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Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction

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FEDERAL FAIRNESS TO STATE TAXPAYERS: IRRATIONALITY, UNFUNDED MANDATES, AND THE “SALT” DEDUCTION

*Brian Galle**

By sheer dollars alone, the largest impact of the Alternative Minimum Tax is to deny many taxpayers the deduction for the taxes they paid to their state and local governments under § 164 of the Internal Revenue Code. This Article provides a fine-grained analysis of the overall fairness of the state-and-local-tax deduction—and, by implication, the fairness of its partial repeal through the Alternative Minimum Tax. I offer for the first time a close examination of how newly understood limits on taxpayer mobility and rationality might affect individuals’ choices of bundles of local taxes and local-government services, which in turn informs our assessment of the “fairness” of those exchanges. Many of these lessons can be generalized to consumer choices more generally. In addition, I track the reciprocal benefits and burdens that flow between the national government and local governments—again, although the influx or outgo of billions of dollars surely affects how the federal tax system should account for the outputs of local government, scholars have neglected that question. Finally, I note that § 164, and therefore the Alternative Minimum Tax, can have serious effects on federal–state relations, such that the debate over both provisions is in many ways a debate not only over fairness but also about federalism.

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INTRODUCTION

This Article is about a single provision of the U.S. Tax Code—§ 164, the deduction for state and local taxes paid (“SALT”). In the tradition of many an introductory tax course, I look through the keyhole of the SALT deduction into some of the deeper mysteries of tax theory. In particular, by evaluating the fairness of § 164, I illustrate the difficulties of relying on utilitarian or welfare theory as a guide to tax policy. I also draw out some novel connections between the Internal Revenue Code and the relationship between the states and the federal government.

The SALT deduction has risen to prominence with the increasing significance of the Alternative Minimum Tax (“AMT”). The AMT is likely the most important practical tax issue facing individual Americans today.¹ In a few short years, the cost of repealing the AMT will exceed the cost of repealing the rest of the individual income tax.² As of this writing, AMT reform is the leading tax goal, and one of the top overall legislative priorities, for the Democratic majority in both houses.³ Although the politics and impressive budget numbers of the AMT have gotten much ink, few have discussed the AMT from the perspective of tax theory. The vast bulk of taxpayers affected by the AMT fall into its grasp because it prevents them from claiming deductions to which they would otherwise be entitled, particularly deductions for taxes paid to state and local governments.⁴ One way to theorize the AMT, then, is as the sum of these constituent parts.⁵

1. The AMT, I.R.C. §§ 55–58 (2000), is a parallel tax system to the ordinary individual income tax, intended originally to ensure that high-earning individuals able to claim many large deductions would nonetheless be obliged to pay a substantial amount of tax. See MICHAEL J. GRAETZ, *DECLINE (AND FALL?) OF THE INCOME TAX* 113 (1997). For a more detailed background, see *The Alternative Minimum Tax*, REVENUE & TAX POL’Y BRIEF (Cong. Budget Office, Washington, D.C.), Apr. 15, 2004, available at <http://cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf>; Leonard E. Burman et al., *The AMT: Projections and Problems*, 100 TAX NOTES 105, 106–115 (2003) [hereinafter Burman et al., *Projections*]; and Leonard E. Burman et al., *The Individual AMT: Problems and Potential Solutions*, 55 NAT’L TAX J. 555, 555–96 (2002).

2. *The Alternative Minimum Tax*, *supra* note 1, at 2.

3. Edmund L. Andrews, *Democrats Seek to Lead the Way in Tax Overhaul*, N.Y. TIMES, Apr. 9, 2007, at A1; Steven R. Weisman, *Rangel Offering Broad Tax Plan, and Big Target*, N.Y. TIMES, Oct. 31, 2007, at A1.

4. The AMT works by obliging a taxpayer to recompute her tax using a different standard deduction amount and omitting most of the individualized deductions she ordinarily could claim. I.R.C. § 56(b)(1)(A)(ii). The deduction for state and local tax is among the most important of the deductions that must be omitted in this recalculation. See Kim Rueben, *The Impact of Repealing State And Local Tax Deductibility*, 37 ST. TAX NOTES 497, 498 (2005).

5. See Burman et al., *Projections*, *supra* note 1, at 115 (observing that, in order to take true measure of the horizontal equity of the AMT, analysts would have to consider its effect on the major deductions it impedes); Beverly I. Moran, *Stargazing: The Alternative Minimum Tax for Individuals and Future Tax Reform*, 69 ORE. L. REV. 223, 240–68 (1990) (arguing that the AMT cannot be justified on its own and instead is a sort of laboratory for testing out a tax scheme in which its pro-

The SALT deduction is perhaps the most theoretically imposing component of the AMT. Debate over the SALT deduction is not new. Prior analyses, however, have made two major assumptions that render them rather suspect. First, they have assumed that taxpayers respond to financial incentives, such as their local tax systems, in a way that is wholly rational. Second, they have assumed (at times for the sake of simplicity) that the states' receipt of billions of dollars in federal grants and federally imposed burdens do not affect state and local taxing and spending decisions, a proposition that is clearly untrue. What I add here is a fine-grained analysis of the deduction once these assumptions are removed.

To begin, it is useful to understand the scope of the deduction and its historic rationales. Commentators over the years have urged Congress to grant taxpayers a deduction for the taxes they pay to their state and local governments.⁶ Proponents have said that the deduction is necessary to treat fairly taxpayers hailing from jurisdictions that impose different taxes.⁷ The argument has succeeded. The annual budget cost of § 164—the provision providing individuals and corporations with a deduction for the state and local income, property, and (in some instances) sales taxes they pay—totaled about \$75 billion in one recent counting.⁸ Yet the provision remains controversial, with some prominent calls—including from the President's Advisory Panel on Tax Reform—for its repeal.⁹

When proponents say that the deduction is necessary to treat taxpayers fairly, they mean to invoke one of the basic norms of the tax system, the notion of horizontal equity—the claim that the tax system should treat similarly situated taxpayers similarly.¹⁰ Under the traditional view of § 164, two

hibitions apply more broadly). To my knowledge, Linda Beale is the only scholar who has attempted, albeit briefly, to sum up the fairness implications of the AMT. Linda M. Beale, *Congress Fiddles While Middle America Burns: Amending the AMT (and Regular Tax)*, 6 FLA. TAX REV. 811, 817–76 (2004).

6. JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003–2007, at 20, 27 (2002).

7. 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); Beale, *supra* note 5, at 861–66; *see also* Rueben, *supra* note 4, at 498 (noting that proponents of the deduction continue to raise this argument).

8. I.R.C. § 164; *see* JOINT COMM. ON TAXATION, *supra* note 6, at 27. The 2008 budget cost of permitting AMT taxpayers to deduct state and local taxes is estimated at \$75 billion.

9. Ian Urbina, *Bush Plan Could Imperil Tax Write-Off for New York*, N.Y. TIMES, Dec. 27, 2004, at B1; PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 70, 83–84 (2005), available at http://www.taxreformpanel.gov/final-report/TaxReform_Ch5.pdf.

10. The term originates with the public-finance economist Richard Musgrave. RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 160 (1959); Richard A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45 (1967). Scholars before and after Musgrave have described the same concept in slightly different terminology. *E.g.*, A.C. PIGOU, A STUDY IN PUBLIC FINANCE 44 (3d rev. ed. 1962) (analyzing “equal sacrifice among similar and similarly situated persons”); HENRY C. SIMONS, PERSONAL INCOME TAXATION 30 (1938) (“[T]ax burdens should bear similarly upon persons whom we regard as in substantially similar circumstances . . .”).

There has been an ongoing debate in the scholarly tax community over whether horizontal equity is an important norm on its own or whether instead it is simply a placeholder for other societal

people who make the same amount of money are not equal if one pays more state tax than the other.¹¹ 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.¹² 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.¹³ Further analysis by Harvard's Louis Kaplow showed that the equity question might turn on complicated 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?¹⁴

This Article argues that the analyses both of Kaplow and the literature he critiques are incomplete. First, both sides of the horizontal-equity debate have so far assumed that an individual's subjective well-being is best measured by the choices she makes in the marketplace. An increasing body of literature, however, shows that we often make choices as a result of our mis-

values. For proponents of horizontal equity, see, for example, Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 451–53 (2005) [hereinafter, Dodge, *Theories*]; Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265, 275 n.42 (1995); David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 87–88 (2006) (arguing that horizontal equity could be defended using some general theories of justice); Kevin A. Kordana & David H. Tabachnik, *Tax and the Philosopher's Stone*, 89 VA. L. REV. 647, 656–57, 667–68 (2003); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993); and Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113–22 (1990). Critics include CHARLES O. GALVIN & BORIS I. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* 128–29 (1969); LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 37–38, 99 (2002); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139, 139–54 (1989); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 611, 621–22 (1993); and David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1646–48 (1999). In this Article, I assume that equal treatment of similarly situated individuals is an important norm in its own right. I acknowledge, however, that our efforts here to measure whether two individuals are “similar” in a meaningful sense may suggest that the endeavor as a whole faces some fundamental difficulties. See *infra* text accompanying notes 195–236.

11. VICKREY, *supra* note 7, at 18–24; Aaron, *supra* note 7, at 543–44; Beale, *supra* note 5, at 861–66.

12. See U.S. DEP'T OF THE TREASURY, *THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY: GENERAL EXPLANATION* 63 (1984), available at <http://www.treas.gov/offices/tax-policy/library/tax-reform/pres85All.pdf>; 2 U.S. DEP'T OF THE TREASURY, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS* 63 (1984), available at <http://www.treasury.gov/offices/tax-policy/library/tax-reform/tres84v2All.pdf> [hereinafter *TREASURY REPORT*]; 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); Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax*, 82 VA. L. REV. 413, 417 (1996); 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. 895, 907–08 (1992).

13. 2 *TREASURY REPORT*, *supra* note 12, at 63; Hulten & Schwab, *supra* note 12, at 68–71.

14. See Kaplow, *supra* note 12, at 490.

perception of what would best satisfy our own preferences.¹⁵ Cognitive biases also limit our ability to process market information accurately.¹⁶ These biases undermine a key assumption of the equity critique of the deduction—that taxpayers are able to freely align themselves in jurisdictions where tax levels match their preference for services. States may play on these biases in order to export the costs of their own services onto their neighbors.

Further, the equity critique so far has neglected the relationship between the states and the federal government. States often must pay to comply with federal mandates; they also receive grants from Congress, some subject to costly conditions. In theory, an imbalance one way or the other between what a state receives and what it must expend might be the basis for an inclusion or deduction. As I show, however, it proves exceedingly difficult to find any administrable metric to sort unwanted costs from desired services, interstate bribes, or regulations that have bite only on paper.

These conclusions have significant implications for ongoing policy debates, especially those concerning the AMT. For example, they may (depending on as yet unmeasured empirical data) undermine some of the President's Advisory Panel's arguments for eliminating § 164. That suggests, in turn, that we should take more seriously the call for AMT "reform," at least to the extent that we want to prevent the AMT from further eroding the SALT deduction.

The SALT deduction also has very significant effects on the relationship between the states and the federal government. I have detailed elsewhere some of the deduction's consequences at the level of state and local government.¹⁷ I explain here how the choice of whether or not to allow the deduction may have the effect of shifting power to or away from the federal government. Economists have described (although lawyers have generally not noticed) how the SALT deduction permits larger state spending, and might arguably reduce federal spending. But deductibility has additional consequences when combined with federal power to attach conditions to federal grants. That power often serves as a tool for allowing states to negotiate with one another to reduce collective-action costs. Deductibility sometimes raises the costs of these negotiations, an outcome that is more or less attractive depending on how highly we value state diversity. Thus the AMT, by way of its influence on the SALT deduction, may have a hidden impact on federal–state fiscal relations. We must first judge how we feel about those relations before we judge this aspect of the AMT.

Part I of this Article sets out in more detail the mechanics, history, and theoretical underpinnings of § 164, explaining that the most basic question

15. See, e.g., Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 633 (1999); Edward J. McCaffery & Jonathan Baron, *Thinking About Tax 2–4* (Univ. S. Cal. Law Sch., Olin Research Paper No. 04-13 & Univ. S. Cal., CLEO Research Paper No. C04-10, 2004), available at <http://ssrn.com/abstract=567767>.

16. McCaffery & Baron, *supra* note 15, at 3.

17. Brian Galle, *A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code*, 82 IND. L.J. 673 (2007).

we face is whether state and local taxes make local taxpayers better or worse off. Part II recomputes this calculus in light of the fact that taxpayers may often choose their bundle of taxes and services irrationally. Part III similarly suggests some adjustments we must make to obtain taxpayers' desired mix of benefits and burdens in light of what we know about the limits on taxpayer freedom to relocate. Part IV expands our scope to take in federal transfers to and from states. Part V then addresses a residual problem raised by the analysis of Part IV: what should we do if it appears that, in order to be "fair" to taxpayers, we must interfere with the efficiency prescriptions of public-finance economics? Part VI attempts to solve some of the tensions and contradictions of the earlier Parts by reconceiving the notion of equal welfare itself. Perhaps we might reach more satisfying results if we measure not the subjective, perceived utility of each individual but instead an objective, as-if, or hypothetical utility of a more fully informed and rational taxpayer. That leaves us with the question of whether welfare, measured on those terms, is really welfare at all. Further, I suggest that these efforts to reimagine utility theory may prove fruitless, leaving us to wonder whether horizontal equity, or welfarism more generally, can be a useful tool of tax policy.

I. BACKGROUND

The federal deduction for state and local taxes paid is long on pedigree—it is as ancient as the federal income tax itself.¹⁸ For much of its life, however, it has been short on theoretical justification. Congress's only modern explanation for the deduction has been a brief 1964 observation that the deduction is necessary to prevent federal taxation from crowding out state opportunities to tax the same base.¹⁹ That justification echoes the original rationale offered in the first income tax act of 1862.²⁰ It doesn't make much sense, though, since the deduction applies to many sources of revenue untapped by the federal government, such as property taxes and sales taxes.²¹

18. See Billman & Cunningham, *supra* note 12, at 1108; Rueben, *supra* note 4, at 498; U.S. Dep't of the Treasury, Fact Sheet on the History of the U.S. Tax System, <http://www.treas.gov/education/fact-sheets/taxes/ustax.shtml> (last visited Oct. 6, 2007) (noting that the income tax of 1862 included deductions for "other taxes paid").

19. H.R. REP. NO. 88-749, at 44-45 (1963), as reprinted in 1964 U.S.C.C.A.N. 1313, 1357-58. I argue elsewhere that it is possible that overlapping state and federal tax bases in fact cause crowd in of state tax rather than crowd out. Galle, *supra* note 17, at 702-09.

20. Daniel Patrick Moynihan, *Constitutional Dimensions of State and Local Tax Deductibility*, 16 PUBLIUS 71, 76 (1986) (citing floor statement of Rep. Justin Smith Morrill).

21. To be fair, Congress explained that its main concern was discouraging states from taxing income and that it was making sales taxes deductible to avoid encouraging states to shift from sales to income taxes. H.R. REP. NO. 88-749, at 1357. However, studies show little or no change in states' preferences for sales taxes in response to the federal deductibility of other tax options. Gilbert E. Metcalf, *Deductibility and Optimal State and Local Fiscal Policy*, 39 ECON. LETTERS 217, 217, 219 (1992). Yet Congress now has reenacted sales-tax deductibility. I.R.C. § 164 (2000). If deductibility does not, in fact, cause states to shift away from sales taxes, why are they deductible again?

Commentators have suggested instead that the deduction can be viewed as an aspect of fundamental tax fairness. In this view, § 164 is an equitable measure intended to put on an equal footing those who earned similar incomes in jurisdictions with different tax rates.²² This claim trades on one of the central tenets of tax policy, the notion of horizontal equity.²³ A horizontally equitable tax system should leave two taxpayers who are similarly situated before a tax is imposed similarly situated after they have paid it.²⁴ For these purposes, we set aside questions of redistribution of societal resources, or “vertical equity.”²⁵

Although tax scholars and philosophers dispute how best to measure what makes two taxpayers “similarly situated” for horizontal-equity purposes, one common claim is that the goal of the tax system is to equalize utility, or individual sense of well-being.²⁶ Sometimes equal regard for utility may result in different treatment for individuals with the same income. For instance, a healthy individual who earns \$100,000 at her job might be better off than her twin sister who was struck by a car and does not work but receives a \$100,000 tort settlement for pain and suffering. Arguably, the injured twin has merely been restored to her initial condition by the tort payment, such that at the end of the transaction she is still \$100,000 worth of utility short of her sister. Thus the injured twin should be able to exclude her tort settlement from her income or take a deduction for her pain and suffering.²⁷

The 1964 Congress additionally justified retaining deductibility of the property tax as an effort to avoid shifting the “distribution of Federal income taxes between homeowners and nonhomeowners.” H.R. REP. NO. 88-749, at 1357. It is hard to fathom what this might mean, other than perhaps that Congress believed (counterfactually, for the most part) that landlords do not pass the costs of property taxes on to their renters. See Kenya Covington & Rodney Harrell, *From Renting to Homeownership: Using Tax Incentives to Encourage Homeownership Among Renters*, 44 HARV. J. ON LEGIS. 97, 107 (2007) (“[R]enters effectively pay the costs of mortgage interest and real property taxes . . .”); Peter Mieszkowski & George R. Zodrow, *Taxation and the Tiebout Model: The Differential Effects of Head Taxes, Taxes on Land Rents, and Property Taxes*, 27 J. ECON. LITERATURE 1098, 1125 (1989) (describing empirical data suggesting landlords are able to pass on property-tax costs to renters). *Contra* Billman & Cunningham, *supra* note 12, at 1115 n.31 (noting the economic debate on this point). Alternatively, Congress might have meant to suggest that there would be winners and losers from changing the deductibility rule, since current home prices would likely decline in response to a loss of deductibility. See Mieszkowski & Zodrow, *supra*, at 1127-31 (reviewing evidence that home prices typically reflect costs and benefits of government services). Probably the best reading of this passage is that Congress was acknowledging that the political opposition to removing the deductibility of property taxes was too steep to overcome.

22. See Burman et al., *Projections*, *supra* note 1.

23. Horizontal equity bears that cumbersome name in order to distinguish it from vertical equity, which is the tax-policy term for distributive justice. JOSEPH M. DODGE, *THE LOGIC OF TAX* 88 (1989).

24. *Id.*

25. *Id.*

26. *E.g.*, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 335-36 (1972); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 386-88 (1989).

27. This theory of income was set out most famously in Andrews, *supra* note 26, at 313-15.

Similarly, supporters of § 164 claim that paying state tax leaves the taxpayer less well-off than someone who doesn't pay state tax. Therefore, in order to be fair to these state taxpayers, the federal system must treat those who pay higher state tax more generously than those with equal incomes who pay less.²⁸ That equity explanation flounders somewhat given that the deduction is available only to itemizers rather than to everyone who paid state tax.²⁹

28. See *supra* note 11.

29. See Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1414 (2004). Tax scholars disagree as to whether utility is an appropriate ground for comparing different taxpayers. Many commentators, noting the serious theoretical problems in making any but the broadest generalization about individual utility, suggest instead that the fundamental measure of taxpayers should be their "ability to pay." See HENRY SIMONS, *PERSONAL INCOME TAXATION* 30–31 (1938); Joseph Bankman, *The Case Against Passive Investments: A Critical Appraisal of the Passive Loss Restrictions*, 42 STAN. L. REV. 15, 40–42 (1989); Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 363–64 (1993); J. Clifton Fleming, Jr. et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 301 n.1, 307–08 (2001); Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAP. L. REV. 157, 188–89 (1999); Richard A. Musgrave, *ET, OT and SBT*, 6 J. PUB. ECON. 3, 5 (1976) (describing the intellectual history of economic approaches to horizontal equity); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 42 (1996). Ability to pay is typically defined as a taxpayer's access to money or other primary goods. Dodge, *Theories*, *supra* note 10, at 449–50; see also SIMONS, *supra*, at 49.

In response, some economists (and others) maintain that horizontal equity measured by income alone would be seriously flawed because it would neglect the role of individual preferences for other goods, such as leisure. See WALTER J. BLUM & HENRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* 49–51 (4th ed. 1963) (describing the equal-sacrifice principle); DAVID GAUTHIER, *MORALS BY AGREEMENT* 271–72 (1986); HARVEY ROSEN, *PUBLIC FINANCE* 345–48 (1995); Martin Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 82–83 (1976); Harvey S. Rosen, *An Approach to the Study of Income, Utility, and Horizontal Equity*, 92 Q.J. ECON. 307–10 (1978).

Another potential problem with the ability-to-pay standard is its seeming inability to answer certain policy questions. See Andrews, *supra* note 26, at 326–27; Edward J. McCaffery, *Tax's Empire*, 85 GEO. L.J. 71, 78–79, 84, 143 (1996) (making this critique of both ability-to-pay and utilitarian approaches); Daniel N. Shaviro, *Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 407 (1993) (questioning whether ability-to-pay theorists can explain why they focus on income rather than wealth or liquidity); Stephen Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867, 939–49 (2002); cf. Griffith, *supra* note 26, at 346 (criticizing earlier theories of deductibility on the ground that they did not by themselves supply any theory to explain what should be included in the concept of income). Section 164 is a good illustration. Do I have a lesser ability to pay federal tax if I have also paid state taxes? If I have chosen to pay state taxes, then I had an ability to pay either the state or the federal government. Which should have the superior claim requires a theory not of tax but of federalism. We might argue that state taxes are not really chosen but are compulsory. That claim seems inconsistent with the Constitution, see U.S. CONST. art. IV, § 4 (guaranteeing to states a republican form of government), and, in any event, probably depends on a contestable theory of political philosophy outside the realm of tax.

A third difficulty of ability-to-pay theory that comes to the fore when we analyze § 164 is that it does not by itself explain whether "imputed" income should be taxable. See Dodge, *Theories*, *supra* note 10, at 449 n.203. That is, services that a taxpayer provides herself do not create primary goods that could be distributed to others and therefore arguably should not be considered part of her ability to contribute to the cost of government. See Andrews, *supra* note 26, at 326. On the other hand, she may well have more income available for other consumption as a result, since she need not pay someone else to build her deck or hum a soulful tune. See *id.* at 324.

We could apply a very similar analysis to the question of state and local taxes. As we will see shortly, we can think of local taxes as a purchase of government services. Many of these services, such as security or clean streets, could not easily be transferred to others. But they may also replace essential services the taxpayer once provided for herself or free the taxpayer to use her available

Contemporary commentators are skeptical of the equity argument on other grounds as well. Their central insight is that state taxpayers get what they pay for.³⁰ Local taxes, for example, pay for schools, pothole filling, road plowing, and other municipal services. Some local governments exact much higher taxes, but they also spend much more on services, especially education. State taxes provide for highways, statewide education grants, and national guardsmen, to name a few. 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.³¹ 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.³² As we will see, this turns out to be at best a very rough view of the actual picture of tax-benefit tradeoffs. For now, though, I merely note that under the prevailing view, 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.³³

These arguments in turn were synthesized and hammered out in far greater detail in a seminal 1996 article by Louis Kaplow.³⁴ Professor Kaplow's view, although qualified, seems highly skeptical of the merits of the deduction. The bulk of his analysis centers on the equity justification. He observes that in a number of possible scenarios, some residents of a jurisdiction will pay, or through tax incidence effects³⁵ will in effect pay, more than

dollars to acquire those services. Ability-to-pay theory assumes a certain base of income that should be exempt from taxation to account for these necessities. If government provides or facilitates them, it is arguable that this base amount should be reduced, resulting in a higher tax. Ability-to-pay theory thus has no clear answer to the question whether receipt of these additional services should count as income, which might or might not completely offset the deduction for taxes paid.

Accordingly, although I acknowledge that ability-to-pay theory represents a major strand of modern tax theory, I largely set it aside in this Article. However, my analysis should still be of interest to those who find ability to pay the most attractive metric, so long as they are willing to assume that government services should count as income.

30. See *supra* note 12.

31. 2 TREASURY REPORT, *supra* note 12, at 63; Hulten & Schwab, *supra* note 12, at 68–71.

32. Largely for the sake of simplicity, I regard all state services as consumption. As I explain later, some forms of state spending may or may not be seen as the equivalent of a consumer purchase, depending on one's political philosophy.

33. See Yorio, *supra* note 12, at 1281. Professor Zelinsky, on the other hand, 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).

34. Kaplow, *supra* note 12. A related set of arguments concern whether the deduction, if not required out of any sense of fairness, might still be appropriate as a subsidy to the States. See Galle, *supra* note 17, at 680–95; Rueben, *supra* note 4, at 498–99.

35. Incidence is a term used by economists to describe where the actual financial burden of a tax falls. For example, the unemployment tax is nominally paid by employers. But unless the market for labor is highly inelastic, employers will simply reduce wages by the amount of the tax. Thus the economic bite of the tax—its incidence—is on workers, not employers.

they receive in benefits.³⁶ Others will receive more and pay less. In theory, we might allow a partial deduction for the first group and perhaps require an inclusion to income for the second.³⁷ That approach, however, would involve difficult questions about how to value the services received by any particular taxpayer.³⁸

Nor are all of the problems strictly practical. We ordinarily measure the value of something by what an individual is willing to pay for it.³⁹ Living in California is expensive, but the Golden State offers rewards other than government services to its beach-loving, winter-eschewing denizens. It might therefore be the case that the individual in California paying high taxes is as well-off as the one in Iowa paying little—even if the Californian receives less in benefits than the taxes she pays, and the Iowan realizes an excess.⁴⁰ Thus Kaplow strongly suggests (without quite committing himself to the position) that even if most of the administrability problems of valuation could be solved, a partial-exclusion–partial-inclusion approach would not solve the equity puzzle.⁴¹

Kaplow's analysis seems to rest on two questionable assumptions. First, it equates the choice of a place of residence, and its accompanying package of taxes and services, with a consumer purchase.⁴² That may imply a view of individuals who are at least somewhat mobile and informed about their choice of living situations or who alternatively are immobile but aware of the taxes and benefits of their own jurisdiction and possess the political power to alter them. Second, Kaplow explicitly accepts the economist's assumption that the only realistic way to measure a taxpayer's subjective well-being is through market allocation of private choices.⁴³ That is, modern economists generally assume that the proper goal of policy is to maximize satisfaction of the preferences individuals actually display in their market decisions.⁴⁴ It is, however, conceivable that these expressed preferences are not, in some sense, individuals' true preferences, or at least are not preferences that the individuals would express in other contexts.⁴⁵ As a result, scholars disagree over whether the economic tradition of taking expressed

36. *E.g.*, Kaplow, *supra* note 12, at 451–52, 459–60.

37. *Id.* at 426.

38. *See id.* at 431–34, 439.

39. *Id.* at 432.

40. *See id.* at 434, 440–41.

41. *See id.* at 491.

42. *Id.* at 432.

43. *See id.* at 439.

44. *See, e.g.*, LIONEL ROBBINS, AN ESSAY ON THE NATURE AND SIGNIFICANCE OF ECONOMIC SCIENCE 140–41 (3d ed. 1984); William J. Baumol, *Community Indifference*, 14 *REV. ECON. STUD.* 44, 47–48 (1947); George J. Stigler & Gary S. Becker, *De Gustibus Non Est Disputandum*, 67 *AM. ECON. REV.* 76, 76–77 (1977).

45. *See* John C. Harsanyi, *Utilities, Preferences, and Substantive Goods*, 14 *SOC. CHOICE WELFARE* 129, 130–35 (1997); Yew-Kwang Ng, *From Preference to Happiness: Towards a More Complete Welfare Economics*, 20 *SOC. CHOICE WELFARE* 307, 308–12 (2003).

preferences as given, without inquiring into their genuineness or motivation, is worthwhile.⁴⁶ Kaplow's approach therefore also implicitly assumes that the choices made by taxpayers truly reflect their preferences and that these expressed preferences, rather than some hypothetical or objective notion of utility, provide the proper basis for measuring taxpayer well-being.⁴⁷ One of my aims over the remainder of this Article is to examine how durable Kaplow's conclusions prove if these assumptions are challenged.

II. EQUITY AND COGNITIVE BIASES

The critique of the equity view of the SALT deduction depends in part on the notion that consumers of state services are getting what they pay for—or, if not, that the free choices of consumers are our best available measure of subjective utility. Under this view, no deduction is appropriate because we presume that each state taxpayer receives in exchange for her taxes a package of benefits that, to her, is worth the price. Yet, we have increasingly begun to realize that taxpayer choices about where to live can be distorted by common biases or mental mistakes. If these biases are predictable and cut consistently in a given direction, we might have a case for designing tax rules to account for them. For example, if taxpayers consistently underestimate their taxes and so pay too much for their government services, maybe they deserve a deduction. In Section II.A, I suggest that the situation is not so clear cut; in Section II.B, I explore what the sensible legal responses to that dilemma might be.

A. Do People Make Good Choices?

One potential challenge for the critique arises out of the relatively recent integration of cognitive psychology with economics and other theories of regulation. Cognitive psychologists have shown that individuals are not perfectly rational in their market decisions.⁴⁸ Rather, we each are prone to a number of tendencies and habits of mind, probably none insuperable, but which nonetheless sometimes lead us to perceive the world other than as a traditional economic view would suggest.⁴⁹ One prominent example of these

46. Compare Amitai Etzioni, *The Case for a Multiple-Utility Conception*, 2 *ECON. & PHIL.* 159, 164–65 (1986); Harsanyi, *supra* note 45, at 134; Daphna Lewinsohn-Zamir, *Consumer Preferences, Citizen Preferences, and the Provision of Public Goods*, 108 *YALE L.J.* 377, 380–83 (1998); and Daniel Kahneman & Richard H. Thaler, *Anomalies: Utility Maximization and Experienced Utility 2–3* (Dec. 1, 2005) (unpublished working paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=870494, with Stigler & Becker, *supra* note 44, at 78–89.

47. Kaplow notes in his other work that an ideal measure of utility might properly consider hypothetical guesses about what individuals would want if perfectly rational. See Louis Kaplow, *A Fundamental Objection to Tax Equity Norms: A Call for Utilitarianism*, 48 *NAT'L TAX J.* 497, 504 (1995). He does not develop that idea in any great depth and does not raise it in his discussion of § 164. See *id.*

48. See Hanson & Kysar, *supra* note 15, at 643–86; Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1471, 1477–79 (1998).

49. See Hanson & Kysar, *supra* note 15, at 645–46, 672.

tendencies, or “cognitive biases,” is the endowment effect: individuals value an object or entitlement they own more than they would value the same property in the hands of someone else.⁵⁰ We fear losses more than we welcome equivalent gains.⁵¹ These biases may have a substantial impact on decisions about risk and investment.⁵²

In addition to the endowment effect, two other general forms of bias are particularly important to the equity of state and local taxes. The first is the so-called isolation effect.⁵³ In making a decision or solving a problem, we tend to concentrate most of our attention on only the most immediate or obvious aspect of the decision, and we have difficulty integrating our feelings about that aspect with other (in theory relevant) aspects that are further from the center of our attention.⁵⁴ We look at two streams of money flowing into one account as separate, even though money is, in reality, completely fungible.⁵⁵ One set of researchers found that in public-finance decisions in particular, subjects consistently disaggregated one tax from another or from correlative spending proposals⁵⁶: even if the subjects wanted an overall progressive tax system, they would resist adjusting one tax or spending program to make up for regressiveness in another tax.⁵⁷ Similarly, “subjects seem[ed] willing to consider higher taxes if there [were] more smaller taxes.”⁵⁸

50. *Id.* at 674–76; Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 625–30 (1998); Cass R. Sunstein, *Endogenous Preferences*, *Environmental Law*, 22 J. LEGAL STUD. 217, 225–27 (1993) (summarizing studies).

51. See Hanson & Kysar, *supra* note 15, at 675; Daniel Kahnemann & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 279 (1979) (showing that the value function for losses is steeper than the value function for gains).

52. W. KIP VISCUSI, *FATAL TRADEOFFS: PUBLIC AND PRIVATE RESPONSIBILITIES FOR RISK* 150 (1992); Hanson & Kysar, *supra* note 15, at 688–89; Sunstein, *supra* note 50, at 227. Theorists have also described countervailing effects that return markets to what they would look like if comprised entirely of strictly rational actors. The correctives, however, generally depend on the presence of an effective market. See Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1657 (1998).

53. McCaffery & Baron, *supra* note 15, at 4.

54. See Edward J. McCaffery & Jonathan Baron, *The Political Psychology of Redistribution* (Univ. S. Cal., CLEO Research Paper No. C05-4, Legal Studies Research Paper No. 05-8, & Law & Economics Research Paper No. 05-8 & Univ. of Pa. Inst. for Law & Econ., Research Paper No. 05-11, 2005), available at <http://ssrn.com/abstract=695305>.

55. Jolls, *supra* note 52, at 1669; Richard H. Thaler, *Anomalies: Saving, Fungibility, and Mental Accounts*, 4 J. ECON. PERSP. 193, 199–201 (1990); Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797, 804 (2005).

56. McCaffery & Baron, *supra* note 54, at 26–28; see also Lewinsohn-Zamir, *supra* note 46, at 390.

57. McCaffery & Baron, *supra* note 15, at 24, 27.

58. *Id.* at 26. I report these results with the usual caution that laboratory tests of economic behavior may not perfectly predict real-world behavior.

Another important bias is sometimes called the anchoring effect.⁵⁹ It causes us to judge the appropriate size of a numerical change by reference to some existing value of which we are already aware.⁶⁰ For example, in the public-finance experiments, subjects who wanted a very progressive tax structure would suggest more progressive systems when starting with a system that was already somewhat progressive and vice versa.⁶¹

These tendencies are significant to the equity argument because they suggest that taxpayers don't always match taxes to services. Most obviously, the isolation effect implies that taxpayers will generally not choose where they live based on a complete evaluation of the benefits and burdens of taxation, regulation, and government services. Instead they are likely to focus on only one or two of the most prominent factors and use that measure as a heuristic—a shorthand device they assume is adequate to stand in for the complex tradeoffs that in theory ought to underlie choices of residency.⁶² Thus, for example, small businesses often choose to move from jurisdiction to jurisdiction based on the operators' sense of whether one spot or another is "business friendly," a gestalt measure that seems to rest largely on business tax rates or other very prominent regulatory features.⁶³

The isolation effect is compounded by the large menu of potential government services. In theory, any particular jurisdiction could choose to deliver an almost infinite combination of taxes and services.⁶⁴ But for the most part, we either don't have or are unwilling to exercise the processing power to compare such long lists of choices, even assuming that we could costlessly acquire that information.⁶⁵

Endowment and anchoring effects also can irrationally limit a citizen's willingness to move. Taxpayers might overvalue the benefits they are already receiving and frame their analysis of competing jurisdictions with the existing state of affairs in their current homes. A new tax-benefit package that departed radically from the existing set could look like it "goes too far" even if the taxpayer, if she lived in the second jurisdiction, would have preferred it to the first. And additional taxes in a different jurisdiction might be seen as a "loss" to be avoided, even though they allow countervailing

59. Hanson & Kysar, *supra* note 15, at 667; Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 159, 1177 (2003).

60. Hanson & Kysar, *supra* note 15, at 667–68; Sunstein & Thaler, *supra* note 59, at 1177–78.

61. McCaffery & Baron, *supra* note 54, at 42; McCaffery & Baron, *supra* note 15, at 25–26.

62. See Hanson & Kysar, *supra* note 15, at 662; Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974).

63. See George R. Karvel et al., *Minnesota Business Migration: Relocation, Expansion, and Formation in Border States*, AM. EXPERIMENTAL Q., Summer 1998, at 67.

64. Cf. William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 223–24 (1997) (arguing that public goods may be bundled together in so many different ways that only a republic with as many jurisdictions as people could ensure a perfect match between all of an individual's preferences and the services his or her jurisdiction provides).

65. See Sunstein & Thaler, *supra* note 59, at 1196–97.

gains.⁶⁶ In short, citizens will sometimes fail to recognize that an alternative package of taxes and benefits would better satisfy their preferences.

Overall, the general trend of the biases I've described is toward overpayment. For instance, by overestimating the benefit of current services and failing to integrate the negative effect of several small taxes, a taxpayer might remain in a state where she pays considerably more than she is actually getting. It seems rather harder to construct a story in which biases might produce a consumer surplus.⁶⁷

On the other hand, biases are probably not inevitable. Research suggests that subjects can be debiased⁶⁸: we can educate ourselves to recognize factors that may be distorting our calculations. In addition, of course, some taxpayers may seek counseling from attorneys, accounting firms, financial consultants, or other money mavens. Careful counseling can lay bare the real tradeoffs between different sets of taxes and available services.⁶⁹

The question, then, is what to make of these potentially conflicting data. Importantly, the fact of distortions in taxpayer decisions does not itself answer the question of fairness. We might also ask how we should understand the very concept of fairness in a system in which choices are less than free—but as a result of taxpayers' own misunderstandings. I begin to unwind these riddles in the next Section.

B. Policy Responses to Uncertainty

At first glance, the phenomenon of cognitive bias seems to undermine the assumptions of the standard critique of the equity argument and perhaps to support the SALT deduction as well.⁷⁰ If taxpayers fail to recognize when they should move to obtain a more desirable combination of taxes and services, we have little assurance that the taxpayer in high-tax jurisdiction A is as well-off as the taxpayer in low-tax jurisdiction B. Arguably, then, we might favor a deduction at least for "stranded" taxpayers, those who pay more than they get. The difficulty, of course, would lie in identifying the

66. McCaffery & Baron, *supra* note 54, at 19.

67. One possible story would rely on the tendency for tax penalties to seem more onerous than benefits of equal magnitude. See Sunstein, *supra* note 50, at 233. A taxpayer might pay fifty dollars but feel as though the actual sting is more like one hundred dollars. Cf. Lewinsohn-Zamir, *supra* note 46, at 390 (observing that citizens misestimate the costs of providing public goods). She might then demand one hundred dollars worth of perceived benefits in exchange. If there is a jurisdiction that matches this set of preferences (perhaps by providing less of other benefits not valued by our exemplar taxpayer), she will realize a surplus.

68. See McCaffery & Baron, *supra* note 15, at 14, 18; Daniel McFadden, *Free Markets and Fettered Consumers*, 96 AM. ECON. REV. 5, 10 (2006).

69. See Adam D. Galinsky & Thomas Mussweiler, *First Offers as Anchors: The Role of Perspective-Taking and Negotiator Focus*, 81 J. PERSONALITY & SOC. PSYCHOL. 657, 665–66 (2001); McCaffery & Baron, *supra* note 54, at 53.

70. It is worth noting here that another form of irrationality—racism—also undermines the assumption that taxpayers have located in order to equalize taxes and benefits. See Vicki Been, *"Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine*, 91 COLUM. L. REV. 473, 517–18 (1991).

stranded. Alternatively, we might simply grant the deduction uniformly in the hope that on net we will enhance overall fairness by improving the lot of the disfavored more than we inappropriately reward the already favored. But that approach is obviously rather rough justice.⁷¹

One cautionary note here is that the deduction might inappropriately reward a fair number of taxpayers, and by a substantial degree. Consider again the possibility of debiasing. We might think that well-advised taxpayers are more likely to live in a place that closely reflects their actual preferences. We should expect that expert counseling services would be most available (and, given the reduced stakes for low-wage earners, most financially practical) for high-income taxpayers. Thus, while it is uncertain how many lower-income taxpayers are stranded, it is likely (on this set of assumptions) that most taxpayers for whom much is financially at stake will not strand themselves. Since the deduction is worth more as income increases, those are precisely the taxpayers for whom the deduction would most be useful.⁷² So the deduction would tend to flow to taxpayers who are least likely to face overcharges as a result of cognitive bias.

Obviously these estimates have a strong back-of-the-envelope character. To make any good predictions about the equity effects of the deduction, it appears as though we need better data, not only about how biases affect individual taxpayers, but also about which of these taxpayers is likely to benefit from debiasing.

A further complication is that one might argue, along the lines of Jon Klick and Greg Mitchell, that government should not, in effect, encourage cognitive biases.⁷³ In the absence of government correctives, Klick and Mitchell argue, individuals may well be obliged to find their own debiasing mechanisms in order to maximize their expected welfare.⁷⁴ Government intervention removes this incentive. Thus, just as insurance creates so-called moral hazards, government correctives for cognitive bias might create “cognitive hazards.”⁷⁵ Similarly, they might argue, providing a deduction for taxpayers who are disadvantaged by their own biases would undesirably diminish their motivation to become better informed.

Crucially, the cognitive-hazard argument depends on the assumption that taxpayers are capable of recognizing the fact of their own bias, or at least the fact that their prior decisions leave room for improvement.⁷⁶ In our

71. For more discussion of the difficulties of this alternative, see *infra* text accompanying notes 197–200.

72. Kim Rueben & Len Burman, *Deductibility of State and Local Taxes*, 108 TAX NOTES 363, 363 (2005); see STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 3 (1985).

73. Jonathan Klick & Gregory Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90 MINN. L. REV. 1620 (2006); cf. Kahneman & Thaler, *supra* note 46, at 20 (noting that the fact of biases does not by itself establish the appropriate policy response).

74. Klick & Mitchell, *supra* note 73, at 1633–41.

75. *Id.* at 1626.

76. See *id.* at 1626, 1629–33 (explaining the importance of information “feedback” to correcting biases).

example, a taxpayer has to recognize that they need better tax advice before seeking out the expert who will help them determine whether they have made the right choice about where to live. Further, it might be that even those who receive debiasing treatment will nonetheless resist it; as tax lawyers know all too well, not every client listens to advice.⁷⁷ If taxpayers (or other decision makers) can't change their behavior, irrespective of government incentives, then choosing a rule that is less advantageous to them is not welfare maximizing (and might strike some simply as cruel or unjust, in the way that criminal punishment used to deter an individual mentally incapable of conforming his conduct to the law would be unjust). Even if we were to agree with Klick and Mitchell, we would have a set of important subsidiary, and largely empirical, questions about how readily taxpayers can be debiased.⁷⁸

Although data on the effectiveness of taxpayer debiasing is unavailable, there is some reason to believe that many taxpayers will not be readily debiased. Anecdotally, at least, taxpayers have no obvious source of feedback to alert them that they are paying too much for or getting too little from their state government relative to their personal preferences. Assuming that the preferences of taxpayers for different amounts and forms of public goods are relatively diverse, taxpayers cannot easily rely on the behavior of others to tell them about the satisfaction of their own preferences.⁷⁹ Taxpayers might rely on decisions by others to move into or out of their jurisdiction—but that, of course, is itself tainted by potential frictions that might prevent any meaningful movement.

Nor does any market participant have a clear incentive to provide feedback in order to benefit from superior, debiased decisions.⁸⁰ Local

77. Cf. Jon Elster, *More than Enough*, 64 U. CHI. L. REV. 749, 754 (1997) (reviewing GARY S. BECKER, *ACCOUNTING FOR TASTES* (1996) and arguing that “the very idea of intentional change of time preferences is incoherent”); McFadden, *supra* note 68, at 10–11 (identifying problems with attempts to debias consumers).

78. See Klick & Mitchell, *supra* note 73, at 1653–56 (acknowledging that the authors' conclusions are to a large extent contingent on unavailable empirical data); cf. Nathan Berg & Gerd Gigerenzer, *Psychology implies paternalism?: Bounded rationality may reduce the rationale to regulate risk-taking*, 28 SOC. CHOICE WELFARE 337, 340 (2007) (“[T]he policy implications of theoretical and empirical departures from neoclassical rational choice are indeterminate.”).

79. But see Klick & Mitchell, *supra* note 73, at 1656 (claiming that irrational behavior often changes readily in response to education and self-correction). However, reasonable sources of information exist about related issues, such as whether the local government is spending the money that it raises efficiently. See, e.g., Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 25, 25–26 (1995) (describing a model in which voters evaluate incumbent performance by reference to success or failure of officials in neighboring regions); cf. Andrei Shleifer, *A theory of yardstick competition*, 16 RAND J. ECON. 319, 319–20 (1985) (suggesting that efficient cost structures of regulated firms could be inferred from cost structures of comparable producers).

80. My analysis here follows recent economic studies of hidden bundled pricing. Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505 (2006). Many firms impose a variety of hidden charges: in Gabaix and Laibson's example, some hotels add on hidden costs in the form of extra fees for gym access, Internet access, local calls, and the like. Other hotels do not. At first, this was puzzling to economists. *Id.* at 506–07. Why would the hotels offering one bundled (and, presumably, higher) price for everything not expose the hidden fees of their competitors? *Id.* The answer, it seems, is that

officeholders, or candidates for office, are unlikely to want to debias their locked-in constituents. Even the candidate who might benefit from exposing the underperformance of her incumbent rival may well calculate that in the long run she is better off not having to deal with the more demanding electorate that would result if she succeeded in both her debiasing and election efforts. It might be better to chance winning the election on other grounds and retain more freedom later.⁸¹ Officials in rival jurisdictions, who might wish to woo high-income taxpayers to bolster the public rolls, have a similar dilemma. It may prove difficult to provide clearer information to the taxpayers they are courting without also giving the same information to their own constituents.

In short, a weak case exists for the deduction as a means of resolving unfairness to biased taxpayers. We can't say for certain to what extent taxpayers will be biased, or in what direction. Taken as a whole, however, taxpayers tend to be a bit worse off as a result of biases and other frictions on their choice of residence. At a minimum, the argument that granting a deduction would create serious cognitive hazards seems somewhat weak in this context.

We could, however, craft another objection to the deduction based on a claim about what it means to be fair to a person laboring under some kind of cognitive bias. More specifically, we might object that, to the extent the equity argument aims to level subjective well-being between similarly situated taxpayers, the SALT deduction inappropriately rewards our stranded taxpayer. If the taxpayer *perceives* herself as being better off where she is than elsewhere, why give her a deduction?

In order to resolve this question, we must define what we mean by taxpayer welfare or utility. A number of economists, led by Daniel Kahneman, have pressed for an economic theory in which policymakers will attempt to maximize “experienced utility”—that is, subjectively perceived satisfaction.⁸² Kahneman contrasts this notion with what he calls “decision utility,”

they had nothing to gain by doing so. *Id.* at 508. Customers tended to split into “sophisticated” and “unsophisticated” customers. *Id.* Sophisticated customers already knew about the hidden fees. Unsophisticated customers could not easily be debiased, and if they were, that would only have prevented the bundled-price hotels from imposing their own hidden fees on the unsophisticated in the future. *Id.* at 509. Thus there was no incentive for any market participant to debias. *Id.* at 509–11. For an earlier work with similar implications for debiasing, see William H. Redmond, *Consumer Rationality and Consumer Sovereignty*, 58 REV. SOC. ECON. 177, 180 (2000), which argues that advertising and easy credit “inhibit the self-corrective learning process which would otherwise return consumers to a rational state.”

For some tentative thoughts in the economics literature about the implications of these kinds of findings for political markets, see Bruno S. Frey & Alois Stutzer, *Does the Political Process Mitigate or Accentuate Individual Biases Due to Mispredicting Future Utility?* (Mar. 1, 2004) (unpublished manuscript, on file with author), available at http://law.usc.edu/academics/centers/csip/conferences/bpf_04/papers/documents/Frey_Stutzer_Misprediction.pdf.

81. In this sense, the candidate is similar to the bundled-fee hotel: she does not want to gain a short-term competitive advantage at the price of sacrificing her long-term opportunities for extracting hidden rents.

82. Daniel Kahneman et al., *Back to Bentham? Explorations of Experienced Utility*, 112 Q.J. ECON. 375, 379–99 (1997); see Etzioni, *supra* note 46, at 160; Daniel Kahneman & Robert Sugden,

which would measure utility on the assumption that the choices individuals actually make accurately reflect their preferences.⁸³ The difference is significant if we think that individuals' decisions do not always reflect what would maximize their own happiness. For example, if a taxpayer falsely believes that she is residing in the place that will make her happiest, then we as policymakers have an opportunity to increase her experienced utility by encouraging her to relocate to somewhere that better satisfies her unexpressed preferences. If we relied exclusively on decision utility, we would overlook that opportunity.

Turning back to our equity question, one implication of this analysis is that, under an experienced utility rubric, in a sense the stranded taxpayer is worse off than one with the same preferences who sees clearly because she suffers an opportunity cost. Again, our two taxpayers both have the same preference for, say, the amount of government services each wishes to consume. The stranded taxpayer, however, misperceives the amount she is paying and receiving and so chooses to live in the wrong state. Thus, even if her experienced utility *at present* is identical to the unbiased taxpayer's, she is worse off, because the stranded taxpayer has a lost opportunity to improve her experienced utility by moving. To take a silly example, think of the M&M aficionado who prefers, in order, green, brown, and yellow M&Ms. She's wearing dark-tinted sunglasses. She is reasonably happy consuming all brown M&Ms, but simply by taking off the sunglasses, she may discover that some of her brown ones are actually green. Happy day!⁸⁴ So perhaps equity would still support a deduction for the stranded taxpayer if some taxpayers see clearly and do not receive a deduction. But if we reject either the notion of experienced utility or the possibility of debiasing, there is no lost opportunity; and thus both our hypothetical taxpayers are equally well-off.

Notice, too, that the opportunity-cost equity argument assumes that while taxpayer perceptions may change, their underlying preferences for

Experienced Utility as a Standard of Policy Evaluation, 32 ENV'T & RES. ECON. 161, 162, 167 (2005); Kahneman & Thaler, *supra* note 46, at 2.

83. Kahneman & Thaler, *supra* note 46, at 2–3.

84. This example, although ridiculous, reflects a large literature on the possibility that individuals can possess what appear to be inconsistent or contingent preferences. *E.g.*, JON ELSTER, *SOUR GRAPES: STUDIES IN THE SUBVERSION OF RATIONALITY* (1983); Kahneman & Thaler, *supra* note 46, at 3; Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317 (1977). Additionally, preferences may be formed by individuals' prior experiences so that they are contingent in a different sense—contingent on the individuals' past, including their past consumption. *See* Sunstein, *supra* note 50, at 236, 238.

One caveat is that not all shifts in preferences in response to new information result in greater experienced utility. As Elster argued, many individuals adopt preferences that misrepresent their highest and best choices because those choices are unattainable, and the feelings of cognitive dissonance and dissatisfaction that might result from frustration may exceed the benefits of pursuing the higher good. Thus, he writes, “[r]elease from adaptive preferences . . . may be good on the autonomy dimension while bad on the welfare dimension.” ELSTER, *supra*, at 138. In the end, Elster claims that the only meaningful welfare measure is satisfaction of fully informed and autonomous preferences, so the apparent disutility that we would experience upon release from our self-imposed misperceptions is no disutility at all when utility is properly measured. *Id.* at 132–33, 135–36. In essence, Elster adopts a version of objective utility—utility measured according to what individuals ought to want, rather than what they express. *See infra* text accompanying notes 202–208.

taxes and services do not. It isn't clear that is the case. We know, for instance, that law and individual preferences shape one another.⁸⁵ Our notions of what is right or desirable reflect to some extent our feeling of belonging to a community that has already made decisions about those questions and enacted some of them as laws.⁸⁶ Our background socioeconomic status may affect our willingness to take risks in exchange for money.⁸⁷ Thus cognitive biases may be overlaid on preferences that have themselves changed as a result of our perception of our cultural setting.⁸⁸ That might suggest that a biased market has no opportunity cost. Our M&M eater might take off her sunglasses and find she no longer cares about the difference between brown and green, since they've given her the same modest thrill for so long.⁸⁹

Ultimately, then, any account of horizontal equity that looks to subjective utility is faced with something of a riddle. How should equity treat contingent preferences? Should it view them as endogenous? Or must it treat preferences, like cognitive biases, as an opportunity cost standing between the individual and greater happiness? If the latter, how do we sort between favored and unfavored preferences? The act of separating preferences to be favored by the tax system from those treated with disfavor would move us toward a system not of subjective utility at all but instead of objective or hypothetical utility.⁹⁰ I consider these problems in more depth in Part VI.

For now, though, let us reserve the preferences dilemma and assume that we are interested in subjective utility. Under that view, if information is free and interstate relocation costless, the deduction partially corrects cognitive bias. That assumes, though, that not everyone is affected by the bias. Our primary difficulties thus are administrative. How would we sort out the stranded from the debiased or well-advised?⁹¹ And, in its current form, the

85. See, e.g., Kenneth G. Dau-Schmidt, *An Economic Analysis of the Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1, 22-24; Richard H. McAdams, *Relative Preferences*, 102 YALE L.J. 1, 80-83 (1992).

86. See Dau-Schmidt, *supra* note 85, at 18-19.

87. See Hanson & Kysar, *supra* note 15, at 696-721.

88. See Sunstein & Thaler, *supra* note 59, at 1161, 1192-93 (explaining that the meaning of the term "preferences" can be unclear when what people want is itself contingent on the perceptual frame within which their choices are made).

89. See *id.* at 1165 (arguing that consumer preferences "might change as a result of consumption"); see also Kahneman & Sugden, *supra* note 82, at 168-69; Redmond, *supra* note 80, at 185.

90. By hypothetical utility, I mean a measure of individuals' utility based on satisfaction of the preferences that they might or ought to have rather than those expressed in an imperfect market by less than completely rational consumers. See Harsanyi, *supra* note 45, at 133-34; Lewinsohn-Zamir, *supra* note 46, at 381 n.9 (explaining that use of hypothetical or objective preferences forms a major alternative to the use of expressed preferences alone). For criticism of the argument that it might meaningfully be said that there is more than one utility, see Timothy J. Brennan, *A Methodological Assessment of Multiple Utility Frameworks*, ECON. & PHIL., Oct. 1989, at 189.

91. See Gregory Mitchell, *Libertarian Paternalism is an Oxymoron*, 99 NW. U. L. REV. 1245, 1253 (2005) (arguing that behavioral law and economics does not predict when consumer preferences will be stable and when they will instead be the products of perceptual biases).

deduction is of relatively little use to precisely those—the uncounseled—who seem to deserve it.

III. MORE ON MOBILITY

We may already have some reason to doubt that taxpayers will sort themselves neatly into clusters of evenly shared benefits and burdens, even in a hypothetical world where information about competing jurisdictions is free and relocation costs are zero. In this Part, I examine what happens when we relax the latter two assumptions. Information and relocation costs impair interstate mobility such that the case for the SALT deduction is rather weakened, especially to the extent that it includes payments for property taxes.

There may be more articles by economists about the effects of state and local jurisdictional competition than there are competing jurisdictions.⁹² I am not an economist and claim no special ability to sort the conflicting claims of that literature. In general, though, economists now largely agree that some basic assumptions of the equity critique are flawed. In particular, substantial barriers impede a taxpayer's freedom to move to another location where the basket of taxes and services are more to her liking.

First, information about alternative jurisdictions is expensive to gather and hard to interpret.⁹³ Despite some laudable efforts by courts to ensure that local governance will remain "transparent," the fact is that some public services are difficult to compare.⁹⁴ As we will see, localities have conflicting incentives on whether to generate data that would be useful to outsiders, and without local cooperation, critical information may be impossible to obtain.

In addition, because public goods may be bundled in different ways, the prospect of moving presents taxpayers with significant decision costs: they have to evaluate not one but hundreds of different potential trade-offs.⁹⁵ Even putting cognitive biases aside, a taxpayer is unlikely to be able to evaluate more than a handful of possibilities, and it is doubtful that this selection will offer her an ideal mix of taxes and benefits.⁹⁶ And our brief survey of the effects of cognitive bias suggests that many taxpayers are likely to respond most strongly to the most visible or "salient" aspects of a jurisdiction, such as its tax rate, its employment rate, and perhaps other fairly straightforward numbers like housing values.⁹⁷

92. For an abbreviated roundup, see Stark, *supra* note 29, at 1410 n.81.

93. Bratton & McCahery, *supra* note 64, at 235; see Shaviro, *supra* note 12, at 964–65.

94. See Bratton & McCahery, *supra* note 64, at 236 (observing difficulty for consumers in identifying the 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 the quality of education services).

95. See Bratton & McCahery, *supra* note 64, at 223–25; Shaviro, *supra* note 12, at 964–65.

96. See Susan Rose-Ackerman, *Tiebout Models and the Competitive Ideal: An Essay on the Political Economy of Local Government*, in 1 PERSPECTIVES ON LOCAL PUBLIC FINANCE AND PUBLIC POLICY 23, 28 (John M. Quigley ed., 1983).

97. See Kahneman & Sugden, *supra* note 82, at 171–72.

Lastly, moving costs are plainly a substantial friction on taxpayer movement.⁹⁸ Moving costs can include the obvious, such as the costs of renting a van, and the more subtle, such as lost access to reliable child care.⁹⁹ Informational and moving costs also can compound one another. A jurisdiction that offers an attractive benefit–burden basket today can change governments, change policies, and lose key employers or other sources of revenue. If each move is costly, the wise taxpayer should try to acquire information not only about the current state of a jurisdiction but also about its future.

More sophisticated economic models attempt to predict how state governments will respond to these imperfect market conditions. For example, one approach hypothesizes that although the existence of alternative regimes generally does not directly align taxpayer interests with government regulation, it has a significant disciplining effect on local governance.¹⁰⁰ Voters can evaluate the quality of their own government by reference to the performance of others.¹⁰¹ Furthermore, the *threat* of exit by capital and big revenue producers so clearly portends future electoral losses that it may be a significant tool for magnifying the political power of those with exit opportunities. Public officials generally cannot know the extent of the frictions facing their constituents, so any conditions in which exit is somewhat plausible from the officials' perspective may result in enhanced influence for those who might leave. Perhaps that will lead, if not to a perfect alignment of voter preferences and government services, at least to a more efficient delivery of the services the government does provide. I explore the relationship of the subsidy arguments for deduction to these models elsewhere.¹⁰²

For now, I want to focus on how the likelihood of impaired taxpayer mobility (absent the possibility of some internal state-government adjustment that reinvigorates the impact of mobility) would cut for the deduction. Certainly the high costs of learning, deciding, and moving undermine the assumption that taxpayers get what they pay for. Taxpayers may often be stranded in a jurisdiction in which they perceive their tax costs as exceeding their government benefits. Under a strictly welfarist view, these taxpayers should be entitled to a deduction.

This result may not hold for wealthier taxpayers. To the extent that moving costs are relatively fixed, investing in them becomes steadily more attractive as the potential gap between taxes and benefits gets wider. Although wealthy or high-income taxpayers may also consume more services, the gap in absolute numbers between their preferences and what they pay will likely be larger than a comparable percentage gap for the less

98. Bratton & McCahery, *supra* note 64, at 233–34; Shaviro, *supra* note 12, at 964.

99. See, e.g., Dorothy E. Roberts, *Welfare Reform and Economic Freedom: Low-Income Mothers' Decisions About Work at Home and in the Market*, 44 SANTA CLARA L. REV. 1029, 1049–52 (2004).

100. Besley & Case, *supra* note 79.

101. *Id.* at 30–31.

102. See Galle, *supra* note 17.

wealthy. If we accept this assumption, wealthy or high-earning taxpayers probably do relocate to equalize taxes and benefits.¹⁰³ Thus the pay-for-what-you-get critique of the SALT deduction seems to have a fair bit of bite for just those taxpayers for whom the deduction is presently most useful—those wealthy enough to itemize and savvy enough about financial matters to think about tax when making decisions about where to live.

For other taxpayers, frictions do not seem to cut in favor of or against a deduction. Taxpayers can be stranded in two different ways. Some taxpayers might live in a jurisdiction where the costs of taxes exceed the perceived value of services; others will be stuck in a state that delivers services worth every penny in taxes but at a lower level than the taxpayer would prefer to pay and get. For the latter group, the costs of relocating may exceed the expected increase in satisfaction they would derive from being able to purchase more government services (rather than spending money on second-best choices). No deduction seems appropriate there, since however undesirable the level of costs and benefits, they still net out to zero. That is, the taxpayer may well be worse off than others, but she is not worse off *as a result of the local tax*.¹⁰⁴ We have no ready way of distinguishing the first kind of stranded taxpayers from the second. Nor is it clear whether we should expect to find far more of one sort of stranded taxpayer than another. Thus, granting a deduction would risk overcompensating a large group of taxpayers.

Even assuming we could overcome this administrative challenge, frictions weigh against the deduction in another way. In a nation where interstate movement is inefficient, states can in theory export some of their tax burden. The possibility of tax exporting is not necessarily a policy outcome to be avoided at the cost of other goals.¹⁰⁵ But for our purposes, the fact that some of a jurisdiction's costs are borne 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. Frictions can facilitate exporting, so evidence of particularly effective frictions might undermine the case for deductibility.

To see how frictions facilitate tax exporting, let us first take a step back and imagine a world with no frictions.¹⁰⁶ Suppose we have a jurisdiction, Hotel-Tax City (“HTC”), that uses taxes on hotel rooms to export the costs of its government services to outsiders. Hotel taxes are an especially good

103. See Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 COLUM. L. REV. 346, 420–21 (1990). As Professor Bakija and Professor Slemrod have noted, there is little empirical work investigating this intuition. Jon Bakija & Joel Slemrod, *Do the Rich Flee From High State Taxes? Evidence From Federal Estate Tax Returns* 1 n.5 (Nat'l Bureau of Econ. Research, Working Paper No. 10645, 2004), available at <https://www.nber.org/papers/w10645>.

104. That is, the fact that the taxpayer cannot obtain her full measure of utility from her expenditures is not the result of her local tax regime but rather of failures in the local private market to provide goods that would be equally as welfare enhancing at the same price.

105. See, e.g., Shaviro, *supra* note 12, at 961–63 (arguing that tax exporting is at least unobjectionable in some circumstances).

106. The following three paragraphs draw extensively from Galle, *supra* note 17, at 688–89.

example of tax exporting since they generally affect the state's own residents only indirectly.¹⁰⁷ If frictions are absent, this strategy is likely to fail.¹⁰⁸ HTC is now a bargain relative to its neighbors, so their citizens will move into HTC, driving up the cost of real estate, crowding out locals from enjoyment of government services, and driving down wages.¹⁰⁹ At equilibrium, the cost of government in HTC and its neighbors is the same.

In the absence of frictions, HTC has a couple of other policy options to facilitate its exporting goal. First, it can simply pay a cash bribe to prospective immigrants to stay home.¹¹⁰ Obviously the transaction costs of bargaining directly with every prospective migrant are too large to make that method viable. There are low-cost methods, however, that have similar effects, such as recruiting a central government to distribute payments to HTC neighbors that approximate the value of living in HTC, or producing public goods in HTC whose value "spills over" into neighboring jurisdictions without much diminishing their value to HTC residents. Even if transaction costs can be minimized, however, these pseudobribes shouldn't work—no rational, fully informed carpetbagger will accept a bribe less than the value of the bargain she'd be getting in HTC.

If we introduce frictions into our tax-exporting nightmare world, bribery becomes a more appealing strategy. If the benefit of living in HTC is \$100, and it costs \$50 to move there, a successful bribe costs only \$50, which may make HTC's tax-exporting scheme economically viable. In addition to moving costs, individuals outside HTC also encounter many of the frictions we found in the real world: they cannot easily get an accurate estimate of the value of living in HTC, will tend to overvalue their own entitlements, will have difficulty integrating the tax and benefit components of HTC's financing, and so on.¹¹¹ 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 considerably below the per capita fiscal advantage of tax exporting. That is crucial for larger models in which prospective immigrants' points of origination expand 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: even as the circle of jurisdictions laden with potential newcomers widens, the bribe necessary to keep them at bay diminishes.

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

107. See Shaviro, *supra* note 12, at 911.

108. See Russell Krellove, *Efficient Tax Exporting*, 25 CAN. 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).

109. See Krellove, *supra* note 108, at 153; Myers, *supra* note 108, at 108–09; cf. Shaviro, *supra* note 12, at 908 (describing the distortionary effects of tax exporting).

110. Shaviro, *supra* note 12, at 908.

111. Bratton & McCahery, *supra* note 64, at 235; Shaviro, *supra* note 12, at 964–65.

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.¹¹² Particularly savvy states might consider imposing taxes in a way that seem highly salient to outsiders—that is, they look like they would obviously apply to the newcomer. And, as I discuss later, a state might voluntarily take on apparent burdens—for instance, through federal legislation—that it could later lighten through less transparent methods such as administrative lobbying.¹¹³

If states in fact engage in this combination of behaviors, then (counterintuitively) a deduction might be appropriate for taxpayers in states that *receive* payments from other states. Clearly, states that successfully export some of their costs will not be entitled to claim deductions for their citizens—if anything, they should have to recognize an inclusion equivalent to their free services. At the same time, states that pay their neighbors' costs are relatively less well-off than their freeloading brethren, so the equity case for a deduction for their residents seems strong. As a simple administrative method for identifying tax exporters, we might look to which jurisdictions are net bribe payers; the net bribe *recipients* are the ones *bearing* an excess tax burden. Interestingly, in recent years, a consistent set of states have paid more in federal taxes than they receive in federal largess.¹¹⁴ Yet those states, the nation's wealthiest, are also the same states that benefit most from the present structure of the deduction.¹¹⁵ Is the current deduction backwards?

Maybe not. The problem with using net federal spending as a marker for tax exporters is that there are lots of other reasons that suggest a state might be a net payer of federal tax. The net payers might just be the losers of this particular political moment; certainly their electoral-college voters have cast ballots for the losing presidential candidate in recent elections.¹¹⁶ Since the net payers are also the wealthiest states, net payments might simply be an effect of an overall progressive federal tax system.¹¹⁷ Even if we could ascertain for certain that the net payments were truly bribes, it wouldn't necessarily follow that they are bribes to facilitate tax exporting. Bribes and their accompanying sleights of hand can also be a way for a state that raises and spends a lot of state tax revenue to prevent free-riding by newcomers,

112. See Bratton & McCahery, *supra* note 64, at 236; Fennell, *supra* note 94.

113. See *infra* text accompanying notes 133–149.

114. Tax Found., Federal Spending By State Per Dollar of Taxes Paid, 1981–2004 (Mar. 6, 2006), <http://www.taxfoundation.org/research/show/347.html> (last visited Oct. 6, 2007).

115. Rueben & Burman, *supra* note 72, at 363 (listing the top total-dollar recipients of deduction as California, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Pennsylvania, and Virginia).

116. Dean Lacy, A Curious Paradox of the Red States and Blue States: Federal Spending and Electoral Votes in the 2000 Election (Mar. 2, 2002) (unpublished manuscript, on file with author), available at <http://psweb.sbs.ohio-state.edu/faculty/hweisberg/conference/Lacy-OSUConf.PDF>.

117. See Rueben, *supra* note 4, at 500.

especially newcomers with low incomes.¹¹⁸ Without some sort of bribe system in place, the deduction equation might actually flip as newcomers receive benefits in excess of their tax contributions to the new, wealthier jurisdiction and the host jurisdiction pays out more than it collects.¹¹⁹

I acknowledge that my analysis so far departs somewhat from more conventional descriptions of local limits on citizen mobility, which focus on the use of exclusive zoning to hedge out new migrants, as well as other economic and race-based barriers.¹²⁰ One can, however, tell a similar story about exclusive zoning, with similarly inconclusive results. The standard account of exclusive zoning is that localities force occupants to live only on large lots in single-family homes, so prospective residents will likely have to contribute a large share of property taxes.¹²¹ That tends to increase entry costs and reduce incentives for outsiders to move in to receive transfer payments.¹²² As a result, we might be somewhat suspicious that exclusively zoned jurisdictions will be receiving more in benefits than they are paying since zoning, like bribes, may offer a low-cost method for imposing frictions that facilitate cost exporting. At the same time, zoning may simply be a method for the jurisdiction to prevent free riding, enabling it to realize benefits at a level equal to, but not necessarily greater than, expenditures. So, while some grounds exist for casting a closer eye at jurisdictions with exclusionary zoning practices, we cannot unequivocally say that such jurisdictions deserve no deduction.

We are left, then, to look for some other handy identifier for tax exporters. Fortunately, the empirical literature suggests one. A well-known study shows that property values decline in relation to higher taxes and increase in

118. See Bratton & McCahery, *supra* note 64, at 212; Mieszkowski & Zodrow, *supra* note 21, at 1121–23 & n.39, 1138.

119. Consistent with this theory, the current regressive structure of the deduction roughly approximates a system in which low-income migrants pay an inclusion while stable, wealthy property owners get a deduction. But that arrangement, too, is wrong if we cannot tell whether the migrants are moving in order to free ride or instead are responding to efforts to export taxes onto them. Another possible reason not to tie net payments made to a locality's neighbors to an inclusion is that in some cases the neighbors are simply leeching. *Cf.* Zelinsky, *supra* note 33, at 34 (observing that a decision to live in the suburbs may be based on desire to free ride on expenditures by a neighboring city).

120. See, e.g., WILLIAM A. FISCHER, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND USE POLICIES 51–57 (2001); Sheryll D. Cashin, *Localism, Self-Interest, and the Tyranny of the Favored Quarter: Addressing the Barriers to New Regionalism*, 88 GEO. L.J. 985, 2012–13, 2015 (2000); Bruce W. Hamilton, *Property Taxes and the Tiebout Hypothesis: Some Empirical Evidence*, in FISCAL ZONING AND LAND USE CONTROLS 13 (Edwin S. Mills & Wallace E. Oates eds., 1975); Mieszkowski & Zodrow, *supra* note 21, at 1099.

121. In jurisdictions that are already fully developed, “implicit” or “heterogeneous” zoning can occur. See Bruce W. Hamilton, *Capitalization of Intra-jurisdictional Differences in Local Tax Prices*, 66 AM. ECON. REV. 743 (1976); Mieszkowski & Zodrow, *supra* note 21, at 1140. Absent some method for hedging out newcomers, demand increases for a relatively fixed amount of housing. Prices then increase until they reach the point where they exactly equal the value of the services delivered by the jurisdiction. Free riding is thus most likely in intermediate scenarios in which there is room for new housing but less than fully restrictive zoning.

122. See MYRON ORFIELD, METROPOLITICS 5 (1997); Fennell, *supra* note 94, at 80–81.

relation to education spending.¹²³ The latter implies that the jurisdiction has actually succeeded in delivering a surplus of benefits over taxes paid by the homeowner.¹²⁴ Of course, a variety of other factors could produce a similar result, such as irrational responses to school spending as an (inaccurate, perhaps) heuristic for the value of all local services, or the distortive effects of the federal mortgage-interest deduction.¹²⁵ In addition, other reasons besides tax exporting may enable a jurisdiction to realize excess value. For example, it may just be very efficient at serving the public. While equity alone might be indifferent to that distinction, it seems unlikely we would deliberately want to levy a higher tax on more efficient jurisdictions. Still, from a strictly equitable perspective, ad valorem property taxes, as a rough meter of a taxpayer's enjoyment of excess government services, should not be eligible for a deduction.¹²⁶

In sum, the mobility story is more nuanced than has generally been appreciated. And, again, it is hard to say for certain that we have any predictable metric for judging whether taxpayers are better or worse off as a result of their choice of jurisdiction. In the case of property taxes, however, we might have something of a yardstick, assuming we believe that property values in fact capitalize, or measure, the excess of government services over local-government tax burdens. But that is not the end of the story. We might well think that capitalization reflects not only state taxes and services but also federal influences. How should we think about those factors in evaluating state taxpayers? The next Part explores just that.

123. Wallace E. Oates, *The Effects of Property Taxes and Local Public Spending on Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis*, 77 J. POL. ECON. 957, 966–67 (1969). For conflicting views about the enduring viability of the Oates study, compare Been, *supra* note 70, at 522–23, which claims that later studies support Oates, with Richard Schragger, *Consuming Government*, 101 MICH. L. REV. 1824, 1830 (2003), which reviews WILLIAM A. FISCHER, *THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES* (2001), and calls results of later studies “somewhat mixed.”

124. See Bratton & McCahery, *supra* note 64, at 240–41.

125. See Note, *Making Mixed-Income Communities Possible: Tax Base Sharing and Class Desegregation*, 114 HARV. L. REV. 1575, 1588–89 (2001).

126. In addition, granting a deduction for property taxes paid would be a windfall for property owners to the extent that owners do not in fact bear the economic burden, or incidence, of the property tax. Cf. Michael L. Goetz, *Tax Avoidance, Horizontal Equity, and Tax Reform: A Proposed Synthesis*, 44 S. ECON. J. 798, 802 (1978) (“[I]f capitalization is complete, an existing tax preference is not a source of horizontal inequity.”). A number of studies suggest that the incidence of the property tax is distributed across all owners of capital. See Mieszkowski & Zodrow, *supra* note 21, at 1110–17, 1127–31 (surveying the theoretical and empirical literature). That is, investors shift away from real property as a result of the property tax, bidding up the price of alternative investments. At equilibrium, investors should be indifferent between property and lesser-taxed investments. Thus property owners likely suffer a smaller diminution in real wealth (relative to what they could obtain from investing in anything other than property) than would be suggested by the face amount of the property tax they pay.

IV. EFFECTS OF FEDERAL MANDATES

As the previous Part illustrates, an important consideration in the equity debate is the possibility of costs and benefits being exported across governments. In addition to imposing costs on one another, states may also experience so-called vertical cost exporting—they may bear some costs imposed on them by Congress or manage to cause Congress to accept some of their own costs.¹²⁷ So far the legal literature hasn't devoted much attention to the impact of federal activity on the case for the deduction, notwithstanding an invitation from Kaplow.¹²⁸ In this Part, I offer some preliminary thoughts by focusing on two general phenomena: the fact that federal mandates may oblige states to spend money to comply with federal policy, and the perhaps countervailing fact that the federal government often provides grants or other assistance to states and localities.

A. State Spending . . .

Consider first the impact of federally imposed obligations on state budgets. Obviously federal law may require a state to provide rather more in services than its voters might otherwise have preferred.¹²⁹ Indeed, one of the primary rationales for federal regulation is to prevent capital leakage from states with a preference for more, and more expensive, regulation to those with a preference for less.¹³⁰ Some states, therefore, may be obliged to regulate in order to accommodate the regulatory preferences of others.¹³¹ While blackletter constitutional doctrine prohibits Congress from directly conscripting a state's regulatory or legislative apparatus,¹³² the Constitution imposes few meaningful limits on federal power to oblige states to meet generally applicable standards of performance—for example, guaranteeing

127. See Neil S. Siegel, *Commandeering and Its Alternatives: A Federalism Perspective*, 59 VAND. L. REV. 1629, 1644 (2006); Richard B. Stewart, *Federalism and Rights*, 19 GA. L. REV. 917, 961 (1985).

128. See Kaplow, *supra* note 12, at 428.

129. Robert W. Adler, *Unfunded Mandates and Fiscal Federalism: A Critique*, 50 VAND. L. REV. 1137, 1231–54 (1997); Edward A. Zelinsky, *Unfunded Mandates, Hidden Taxation, and the Tenth Amendment: On Public Choice, Public Interest, and Public Services*, 46 VAND. L. REV. 1355, 1356 (1993).

130. See Lynn A. Baker, *Conditional Federal Spending After Lopez*, 95 COLUM. L. REV. 1911, 1951 (1995); Richard P. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1216–17 (1992). Of course, self-interested behavior by federal officials may contribute to federal demands for more state-level regulation. See, e.g., Zelinsky, *supra* note 129, at 1369–89 (identifying political-process failures that may lead to excessive federal lawmaking).

131. Relatedly, the federal government may impose regulatory mandates to accompany its grants in order to ensure that the grant serves the purpose of encouraging efficient state regulation. See Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120, 1126–27 (1999). As I discuss in Part V, we would not want taxpayers to be able to deduct the costs of conditions the federal government imposes to encourage efficient state behavior.

132. *Printz v. United States*, 521 U.S. 898, 918–33 (1997); *New York v. United States*, 505 U.S. 144, 161–66 (1992).

access to public places for persons with disabilities.¹³³ Congress's power is especially expansive if the states' duties are tied to a corresponding expenditure of federal funds.¹³⁴ Under the equity theory, then, the residents of the low-regulatory-preference states (assuming we could reliably identify them) could claim a deduction for services they didn't want or value but for which they now must pay state taxes.

There are some countervailing arguments. First, in some situations it may be the case that even the low-regulation states desire the "imposed" regulation but do not value it as much as the potential for luring capital from elsewhere.¹³⁵ For example, the state might have been willing to pay one million dollars to enact a regulatory program, but it might not do so after recognizing that it can instead attract capital fleeing from regulation in other states, which will generate more than one million dollars in value in the forbearing state. Federal mandates thus deny the state this opportunity to lure capital away from others.¹³⁶ In one sense, taxpayers in these would-be "lure" states are no worse off for complying with a federal mandate than taxpayers elsewhere; all have the program they wanted. But the would-be lure states also have an opportunity cost. That might arguably provide a basis for a tax deduction for their residents.

Yet once the federal mandate is enacted, every other state also has a comparable opportunity cost: each one could have poked a hole in the federal dam and caught buckets full of leaking capital. While that opportunity may have made less proportional impact on the budgets of larger states, its absolute magnitude was, in theory, similar. Our preliminary diagnosis of deduction would then disappear. As a result, we have a significant tax administrative challenge: how should we differentiate states that genuinely prefer less regulation from those that simply prefer to exploit opportunities to defect from a regulatory regime?

Another possible problem with the equity argument here is that federally imposed costs may be somewhat illusory. If the goal of nationalizing a program is to prevent outflow of capital or taxpayers, then it likely does not have to genuinely impose comparable costs on states that are required to regulate. As we saw in the last Part with the use of federal funds to prevent *in*-migration, the appearance or threat of costs elsewhere is probably enough to assure a fair amount of stability. Residents know their own situation better than they know the lay of the land elsewhere, gathering more information and relocating are expensive, and cognitive biases may favor the status

133. See *Reno v. Condon*, 528 U.S. 141, 149–51 (2000).

134. See Lynn A. Baker & Mitchell N. Berman, *Getting Off the Dole: Why the Court Should Abandon Its Spending Doctrine, and How a Too-Clever Congress Could Provoke It to Do So*, 78 *IND. L.J.* 459, 460, 484 (2003); Albert J. Rosenthal, *Conditional Federal Spending and the Constitution*, 39 *STAN. L. REV.* 1103, 1105–06 (1987).

135. See Thomas R. McCoy & Barry Friedman, *Conditional Spending: Federalism's Trojan Horse*, 1988 *SUP. CT. REV.* 85, 124.

136. That temptation would be especially powerful in small states, where capturing any new source of revenue might have a substantial effect on the state's bottom line. See Bratton & McCahery, *supra* note 64, at 267.

quo.¹³⁷ Thus, it may be that some federal regulations only *appear* to impose mandates.¹³⁸ If so, those states in which the mandate is not truly binding should have no argument that they are worse off than others and therefore no argument for a deduction on equity grounds.

There is a credible case that many federal mandates in fact are illusory in this way. A system in which most costs in states uninterested in regulation are illusory could be attractive to the enacting, proregulatory majority for several reasons. Illusory costs are utility maximizing in that they come closer than full enforcement to satisfying everyone's preferences: the proregulatory majority can prevent defections from collapsing its own regime but allow those with a preference for less regulation to still go basically unregulated.¹³⁹ On the pragmatic level, the political cost of enacting a national scheme with illusory costs is rather lower: logrolling debts will be reduced,¹⁴⁰ and the credibility of threats of holdouts¹⁴¹ from fence-sitters (or credibly self-described fence-sitters) is lower. Similarly, if Congress is purchasing its regulatory power through the Spending Clause, the costs of buying out minority states will be smaller if the actual anticipated costs to those states will be greatly lessened.¹⁴²

The enforcement structure of some federal mandates makes this arrangement plausible. Many federal statutes impose what appear to be fairly clear mandates on states—that they must offer reasonable access to a primary-care provider,¹⁴³ guarantee a “free and appropriate education” to all children with disabilities,¹⁴⁴ and reduce ozone to acceptable levels within a

137. See *supra* text accompanying notes 48–66.

138. See Sunstein, *supra* note 50, at 218 (describing “measures that appear on their face to promise vigorous . . . regulation but that in the enforcement process amount to little more than mere words”).

139. As Professor Sunstein points out, officials may also want to enact legislation that only appears stringent in order to simultaneously claim credit for responding to constituent demands for action and avoid blame from the regulated parties. Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 430 (1990). Of course, this strategy is only effective if the regulated parties are more attentive to the political process than the constituents demanding regulation. A number of scenarios make this split plausible. See Peter H. Aranson et al., *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1, 38–39 (1982). This analysis implies that the possibility of illusory mandates also undermines any argument that the deduction is required to account for overlegislation by self-serving public officials. See Zelinsky, *supra* note 129. That is, even if federal officials serve their own ends rather than the public's, they often can do so without imposing real costs on states.

140. For general descriptions of the logrolling bargaining process, see JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* chs. 10–13 (1962), and William H. Riker & Steven J. Brams, *The Paradox of Vote Trading*, 67 AM. POL. SCI. REV. 1235, 1240 (1973).

141. For a more detailed discussion of the holdout problem, see *infra* text accompanying notes 171–174.

142. See Brian Galle, *Getting Spending: How to Replace Clear Statement Rules with Clear Thinking About Conditional Grants of Federal Funds*, 37 CONN. L. REV. 155, 187 (2004).

143. 42 C.F.R. § 431.53 (2006).

144. 20 U.S.C. § 1412(a)(1)(A) (2000).

given span of years.¹⁴⁵ But the penalty for noncompliance proves to be rather murky. Under some statutes, such as the Individuals With Disabilities Education Act (“IDEA”), the primary penalty is the revocation of a vast amount of federal funds by the administering agency.¹⁴⁶ That outcome is politically unlikely for a host of reasons, not the least of which is that states are highly effective at administrative lobbying.¹⁴⁷ The actual outcome of these disputes is likely to be some conciliation process, relatively obscured from public view, in which the state’s ultimate penalty will be far short of the revocation guillotine stroke.¹⁴⁸ States therefore will often have a substantial degree of control over the extent to which they are really bound to comply with federal regulatory systems.¹⁴⁹ Depending on the transparency of these lobbying and conciliation efforts, the degree of that control may not be obvious to private parties, who may therefore still be deterred from revocation by the seemingly stern and universal statutory language. And, indeed, groups who closely monitor IDEA often complain that in practice its requirements for states tend to prove fairly illusory.¹⁵⁰

It might be objected that federal statutes are often privately enforceable, so it may be fairly difficult for Congress or an agency to control whether or where a statute has real bite. But in recent years the Supreme Court has increasingly yoked private enforceability to express congressional authorization.¹⁵¹ Even writers who have argued for fairly expansive private enforcement of federal norms have acknowledged that judicial control over the existence of a right of action is likely to take a back seat not only to Congress but also to the views of agencies.¹⁵²

In any event, equitable considerations raised by federal mandates will often be swamped by other factors. For example, at least some national regulation is enacted because the majority coalition believes that contrary

145. 42 U.S.C. § 7511 (2000); see Sunstein, *supra* note 139, at 408–10.

146. 20 U.S.C. § 1416.

147. See Galle, *supra* note 142, at 193.

148. See Harold J. Krent, *Delegation and Its Discontents*, 94 COLUM. L. REV. 710, 717 (1994) (reviewing DAVID SCHOENBROD, *POWER WITHOUT RESPONSIBILITY* (1993)); Jonathan R. Macey, *Public Choice and the Legal Academy*, 86 GEO. L.J. 1075, 1080 (1998) (reviewing JERRY L. MASHAW, *GREED, CHAOS, AND GOVERNANCE: USING PUBLIC CHOICE TO IMPROVE PUBLIC LAW* (1997)).

149. Galle, *supra* note 142, at 193–95.

150. E.g., *Individuals with Disabilities Education Act: Hearing Before the H. Comm. on Government Reform*, 107th Cong. (2001) (testimony of Marca Bristo, Chairperson, Nat’l Council on Disability) (claiming that federal enforcement actions were not sufficient to encourage states to comply with IDEA and that a large majority of states were significantly noncompliant).

151. See *Gonzaga Univ. v. Doe*, 536 U.S. 273, 285–86 (2002); *Alexander v. Sandoval*, 532 U.S. 275, 286–87 (2001).

152. See Brian D. Galle, *Can Federal Agencies Authorize Private Suits Under Section 1983? A Theoretical Approach*, 69 BROOK. L. REV. 163, 206–07, 218–19 (2003); Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 94–95 (2005).

behavior is inconsistent with national norms.¹⁵³ It seems perverse to grant a deduction to a state to cover its compliance costs (say, for busing to integrate schools) with a national norm when noncompliance would be morally objectionable. Equity here gives way to other notions of justice, or perhaps we simply define a fair basis for comparison between sets of state taxpayers, with some costs neglected because they fail to meet that baseline.¹⁵⁴ Put another way, it would seem strange if the tax system treated some individuals as having been disfavored when, in fact, the reason for their disfavor is because federal law was ironing out some larger inequity. Or, more pithily, tax law shouldn't reward discriminators.

In short, although some state taxpayers may think they are paying for select federally mandated regulatory regimes, in practice they may not be. Discerning one situation from another seems administratively arduous. And, for obvious reasons, Congress would be unlikely to sanction a tax system that laid bare instances where its threat of national regulation is actually a bluff. Accordingly, the fact of state spending to comply with federal dictates doesn't appear to support an equitable basis for the deduction.

B. . . . And Getting

At the same time that Congress imposes obligations on the States, it also provides them with significant financial benefits, often as part of the same regulatory regime.¹⁵⁵ In select circumstances states may be in a position to demand payment well in excess of their actual costs of compliance with federal programs.¹⁵⁶ National payments may cover the cost of services that some states would happily have funded themselves, giving the state another kind of cash excess.¹⁵⁷ Some federal payments, though, may only barely provide states with services to which they were at best indifferent or may induce additional expenditures on unwanted services.¹⁵⁸ Unfortunately, the administrative obstacles to any equitable result are formidable.¹⁵⁹

The first question we have to answer is whether the money that a state receives pays for services that in fact improve the subjective well-being of

153. See Richard Briffault, "What About the 'Ism'?" *Normative and Formal Concerns in Contemporary Federalism*, 47 *VAND. L. REV.* 1303, 1320 (1994).

154. For an example of one effort at such a definition, see Zelinsky, *supra* note 33, at 22–29.

155. See Richard Briffault, *Public Finance in the American Federal System: Basic Patterns and Current Issues*, 2 *COLUM. J. EUR. L.* 533, 537–39 (1996).

156. Galle, *supra* note 142, at 187–91.

157. *Id.* at 186–87.

158. See David A. Super, *Rethinking Fiscal Federalism*, 118 *HARV. L. REV.* 2544, 2568–69 (2005).

159. Cf. Jeffrey Schoenblum, *Taxation, the State, and the Community*, 23 *SOC. PHIL. & POL'Y* 210, 213–14 (2006) (considering whether net benefits and burdens of tax and government should be assessed at the individual or community levels).

the state's citizens. Unrestricted cash payments are fungible,¹⁶⁰ and we can safely assume that in a state with anything like a functioning representative process, the funds will improve the well-being of at least some of the state's residents.¹⁶¹ But few federal payments are unrestricted. Most are earmarked for use in a particular program, be it health care for seniors, leaving no child behind, or buttressing the states' readiness for "emergencies."¹⁶² In effect, federal spending looks a lot like a fungible cash gift combined with a federal mandate.¹⁶³ We can't count cash gifts against deductibility but fail to consider the impact of accompanying restrictions. Again, we have the puzzle that bedeviled our treatment of federal mandates: how should we sort welcome regulation from undesired imposition? If the federal mandate is irksome and unwanted, it ought to offset the benefits of the cash gift. But we usually can't tell when that happens.

The state delegation's initial vote for or against the initiative does not solve this problem because we have to consider spending programs not only year by year but also over time. Law shapes our preferences, so in time, even an unpopular federal initiative may develop a constituency within the state.¹⁶⁴ As we saw, states have considerable power to affect the actual costs of a program as it is applied to them, and plausibly, their power increases

160. David F. Bradford & Wallace E. Oates, *Towards a Predictive Theory of Intergovernmental Grants*, 61 AM. ECON. REV. 440, 443-45 (1971); Ronald C. Fisher, *Income and Grant Effects on Local Expenditure: The Flypaper Effect and Other Difficulties*, 12 J. URB. ECON. 324, 325 (1982).

161. See *New York v. United States*, 505 U.S. 144, 168 (1992); 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, 861, 874 (1998).

162. See Briffault, *supra* note 155, at 543-45.

163. Under classic economic theory, a grant should have almost no effect on state spending. Because money is fungible, even an earmarked federal grant should simply reduce slightly the price for all a state's expenditures, in effect redistributing the grant evenly to every beneficiary of state spending. For example, suppose a state chooses to spend \$100 million of its \$1 billion budget on highways. The federal government gives the state \$50 million earmarked for highway spending. The state still prefers to tax its citizens and allocate its resources in such a way that it spends \$100 million on roads (or, to be precise, a bit more than \$100 million, as a result of the added wealth represented by the grant). Bradford & Oates, *supra* note 160, at 444-45; James R. Hines, Jr. & Richard H. Thaler, *Anomalies: The Flypaper Effect*, J. ECON. PERSP., Fall 1995, at 217, 218. The effect should be that the state reduces its own spending on highways by \$50 million and either cuts taxes by \$50 million, distributes the \$50 million proportionately among all its other spending priorities, or, more likely, a mix of the two. Fisher, *supra* note 160, at 328; Oates, *supra* note 131, at 1129. For obvious reasons, matching grants change this calculation, as states are willing to spend more in order to obtain more federal funds. Stephen J. Bailey & Stephen Connolly, *The flypaper effect: Identifying areas for further research*, 95 PUB. CHOICE 335, 336 (1998). In practice, however, the effect of federal earmarking is often to shift state spending in compliance with the earmark or mandate, even if there is no explicit matching requirement. Fisher, *supra* note 160, at 329-30 (analyzing earlier studies); Oates, *supra* note 131, at 1129. No coherent theory currently explains why states respond this way to federal grants. Sang-Seok Bae & Richard C. Feiock, *The Flypaper Effect Revisited: Intergovernmental Grants and Local Governance*, 27 INT'L J. PUB. ADMIN. 577, 583-85 (2004); Fisher, *supra* note 160, at 324; Hines & Thaler, *supra*, at 220-22. Thus it is uncertain whether state spending in response to federal grant conditions increases or decreases actual constituent welfare.

164. See Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 539-40 (1998); Jon Elster, *Social Norms and Economic Theory*, J. ECON. PERSP., Fall 1989, at 99, 99-100.

over time as federal regulators come to rely on their state counterparts for information, efficient implementation, and political support.¹⁶⁵ On the flip side, some commentators argue that states can be “locked in” to federal spending programs as an initial commitment to cooperate with the federal government becomes too expensive (politically, if not literally) to alter despite increasingly burdensome changes to the program.¹⁶⁶ Unless these two opposing possibilities happen to balance out perfectly, the initial relationship between a state’s subjective welfare and the details of a federal program will not be a good measure of that relationship in the future.

Still, an objector can reply that most federal spending is reauthorized every year, and in many programs, the states have the annual option of refusing federal money and the restrictions that come with it.¹⁶⁷ Thus, we should still have an up-to-date measure of the state’s perceived well-being. The problem here is that many of the decisions we would be looking to under this theory are not in fact decisions about present utility but instead are bets about future returns—returns when the decision maker next stands for election.¹⁶⁸ State officials might agree to a program that looks, and in its first year in fact is, very cumbersome to the state on the assumption that their administrative lobbying efforts will make the deal turn out for the best by the next time they have to answer to constituents. Other decisions, such as the determination whether or not to accept federal funds, might be delegated to politically insulated bureaucrats more likely to put the state’s long-term fiscal health ahead of momentary political preferences.¹⁶⁹ For reasons I’ve explained elsewhere, that may be a sound state fiscal policy,¹⁷⁰ but it makes it rather hard to say whether federal benefits and burdens are netting out for the state’s residents in the short run. In any event, the objection relies on the assumption that subjective well-being does not change between fiscal years.

In addition to this fundamental administrative obstacle, in order to allocate the deduction equitably, we also have to determine the incidence of the burden of federal mandates in excess of payments. Recall that federal regulation may be attractive to some states because it allows them to institute a desired policy without squeezing capital into less-regulated jurisdictions.¹⁷¹ Often, this nationalization process is accompanied by federal spending to persuade the

165. Galle, *supra* note 142, at 193.

166. Briffault, *supra* note 155, at 542–43; David Freeman Engstrom, *Drawing Lines Between Chevron and Pennhurst: A Functional Analysis of the Spending Power, Federalism, and the Administrative State*, 82 TEX. L. REV. 1197, 1243–44 (2004).

167. Peter J. Smith, *Pennhurst, Chevron, and the Spending Power*, 110 YALE L.J. 1187, 1234 (2001).

168. See Engstrom, *supra* note 166, at 1249. In addition to this problem, many federal conditions are attached to a variety of grants, so determining any one day on which a state chooses to accept the grant and all its associated conditions is problematic. Smith, *supra* note 167, at 1234–36.

169. See Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511, 1554–55 (1992).

170. Galle, *supra* note 142, at 195 n.244.

171. See John O. McGinnis & Ilya Somin, *Federalism vs. States’ Rights: A Defense of Judicial Review in a Federal System*, 99 NW. U. L. REV. 89, 94–100 (2004).

states to adopt programs that they would otherwise be inclined to oppose.¹⁷² Payments might lower the political costs of enactment.¹⁷³ Alternatively, it might be the case that Congress *must* legislate by attaching conditions to grants because for constitutional reasons the bill would be outside Congress' power to enact without agreement by each affected state.¹⁷⁴

In either event, the fact that Congress chooses conditional payments rather than outright mandates may result in a shift of the ultimate economic burden of compliance away from those who must comply. Consider how states might respond to an offer of conditional funds. The optimal game theory strategy for each state is complex, especially if the states have incomplete information about each others' preferences.¹⁷⁵ If legislators are unable to analyze their strategic possibilities thoroughly, the simplest strategy for an antiregulatory state would likely be to demand more in payment than the state will lose in negative utility (assuming, by hypothesis at this point, that that is a measurable number).¹⁷⁶ Somewhat more sophisticated negotiators might attempt to hold up the would-be enacting coalition, demanding that the coalition pay over some of its own excess utility.¹⁷⁷ In either scenario, the burden of the mandates imposed by the regulation is paid not by those who oppose it but by those for whom the regulation is itself an improvement in subjective well-being. As a result, in order to impose an inclusion or grant a deduction, we would have to know not only the *ex ante* subjective preferences of the various states but also the *ex post* distribution of costs resulting from the legislative process. And both change annually.

Thus the fiscal interrelationship between the states and the federal government creates two difficult sets of questions, one related to § 164 and one rather more broad. First, the flow of grants from the federal treasury to localities, albeit with strings attached, greatly complicates our effort to pinpoint the comparative well-beings of state taxpayers. Not all decisions to accept conditional funds in fact represent utility gains for the acceptor. Nor do all burdens have the weight they purport to have; even the burdens that genuinely are imposed may actually be borne by taxpayers other than those whom they appear to limit. Second, and perhaps more significantly, it appears that the deduction might significantly affect federal goals. The next Part considers those effects in more detail.

172. Hills, *supra* note 161, at 861, 874; Earl M. Maltz, *Sovereignty, Autonomy and Conditional Spending*, 4 CHAP. L. REV. 107, 113 (2001).

173. Galle, *supra* note 142, at 188–89.

174. *Id.* The Spending Clause allows Congress to legislate in a variety of ways that would be beyond the scope of its other delegated powers. *South Dakota v. Dole*, 483 U.S. 203, 207 (1987).

175. See Galle, *supra* note 142, at 188–89.

176. See *id.* at 186–87.

177. Hills, *supra* note 161, at 856; Ilya Somin, *Closing the Pandora's Box of Federalism: The Case for Judicial Restriction of Federal Subsidies to State Governments*, 90 GEO. L.J. 461, 476 (2002).

V. FAIRNESS IN TAX VERSUS FAIRNESS IN GOVERNMENT?

In the last Part, I suggested that at times tax norms of horizontal equity might conceivably interfere with other federal policy goals. For instance, we saw that a deduction for those burdened by federal law would be an odd result if the entire purpose of the federal law was to strip some benefit from those who took it unfairly. In this Part, I develop that theme. I also want to highlight that the SALT deduction may have other less obvious effects on the dynamic of fiscal relations between local governments and the federal government.

First, consider some simple ways in which a horizontal-equity rationale for the deduction would be at odds with federal goals. Under the equity analysis, we should grant the state's residents an offset against their total federal tax liability in proportion to the amount of costs that the federal government imposes on them. However, a major reason for enacting regulation at the national level is to ensure that local actors fully internalize the costs and benefits of their decisions.¹⁷⁸ Granting a deduction would be completely contrary to the goal of forcing state actors to bear the full costs of their own decisions.

Taking account of interstate relationships thus shows us a possible tension between horizontal equity and efficiency. We ordinarily think of horizontal equity and economic efficiency as being closely related.¹⁷⁹ Taxing two similarly situated parties similarly is not only fair but also usually more efficient, since the parties will have no incentives to shift positions purely in response to the tax.¹⁸⁰ In this case, however, focusing strictly on horizontal equity neglects the possibility of state-imposed externalities.¹⁸¹ We probably should be willing to trade some equity for increased national efficiency, which would make everyone, including those who are relatively less well-off as a result of the tax inequity, better-off. In addition, many state taxpayers who can export some of their costs onto neighboring states have no equity complaint when denied a deduction because they begin from a superior economic position before the costs of the federal regulation are imposed.

Next, the desirability of a deduction might depend significantly on our views about the ideal distribution of power between central and local governments. Suppose, for example, that states with preferences for more regulation want to use nationalization in order to reduce capital leakage.¹⁸² If we allow a deduction for citizens in the states that prefer less regulation, we

178. See Baker, *supra* note 130, at 1951; Revesz, *supra* note 130, at 1216–17.

179. See Elkins, *supra* note 10, at 47–48. But see Joseph E. Stiglitz, *Utilitarianism and Horizontal Equity: The Case for Random Taxation*, 18 *J. Pub. Econ.* 1, 30–31 (1982).

180. See DODGE, *supra* note 23, at 287–90.

181. Cf. Elkins, *supra* note 10, at 48–49 (noting that a tax system may increase economic efficiency by imposing penalties on inefficient actors and that this penalty may be inconsistent with pure horizontal equity); Zolt, *supra* note 29, at 70–71 (observing that taxes imposed to correct for externalities often cannot be uniform).

182. See *supra* text accompanying notes 130–131.

have in effect imposed a nationalization surtax on the nationalizing states, since they will bear the tax expenditure cost of the deduction. It seems fair to assume that the added costs will make national legislation less attractive. On the other hand, if we can't sort out states' individual preferences, but instead simply permit the deduction across the board for federally imposed costs, then deductibility might in some cases subsidize federalization strategies. If, for instance, the states that want more regulation are also the states with the largest incomes, a deduction might actually shift some of the federal tax burden from the nationalizers to other, lower-income states.¹⁸³ Either outcome might seem attractive, depending on whether we'd prefer to penalize or encourage efforts to displace disparate state regulatory regimes with federal mandates.

But prescriptive federal legislation is hardly the only tool for coordinating federal and state policy. States also use conditional federal spending to ease the challenges of collective action. As we have already seen, federal grants may come with strings attached. States can use this structure to permit regulation that would otherwise be choked off by collective-action problems.¹⁸⁴ Suppose that forty-eight states want to tax corporations. Suppose further that the two remaining states are indifferent about corporate taxation, but they recognize that they could offer themselves as corporate-tax havens, drawing large amounts of revenue from their neighbors.¹⁸⁵ In all likelihood, the remaining forty-eight states will not be able to tax corporations, or at least not tax them at near the levels they would otherwise prefer.¹⁸⁶ This result ultimately diminishes state political autonomy: we have prevented many states from achieving a desired policy end without fulfilling any preference of the defectors (other than a preference for exacting rents where available). However, the forty-eight states have another option: they can bribe the two holdout states to also enact a corporate tax, thereby preventing capital from leaking across their borders.¹⁸⁷

The SALT deduction may interfere with this system by changing the fiscal dynamics between states and the federal government. Suppose that the deduction will be in place regardless of the individual equity analysis for each state. Economists have recognized that the SALT deduction may ex-

183. To see why the deduction has this effect, recall that the deduction is generally more valuable for higher-income taxpayers. It follows that states with more high-income taxpayers will derive greater value from the deduction, shifting money away from lower-income states. See STEVEN MAGUIRE, CONG. RESEARCH SERV., STATE AND LOCAL TAXES AND THE FEDERAL ALTERNATIVE MINIMUM TAX 4 (2005).

184. See *supra* text accompanying notes 175–177.

185. See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1586–99 (2000) (describing how tax havens prevent other nations from setting optimal tax levels).

186. *Id.*

187. See Steven A. Dean, *Philosopher Kings and International Tax: A New Approach to Tax Havens, Tax Flight, and International Tax Cooperation*, 58 HASTINGS L.J. 991 (2006) (proposing a regime in which large nations pay fees to tax havens to persuade them not to act as havens).

pand the budgets available to states and local governments.¹⁸⁸ This stronger financial position will likely make it more expensive for a coalition, acting through Congress, to buy out minority states.¹⁸⁹ Intuitively, it seems plausible that a government in greater need of funds will be more willing to accept federal conditions attached to the funds. Indeed, several scholars have complained that federal conditional spending is unfair to states because it trades on their financial hardships.¹⁹⁰ While I disagree with the characterization that these arrangements are unfair—for reasons beyond the scope of this Article—I agree with the underlying claim that bread is more tempting to a starving man. Some empirical studies by economists appear to support this dynamic, although the available evidence could be explained in a number of different ways.¹⁹¹ To the extent that the SALT deduction strengthens state fiscal standing, it also makes conditional spending more difficult.

Whether or not this is a desirable result probably depends on our views about federalism, or at least about state and local diversity. In at least some fields, our political process seems to overproduce diversity.¹⁹² Deductibility may be undesirable for those areas, since it will make it more difficult for states to buy their way to uniformity. And uniformity may sometimes be necessary to maximize state autonomy, as with our corporate-tax example above. But these conclusions depend on the details of the institutions that implement any given policy.¹⁹³ A one-size-fits-all deductibility rule would be unlikely to have the desired effect for all situations.

In short, our views about the deduction's effect on these aspects of federal-state relations seem to turn on debates over whether centralization enhances or reduces efficiency in government, enhances or reduces individual liberty, strengthens or weakens a meaningful sense of community, and all the other disputes that generally attach to the question of federalism. Tax has no obvious answers for them.

Supposing for the moment that we had concrete views about these problems and wanted to employ the SALT deduction to achieve them, strong counterarguments cut against the deduction as an instrument of federalism. Viewed at this level of remove, the deduction looks like a very crude tool for

188. See PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, *supra* note 9, at 83; Oates, *supra* note 131, at 1126–27.

189. For a mathematical model of this prediction, see Craig Volden, *Intergovernmental Grants: A Model of Political Competition in a Federal System* 9–22 (unpublished manuscript, on file with author), available at http://www.kellogg.northwestern.edu/meds/papers/econ_volden.pdf.

190. See Baker, *supra* note 130, at 1933–36; McCoy & Friedman, *supra* note 135, at 86; Somin, *supra* note 177, at 468; Stewart, *supra* note 127, at 971.

191. For an in-depth discussion of the evidence and its best interpretation, see Brian Galle, *Federal Grants, State Decisions*, 16 SUP. CT. ECON. REV. (forthcoming 2008) (manuscript at 69–78, on file with author), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963915.

192. See Shaviro, *supra* note 12, at 919–21, 925–26.

193. See Brian Galle, *Designing Interstate Institutions: The Example of the Streamlined Sales and Use Tax Agreement (“SSUTA”)*, 40 U.C. DAVIS L. REV. 1381, 1396, 1402–28 (2007) (analyzing the effects of choice of institutional form on the tradeoff between diversity and other federalism values).

either strategy. For one, it doesn't distinguish between federal programs that themselves reward and promote state experimentation and those that simply replace it with one set of uniform rules.¹⁹⁴ Further, Kaplow's criticism of the deduction's flaws seems especially trenchant here: we could accomplish these same effects, with none of the distortions and administrative difficulties of the deduction, by simply enacting a law requiring Congress to fund all of its mandates.

Thus it may be difficult for us to isolate horizontal equity from other policy considerations. In our effort to ensure fairness for taxpayers in different jurisdictions, we may interfere with other federal efforts at fairness or efficiency. It might be possible, though, to construct a notion of horizontal equity in which we can account for these additional effects. For instance, as we saw with the equity treatment of those the federal government regards as discriminators, we could set a baseline of "fair" comparisons. In the next Part, I attempt to sketch one possible such approach to equity.

VI. BEYOND SUBJECTIVE WELL-BEING?

Although my analysis over the past few Parts has drifted fairly far in different directions, it has one strong undercurrent: it is extremely difficult to reach fine-grained, or at times even coarse, conclusions about the welfare effects of local government on different taxpayers. Some of the obstacles seem unique to local government, as with the effects of federal grants. Yet others, such as doubts about whether consumer choices maximize consumer welfare, call into question whether utility analysis can be a coherent tool for tax policy generally. The dilemma of measuring and comparing individual welfare is not unique to the SALT deduction, and tax theory has previously hazarded some rough solutions. In this Part, I suggest that most of these solutions also leave us largely unable to compare taxpayers based on their welfare. Some new approaches may be more workable, but, importantly, these approaches appear limited to SALT and other deductions like it.

One common response among tax theoreticians to the problem of divergent individual wants and behavior is to assume that we can simply average away the differences. Consider the Buddhist monk and the exceptionally venal millionaire. A basic assumption of vertical equity—that is, of tax policy's treatment of distributive justice—is that money has declining marginal utility.¹⁹⁵ My first dollar is worth much more to me than my millionth. But to the monk who renounces all worldly concerns, consumes only donated rice, and lives on a mountainside, the first dollar is subjectively worth much less than the millionth dollar to the venal millionaire.

Many economists, especially those working in the optimal-tax tradition associated with James Mirrlees, deal with this difficulty by assuming an

194. I elaborate on this point in more detail in my discussion of the subsidy arguments for and against the deduction. Galle, *supra* note 17, at 696–701.

195. DODGE, *supra* note 23, at 301–06.

identical utility function, such that in our minds there are, in effect, neither monks nor millionaires.¹⁹⁶ No doubt the monks would approve.

Other commentators justify this approach by resorting to a wave of the administrability broom: the presumption of declining marginal utility is a reasonably accurate baseline that may miss some nuance but is easier to administer than more accurate measures.¹⁹⁷ Instead of identical utility functions, this view posits that deviations from the average utility function are evenly distributed throughout the population. Thus, formulating policy *as if* everyone is identical will result in no net change to total welfare since those who are overrewarded average out with those who are undercompensated by any given policy choice. This assumption is very useful for economic modeling, since it greatly reduces the mathematical complexity of any model. And from the perspective of an individual taxpayer, the odds of being treated either too generously or not generously enough should be equal.

Our recent encounters with the SALT deduction suggest that such generalization may be unsatisfying when we begin to peer very closely at the fairness of the tax system for each individual.¹⁹⁸ The claim that individual differences can be averaged away, or that an individual can expect an equal chance of being either over- or underrewarded by the tax system, puts pressure on empirical measures of real utility curves.¹⁹⁹ What, for instance, becomes of the assumption of declining marginal utility in a society with lots of monks or venal millionaires? Similarly, as we saw with the SALT deduction, there may be unexpected distortions away from our baseline assumptions. Gathering enough information to give us confidence about the likelihood of an even distribution is challenging because (at least in the experienced utility model) the self-reporting or behavior of individuals who do not know what would maximize their own utility is likely unreliable.²⁰⁰

196. The foundational article in optimal-income-tax theory is J.A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 *REV. ECON. STUD.* 175 (1971). For a lawyer-friendly summary of optimal-tax theory, see Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 *CAL. L. REV.* 1905, 1946–58 (1987). On the assumption of identical utility functions, see *id.* at 1947.

197. See DODGE, *supra* note 23, at 305–06; DANIEL SHAVIRO, *WHEN RULES CHANGE: AN ECONOMIC AND POLITICAL ANALYSIS OF TRANSITION RELIEF AND RETROACTIVITY* 27–32 (2000); Bankman & Griffith, *supra* note 196, at 1947–48; Musgrave, *supra* note 29, at 6 n.4, 8–9, 14 (examining various compromises that administrable measures of equity demand).

198. Cf. Musgrave, *supra* note 29, at 16 (arguing that presumption of identical utility functions is too inaccurate to be satisfying grounds for tax theory); Daniel Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Income*, 45 *TAX L. REV.* 215, 224–26 (1990) (claiming that, while it is administratively necessary to use income or consumption as proxies for well-being, tax policy should still be “guided by the goal of approaching as closely as possible what we believe are the underlying subjective realities”).

199. See BLUM & KALVEN, *supra* note 29, at 53.

200. Even in a world of rational actors, designing a tax system based on utility is difficult because individuals who are taxed based on their reported or observed utility will obviously have incentives to underreport. A variety of economists have imagined theoretical solutions to this problem, with generally mixed results. See Fried, *supra* note 29, at 170–72 (summarizing and critiquing Lindahl, Samuelson, and Tiebout).

One potential response to these uncertainties could be to adopt a set of second-best rules. We can expect that our tax rule will sometimes fail to correspond with an individual's actual utility. In the SALT context, we may have false positives that can sometimes erroneously grant a deduction when the taxpayer's local government delivers to her more than she pays. Other errors will be false negatives that can deny deductions that in theory the taxpayer deserves. While we may be unable to predict precisely when these errors will occur, we can derive a second-best outcome based on which form of error we would prefer to avoid. Suppose we suspect that overpaying taxpayers are likely to be worse off than underpaying taxpayers, as they will be less likely to be wealthy. If we are more concerned about the welfare of those who are less wealthy (for instance, if we believe in the declining marginal utility of wealth), we might well set a rule that tended to overpay.

Unfortunately, these forms of error-avoiding, second-best rules still demand a fair amount of information. Second-best judgments will turn on matters of degree. We might care more about false negatives, but not to the point that we are willing to overpay by billions of dollars to avoid them. Thus, we are likely to be uncomfortable even with our second-best rule unless we have at least ballpark guesses about the size and direction of each kind of error. At present, though, our empirical uncertainty about the welfare effects of consumer choice, particularly the effects of policy responses to irrational consumers, is such that we may not even be in the parking lot of the ballpark.

Another tactic for rehabilitating welfare comparisons could be to reconceive the meaning of utility. Arguably, the only truly thorough account of tax fairness grounded in utility theory would have to resort to objective or hypothetical utility. By objective utility I mean the satisfaction that an individual, in the policy analyst's judgment, *ought* to derive from a particular choice or situation. Assuming, as Kaplow does, that purchase price equals subjective utility moves in this direction.²⁰¹ But markets may be distorted by cognitive biases, collective-action problems, and other familiar devils.²⁰² Objective utility describes purchase price in an ideally functioning market.²⁰³

201. Kaplow, *supra* note 12, at 439; *see also* Sunstein & Thaler, *supra* note 65, at 1191 (noting the authors' "reliance on behavior as an indication of welfare").

202. *See supra* text accompanying notes 48–67.

203. *See* John C. Harsanyi, *Morality and the theory of rational behaviour*, in *UTILITARIANISM AND BEYOND* 39, 55–56 (Amartya Sen & Bernard Williams eds., 1982); Kaplow, *supra* note 47, at 504; *cf.* Lewinsohn-Zamir, *supra* note 46, at 379, 394 (arguing that consumer preferences should be assessed in light of how those preferences would be expressed absent collective action problems). For alternative notions of objective utility, see ELSTER, *supra* note 84, at 125–40, which claims that a meaningful measure of welfare requires the satisfaction of fully autonomous choices; MARTHA C. NUSSBAUM, *WOMEN AND HUMAN DEVELOPMENT* 150–55 (2000), which argues that preferences are simply an "epistemic" tool for identifying central human capabilities and universal values; and Amartya K. Sen, *Women, Technology and Sexual Division*, *TRADE & DEV.*, 1985, at 195, which develops an argument that welfare measures should include not only mental states but also human "functionings" and "capabilities." For a helpful overview and critical discussion, see T.M. SCANLON, *WHAT WE OWE TO EACH OTHER* 108–43 (1998). As an additional note, objective utility should not be confused with what Professor Kahneman labels "objective well-being," which in his usage refers to "happiness data" from self-reporting, brain imaging, and the like. Daniel Kahneman, *Objective*

Alternatively, hypothetical utility might measure relative utility according to a fair set of judgments that would be equally acceptable to every participant.²⁰⁴ For example, given that we would likely want to maximize society's available resources if we did not know our future social position or preferences, we may favor efficient over inefficient outcomes.²⁰⁵ But at the same time, we would recognize that money typically does have declining marginal value, thereby making a fair degree of progressivity in the distribution of benefits and burdens desirable.²⁰⁶

A possible difficulty for both of these approaches is that they are not utilitarian, or at a minimum they contravene some core goals of most utilitarians. Both seem likely to produce a handful of relatively uncontroversial propositions, such as our earlier conclusion that committing racial discrimination should not be grounds for a deduction. Beyond that common ground, though, it can be plausibly argued that the policymaker's selection of criteria on which to judge what taxpayers objectively should or hypothetically would value cannot be value neutral. Instead, it will reflect the preferences of the policymaker rather than the individualized value orderings of each consumer.²⁰⁷ Some commentators would find this unproblematic inasmuch as they believe that the tax system should reflect an overall vision of social justice, even if that vision is contestable.²⁰⁸

Others, however, might object that these approaches are not true to the aims of policy analysis grounded in theories of utility.²⁰⁹ Utility has both a practical and a deep moral contribution to the study of equality. On the practical front, measures of utility based in actual behavior permit more academic rigor. We can remain open to gathering information about what individuals want without clouding our analysis by presupposing the an-

Happiness, in WELL-BEING: THE FOUNDATIONS OF HEDONIC PSYCHOLOGY 3 (Daniel Kahneman et al. eds., 1999).

204. JOHN RAWLS, *A THEORY OF JUSTICE* 12, 136–42 (1971).

205. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 453–54 (3d ed. 1986).

206. See Bankman & Griffith, *supra* note 196, at 1953–66.

207. See James S. Fishkin, *Justice Versus Utility*, 84 *COLUM. L. REV.* 263, 266, 269–70 (1984) (reviewing *UTILITARIANISM AND BEYOND* (Amartya Sen & Bernard Williams eds., 1982)); Kaplow, *supra* note 47, at 509 n.1; cf. Donna M. Byrne, *Progressive Taxation Revisited*, 37 *ARIZ. L. REV.* 739, 753 (1995) (explaining that interpersonal utility comparisons are difficult, in part because they invite the comparer to supply her own standard for comparison); Lewinsohn-Zamir, *supra* note 46, at 381 n.9 (“[I]t may be argued that the hypothetical preferences theory is not a theory of preferences at all.”); Sunstein, *supra* note 50, at 222 (“[I]t may be impossible to describe something as a ‘preference’ without undertaking some controversial normative tasks.”). *But see* Harsanyi, *supra* note 45, at 142–44 (arguing that hypothetical utility can be neutrally measured by observing behavior of other similar individuals).

208. See MURPHY & NAGEL, *supra* note 10, at 38–39; Thomas D. Griffith, *Should “Tax Norms” Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 *WIS. L. REV.* 1115, 1152–55, 1158.

209. I include in this group both strict utilitarianism as well as “welfarism” writ more broadly. They differ insofar as utilitarianism is indifferent to distributions of utility except to the extent that such differences impact individually experienced utility, while other forms of welfarism may take utility into account but also factor in considerations about the most desirable distribution of utility. For a more in-depth account, see Matthew D. Adler & Chris William Sanchirico, *Inequality and Uncertainty: Theory and Legal Applications*, 155 *U. PA. L. REV.* 279, 291–95 (2006).

swer.²¹⁰ More philosophically, utility can claim to honor equality by giving equal weight to the expressed desires of each individual rather than devaluing those preferences deemed by the policymaker inconsistent with “objective” preferences.²¹¹ We might doubt, for example, that a researcher or policymaker could determine what an “ideally” functioning market comprises without injecting her own vision of social justice.²¹²

It is difficult to say, then, whether the move to objective or hypothetical utility resolves our problem or broadens it. Quite possibly, the swamp in which we now stand hip deep should weigh against the allure of utilitarian analyses, at least when it comes to horizontal equity. There seems little point in arguing that we have unfairly treated like taxpayers if we cannot agree how to fairly compare them. Can we narrow the field, by asking whether either the objective or subjective approach to utility is inconsistent with the overall project of horizontal equity? Unfortunately, at present, no consensus exists on what purposes the horizontal-equity norm in fact serves, whether those norms are coherent in their own right, or whether they instead must rest on some underlying and contestable theory of distributive justice.²¹³ Thus, perhaps it is horizontal equity, not utility, that should be in peril.²¹⁴

But before we abandon hope, two other potential moves, each arguably less problematic than objective utility, might still do useful intellectual work, if only in the limited context of benefits and burdens received from state or local government. First, we might consider measuring the utility of

210. See Stiglitz, *supra* note 179, at 36. On the other hand, one could also respond that ignoring the problems of expressed preferences and assessing “utility” solely on the basis of actual consumption is itself not a neutral choice. *E.g.*, Patrick B. Crawford, *The Utility of the Efficiency/Equity Dichotomy in Tax Policy Analysis*, 16 VA. TAX REV. 501, 514–15, 521 (1997); see also BLUM & KALVEN, *supra* note 29, at 69 (arguing that the “ostensibly scientific” approach of measuring consumer behavior “frequently conceals a normative judgment either about the way people ought to value money or about the social value of typical expenditures at different levels of income” (footnote omitted)).

211. See NUSSBAUM, *supra* note 203, at 117 (noting this possible argument in favor of welfarism).

212. See Schoenblum, *supra* note 159, at 223, 230 (arguing that experts and bureaucrats cannot be trusted to make objectively correct tax-policy decisions, while also asserting that this same problem applies to efforts at employing utilitarianism); *cf.* Stiglitz, *supra* note 179, at 38–39 (arguing that horizontal equity may be a check against distortions of utilitarian analysis within the political process). It should be noted that at least one of Rawls’s explicit goals was to counter this argument by appealing to claims that “all can accept.” John Rawls, *Kantian Constructivism in Moral Theory*, in MORAL DISCOURSE AND PRACTICE: SOME PHILOSOPHICAL APPROACHES 247, 248 (Stephen Darwall et al. eds., 1997); see McCaffery, *supra* note 29, at 75–76.

213. For a selection of the various perspectives on this front, see *supra* note 10.

214. In a future work, I will offer a freestanding justification for horizontal equity. For now, it is perhaps sufficient to say that we could think of horizontal equity as expressing our belief in a default presumption in favor of the existing status quo distribution, and that this default presumption is useful to the extent that it represents an incomplete agreement to formulate tax policy while taking as given all of the surrounding facts and preferences of society. Viewing the goals of equity in this way, we might see significant difficulties in invoking any single notion of hypothetical utility across state boundaries. The states, after all, are themselves sovereign in some sense. Therefore, a question exists as to whether one single policy judgment about the appropriate measure of utility is consistent with our ideal of state individual political sovereignty.

taxpayers from an ex ante rather than ex post perspective.²¹⁵ That is, we might consider whether the taxpayers under comparison took certain risks which offered comparable *expected* average utility before the result of the risk was known.

This argument is common in the law of takings.²¹⁶ Individuals acquire property knowing that they are subject to the risk of legal regulation that will reduce the value of their investment. Over the long-term, however, we expect that a fairly constituted government will deliver, at worst, an equal distribution of gains and losses.²¹⁷ Viewed from the ex ante perspective, the owner who suffers a taking has been treated no differently than any other property holder; all took a similar risk of suffering temporary, disproportionate losses.²¹⁸ Alternatively, from an efficiency perspective, compensation may encourage overinvestment in risky bets.²¹⁹ We could similarly say of state and local taxpayers that each is equally likely to experience temporary losses in welfare in excess of gain from their government, and that, having freely accepted that risk in choosing her jurisdiction, the taxpayer has no equitable or efficiency claim to ex post compensation in the form of a deduction.²²⁰

215. For an overview of the ex ante–ex post question in welfare theory generally, see Adler & Sanchirico, *supra* note 209, at 285–322. For contrasting views of its application, compare Donald T. Hornstein, *Reclaiming Environmental Law: A Normative Critique of Comparative Risk Analysis*, 92 COLUM. L. REV. 562, 595–98 (1992), with Kaplow, *supra* note 10, at 143–48.

216. For the early definitive work, see Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967).

217. RAWLS, *supra* note 204, at 380–81.

218. See SHAVIRO, *supra* note 197, at 18; Ronald Dworkin, *What is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283, 294 (1981).

219. That is, if an owner knows she will be compensated for takings or other losses, she will invest in property at risk of loss without respect for that loss, even if society would be better off if she avoided investing. See Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CAL. L. REV. 569, 596–97 (1984); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 531, 541 (1986). There is considerable nuance to this claim. See Barbara H. Fried, *Ex Ante/Ex Post*, 13 J. CONTEMP. LEGAL ISSUES 123, 129–31 & n.11 (2003); Kaplow, *supra*, at 536–50.

220. See Barbara H. Fried, *Compared to What? Taxing Brute Luck and Other Second-Best Problems*, 53 TAX L. REV. 377, 393–94 (2000) (identifying a similar argument but disagreeing with some of its premises); Michael J. Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1834–35 (1985); cf. Adler & Sanchirico, *supra* note 209, at 361 (noting that ex ante equity analysis of capital gains taxation might be indifferent to distributive consequences of divergence between winning and losing investments); Stiglitz, *supra* note 179, at 1–2 (pointing out the possibility of defining horizontal equity in tax by reference to ex ante distribution of probable outcomes). Key to this argument is the point that if individuals are aware of the extent of the risks they run, they can insure against them. Thus, if risk is disproportionate to insurance, negative ex post outcomes result from a choice not to insure. See Adler & Sanchirico, *supra* note 209, at 285–322 (explaining conditions in which this would likely hold true).

Some commentators have argued that state taxes should be deductible to the extent that they are redistributed to others, on the ground that those funds are not consumed by the taxpayer. Boris I. Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 200–01 (1973). However, the extent to which transfer payments really do not benefit the transferor, even ex post, is questionable. See DODGE, *supra* note 23, at 103; MURPHY & NAGEL, *supra* note 10, at 145–48.

Commentators offer some strong arguments against this strict no-compensation view, but at least some of their claims have less force in the special case of state and local taxes. One familiar objection is that compensation may encourage individuals to engage in efficient behavior.²²¹ We tend to think that people avoid risks when they cannot obtain insurance.²²² In other instances, individuals may irrationally overestimate risk and so overinsure.²²³ Both of these outcomes are socially undesirable. Even if individuals are insured against risk and act rationally, they may “underrisk” from a social perspective if externalities are involved. Thus the promise of compensation can serve as a form of insurance or as a method for paying people to take larger risks than their own personal gains would merit.

It is hard to tell this welfare-enhancing compensation story about § 164.²²⁴ In theory, the availability of a deduction, either in all cases or in those instances where government burdens can be shown *ex post* to exceed benefits, should encourage us to be “riskier” in our choice of governments. We might be more willing to move to a jurisdiction that offered services we are uncertain we will appreciate or that are of dubious quality, knowing that the deduction will soften the blow if we choose wrongly. This enhanced willingness to move and experiment could produce positive externalities for others, particularly if it has the effect of rewarding innovative government. On the other hand, the deduction might simply reinforce our inertia, since staying at home, too, is a risk: a risk of regretting foregone opportunities.²²⁵ Further, without knowing the exact degree of our risk aversion and the deduction’s effect on it, granting a deduction might produce excess risk. We might become so indifferent to the hazards of bad local government that we underinvest in our efforts to learn about it, engage with it, and change it. That, obviously, would likely reduce overall social welfare.

Another established critique of the no-compensation rule, albeit one itself subject to much debate, is that it is unfair to attach moral consequences to some kinds of risks. For instance, it might be argued that since everyone must eat, it would be unfair to hold individuals strictly to the consequences of the risks they run in obtaining just enough sustenance to survive. Similarly, one could say that only genuine, freely chosen risks should have moral

221. Fried, *supra* note 219, at 145–46, 148; Kaplow, *supra* note 219, at 549–50.

222. See Kaplow, *supra* note 219, at 596.

223. See Fried, *supra* note 219, at 157–58; Kaplow, *supra* note 219, at 549.

224. One might also argue that *ex ante* utility is a poor fit for our tax system generally. After all, we permit deductions for losses on investments, I.R.C. § 165(c)(2) (2000), when it might be said that on average the investment was simply a bet that failed to pay off. It should follow, as a matter of *ex ante* utility, that the loser is no worse off than one whose investments gain and should be entitled to no deduction. Since this is not the law, the argument would go, we can conclude that our law generally rejects the use of *ex ante* measures of utility. It is possible, however, that our decision to grant the deduction reflects not a purely equitable analysis but rather a calculation that in the absence of a deduction, individuals would underinvest. *Cf.* Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388, 389 (1944) (explaining that in the absence of deductibility for losses, individuals will choose less-risky investments than they would absent tax).

225. See Galle, *supra* note 17, at 696–701.

consequences.²²⁶ Eventually, as Barbara Fried has suggested, this type of claim reduces to the argument that individuals should be compensated for rationally undertaking reasonable or prudent but not unreasonable risks.²²⁷ The reasonableness prong here looks to be a reformulation of our earlier discussion of objective utility, while the rationality requirement poses again the question of how government should best respond to behavior that appears in one sense or another irrational. Thus it looks as though ultimately the move to ex ante measures of utility leaves us mired in the same spot as our earlier efforts.

My last effort at salvaging a useful measure of the horizontal equity of gains and losses from local taxation begins by returning to the notion that, in the long-term, we should expect a fair government to deliver a roughly even proportion of benefits and burdens to all its constituents. If we accepted this view, the equity case for the deduction would likely be much weaker. Recognizing year-by-year deductions or inclusions would fail to acknowledge that each state government will ultimately smooth out temporary ups or downs for each taxpayer, and that states are treating each taxpayer the same regardless of momentary bottom line. That would be true regardless of whether we were measuring ex ante expected utility or ex post actual welfare.

Note, though, that reaching this result would require two important assumptions. First, we would have to attach a very strong presumption of justness to the outcomes of state taxation and regulation. For example, even if the average expected return to all citizens of a given local regime is net positive, there still may be some large net losers. In order to refuse the claim for deduction by these unfortunates, we would have to assume either that in the end what appears an injustice will be made right as to those persons or alternatively that we will refuse to second-guess the locality's decision to leave some losses as they fall.

Second, we would have to presume either that the locality would correct for the effects of the time value of money or that the federal system would be indifferent to it. For instance, if our taxpayer A is a net loser in year one but expects to be a winner in year five, she is still worse off than taxpayer B in the reverse situation because taxpayer B can invest her year-one gains.²²⁸ So we would have to assume that the year-five gains that A realizes will be enough to offset the fact that they arrived later while her losses arrived earlier. Alternatively, the decision to impose no tax and grant no deduction could rest on a decision to make the federal choice of temporal justice sec-

226. See Fried, *supra* note 219, at 136–49, 157–58; Daniel Markovits, *How Much Redistribution Should There Be?*, 112 *YALE L.J.* 2291, 2300–03 (2003).

227. Fried, *supra* note 219, at 157–58. For example, a strict utilitarian in a society in which distribution is unimportant would say that there is no difference between the ex ante and ex post views because overall utility is the same in either. See Adler & Sanchirico, *supra* note 209, at 334. Thus before we can critique either view, we must first specify a social-welfare function with some distributive component.

228. See Stiglitz, *supra* note 179, at 30 (observing that the opportunity for savings implies that lifetime smoothing of year-to-year inequalities may still be inequitable).

ondary to local choices. That is, we could simply accept the state government's claim that its overall system is just, irrespective of any "failure" to strictly account for time effects.²²⁹

By itself, tax theory does not supply any clear justification for why we would make either set of assumptions, but tax aficionados may notice that this approach bears some strong resemblances to the tax treatment of loans. In theory, we might tax "income" from a loan at the time it is received and grant a deduction at the time of repayment. Instead, however, genuine loans with market-rate interest result in no tax for cash-method taxpayers.²³⁰ Although this may not fully capture the welfare effects of the loan, especially in times of inflation,²³¹ the administrative costs of determining the welfare effects more precisely would likely exceed the gains to individuals of more accurate assessment.²³² This assessment, though, depends on an assumption about the relationship between the lender and borrower: it assumes that the transaction is at arm's length, so that most risks of inflation or default are reflected in the pricing (for example, in the interest rate) of the loan.²³³

A no-deduction rule for state and local taxes would rest on a similar type of assumption about the relationship between individuals and their government. It would assume, as I said, that local government is "fair," such that the occasions on which losses will on net exceed gains are so rare that they are administratively not worth determining. Quite possibly our commitment to state sovereignty, or the constitutional guarantee to states of a republican form of government,²³⁴ obliges the national government to make that assumption as a general rule. But just as the rule for loans has exceptions where its assumptions break down,²³⁵ so too it is possible that our presumption against local unfairness in certain situations might be so likely to be unjustified as to merit a deduction. For instance, the Court and scholars have famously described many constitutional violations as cognizable where the fair processes of government fail.²³⁶ It might follow that there should be a

229. Cf. Zolt, *supra* note 29, at 93–94 (arguing that use of horizontal equity to evaluate annual tax assessment may be misguided since justice in distributions often happens over period of years).

230. *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983).

231. See Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CAL. L. REV. 1159, 1160 n.5, 1163–64 (1978) (describing reasons loans may change in value during the life of the loan).

232. See *id.* at 1165–66; Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated*, 26 VA. TAX REV. 245, 248, 280 (2006).

233. JOSEPH M. DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY* 286–87 (3d ed. 2004); see I.R.C. § 7872 (2000) (treating portions of certain below-market-interest loans as income).

234. U.S. CONST. art. IV, § 4. I am grateful to Ron Pearlman for suggesting a version of this argument.

235. See DODGE ET AL., *supra* note 233, at 288–90, 299–300 (providing examples of below-market loans and phantom repayment obligations); Bittker & Thompson, *supra* note 231, at 1187 (providing the example of cancellation of indebtedness).

236. That, of course, is the classic account of the basic justification for judicial review formulated by John Hart Ely, among others. JOHN HART ELY, *DEMOCRACY AND DISTRUST* (1980); Frank I.

deduction for individuals who are victims of constitutional wrongs inflicted by their local government. Conceivably the federal government, if it so chose, could then file a suit against the actual wrongdoer to recover its lost funds.

In the end, it may be possible to resolve the problem of horizontal equity among state and local taxpayers, but perhaps only by assuming that any differences among the taxpayers are typically too small to be worth notice. That assumption, to the extent it is contrary to fact, depends on a theory of relations between the federal government and the states external to tax theory itself. As a result, we must once more confront our vision of nationhood before we can answer our tax question satisfactorily. Alternatively, we can confront the issue of tax equity head on. But there our problem grows from defining nationhood to defining justice more broadly or to deciding to adopt some notion of horizontal equity that is independent of controversial justice norms. In a work in progress I essay the latter. For now, it is likely that tax theory, standing alone, cannot satisfactorily answer whether either the income tax or the AMT tax base ought to grant a deduction for taxes paid to state and local governments.

CONCLUSION

In large measure my analysis here has confirmed the received wisdom that the equitable case for a deduction for state and local taxes is tenuous. But in a sense it now seems that the purely theoretical equity case for the SALT deduction is stronger than its critics, including even Kaplow, have recognized. Where once it was said that paying SALT is simply a freely chosen consumption choice, such that no deduction could ever be justified, there now is at least a possibility that, depending on empirical findings, some deduction could be warranted.

For example, a deduction or credit may make some sense for taxpayers unable to correlate state burdens with state benefits due to cognitive biases and other frictions. To be sure, we cannot confirm that claim without a better understanding of how taxpayers connect state taxes with state services and how those processes change in response to the grant of a deduction. Further, to make the deduction theoretically coherent, we need a way to ensure that its benefits flow primarily to those who in fact are stranded rather than to those with access to good tax advisers. We don't have strong enough data to establish whether these frictions are sufficiently predictable to justify a tax rule in one direction or another, and as a result we may prefer to invoke a theory of welfare that would ignore any such differences. But that is not the same thing as saying that no such data can ever be gathered.

On the other hand, I have also shown that the equity case for certain local taxes may be weaker than for others. In particular, *ad valorem* local

Michelman, *Welfare Rights in a Constitutional Democracy*, 1979 WASH. U. L.Q. 659. That is not to say that the theory is without its own problems. See, e.g., Paul Brest, *The Substance of Process*, 42 OHIO ST. L.J. 131, 134-37 (1981); Laurence H. Tribe, *The Puzzling Persistence of Process-Based Constitutional Theories*, 89 YALE L.J. 1063, 1072-77 (1980).

property taxes probably should not be deductible under traditional equity analysis. Property values seem in some cases to be a meter for local taxpayers' consumer excess, so granting deductions for higher property taxes would be rewarding exactly those taxpayers whom theory suggests should be paying higher, not lower, federal taxes.

Given the vast budget space allocated to the deduction each year and the centrality of § 164 in debates about the AMT, these two conclusions are worthy of note standing alone. But my analysis here suggests some larger questions.

First, the choice to deduct state and local taxes has ramifications far more wide reaching than individual fairness to taxpayers. Neither the economic nor legal literature has fully considered the extent to which the SALT deduction (or its absence) could undermine (or strengthen) efforts to promote nationwide uniformity (or diversity). If we think that the choices between diversity and uniformity and between experiment and certainty should arise out of the political marketplace or out of free bargaining between the states (through their agents in Congress), then the deduction distorts that market, generally in favor of diversity. That result is usually, if not universally, unfortunate. Thus the deduction should have a place in debates about the appropriate distribution of authority between the states and the federal government.

Finally, this Article raises some questions about the very possibility of making meaningful comparisons between individual taxpayers. If I am wrong about the possibility of better understanding taxpayer irrationality, then it may follow that we cannot definitively establish the welfare effects of any kind of consumer choice. As we have seen, there are some modulations of welfare theory that might allow us to make use of utility as a tax yardstick. But the most effective of these turned on special regard for the decisions of state and local governments. It remains questionable whether any of these efforts can serve outside that particular context. Whether horizontal equity as a concept can be rehabilitated in the face of these uncertainties remains a task for another day.