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In this article, the authors take issue with the analysis put forth in the President's tax reform proposal to justify eliminating the deduction for nonbusiness state and local taxes. The authors contend that repeal of the deduction would not produce a federal income tax system that better measures the income of all taxpayers. Indeed, the authors contend that repeal may actually increase inter-taxpayer unfairness by overstating the taxable income of many taxpayers. The authors also contend that, in the context of an overall tax reform package, it is fundamentally inconsistent and unfair to deny deductibility for state and local taxes while permitting deductions for nonbusiness interest including owner-occupied homes, and charitable contributions.

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Introduction

In the ongoing debate about fundamental tax reform, the deduction for nonbusiness state and local taxes has come under repeated fire. No major tax reform proposal has left it untouched, and the Department of the Treasury has twice proposed that the deduction be completely repealed. This article evaluates the merits of the various arguments that have been made for the elimination of the deduction. In addition, the article examines other arguments that have been given little attention in the debate over its future.

[P. 1108]

History of the Deduction for State and Local Taxes

Since 1861, amounts paid as state and local taxes have been deductible for purposes of the federal income tax. Over the years, two quite different rationales have been offered in support of the deduction. First, the deduction has been justified as being necessary to properly measure an individual's taxable income. Under this view, an amount paid in state and local taxes reduces an individual's ability to pay federal taxes. From a tax policy perspective, an appropriate remedy in such a situation is to grant a deduction for the payment, thereby removing the amount of the payment from the federal income tax base. Implicit in this rationale is the conclusion that the deduction is not a tax expenditure; rather, it is a necessary adjustment to properly define the tax base.

The second rationale is that the deduction, to the extent that it is not necessary to define the proper federal income tax base, facilitates fiscal coordination in our federal system. Under this rationale, the deduction is a tax expenditure and must be analyzed and justified as such. As viewed by some, this tax expenditure is a subsidy...
to state and local governments; as viewed by others, it is a crucial component of the overall financing scheme of our federal system of government.

Summary of Treasury Position

In Treasury II and in congressional testimony, the Treasury has offered several arguments in support of the repeal of the nonbusiness state and local tax deduction for itemizing taxpayers. First is "Fairness." Treasury II states that the deduction is unfair because it disproportionately benefits high-income individuals residing in high-tax states. As further explained, this creates two types of inequities. As between itemizing and nonitemizing taxpayers (regardless of location), the deduction benefits only those who itemize their deductions. Treasury II finds this to be unfair because only about one-third of all taxpayers itemize their deductions, with the clear implication that the predominant number of itemizers are higher-income taxpayers. In addition, as between itemizing taxpayers, the deduction benefits taxpayers residing in high-tax jurisdictions more than those in lower-tax states.

Second, the deduction creates an "Erosion of the Tax Base." Viewing the deduction as a tax expenditure and as revenue that the federal government could, but does not, collect, Treasury II states that marginal tax rates could be lowered significantly if the taxable income represented by this deduction were included in the tax base.

Third is the "Fallacy of the 'Tax on a Tax' Argument." One component of the tax on a tax argument is the question as to whether the deduction for state and local taxes is necessary for the proper definition of the federal tax base. Treasury II answers this question in the negative, arguing that state and local taxes are "voluntary" payments made by residents of a particular jurisdiction in exchange for public goods and services that represent items of "personal consumption." As such, they should not be allowed as reductions in the federal tax base.

Treasury II also criticizes the deduction on this level because it shifts the burden of the federal income tax from high-tax to low-tax states. It inhibits the ability of the federal government to insist that the federal income tax burden be distributed evenly among the states. In addition, Treasury II maintains that the repeal of the deduction is critical, because the federal government must be able to control its own tax base. With the deduction, state and local jurisdictions effectively control the federal tax base by being able to increase their taxes and diminish federal revenue.

Fourth, Treasury II argues that the deduction for state and local taxes is an "Inefficient Subsidy" to state and local governments. The basic point of this argument is that the federal government should only be spending money (either directly or indirectly through the tax system) on projects that are national in character -- i.e., that have benefits that cross or "spill over" individual state and local boundaries. Treasury II finds support for its position in favor of repeal in the absence of strong evidence that these spillover items make up a significant portion of all state and local expenditures. Moreover, even though Treasury II does acknowledge that certain spillover expenditures do exist in almost every state and local jurisdiction, the deduction does not properly identify what expenditures are local and national in character.

Evaluating the Deduction for State and Local Taxes

Treasury II's position arguing for repeal of the deduction for nonbusiness state and local taxes is based upon two fundamental premises that reject the historical justifications for the deduction: First, the deduction is not
necessary to define the federal income tax base properly. As such, the deduction represents a tax expenditure. Second, Treasury II has concluded that, viewed as a tax expenditure, the deduction cannot be justified on the basis of economic considerations. This article examines both of these premises.

With regard to whether the deduction for state and local taxes is necessary for the proper definition of the federal income tax base, the first section of this article draws upon two theoretical models -- a time-honored economic model of the ideal federal system of government (sometimes referred to as “fiscal federalism”) and a model of the comprehensive income tax base -- and explores the role of the deduction for state and local taxes in a world with both of these models in place. Once these models have been developed, the article then compares these theoretical constructs with the real world, seeking to determine whether Treasury II’s proposed repeal of the deduction for state and local taxes produces a federal income tax system that, in fact, better measures the income of all taxpayers.

The second part of this article examines the deduction for state and local taxes as a tax expenditure, both in its own right and in comparison with other significant tax expenditures, such as the deductions for home mortgage interest and charitable contributions. Each of Treasury II’s arguments regarding the deduction is explored in detail in this section of the article.

The article concludes that Treasury II has not made the case for repeal of the deduction. Treasury II does not explicitly address the question of whether the deduction is necessary to properly define taxable income. As developed below, a deduction for state and local taxes would not be necessary in the ideal economic world of fiscal federalism. Presumably, Treasury II’s position is based upon this ideal model. In fact, the real world diverges from the ideal in so many significant ways that it is highly questionable whether repeal of the deduction will result in a better formulation of the federal tax base. Indeed, its repeal may actually increase inter-taxpayer unfairness by overstating the taxable income of many taxpayers.

At the tax expenditure level, the article concludes that Treasury II overstates the arguments against the deduction for state and local taxes, especially when compared to the proposed retention of both the home mortgage interest and charitable contribution deductions under Treasury II. From a tax policy perspective, it is difficult to rationalize the repeal of the deduction for state and local taxes alongside the retention of many other similar expenditure items, especially the deduction for charitable contributions. Both of these deductions in many ways seek to accomplish similar goals and purposes and, as tax expenditures, both have very similar effects upon the fairness, efficiency, and neutrality of the tax base. The repeal/retention dichotomy in this particular comparison is quite stark, and clearly calls into question the merits of Treasury II’s position. The article now turns to a detailed development of these arguments.

State and Local Tax Deduction
as Part of Ideal Tax Base
A Theoretical Model for a Multiunit Taxing System

The deduction for nonbusiness state and local taxes is somewhat unique because, at least in the past, it has been viewed as an element of a much larger picture, namely, the manner in which our complicated federal system, with a multitude of federal, state, and local jurisdictions, is financed./10/ Over the years, economists have thoroughly analyzed what the ideal multiunit or federal public finance system should look like from traditional
economic perspectives, primarily efficiency. It is helpful to examine this theoretical economic model of a federal system briefly as the starting point in the examination of the need for a deduction for state and local taxes.

Fiscal Functions of Government. In the theoretical model of one noted economist, Professor Richard A. Musgrave, governments perform at least three major fiscal functions -- allocation, distribution, and stabilization./11/ Under the allocation function, governments make decisions as to what portion of total resources are to be dedicated to so-called public or social goods -- goods that will not be provided at all, or at socially desirable levels, if left to the private marketplace. Examples of public goods include national defense, education, and police and fire protection. In addition, governments also determine what the resource allocation mix among the various public goods should be. Under the distribution function, governments determine through fiscal policies what the fair distribution of income and wealth in society should be. Through the stabilization function, governments seek through economic policy to maintain high employment, a reasonable level of price stability, and an appropriate rate of economic growth for society.

The Ideal Multiunit System./12/ The Musgrave model posits that it is not only appropriate, but economically efficient, to divide these basic governmental functions among various levels of government, with each level performing those functions for which it is best (i.e., most efficiently) suited. Hence, a federal system comprised of both a central or national government, and state and local governments, not only makes sense from a political perspective, but it may be economically efficient and desirable as well. The most important division of labor among the various levels of government in a multiunit or federal system arises with respect to the allocation function.

A central premise of the Musgrave optimal allocation function is "the spatial limitation of benefit incidence."/13/ This maxim of allocation theory assumes that different public goods and services benefit different regions within a country ("benefit regions"). In the context of multiunit governmental structure, there are thus essentially two types of public goods -- those goods whose benefits are "federation-wide" (national goods) and those goods whose benefits are less than federation-wide (regional or local goods).

Under allocation theory generally, the optimum level of goods and services is determined by the preferences of the consumers of those goods and services in society. Consumers reveal their preferences for types and amounts of private goods and services via their purchases in the marketplace. For social or public goods, the basic manner in which consumer preferences are revealed is through the political process (i.e., voting and other mechanisms of representative government). Given the manner in which consumer preferences for public goods are determined through the political process, the model assumes that the ideal multiunit governmental system should seek to correlate benefit regions with the political constituency that both votes and pays for the benefits.

For example, national goods, such as national defense, whose benefits are "federation-wide," should be provided by the central or national government, because all consumers in the country benefit from these national goods and their preferences should be ascertained to determine the optimum levels for the various potential national benefits. Local goods, those with less than federation-wide benefits, should be provided by the local governments whose citizens benefit therefrom and whose citizens' preferences should determine the proper level of benefit provision. These local goods will not be provided at optimum levels of efficiency if consumer preferences beyond the proper benefit region are taken into account (through the political process) in establishing the allocation level.
Under the Musgrave model, the distribution function, unlike the allocation function, must be provided only at the national or central government level. To do otherwise would create disparities among various jurisdictions with different redistributional policies, thereby causing high-income individuals to move to low-tax jurisdictions and vice versa. Because this would result in all low-income individuals residing in the high redistribution jurisdictions, the local redistribution scheme would fall apart unless restrictions on mobility were put in place. Finally, the model assumes that the stabilization function must be within the province of the national government, because local jurisdictions do not have the capacity to affect the entire nation’s economy in a uniform manner.

Thus, under this ideal model of fiscal federalism, national governments would generally provide goods that had benefits that were "national" in nature, and local governments would provide those goods that were "local" in nature. In this ideal world, to the extent that a particular public good was somewhere in between purely local and clearly national, i.e., a good that had benefits that "spilled over" local boundaries, but did not necessarily rise to a truly national level, the national government would aid in the provision of such goods through a series of grants to local or regional governments. On the other hand, the national government would engage in income redistribution among the national citizenry, with the regional and local governments only seeking to raise revenue to provide the social goods within the purview of the regional and local governments.

How the Model Translates Into a Tax System./14/ This ideal model of multiunit government fiscal coordination translates directly into a general taxation scheme. The guiding principle is that the residents of each benefit region or jurisdiction establish a desired level of benefits (expressing their preferences through the political process), and then they pay for the services provided by that jurisdiction through taxes. This implies that all taxes at the local level should be based upon benefits received -- so-called "benefits received" taxation./15/ In an ideal world in which individuals have ready mobility, if the level of benefits (and thus the level of taxes) did not correspond [P. 1111] to an individual's level and mix of preferences for public goods, such individual would be able to relocate to a benefit region that allocated its resources more in line with that individual's preferences./16/

The national government would impose broad-based taxes, independent of the location or residence of any particular taxpayer. Since this level of government is solely responsible for the distribution function, it would not be restricted to benefits received taxation. If it chose to engage in income redistribution, it could adopt a tax based solely upon each individual's ability to pay taxes, regardless of the benefits that the individual receives -- so-called "ability-to-pay" taxes. Ability-to-pay taxes are not assessed on the basis of the level of services or goods a taxpayer receives in exchange therefor. Rather, these taxes primarily carry out the income redistribution goals of society./17/ Under the ideal federal model, since only the national government would be charged with any income redistribution responsibility, it would be the only government imposing ability-to-pay taxes. Conversely, since the local jurisdictions would not be engaged in income distribution, but only resource allocation, such jurisdictions would impose only benefits received taxes upon their taxpayers.

Fundamentals of Tax Policy

Under the ideal model of fiscal federalism, the central or national government would be charged with income redistribution. Assuming that the nation as a whole had determined that income redistribution should be accomplished, what would the national tax system look like? There are several potential models for a redistributive tax system, but this article will concentrate upon the comprehensive income tax, since that has been the basic model used in the United States to date, and since it seems likely that an income-based tax will remain the goal of our federal taxing scheme. The most important aspect of the design of an appropriate income
tax is the determination of the proper tax base. Once the tax base is established, the tax rates can be set to raise any level of revenue necessary to support the desired level of national goods and services. Hence, the goal would be to define "income" in a fair, efficient, and neutral manner for all taxpayers.

Defining a Comprehensive Income Tax Base. Although no single ideal definition of "income" has been adopted as part of the ongoing debate regarding broad-based tax reform, the Haig-Simons definition is the starting point for most discussions: Income is the sum of a taxpayer's consumption and his change in wealth over a period of time, usually a year./18/ This definition is very broad, and it brings within its reach certain items that cannot reasonably or practically be included within an administrable tax base. For example, the Haig-Simons definition of income would include unrealized appreciation on non-marketable assets and the imputed income that arises from owner-occupied homes. Nonetheless, this definition provides a useful frame of reference by setting the outer limits of a model comprehensive income tax base, and by allowing each potential exclusion from the tax base to be judged against a uniform standard.

The Haig-Simons definition of income is somewhat different from what most taxpayers normally think of as income (e.g., wages, dividends, interest, etc.). Under present law, the starting point for measuring taxable income is a taxpayer's sources or receipts for the appropriate year. Yet under the Haig-Simons definition, income is measured by its uses, not by its sources. Under this scheme, a basic equality is assumed: If a taxpayer purchases or consumes a good or service in the market, the value received is equal to the price paid for the good or service. Hence, the uses of income should be equal to the sources of income, and either side of this equation may be used as the measure of income in a given period. Moreover, under the Haig-Simons definition, there are only two categories of potential uses of income -- current consumption and savings. If a person does not currently use income, it is saved. Hence, the notion of the increase in a taxpayer's net worth in a given period of time is synonymous with savings. Whatever a taxpayer does not consume, of necessity, adds to the taxpayer's net worth. Thus, a taxpayer's income in a given period can be measured by looking at the sum of his or her consumption and additions to savings during that period.

State and Local Taxes Under a Comprehensive Definition of Income. Keeping in mind the basic equality between the amount paid for goods and services and the value of those goods and services, it is possible to analyze how state and local tax payment transactions should be treated under a comprehensive income tax base. In any state and local tax transaction, two basic events take place: (1) A taxpayer makes tax payments to the government, and (2) the same taxpayer receives certain goods and services for those payments. Since step (1), the payment of taxes, is neither consumption nor savings, the payment of taxes would not be included in the tax base. Under the Haig-Simons definition of income, however, the value of the benefits received by the taxpayer in step (2) does constitute income and should be included in the base. Similarly, under the Musgrave model, state and local taxes would all be based on benefits received; therefore, the amount paid in taxes would be deemed to be equal to the value of the benefits received. One could effectively include the value of these benefits simply by denying a deduction for the state and local taxes.

To illustrate, if a person earns $200 in a year, this amount would be the person's Haig-Simons income for [P. 1112] that year if nothing else happened, because it would represent savings of $200. If the same person also paid $50 of state and local taxes, and received $50 in goods and services in return, although the tax payments would be, in effect, deductible in computing taxable income (because they represent neither consumption nor savings), the $50 in goods and services received would represent consumption (and thus income) creating a wash. The
person would still have $200 of taxable income -- $150 of savings and $50 of consumption. In other words, in cases in which the amount of taxes paid equals goods and services received, the comprehensive income tax would allow no net deduction for state and local taxes.

In an income-based, ability-to-pay federal income tax scheme, denying a deduction for state and local taxes only produces the proper result if the state and local taxes are imposed on a benefits received basis. If, for example, the above taxpayer paid $50 in state and local taxes, but received only $25 in goods and services in return (as would be the case, for example, in a state or local jurisdiction engaged in income redistribution), his or her Haig-Simons income would be $175 ($150 savings plus $25 of consumption). Completely denying a deduction for state and local taxes in this case would result in the person being overtaxed. In this example, a state and local tax deduction should be eliminated only to the extent of the benefits received from the state and local governments. The ability-to-pay portion of the state and local levies must be deductible to measure income properly.

Fiscal Federalism, the Income Tax, and the Real World

Since, under the ideal model of federalism, no state or local jurisdiction would impose anything other than benefits received tax levies, there would never be a case in this ideal world in which state and local taxes reduced a taxpayer’s taxable income. The taxes paid would always be washed out by benefits received, creating the net effect of no deduction for state and local taxes. The real world, however, differs from the Musgrave ideal in several important respects.

First, state and local governments do not only provide local goods that benefit only their residents. Rather, they frequently must provide at least two different types of public goods, whose benefits flow beyond the benefit region of the government in question. One such type of good -- public welfare transfer payments -- actually puts state and local governments in the role of providing goods that are national in character. In other words, the Musgrave model of ideal fiscal federalism is not borne out by reality, because the national government does not always perform all of the allocation functions that it ideally should under that model. In the recent past, the national government has increased the number of these national resource allocation priorities that have been "turned back" to the state and local jurisdictions./19/

Another example of this type of public good is the spillover good. Even though its benefits are not national in nature (and thus it would not be the responsibility of the national government directly), such benefits extend beyond the governmental region that is providing the good. To illustrate, certain expenditures for environmental protection may create benefits for neighboring jurisdictions as well as the jurisdiction making the expenditure. Under the Musgrave model, national grants or subsidies are intended to deal with this type of spillover situation./20/ In reality, many state and local jurisdictions must provide these spillover goods without the help of a federal grant.

Perhaps the most important aspect of this first divergence of reality from the ideal model is that the situation is not one that has been voluntarily created by the citizens of the state and local government. Especially in the case of public welfare transfer payments, state and local governments have established these programs at least partially in response to national goals. The same is true for many of the spillover situations. To say that a state or local jurisdiction can easily move toward the ideal model of fiscal federalism ignores the reality of the situation. Until the federal government plays its proper role under the model of fiscal federalism, i.e., by providing all
significant national goods and aiding states with spillover situations, it is unrealistic and inappropriate to assume that state and local governments will do the same.

A second, related way in which state and local government policies do not reflect the Musgrave model is that states and, to a lesser extent local governments, impose taxes on the basis of their residents' ability to pay, not upon the benefits they receive. In other words, state and local governments do engage in income redistribution, in violation of the ideal model of fiscal federalism. Once again, however, the impetus for this conduct seems to be closely related to the real world distortions in the model allocation function. If the state and local jurisdictions are forced to provide resources of a national character, such as welfare, it is almost inevitable that these jurisdictions will have to engage in income redistribution through the tax system. Welfare payments are the means by which income redistribution is accomplished. They are not most effectively provided through benefits received taxation./21/ Hence, the reality is that state and local governments do [P. 1113] engage in both benefits received and ability-to-pay taxation to provide the public goods within their benefit regions.

A third way in which the real world diverges from the ideal model is that individuals do not have ready mobility. The model assumes that all individuals may express their preferences for public goods initially through the political process. If, under traditional majority rule procedures, a particular individual ends up living in a benefit region that provides public goods differently from that individual's preferences, the model assumes that the individual is free to relocate in a jurisdiction that allocates goods more in line with the individual's preferences. In fact, no such absolute mobility exists. In the real world, many individuals live in jurisdictions that may overprovide public goods from their perspective, but those individuals may not be perfectly free to "vote with their feet" and leave that benefit region.

This lack of mobility is especially important when examining the nature of the state and local taxation system. If an individual is not free to move out of a high-tax jurisdiction, then the taxes of that jurisdiction become all the more involuntary to that individual. He or she is locked in, by both majority rule and the lack of perfect mobility, to paying taxes for public goods and services from which he or she receives no benefits./22/ This involuntary aspect of the present state and local taxing scheme is quite important to the overall question of whether those taxes should be deductible for federal income tax purposes.

The significance of these differences between the ideal fiscal federalism model and reality is that they directly contradict the theoretical equality between state and local taxes paid and benefits received. Since this equality does not exist in the real world, denying the deduction of state and local taxes is not equivalent, in terms of the tax base, to including the government benefits received in the base. Thus, under the Haig-Simons definition of income, the only accurate measure of income will be the value of the government benefits received by each individual.

It is also very difficult, if not impossible, however, to measure the value of the consumption-type benefits received by any individual from state and local government goods and services. Thus, the comprehensive income tax model is left in a quandary. The posited equality between tax payments and benefits received is not present, and the precise portion of those tax payments corresponding to benefits received cannot be ascertained. Hence, only two basic solutions are available: (1) Allow the deduction for state and local taxes, except in cases in which there is an ascertainable relationship between the tax payment and the benefit received; or (2) Disallow the deduction completely on the assumption that the predominant portion of state and local taxes involves a direct correlation between benefits and tax payments./23/
Neither of these two solutions is perfect. Under the first solution, the value of most public goods and services consumed by taxpayers will be excluded from the tax base. As with other exclusions, this solution will create a bias in favor of local public goods over individual private expenditures. Under the second solution, the federal government will be arbitrarily overtaxing a considerable portion of its citizenry, while at the same time undertaxing another segment of society./24/

Denying the deduction completely is particularly troublesome, given the reasons why reality diverges from the ideal. In fact, state and local tax levies go beyond benefits received taxation in large part to allow the state and local jurisdictions to carry out national resource allocation goals. When combined with the lack of perfect mobility, a solution that eliminates the deduction for state and local taxes completely ignores the significant portion of state and local taxes that is both involuntary in nature and redistributive in purpose.

Treasury II, Fiscal Federalism and Comprehensive Income Taxes

Treasury II opts for the second approach above, disallowing all state and local tax deductions. Although there is little articulated rationale in the report, its predecessor, Treasury I, spoke more forcefully on the issue. Treasury I quite clearly took the position that most state and local tax levies do represent so-called "benefits received" taxation -- i.e., that most state and local taxes are levies to pay for specific goods and services received by taxpayers of that jurisdiction./25/ Another way of looking at this type of state and local tax levy is that it is essentially a "user charge" for the services received. User charges are currently excluded from the category of deductible nonbusiness taxes. Treasury II also seems to place state and local taxes under the consumption category when it refers to such taxes as "voluntary" payments by taxpayers. In general, voluntary payments would be [P. 1114] indicative of consumption-type expenditures and of a benefits received situation./26/

It seems clear that Treasury II, in large measure, assumes the existence of a pure system of federalism as set out in the Musgrave model. Under that view, all state and local taxes would be of the benefits received variety, and a deduction for those taxes would not be required in measuring income under a comprehensive income tax. Much of the language and rationale of the report can be understood in light of this theoretical construct. Treasury II simply refuses to acknowledge that state and local taxes are actually based upon something other than the benefits received by the taxpayers in those jurisdictions. Moreover, Treasury II seems to assume a very high degree of taxpayer mobility among state and local jurisdictions, a fact that arguably is not borne out by reality. Treasury II's position would be wholly defensible if the real world actually reflected the state of affairs postulated in the ideal model of fiscal federalism.

The real nature of state and local taxes is far less clear than Treasury II would suggest. To the extent that state and local taxes are based upon an ability to pay, and not upon a benefits received, policy, there are two strong arguments that full deductibility is preferable to nondeductibility. The first argument is premised upon the fact that there is not adequate correspondence between the amount of taxes paid by a particular individual and the value of government benefits received. Although allowing a full deduction has the effect of excluding from the federal tax base the value of most services provided by state and local governments, arguably this result is preferable to denying the deduction completely and, thereby, overtaxing many individuals, while undertaxing many others. This is essentially the argument that was adopted in the highly regarded study done by the Department of the Treasury in 1977 -- Blueprints for Basic Tax Reform./27/
The second argument is that once it is recognized that multiple levels of government share in the distribution function by imposing ability-to-pay taxes, it becomes essential for at least one level of government to provide for deductibility of these taxes in order to integrate an overall measure of ability to pay. Allowing a deduction at the federal level is most consistent with Musgrave's ideal model and allows the federal government to act as "the primary and the final arbiter of the national distribution of income and wealth."/28/ This is also the practical choice because the federal government has greater ability to effect national income redistribution than does any one state, as well as a greater ability to adjust for the deduction. Deduction of federal ability-to-pay taxes at the state level is a plausible alternative, but would impose significant costs upon state revenues while also being inconsistent with the ideal model of income redistribution as primarily a national priority and responsibility.

The basic question is whether state and local taxes are benefits received or ability-to-pay taxes. This determines how any particular state and local tax should be treated under a comprehensive income tax model. If any substantial portion of state and local taxes is assessed on an ability-to-pay basis, Treasury II is significantly flawed in its definition of the income tax base. Ability-to-pay state and local taxes, however inconsistent with the ideal model of federalism, are not properly part of a comprehensive federal income tax base. The failure of Treasury II to acknowledge this fact represents the most serious fundamental weakness in the position of the report.

The clearest example of an ability-to-pay levy is a state and local income tax. It is reasonably clear that most of these taxes are not established on a benefits received or user charge basis, and thus should be deducted when measuring income under a comprehensive base. A broad-based sales tax is a little less clear but, unless one believes that the distribution of governmental benefits is similar to the distribution of expenditures subject to the sales tax, it too should be considered an ability-to-pay tax./29/

The property tax is probably more in the nature of a benefits received tax than either the income tax or sales tax. While state governments generally use a sales tax and/or an income tax, the property tax is almost exclusively within the province of local governments. There may be some basis for the assertion that local governments spend a higher percentage of their revenue on public goods that only benefit their particular region than do state governments. If this is true, there probably would be a higher degree of correlation between taxes paid and benefits received for the property tax than with the other two general levies. On the other hand, even in the case of property taxes, it is quite possible that the relationship between taxes paid and benefits received may be sufficiently [P. 1115] attenuated to warrant classifying the property tax as an ability-to-pay tax.

Many commentators argue that the federal government should be neutral with respect to how state and local governments choose to raise revenue. For this reason, if state and local income taxes are deductible, these commentators/30/ favor retaining the deduction for both property/31/ and sales taxes. If a deduction were permitted only for income taxes, undue pressure would be placed on state and local governments to use this type of levy, even though it might not otherwise be appropriate./32/

Should the Federal Income Tax Base Be Evenly Distributed Among the States? One further point deserves comment under the discussion of the model comprehensive income tax. A stated goal of Treasury II is to produce a more even distribution of the burden of federal income taxes among the states. This report concludes that the present deductibility of state and local taxes skews the distribution of federal income taxes in favor of high-tax jurisdictions, with low-tax jurisdictions bearing an unfair share of the total federal income tax burden. There are problems with this approach.
First, this argument is interesting in that it explicitly focuses on inter-regional, rather than inter-individual, equities. Since the federal income tax is imposed upon individuals and not upon regions, the argument must be implying that the state and local tax deduction is not necessary to properly measure federal taxable income. Absent the deduction, the federal income tax base will be defined without regard to the taxing policies of the various state and local jurisdictions, thereby treating two individuals in different jurisdictions alike, irrespective of the amount of state and local taxes that each has to pay. In terms of Treasury II, both individuals would bear an equal share of the federal tax burden.

The important question, however, is the one that Treasury II has ignored -- whether it is fair to define the federal income tax base without regard to state and local taxes. To the extent that such taxes do affect an individual's ability to pay, the federal tax base should be reduced for such taxes. Treasury II again skips over this crucial point, assuming that those taxes are properly part of the tax base.

Moreover, under both the Musgrave theoretical model of fiscal federalism and under most comprehensive income tax models, it is clear that the individual is the proper level for income measurement. It is the individual's ability to pay with which the federal income tax should be concerned. Therefore, if a state and local tax levy is truly an ability-to-pay tax, it is properly excluded from the tax base, because it does not represent amounts that are available for either consumption or savings of that individual. The distribution of the effect of that deduction among the various states has little to do with the proper measurement of income under a comprehensive federal income tax that measures only an individual's ability to pay.

Conclusion

Under a comprehensive federal income tax, state and local taxes that represent ability-to-pay tax levies should be deductible in determining income. In the absence of the ability to ascertain precisely what portion of state and local taxes represents ability-to-pay levies, at least some deduction for those taxes must be maintained in the federal income tax system in order to avoid the unfairness of forcing taxpayers to pay federal income tax upon amounts that are not properly part of a comprehensive tax base. If partial deductibility is not possible, then full deductibility is a very defensible solution, given the lack of any significant degree of correlation between government benefits received and taxes paid in many jurisdictions. To keep the federal income tax neutral with respect to the use of different types of taxes by state and local governments, the deduction should not distinguish among various types of state and local tax levies.

State and Local Taxes as a Tax Expenditure

The deduction for state and local taxes can properly be viewed as a tax expenditure only if the deduction is not necessary to properly define the income tax base. As a tax expenditure, however, it is still possible to justify the deduction. Historically, the basic rationale for the deduction as a tax expenditure has been that it facilitates fiscal coordination in our federal system.

The primary focus of this rationale is that serious equity problems may arise if several independent taxing jurisdictions use the same tax base (e.g., a tax based upon income) to raise revenue. For example, under our federal system of government, it is not unusual for an individual to be both a resident and a taxpayer in three or more jurisdictions simultaneously. These various levels of government often use the same tax base to raise [P. 116] revenue and, if they operated independently, certain groups of taxpayers might be burdened by excessively
high rates of tax. At present, the federal government, 45 states, the District of Columbia, and numerous local jurisdictions all impose a tax on income. In the absence of a deduction for state and local income taxes at the federal level, the combined marginal tax rate on a taxpayer's income might approach, or even exceed, 100 percent. Although confiscatory rates are currently unlikely, the possibility of confiscation does illustrate the potential inequities that could result from a lack of fiscal coordination. This rationale is not without merit and has received congressional approval.

Since the deduction reduces the impact of state and local taxes on residents, it can also be viewed as a form of financial aid from the federal government to facilitate the financing of local public services. Some observers also believe that the existence of the deduction reduces local opposition to ability-to-pay taxes, thereby promoting a more equitable overall tax system. Finally, the deduction reduces the tax differential among states and other communities, thereby reducing the economic inefficiencies created by large geographic differentials.

Treasury II

The Treasury has apparently rejected the notion that the deduction is necessary to properly define the income tax base. Moreover, Treasury II has also rejected as unnecessary the role that the deduction plays in fiscal coordination. Rather, the report has taken the position that the state and local tax deduction should be repealed in its entirety. There are a number of problems with the arguments used in Treasury II to defend the repeal of the deduction for nonbusiness state and local taxes. To address some of these problems, it is helpful to examine three similar itemized deductions under current law -- nonbusiness interest deductions, especially for owner-occupied homes; charitable contributions; and state and local taxes. Under Treasury II, there is some cutback in the interest deduction, there is very little direct change in the charitable contribution deduction, and there is a total repeal of the state and local tax deduction. Can the obvious discrepancy between the actions proposed by Treasury II for interest and charitable contributions on the one hand, and state and local taxes on the other, be rationalized in an appropriate way?

Fairness. Treasury II takes the position that the state and local tax deduction disproportionately benefits high-income taxpayers residing in high-income states. Under this view, the deduction has the effect of requiring taxpayers in low-tax states to subsidize taxpayers in other communities. Furthermore, Treasury II argues that since only one-third of all taxpayers itemize, the federal deduction effectively skews the burden of the state and local taxes within a particular community, because the deduction makes those taxes less costly to those higher income taxpayers who, in effect, have part of their state and local tax burden paid by the federal government through the itemized deduction.

The issue of fairness is directly tied to the appropriate definition of taxable income. Treasury II's position with respect to fairness is tenable only in the Musgrave model of the ideal fiscal world. As discussed above, our federal system deviates from this world in significant ways. Because of these deviations, there is, in fact, no equality between the amount paid in state and local taxes and the governmental benefits received by individual taxpayers. This is particularly true with respect to residents of high-tax states that actively engage in income redistribution. In these jurisdictions, there is little doubt that as the amount paid in taxes increases, the value of benefits received as a percentage of these taxes decreases.

If one returns to the Haig-Simons definition of income, it is clear that the present law benefits both lower- and higher-income taxpayers. As the previous discussion developed, under that general definition of income,
consumption-type items (including the benefits received from state and local governments in the form of public goods and services) are properly part of a comprehensive income tax base. At present, however, because of the difficulty of measuring the value of those public goods and services received, the tax base generally does not include the value of those consumption items.

This imperfection in the tax base does benefit those individuals who receive a deduction for state and local taxes, to the extent that those taxpayers actually receive benefits from state and local governments in the form of public goods and services. Equally as important in this context, however, is the benefit received by lower-income taxpayers who are not taxed upon the benefits they receive in the form of public goods and services from state and local governments. In a world in which state and local governments engage in any significant degree of income redistribution through ability-to-pay state and local taxes, it is difficult to say precisely where the greater benefit of the present system lies. It is quite clear, however, that the benefits of the present system do not run solely to higher-income taxpayers at the expense of lower-income taxpayers.

Denying the deduction for state and local taxes is an expedient, but not a fair, mechanism to insure that the value of public goods and services provided by state and local governments will be included in the tax base. Under the Haig-Simons definition of income, the repeal of the deduction for state and local taxes would have the effect of including the value of the government benefits received in the income tax base. Only where a pure benefits received taxation scheme is in place, however, is such a structure fair among all taxpayers. If, in the real world, state and local governments engage in a significant degree of ability-to-pay taxation, repeal of the deduction overtaxes individuals whose taxes exceed government benefits received, while undertaxing those lower-income taxpayers whose government benefits received exceed taxes paid. It is difficult to agree with Treasury II that such a state of affairs is "fair" in any overall sense, and it may well be seen as adding a significant degree of unfairness to the system.

Treasury II makes a further argument that the deduction for state and local taxes discriminates among citizens of the same jurisdiction depending on whether they itemize their deductions. At present, for those taxpayers who do not itemize, a portion of their standard deduction or "zero bracket amount" is deemed to represent state and local taxes paid./41/ Simplicity and administrability have dictated the standard deduction approach. Treasury II, however, seems to lose sight of the relationship between the amount of the standard deduction and personal deductions, such as state and local taxes. Contrary to Treasury II, it is an appropriate view of the present tax system that all taxpayers receive a deduction for state and local taxes -- in the form, first, of the standard deduction and, second, of itemized deductions, if itemized deductions exceed the standard deduction.

Finally, from the perspective of low-income taxpayer/ high-income taxpayer equity, it is difficult to justify the conclusion of unfairness with respect to the state and local tax deduction in light of the proposed treatment of home mortgage interest and charitable contributions in Treasury II. Both of the latter deductions are also itemized deductions and have the same general distribution among the income brackets./42/ Both of the latter are utilized disproportionally by higher-income taxpayers. If fairness and equity are truly at the heart of a fundamental tax reform proposal, it is difficult to reconcile the liberal treatment of home mortgage interest and charitable contributions with the repeal of the state and local tax deduction.

Erosion of the Tax Base. Treasury II describes the state and local tax deduction as "one of the most serious omissions from the federal income tax base." Under recent estimates by the Joint Committee on Taxation, repeal
of the deduction would generate $44.4 billion in 1988 at present tax rates. Treasury II implies that without the repeal of this deduction, tax rates, which are at "unnecessarily high levels," cannot be reduced.

Although the repeal of this deduction would generate a great deal of federal revenue, that fact, by itself, does not justify its demise. Rather, as a tax expenditure, the deduction should be analyzed as a spending program and its merits judged alongside other comparable spending programs. As articulated above, this deduction has long been justified as playing a significant fiscal coordination role in the federal system. Moreover, the state and local tax deduction is not often thought of as a "loophole," or a "tax shelter," and has never been the principal target of tax reform. Although some observers advocate the repeal of this section, this is invariably in the context of an overall reform of the tax base, in which such preferences as depletion, capital gains, fringe benefits, charitable contributions, nonbusiness interest, and qualified deferred compensation are also being carefully scrutinized. What appears to be lacking in Treasury II is the balanced scrutiny of all tax expenditures that traditional tax expenditure analysis requires.

Treasury II takes the position that the repeal of the deduction for state and local taxes is necessary in the overall effort to reduce unnecessarily high tax rates. This argument may be facially accurate, but it has little to do with the overall process of fundamental tax reform. Initially, it is not necessary to reduce tax rates as part of the process of fundamental tax reform, so long as the tax base is broadened in a fair and efficient manner. For example, it would not be irrational for Congress to broaden the tax base without reduction in rates to deal with the federal government deficit. Furthermore, if Congress decides to lower rates as part of a revenue neutral tax reform package, there are numerous possible sources of revenue that are worth considering. For example, according to recent estimates, the amount of foregone revenue at present tax rates that will result from the exclusion for health insurance premiums in 1988 is $29.0 billion; from the deduction for interest on owner-occupied homes, $33.8 billion; from the preferences given to qualified deferred compensation, $71.1 billion; and from individual retirement accounts, $15.6 billion.

The Fallacy of the 'Tax on a Tax' Argument

Treasury II states that some argue that state and local taxes should be deductible to avoid imposing a "tax on a tax." Treasury II finds this argument deficient for three reasons: First, the argument ignores the effect of the deduction for state and local taxes on the federal income tax base. The report states that this provision effectively permits state and local governments to define the federal tax base. Second, the argument suggests that the state and local taxes are involuntary and citizens of the jurisdiction receive nothing for their taxes. Treasury II disagrees with both suggestions. Finally, Treasury II concludes that the argument is contradicted by the practice of denying a deduction at the state and local level for federal taxes. Whether taken alone or cumulatively, none of Treasury II's reasons is convincing.

Who Should Define the Federal Tax Base? Treasury II argues that, through the deduction for state and local taxes, state and local jurisdictions are inappropriately but effectively in a position to define the federal income tax base. By enacting additional deductible taxes, a state or local government can reduce the federal tax base and shift the burden of the federal income tax to other jurisdictions.

Several points deserve attention here. First, as previously noted, the federal income tax is imposed on individuals, not jurisdictions. Second, it can be argued that the basic definition of income, not state and local taxing policies, define the federal income tax base. If ability-to-pay state and local taxes are not part of a proper federal income
tax base, that is the result of the theoretical underpinnings of a comprehensive income tax, not the policies of state and local governments. Third, to the extent that fiscal coordination is a desired objective, there is little doubt that the federal government, given its greater resources and financial strength, is in a better position than most state and local governments to coordinate overlapping demands on the same tax base.

Finally, if the question is whether a particular deduction or credit involves a loss of federal power over its own tax base, every tax expenditure violates this standard. The home mortgage interest and the charitable contribution deductions are but two of many examples of cases in which the federal government has effectively ceded the power to define its tax base in a manner at least as great as that claimed by Treasury II with respect to state and local taxes. The home mortgage interest deduction allows every individual to redefine the federal tax base by excluding his or her mortgage interest payments from that base. Under the same rationale, when an individual makes a charitable contribution, that individual is redefining the federal tax base. At least in the case of state and local tax deductions, there is a degree of public control over the definition of the federal tax base that is not present when an individual deducts home mortgage interest or charitable contributions. Hence, it is difficult to justify the repeal of the state and local tax deduction on the basis that it represents a loss of control over the federal tax base, given the even greater loss of control over that base represented by other tax expenditures. A tax reform program aimed at fairness and simplicity would seem to require a more consistent treatment of essentially the same types of expenditure.

The Voluntariness of the Payment. Treasury II maintains that state and local taxes are essentially voluntary payments made in exchange for items of personal consumption. On that basis, it would repeal the deduction for state and local taxes. Apart from the theoretical discussion of the proper elements of the tax base above, if voluntariness of the payment is to be a proper measure of the deductibility of a personal expenditure, it is difficult [P. 1119] to justify the proposed retention of the home mortgage interest and charitable contribution deductions alongside of the repeal of the state and local tax deduction. Both a payment of mortgage interest and a charitable contribution involve transactions at least as voluntary as the payment of state and local taxes. At best, taxpayers have only indirect control over state and local tax burdens through their ability to elect the legislative body. In addition, although Treasury II asserts that taxpayers can move from high-tax to low-tax jurisdictions if they do not approve of the former’s taxing policies, such a move is a very complicated matter in a world in which taxpayers clearly do not enjoy perfect mobility. The payment of state and local taxes, therefore, involves only a limited degree of voluntariness. On the other hand, the making of a charitable contribution is completely voluntary. So is choosing to place a roof over one’s head with a debt-financed purchase of property.

If the voluntariness of a payment is the appropriate criterion for measuring deductibility, the treatment of these three important itemized deductions in Treasury II is inconsistent and indefensible.

Payment for Personal Consumption. Under current law, payments to charities and state and local governments are generally treated consistently. In each case, not every payment to such an entity is deductible. In both cases, if a taxpayer receives, in exchange for that payment, a direct benefit, no deduction is allowed. For example, a taxpayer is not entitled to any deduction for tuition payments made to a private, tax-exempt school, despite its charitable status, because of the direct benefit received in the form of educational services. Similarly, a payment to a state or local government for a sewer assessment is not deductible, despite the fact that it is levied by a taxing jurisdiction, because it is in exchange for sewer services.
On the other hand, if a payment to a charity or a state and local government can only be said to be indirectly in exchange for any specific service or benefit, the payment is usually deductible. For example, the Internal Revenue Service has ruled that undifferentiated payments made by a member of a church as an annual contribution to support all church activities will be deductible in full, even though the member's children may benefit from one of the church's activities -- free secular and religious education./47/ This is essentially the same analysis that is applied to allow a full deduction for state and local taxes under a comprehensive income tax, even though there may be some indirect benefits passing to a given taxpayer./48/ As long as the payments (whether charitable contributions or taxes) are not directly linked to benefits received, they should be deductible.

There is yet another similarity between the function of charities and state and local governments that makes any differentiation in the tax treatment of charitable contributions and state and local taxes difficult to defend. In many cases, governments and charities provide similar services to the public at large. For example, the Internal Revenue Service has ruled that payments to a charitable organization performing volunteer fire department services in the locality of the taxpayer's home are deductible./49/ Apparently, despite the clear benefits received by the taxpayer from this form of fire protection, the payment was not directly in exchange for fire protection and thus still deductible. It would certainly be anomalous under Treasury II for such a payment to remain deductible if made as a charitable contribution but not deductible if made in the form of taxes to a state and local government. Such a distinction would create inequities and inefficiencies and would violate a basic principle of neutrality upon which fundamental tax reform is based.

Both the theory and the practice behind the taxation of payments to charities and state and local governments reflect the strong similarities between the purposes of, and the functions performed by, both types of entities. On the level of personal consumption, it is difficult to repeal the deduction for state and local taxes in full, without questioning the basis upon which the charitable contribution deduction remains intact. To be consistent, both types of payments should be treated similarly for federal income tax purposes.

Must State and Local Governments Allow a Deduction for Federal Taxes? Treasury II takes the position that the fact that only 16 states allow a deduction for federal income taxes at the state level contradicts the "tax on a tax" argument. It is not clear which underlying rationale for the deductibility of state and local taxes this aspect of Treasury II's argument is intended to address.

If this point is intended to address the rationale of fiscal coordination (i.e., alleviation of the burden of overlapping taxes), the deduction is only necessary at one level in order to prevent overburdening of the tax base. Assuming a deduction at the federal level, a similar deduction for federal taxes at the state and local level would not be required.

Treasury II may also be suggesting that because most states do not have such a deduction, state and local taxes are not actually based on ability to pay. The implication is that if a state desired to impose an income tax based on the ability to pay of its residents, the base would be determined on an amount net of federal tax liability. This argument is not persuasive. Given the lack of true taxpayer mobility and the fact that most states currently engage in income redistribution among their citizenry, it [P. 1120] is beyond peradventure to suggest that state income taxes are not based, at least in part, on ability to pay. In addition, although deductibility at both the federal, and state and local, levels may be preferable in terms of pureness in measuring a taxpayer's ability to pay, it has been shown that federal deductibility alone may be sufficient for overall equity in a federal tax system./50/
Inefficient Subsidy. Treasury II states that the deduction for state and local taxes could be regarded as a subsidy to state and local governments. Viewed in this way, Treasury II argues that the subsidy is both inefficient and unfair. The existence of the deduction also encourages state and local governments to impose general taxes rather than user charges.

It must be conceded that if the deduction for state and local taxes were solely a subsidy, it would be hard to defend. Although those who favor the deduction on other grounds might consider the subsidy aspects an added plus, no one defends the deduction on this ground alone.

Summary

This article has evaluated the itemized deduction for nonbusiness state and local taxes from two perspectives: Whether such deduction is required in the process of defining the appropriate federal income tax base, and whether, even if the answer to the first question is assumed to be in the negative, the deduction can be justified as a proper exercise of fiscal policy by the federal government. On both counts, this article concludes that the treatment of the deduction in Treasury II is less than adequate. It virtually ignores the role of the deduction in properly defining a comprehensive income tax base. In addition, if the deduction is to be examined as a tax expenditure, Treasury II is questionable. Especially when Treasury II's treatment of home mortgage interest and charitable contributions is lined up against the proposed repeal of the state and local tax deduction, the report cannot be said to be either fair or neutral.

FOOTNOTES

1 See Code section 164. Unless otherwise indicated, all references to sections are to the Internal Revenue Code of 1954, as amended.


3 See Revenue Act of 1861, Pub. L. No. 40, section 49, 12 Stat. 292 (1861) (allowing a deduction for "national, state, or local taxes assessed upon the property, from which the income is derived"); Revenue Act of 1894, Pub. L. No. 227, section 28, 28 Stat. 509 (1894) (allowing a similar deduction, but excluding amounts paid for taxes assessed against local benefits); Revenue Act of 1917, Pub. L. No. 50, section 1201, 40 Stat. 300 (1917) (allowing a deduction in early version of current income tax, but eliminating the deductibility of amounts paid for federal income and excess profits taxes); Act of May 12, 1951, Pub. L. No. 29, section 1, 65 Stat. 40 (1951) (added the deduction by consumers of state and local sales and fuel taxes levied at the wholesale level but passed on to, and separately stated, in the price to consumers); Revenue Act of 1964, Pub. L. No. 88-272, section 207(a), 78 Stat. 40 (1964) (current version of section 164 added to the Code, without substantive change in the deduction) (see excerpts from House report on this bill explaining why retention of the deduction for state and local taxes was deemed necessary at footnote 37, infra); Revenue Act of 1978, Pub. L. No. 95-600, section 111(a), 92 Stat. 2777 (1978) (repealing deduction for state and local fuel taxes, because allowance of the deduction was inconsistent with the user charge nature of the tax, elimination of the deduction would aid in tax simplification by eliminating recordkeeping burdens, and allowance of the deduction ran counter to the national goal of energy conservation).
As used throughout this article, the term "tax expenditure" means an exclusion, deduction, or other departure from the normal comprehensive income tax base for the purpose of carrying out a social or economic goal. Such an exclusion or deduction is described as an "expenditure," because the failure of the federal government to collect as much revenue as it otherwise could (through the allowance of an exclusion or deduction that is not necessary to define the proper tax base) is a form of spending. For a rudimentary overview of the concept of tax expenditures, see Staff of Joint Committee on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990 2-6 (Comm. Print 1985).

This rationale has been explicitly endorsed by Congress. See, e.g., H.R. Rep. No. 749, 88th Cong., 1st Sess. (1963), reprinted in 1964-1 C.B. (Part 2) 125, 171-174. The text of this portion of the House report is quoted at footnote 37, infra.

For data on the use of itemized deductions and tax expenditures by income class, see Staff of Joint Committee on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990 24-29 (Table 3) (Comm. Print 1985).


For a detailed discussion of these functions, see Musgrave & Musgrave, Ch. 1, especially 6-16. Professor Musgrave first posited this model of federalism in R. Musgrave, The Theory of Public Finance: A Study in Public Economy (1959).

These principles are more fully developed in Musgrave & Musgrave, Ch. 24.

Musgrave & Musgrave at 502-503.

Musgrave & Musgrave at 517-20.

For a general discussion of the concept of "benefits received" taxation, see Musgrave & Musgrave at 228-232.

In a world in which individuals have ready mobility and in which local jurisdictions only provide local goods, the taxes imposed by the local jurisdiction can be imposed on a number of different bases, e.g., property, income, or consumption. Although these are not explicitly tied to actual benefits, by choosing to live in a particular locale, an
individual has revealed his or her preference for the mix and the level of services he or she desires, with overall
taxes thereby being equated with overall benefits received.

17 See Musgrave & Musgrave at 232.


19 See Musgrave & Musgrave at 564-572.

20 See Musgrave & Musgrave at 509, 513.

21 See Musgrave & Musgrave at 228-232.

22 As Musgrave and Musgrave have characterized the situation, "Taxpayers must pay the tax, and while they have
a vote, they do not have a veto." See Musgrave & Musgrave at 346.

23 An intermediate approach would be artifically to establish a percentage of state and local taxes that, on
average, represents consumption. Only state and local taxes in excess of this amount would be deductible. A
variation of this approach was suggested by Due, Personal Deductions, in Comprehensive Income Taxation 37,
51-52 (J. Pechman ed. 1977).

24 As described in more detail in the text at pages 1116-1117, infra, disallowance of the deduction, in effect,
correctly taxes government benefits received only for those individuals whose state and local taxes paid exactly
equal government benefits received. If the state and local jurisdictions engage in income redistribution, there will
be a substantial number of taxpayers for whom this equality does not exist. If taxes paid are greater than
government benefits received, disallowance of the deduction overtaxes, because only the benefits received
should be included in the tax base. If benefits received exceed taxes paid, disallowance of the deduction does
nothing to remedy the undertaxation that arises because benefits received are not presently included in the
base.


26 Under the ideal model, all state and local tax payments would be "voluntary" also in the sense that, with
perfect mobility, an individual who paid those taxes had acquiesced in the level of public goods and services
being provided by the jurisdiction in question. Mobility allows an individual only to pay that level of taxes that
coincides with the individual's preferences for public goods.

27 See U.S. Dept. of Treasury, Blueprints for Basic Tax Reform 92-93 (1977): "The general principle, then, is that
payments to the state or local government are excluded from the tax base other than in cases when there is a
reasonable correspondence between payments and value of services received."

ed. 1980).

29 Id. at 324.
30 See e.g., Special Committee on Simplification, Section of Taxation, American Bar Association, Evaluation of the Proposed Model Comprehensive income Tax, 32 Tax Law, 563, 651-653 (1979).

31 The property tax is the most questionable of these three levies. Many economists believe that property taxes are passed on by landlords to tenants in the form of higher rents; tenants, however, are not given a deduction. Since the property tax deduction is only available to homeowners, it "gravely discriminates against renters." R. Goode, The Individual Income Tax 171 (1976). This is the position taken in Blueprints for Basic Tax Reform. See U.S. Dept. of the Treasury, Blueprints for Basic Tax Reform 86-88, 93 (1977). On the other hand, certain economists, viewing the problem from a national perspective, believe that landlords, not tenants, bear the burden of the property tax. Under this latter view, the discrimination against renters is entirely a product of the exclusion from income of the gross imputed fair rental value of owner-occupied homes. See, e.g., Comments by Charles E. McClure, Jr., in Comprehensive Income Taxation 69, 71-72 (J. Pechman ed. 1977). The authors take no position with respect to this particular issue.


33 See Musgrave & Musgrave at 514-515.

34 Fiscal coordination could also be achieved by allowing a deduction for federal taxes at the state and local level. This is in fact done in 16 states. Because of the far greater resources at the federal level, most agree that the deduction at the federal level is a more realistic way to coordinate the taxes. This point is developed further in the text accompanying footnote 50, infra.

35 Although the maximum marginal rate for individuals at the federal level is currently only 50 percent, it has been as high as 94 percent.


Your committee recognized that there were important reasons for continuing the deductibility of property taxes, income taxes, and general sales taxes. The burden of property taxes varies widely among individuals according to whether or not they are homeowners. Thus, any denial of deductions in such cases would result in an important shift in the distribution of federal income taxes between homeowners and nonhomeowners. In the case of state and local income taxes, continued deductibility represents an important means of accommodation.
where both the state and local governments on one hand and the federal government on the other hand tap this same revenue source, in some cases to an important degree. A failure to provide deductions in this case could mean that the combined burden of the state, local and federal income taxes might be extremely heavy.

If property and income taxes are to be deductible in computing income subject to federal income tax, it also becomes important to allow the deduction of general sales taxes as well. These are the three major sources of state and local government revenue, and were the federal government to allow the deduction of some but not all of these taxes, it would be encouraging state and local governments to use one or more of the other types of taxes. Since your committee believes that it is important for the federal government to remain neutral as to the relative use made of these three forms of state or local revenue sources, it in this bill has continued a deduction of these three types of taxes.


38 The most direct statement to this effect appears in Treasury I, Vol. 1 at 78: "Itemized deductions for state and local taxes are not required for the accurate measurement of income."

39 In general terms, Treasury II proposes to disallow deductions for nonbusiness interest (i.e., interest on nonprincipal residences, consumer interest, and most other interest not incurred in the conduct of a trade or business) to the extent that those deductions exceed the sum of $5,000 plus the taxpayer's net investment income. See Treasury II at 323.

40 Treasury II proposes no direct change to the itemized charitable contribution deduction under section 170. The charitable contribution deduction for non-itemizers is repealed under this proposal (see Treasury II at 70-71), and there may be an indirect effect on charitable contributions as a result of the lower marginal rates that are a cornerstone of Treasury II.

41 See S. Rep. No. 885, 78th Cong., 2d Sess. (1944), reprinted in 1944 C.B. 858, 860, in which the original enactment of the standard deduction is explained. "The standard deduction is in lieu of the nonbusiness deductions and certain credits against net income and against tax . . . . [A taxpayer] is not required to itemize and substantiate his nonbusiness deductions."

42 For data on the use of itemized deductions and tax expenditures by income class, see Staff of Joint Committee on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990 24-29 (Table 3) (Comm. Print 1985).
See Staff of Joint Committee on Taxation, 99th Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990 (Comm. Print 1985). Under this estimate, the deduction for state and local taxes other than taxes with respect to owner-occupied homes will result in an expenditure of $31.2 billion in 1988. The deduction for taxes on owner-occupied homes will add an additional expenditure of $13.2 billion. Treasury II states that the repeal of the state and local tax deduction would generate $33.8 billion in 1988.

Ibid.

Under Treasury II, employer contributions to a health plan would be includable up to $10/month for individual coverage and up to $25/month for family coverage. Treasury II estimates that this change will raise an additional $3.7 billion in revenue (determined at the future tax rates proposed in that report).

See Treasury II at 63-64. As it has traditionally been articulated, the "tax on a tax" argument is that it is unfair to include in a tax base an amount already paid in taxes. Under this reasoning, to determine the proper income tax base, a deduction would be permitted for all taxes, such as the federal gift and excise taxes. This particular argument is no longer widely accepted. Treasury II, however, is apparently using the phrase to encompass other arguments, including the comprehensive tax base definitional issue and the questions concerning fiscal coordination.

See, e.g., Rev. Rul. 83-104, 1983-2 C.B. 46 (Situation 6) in which a taxpayer was allowed a deduction for the full amount contributed to a church that operated a free secular and religious school for church members and nonmembers. In this example, the basis for the ruling was that "most contributors to the church are not parents of children enrolled in the school, and that contributions from parent members are solicited in the same manner as contributions from other members." The Service also said that the absence of a tuition charge was not determinative, "unless there is a showing that the contributions by members with children in X's school are significantly larger than those of other members."

