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Articles

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OUTLINE

* Assistant Professor of Law, University of Nebraska College of Law. J.D. 1981, University of Michigan, LL.M. (Tax) 1986, New York University. This article is dedicated to my grandparents, who have received too little credit for the ways in which they have enriched my life. Burrell C. and Elsa G. High, and the late Samuel J. McCombs, Jr. (1898-1987) and Cecile K. McCombs (1902-1987). I am also indebted to Jami Changaris Voge, my brilliant and ruthless editor.

In the Tax Reform Act of 1986 Congress repealed the long-standing personal deduction for state and local sales taxes.[1] The similar allowance for deduction of state and local income and property taxes was retained.[2] This article describes a new treatment of all three of these state and local taxes, which is different than the new law and the prior law.

The first question addressed is whether a general sales tax should be treated differently than income and property taxes. After concluding that the payment of all three types of tax should be combined and subjected to a single treatment, the second question addressed is how that combined total should be characterized and treated, for federal income tax purposes.

COMPARE THE PRACTICAL ECONOMIC EFFECT OF DIFFERENT TAX TYPES

The Haig-Simons definition of income is widely accepted as describing the theoretically ideal income tax base.[3] It defines income as the sum of the taxpayer's consumption of goods and services plus the net increase in his or her savings and investments during the year.[4] There is no serious argument that state and local tax payments represent any form of savings or investment by the individual taxpayer. Therefore, the focus throughout this article is on their possible characterization as a form of consumption by the taxpayer.

One plausible view of a sales tax is that it is an integral part of the cost of consumption. Because consumption is one component of the Haig-Simons definition of income, that view leads to the conclusion that sales tax payments are part of one's income, and should not be deductible for federal income tax purposes. In other words, the sales tax on a new stereo is no different, economically, than the actual purchase price of the stereo. From this viewpoint, the recent change improves the theoretical soundness of the law.[5]

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1. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 134(a)(1), 100 Stat. 2085, 2116 (1986) [hereinafter cited as TRA 1986], amending 26 U.S.C. § 164(a) (1985).
2. I.R.C. § 164(a) (1986).
3. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 313 (1972) (hereinafter cited as Andrews); Block, *Personal Deductions Under the Bradley-Gephardt Fair Tax Act: Necessary Departures from the Ideal?*, 29 ST. LOUIS U.L.J. 921, 931 (1985); Turnier, *Evaluating Personal Deductions in an Income Tax—The Ideal*, 66 CORNELL L. REV. 262, 263 (1981).
4. H. SIMONS, PERSONAL INCOME TAXATION 50 (1938).
5. Turnier, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 VILL. L. REV. 1703, 1735 (1986).

The foregoing argument appears to be correct, if one views the issue through a close-up lens. This author looks at the big picture and comes to a different conclusion.

In a world where the average individual taxpayer spends ninety-eight percent of his earnings, there is very little practical difference between an income tax that takes five percent from the taxpayer as he earns it, and a sales tax that takes five percent from the taxpayer as he spends it. The taxing government receives an essentially identical pound of flesh under either system. In both cases, the taxpayer has the same amount of after tax income remaining to purchase the goods and services he desires to consume. Although the two systems as found in practice have somewhat different impacts due to their differing deductions and exemptions, as a general proposition sales tax and income tax are more alike than different in their real economic effect. They represent government attempts to take water from the same stream, but simply at different points along its course. The theoretical argument to distinguish them breaks down when transferred to the real world where saving approaches zero and income virtually equals consumption.

The similarity between sales and income tax increases when a consideration of the property tax is added to the analysis. One major difference between the economic impact of an income tax and that of a sales tax is that the dollars used to buy[6] or rent a home are subjected to the income tax, but are not normally reached by the sales tax. The real property tax, by taxing those dollars at the expenditure end of the stream, fills this gap left by the sales tax structure. A property tax can be viewed as a massive sales tax on the construction and sale of a new home, which is collected (with interest) over the life of the home. Sales and property taxes, viewed together, tax nearly all dollars as they are spent. The income tax reaches nearly all dollars as they are received.[7] An income tax dips from the taxpayer's stream of money at one point, while the sales and property taxes together take from the same stream at a different location. Therefore, any federal distinction between these three types of general revenue taxes is not well founded in theory.[8]

6. I am referring here to the actual purchase price, to the extent paid in cash, or principal payments on a home loan.

7. Note that interest payments on a home loan escape taxation under all three tax types, thereby continuing the similarity in a negative way. The food exemption in most sales taxes and the analogous portions of the personal exemption and standard deduction in the federal income tax further extend this similarity.

8. In practice, one political difference is that income taxes are traditionally progressive,

The foregoing argument is not meant to imply that all forms of state and local taxes are economically equivalent and should receive consistent federal tax treatment. The basic similarity between the three principal types of tax systems does not carry over to a sales or excise tax imposed on a narrow category of goods or services. The taxes imposed on liquor and cigarettes are not at all comparable to an income tax, because a class of people who all have the same income will spend widely varying amounts on alcohol and tobacco. Shifting from an income tax to a "sin" tax will cause a significant shift in the burden of the tax. Shifting from an income tax to a broad based, general sales tax will cause only a moderate rearrangement of the tax burden, within any given income class, because most people spend almost every dollar they earn. The different federal treatment of sin taxes paid is theoretically sound.

Furthermore, the separate treatment of gasoline taxes is similarly defensible. In addition to the preceding analysis of narrow based sales taxes, which does apply to the gas tax, another difference between the gas tax and the three principal types of taxes is the fact that a gas tax is intended as, and has the effect of, a toll for the use of the roads. The more one drives, the more one pays. It is economically equivalent to having a toll booth on every road in the state, but is much simpler and more efficient. If actual tolls paid for the use of toll roads and bridges are not deductible, gas tax payments should also not be deductible. If a state raised more money from its gas tax than it spent on the road system, the excess amount could not be characterized as a toll charge; it would be a narrow based sales tax as discussed above, and would not be subject to this argument. In fact, state and local gas taxes typically pay less than one-third of total road costs.[9]

In addition to the above comparison of the economic impact which the state and local income, property, and sales taxes have on the taxpayer, there is a strong federalism argument for applying the same federal tax treatment to each of said taxes. Each of these three taxes represents a major source of state and local revenue, and the federal government should not arbitrarily allow the great power of the Internal Revenue Code to affect a state or local government's decision

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or made to appear so, while sales taxes are regressive. This follows from the annual versus transactional methods of accounting; but I do not think it destroys the basic similarity alleged in the text, especially since some state income taxes are not progressive.

9. Manvel, *A Deficit-Cutting Extra Gasoline Tax?* TAX NOTES 509, 510 (May 4, 1987).

of which source(s) to use, and in what proportions. In 1979, the American Bar Association, Section of Taxation, Special Committee on Simplification (hereinafter, ABA committee) reviewed a major tax reform proposal by the Treasury Department, entitled Blueprints for Basic Tax Reform.[10] With respect to Blueprints' proposed treatment of state and local taxes, the ABA committee made the following recommendation:

> On balance, the Committee favors continued deductibility of the taxes here considered. [Income, sales, and property taxes.] It reaches this conclusion because it believes, as the authors of *Blueprints* apparently also do, that it would be impractical to eliminate the deduction for income taxes. Moreover, the Committee considers it highly desirable for the federal tax system to remain neutral with respect to the choices made by states and localities regarding the major sources of tax revenue available to them.[11]

This argument was also made (and heeded) in the Congressional debate over the Revenue Act of 1964. After concluding that state and local income and property taxes should remain deductible, the House Ways and Means Committee stated:

> If property and income taxes are to be deductible in computing income subject to Federal income tax, it also becomes important to allow the deduction of general sales taxes as well. These are the three major sources of State and local government revenue, and were the Federal Government to allow the deduction of some but not all of these taxes, it would be encouraging State and local governments to use one or more of the other types of taxes. Since your committee believes that it is important for the Federal Government to remain neutral as to the relative use made of these three forms of State or local revenue sources, it in this bill has continued a deduction of these three types of taxes.[12]

In Blueprints for Basic Tax Reform, the tax policy staff of the Treasury argued that a sales tax is fundamentally different than an income tax.

> General sales taxes, it may be argued, should not be deducted separately because they do not enter household receipts. Unlike the personal income tax, which is paid by households out of gross-of-tax wages, interest, dividends, and the like, the sales tax is collected

10. *Evaluation of the Proposed Model Comprehensive Income Tax*, 32 TAX LAW. 563 (1979).
11. *Id.* at 651-53.
12. H.R. Rep. No. 749, 88th Cong., 1st Sess. 48-49 (1963).

> and remitted to government by businesses that then pay employees and suppliers of capital out of after-sales-tax receipts. Therefore, the sum of all incomes reported by households must be net of the tax; the tax has already been "deducted" from income sources. To allow a deduction to individuals for the sales tax would be to allow the full amount of the tax to be deducted twice.[13]

The flaw in this argument is that it analyzes the two tax systems over two different time spans. It follows the income tax from the time a household earns a dollar until it spends that dollar, while it analyzes the sales tax from the time a household spends its money until the receiving businesses pay that money to their employees, lenders, and owners, i.e., other households. The Blueprints distinction disappears if one compares the two tax types over an identical part of the economic cycle. Assume that the households of America earn a collective total of $100,000 on Friday, and spend it all on Saturday. If they are subject to a 5% income tax, the government will receive $5,000 from this cycle of earning and spending, and the people will have $95,000 to pay for the goods and services they desire. If, instead, they are subject to a 5% sales tax, the government will receive $5,000 and the people will have $95,000 to purchase goods and services. From a simplistic view, they will deliver $100,000 to the businesses they patronize, but only $95,000 is available to those businesses to pay their employees, lenders, and owners for the start of the next economic cycle. In each case, the households earn the same amount, the government receives the same amount, and the businesses receive the same amount. The Blueprints distinction between income and sales taxes is not sound.

Finally, in watching the political development of the Tax Reform Act of 1986, one gets the impression that the repeal of the sales tax deduction was a very untheoretical move designed solely to achieve the alleged revenue neutrality of the bill. Even this pedestrian purpose is poorly served by the change, to the extent that sophisticated state and local jurisdictions respond to this improper federal pressure by shifting some or all of their revenue sources (or future revenue growth) from the sales tax system to other systems which are still deductible.

The Basic Argument for Deduction of State and Local Taxes

In layman's terms, state and local taxes have generally been deductible because, while they represent dollars which technically were

13. Department of the Treasury, Blueprints for Basic Tax Reform 93 (1st ed. 1977).

earned by the taxpayer, those dollars can never be personally enjoyed by that taxpayer. The payment is analogous to an involuntary charitable contribution, or perhaps, more cynically, to a theft loss.

The Haig-Simons definition of income provides that income equals consumption plus accumulation.[14] Accumulation is used to refer to new savings, as well as increases in the value of prior investments, and is not at issue in this discussion. Accordingly, the definition of consumption, as used in this formula, is the only issue to address in considering whether the funds used to pay state and local taxes should be included in our statutory definition of taxable income.

So the question is whether payment of state and local taxes is a form of consumption. If it is, the dollars used for that payment should be included in the income tax base. Because those dollars are initially included in the income tax base through the far reaching statutory definition of gross income, they will be included in taxable income if the payment of said taxes is not deductible. If, on the other hand, the payment of state and local taxes cannot reasonably be labeled as a form of consumption, the dollars used to make that payment should be deducted from the income tax base.

One view is that these tax payments do not represent consumption by that particular taxpayer in the Haig-Simons sense.[15] Professor Bittker recognizes the more subtle issue, which is that some or all of the dollars paid in state and local taxes are then spent by the state and local governments in ways that benefit the taxpayers.[16] While admitting that an individual taxpayer's share of the goods and services provided by the state and local governments to the public does constitute consumption in the Haig-Simons sense, he does not support their inclusion in gross income. He does not, however, address the deduction for payment of the taxes which fund those benefits.

A Closer Scrutiny of State and Local Tax Payments, in Light of Benefits from State and Local Governments

Professor Turnier states that "economists are in wide agreement that payments of state income taxes do not provide taxpayers with

14. H. Simons, Personal Income Taxation 50 (1938).

15. Aaron, *What is a Comprehensive Tax Base Anyway?*, 22 Nat'l. Tax J. 543, 543-44 (1969); Feldstein, *Fiscal Policy for the 1980's*, in New Directions in Federal Tax Policy for the 1980's, 31 (C. Walker and M. Bloomfield ed. 1983).

16. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 935-38 (1967).

benefits which are in any way commensurate with the amount of the tax paid."[17] Nevertheless, each taxpayer does receive some level of direct benefits from state and local government programs, and it seems fair to presume that such direct benefits were funded with a portion of that particular individual's state and local tax payments. The fact that the payment is often much greater than the benefit is not sufficient reason to totally ignore the benefit.

Furthermore, the fact that these government benefits are enjoyed by large numbers of taxpayers at the same time cannot be allowed, in and of itself, to end the inquiry. If it does, then the cost of admission to a movie, football game, or any other audience event must also be excluded from the Haig-Simons definition of consumption, and therefore excluded from the definition of income. For the same reason, the fact that a large number of individuals pay money into a common fund to finance the benefit also is not enough to exclude the benefit from the definition of consumption.

A more appropriate test is the directness of the benefit. When Mr. and Ms. Taxpayer pay their state and local taxes, and some of those dollars are used to provide assistance to the handicapped, Mr. and Ms. Taxpayer have a benefit, which is the satisfaction of living in a compassionate society. That benefit is extremely indirect. The government's primary intention in making that particular expenditure was to benefit the handicapped persons who qualify for the particular program. On the other hand, if some of the dollars paid by Mr. and Ms. Taxpayer are used to educate their children, the benefit to them is extremely direct. Even though the line between direct and indirect benefits cannot be precisely drawn, it is important to recognize the distinction as conceptually valid.

It is possible to identify several clear examples of direct benefits. One guiding principle is that a direct beneficiary of a government expenditure is one who personally uses the physical item purchased with that expenditure, or one to whom the government service is personally rendered. If the money is used to build a road, the people who drive on that road are direct beneficiaries of that expenditure. The people who simply buy the goods that are shipped over that road are indirect beneficiaries. In the case of services, if the government dollars are paid to a doctor as compensation for providing medical services to people below the poverty line, the patients are

17. Turnier, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 VILL. L. REV. 1703, 1717 (1986).

the direct beneficiaries. The rest of us, who may have consequently avoided the spread of a contagious disease, are indirect beneficiaries.

This argument is leading, first, to the point that the value of goods and services provided by a state or local government to a direct beneficiary should be included in the definition of consumption, as that term is used in the Haig-Simons definition of income.[18] From that conclusion, this author makes the argument that, as a theoretical ideal, tax payments to state and local governments should not be deducted for federal income tax purposes to the extent of the taxpayer's receipt of direct benefits from those governments. The state and local taxes paid in excess of that amount should be deductible. As discussed earlier, the deductibility of the latter portion should be without distinction between income, property and sales taxes.

Some examples will show that this theoretical argument also comports with common sense, by illustrating certain services which some people purchase and other people receive "free" from their state or local government. The cost of acquiring such services by direct purchase is not deductible. The "cost" of acquiring such services through a government program is hidden in one's state and local tax payments, and is deductible, for those who itemize, but nondeductible for those who do not itemize. There is no sensible reason for this difference in tax treatment of people who are all receiving the same service.

John pays $500 tuition to send his child to a private school, and gets no deduction for that payment. Beth sends her child to public school, and $500 of her (deductible) property tax payment is used to pay for her child's education. There are three ways to eliminate this inequity. Congress could grant John a deduction for his tuition payment, but that would result in an even greater budget deficit or it would require increased tax rates to offset the revenue loss. Alternatively, Beth could be required to include the value of her child's education in her taxable income. Finally, $500 of Beth's property tax payment could be made nondeductible. This author proposes that the third alternative be adopted.

Garbage collection is another, more homely example which illustrates the author's recommendation that state and local tax payments

18. This point has already been made in Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 935-38 (1967), although for practical reasons Professor Bittker and I do not endorse the inclusion of most in-kind government benefits in gross income.

should not be deductible to the extent they represent consumption by the taxpayer. In some cities, garbage is collected by private businesses, and a resident's payments to such a business are not deductible. In other cities, garbage is collected by municipal workers, and each household is charged a fixed monthly fee for the service. Payment of that fee is also not deductible. Finally, still other cities collect garbage with municipal workers, and pay for the service from general revenues. Obviously some portion of each household's city taxes is being used to pay for garbage collection, but because that money is paid to the city as a tax rather than a special fee, it is deductible for federal income tax purposes.

Finally, consider a hypothetical situation involving a small, very wealthy residential community. The residents deed their front yards to the city, so the city owns not only the paved street, but also the lawn in front of each house. Then the city parks department lavishly landscapes, gardens, and maintains the unpaved portion of this enormous right of way, i.e., the residents' front yards. The work is paid for with the city's property tax revenue. The cost of beautifying each resident's front yard is tax deductible, because it is hidden in her annual property tax payment. In contrast, people who hire and pay a gardener in the direct, traditional manner are not allowed a deduction for such expenditures.

In one simple situation, the Code already applies this argument that payments to the city or state are not deductible if they represent the cost of a direct benefit received by the taxpayer or her property. I.R.C. section 164(c)(1) provides that no deduction shall be allowed for "[t]axes assessed against local benefits of a kind tending to increase the value of the property assessed. . ." This provision prohibits a taxpayer from deducting payments for special improvement assessments, paid by the landowners in a neighborhood which has received new pavement, or a sewer or water system. The reason behind this rule is also the reasoning behind this article. If a payment to a government looks more like a purchase of goods and services than a charitable contribution, it should be treated as a purchase, and be nondeductible. This author is merely proposing that the well-established concept of I.R.C. section 164(c)(1) be applied on a broader, more sophisticated level, to improve the theoretical soundness of the tax law, and to provide a thoughtful alternative to the tax rate increases which loom ahead as a simple minded answer to the budget deficit.

Pragmatic Limits on the Reach of the Theory

Consistent with the theory developed in this article, a taxpayer's deduction for state and local tax payments should be reduced by the value of the *direct* benefits such taxpayer receives from state and local governments. One might argue that this concept could be pushed even further, by attempting to identify and quantify the numerous *indirect* benefits which accrue to a taxpayer from state and local government programs. The value of indirect benefits received by the taxpayer is theoretically part of his or her consumption; but any attempt to move beyond the direct benefit category in search of additional consumption by the individual taxpayer can be accomplished, in practice, only by stopping at some arbitrary point. Even though the direct vs. indirect dividing line is not crystal clear, it is the only relatively clear place of division in this area.

The weakness of an attempt to reach indirect benefits with the theory developed herein can be demonstrated with a simple example. The taxpayer pays a total of $1,000 in state and local taxes. Assume, for simplicity, that the only state and local government program is free public education, and therefore, this entire $1,000 is spent on education. The school system spends $250 per student per year. One-half of this taxpayer's $1,000 payment is spent to educate her two children, while the other $500 is spent to educate two children from a poor family which pays no tax. This article focuses almost exclusively on taxpayers who itemize, because I.R.C. section 164 is an itemized deduction; but the theory that direct benefits represent a hidden but very real form of consumption is equally valid with respect to non-itemizers.[19] In spending this $1,000, the school district has provided a $500 direct benefit to the taxpayer in question, and a $500 direct benefit to the poor family. One thousand dollars was spent, and $1,000 in direct benefits is apparently identified. To try to place any value on the indirect benefits to the taxpayer from having the poor family's children educated would force the analysis down one of two possible paths. One might conclude that $1,000 was spent but more than $1,000 in benefits was received. Although

19. I do not propose that the value of direct government benefits should be included in each taxpayer's income, including those who do not itemize, although that is a theoretically justifiable position. *See* Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 935-38 (1967).

philosophers may be able to formulate subtle arguments which support this conclusion, it violates the simple rules of arithmetic so completely that this author will not endorse it. Alternatively, one could conclude that, for example, when the school district spent $500 educating the children from the poor family, those children only received $400 worth of education as their direct benefit, and the remaining $100 of the expenditure is theoretically attributable to the indirect benefit received by the other members of the community, including the taxpayer in question.

In the first place, this latter conclusion leads to the impossible task of dividing every government expenditure into its direct and indirect value components. In the second place, even if that labor of division is successful, much if not all of it will prove unnecessary when the analysis is completed. For example, note that if one-fifth of the cost of educating the two poor children ($100) is attributable to the taxpayer as the value of an indirect benefit, then theoretical consistency requires that one-fifth of the cost of educating the taxpayer's two children ($100) must similarly be attributed to the poor family, as an indirect benefit, and away from the taxpayer. Within the scope of this article, such attribution would have no practical impact on the poor family, but on these facts, it would reduce the taxpayer's consumption (and therefore, income) by the same amount as that consumption was increased in the prior step. Although the offset would rarely be as exact as in this example, in most cases a majority of the indirect benefit value attributed to the particular taxpayer in the first step would probably be offset by a similar attribution away from that taxpayer in the second step. The tax world is already so full of rounded corners that it makes no sense to pursue this level of precision here. Therefore, the cost to the state and local governments of providing direct benefits to the taxpayer in question should be retained as the yardstick for measuring this form of consumption. By ignoring the value of indirect benefits received by the taxpayer, hopefully one is excused from ignoring the fact that the government's *cost* of providing a service is usually greater than the *value* of that service to the recipient taxpayer.

A Practical Application of the Theoretical Ideal

Of course, it is neither feasible or possible to determine, on an individual basis, the value of direct benefits received by each taxpayer in the United States. As is often the case in writing and administering tax laws, an approximate figure (or approximating formula) must be established and applied to all taxpayers. One observation which will simplify the determination of the proper figure or formula is to note that these taxes are allowed only as itemized deductions. If one can assume that taxpayers who itemize their deductions are found primarily in the middle class and above, the scope of inquiry into direct benefits can be narrowed.[20]

The task is to identify the major state and local government programs from which the middle class and above (hereinafter, for simplicity, the middle class) receive at least their pro rata share of the benefits. For example, if a city of 1,000 residents spends $40,000 to provide police protection, it is fair to say that the average middle class resident enjoys approximately $40 of police protection. If this city spends $15,000 for its symphony, one would be certain that the average middle class resident will enjoy more than $15 of symphonic performance, because the poor generally do not partake of such services in proportion to their numbers. Even if an exacting study showed that this $15,000 program was attended by all of the city's 750 middle class residents, and none of its 250 poor residents, reflecting an average middle class benefit of $20, it would be fair (and to the taxpayer's benefit) to round down to the per capita benefit of $15. Finally, if this city spends $25,000 on its welfare program, it is neither accurate or fair to say that the average middle class resident receives $25 in direct benefits from that program. That would cause $25 of each middle class resident's city taxes to be classified as consumption by that resident, and therefore to be part of his or her (theoretical) income, and therefore (under this proposal)

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20. In 1984, 54% of the returns claiming itemized deductions reported adjusted gross income (AGI) of $30,000 or more. More directly to the point, 54% of the returns claiming state and local taxes as itemized deductions also reported AGI of $30,000 or more. INTERNAL REVENUE SERVICE, *Statistics of Income—1984, Individual Income Tax Returns* 57 (Table 2.1) (U.S. Gov't. Printing Office, Publication 1304 (rev. 11-86)). In that era of nearly unrestrained tax sheltering, many of the itemized returns with AGI less than $30,000 are probably from well-to-do people whose AGI are not representative of their comfortable financial positions. The 11,000,000 itemizers who are predicted to shift to the new $3,000 standard deduction ($5,000 for joint returns) will probably be predominantly lower income individuals, thus increasing the percentage of remaining itemizers who are in the middle and upper classes.

If you will assume with me that mortgage interest (and therefore, ownership of a significantly encumbered home) is nearly a prerequisite of claiming itemized deductions, Census Bureau statistics make an even stronger statement of the proposition that itemizers are primarily middle class and above. Those statistics show that 57.7% of homeowners have a household money income of $25,000 per year or more. If we further assume that those homeowners with money incomes below $10,000 must own their homes debt free (or have such a small mortgage that the interest is insufficient to itemize), and exclude them from consideration, 66.8% of the remaining homeowners have money incomes of $25,000 or more. BUREAU OF CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES (TABLE 724) (1987).

not deductible for federal income tax purposes. Programs which do not provide at least proportionate direct benefits to middle class taxpayers should be dropped entirely from consideration in attempting to estimate the amount of direct benefits received by itemizing taxpayers from their state and local governments.

Some fairly obvious nominees to the category of programs that directly benefit the middle class are education, roads, health and hospitals, police protection, and fire protection. Programs such as housing and welfare should not be included, because most itemizers probably receive less than their per capita share of the benefits provided by such programs.

The quantitative approach to this problem can be described simply through the following example. The city described above spends $40 per person to provide police protection to its residents, and each resident has received approximately $40 of police protection in that year. Therefore, $40 of city taxes paid by any given resident should be viewed as having been paid to the city and then promptly spent by the city for the consumptive benefit of that particular resident. That $40 tax payment is analogous to a $40 expenditure for private security services, which would not be deductible for federal income tax purposes. The analogous payment to the city for the purchase of public security services should also not be deductible. If that same resident paid an additional $25 in city tax, which money was spent for the welfare program (assuming this taxpayer does not qualify for such program), that $25 payment fits within the conventional, quasi-charitable view of state and local tax payments. It cannot reasonably be classified as consumption by the taxpayer, and therefore, should not be treated as income of the taxpayer. The taxpayer should be allowed to deduct the $25 payment.

This approach can now be applied to some actual figures for government spending. In 1984 the state and local governments of America spent a combined total of $145.3 billion (from their sales, property, and individual income tax revenues) on the following programs: education, roads, health and hospitals, police protection, and fire protection.[21] Based on a population estimate of 236 million,

21. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATE AND METROPOLITAN AREA DATA BOOK 565-68 (1986) (Items 992, 1012, 1013, 1031, 1034, 1036, 1049, 1050, and 1052). The pre-1984 data in certain of those items were adjusted to 1984 at an assumed growth rate of 8% per year. Amounts received from federal grants, user fees, and other sources which are not part of the income/property/sales tax package addressed here are not included in this expenditure analysis, because those other sources do not represent dollars which qualify for a

this translates into an expenditure of $616 per capita.[22] Because these program categories were intentionally selected as being those from which the middle and upper class taxpayers receive at least their per capita share of benefit, one can conclude that the average itemizing taxpayer also received direct benefits from this package of programs totaling at least $616 per person. As with any average, a substantial number of itemizing taxpayers surely received less than this amount of direct benefit. Any rule that will operate to the detriment of taxpayers should be based on numerical assumptions that are valid for at least 80% of the individual taxpayers involved. Until some rigorous empirical study and statistical analysis are conducted, let us assume that at least 80% of the itemizing taxpayers receive direct state and local government benefits in the amount of $500 or more each year.

Of course, each taxpayer will receive different amounts of benefit from each of these various programs. Those with more children enrolled in public schools and universities will receive a greater amount of benefit from the educational programs. Others may make much greater use of local roads and state highways, thereby receiving a greater amount of benefit from the programs which build and maintain the roadways. Others may have no children, but make extensive use of government subsidized health systems, which are often not limited to the poor.

Criticism Arising from the High Cost of Educational Programs

It may be tempting at this point to criticize this approach on the ground that educational expenditures comprise a very large percentage of the total expenditures in this package of programs that directly benefit the middle class. In any given year, there will be millions of itemizing taxpayers who have no children in the public school or university systems. If the value of free primary and secondary education, and highly subsidized college education is removed from a

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personal deduction under I.R.C. § 164. State grants made to, and spent by local governments are included here to the extent such grants came from (on a pro rata basis) state sales, property, or individual income taxes.

22. One might expect that the total expenditure would be divided by the number of itemizing taxpayers, taxpayers, or adults, rather than by the entire population. Such methods, however, would magnify the problem discussed at *infra* notes 23-26 and accompanying text, and cause more individuals to receive more seriously unfair treatment from the necessarily imprecise practical implementation of this theoretical concept.

particular taxpayer's balance sheet, that taxpayer would have to make an astronomical use of the public roadways and other programs to actually receive the $500 minimum total benefit estimated above.[23] Therefore, the claim that 80% or more of the itemizers enjoy $500 of benefits or more per year seems invalid.

The foregoing attack is a legitimate one if the analysis is restricted to a single year in a particular person's taxpaying life. That concern is laid to rest, however, if a long term view is taken. Due to the high cost of education, during any year in which a taxpayer has one child in an average public school system, the taxpayer receives government benefits from that single program which cost $3,000 dollars.[24] If state and local expenditures are viewed as coming proportionately from all state and local revenue sources, $1,440, or 48% of this $3,000 cost is funded from state and local sales, property, and individual income taxes. The *theoretical* ideal described earlier is that state and local taxes be nondeductible to the extent of each individual's *actual* amount of direct benefits received from those tax payments.[25] Because this article is proposing that a minimum floor of $500 in state and local tax payments be nondeductible, with any excess remaining deductible, the taxpayer with one or more children in school is receiving a huge windfall deduction, relative to the theoretical ideal. When a taxpayer who does not have school age children complains that he or she cannot possibly receive benefits in the current year equal to the proposed $500 nondeductible floor, this author would defend the current imposition of that floor by pointing to the windfall deductions that the older taxpayer may have already received in prior years when his or her children were in the public school system, or the similar windfall deductions which the young taxpayer may receive in future years when his or her children enter the public school system.

Stated another way, during a 50 year lifetime of paying federal taxes, at least 80% of the itemizing taxpayers of this country will receive cumulative state and local benefits exceeding $25,000 each (50 years x $500 per year). If a taxpayer claims itemized deductions

23. Of the money spent by state and local governments on the "middle class programs" being analyzed here, 59% was spent on education. If an average itemizing taxpayer's direct benefits are estimated without including educational programs, the amount is only $252 per person, instead of $616. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATE AND METROPOLITAN AREA DATA BOOK 566-69 (1986) (Items 1019, 1021, 1022, 1023, 1055, 1057, 1058, 1060, 1061 and 1062).

24. NATIONAL EDUCATION ASSOCIATION, ESTIMATES OF SCHOOL STATISTICS 1983-84, at 40 (1984).

25. *See supra* text following note 18.

for each of those 50 years, this proposed rule would deny him a total of $25,000 of deductions for state and local tax payments, relative to current law. The receipt of the benefits might not be accurately matched with the denial of the deduction in any particular year, but such matching will occur over a longer period. Therefore, in most cases, the apparent inequity to most taxpayers who have no children in the public schools in a given taxable year appears purely as a result of the annual accounting system used for tax purposes. The appearance of inequity fades entirely for such taxpayers when the long term view is taken.

This inequity does not disappear in every case, however. Some people will never have children. Another group will have children but will never send them to public schools for any appreciable length of time. The itemizing taxpayers in these two categories will have to take unusually high advantage of other state and local government programs to receive total benefits equal to or exceeding the proposed $500 nondeductible floor. Many of them, however, will not achieve that level of benefits. To the extent their total benefits received is less than $500, and their total state and local tax payments exceed their benefits, their nondeductible floor should theoretically be reduced from $500 to their actual level of direct benefits. In such cases, some inequity will result. If this and other base broadening proposals are used to keep the top tax rate (after 1987) at its current 33%, the individual burden from this inequity will never be more than $167 (33% x $500), and normally much lower than that.[26]

In light of the high proportion of educational costs in state and local government spending, one way to conform the proposal that the first $500 paid in state and local taxes be nondeductible more closely to the theory on which it is based, i.e., that a taxpayer should be allowed to deduct state and local tax payments only to the extent they do not operate to "purchase" direct benefits for him, is to begin with a lower nondeductible floor, and increase it for each school age child of the taxpayer. Although this suggestion is theo-

26. If a person received no state or local benefits of any kind, he should be entitled to deduct his entire state and local tax payments. Denial of the deduction for the first $500 of such payments would increase his federal income tax liability by $500 multiplied by his marginal tax rate, for a maximum of $167. The more likely situation is that he will receive no educational benefits, but will receive, for example, $200 of benefits from other programs. In that case, the application of the $500 nondeductible floor will comply with the theoretical ideal to the extent of $200, but will violate the theory to the extent of $300. That $300, multiplied by his marginal tax rate, is the measure of the inequity, and will generate $100 of actual tax liability under current (post-87) law.

retically sound, the purpose of a public educational system is to spread the cost over all citizens. The foregoing suggestion would operate counter to that policy by shifting a disproportionate part of the burden back to the pupils' parents.

PROGRESSIVITY

Another possible modification is to calculate the proposed floor as a percentage of adjusted gross income (AGI), as is currently done with the medical,[27] casualty,[28] and "miscellaneous itemized"[29] deductions. That would eliminate the admittedly regressive effect of the proposal made by this article. Such a rule, using a 3% AGI floor, was suggested by Senator Long in 1986.[30] However, without some evidence that people get ever increasing amounts of direct benefits from their state and local governments as their incomes rise, such a modification cannot be justified by the theory described in this article. If the nondeductible floor is to be a percentage of AGI, that should be openly proposed and adopted as a means to increase progressivity, which is a separate issue. This article is addressed to a more theoretically sound definition of taxable income, which is achieved by the fixed dollar nondeductible floor proposed herein. Ideally, taxable income should be defined without regard to progressivity, which should be pursued entirely through changes in the rate structure. A minor change in the rate structure may, indeed, be an appropriate accompaniment to the proposed $500 nondeductible floor.

REVENUE RAMIFICATIONS OF THE PROPOSAL

The proposal to disallow a deduction for the first $500 paid in state and local taxes is not only theoretically sound, but is also economically attractive in that it will add billions of dollars to the national tax base. It will, therefore, generate substantial additional tax revenues without an increase in the statutory tax rates. If each itemizer in 1984 had been subject to a $500 nondeductible floor for deduction of combined state and local income, sales and property taxes ($1,000 for married taxpayers filing jointly), the total deductions

27. I.R.C. § 213(a).
28. *Id.* § 165(h).
29. *Id.* § 67(a).
30. N.Y. Times, Feb. 2, 1986, at A1, col. 2.

for such taxes would have been reduced by $32.6 billion.[31] That figure cannot be translated directly to 1988 and later years, because the standard deduction (zero bracket amount) in 1984 was $2,300 ($3,400 for married filing jointly),[32] while the standard deduction for 1988 has been raised to $3,000 ($5,000 for married filing jointly).[33] As a result, the staff of the Joint Committee on Taxation estimates that the number of taxpayers claiming itemized deductions will be substantially reduced in 1988.[34] Using the Committee staff estimates, it appears that itemized deductions will be claimed by approximately 7.2 million individual, head of household, and surviving spouse taxpayers and 18.3 million married taxpayers filing jointly. If that is correct, the threshold proposed in this article will reduce itemized deductions by $21.9 billion in 1988. Assuming that the average affected taxpayer will be in a 25% marginal tax bracket, this proposal would increase federal revenues from the individual income tax by $5.5 billion in 1988. Much of that increase will be offset by the proposed reinstatement of the sales tax deduction, but that is simply the cost of responsible federalism. The Treasury will still enjoy a net gain of approximately $850 million. Also, Congress will be replacing $4.65 billion of ill-gotten gains (from the recent elimination of the sales tax deduction) with $5.5 billion of well reasoned revenue (from implementation of this proposal), which change has a value greater than the $850 million net monetary gain. Furthermore, if a closer study shows that a nondeductible floor greater than $500 is justified, the additional revenue gain from raising the floor above $500 will all be enjoyed by the Treasury, without offset.

If the sales tax deduction is irretrievable, this theory can, and should, be applied to an itemizing taxpayer's combined state and local income and property tax payments. Given the nondeductible status of the sales tax, the remaining two deductible taxes would constitute only 35.6% of total state and local expenditures. Accord-

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31. In 1984, the state and local tax deduction was claimed on 27,226,539 joint returns and 10,675,809 single, married (separate), head of household, and surviving spouse returns. The mathematical conclusion is based on the assumption that each such return reflected at least $500 ($1000) of excess itemized deductions, so that the entire floor would operate to reduce deductions claimed. Because that assumption is not entirely accurate, the deduction reduction is slightly overstated. INTERNAL REVENUE SERVICE, *Statistics of Income—1984, Individual Income Tax Returns* 60 (Table 2.2) (U.S. Gov't. Printing Office, Publication 1304 (rev. 11-86)).

32. I.R.C. §§ 1(c)(3); 1(a)(3) (1984).

33. I.R.C. §§ 63(c)(2)(C); 63(c)(2)(A) (1986).

34. *General explanation of the Tax Reform Act of 1986*, at 19 prepared by the Joint Committee on Taxation (CCH) (May 8, 1987).

ingly, only 35.6% of the $303 billion spent by state and local governments for direct benefit, middle class programs would be deemed to be an in-kind return of a taxpayer's deductible tax payments. The resulting figure, $107.7 billion, divided by a population of 236 million, yields a per capita amount of $456. The actual nondeductible floor would probably be set at $350 ($700 for married filing jointly), to assure that a strong majority of itemizing taxpayers actually experience the theoretical benefit package posited by this article.[35]

With sales tax nondeductible, the imposition of a $350 nondeductible floor ($700 for married filing jointly) under the deduction for combined state and local income and property tax would reduce such deductions in 1988 by approximately $15.3 billion. Assuming that the average affected taxpayer will be in a 25% marginal tax bracket, this alternative proposal would increase federal revenues from the individual income tax by approximately $3.8 billion.

CONCLUSION

There are four possible futures for the fiscal situation of the U.S. government: Significant spending reductions, continued massive deficits, higher tax rates, or a broader tax base. The first seems impossible, and the second seems unbearable. This author is not fully convinced that the new, low tax rates are the cure for any of our major national problems, but the 33% top rate represents a new approach in post-war American taxation, and probably deserves a chance to demonstrate its effects. If the recently enacted rate structure is to be saved, either as an icon of the Reagan era or as a dispassionate experiment in tax policy, a broader tax base is the only remaining alternative.

The definition of taxable income can be enlarged arbitrarily, in the direction of the least political resistance, or it can be expanded by enacting the most sound theoretical arguments. This paper is an attempt to describe one such theoretical argument. All taxpayers, whether or not they claim itemized deductions, receive valuable benefits from the government. Taxpayers are, in effect, purchasing those benefits from their state and local governments when they pay their state and local taxes. There is no sound reason for allowing

35. For more on the thought and data behind the calculations in this paragraph, see text accompanying *supra* notes 21-22.

them to deduct the purchase price of the benefits they receive, especially when other individuals are acquiring similar goods and services in more traditional purchase transactions, and are not allowed to deduct their analogous costs.

Congress and the Treasury should obtain a well-informed estimate of the minimum amount of direct benefits received by a large majority of itemizing taxpayers from their state and local governments, and establish that amount as a floor under the deduction of tax payments to state and local governments. Tax payments below that level are generally spent by the recipient government to provide benefits directly to the individual taxpayer, and should not be deductible. Tax payments above that level are spent by the government to benefit other, generally poorer, citizens; as such they are analogous to charitable contributions, and should continue to be deductible.