)").

155. Note, however, that a different analysis would apply in the case where the disparity in the tax-service offerings between the two jurisdictions is attributable to differences in the level of taxes. Thus, a taxpayer choosing between one jurisdiction that offers $3000 of benefits for $4000 of taxes (State *X*) and another that offers $3000 of benefits for $3000 of taxes (State *Y*) would factor in the additional federal tax benefit available in State *X* due to the payment of an additional $1000 of taxes in that state. In other words, the "detriment" of choosing State *X* over State *Y* (which represents a $1000 loss *before* the subsidy) would be mitigated by the fact that the federal government absorbs a percentage of the $1000 loss in the form of the SALT deduction.

shifting a portion of the tax burden from high-income itemizers to those who previously could not benefit from the SALT subsidy. Because the SALT subsidy will no longer be skewed in favor of high-income itemizers, state and local governments will have a reduced incentive to bias their tax systems in favor of progressivity. Accordingly, it is expected that state and local tax structures would, over time, become less progressive. Of course, at the same time, the federal tax structure would become more progressive by virtue of the changes to the SALT subsidy. It is impossible to predict whether the net effect of these changes would increase or decrease the progressivity of the combined federal, state, and local tax burden. From an *ex ante* perspective, however, there is no reason to think that the changes would have any predictable distributional effect. The purpose of the change, after all, is not to favor one distributive scheme over another, but rather to eliminate the progressivity bias in the current SALT subsidy.

CONCLUSION

As the devolution of fiscal responsibilities to state and local governments continues over the next several years, questions regarding how best to coordinate national and subnational fiscal policies will assume greater significance. As I have argued above, the federal income tax deduction for state and local taxes is at the heart of the field of fiscal federalism, bringing together questions of subnational redistribution and tax design in a multiunit system of governments. Yet the current approach for addressing these issues in federal tax law, codified in section 164, fails to reflect properly the normative concerns of fiscal federalism. As currently structured, this SALT deduction is a highly regressive federal subsidy that operates to encourage states and local governments to adopt progressive tax systems.

This progressivity bias in federal tax law is exactly backwards. A restructured federal SALT subsidy, based on the design principle of distributional neutrality as outlined above, would eliminate the unnecessary distortions and inefficiencies created by the current system. To be sure, by removing the current incentives for state and local governments to impose a greater tax burden on high-income, high-wealth taxpayers, this change would also likely result in less progressive state and local tax systems. At the same time, however, a distributionally neutral SALT subsidy would alter the distribution of the federal income tax burden, making it more progressive. This outcome—a more progressive federal tax structure and a

less progressive state and local tax structure—is more consistent with basic principles of fiscal federalism than is current law.

APPENDIX I
ITEMIZATION RATES FOR ALL 50 STATES (AND THE DISTRICT OF COLUMBIA)[156]

STATE	*TOTAL RETURNS*	*ITEMIZED*	*% ITEMIZED*
MARYLAND	2,583,130	1,236,032	48%
NEW JERSEY	4,088,063	1,785,895	44%
CONNECTICUT	1,679,055	713,823	43%
OREGON	1,571,716	656,202	42%
MINNESOTA	2,384,900	994,725	42%
UTAH	954,936	391,149	41%
COLORADO	2,109,160	859,727	41%
MASSACHUSETTS	3,106,209	1,240,197	40%
VIRGINIA	3,372,644	1,342,201	40%
D.C.	282,308	112,031	40%
NEW YORK	8,667,488	3,345,293	39%
CALIFORNIA	15,067,041	5,805,997	39%
WISCONSIN	2,590,020	996,133	38%
ARIZONA	2,201,468	838,632	38%
GEORGIA	3,655,752	1,382,043	38%
MICHIGAN	4,585,188	1,704,376	37%
DELAWARE	380,789	141,354	37%
RHODE ISLAND	495,959	182,892	37%
IDAHO	563,920	206,880	37%
NORTH CAROLINA	3,648,792	1,334,943	37%
NEVADA	980,542	348,479	36%
ILLINOIS	5,775,115	2,034,998	35%
NEW HAMPSHIRE	632,936	222,930	35%
WASHINGTON	2,788,815	966,732	35%
OHIO	5,547,528	1,920,976	35%
HAWAII	577,693	195,662	34%
SOUTH CAROLINA	1,799,466	587,857	33%
VERMONT	301,294	96,876	32%
IOWA	1,338,114	429,018	32%
PENNSYLVANIA	5,789,615	1,851,076	32%
INDIANA	2,824,241	898,232	32%
MAINE	610,718	193,450	32%
MONTANA	426,919	135,069	32%
MISSOURI	2,566,494	806,699	31%
KENTUCKY	1,759,231	551,842	31%
KANSAS	1,225,868	383,523	31%
ALABAMA	1,892,976	575,608	30%
NEBRASKA	805,959	242,647	30%
OKLAHOMA	1,472,656	433,105	29%

156. Source: Internal Revenue Service, Statistics of Income Division (2001).

FLORIDA	7,630,491	2,194,081	29%
NEW MEXICO	849,993	242,149	28%
ALASKA	333,061	84,405	25%
ARKANSAS	1,121,265	275,429	25%
TENNESSEE	2,558,039	599,675	23%
MISSISSIPPI	1,165,215	265,816	23%
TEXAS	9,202,582	2,075,262	23%
LOUISIANA	1,881,047	399,782	21%
WYOMING	238,645	49,217	21%
NORTH DAKOTA	301,436	59,534	20%
WEST VIRGINIA	750,456	139,048	19%
SOUTH DAKOTA	354,978	60,471	17%
UNITED STATES	*130,977,219*	*44,961,551*	*34%*