

# A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code

Brian Galle\*

## INTRODUCTION

Our federal government annually passes up more than \$75 billion in potential revenue in an effort to guide that money to the States under section 164 of the Tax Code, the provision allowing itemizing taxpayers to deduct the cost of the state and local income, property and (to a limited extent) sales taxes they paid during the tax year.<sup>1</sup> The eye-popping size of that number makes section 164 a perennial issue in tax policy circles, and, as one of the deductions omitted from the Alternative Minimum Tax's parallel tax universe, the section is also a key component of debates about the AMT.<sup>2</sup> Indeed, the President's Advisory Panel on Tax Reform recommends eliminating the deduction to pay for its proposed AMT reform.<sup>3</sup> Other Bush administration rumblings that axing the deduction may be on their agenda, even aside from any possible AMT fix, make a reconsideration of section 164 especially timely.<sup>4</sup>

It has been almost a decade since the last comprehensive legal academic examination of

---

\* A.B. Harvard, J.D. Columbia, LLM (Taxation) Georgetown. Assistant Professor, Florida State University College of Law (effective July 2006). Attorney, U.S. Department of Justice, Tax Division. I am grateful for many helpful comments and suggestions from, among others, Reuven Avi-Yonah, Brookes Billman, Bill Bratton, John Buckley, Peter Byrne, John Colvin, Noel Cunningham, Mike Dorf, Tom Field, Vic Fleischer, Martin Ginsburg, Robert Katzmann, Yoram Keinan, Edward McCaffery, Trevor Morrison, Gregg Polsky, Julie Roin, David Schizer, David Weisbach, and Ethan Yale, as well as faculty attending presentations of this paper at Florida State University, the University of Minnesota, Quinnipiac, Southwestern, and Syracuse Law Schools. I owe a particular debt to Ron Pearlman and Kirk Stark for their willingness to read carefully and offer me extensive and insightful suggestions. The opinions noted in this draft are those of the author alone and do not represent the views of the Justice Department or the United States.

<sup>1</sup> 26 U.S.C. § 164; *see* JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003--2007, at 20, 27 (2002).

<sup>2</sup> 26 U.S.C. § 56(b)(1)(A)(ii).

<sup>3</sup> REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM 70, 83--84 (2005), *available at* <[www.taxreformpanel.gov/final-report/TaxReform\\_Ch5.pdf](http://www.taxreformpanel.gov/final-report/TaxReform_Ch5.pdf)>

<sup>4</sup> *See* Ian Urbina, *Bush Plan Could Imperil Tax Write-Off for New York*, N.Y. TIMES, Dec. 27, 2004, at B1.

the merits of the deduction.<sup>5</sup> This Article aims, humbly, at attempting to update that earlier work with recent developments and new insights. To date, scholarly examination of the deduction has focused on its fairness, or “horizontal equity,” as well as the role it may play in encouraging localities to raise more of their own tax revenues. My focus here is on the latter. One view I do not consider, though, is the taxation of corporations and other entities. As I suspect the reader will see, the nuances of individual taxation provide more than enough material for one paper; corporations and their additional complexities must await another day.

On the fairness front, prevailing wisdom questions the traditional equitable justification for the deduction. Under the traditional view, it was said, two people who make the same money are not equal if one pays more state tax than the other.<sup>6</sup> Thus, the federal tax system should favor the higher state-tax payer. Later critics argued that this was considering only half the apple (or half the orange); state taxes generate services, which increase taxpayer well-being.<sup>7</sup> So, the critics said, the higher-tax payer, like a consumer who buys a product at retail, has less money in her pocket at the end of the year but is just as well off as the taxpayer with more money but fewer services.<sup>8</sup> Further analysis showed that the equity question actually turned on complicated

---

<sup>5</sup> That examination was Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413 (1996).

<sup>6</sup> WILLIAM VICKREY, AGENDA FOR PROGRESSIVE TAXATION 18--24 (1947); Henry Aaron, *What is a Comprehensive Tax Base Anyway?*, 22 NAT'L TAX J. 543, 543--44 (1969).

<sup>7</sup> See 2 U.S. DEP'T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 63 (1984) [Treasury I]; U.S. DEP'T OF THE TREASURY, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 63 (1984) [Treasury II]; 71; Charles McClure, *Comments*, in THE PROMISE OF TAX REFORM 71 (J. Pechman ed. 1985); Brookes D. Billman & Noel B. Cunningham, *Nonbusiness State and Local Taxes: The Case for Deductibility*, 28 TAX NOTES 1107, 1111--12 (1985); Charles R. Hulten & Robert M. Schwab, *A Haig-Simons-Tiebout Comprehensive Income Tax*, 44 NAT'L TAX J. 67, 68--71 (1991); J.B. McCombs, *A New Federal Tax Treatment of State and Local Taxes*, 19 PAC. L.J. 747, 754 (1988); Edward Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 FORDHAM L. REV. 1255, 1278 (1985); see also Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 907--08 (1992).

<sup>8</sup> 1 TREASURY, *supra* note 7, at 63l; Hulten & Schwab, *supra* note 7, at 68--71.

empirical questions of who truly bore the burden of a given state tax -- was it true, in other words, that taxpayers got everything they paid for?<sup>9</sup> Those questions, too, I reserve for discussion elsewhere.

Instead I focus here on challenges to the deduction's use as a "tax expenditure," or subsidy. For example, the President's Advisory Panel on Tax Reform reportedly believes that the deduction causes citizens to overinvest in local government, because that spending is tax-favored compared to private purchase of government-like services. That echoes a claim raised by President Reagan's Treasury Department prior to the 1986 reforms.<sup>10</sup>

Whatever one's view about the economics of the Advisory Panel's argument, whether or not it is of concern ultimately turns on whether we would like to see some services now carried out by the federal government or in the private sector shifted to state and local government. I argue here that, to the extent we may desire such a shift, the deduction may be an imperfect tool for accomplishing it. The tax literature so far does not consider the possible effects of the deduction on the actual quality of state and local governance. Yet local governments develop in response both to direct political demands and also the indirect pressure generated by the threat of "exit," or out-migration to a more efficient or more responsive jurisdiction. The deduction, I argue, significantly affects both of these factors -- most obviously by reducing exit pressures, but also by in more subtle ways transforming the processes of direct politics.

Further, most commentators claim that the deduction is in theory warranted (albeit administratively difficult to implement) in order to encourage local tax jurisdictions to raise and

---

<sup>9</sup> See Kaplow, *supra* note 5, at 490.

<sup>10</sup> See Treasury I, *supra* note 7, at 63-64.

spend money in ways that benefit their neighbors.<sup>11</sup> Since each locality fails to internalize the benefits of these “spillovers,” the argument goes, a deduction may help to move local spending closer to the ideal level the localities would choose if their incentives were properly aligned.<sup>12</sup> In fact, though, localities do internalize spillover benefits. Localities may use spillovers as a form of inter-jurisdictional bribe to influence the behavior of outsiders. In combination with a variety of frictions and biases, that bribe allows the briber to reduce free-riding by neighbors and, in some instances, permits it to export the costs of its services onto the unwitting bribees.

But this is not to say I am on the side of the President’s Advisory Panel. While I acknowledge flaws in the way that the deduction now functions, I also argue that condemning the deduction on the basis of present failings could prove short-sighted. The deduction can in fact be an important instrument for reforming the administration of cooperative regulation between the federal government, states, and private stakeholders.

In addition, the deduction may facilitate shared state and federal tax enforcement, a necessity for states in a world where it is ever easier to hide wealth through complex international transactions. For cognitive and distributional reasons it may be difficult for states to tax the same base as the federal government, and therefore difficult most effectively to share enforcement resources with it. The deduction arguably offsets some of these “stacking”

---

<sup>11</sup> See Billman & Cunningham, *supra* note 7, at 1112; Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519, 1554 (1982); Kaplow, *supra* note 5, at 481--83; Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1410 (2004); Yorio, *supra* note 7, at 1280; *see also* Clayton P. Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1045--46 (1983) (making this argument in context of tax-exempt municipal bonds).

<sup>12</sup> See Gillette, *supra* note 11, at 1046; Kaplow, *supra* note 5, at 480--83; Stark, *supra* note 11, at 1410; *cf.* Yorio, *supra* note 7, at 1280--81 (arguing that deduction increases beneficial spillovers without noting internalization problems).

limitations. It also can be centripetal force for what would otherwise be an ever-diversifying set of state tax rules.

These conclusions, I should acknowledge at the outset, are first steps, not final ones. The novel benefits of the deduction I identify might justify only a targeted or more nuanced deduction. And the relative societal value of those goals is likely a sum that can be computed only through the market of political ideas.

As for the roadmap of the paper, Part I orients the reader in the mechanics of section 164 and the extant policy arguments on either side. Part II explains the benefits of shared tax enforcement, and notes that depending on unresolved empirical questions the deduction may be helpful in achieving those benefits. Part III considers the possibility that the deduction could function as a tax expenditure to subsidize state spending. I analyze three distinct forms of spending that we might imagine the deduction could subsidize, and identify significant problems with all three. I conclude, however, that the stability offered by the deduction may make it one among several viable tools for locally-controlled redistributive taxing and spending. Finally, Part IV outlines the possible impact of a deduction on state and local governance, both in the current anarchic state of that governance and in a possible “experimentalist” or collaborative regime designed to remedy some of the pathologies of the present.

## **I. Background**

The federal deduction for state and local taxes paid is as old as the federal income tax itself. For much of its life, though, it has been short on theoretical justification. Most commentators initially seemed to view the deduction as simply an equitable measure intended to put on an equal footing those who earned similar incomes in jurisdictions with differing tax

rates.<sup>13</sup> That equity explanation, though, foundered somewhat in the face of the fact that the deduction was available only to itemizers.<sup>14</sup>

Contemporary commentators are skeptical of the equity argument on other grounds, as well. The central insight of the contemporary view is that state taxpayers get what they pay for.<sup>15</sup> Local taxes, for example, pay for schools, filled potholes, plowed roads, and all the rest of the basket of services a municipality might provide. Some townships exact much higher taxes, but they also spend much more on services, especially education. State taxes offer highways, statewide education grants, national guardsmen. In this view, the equity argument melts away. Two taxpayers earning equal salaries in different jurisdictions might pay different tax rates, but they are still equally well-off.<sup>16</sup> One has less money in her pocket, but she also has purchased a set of services that leave her better off than her counterpart in the low-tax jurisdiction. Ultimately, this turns out to be at best a very rough view of the actual picture of tax-benefit tradeoffs. For purposes of this paper, though, my only goal is to note that the prevailing view is that the equity justification for a deduction is fairly weak, especially if one accounts for the administrative difficulties of more precise measures of equity that depart from the assumption that services received equals taxes paid.<sup>17</sup>

Some economists, however, have also suggested that the deduction could be viewed as a

---

<sup>13</sup> See *supra* note 5.

<sup>14</sup> See Stark, *supra* note 11, at 1414.

<sup>15</sup> See *supra* note 7.

<sup>16</sup> 2 TREASURY I, *supra* note 7, at 63; Hulten & Schwab, *supra* note 7, at 68--71.

<sup>17</sup> See Yorio, *supra* note 7, at 1281. Professor Zelinsky, on the other hand, has argued for a more granular analysis; he would grant a deduction for state taxes tied to state expenditures where the proper view of income would have resulted in federal deductibility if the same expenditure had been made by an individual. Edward A. Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 6 AM. J. TAX POL'Y 9, 10-11 (1987). His primary example is health care costs. *Id.* at 23.

tax expenditure on behalf of state governments.<sup>18</sup> That is, although the deduction nominally is claimed by individual taxpayers, it was said that the benefit flowed in the end to state taxing authorities.<sup>19</sup> In effect, the cost of any deductible state tax would decline by its taxpayers' marginal federal rate.<sup>20</sup> That would, in theory, allow the state to raise rates by the same margin without reducing the portion of state private output devoted to taxation or, more importantly, without incurring any additional political resistance.<sup>21</sup> Empirical studies seemed to bear out this analysis to some extent, showing that states do tend to raise and spend somewhat more revenues from deductible than from non-deductible taxes.<sup>22</sup>

A concrete example here may be helpful. Suppose I earn \$100,000, I itemize deductions, and my federal marginal tax rate is 28%. Let us say that Washington, D.C. imposes a further 10% tax on my earnings. Without deductibility my take-home pay is  $100 - 28 - 10 = \$62,000$ . With deductibility, it is  $100 - 10 - (28 - (.28 * 10)) = \$64,800$ . Knowing that I have received \$2,800 from the federal government, the District might respond by increasing its own taxes to recapture some of my savings. Assuming that I was willing politically to tolerate a combined tax burden that left me with \$62,000 in the first instance, I may well be willing to accept the same burden with some of the tax revenue now shifted to the District.

---

<sup>18</sup> See, e.g., 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); Gilbert E. Metcalf, *Deductibility & Optimal State and Local Fiscal Policy*, 39 ECON. LETTERS 217 (1992); see also Zelinsky, *supra* note 17, at 10. For more on the basics of tax expenditures, the reader is referred to Stanley S. Surrey & Paul R. McDaniel, *TAX EXPENDITURES* 3 (1985). For ease of reference, I will advert to state and local governments collectively as "state governments" unless distinguishing between the two is important in context.

<sup>19</sup> See REPORT OF THE PRESIDENT'S ADVISORY PANEL ON TAX REFORM, *supra* note 3, at 83; Lawrence B. Lindsey, *Federal Deductibility of State and Local Taxes: A Test of Public Choice by Representative Government*, in *FISCAL FEDERALISM: QUANTITATIVE STUDIES* 137 (Harvey Rosen, ed.).

<sup>20</sup> See JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 133, 152 (2d ed. 1988).

<sup>21</sup> Lindsey, *supra* note 19, at 137--76.

<sup>22</sup> See TREASURY II, *supra* note 7, at 65; Bruce Bartlett, *The Case for Eliminating Deductibility of State and Local Taxes*, 28 TAX NOTES 1121, 1122--23 (1985); Douglas Holtz-Eakin & Harvey Rosen, *Federal Deductibility and Local Property Tax Rates*, 27 J. URB. ECON. 269 (1990).

Yet, as the President’s Advisory Panel seemingly has concluded, the very effectiveness of the deduction may subject it to criticism from classical tax policy. As with many expenditures, the deduction is not “neutral”; that is, it distorts the incentives of some economic actors.<sup>23</sup> As we have just seen, the deduction might arguably encourage state governments to levy more taxes than they otherwise would, since the additional tax in a sense is paid for by the federal government rather than by the states’ own taxpayers. If nothing else, the deduction very likely induces state taxing authorities to shift their tax to those tax bases covered by the deduction, in order to maximize the revenue benefits from the federal government to its citizens.<sup>24</sup>

That leaves us to grope for an explanation for why such distortions might be desirable. If our only goal is to shift taxation from the federal government to the states, why not simply lower federal rates across the board rather than giving the deduction? Is there a good reason to think state governments would tax at less than optimal levels without a deduction?

The literature thus far offers two general answers. The first posits that redistributive taxing and spending is difficult on the state level.<sup>25</sup> To take the most basic example, assume that individuals are rationally self-interested, and that they can easily gather and comprehend information about the relationship between the taxes they pay and the benefits they realize not only in their own jurisdiction but in a number of others, each of which they could relocate to relatively costlessly. In that situation, we might expect that a tax system that took money from

---

<sup>23</sup> William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 366--67 (1972).

<sup>24</sup> See *supra* note 22.

<sup>25</sup> 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); Richard Briffault, “What About the ‘Ism’?” *Normative and Formal Concerns in Contemporary Federalism*, 47 VAND. L. REV. 13013, 1321 (1994); Henry W. Herzog, Jr. & Alan M. Schlottmann, *State and Local Tax Deductibility and Metropolitan Migration*, 39 NAT’L TAX J. 189 (1986); see also William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 212, 246, 248 & n.196 (1997).

Taxpayer A to give to Taxpayer B might prompt A to move to somewhere that did not. If Taxpayer A's jurisdiction wants to keep her and her tax dollars from fleeing, it must reduce or abandon its redistribution efforts. On the other hand, unless A wants to give up the benefits of U.S. residency, it will be rather harder for her to escape redistributive taxing by the national government.<sup>26</sup> So the deduction might be a form of redistributive federalism, in which the national government shares its tax dollars with states, who can then soften the blow of their own redistributive taxes.<sup>27</sup>

Relatedly, some writers have also claimed that the deduction may be a way for the federal government to encourage positive externalities.<sup>28</sup> Some of the things a state spends its money on might benefit not only its own taxpayers but also its neighbors. Good roads, clean air, safe shopping districts, schools that produce potential skilled employees -- all likely appeal nearly as much to nearby states as the state itself.<sup>29</sup> And, in a sense, the existence of other desirable locations other than the one we live in now might benefit us even if we don't directly enjoy its scenic vistas or top-tier law schools. The opportunity to relocate when times get dark in our own neck of the woods might be a form of insurance, allowing us to take risks with our own local governance. Neighbors can be a source of best practices to instruct us how to do our own governing better. And the threat of easy relocation to an appealing alternative might serve as a disciplining force on our current state government. The trouble is that each individual state government has no obvious incentive to internalize all the benefits of these positive

---

<sup>26</sup> See Gillette, *supra* note 11, at 1046 n.62.

<sup>27</sup> See Bratton & McCahery, *supra* note 25, at 248 n.196; Stark, *supra* note 11, at 1431.

<sup>28</sup> See Billman & Cunningham, *supra* note 7, at 1112; Kaplow, *supra* note 5, at 481--83; Stark, *supra* note 11, at 1410. *But see* 1 TREASURY I, *supra* note 7, at 78 (arguing that spillover effects are not beneficial enough to be worth the expenditure of the deduction).

<sup>29</sup> See, e.g., Clayton Gillette, *The Conditions of Interlocal Cooperation*, 21 J. L. & POL. 365, 365--66 (2005).

externalities.<sup>30</sup> The deduction, some have suggested, moves in that direction by at least encouraging state governments to spend in ways that might produce some benefits to others.<sup>31</sup>

Obviously, though, there are serious counter-arguments to both of these claims. Both, for example, seem to rely heavily on the assumption that states will make beneficial use of the deduction rather than simply lowering their own tax burden. And both make extensive assumptions about why and how easily people move from jurisdiction to jurisdiction. Nor does either offer a good reason, aside from administrability, to push states to impose income, property, and sales taxes over any others. I return to these problems later in the paper.

Another set of challenges for the deduction was laid out in 1996 by Harvard professor Louis Kaplow. On the redistribution point, Kaplow argues that it is possible that subsidies are not necessary to produce local redistribution. Programs we term “redistributive” might result instead from a locality’s view that such spending in fact produces good for the whole community. If not, potential transferees might have enough political power to extract transfers from others.<sup>32</sup> In either case, he claims, redistribution is indistinguishable from any other local government service.<sup>33</sup> His view of spillovers is similar.<sup>34</sup> Alternatively, where redistribution might be efficient or otherwise desirable from a national perspective, Kaplow argues that we would be better off with direct spending instead of a deduction.<sup>35</sup> Deductions, he says, are regressive,

---

<sup>30</sup> See Ellickson, *supra* note 11, 30, at 1554.

<sup>31</sup> See Gillette, *supra* note 11, at 1046; Kaplow, *supra* note 5, at 480--83; Stark, *supra* note 11, at 1410; Yorio, *supra* note 7, at 1280.

<sup>32</sup> *Id.* at 478-79

<sup>33</sup> *Id.* at 480. Kaplow’s position, in other words, is that it is likely that no deduction is appropriate in those circumstances because we should measure the subjective value of the tax and redistribution package by the resident’s choice to live in that community.

<sup>34</sup> *Id.* at 481-83.

<sup>35</sup> *Id.* at 477-78, 484.

because they are most valuable to taxpayers with higher income.<sup>36</sup> They also are not especially well targeted to reward only redistribution or spillover spending, and offer little transparency or political accountability to ensure that they are money well spent.<sup>37</sup>

My aim over the remainder of this paper is to examine how durable these conclusions prove in light of other claims based in fiscal federalism and regulatory theory.

## **II. A State Subsidy?**

The traditional view of the deduction as tax expenditure rejects the claim that tax preferences for state and local spending lead to too much local government. In a sentence, the basic argument here is that it is difficult for states to tax without driving away taxpayers to lower-tax states, so that federal subsidies help to transfer money from a central taxing jurisdiction that is not easily escaped back to competing states.<sup>38</sup> This position, which I'll call the "state subsidy" view, has attracted proponents as diverse as Marty Feldstein and Mario Cuomo.<sup>39</sup> Perhaps because of that apparently broad agreement, its treatment in the legal literature is fairly thin, although it has attracted at least two very persuasive critics. In this Part I try to flesh out the state subsidy explanation, and examine the skeptics' claims. Ultimately, I find the subsidy argument somewhat tenable, but not generally for the reasons most commentators have previously said. And I conclude that the strongest arguments may bring the subsidy directly into conflict with any effort to encourage states and the federal government to tax the same base.

---

<sup>36</sup> *Id.* at 484-85. Our current system exacerbates this effect by allowing the deduction only for itemizers, who generally are wealthier than those taking the standard deduction.

<sup>37</sup> *Id.* at 485-86; *see also* Yorio, *supra* note 7, at 1280. I don't believe that these are inevitable features of a tax system. But that is a subject for other work.

<sup>38</sup> Bratton & McCahery, *supra* note 25, at 248 & n.196; Briffault, *supra* note 45, at 539; *see* Stark, *supra* note 11, at 1431; Lior Jacob Strahilevitz, *The Uneasy Case for Devolution of the Individual Income Tax*, 85 IOWA L. REV. 907, 926 (2000).

<sup>39</sup> *See* Feldstein & Metcalf, *supra* note 18, at ; Michael I. Luger, *Federal Tax Reform and the Interjurisdictional Mobility Impulse*, 23 J. URB. ECON. 235, 235 (1988).

## A. Redistribution

In its classic formulation, the tax expenditure argument for the deduction posits that it is difficult for the States to impose some forms of taxation. Typically, the state subsidy proponent will begin her argument by noting that taxpayers may flee a high-tax jurisdiction for a lower, so that states race to the bottom of the bracket to prevent population and capital leakage.<sup>40</sup> In this view, there is downward pressure on state taxes, resulting from the simple fact that some taxpayers pay more than they get, and would prefer that it were otherwise.<sup>41</sup> Indeed, many proponents of the state subsidy theory suggest that the subsidy is not to support state spending generally, but rather to ensure the possibility of state *redistributive* spending.<sup>42</sup> That claim is directly contrary to the view of the President's Advisory Panel, which argues that favorable tax treatment encourages over-consumption of state government.

The argument in favor of subsidy rests largely on exit pressures. Suppose that citizens flee or threaten credibly to flee from a jurisdiction that imposes redistributive taxation upon them. It then becomes much easier for the federal government, whose tax authority it is very difficult for individuals to escape, to extract more than it gives to an individual. In the abstract states might cooperate or negotiate to prevent destructive rate competition.<sup>43</sup> It is generally

---

<sup>40</sup> See RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 181 (1959) Stark, *supra* note 11, at 1395; see also Bratton & McCahery, *supra* note 25, at 248 & n. 196; Richard Briffault, "What About the 'Ism'?" *Normative and Formal Concerns in Contemporary Federalism*, 47 *VAND. L. REV.* 13013, 1314, 1321 (1994); D. Bruce LaPierre, *Political Accountability in the National Political Process --- The Alternative to Judicial Review of Federalism Issues*, 80 *NW. U. L. REV.* 577, 594 (1985); Revesz, *supra* note ?, at 1239--40.

<sup>41</sup> See *supra* note 25.

<sup>42</sup> See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 454--55 (5th ed. 1989); WALLACE E. OATES, *FISCAL FEDERALISM* 6--8, 137--40 (1979); Billman & Cunningham, *supra* note 7, at . In this section I take a particularly broad view of redistribution; I include not only single-year transfers from wealthy to indigent, but also inter-temporal transfers from current taxpayers to later taxpayers in the form of capacity-building, capital investment, and other outlays that may be of more benefit to those in the future than they are to those who pay for them now.

<sup>43</sup> See Bratton & McCahery, *supra* note 25, at 248.

thought, though, that cooperation between states (other than through the federal government) is unlikely to be sustainable, because of the high transaction costs in reaching agreement with so many other jurisdictions and because of the large benefits that would flow to defectors from any tax cartel.<sup>44</sup> Taxation at the federal level largely mitigates both these problems.<sup>45</sup> The deduction then returns some of the resulting extra revenue capacity to states.<sup>46</sup> Predictably, though, there are some potential holes in this theory.

First, it may not be quite right that the States can't effectively impose redistributive taxes. Some economists suggest that in certain circumstances the existence of a tax in jurisdiction A may actually encourage jurisdiction B to impose a similar tax.<sup>47</sup> Suppose, for instance, we have nextdoor states A and B. A imposes a luxury tax on the sale of african diamond-crusted widgets. Demand for ADCW's now shifts to B, where, in all likelihood, it drives up the price. Perhaps money now flows from B to african widget-makers, who have integrated their wholesale and retail businesses. At some point, the price in B and tax rate in A reach an equilibrium point at which buyers are indifferent between purchases in either state. In this scenario, the state of B has a fairly clear-cut incentive to impose its own luxury tax. Since the incidence of A's tax rests in part on consumers in B,<sup>48</sup> and that money benefits either A's citizens or african widget-makers, B

---

<sup>44</sup> See Lynn A. Baker, *Conditional Federal Spending After Lopez*, 95 COLUM. L. REV. 1911, 1971 n.280 (1995); Thomas S. Ulen, *Economic and Public-Choice Forces in Federalism*, 6 GEO. MASON L. REV. 921, 927 (1998).

<sup>45</sup> See Bratton & McCahery, *supra* note 25, at 212; Richard Briffault, *Public Finance in the American Federal System: Basic Patterns and Current Issues*, 2 COLUM. J. EUR. L. 533, 539--40 (1996); Ulen, *supra* note 44, at 948; cf. Reuven S. Avi-Yonah, *Passport to Toledo: Cuno, the World Trade Organization, and the European Court of Justice*, TAX NOTES 1661, 1665 (Dec. 26, 2005) (making similar argument with respect to international flow of capital in response to nation-state tax efforts).

<sup>46</sup> See Briffault, *supra* note 45, at 545--46.

<sup>47</sup> See, e.g., Ravi Kanbur & Michael Keen, *Jeux Sans Frontieres: Tax Competition and Tax Coordination When Countries Differ in Size*, 83 AM. ECON. 877, 879-81; Jack Mintz & Henry Tulkens, *Commodity Tax Competition Between Member States of a Federation: Equilibrium and Efficiency*, 29 J. PUB. ECON. 133 (1986).

<sup>48</sup> I assume as part of the hypothetical that A has in place some strategy that allows it to blunt possible in-migration from taxpayers in B. For example, A might conceal from outsiders the amount of quality of its services.

would be better served imposing a tax that brought its own ADCW prices to the equilibrium point and keeping the resulting money in benefits for B residents. Obviously, this example is exceedingly simplified, especially in that it is built to exclude the possible effects of changes in wage rates and return to capital in the event that some ADCW manufacturers or retailers are themselves resident in A or B. But the point is that the possibility that states can sometimes export the burden of their taxes may lead to upwards, rather than downwards, tax pressure. There don't seem to be any good data on how often, if at all, this actually occurs, though.

Second, we might wonder whether in fact exit is a significant source of downward pressure on redistributive taxation. Certainly, as we saw, there are major frictions that limit exit. But credible *threats* of exit are likely more important than exit itself.<sup>49</sup> Many commenters of earlier drafts also wondered whether people really relocate for tax reasons. Limited empirical data suggest that tax is, in fact, a significant motivator in the relocation decisions of at least wealthy individuals and small business owners (who are usually taxed only as individuals, because their business is taxed as a pass-through entity).<sup>50</sup> That data is especially significant in light of the possibility, as I suggest in more detail later, that the existence of the deduction itself dampens mobility. That we can measure some mobility effect notwithstanding the influence of

---

<sup>49</sup> Cf. Kim Rueben, *The Impact of Repealing State and Local Tax Deductibility*, STATE TAX NOTES 497, 511 (Aug. 15, 2005) (suggesting that fear that high-income households will leave in the absence of deduction will drive down state and local taxes and services). I develop this point more extensively in Part III, *infra*. See *infra* text accompanying notes 112, 132, 132 -- 33. In brief, office-holders fear that exit will reflect poorly on them in future elections, and lack information to assess the credibility of most exit threats. Therefore, they act as though threats have force, even though they know that many are in fact irrational.

<sup>50</sup> See Jon Bakija and Joel Slemrod, "Do the Rich Flee From High State Taxes? Evidence From Federal Estate Tax Returns," National Bureau of Economics Research Working Paper 10645 (2004); Charles E. McClure Jr., *The Nuttiness of State and Local Taxes -- and the Nuttiness of Responses Thereto*, STATE TAX NOTES, Sept. 16, 2002, at 841; cf. Amy Feldman, *Fifty States, a Thousand New Tax Laws*, INC. MAGAZINE, June 14, 2005 (advising taxpayers, apparently in all seriousness, to move to a tax haven in response to confusing state tax laws). Lior Strahilevitz also points out that there is strong evidence that individuals move in response to cost of living considerations, which necessarily include tax effects. Strahilevitz, *supra* note 38, at 929-30.

the deduction suggests that exit, and exit-driven downward pressures, would be rather greater in its absence. Depending on how strong the downward pressure is, that conclusion implies that the President's Panel is wrong that the deduction creates over-consumption of state government, rather than helping to balance out the downward pressure exerted by interstate competition.

A more potent objection, then, might be that it is unclear why we should prefer redistributive spending by the States to similar spending by the federal government. Professor Stark, for example, recently has argued that as a "normative" matter we should prefer federal to state redistribution.<sup>51</sup> That is, he claims that exit is inefficient, because of the deadweight losses that attach to gathering information and uprooting.<sup>52</sup> But the main argument usually offered in favor of federalism is that it is efficient.<sup>53</sup> Exit is supposed to ensure that resources flow to where they are most useful, and to chasten local governments to be more effective.<sup>54</sup> The question then becomes whether the supposed efficiency losses that attend localized redistribution predominate over the efficiency gains of dispersed delivery of government services.<sup>55</sup>

---

<sup>51</sup> Stark, *supra* note 11, at 1395.

<sup>52</sup> As a sidenote, the arguments Stark summarizes for why redistribution may not prompt exit are consistent with our current working hypothesis for the state subsidy theory. He notes that some communities might willingly move money from wealthier taxpayers to the less wealthy in order to satisfy their sense of charitable obligation and to prevent crime. *Id.*; *see also* Fennell, *supra* note 77, at 4. As Kaplow points out, that is not redistribution; it is consumption. *See* Kaplow, *supra* note 5, at 474--79. I address here only redistribution that is viewed subjectively by the payers as a net loss.

<sup>53</sup> *See* WILLIAM A. FISCHER, *THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND USE POLICIES* ix (2001); Been, *supra* note ?, at 475--76; Briffault, *supra* note 45, at 540.

<sup>54</sup> *See* PAUL E. PETERSON, *THE PRICE OF FEDERALISM* 17--18, 25 (1995); Briffault, *supra* note 45, at 540; Robert G. Lynch, *Weaknesses in the Common Arguments for State and Local Tax Cuts and Incentives*, 32 *STATE TAX NOTES* 597, 602 (2004); McConnell, *supra* note 59, at 1498--50. As we've seen, there are many barriers to exit that draw the efficiency of any exit-driven system into question. However, a market may be chastened even by a relatively small segment of its participants. *See, e.g.*, Kaplow, *supra* note 5, at 442. I have argued that at least some taxpayers are likely to relocate in search of more efficient jurisdictions despite substantial frictions. *See Brian Galle, Rethinking the Horizontal Equity of Section 164*, at 12, 18 (unpublished manuscript, on file with author). Therefore, it looks possible at this point that exit may generate some efficiency gains.

<sup>55</sup> There is no real agreement in the economic literature on this point. *See, e.g.*, George Zodrow, *Reflections on the Economic Theory of Local Tax Incentives*, 2003 *STATE TAX TODAY* 110-5 (June 9) (setting out conflicting views of the efficiency of permitting redistributive taxing and spending on the local level). My argument in the next Part is

Although I sound skeptical, in fact I do agree that local redistribution may sometimes be inferior to national efforts. As other writers have described, it is possible to design national systems in a way that permits, even magnifies, the diversity and autonomy benefits of federalism.<sup>56</sup> A central federal authority regulating in collaboration with the States can serve as a clearinghouse for information, force states to be more forthcoming about the quality of the services they are delivering, render the data in a way that facilitates comparison, and thereby perhaps encourage migration from laggards.<sup>57</sup> Of course, not all federal spending programs are designed so well. For now, though, the comparative efficiency debate looks like a draw.

A key point, however, is that the deduction may itself affect the efficiency both of state and federal governance. I discuss in the next Part some ways in which the deduction may actually degrade the quality of state government, an outcome that certainly gives us pause about the wisdom of encouraging redistribution by those governments. Still, the tax system may offer its own potential to ensure that the funds it disburses to states for redistribution are spent well. It should be possible, in theory, to create a sort of market for the deduction, in which states are rewarded for transparency and penalized (by the market or regulators) for highly inefficient outcomes. In that situation we would be inclined to say that the “normative” case against using the deduction to encourage state-level redistribution is weak.

In sum, there is only moderate bite to claims by critics that fiscal supports for state government redistributive projects distort the market for state government. Rather, federal subsidies generally restore consumer choice to a marketplace otherwise crippled by collective

---

that these debates overlook the potential impact of the deduction itself.

<sup>56</sup> See Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 314, 321 (1998).

<sup>57</sup> See *id.* at 299--301, 322, 347, 354, 444.

action problems. But the case for using tax deductions, rather than direct spending, to achieve that end is not at this point as clear cut. There are trade-offs between the tax and spending alternatives that may warrant choice of one or the other in different circumstances, a problem I return to shortly in section D of this Part.

## **B. Devolution**

There is another challenge for the state subsidy theory. Recall the argument, generally advantaged in the context of analyses of the “tax equity” of the deduction, that annually state taxes roughly equal the benefits a given individual taxpayer receives.<sup>58</sup> Under that premise, it quickly becomes difficult to see the tax expenditure argument for the deduction. If there is a rough equilibrium in most jurisdictions between taxes and services, though, then there is no race to bottom to avoid burdensome transfer payments. Taxpayers may relocate to find their desired level of taxing and spending. But they lose as much as they gain if they prefer more services and flee to a low-tax, low-service state.

There is a residual argument for the state subsidy position, though. Or, really, an argument that was there all along. The only reason we care about whether states are able to tax is if we are in favor of state spending. Quite possibly, we could respond to the fact that states can’t raise much revenue by shrugging and then taxing and spending almost exclusively at the federal level. So the state subsidy claim is really a claim about federalism – that local spending is better, whether because it facilitates nationwide experimentation, maximizes autonomy, encourages a

---

<sup>58</sup> See *supra* text accompanying notes 14--17. It is worth reminding the reader that I limit my scope here to the taxation of individuals. The incidence of entity taxation and the possible responses by entities are, if possible, more complex than for individuals.

spirit of community, or achieves some other similar set of values that we might imagine.<sup>59</sup> The particulars aren't important just yet. The point is that the deduction would have the effect of moving money from federal hands to state hands so that, without necessarily changing the amount of government services purchased nationwide, we've reduced the scope of federal operations and increased the money, and presumably the opportunities to regulate, available to states.

The question now arises why we need the deduction to accomplish that goal. It seems like we could well get to the same bottom line simply by cutting federal taxes across the board. Assuming that some localities have a preference for the level of combined services delivered by the federal and state governments before, they ought to respond by raising their own taxes to make up for the diminished federal demands and deliveries. Indeed, as I sketched before, it's quite likely that many taxpayers prefer locally-delivered services to nationalized services. So they should, if anything, be happy to take up federal slack with state wind.

Research by tax scholars and psychologists suggests, however, that things are rarely so clear-cut.<sup>60</sup> In some experiments, voters were unlikely to treat different groups of taxes with identical incidence as a single interchangeable mental category, "tax."<sup>61</sup> That results is contrary to our initial assumption that taxpayers are likely indifferent to different allocations between federal and state taxes in their overall tax burden. Study participants were similarly unlikely to

---

<sup>59</sup> See Bratton & McCahery, *supra* note 25, at 215--16 (noting view that "locally adopted regulation more likely approaches the ideal of consonance with citizen preferences"); Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1494 (1987); Shaviro, *supra* note 7, at 960.

<sup>60</sup> See, e.g., Edward J. McCaffery & Jonathan Baron, *Thinking About Tax*, USC CLEO Research Paper No. C04-10, at 2-4 (July 16, 2004), available at <http://ssrn.com/abstract-567767>

<sup>61</sup> McCaffery & Baron, *supra* note ?, at 26--28; Edward J. McCaffery & Jonathan Baron, *The Humpty Dumpty Blues: Disaggregation Bias in the Evaluation of Tax Systems*, USC CLEO Research Paper No. C02-1, at 6 (Jan. 28, 2002), available at [http://papers.ssrn.com/abstract\\_id=29648](http://papers.ssrn.com/abstract_id=29648).

be able to keep together in their mind taxes with the benefits those taxes bought, a phenomenon the researchers dubbed the “isolation effect” or the “disaggregation bias.”<sup>62</sup> The real-world prediction that flows from these effects is that voters will be discontent about decreased federal services, but also hostile to higher state taxes. That is, taxpayers will fail to put together the fact that their taxes and services have shifted from the federal level to the state level; they will more likely notice, and be angry at, higher state taxes and lower federal services. That is especially likely if state taxes are highly “salient,” or imposed in a form very noticeable by the taxpayers. Thus, they may resist new state taxes, even if to pay for services shifted from the federal level. So federal tax cuts may simply lead to smaller government, even if the actual preference of the electorate is for more regulation.<sup>63</sup>

The deduction responds to this type of problem by tying any decrease in federal tax levels to higher state tax levels.<sup>64</sup> Of course, the effectiveness of the deduction itself is probably also limited by the isolation effect. The deduction will likely not be fully effective at lessening the sting of higher state taxes, because many taxpayers won’t associate their higher state bill with the lower federal bill. But, unlike any effort to use the deduction to force state and federal tax bases to overlap, a purely devolutionary deduction can also make use of the disaggregation bias. To maximize the usefulness of the deduction, the federal government could allow the deduction to recognize as wide a variety of state taxes as the States can invent. By spreading out its tax burden over many small taxes, each with its blow somewhat cushioned by a federal deduction, the state might rather reduce the salience of its tax burden.<sup>65</sup> That, in turn, may make it feasible

---

<sup>62</sup> *Id.*

<sup>63</sup>

<sup>64</sup> See Gillette, *supra* note 3, at 1053 (noting that federal government uses matching grants to ensure that its contribution to state will not be used simply to decrease state’s tax burden).

<sup>65</sup> McCaffery & Baron, *supra* note 60, at 26.

that the decline in federal revenue will actually be matched by a corresponding expansion of state proceeds.

The attentive reader no doubt has noticed that I have sprinkled this discussion with qualifiers. I confess that many of my conclusions, such as they are, turn on the actual psychological effects of differently structured tax regimes. They are, in other words, guesses. More empirical work in these areas may give us more confidence in the accuracy of our guesses. For now, though, it looks as though a purely devolutionary-targeted deduction could conceivably be somewhat effective, especially if it allows taxpayers to claim a wide variety of state taxes.

Even so, that leaves us again with the question of de-biasing. The deduction here seems both to respond to and also trade in the fact of taxpayer misconceptions. It seems unwise, and perhaps even illegitimate, to make social policy whose basis depends on ignorance or misunderstanding. If we are committed to devolution, then, the better route might be to educate voters, not to manipulate their perceptions.<sup>66</sup> Thus, there is another front for more and better empirical work: how can we make de-biasing work, and can we make it work at a cost of less than the deduction's \$75 billion sticker?

### **C. Spillovers**

There is one last aspect of the state subsidy view we haven't yet considered. Local spending, we've seen, can serve not only residents of the locality but also their neighbors. The present wisdom is that each such locality is under-motivated to produce these kinds of "spillover" benefits.<sup>67</sup> Supposedly, states do not internalize the gains their spending provides to

---

<sup>66</sup>

<sup>67</sup> Ellickson, *supra* note 11, 30, at 1554.

others.<sup>68</sup> If that is true, then they will have no particular incentive to allocate their resources in a way that people who reside outside their own borders can enjoy.<sup>69</sup> The deduction, in this view, might make up for what would otherwise be an under-production of good spillovers.<sup>70</sup> Of course, there are some administrative challenges in making sure that the deduction is cost-effective (for example, in targeting it to jurisdictions that benefit their neighbors the most), but these perhaps are not insuperable. The larger difficulty for this theory, I suggest here, is that it is wrong that states don't internalize the benefits of the spillovers they produce. In particular, states can use spillovers as a way of bribing non-residents not to move in, which can benefit the state in two distinct ways.

### 1. The Benefits of Bribery

The first benefit to states flows from the fact that in a nation where interstate movement is inefficient, states can in theory export some of their tax burden.<sup>71</sup> To see how this works, start with a model where there are no frictions. To take a simple example, sales taxes are a classic way that a state can pay for some of its services with money supplied by outsiders – tourists and other short-term visitors – who consume relatively little in the way of some services, such as education and health care.<sup>72</sup> Hotel taxes are an especially good example, since they generally

---

<sup>68</sup> Gillette, *supra* note 11, at 1045--46; *see also* Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1147 (1996) (making this argument outside of tax context).

<sup>69</sup> Briffault, *supra* note 45, at 540--41; Ellickson, *supra* note 11, 30, at 1554; Gillette, *supra* note 11, at 1046--47.

<sup>70</sup> *See* Gillette, *supra* note 11, at 1046; Kaplow, *supra* note 5, at 480--83; Stark, *supra* note 11, at 1410; *cf.* Yorio, *supra* note 7, at 1280--81 (arguing that deduction increases beneficial spillovers without noting internalization problems).

<sup>71</sup> I should note here that the possibility of tax exporting is not necessarily a policy outcome to be avoided at the cost of other goals. *See, e.g.*, Shaviro, *supra* note 7, at 961-63 (arguing that tax exporting is at least unobjectionable in some circumstances). But for our purposes, the fact that some of a jurisdiction's costs are born by outsiders would weigh against a federal tax deduction, because it indicates that the jurisdiction is getting more in services than it is paying for.

<sup>72</sup> *See* Shaviro, *supra* note 7, at 911.

affect the state's own residents only indirectly.<sup>73</sup> But in a frictionless republic, the sales-tax state's citizens wouldn't be able to realize the benefits of exporting their tax.<sup>74</sup> The hotel-tax state is a bargain relative to its neighbors, so that their citizens now move into the state, driving up the cost of real estate and driving down wages.<sup>75</sup>

The hotel-tax state has two main options in the frictionless republic, neither very likely to succeed in allowing it to export its tax burden. First, it can simply pay a cash bribe to prospective immigrants to stay home.<sup>76</sup> Since the transaction costs of direct bargaining are likely to be immense, it would have to use some central authority to distribute its bribes; the federal government seems like a fine candidate. But even if transaction costs can be minimized, bribery shouldn't really work, because no rational, fully-informed carpet-bagger will accept a bribe of less than the value of the bargain she'd be getting in good old HTS. The state might also try another form of bribery – producing its services in a way that can also be used relatively costlessly by the neighbors who are bearing its tax burden. Again, though, that doesn't quite work. Having a clean, accessible, and safe vacation spot next door, filled with well-educated potential employees, is dandy. But, all else being equal, it isn't as good as living there.

Frictions make bribery and deception viable strategies. If the benefit of living in Hotel Tax City is \$100, and it costs \$50 to move there, a successful bribe obviously costs only \$50, which may make Hotel Tax City's tax-exporting scheme economically viable. Of far greater significance, though, is the fact that prospective immigrants probably cannot easily get an accurate estimate of the value of living in HTC, will tend to overvalue their own entitlements,

---

<sup>73</sup> *Id.* The state's residents are affected if the increased price for hotel rooms drives down demand, resulting in reduced return to capital for local hotel investors and maybe fewer jobs or lower wages for local workers.

<sup>74</sup> See Russell R. Krellove, *Efficient Tax Exporting*, 25 CANADIAN J. ECON. 145, 153 (1992); Gordon M. Myers, *Optimality, Free Mobility, and the Regional Authority in a Federation*, 43 J. PUB. ECON. 107, 108--09 (1990).

<sup>75</sup> *Id.*; cf. Shaviro, *supra* note 7, at 908 (describing distortionary effects of tax exporting).

<sup>76</sup> *Id.*

will have difficulty integrating the tax and benefit components of HTC's financing, and so on. Thus, even in a two-jurisdiction model, in which bundling problems are nonexistent and decision costs are relatively low, a successful bribe probably could be priced at considerably below the per capita fiscal advantage of tax exporting. That is crucial for larger models, in which the number of prospective immigrants widens far beyond the small group of neighbors on whom a jurisdiction is able to impose its own costs. The bribery story seems even more plausible if we think that moving and information-gathering costs increase with distance, so that even as the circle of jurisdictions laden with potential newcomers widens, the bribe necessary to keep them at bay diminishes.<sup>77</sup>

In addition to permitting tax exporting, spillovers enable a state to provide services to its citizens without also having to pay for free-riders. Any jurisdiction that offers public services will be likely to attract migrants. Migrants may be from lower-tax jurisdictions, or they may simply be late-comers who want to enjoy the fruit of the state's earlier investments in developing the capacity and know-how to deliver a given service.<sup>78</sup> One way the state can fend off the newcomers is to bribe them to stay at home. And one way of offering a bribe is for the state to deliver its services in a way that the would-be immigrant can enjoy without moving in. In a frictionless world, of course, that would not result in any gains for the service-providing state;

---

<sup>77</sup> As I suggested, this analysis also implies that states have an interest in deceiving outsiders about the mix of benefits and burdens they offer to their residents. By increasing information costs and uncertainty, a jurisdiction can lower the bribe it will have to pay to keep away newcomers. States should want to spend most on services whose value to outsiders is especially opaque -- education, for instance, seems a plausible candidate. See Bratton & McCahery, *supra* note 25, at 236 (observing difficulty for "consumers" in identifying quality of education a jurisdiction produces); cf. Lee Anne Fennell, *Beyond Exit and Voice: User Participation in the Production of Local Public Goods*, 80 TEX. L. REV. 1, 2-3 (2001) (observing that legal scholars have struggled to measure quality of education services). This incentive is significant for the impact of the deduction on the transparency of local government, as I detail in the next Part.

<sup>78</sup> See Roderick Hills, *Poverty, Residency, and Federalism: States' Duty of Impartiality Toward Newcomers*, 1999 SUP. CT. REV. 277, 304--07.

bribes would have to equal the benefits of residency.<sup>79</sup> But our nation is not so slippery as that. Moving is expensive, information about where and when to move is costly, and citizens often overvalue what they have relative to what they might get.<sup>80</sup>

Thus, producing some spillover benefits for neighboring jurisdictions in turn can produce yet larger gains for the spilling state.

## **2. Why Not Zoning?**

It might be argued, though, that states do not actually use bribes, because bribes are an inferior tool for achieving the same ends that could be accomplished through restrictive zoning. Localities can use zoning to force potential newcomers to consume more housing than they could afford, and to pay enough property tax to cover any services they might consume.<sup>81</sup> Here, though, we see a significant difference between state and local incentives: The States, at least at present, do not zone.<sup>82</sup> So bribery is a significant factor in state-level fiscal decisions.

At the local level, many jurisdictions cannot effectively employ restrictive zoning. Because exclusive zoning depends on restricting the number of people who can occupy a lot of land, it is not useful in wealthy but already-densely populated areas, such as Manhattan or San Francisco. In other regions exclusive zoning is unlawful or restricted by judicial supervision. Although would-be migrants don't have standing in federal court to challenge exclusive zoning in a jurisdiction where they don't reside,<sup>83</sup> a zoning jurisdiction must run the risk that its state

---

<sup>79</sup> Unless the service is a true public good -- that is, its value to the producer is not reduced by additional consumers.

<sup>80</sup> See Galle, *supra* note 54, at 17, 19--20. It is worth mentioning that the state cannot choose simply to refuse to pay benefits to new arrivals. *Saenz v. Roe*, 526 U.S. 489, 498--507 (1999).

<sup>81</sup> See *supra* note .

<sup>82</sup> Daniel R. Mandelker, *LAND USE LAW 1-1 to 1-2* (5th ed. 2003); Patrick J. Rohan, *ZONING AND LAND USE CONTROLS 1-10* (Eric Damian Kelly ed., rev. ed. 2005).

<sup>83</sup> *Warth v. Seldin*, 422 U.S. 490, 502--08 (1975). Fiscal federalism theory suggests much that is wrong in the reasoning of the *Warth* court, but that is a subject for another day.

will take a broader view of the rights cognizable in state court.<sup>84</sup> Further, zoning is not effective at shifting costs onto neighbors who can afford to respond by moving into the would-be exporter. Exclusive zoning also has social costs, such as lost diversity, that some jurisdictions may recognize as significant.<sup>85</sup> Finally, it may be that bribery is cost-effective even in addition to exclusive zoning.

\*\*\*

In short, there looks to be little reason to think that states need to be encouraged to generate spillover benefits. A good number of localities, too, are likely to internalize many of the benefits of spillovers, because exclusive zoning is not a fully effective alternative. It isn't clear that we would be able to, or want to, sort out those that needed further encouragement. Indeed, the fact that the deduction facilitates spillovers should give us some hesitation about the deduction generally, since it might, in turn, also grease the skids for tax exporting.

#### **D. Why Not Direct Spending?**

From this sketch, it doesn't look like any of these three possible tax subsidy arguments is particularly overwhelming. But suppose we thought one or more of them was reasonably persuasive. We might then ask, with Professor Kaplow, why bother with taxes at all? Kaplow argues that direct federal grants to the States could serve the same ends as the deduction without some of the attendant distortions.<sup>86</sup> Obviously, the debate over using the tax system for policy objectives is a subject much larger than I can do justice to here. An abbreviated glance, however,

---

<sup>84</sup> Cf. Helen Hershkoff, *State Courts and the Passive Virtues: Rethinking the Judicial Function*, 114 HARV. L. REV. 1833, 1836--37, 1852--59, 1881--97 (2001) (noting that state courts sometimes take broader view of standing than federal courts, and setting out detailed rationale for that approach).

<sup>85</sup> See Fennell, *supra* note 77, at 85.

<sup>86</sup> Kaplow, *supra* note 5, at 484--86; see also Gillette, *supra* note 11, at 1067, 1074 (arguing that direct grants would be preferable to deduction for municipal bonds for subsidizing local spending because grants would minimize distortions).

suggests at least some potential role for deductions alongside direct expenditures.

Perhaps Kaplow's most trenchant argument is his claim that direct grants would allow for more accountability on the part of state officials who take receipt of the grant moneys and decide how to spend.<sup>87</sup> He may be thinking of the many strings, including judicial oversight, that often come with federal grants. But, again, assuming that is an attractive approach, it is at least conceivable to design a similar structure around tax expenditures.<sup>88</sup> Consider two tax long-standing tax expenditures: the charitable deduction and exemptions, centered around section 501 of the Code, and the Low-Income Housing Tax Credit.<sup>89</sup> Both offer potential models for how favorable tax treatment can mimic the accountability and transparency of direct spending programs. Under both programs, the IRS actively monitors the behavior of recipients. While not all the results of the IRS's enforcement activities are made public, the process of complying with IRS mandates produces vast amounts of public information, such as the Forms 1023 prepared by entities applying for exempt status and annual Form 990 returns filed by those entities. These forms are now collected on-line,<sup>90</sup> and offer taxpayers -- as well as prospective donors or business partners -- a window into the finances, charitable objectives, and internal governance structures of various charities. At the same time, the IRS is not alone in its enforcement and monitoring efforts. Under both programs, the IRS draws significantly on the expertise and eyes

---

<sup>87</sup> *Id.* at 485--86.

<sup>88</sup> See generally Mary L. Heen, *Reinventing Tax Expenditure Reform: Improving Program Oversight Under the Government Performance and Results Act*, 35 WAKE FOREST L. REV. 751 (2000); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004).

<sup>89</sup> 26 U.S.C. 42. For a review of the LIHTC and its mechanics, see U.S. Dep't of Housing and Urban Development, *HOME and Low Income Housing Tax Credits (LIHTC)* (Aug. 30, 2004), available at <http://www.hud.gov/offices/cpd/affordablehousing/training/lihtc/index.cfm>; Andrew Zack Blatter & Elena Marty-Nelson, *An Overview of the Low Income Housing Tax Credit*, 17 U. BALT. L. REV. 253, 255--70 (1988); Sagit Leviner, *Affordable Housing and the Role of the Low Income Housing Tax Credit Program: a Contemporary Assessment*, 57 TAX LAWYER 869, 871--75 (2004). For a discussion of the tax credit in the context of housing preservation policy, see Brian Galle, *Preserving Federally Assisted Housing at the State and Local Level: A Legislative Toolkit*, 29 HOUS. L. BULL. 183 (1999).

<sup>90</sup> <[www.guidestar.org](http://www.guidestar.org)>

of regulatory partners -- state attorneys general in the case of exempt entities, and HUD and state housing finance agencies in the case of the LIHTC.

The analogy to exempt entities suggests another possible strength of subsidizing states with tax deductions rather than grants: the size of the subsidy is dictated by market decisions, rather than by Congress. Recall that one of the premises of the state-subsidy rationale was that it helped to restore to states the political autonomy to set their own fiscal policy, a freedom somewhat compromised by collective action problems. That goal seems incompatible with direct subsidies: If the federal government collects the revenues on the States' behalf, how does it know what allocation of funds would duplicate what would have been the states' original preferences? Once the money is collected the individual states are unlikely to claim that they are uninterested in distributing it to their citizens; no one turns down free money.<sup>91</sup> One possibility is that we could allocate federal money according to the extent to which states actually redistribute their own money, much as the charitable deduction in effect rewards charities in proportion to the amount of public support they can garner.<sup>92</sup> The current deduction superficially seems to do just that, since it rewards states in proportion to the extent to which they impose their tax burden on wealthy itemizers.

There is a problem with this argument, though. State tax revenues speak only to the intake side of the balance sheet; we don't know what states do with the money they raise.<sup>93</sup> It seems fairly plausible that they shift both taxes and services to high earners. That is, although states may tax more heavily because of the deduction, they might not *redistribute* the tax income

---

<sup>91</sup> See Lynn A. Baker, *The Spending Power and the Federalist Revival*, 4 CHAPMAN L. REV. 195, 201--04 (2001).

<sup>92</sup> See David E. Wildasin, *Income Redistribution in a Common Labor Market*, 81 AM. ECON. REV. 757, 761--65 (1991).

<sup>93</sup> To be a bit more precise, we do know that states for the most part do not spend their money on programs typically defined as redistributive, such as pure transfer payments. PETERSON, *supra* note 54, at 211 (1995). We don't have good data about the distributive effects of other forms of state spending.

in the way they would have preferred absent collective action barriers. Professor Stark argues to the contrary, claiming that many state constitutions require some equity in education expenditures, and noting that the U.S. Constitution prohibits discrimination based on race, thereby putatively limiting a state's ability to channel its tax dollars to selected groups.<sup>94</sup>

With due respect to Professor Stark, these are unconvincing arguments. Federal constitutional scrutiny of class-based state spending is minimal,<sup>95</sup> and is not heightened by the fact that class differences may overlap with racial differences.<sup>96</sup> Notably, the Supreme Court has upheld large disparities in state allocations of education spending.<sup>97</sup> State constitutional rulings have largely set minimum standards for all school districts without capping what wealthier districts can spend on themselves.<sup>98</sup> And there are few, if any, limits anywhere on how a locality can allocate its money for jobs, policing, parks, clean streets, or filled potholes, or how it chooses between services with obvious distributive implications, such as highways versus public transit, workplace safety and health inspectors versus securities regulators.<sup>99</sup> Moreover, to the extent that jurisdictions may want to discourage free-riding by indigent newcomers, the jurisdictions have an incentive to allocate service dollars in ways that will benefit those with more wealth.

So allocation has no obvious workable shortcut, and it is a serious conceptual problem.

---

<sup>94</sup> Stark, *supra* note 11, at 1426--27.

<sup>95</sup> *E.g.*, FCC v. Beach Comm., 508 U.S. 307, 313--14 (1993).

<sup>96</sup> See McCleskey v. Kemp, 481 U.S. 279, 297--99 (1987) (rejecting argument that facially neutral policy with incidental disparate impact on protected minority group violated Constitution); Washington v. Davis, 426 U.S. 299, 239--42, 248 & n.14 (1976) (same).

<sup>97</sup> San Antonio Indep. Sch. Dist. v. Rodriguez, 411 U.S. 1, 28--44 (1973).

<sup>98</sup> See Laurie Reynolds, *Skybox Schools: Public Education as Private Luxury*, 82 Wash. U. L.Q. 755, 756--61 (2004); Avida Y. Cover, Note, *Is "Adequacy" a More "Political Question" than "Equality?"*: *The Effect of Standards-Based Education on Judicial Standards for Education Finance*, 11 Cornell J.L. & Pub. Pol'y 403, 409--11 (2002).

<sup>99</sup> See Briffault, *supra* note 45, at 536; Clayton P. Gillette, *Equality and Variety in the Delivery of Municipal Services*, 100 HARV. L. REV. 946, 950 (1987) (reviewing CHARLES M. HAAR & DANIEL W. FESSLER, *THE WRONG SIDE OF THE TRACKS: A REVOLUTIONARY REDISCOVERY OF THE COMMON LAW TRADITION OF FAIRNESS IN THE STRUGGLE AGAINST INEQUALITY* (1986)).

The deduction seems an attractive alternative to grants if its goal is to restore spending discretion -- and therefore political autonomy -- to states hamstrung by collective action problems. But it appears clear that any distribution of money for redistribution will be according to a federal formula highly unlikely to capture the actual preferences of each state.

Another criticism of the deduction is that it may not be a particularly efficient tool for delivering money to state governments.<sup>100</sup> Unlike a simple grant, the deduction does not necessarily deliver money to states on a dollar-for-dollar basis; instead, it relies on some alchemy of the political views of deduction recipients and responses by state officials. The perceived after-federal-tax cost of a state tax to a state voter may be hard to calculate, especially in light of possible federal changes. This uncertainty arguably reduces the value of the deduction in a way that cash in hand certainly does not. However, the deduction might also actually buoy federal revenues. Remember that the deduction, especially in its current form, is most valuable to high-income states. At the moment, most of the highest-earning states are net federal tax exporters.<sup>101</sup> The deduction counter-balances that disparity (hence, the support of Mario Cuomo).<sup>102</sup> And the federal income tax is considerably more salient than most federal expenditures, especially for higher-wage earners who don't receive Social Security, Medicare, Medicaid, or AFDC benefits. So the deduction could make voters in these net-payer states more willing to shoulder their high combined tax burden. Cognitive biases, in short, might allow the deduction to do much more

---

<sup>100</sup> I am grateful to Professor Pearlman for his thoughtful arguments on this point.

<sup>101</sup> Tax Foundation, *Federal Taxing and Spending By State*, available at <http://www.taxfoundation.org/taxdata/topic/92.html>

<sup>102</sup> See, e.g., Daniel J. Mitchell, Heritage Foundation, *The Deduction for State and Local Taxes Undermines Tax Reform and Subsidizes High-Tax States* (July 25, 2005), available at <http://www.heritage.org/Research/Taxes/em974.cfm> (arguing that deduction supports state tax revenues in richest states).

work in facilitating federal spending than its pure dollar value.<sup>103</sup> But it could well also leverage much less. More data undoubtedly would be welcome here. We do know, though, that cooperative spending programs are not 100% efficient, either, since they entail significant bureaucratic costs. So it isn't clear at the moment that the deduction is a comparatively inefficient way of delivering federal monies.

On the other hand, it seems as though there ought to be room for *both* grants and tax expenditures as tools of federal subsidy. As we've seen, it probably is politically very difficult to remove a large deduction, enjoyed by politically powerful wealthy taxpayers, from the federal income tax. At least some benefits financed through direct expenditure are not comparably resilient. Thus, tax subsidies can be rather more stable than direct spending.<sup>104</sup> That stability obviously makes planning and reliance easier for those affected by the federal program. Further, stability can save the federal government money. I've noted elsewhere that a prospective regulatory partner contemplating working together with the federal government in exchange for financial gain is likely to demand a premium for uncertainty.<sup>105</sup> Changes in federal policy may lock the partner in to continuing a course that, while unprofitable, is less disadvantageous than abandoning sunk investments and starting over.<sup>106</sup> The rational partner wants to be paid against

---

<sup>103</sup> Indeed, depending on how effective the deduction proves at increasing federal revenue, it might actually have federalizing, rather than devolutionary, net effects.

<sup>104</sup> See Zelinsky, *supra* note ?, at 805; cf. Gillette, *supra* note 11, at 1080 (noting that tax exemptions are "less susceptible of political machinations that could disfavor certain localities" than are grants). In addition to these political economy effects, a deduction is more politically resilient than some direct expenditures as a result of some quirks in the congressional rules. Whereas a deduction need only be enacted once, albeit subject to CBO scoring, discretionary spending is subject to annual appropriations. This puts legislative inertia in the corner of the deduction, which requires an affirmative act of Congress to shut it off. Further, direct grants must run a double committee gauntlet in each House -- they must both be authorized and appropriated -- while tax subsidies begin and end only in the House Ways & Means Committee and Senate Finance Committee.

<sup>105</sup> Brian Galle, *Getting Spending: How to Replace Clear Statement Rules With Clear Thinking About Conditional Grants of Federal Funds*, 37 CONN. L. REV. 155, 196 n. 244 (2004).

<sup>106</sup> See *id.* at 192; David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2564 (2005).

the possibility of that outcome.<sup>107</sup> A more reliable federal promise, such as policies enacted through the tax system might carry, can make the uncertainty premium lower. In some circumstances these planning benefits and cost savings should make the deduction an attractive alternative to grants, even if somewhat less efficient.

### **III. No Exit?**

And so it appears that the deduction is not without some appeal as a tool for facilitating state spending. But is the deduction money well spent? I've implied several times that the deduction may also affect state governance itself. In this section I argue, apparently for the first time in the literature, that the deduction may well be expanding state government at the same time it is undermining state government's effectiveness. But I also acknowledge that there is some hope we can make the deduction more amenable to federalism and localism, by making it a useful component of a broader system to reform some of the structural problems that plague governance by many parallel, competing jurisdictions.

These questions about the quality of state governance arise because the deduction significantly curtails interstate movement. For example, an individual taxpayer is considerably less likely to move in order to escape subjectively burdensome taxes if she perceives the deduction as lightening her burden,<sup>108</sup> especially if moving would be costly and somewhat risky. More generally, by shifting some revenue from the federal government to the states, the deduction may damper interstate movement by encouraging localized investment. Although federalism provides many different baskets of taxes and services, it paradoxically makes it harder to choose among the baskets, and greatly magnifies the costs of ascertaining what each one

---

<sup>107</sup> Galle, *supra* note ?, at 196 n. 244.

<sup>108</sup> See Briffault, *supra* note 45, at 545; Lynch, *supra* note 54, at 598; Stark, *supra* note 11, at 1426 n. 133.

contains.<sup>109</sup> If all spending were national, each taxpayer would know that in moving from one state to another she would be getting, roughly speaking, the same basket, and wouldn't have to research thousands of alternatives, compare them, and decide between them before moving.

Many commentators would claim that this diminished mobility will significantly reduce the efficiency of state government.<sup>110</sup> In an ideal market, taxpayers will flee inefficient or corrupt governments for those who deliver similar sets of services with less waste.<sup>111</sup> Some writers predict that even in a more realistic model, in which we recognize that there are significant frictions on interjurisdictional movement, intrastate politics can be shaped by the *threat* of exit.<sup>112</sup> An important taxpayer doesn't have to actually analyze all the costs and benefits of every possible other jurisdiction in order to claim credibly she will leave.<sup>113</sup> All she has to do is find one other jurisdiction that delivers one service more efficiently than her current home. The government of her home state doesn't know that she hasn't analyzed all the other factors; for all it knows, she's indifferent to them. Indeed, politicians have a professional interest in understanding human nature, so that our taxpayer's elected officials may guess that she might be

---

<sup>109</sup> Bratton & McCahery, *supra* note 25, at 273.

<sup>110</sup> See *supra* note 54.

<sup>111</sup> See Abraham Bell & Gideon Parchomovsky, *Of Property & Federalism*, 115 YALE L.J. 72, 103 (2005); Bratton & McCahery, *supra* note 25, at 208--09; Briffault, *supra* note 45, at 540.

<sup>112</sup> See Timothy Beasley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 30--31 (1995); Bratton & McCahery, *supra* note 25, at 264--65; see also ALBERT HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* 44--54, 120--26 (1970) (noting interdependence of exit and political influence).

<sup>113</sup> This point also has a broader significance for my argument. Many commenters on earlier drafts observed that the deduction's effects on mobility would seem unimportant to the extent that tax generally is not an important factor in individuals' decisions about where to live. Several empirical studies are skeptical about the impact of local tax considerations on mobility. See ALBERT BRETON, *THE ECONOMIC THEORY OF REPRESENTATIVE GOVERNMENT* 112-13 (1974); Roger J. Vaughan, *State Taxation and Economic Development*, in *STATE TAXATION POLICY* 109 (Michael Barker ed., 1983). But see my discussion of this point at note 50, *supra*. And, again, the skeptical studies take place in a universe (ours) where state and local taxes are deductible, so they may in fact support my point that the deduction significantly diminishes mobility. The more important point to take away, though, is that our working assumption is already that *actual* mobility is limited. It may be the threat of departure that serves mostly to chasten local governments, and that threat is less credible when state and local tax burdens are deductible. See Benjamin Bridges, Jr., *Allowances for State and Local Nonbusiness Taxes*, in *ESSAYS IN FISCAL FEDERALISM* 187, 214 (Richard A. Musgrave ed., 1965) ("[P]oliticians and voters believe that changes in interstate income tax differentials significantly affect citizens' choices of residence, place of work, and business location.").

motivated more by heuristics than detailed cost analysis. These officials have a strong incentive to satisfy the powerful taxpayer, because although her one vote may not be very important, her departure (and, of course, her campaign contributions) would be: the lost revenue would hurt the state in ways that would cost the officials more votes, and other citizens may look to her as an opinion leader.<sup>114</sup> When all the wealthy families leave (or threaten to leave) a neighborhood, few of the residents who remain are likely to conclude that the government has been doing a good job recently.<sup>115</sup> So, again, exit can be an important mechanism in chastening local governments, even if no one actually ever goes anywhere.

To this familiar argument I would add that mobility can also foster a form of taxpayer participation in government by curbing tax exporting. For the most part, we have no right to participate in the politics of a jurisdiction where we don't reside, even if it makes decisions that affect us, such as by instituting a tax whose incidence we bear.<sup>116</sup> But as I've mentioned, we can force the exporting jurisdiction to take some consideration for us simply by the threat of moving there in response.<sup>117</sup> That threat may even give rise to negotiations between exporter and nonresident over what bribe the exporter must pay to prevent in-migration.

It therefore is possible that the deduction undermines the efficiency and participatory character of state and local government. The deduction diminishes the chastening force of exit, undercuts the force of threats to depart, and weakens incentives for jurisdictions to pay heed to the needs of neighbors affected by their policies. These effects are particularly troubling if our main rationale for the deduction was precisely in order to expand the range of services offered by

---

<sup>114</sup> See Fennell, *supra* note 77, at 26.

<sup>115</sup> G. BRENNAN & J. BUCHANAN, *THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF THE FISCAL CONSTITUTION* 178 (1980); see Mancur Olson, *Dictatorship, Democracy, and Development*, 87 *AM. POL. SCI. REV.* 567, 576 (1993).

<sup>116</sup> See Kirk Stark, *The Right to Vote on Taxes*, 96 *NW. UNIV. L. REV.* 191, 229 (2001).

<sup>117</sup> See *supra* text accompanying notes 77-79.

local governments.

However, as the tax exporting example also suggested, mobility and exit also create incentives for state governments that might cut *against* good government. The premise of the efficient exit argument is that state government must be relatively transparent, so that mobile citizens can recognize inefficiencies and move to avoid them or threaten to move if they aren't repaired.<sup>118</sup> The trouble is that in order to frustrate migration, both in and out, states may prefer to make the quality and kind of their services as opaque as possible. Of course, individual officials will always want to be able to campaign on demonstrable successes. But, in the absence of any benchmark for what constitutes "success," and faced with substantial obstacles to acquiring that information, the average voter will have no way of assessing claims by local officials that they have far outstripped their neighbors.<sup>119</sup> And the government can always deliver essentially secret benefits – through zoning variances, property tax waivers, special regulatory rulings, and other highly opaque avenues -- to important constituencies.

One might argue, on the other hand, that jurisdictions should have an incentive to offer good comparative data in order to entice wealthy newcomers. If losing successful residents hurts officials' prospects for reelection, attracting prominent new ones should help. Admittedly, this information will be limited. Since the jurisdiction will want to attract only the wealthy, it is likely to compile only data about services that would be attractive to that group, and not about, say, transfer payments. Information may be screened in a way to keep it from those with modest means, such as by disclosing exclusively through realtors or the local Chamber of Commerce, and/or by imposing a small charge for access. Moreover, information disclosure may not be

---

<sup>118</sup> See Bratton & McCahery, *supra* note 8, at 208.

<sup>119</sup> Cf. Strahilevitz, *supra* note 11, at 970 (noting incentives for public officials to provide public with misleading data about their own performance).

effective at attracting outsiders. Prospective migrants don't know how long the transparent phase of government will last.<sup>120</sup> They may reasonably calculate that the jurisdiction doesn't want them to leave, and the potential inflow of less beneficial taxpayers may at some point outweigh the gains of continued openness, so that the taxpayers enticed by the possibility of open and efficient government will be stranded again. If that attitude proves widespread there might never be a strong reason for the jurisdiction to provide good data in the first place. So exit produces only somewhat modest incentives for transparency, and even then only for some sorts of services.

The deduction doesn't help matters, and in fact likely makes information problems worse. Recall that the deduction has little effect on the mobility of low-income taxpayers. As we saw, a major reason states attempt to occlude the kind and quality of services they provide is in order to exclude those low-income taxpayers. Thus, even though the deduction reduces some kinds of exit, and exit in general creates an incentive for opaque government, the deduction does little to stem a locality's desire to obscure. The deduction does, though, reduce the mobility of high-income taxpayers. That would make it harder for states to attract these high-earners through transparency. The result is that the deduction actually diminishes any incentive for jurisdictions to generate good information about themselves.

There is a bit of a bright side, though. Mobility may also damage local government in two other fairly well-known ways. First, it will tend to undermine the possibility that each locality will develop into a strongly connected community of principle, in which the residents understand each other's needs and values and set policy after debate about issues of shared

---

<sup>120</sup> Cf. Bratton & McCahery, *supra* note 25, at 236 (claiming that difficulty of ascertaining quality of public goods makes entrepreneurial efforts to attract capital difficult).

importance.<sup>121</sup> Relatedly, the likelihood of frequent relocation may tend to lead voters to make political decisions based on short-term needs rather than the long-term interests of the community as a whole.<sup>122</sup> To the extent that it reduces exit, the deduction helps preserve these two values.

On the whole, though, it looks doubtful that mixing the deduction with unmediated, free-market federalism will lead to salutary developments in state governance. One response to this situation would be to shift regulation to the federal government.<sup>123</sup> But, obviously, that would often come at the expense of the experimentation and diversity benefits that accompany independent local lawmaking. So at this point the deduction looks like a very bad choice if our goal is to encourage devolution or local redistribution, and its negative effects on local governance are surely a concern if we want to improve the equity of the federal tax base or achieve societal tax-enforcement savings.

Over the last decade, however, a number of commentators have suggested tactics for reforming federalism so as to cure some of the pathologies of it in its free-market form. These proposals combine federal and state regulation, sometimes along with direct popular participation, in an effort to gain the best of both worlds.<sup>124</sup> The federal government in these

---

<sup>121</sup> See Fennell, *supra* note 77, at 27, 71; Richard T. Ford, *Beyond Borders: A Partial Response to Richard Briffault*, 48 STAN. L. REV. 1173, 1175 (1996); Jerry Frug, *Decentering Decentralization*, 60 U. CHI. L. REV. 253, 266-67 (1993); Gillette, *supra* note 11, at 1078.

<sup>122</sup> See Sheryll D. Cashin, *Localism, Self-Interest, and the Tyranny of the Favored Quarter: Addressing the Barriers to the New Regionalism*, 88 GEO. L.J. 1985, 2012 (2000).

<sup>123</sup> Cf. Shavero, *supra* note 7, at 952 (noting that classic Madisonian solution to defects in state governance was to shift regulatory authority to federal government).

<sup>124</sup> See, e.g., David J. Barron, *Reclaiming Home Rule*, 116 HARV. L. REV. 2255, 2340--42 (2003); Michael C. Dorf & Charles Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267 (1998); Gerald E. Frug, *Beyond Local Government*, 115 HARV. L. REV. 1763, 1824--25 (2002); Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?*, 89 GEO. L.J. 257, 321--23 (2001); Orly Lobel, *The Renew Deal: the Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 402--46 (2004); Martha Minow, *Reforming School Reform*, 68 FORDHAM L. REV. 257, 287 (1999); Philip J. Weiser, *Cooperative Federalism and its Challenges*, 2003 MICH. ST. DCL L. REV. 727, 728--29; see also Fennell, *supra* note 77, at 24-25 (describing user participation systems generally, without

schemes serves as a sort of clearing house and analyst for good governmental practices.<sup>125</sup> For each policy, a federal agency sets out broad goals, which states then may pursue through their own means, but with technical and in some cases financial assistance from the feds.<sup>126</sup> As state regulators on the ground gather information about the nature of the problem and how to address it, they feed that information back to the agency, which collects the data and rates the states according to rolling sets of standards that are themselves revised in response to the developing set of information.<sup>127</sup> “Consumers” of the regulatory product – in other words, voters – then put pressure on their local government to meet the standards achieved by other jurisdictions.<sup>128</sup> Citizens can also participate throughout all levels of the project,<sup>129</sup> and may serve as an additional force for transparency by exposing efforts by inside players to game the system.<sup>130</sup> The result, in theory, is a system that is at once open and responsive to public input but also flexible, that involves localized communities of principle but that submits their conclusions to comparison against a wide variety of other viewpoints.<sup>131</sup>

Exit and the threat of exit are still a problem for these collaborative systems, however. In essence, collaboration faces a familiar trade-off between “voice” and “exit.”<sup>132</sup> The collaborative design depends significantly on active, well-informed members of each community who will

---

limitation to those coordinated by a central authority); Jody Freeman, *Private Parties, Public Functions, and the New Administrative Law*, 52 ADMIN. L. REV. 813 (2000) (describing collaborative regulation between government and stakeholders). Of course, these commentators are hardly all of one piece. To the extent that I generalize, I mostly take Dorf and Sabel as my exemplar, but other writers certainly take different positions on some of these issues.

<sup>125</sup> Dorf & Sabel, *supra* note 124, at 345.

<sup>126</sup> *Id.*

<sup>127</sup> Dorf & Sabel, *supra* note 124, at 323, 345--46, 350--51. Agencies can also provide technical assistance, as by analyzing relevant data and explaining how it can be utilized to solve problems. *Id.* at 323.

<sup>128</sup> Dorf & Sabel, *supra* note 124, at 319--20.

<sup>129</sup> Dorf & Sabel, *supra* note 124, at 316--19; *see* Fennell, *supra* note 77, at 24-25.

<sup>130</sup> Dorf & Sabel, *supra* note 124, at 349.

<sup>131</sup> Dorf & Sabel, *supra* note 124, at 320.

<sup>132</sup> ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY 4 (1970)

help implement each program, provide vital ground-level data, check groupthink or self-dealing by insiders, and, most significantly, study how their locality performs relative to others and demand that it match the benchmarks set by others.<sup>133</sup> But all of that is time-consuming and costly. At the same time, in the collaborative system, information is very cheap (because it is gathered by the federal government) and usually rendered in a way that is designed to facilitate comparisons.<sup>134</sup> That relieves one of the major frictions on interstate movement. So in many cases it will be more attractive simply to move to one of the better jurisdictions than to stay home and fix what's wrong. And that possibility, in turn, may make some localities, especially those who expect that they may initially lag others, reluctant even to participate in a collaborative project, or more likely to game it and hide their results if they must take part to get federal funds or other benefits.<sup>135</sup> If the most attentive citizens have already left, a weasely local government puts a lot of pressure on federal regulators to require real transparency,<sup>136</sup> a relationship somewhat at odds with the system's object of reducing adversarial relationships between central and local regulators.

Cooperative theorists, recognizing this difficulty, argue that the threat of exit, again, is an effective second-best alternative to actual exit. In a highly transparent system, threats of exit by opinion-leaders or revenue-generating taxpayers will be even more credible, and therefore magnify the responsiveness of local governments to the pressure of citizen scrutiny and comparison to national benchmarks.<sup>137</sup> Additionally, secret payments to these groups might be a

---

<sup>133</sup> See, e.g., Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking*, Precursor to a New Paradigm?, 89 GEO. L.J. 257, 360, 363, 369 (2001).

<sup>134</sup> Dorf & Sabel, *supra* note 124, at 321; see also Bratton & McCahery, *supra* note 25, at 235 n. 140 (observing that “the information problem could be ameliorated through central government intervention”).

<sup>135</sup> Cf. Dorf & Sabel, *supra* note 124, at 338 (noting that “some jurisdictions -- or at least their leaders -- will be unwilling to exchange information for fear of showing poorly in comparison”).

<sup>136</sup> Cf. *id.* (suggesting that national regulators' role could be to encourage reluctant localities to provide information).

<sup>137</sup> Dorf & Sabel, *supra* note 124, at 338, 348--49

bit harder. Although this view explains why the *possibility* of exit can enhance local government, it does not seem completely to address whether exit itself might be damaging.

Thus the problem, I think, is in equilibrating the gains of the threat of exit against the perils of actual brain drain. There is an obvious analogy here to debates over voucher systems, both in education and in subsidized housing. Portable subsidies put pressure on the service provider to keep its mobile customers.<sup>138</sup> But there is a certain point at which mobility might deprive a foundering school system or housing project of those engaged and capable enough both to recognize peril or to remedy it, and leave the rest behind in a system that may be beyond repair without the aid of those who have departed.<sup>139</sup> The risks in those two situations seem at least to this writer large enough to be attractive only at last resort. The difference in collaborative systems is that we have other choices. Again, collaborative systems, it is thought, enhance the “voice” of local citizens by involving them directly in regulation, and providing them with low-cost access to information they can employ in the political process.<sup>140</sup> While the threat of exit might further amplify that voice, it carries too the risks I’ve just mentioned. In some situations the risk that exit will collapse a locality instead of helping to reshape it may be very serious, and perhaps hard to predict beforehand. In those instances we might prefer collaboration with relatively little possibility of exit.

It is possible that the deduction could help to create a low-exit collaborative environment. As we’ve seen, the deduction blunts the impact of citizen mobility without eliminating it. In the context of a collaborative system, we could view the deduction as a payment to well-informed

---

<sup>138</sup> Michael H. Schill, *Distressed Public Housing: Where Do We Go From Here?*, 60 U. CHI. L. REV. 497, 537--38 (1993).

<sup>139</sup> See HIRSCHMAN, *supra* note ?, at 45-52; Fennell, *supra* note 77, at 26--28, 78--80, 86; cf. Schragger, *supra* note ?, at 1839 (observing negative effects for residents left behind by out-migration).

<sup>140</sup> Dorf & Sabel, *supra* note 121, at 320.

citizens who might be tempted to leave to stay and lobby within their existing system rather than fleeing it.<sup>141</sup> Thus, it may help assure that efforts to govern transparently and collaboratively can actually achieve that end.

In short, although the deduction may have an uncertain or even negative effect on state government at present, it may also serve some role in mitigating the risks of hypothesized reformed systems of collaborative federal-state regulation.

#### **IV. An Enforcement Expenditure?**

What we've seen so far raises some questions about whether section 164 makes sense as a tax expenditure. Here, though, I want to suggest another possible goal of the deduction as tax expenditure, one that, to my knowledge, has not previously been suggested either in the economic or legal literature. The deduction, I argue, may facilitate socially useful efficiency gains by allowing states to free-ride on federal tax enforcement efforts.<sup>142</sup>

The enforcement argument rests on three basic premises. First, it posits that tax enforcement is expensive and difficult, but can easily be centralized at some savings if different jurisdictions generally tax the same income base. Next, it claims that notwithstanding this benefit states will ordinarily be somewhat inclined against taxing the same base taxed by the federal government, among other reasons because political resistance to a single high tax is more substantial than resistance to several equivalent small taxes. Finally, it suggests that the deduction, by mitigating this effect, can induce states to shift their taxes to the base taxed and policed by the federal government.

---

<sup>141</sup> For discussions of similar stay-put bribe techniques, see James M. Buchanan, *Principles of Urban Fiscal Strategy*, 11 PUB. CHOICE 1 (1971); Fennell, *supra* note 77, at 48; Clayton Gillette, *Opting Out of Public Provision*, 73 DENV. U. L. REV. 1185, 1204-05 (1996).

<sup>142</sup> In addition, to the extent that the deduction in fact increases the enforceability of state tax provisions, rather than simply making enforcement cheaper, the deduction also increases horizontal equity. Lax enforcement, obviously, is inequitable in that some random taxpayers may escape the payments that fall on others.

## A. The Benefits of Overlapping Enforcement

Effective tax enforcement is not cheap.<sup>143</sup> More importantly for my purposes, it comes with very substantial overhead costs. An enforcing jurisdiction must develop or recruit a team of expert investigators, analysts, auditors, and lawyers, many of whom must be conversant not only in the substantive tax law of the jurisdiction but also in the very numerous ways that wealth or revenue may be invested, transported, exchanged, and concealed. That challenge has grown exponentially with the rise of international markets for capital and the development of overseas tax havens designed to make it easy to conceal ownership of property.<sup>144</sup> The international aspect of tax enforcement also means that it is not enough for states to be able to track and understand transnational financial transactions; often, the enforcing jurisdiction will also have to have some agreement with the foreign state in order to obtain any information from it at all. In the case of tax havens, securing such an agreement can be a matter of some delicacy – or, perhaps, one calling for some significant bluster.

As I've suggested, states can relatively easily economize on these costs by relying in some measure on the federal government.<sup>145</sup> Commentators on international tax arbitrage have already observed that foreign states may themselves depend on the IRS, with its relatively sophisticated information gathering, computer data analysis, and web of treaties, to collect information about the flow of international capital.<sup>146</sup> The same is surely true of our 50 states.

---

<sup>143</sup> See Louis Kaplow, *Accuracy, Complexity, and the Income Tax*, 14 J. L., ECON. & ORG. 61, 61-62 (1998). As I explain more in a bit, in this section my references to the costs of tax enforcement should be taken to mean only the governmental costs; the burdens of tax compliance by taxpayers is a separate issue I largely leave for debate by others.

<sup>144</sup> See William F. Fox & Matthew N. Murray, *A National Retail Sales Tax: Consequences for the States*, 37 STATE TAX NOTES 287, 291 (2005).

<sup>145</sup> See Strahilevitz, *supra* note 38, at 981-82.

<sup>146</sup> Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1336 (1996).

The feds have more leverage – such as, in extreme cases, the threat of tariffs – to extract agreements from tax havens.<sup>147</sup> And relying on federal enforcement efforts can save not only these sorts of overhead costs, but also the year-to-year costs of auditing and litigating.<sup>148</sup> It is relatively costless for the IRS, once it has detected that a taxpayer has failed to declare income from her Cayman real estate trust, to turn that data over to state authorities.<sup>149</sup> Federal authorities can even punish noncompliant taxpayers for violating state law; for example, some federal courts have held that a sentencing court can enhance a tax offender’s sentence based on the combined total of state and federal taxes evaded.<sup>150</sup> Thus, the threat of federal enforcement also greatly supplements the deterrent effect of individual state enforcement efforts, leading to higher compliance even in cases where there is no investigation by anyone.

Therefore, overlapping enforcement is an attractive goal for the tax system, since it would eliminate inefficient duplication of overhead expenses across the nation. For small jurisdictions, overhead may be so large that cooperative enforcement is the only realistic alternative.<sup>151</sup> Overlap is therefore important even to jurisdictions willing to pay their own way, because the existence of another state where enforcement is known to be lax would be a sort of domestic tax haven, luring capital and other loophole-seekers.

It seems fairly clear, though, that to a significant extent these benefits are only available if state and federal tax bases overlap. A state that derives its income from a sales tax collected at

---

<sup>147</sup> See U.S. Const. Art. I, § 10 (prohibiting states from enacting tariffs, absent congressional approval); LOUIS HENKIN, *FOREIGN AFFAIRS AND THE UNITED STATES CONSTITUTION* 150 (2d ed. 1996) (describing limits on states’ powers to establish relationships with foreign powers).

<sup>148</sup> See Super, *supra* note 106, at 2595.

<sup>149</sup> See Fox & Murray, *supra* note 144, at 291.

<sup>150</sup> *E.g.*, *United States v. Powell*, 124 F.3d 655, 663--64 (5th Cir. 1997); see *United States v. Jordan*, 66 Fed. Appx. 488, 490 (4th Cir. 2003) (unpublished); *United States v. Karamanos*, 38 Fed. Appx. 727, 731 (3d Cir. 2002) (unpublished).

<sup>151</sup> See Fox & Murray, *supra* note 144, at 291.

retailer's registers has relatively little to gain from careful federal auditing of individual income tax returns. It *will* spend lots of money auditing the books of its retailers (and, probably, their suppliers, as well), though.

Another benefit states can realize with overlapping tax bases is simplification. A state with few disparities between its own tax system and the federal system can attract capital with the promise of lower tax planning expenses.<sup>152</sup> Although it may make accountants unhappy, that strategy obviously is considerably less burdensome for ordinary taxpayers.<sup>153</sup>

As a result, we may well want to encourage states to rest a fair portion of their tax burden on a base already taxed and scrutinized by the federal government. The list for individuals at present is fairly short – income taxes, estate taxes, and some excises. That would transfer substantial wealth to the states, reduce tax planning costs to citizens, and prevent a serious potential source of interstate capital leakage. But, one might ask, if overlapping tax bases is so great, why should we need to pay states to do it?

## **B. Obstacles**

It turns out there are a number of good answers to our last question, some of them theoretical, others a matter of practical politics. I'll begin with what I think is the simplest, the distortionary effects of taxation. Taxes, of course, affect behavior – thus the entire notion of the tax expenditure. Not all of these effects are socially desirable. For instance, depending on how a

---

<sup>152</sup> See Bratton & McCahery, *supra* note 25, at 273; Super, *supra* note 106, at 2594.

<sup>153</sup> Shaviro, *supra* note 7, at 910, 919; see Fox & Murray, *supra* note 144, at 291. On the other hand, as we saw in Part III, we should remember that the state in so doing also makes it easier for out-of-state residents to evaluate the costs and benefits of living there, which may tend to attract free-riders or facilitate the flight of current residents unhappy with that balance.

Another potential effect of shared enforcement is that, as states all converge towards the federal base, they also converge towards one another. See Fox & Murray, *supra* note 144, at 291. This Article is agnostic about whether that is a desirable end; Professor Shaviro has already examined the trade-offs thoroughly. See generally Shaviro, *supra* note 7.

tax system treats the income of married couples, a progressive rate structure coupled with no imputed income from household work may tend to cause potential married part-time or low-wage earners to stay home.<sup>154</sup> Those effects are magnified if two jurisdictions tax the same sets of income in similar ways. The deduction, however, blunts the incentive effects of state taxation by repaying the state taxpayer a significant percentage (his federal marginal rate) of the state tax. We could thus view the deduction as a way of permitting double taxation with somewhat lessened distortive effects.

One irony here is that some tax incentive effects are desirable – again, that’s the whole point of a tax expenditure. The deduction therefore may make it more difficult for states to achieve policy objectives through higher taxes on select behavior.<sup>155</sup> That may not be especially troublesome from a federal perspective; it helps to prevent states from constructing tax incentives that work at cross-purposes with federal goals. But, obviously, it may reduce the appeal of overlapping tax bases for the states.

Another theoretical problem the deduction may not entirely solve is the increased risk to a state’s fiscal condition that can come with taxing the same base as the federal government. Suppose most state revenues come either from federal subsidies or state taxes. In the event of an economic downturn that depresses federal revenues, the federal subsidy portion of the state’s budget will likely decline. If the state is depending on the same source of revenue, its tax revenues, too, will be hit hard by the downturn. A diversified tax base, like a diversified

---

<sup>154</sup> See Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 20--21 (2000).

<sup>155</sup> That would not be true in a world of perfectly rational taxpayers in which every state taxpayer had an equal opportunity to claim the federal deduction. In that situation, the state could simply raise taxes by an additional amount necessary to offset the effects of the federal deduction. Where the deduction is only available to itemizers, however, this might result in overdeterrence of non-itemizers. Additionally, as we’ve seen, not all taxpayers view state and federal taxes as completely fungible, so that a higher nominal state tax rate combined with a deduction, despite being fiscally equivalent to a lower rate with no deduction, might be less feasible politically.

investment portfolio, could help the state avoid some of that risk. It is unclear that the deduction does much to replace the benefits of diversification. In the event of a fiscal squeeze, the deduction still comes out of the same tightening federal budget the state was depending on for other forms of subsidy, so that adjusting state taxes to draw more federal cash through the deduction will only reduce other federal contributions.

Turning to more worldly political considerations, a potential downside for state politicians in tying their own tax system to the federal system is that that link may also bind their political fortunes to federal policy.<sup>156</sup> The 2002 and 2003 tax bills plunged not only federal but also many state tax receipts deep into the red, because many states explicitly tie their income and estate tax calculations to federal methods.<sup>157</sup> Unfortunately for state office-holders, many of those states have balanced-budget provisions in their constitutions, or are subject to harsh discipline from financial markets and other political pressures, so that the legislatures did not have the luxury of borrowing.<sup>158</sup> They got to raise taxes and cut services, instead, which naturally endeared them to their constituents.<sup>159</sup> Of course, it is possible to tax roughly the federal base without expressly mirroring federal provisions. That approach, though, sacrifices many of the benefits of simplification – which is especially significant in a competitive world if other states are simpler – and in some cases may produce a somewhat different base. For instance, many

---

<sup>156</sup> Cf. Shaviro, *supra* note 7, at 926, 958--59 (arguing that local governments may have incentive to diverge from federal tax system in order to maintain “their own power and function”). I am grateful to Martin Ginsburg for making this point.

<sup>157</sup> Timothy Catts, *President’s Tax Cuts Take a Bite Out of State Budgets*, 100 TAX NOTES 1098, 1098 (2003); Iris J. Lav & Andrew Brecher, *Passing Down the Deficit: Federal Policies Contribute to the Severity of the State Fiscal Crisis* 2, 3 (Aug. 18, 2004), available at <[www.cbpp.org/5-12-04sfp.pdf](http://www.cbpp.org/5-12-04sfp.pdf)>.

<sup>158</sup> Briffault, *supra* note 45, at 548, 554--55; Super, *supra* note 106, at 2255, 2592.

<sup>159</sup> John M. Broder, *Despite Signs of Economic Recovery, States’ Budgets are Still Reeling*, THE NEW YORK TIMES, Jan. 5, 2005, at A1; Isaac Shapiro & Nicholas Johnson, *Total Revenues from All Levels of Government Drops to Lowest Share of Economy Since 1968*, TAX NOTES TODAY, Jan. 16, 2004, at 11.

states tax estates the federal government leaves unscathed,<sup>160</sup> and, more significantly for present purposes, many estates it leaves unaudited. So getting the main benefits of overlap probably entails some political risk. The deduction can help somewhat here, in that it may soften the blow if a state is forced to raise its rates in response to enactment of new federal deductions.

The most significant obstacle to overlapping tax bases, however, is the political economy of taxing a single base at a much higher combined rate. A diversified set of state taxes has the advantage that each tax may have a somewhat distinctive incidence, so that the collective burdens of the tax are spread across different subsets of the state population (or outsiders). If the state shifts its base to match the federal base, it is concentrating the tax burden on that particular group of taxpayers, a group already targeted by the federal government, as well. Perhaps counterintuitively, this narrowing of the tax base may actually increase political resistance to the state tax, even though it may now be concentrated on fewer voters.<sup>161</sup> That is because politics often depends not only on the numerosity of voters but also the intensity of their engagement in the political process.<sup>162</sup> Engaged citizens will likely follow issues closely, be more likely to vote based on their issue, lobby others, and, crucially, contribute money to support their position.<sup>163</sup> Because of collective action problems, a tax that lands heavily on a smaller, easily-identified

---

<sup>160</sup> Virginia Munger Kahn, *Inheriting? Don't Forget Your State's Tax Bill*, THE NEW YORK TIMES, Feb. 12, 2006, § 3, p. 24 (listing 13 states in which estates too small to be subject to federal estate tax are taxed by the state).

<sup>161</sup> Cf. RONALD JOHN HY & WILLIAM L. WAUGH, JR., STATE AND LOCAL TAX POLICIES: A COMPARATIVE HANDBOOK 31 (1995) (stating that localities prefer property taxes because that base is not taxed by federal government); James M. Buchanan, *Financing a Viable Federalism*, in STATE AND LOCAL TAX PROBLEMS 3, 11 (Henry L. Johnson ed., 1969) (claiming that there is an inherent tradeoff between the ability of the state and federal governments to collect tax revenues).

<sup>162</sup> George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971), reprinted in ADMINISTRATIVE LAW ANTHOLOGY 399, 402 (Thomas O. Sargentich ed., 1994).

<sup>163</sup> In this view of voting, called “public choice” theory, most potential voters are not actively engaged in politics due to collective action problems and free rider effects. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 21, 35 (1971). Acquiring the information necessary to act is costly, and each voter assumes that someone else will adequately advocate their position for them. *Id.* Further, it is difficult to form a successful political coalition, in part because it is hard to identify potential allies. Stigler, *supra* note 162, at 402. However, free rider effects decline as costs become larger and more visible. *Id.*

group will typically face more opposition than a fiscally equivalent service cut that affects only slightly a large, diverse segment of the population.<sup>164</sup>

This effect is exaggerated by the fact that the particular federal tax we'd be encouraging states to adopt, the income tax, is among the most visible. Researchers have suggested that because of a bias known as the "availability" heuristic, taxpayers prefer hidden, or less "salient" taxes to those whose incidence is obvious and well-known to the payors.<sup>165</sup> Of course, it's not that the taxpayers really "prefer" hidden taxes; it's simply that they don't oppose them as much. The income tax, in these surveys, is usually among the most salient, and therefore least popular.<sup>166</sup> We all know who pays our income tax bill. That increased awareness likely lowers the threshold for activating potential voters, and makes it easier for them to find like-minded opponents.

Interestingly, the bias against salient taxes implies that shifting state revenues to an income tax will increase political opposition even if the shift does not change the actual incidence of state taxes. That is, even if the same taxpayers bear identical proportional burdens under state sales, property, and income taxes, shifting to the income tax with no net change in state revenue will make state taxes less popular. That is one reason researchers have deemed salience a "cognitive bias"; it seems to have bite even when the change in incidence is a fiscal illusion.<sup>167</sup>

A similar problem is suggested by research showing that taxpayers will support a higher

---

<sup>164</sup> See OLSON, *supra* note 163, at 21--22, 31, 35; Stigler, *supra* note 162, at 401.

<sup>165</sup> See George Loewenstein et al., *Statistical, Identifiable and Iconic Victims and Perpetrators*, Stanford Law School John M. Olin Program in Law and Economics Working Paper No. 301, at 2, available at <http://ssrn.com/abstract=678281>; McCaffery & Baron, *supra* note 60, at 5, 12--13; see also Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1663 (1998) (explaining cognitive impact of more "salient" facts).

<sup>167</sup> See Shaviro, *supra* note 7, at 957.

overall level of taxation through a constellation of small taxes than they will through a fiscally identical single large tax. Professors McCaffery and Baron term this effect the “disaggregation” bias.<sup>168</sup> When evaluating any single tax, individuals tend to focus strongly on that tax without being able to keep in mind its combined impact with other tax and spending policies.<sup>169</sup> Thus, each individual small tax looks acceptable, or in any event less unappealing than the single large tax, so that the taxpayer is willing to accept a series of small bites that cumulate to as much or more than the big one.<sup>170</sup> As a result, depending on a state’s political climate, attempting to shift from many disparate taxes to principle reliance on the income tax may not be revenue-neutral.

At first pass, then, the deduction looks like it might be an effective counterweight to these problems of political economy. Especially in its current incarnation, the deduction rewards disproportionately wealthy itemizers.<sup>171</sup> But that is precisely the group – small, easily self-identified, heavily impacted by higher state income-tax rates, and (as evidenced by the capacity to itemize) relatively knowledgeable about tax – that would be most active in opposing higher state income taxes. And, assuming state taxpayers can integrate the effect of a smaller federal tax bill with the fact of a higher state tax bill, it might soften the impact of other taxpayer biases. But that last assumption already looks shaky, considering what we’ve already seen of the disaggregation bias.

It might also be argued that political effects cut, not against the state income tax, but instead against an overlapping federal income tax. If the unwanted burden is the combination of state and federal taxes, it may be that political resistance will be aimed at federal taxation rather

---

<sup>168</sup> McCaffery & Baron, *supra* note ?, at 9; McCaffery & Baron, *supra* note 60, at 26.

<sup>169</sup> *Id.* at 25–26.

<sup>170</sup> McCaffery & Baron, *supra* note ?, at 30; McCaffery & Baron, *supra* note 60, at 26.

<sup>171</sup> *See supra* note ?.

than the smaller state piece.<sup>172</sup> State taxpayers might rationally prefer to see taxing and spending on the local level, where their voices are proportionately stronger and their control over expenditures correspondingly more powerful.<sup>173</sup> Self-interested voters might prefer to keep taxes local because local expenditures might look more like services and less like transfer payments to others.<sup>174</sup> Even state programs identified expressly as “welfare” or transfer payments might be seen as a way of purchasing insurance for the possibility of personal economic downturns. The same program instituted nationally might look less like insurance because the taxpayer may assume she is unlikely ever to be unemployed or without health insurance in the many distant states where her tax dollars are now developing a service-delivery infrastructure.

These tendencies might also produce reinforcing cognitive biases, such as through the “generalization effect.”<sup>175</sup> Some research, for instance, suggests that individuals respond negatively to taxation, but have less negative views about taxing for many specific programs.<sup>176</sup> The exceptions are categories like foreign aid, which are obviously transfer payments.<sup>177</sup> It is possible that the tested individuals “generalize” their negative feelings about foreign aid to an undifferentiated tax. Similarly, taxpayers might generalize from the negative aspects of national taxation, to the point that they neglect some of the service benefits it provides them.

In this view, the deduction may actually be more useful to the federal government than to

---

<sup>172</sup> Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and “Dual Sovereignty” Doesn’t*, 96 MICH. L. REV. 813, 865 (1998).

<sup>173</sup> See Shaviro, *supra* note 7, at 967; Strahilevitz, *supra* note 50, at 932-33.

<sup>174</sup> Cf. Strahilevitz, *supra* note 50, at 942-43 (“[T]he perception that the revenues collected by the federal government are used to benefit far-flung special interests undoubtedly erodes the system’s legitimacy, as well as compliance with federal income tax requirements.”) One might suspect much the same point is actually made by Professor McConnell when he notes that individuals are more likely to feel benevolent towards those near them geographically. McConnell, *supra* note , at 1510.

<sup>175</sup> Baron

<sup>176</sup> McCaffery & Baron, *supra* note ?, at 39, 44.

<sup>177</sup> *Id.* at 44-45 & Fig. 4.

the States. State representatives should happily free ride on federal enforcement efforts, and let their congressmen deal with the headache of political groundswells. The deduction could then be a useful tactic for federal representatives to maintain support for existing revenue levels.

Obviously, if popular responses to tax levels were uniform and rational, it would be impossible for the deduction to be cost-effective on that front. But again, the strongest and most energetic political opposition is likely to come from exactly that group most benefitted by the current form of the deduction. The feds may not have to pay off the large group of relatively inattentive taxpayers who pay higher combined rates. More empirical research is needed, but it is possible that the deduction could actually be, strangely, a political expenditure from the federal government to itself.

### **C. Will It Float?**

Suppose, though, that we are convinced that political economy impedes states' ability to rely on federal enforcement. How accurate is our first-glance take that the deduction might mitigate the problem? Again, the answer on some level depends on empirical data we don't have right now.

Remember our tentative thought that the disaggregation bias might limit the effectiveness of the deduction in taking the sting from state income taxes. The difficulty, again, is that when state voters consider a ballot proposition, or evaluate the performance of a state politician, they may tend to focus on the burden of the state tax alone, without considering the offsetting benefit they receive on their federal return. On the other hand, many taxpayers file their state and federal returns at the same time, so that they may be somewhat more likely to view the two as a whole.

These predictions may seem hard to square with other research, which shows that states

generally do adjust their tax base to take advantage of available federal deductions.<sup>178</sup> A problem with relying on those studies for our purposes, though, is that during the period of the studies the federal deduction allowed credits not only for the income tax but also property tax and, in some studies, sales taxes.<sup>179</sup> Thus, the taxpayers were getting a credit in a highly “salient” tax, the federal income tax, and paying more in less salient state taxes. We can’t be sure whether states were responding rationally to a straightforward subsidy offer or somewhat irrationally substituting hidden taxes for a salient one, or some of both. As a result, the studies are only weakly predictive of what would happen if we were to try to replace federal income taxes with equally salient state income taxes. Also, the studies don’t seem to track how durable the switches they document prove. It is possible that a well-informed, “rational” group of high-tax payers might lobby for the state to change its base to capture the federal deduction, but that over time the rest of the taxpayers would (irrationally) find the new tax so burdensome that they would demand it be switched back.<sup>180</sup>

There are, though, two uses for the deduction that would seem not seriously threatened by the possibility of fiscal illusion. One is its potential to soften the impact of tax base consolidation on high-income taxpayers.<sup>181</sup> A well-advised taxpayer is highly unlikely to complain about a new tax structure that imposes 15% more state tax on her but gives her back 20%. The other is that if the deduction is actually a self-defense mechanism for federal legislators, the disaggregation bias isn’t very important. Indeed, the disaggregation bias would

---

<sup>178</sup> See *supra* note 22.

<sup>179</sup> Recall that our object here is to induce the States to tax primarily the same base taxed by the federal government, so we would not want to offer the deduction for property or sales taxes.

<sup>180</sup> See Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913 (1987).

<sup>181</sup> The extent to which a switch to an income tax would result in more progressivity depends, of course, on the rate structure of the income tax, as well as whether the old revenue stream flowed mostly from (largely regressive) sales taxes or (generally progressive) property taxes.

help to make a discount on the federal tax bill mollify taxpayers, even if the discount is not as big as the state bill that, in theory, would otherwise threaten to crowd out federal revenue.

\*\*\*

In sum, it isn't clear that we need the deduction in order to get the benefits of shared federal and state tax enforcement. At the same time, it isn't clear that we *don't*. More work in this field would be welcome. One thing that does seem reasonably clear, though, is that to the extent enforcement is a justification for the deduction, it should extend only to sources of state revenue that match the federal tax base. In our current system, that would mean keeping the deduction for state income tax<sup>182</sup> but scrapping deductions for sales and property taxes.

#### CONCLUSION

I do not want to overstate my conclusions. One thing I believe this analysis has shown convincingly is that the merits of the deduction are complex, and may turn on facts we do not now know. To tax ourselves we must know ourselves -- but our minds are still to us very mysterious engines. To shape our institutions we must know them not only as they are now but also as they properly ought to be, a question that tax policy alone cannot resolve.

Still, this Article contributes some promising new leads. I have shown that the project of using deductions to shift spending to states and local governments is misguided to the extent that it includes a simple federal handover of money to those governments. The deduction can substantially erode the efficiency, transparency, and democratic character of sub-national government. Thus, using the deduction to effect any shift to the States may seem almost cruelly mistaken, to the point where one is inclined to wonder whether the whole enterprise isn't simply

---

<sup>182</sup> Another provision of the Code, allowing a federal credit for state estate taxes, would also be justifiable under this theory. These moves would also be consistent with Professor Shaviro's argument that greater uniformity across states would lead to productive reductions in tax planning costs. Shaviro, *supra* note 7, at 911, 919.

an effort to produce government that is so unlovely that citizens prefer to eliminate it entirely.

But this Article also demonstrates entirely abandoning the deduction as a tool of fiscal federalism would be short-sighted. For the deduction can also be a tool of government reform. It can mitigate exit risks that might threaten experimentalist efforts to build collaboration between states, private stakeholders, and the federal government. And its relative political stability, and cognitive features, may make it more efficient than direct spending at nationalizing federal policy.

If nothing else, the deduction has powerful effects on state tax policy. I have suggested here a previously unrecognized goal for the deduction in shaping states' tax policy: the possibility of societal gains from overlapping tax enforcement also may establish a decent case for some targeted deductions. While other potential benefits from greater state overlap with the federal tax base, such as simplifying tax planning and compliance, have been treated before in the literature, I add here that the deduction may be a mechanism for achieving those good ends.

However uncertain these beginnings, I think this Article is a success if it shows that section 164 is about more than (boatloads of) money. The tax literature, while recognizing in broad terms the significance of federalism for tax policy, has been slow to integrate the insights of regulatory theory, which profoundly changes traditional ideas of federal-state relations. And non-tax scholars have given very little consideration to the extent that in a very real sense almost all important federalism questions are really questions about tax. Certainly, as we've seen here, areas we thought far removed from tax, such as the effectiveness of local governance, prove subject to very substantial tax influences. My work here implies that tax's gravity may tug on other bodies in the federalism solar system, as well. The doctrines of sovereign immunity,

qualified immunity, and 10th Amendment limits on federal “conscription” of state officials all spring, to some significant extent, from judicial concerns about the transparency of, and lines of accountability in, state government.<sup>183</sup> Even leaving aside the revenue effects of federal tax rules, the influence of the deduction on state incentives for transparency or opacity will likely seriously affect all three doctrines. Further, the ways in which taxpayers understand and integrate taxes and spending has implications for my previous work on the Spending Clause -- explication of which I leave for further work.

In short, what we should think about section 164 depends on much more than the bottom of a balance sheet. Any fully considered judgment must include our philosophy of mind, our plan for the individual states’ place in an international marketplace, and our optimal design for good local government. Seventy-five billion? That’s nothin’.

---

<sup>183</sup> See, e.g., Robert C. Post & Reva B. Siegel, *Equal Protection by Law: Federal Antidiscrimination Law After Morrison and Kimel*, 110 YALE L.J. 441, 512 (2000).