



2007

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

Brian Galle

*Georgetown University Law Center*, [brian.galle@law.georgetown.edu](mailto:brian.galle@law.georgetown.edu)

This paper can be downloaded free of charge from:  
<https://scholarship.law.georgetown.edu/facpub/1828>

---

82 Ind. L.J. 673-710 (2007)

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author.  
Follow this and additional works at: <https://scholarship.law.georgetown.edu/facpub>



Part of the [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

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

BRIAN GALLE\*

INTRODUCTION.....	673
I. BACKGROUND .....	676
II. A STATE SUBSIDY? .....	680
A. <i>Redistribution</i> .....	680
B. <i>Devolution</i> .....	685
C. <i>Spillovers</i> .....	687
D. <i>Why Not Direct Spending?</i> .....	691
III. NO EXIT?.....	696
IV. AN ENFORCEMENT INCENTIVE? .....	701
A. <i>The Benefits of Overlapping Enforcement</i> .....	702
B. <i>Obstacles</i> .....	704
C. <i>Will It Float?</i> .....	708
CONCLUSION.....	709

## INTRODUCTION

In its efforts to guide money to the states, our federal government annually passes up more than \$75 billion in potential revenue under a single provision of the Tax Code. That provision, section 164 of the Code, allows itemizing taxpayers to deduct the cost of the state and local income, property, and (to a limited extent) sales taxes they paid during the tax year.<sup>1</sup> The eye-popping size of that number makes section 164 a perennial issue in tax policy circles, and as one of the deductions omitted from the Alternative Minimum Tax's (AMT)<sup>2</sup> parallel tax universe, the section is also a key component of debates about the AMT. Indeed, the President's Advisory Panel on Tax Reform recommends eliminating the deduction to pay for its proposed AMT reform.<sup>3</sup>

---

\* A.B. Harvard, J.D. Columbia, LLM (Taxation) Georgetown. Assistant Professor, Florida State University College of Law. I am grateful for many helpful comments and suggestions from, among others, Reuven Avi-Yonah, Brookes Billman, Bill Bratton, John Buckley, Peter Byrne, John Colvin, Noel Cunningham, Mike Dorf, Tom Field, Vic Fleischer, Martin Ginsburg, Robert Katzmann, Yoram Keinan, Edward McCaffery, Trevor Morrison, Gregg Polsky, Julie Roin, David Schizer, David Weisbach, and Ethan Yale, as well as faculty attending presentations of this paper at the National Tax Association Annual Conference, Florida State University, the University of Minnesota, Quinnipiac, Southwestern, and Syracuse Law Schools. I owe a particular debt to Ron Pearlman and Kirk Stark for their willingness to read carefully and offer me extensive and insightful suggestions. All errors are my own.

1. 26 U.S.C.A. § 164 (2006); see STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003–2007, at 20, 27 (Comm. Print 2002).

2. 26 U.S.C.A. § 56(b)(1)(A)(ii) (2006).

3. THE PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-

It has been almost a decade since Louis Kaplow produced the last comprehensive legal academic examination of the merits of the deduction.<sup>4</sup> This Article aims, humbly, at attempting to update that earlier work with recent developments and new insights. As I will explain more in a moment, the deduction also plays a so-far unrecognized role in economists' debates about the efficiency of decentralized government.

To date, scholarly examination of the deduction has focused on its fairness, or "horizontal equity," as well as the role it may play in encouraging localities to raise more of their own tax revenues. My focus here is on the latter. One view I do not consider, though, is the taxation of corporations and other entities. As I suspect the reader will see, the nuances of individual taxation provide more than enough material for one paper; corporations and their additional complexities must await another day.

On the fairness front, prevailing wisdom questions the traditional equitable justification for the deduction. Under the traditional view, it was said, two people who make the same money are not equal if one pays more state tax than the other.<sup>5</sup> Thus, the federal tax system should favor the higher-state-tax payer. Later critics argued that this was considering only half the apple (or half the orange): state taxes generate services, which increase taxpayer well-being.<sup>6</sup> So, the critics said, the higher-tax payer, like a consumer who buys a product at retail, has less money in her pocket at the end of the year, but is just as well off as the taxpayer with more money but fewer services.<sup>7</sup> Further analysis showed that the equity question actually turned 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?<sup>8</sup> Those questions, too, I reserve for discussion elsewhere.

Instead, I focus here on challenges to the deduction's use as a "tax expenditure" or subsidy. For example, the President's Advisory Panel on Tax Reform reportedly believes that the deduction causes citizens to overinvest in local government because that spending is tax-favored compared to private purchase of government-like services. That echoes a claim raised by President Reagan's Treasury Department prior to the 1986 reforms.<sup>9</sup>

---

GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 70, 83–84 (2005), available at <http://www.taxreformpanel.gov/final-report/> [hereinafter ADVISORY PANEL REPORT].

4. Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413 (1996).

5. 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).

6. See 2 DEP'T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 63 (1984) [hereinafter TREASURY I]; 25 Standard Fed. Tax. Rep., Dep't of the Treasury, The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (CCH) 63 (1984); Brookes D. Billman & Noel B. Cunningham, *Nonbusiness State and Local Taxes: The Case for Deductibility*, 28 TAX NOTES 1107, 1111–12 (1985); Charles R. Hulten & Robert M. Schwab, *A Haig-Simons-Tiebout Comprehensive Income Tax*, 44 NAT'L TAX J. 67, 68–71 (1991); J.B. McCombs, *A New Federal Tax Treatment of State and Local Taxes*, 19 PAC. L.J. 747, 754 (1988); Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 907–08 (1992); Edward Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 FORDHAM L. REV. 1255, 1278 (1985).

7. TREASURY I, *supra* note 6, at 631; Hulten & Schwab, *supra* note 6, at 68–71.

8. See Kaplow, *supra* note 4, at 490.

9. See TREASURY I, *supra* note 6, at 63–64. For a similar view in the economic literature, see Christian Kelders & Marko Kothenburger, *Tax Incentives in Fiscal Federalism* 3–4 (Nov.

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

Further, most commentators claim that the deduction is in theory warranted—albeit administratively difficult to implement—in order to encourage local tax jurisdictions to raise and spend money in ways that benefit their neighbors.<sup>10</sup> Since each locality fails to internalize the benefits of these "spillovers," the argument goes, a deduction may help to move local spending closer to the ideal level the localities would choose if their incentives were properly aligned.<sup>11</sup> My claim here is that in fact, localities do internalize spillover benefits. Localities may use spillovers as a form of an inter-jurisdictional bribe to influence the behavior of outsiders. In combination with a variety of frictions and biases, that bribe allows the briber to reduce free riding by neighbors and, in some instances, permits the briber to export the costs of its services onto the unwitting bribees.

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

In addition, the deduction may facilitate shared state and federal tax enforcement, a necessity for states in a world where it is ever easier to hide wealth through complex international transactions. For cognitive and distributional reasons, it may be difficult for states to tax the same base as the federal government and therefore difficult for them to most effectively share enforcement resources with it. The deduction arguably offsets some of these "stacking" limitations. It also can be a centripetal force for what would otherwise be an ever-diversifying set of state tax rules.

---

2005) (unpublished manuscript), available at [http://www.lrz-muenchen.de/~ces/Marko/Fiscal\\_Federalism.pdf](http://www.lrz-muenchen.de/~ces/Marko/Fiscal_Federalism.pdf).

10. See, e.g., Billman & Cunningham, *supra* note 6, at 1112; Robert C. Ellickson, *Cities and Homeowners Associations*, 130 U. PA. L. REV. 1519, 1554 (1982); Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1410 (2004); Yorio, *supra* note 6, at 1280; cf. Clayton P. Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1045–46 (1983) (making this argument in context of tax-exempt municipal bonds).

11. See Gillette, *supra* note 10, at 1046; Kaplow, *supra* note 4, at 480–83; Stark, *supra* note 10, at 1410; cf. Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120, 1126–27 (1999) (describing use of federal conditional grants to encourage localities to internalize effects of spillovers); Yorio, *supra* note 6, at 1280–81 (arguing that deduction increases beneficial spillovers without noting internalization problems).

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

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

## I. BACKGROUND

The federal deduction for state and local taxes paid is as old as the federal income tax itself. For much of its life, though, it has been short on theoretical justification. Most commentators initially seemed to view the deduction as simply an equitable measure intended to put those who earned similar incomes in jurisdictions with differing tax rates on an equal footing.<sup>12</sup> That equity explanation, though, foundered somewhat in the face of the fact that the deduction was available only to itemizers.<sup>13</sup>

Contemporary commentators are skeptical of the equity argument on other grounds, as well. The central insight of the contemporary view is that state taxpayers get what they pay for.<sup>14</sup> Local taxes, for example, pay for schools, filled potholes, plowed roads, and support the rest of the basket of services a municipality might provide. Some townships exact much higher taxes, but they also spend much more on services, especially education. State taxes offer highways, statewide education grants, and national guardsmen. In this view, the equity argument melts away. Two taxpayers earning equal salaries in different jurisdictions might pay different tax rates, but they are still equally well off.<sup>15</sup> One has less money in her pocket, but she also has purchased a set of services that leave her better off than her counterpart in the low-tax jurisdiction. Ultimately, this turns out to be, at best, a very rough view of the actual picture of tax-benefit tradeoffs. For purposes of this paper, though, my only goal is to note that the prevailing view is that the equity justification for a deduction is fairly weak, especially if one accounts for the administrative difficulties of more precise measures of equity that depart from the assumption that services received equals taxes paid.<sup>16</sup>

---

12. See, e.g., Kaplow, *supra* note 4, at 435–36.

13. See Stark, *supra* note 10, at 1414.

14. See sources cited *supra* note 6.

15. See TREASURY I, *supra* note 6, at 63; Hulten & Schwab, *supra* note 6, at 68–71.

16. See sources cited *supra* note 6. Professor Zelinsky, on the other hand, has argued for a more granular analysis: he would grant a deduction for state taxes tied to state expenditures

Some economists, however, have also suggested that the deduction could be viewed as a tax incentive on behalf of state governments.<sup>17</sup> That is, although the deduction nominally is claimed by individual taxpayers, it was said that the benefit flowed in the end to state taxing authorities.<sup>18</sup> In effect, the cost of any deductible state tax would decline by its taxpayers' marginal federal rate.<sup>19</sup> That would, in theory, allow the state to raise rates by the same margin without reducing the portion of state private output devoted to taxation or, more importantly, without incurring any additional political resistance.<sup>20</sup> Empirical studies seemed to bear out this analysis to some extent, showing that states do tend to raise and spend somewhat more revenues from deductible than from nondeductible taxes.<sup>21</sup>

A concrete example here may be helpful. Suppose I earn \$100,000, I itemize deductions, and my federal marginal tax rate is 28%. Let us say that my home state imposes a further 10% tax on my earnings. Without deductibility my take-home pay is  $100,000 - [(100,000 * 0.28) + (100,000 * 0.10)] = \$62,000$ . With deductibility, my take home pay is increased to  $100,000 - (100,000 * 0.10) - [(100,000 * 0.28) - (10,000 * 0.28)] = \$64,800$ . Knowing that I have received \$2,800 from the federal government, the state might respond by increasing its own taxes to recapture some of my savings. Assuming that I was willing politically to tolerate a combined tax burden that left me with \$62,000 in the first instance, I may well be willing to accept the same burden with some of the tax revenue now shifted to the state. This calculus also implies that the deduction will be more useful to high-income and wealthy taxpayers, since they are more likely to itemize (and therefore claim the deduction at all), have a higher federal marginal rate, and probably pay more state income and property taxes.<sup>22</sup>

---

where the proper view of income would have resulted in federal deductibility if the same expenditure had been made by an individual. Edward A. Zelinsky, *The Deductibility of State and Local Taxes: Income Measurement, Tax Expenditures and Partial, Functional Deductibility*, 6 AM. J. TAX POL'Y 9, 10–11 (1987). His primary example is healthcare costs. *Id.* at 23.

17. See, e.g., Martin S. Feldstein & Gilbert E. Metcalf, *The Effect of Federal Tax Deductibility on State and Local Taxes and Spending*, 95 J. POL. ECON. 710, 726 (1987); Zelinsky, *supra* note 16, at 10; Gilbert E. Metcalf, *Tax Exporting, Federal Deductibility, and State Tax Structure*, 10–12, 17 (Nat'l Bureau of Econ. Research, Working Paper No. 3839, 1991). For more on the basics of tax incentives and expenditures, see STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 3 (1985). For ease of reference, I will advert to state and local governments collectively as "state governments" unless distinguishing between the two is important in context.

18. See ADVISORY PANEL REPORT, *supra* note 3, at 83; Lawrence B. Lindsey, *Federal Deductibility of State and Local Taxes: A Test of Public Choice by Representative Government*, in *FISCAL FEDERALISM: QUANTITATIVE STUDIES* 137 (Harvey Rosen ed., 1988).

19. See JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 133, 152 (2d ed. 1988).

20. Lindsey, *supra* note 18, at 138.

21. 25 Standard Fed. Tax. Rep., Dep't of the Treasury, *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity* (CCH) 65 (1984); Bruce Bartlett, *The Case for Eliminating Deductibility of State and Local Taxes*, 28 TAX NOTES 1121, 1122–23 (1985); Douglas Holtz-Eakin & Harvey Rosen, *Federal Deductibility and Local Property Tax Rates*, 27 J. URB. ECON. 269, 271, 289, 291 (1990).

22. Kim Rueben & Len Burman, *Deductibility of State and Local Taxes*, 106 TAX NOTES 363, 363 (2005); Howard Chernick, *On the Determinants of Subnational Tax Progressivity in the U.S.*, 58 NAT'L TAX J. 93, 97 (2005); SURREY & MCDANIEL, *supra* note 17, at 3; cf. Metcalf, *supra* note 17, at 14–15 (arguing that high-income taxpayers are the most politically influential

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

That leaves us to grope for an explanation for why such distortions might be desirable. If our only goal is to shift taxation from the federal government to the states, why not simply lower federal rates across the board rather than giving the deduction? Is there a good reason to think state governments would tax at less than optimal levels without a deduction? The literature thus far offers two general answers. The first posits that redistributive taxing and spending is difficult on the state level.<sup>25</sup> To take the most basic example, assume that individuals are rationally self interested, and that they can easily gather and comprehend information about the relationship between the taxes they pay and the benefits they realize, not only in their own jurisdiction but in a number of others, each of which they could relocate to at little expense. In that situation, we might expect that a jurisdiction that took money from Taxpayer A to give to Taxpayer B might prompt A to move to a jurisdiction that did not. If Taxpayer A's jurisdiction wants to keep her (and her tax dollars) from fleeing, it must reduce or abandon its redistribution efforts. On the other hand, unless A wants to give up the benefits of U.S. residency, it will be rather hard for her to escape redistributive taxing by the national government.<sup>26</sup> So the deduction might be a form of redistributive federalism, in which the national government shares its tax dollars with states, enabling the states to then soften the blow of their own redistributive taxes.<sup>27</sup>

Relatedly, some writers have also claimed that the deduction may be a way for the federal government to encourage positive externalities.<sup>28</sup> Some of the things a state

---

in determining whether government shifts to deductible tax because they incur the largest benefits). In this Article, I assume away any effects caused by the Alternative Minimum Tax (AMT) on the ground that it is theoretically cleaner to analyze the deduction separately. At present, though, the AMT would limit the extent to which the deduction is useful to high-income taxpayers.

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

24. See Lindsey, *supra* note 18, at 169; sources cited *supra* note 21.

25. See John Shannon, *Federalism's Invisible Regulator: Interjurisdictional Competition*, in COMPETITION AMONG STATE AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM 117, 118-19 (Daphne A. Kenyon & John Kincaid eds., 1991); William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 212, 246, 248 & n.196 (1997); Richard Briffault, "What About the 'Ism'?" *Normative and Formal Concerns in Contemporary Federalism*, 47 VAND. L. REV. 1303, 1321 (1994); Henry W. Herzog, Jr. & Alan M. Schlottmann, *State and Local Tax Deductibility and Metropolitan Migration*, 39 NAT'L TAX J. 189 (1986).

26. See Gillette, *supra* note 10, at 1046 n.62.

27. See Bratton & McCahery, *supra* note 25, at 248 n.196; Stark, *supra* note 10, at 1431.

28. See Billman & Cunningham, *supra* note 6, at 1112; Kaplow, *supra* note 4, at 481-83;

spends its money on might benefit not only its own taxpayers but also its neighbors. Good roads, clean air, safe shopping districts, and schools that produce potential skilled employees all likely appeal nearly as much to nearby states as to the state itself.<sup>29</sup> And, in a sense, the existence of desirable locations other than those in which we live might benefit us even if we do not directly enjoy their scenic vistas or top-tier law schools. The opportunity to relocate when times get dark in our own neck of the woods might be a form of insurance; it allows us to take risks with our own local governance. Neighbors can be a source of best-practices to instruct us how to better do our own governing. And the threat of easy relocation to an appealing alternative might serve as a disciplining force on our current state government. The trouble is that each individual state government has no obvious incentive to internalize all the benefits of these positive externalities.<sup>30</sup> The deduction, some have suggested, moves in that direction by at least encouraging state governments to spend in ways that might produce some benefits to others.<sup>31</sup>

Obviously, though, there are serious counterarguments to both of these claims. Both, for example, seem to rely heavily on the assumption that states will make beneficial use of the deduction rather than simply lowering their own tax burden. And both make extensive assumptions about why and how easily people move from jurisdiction to jurisdiction. And neither offers a good reason, aside from administrability, to push states to impose income, property, and sales taxes over any others. I return to these problems later in the Paper.

In 1996, Harvard professor Louis Kaplow laid out another set of challenges for the deduction. On the redistribution point, Kaplow argues that it is possible that subsidies are not necessary to produce local redistribution.<sup>32</sup> Programs we term “redistributive” might result instead from a locality’s view that such spending in fact produces good for the whole community. If not, potential transferees might have enough political power to extract transfers from others.<sup>33</sup> In either case, he claims, redistribution is indistinguishable from any other local government service.<sup>34</sup> His view of spillovers is similar.<sup>35</sup> Alternatively, where redistribution might be efficient or otherwise desirable from a national perspective, Kaplow argues that we would be better off with direct spending instead of a deduction.<sup>36</sup> Deductions, he says, are regressive because they are most valuable to taxpayers with higher income.<sup>37</sup> They also are not especially well-

---

Stark, *supra* note 10, at 1410. *But see* TREASURY I, *supra* note 6, at 78 (arguing that spillover effects are not beneficial enough to be worth the expenditure of the deduction).

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

30. *See* Ellickson, *supra* note 10, at 1554.

31. *See* Gillette, *supra* note 10, at 1046; Kaplow, *supra* note 4, at 480–83; Stark, *supra* note 10, at 1410; Yorio, *supra* note 6, at 1280.

32. Kaplow, *supra* note 4, at 478–80.

33. *Id.* at 478–79.

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

35. *Id.* at 481–83.

36. *Id.* at 477–78, 484.

37. *See id.* at 484–85. Our current system exacerbates this effect by allowing the deduction only for itemizers, who are generally wealthier than those taking the standard deduction.



targeted to reward only redistribution or spillover spending, and they offer little transparency or political accountability to ensure that they are worth their cost.<sup>38</sup>

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

## II. A STATE SUBSIDY?

The traditional view of the deduction as a tax subsidy rejects the claim that tax preferences for state and local spending lead to too much local government. Again, the basic argument here is that it is difficult for states to tax without driving away taxpayers to lower-tax states; thus, federal subsidies help competing states by transferring to them money from a federal jurisdiction that taxpayers cannot easily escape.<sup>39</sup> This position, which I will call the “state subsidy” view, has attracted proponents as diverse as Marty Feldstein and Mario Cuomo.<sup>40</sup> Perhaps because of that apparently broad agreement, its treatment in the legal literature is fairly thin, although it has attracted at least two very persuasive critics. In this Part, I try to flesh out the state subsidy explanation, and examine the skeptics’ claims. Ultimately, I find the subsidy argument somewhat tenable, but not generally for the reasons most commentators have previously stated. And I conclude that the strongest arguments may bring the subsidy directly into conflict with any effort to encourage states and the federal government to tax the same base.

### A. Redistribution

In its classic formulation, the tax expenditure argument for the deduction posits that it is difficult for the states to impose some forms of taxation. Typically, the subsidy proponent will begin her argument by noting that taxpayers may flee a high-tax jurisdiction for a lower one, so that states race to the bottom of the bracket to prevent population and capital leakage.<sup>41</sup> Some taxpayers, however, may have chosen their place of residence in order to, in effect, purchase a basket of services from their local

---

38. See *id.* at 485–86; Yorio, *supra* note 6, at 1280. I do not believe that these are inevitable features of a tax system. But that is a subject for Part III.

39. Bratton & McCahery, *supra* note 25, at 248 & n.196; Richard Briffault, *Public Finance in the American Federal System: Basic Patterns and Current Issues*, 2 COLUM. J. EUR. L. 533, 539–40 (1996); see Stark, *supra* note 10, at 1431; Lior Jacob Strahilevitz, *The Uneasy Case for Devolution of the Individual Income Tax*, 85 IOWA L. REV. 907, 926 (2000).

40. See Feldstein & Metcalf, *supra* note 17, at 730–31; Michael I. Luger, *Federal Tax Reform and the Interjurisdictional Mobility Impulse*, 23 J. URB. ECON. 235, 235 (1988).

41. See RICHARD A. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 181 (1959); Robin Boadway, Maurice Marchand & Marianne Vigneault, *The Consequences of Overlapping Tax Bases for Redistribution and Public Spending in a Federation*, 68 J. PUB. ECON. 453, 453–54 (1998); Bratton & McCahery, *supra* note 25, at 248 & n.196; Briffault, *supra* note 25, at 1314, 1321 (1994); D. Bruce LaPierre, *Political Accountability in the National Political Process—The Alternative to Judicial Review of Federalism Issues*, 80 NW. U. L. REV. 577, 594 (1985); Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the “Race-to-the-Bottom” Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1239–40 (1992).

government.<sup>42</sup> In this view, the downward pressure on state taxes results from the subset of taxpayers who believe they pay for more than they get from state government and would prefer that it were otherwise.<sup>43</sup> Indeed, many proponents of the state subsidy theory therefore suggest that the subsidy's purpose is not to support state spending generally, but rather to ensure the possibility of state *redistributive* spending.<sup>44</sup>

In the abstract, states might cooperate or negotiate to prevent destructive rate competition.<sup>45</sup> It is generally thought, though, that cooperation among states (other than through the federal government) is unlikely to be sustainable because of the high transaction costs in reaching agreement with so many other jurisdictions and because of the large benefits that would flow to defectors from any tax cartel.<sup>46</sup>

Taxation at the federal level largely mitigates both of these problems.<sup>47</sup> It is much easier for the federal government, whose tax authority it is very difficult for individuals to escape, to extract more than it gives to an individual. The deduction then returns some of the resulting extra revenue capacity to states.<sup>48</sup> That claim is somewhat at odds with the view of the President's Advisory Panel, which apparently believes that favorable tax treatment encourages overconsumption of state government.<sup>49</sup> Predictably, though, there are some potential holes in this theory.

First, it may not be quite right that the States cannot effectively impose redistributive taxes. Some economists suggest that in certain circumstances the existence of a tax in jurisdiction A may actually encourage jurisdiction B to impose a similar tax.<sup>50</sup> Suppose, for instance, that we have neighboring states A and B. A imposes a luxury tax on the sale of African diamond-crusted widgets (ADCWs). Demand for ADCWs now shifts to B, where, in all likelihood, it drives up the price.

---

42. See sources cited *supra* note 6.

43. See sources cited *supra* note 25.

44. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 454–55 (5th ed. 1989); WALLACE E. OATES, *FISCAL FEDERALISM* 6–8, 137–40 (1979); Billman & Cunningham, *supra* note 6, at 1112. In this section I take a particularly broad view of redistribution; I include not only single-year transfers from wealthy to indigent, but also inter-temporal transfers from current taxpayers to later taxpayers in the form of capacity building, capital investment, and other outlays that may be of more benefit to those in the future than they are to those who pay for them now.

45. See Bratton & McCahery, *supra* note 25, at 248.

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

47. See Bratton & McCahery, *supra* note 25, at 212; Briffault, *supra* note 39, at 539; Oates, *supra* note 11, at 1128; Ulen, *supra* note 46, at 948; cf. Reuven S. Avi-Yonah, *Passport to Toledo: Cuno, the World Trade Organization, and the European Court of Justice*, 108 TAX NOTES 1661, 1665 (2005) (making a similar argument with respect to international flow of capital in response to nation-state tax efforts).

48. See Boadway, Marchand & Vigneault, *supra* note 41, at 475; Briffault, *supra* note 39, at 545–46.

49. Other economists have made a similar argument. See Kelders & Kothenburger, *supra* note 9, at 3–5.

50. See, e.g., Ravi Kanbur & Michael Keen, *Jeux Sans Frontières: Tax Competition and Tax Coordination When Countries Differ in Size*, 83 AM. ECON. REV. 877, 879–81 (1993); Jack Mintz & Henry Tulkens, *Commodity Tax Competition Between Member States of a Federation: Equilibrium and Efficiency*, 29 J. PUB. ECON. 133 (1986).

Perhaps money now flows from B to African widget-makers who have integrated their wholesale and retail businesses. At some point, the price in B and tax rate in A reach an equilibrium point at which buyers are indifferent between purchases in either state. In this scenario, state B has a fairly clear-cut incentive to impose its own luxury tax. Since the incidence of A's tax rests in part on consumers in B,<sup>51</sup> and that money benefits either A's citizens or African widget-makers, B would be better served imposing a tax that brought its own ADCW prices to the equilibrium point and keeping the resulting money in benefits for B residents. Obviously, this example is exceedingly simplified, especially in that it is built to exclude the possible effects of changes in wage rates and return to capital in the event that some ADCW manufacturers or retailers are themselves residents of A or B.

The point here is that the possibility that states can sometimes export the burden of their taxes may lead to upwards, rather than downwards, tax pressure. However, no good data seem to exist to show how often, if at all, this actually occurs. In general, while economists agree that state tax levels may often be set below a level that would exist absent inter-state competition, it is difficult to predict just how far they will likely fall in light of possible countervailing pressures.<sup>52</sup>

Second, we might wonder whether in fact exit is a significant source of downward pressure on redistributive taxation. Certainly, as we saw, there are major frictions that limit exit. But credible *threats* of exit are likely more important than exit itself.<sup>53</sup> Many commenters on earlier drafts of this Article also wondered whether people really relocate for tax reasons. Limited empirical data suggest that tax is, in fact, a significant motivator in relocation decisions at least of wealthy individuals and small business owners (who are usually taxed only as individuals because their businesses are taxed as pass-through entities).<sup>54</sup> Those data are especially significant in light of the possibility,

---

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

52. See Oates, *supra* note 11, at 1136–37.

53. Cf. Kim Rueben, *The Impact of Repealing State and Local Tax Deductibility*, 2005 ST. TAX NOTES 497, 511 (suggesting that fear that high-income households will leave in the absence of deduction will drive down state and local taxes and services). I develop this point more extensively in Part III. See *infra* text accompanying notes 136–39, 156. In brief, office holders fear that exit will reflect poorly on them in future elections, and they lack information to assess the credibility of most exit threats. Therefore, they act as though threats have force, even though they know that many are in fact irrational.

54. See SALLY WALLACE, GA. STATE UNIV., *THE EFFECT OF STATE INCOME TAX STRUCTURE ON INTERSTATE MIGRATION*, 7–8 (2002); Karen Smith Conway & Andrew J. Houtenville, *Elderly Migration and State Fiscal Policy: Evidence from the 1990 Census Migration Flows*, 54 NAT'L TAX J. 103, 119–21 (2001); Charles E. McClure Jr., *The Nuttiness of State and Local Taxes—and the Nuttiness of Responses Thereto*, 25 ST. TAX NOTES 841, 842–47 (2002); Jon Bakija & Joel Slemrod, *Do the Rich Flee From High State Taxes? Evidence From Federal Estate Tax Returns* 1–36 (Nat'l Bureau of Econ. Research, Working Paper No. 10645, 2004); cf. Amy Feldman, *Fifty States, a Thousand New Tax Laws*, INC., June 2005, at 21 (advising taxpayers, apparently in all seriousness, to move to a tax haven in response to confusing state tax laws). Lior Strahilevitz also points out that there is strong evidence that individuals move in response to cost of living considerations, which necessarily include tax effects. Strahilevitz, *supra* note 39, at 929–30; see also Richard J. Cebula, *Internal Migration Determinants: Recent Evidence*, 11 INT'L ADV. ECON. RES. 267, 272 (2005) (describing evidence that cost of living

as I suggest in more detail later, that the existence of the deduction itself dampens mobility. That we can measure some mobility effect notwithstanding the influence of the deduction suggests that exit, and exit-driven downward pressures, would be rather greater in its absence.<sup>55</sup> Depending on how strong the downward pressure is, that conclusion could imply that the President's Panel is wrong that the deduction creates overconsumption of state government, rather than helping to balance out the downward pressure exerted by interstate competition.

A more potent objection, then, might be that it is unclear why we should prefer redistributive spending by the states to similar spending by the federal government. Professor Stark, for example, has recently argued that as a "normative" matter we should prefer federal to state redistribution.<sup>56</sup> That is, he claims that exit is inefficient because of the deadweight losses that attach to gathering information and uprooting.<sup>57</sup> But one of the main arguments usually offered in favor of federalism is that it is efficient.<sup>58</sup> Exit is supposed to ensure that resources flow to where they are most useful, and to chasten local governments to be more efficient.<sup>59</sup> The question then becomes

---

influences choices of where to live). There is some possibility, though, that individuals may receive higher salaries in order to offset higher taxes. Intuitively we might think that this would depend on how easily local taxes are measurable by an employer and how elastic or inelastic the wage curve is. The available data look consistent with this intuition; they suggest that wages rise to cover taxes only for some jobs in some regions and only for income taxes, rather than property or sales taxes, which would be harder for employers to adjust for. WALLACE, *supra*, at 21–22.

55. I read some of the empirical evidence to support this inference. For example, one study reported that older taxpayers' locational decisions were more sensitive to sales tax changes than they were to differences in property and income tax. Conway & Houtenville, *supra* note 54, at 120. Although that seems hard to explain as a personal preference (do the elderly really consume less real property than other goods?), it makes quite a bit of sense when we realize that sales taxes are not usually deductible but property and income taxes are.

56. Stark, *supra* note 10, at 1395.

57. *Id.* at 1408. As a sidenote, the arguments Stark summarizes for why redistribution may not prompt exit are consistent with our current hypothesis that taxpayers do move to avoid genuine redistribution. He notes that some communities might willingly move money from wealthier taxpayers to the less wealthy in order to satisfy the community's sense of charitable obligation and to prevent crime. *Id.* at 1409; see also Lee Anne Fennell, *Beyond Exit and Voice: User Participation in the Production of Local Public Goods*, 80 TEX. L. REV. 1, 4 (2001). As Kaplow points out, that is not redistribution; it is consumption. See Kaplow, *supra* note 4, at 474–79. I address here only redistribution that is viewed subjectively by the payers as a net loss.

58. See WILLIAM A. FISCHER, *THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND USE POLICIES*, at ix (2001); Vicki Been, "Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine, 91 COLUM. L. REV. 473, 475–76 (1991); Briffault, *supra* note 39, at 540; Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120, 1121–23 (1999).

59. See PAUL E. PETERSON, *THE PRICE OF FEDERALISM* 17–18, 25–26 (1995); Briffault, *supra* note 39, at 540; Robert G. Lynch, *Weaknesses in the Common Arguments for State and Local Tax Cuts and Incentives*, 32 ST. TAX NOTES 597, 602 (2004); Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1498–1500 (1987). As we have seen, there are many barriers to exit that call the efficiency of any exit-driven system into question. However, a market may be chastened even by a relatively small segment of its participants. See, e.g., Kaplow, *supra* note 4, at 442.

whether the supposed efficiency losses that attend localized redistribution predominate over the efficiency gains of dispersed delivery of government services.<sup>60</sup>

Although I may sound skeptical, I do in fact agree that local redistribution may sometimes be inferior to national efforts. As other writers have described, it is possible to design national systems in a way that permits, even magnifies, the diversity and autonomy benefits of federalism.<sup>61</sup> A central federal authority regulating in collaboration with the states can serve as a clearinghouse for information, force states to be more forthcoming about the quality of the services they are delivering, render the data in a way that facilitates comparison, and thereby perhaps encourage migration from laggards.<sup>62</sup> Of course, not all federal spending programs are designed so well. For now, though, the comparative efficiency debate looks like it might be a draw.

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

In sum, there is only moderate bite to claims by critics that fiscal supports for state government redistributive projects distort the market for state government. Rather, federal subsidies generally restore consumer choice to a marketplace otherwise crippled by collective action problems. As Professor Kaplow argued, the case for using tax deductions, rather than direct spending, to achieve that end is not at this point as clear cut.<sup>63</sup> There are tradeoffs between the tax and spending alternatives that may

---

60. There is no real agreement in the economic literature on this point. For summaries by some of the primary combatants, see Wallace E. Oates, *Fiscal Competition and European Union: Contrasting Perspectives*, 31 REGIONAL SCI. & URB. ECON. 133 (2001); John Douglas Wilson & David E. Wildasin, *Capital Tax Competition: Bane or Boon*, J. PUB. ECON. 1065 (2004); George R. Zodrow, *Reflections on the Economic Theory of Local Tax Incentives*, 28 ST. TAX NOTES 891, 893–94 (2003) (setting out conflicting views of the efficiency of permitting redistributive taxing and spending on the local level); George R. Zodrow, *Tax Competition and Tax Coordination in the European Union*, 10 INT’L TAX & PUB. FIN. 651 (2003). My argument in the next Part is that these debates overlook some of the potential impact of the deduction itself.

61. See Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 314, 321 (1998); Gerald E. Frug, *Beyond Regional Government*, 115 HARV. L. REV. 1763, 1824–25 (2002); Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?*, 89 GEO. L.J. 257, 321–23 (2001); Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 402–46 (2004); Martha Minow, Lecture, *Reforming School Reform*, 68 FORDHAM L. REV. 257, 287 (1999); Philip J. Weiser, *Cooperative Federalism and Its Challenges*, 2003 MICH. ST. L. REV. 727, 728–29.

62. See, e.g., Dorf & Sabel, *supra* note 61, at 299–301, 322, 347, 354, 444.

63. Kaplow, *supra* note 4, at 477–78, 484.

warrant choice of one or the other in different circumstances, a problem I return to shortly in Part II.D.

### B. Devolution

There is another challenge for the state subsidy theory. Recall the argument, generally advanced in the context of analyses of the “tax equity” of the deduction, that annually state taxes paid roughly equal the benefits a given individual taxpayer receives.<sup>64</sup> To this we could add a claim that even redistributive spending might be viewed by some as a form of consumption, in that it creates the conditions for a thriving society, represents social insurance, or the like.<sup>65</sup> Further, we might argue, with Kaplow, that while taxpayers might desire to free ride on such benefits where they can, at bottom their choice of where to live often fully reveals how much they are willing to pay for government.<sup>66</sup> Under those premises, it quickly becomes difficult to see the tax expenditure argument for the deduction. If there is a rough equilibrium in most jurisdictions between taxes and services then there is no race to the bottom to avoid burdensome transfer payments. Taxpayers may relocate to find their desired level of taxing and spending, but they lose as much as they gain if they prefer more services and flee to a low-tax, low-service state.

There is a residual argument for the state subsidy position—really an argument that was there all along. We only care about whether states are able to tax if we are in favor of state spending. Quite possibly, we could respond to the fact that states cannot raise much revenue by shrugging, and then taxing and spending almost exclusively at the federal level. So the state subsidy claim is really a claim about federalism—that local spending is better, whether because it facilitates nationwide experimentation, maximizes autonomy, encourages a spirit of community, or achieves some other similar set of values that we might imagine.<sup>67</sup> The particulars are not important just yet. The point is that the deduction would have the effect of moving money from federal hands to state hands so that, without necessarily changing the amount of government services purchased nationwide, we would reduce the scope of federal operations and increase the money—and presumably the opportunities to regulate—available to states.

The question now arises why we need the deduction to accomplish that goal. It seems like we could well get to the same bottom line simply by cutting federal taxes across the board. Assuming that some localities have a preference for the level of combined services already delivered by the federal and state governments, they ought to respond by raising their own taxes to make up for the diminished federal demands and deliveries. Indeed, it is quite likely that many taxpayers prefer locally delivered

---

64. See *supra* text accompanying notes 12–15. It is worth reminding the reader that I limit my scope here to the taxation of individuals. The incidence of entity taxation and the possible responses by entities are, if possible, more complex than for individuals.

65. See, e.g., LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 17–19 (2002); Deborah Geier, Letter to the Editor, *Time to Bring Back the “Benefit” Norm?*, 33 *TAX NOTES INT’L* 899, 900–01 (2004).

66. See Kaplow, *supra* note 4, at 479.

67. See, e.g., Bratton & McCahery, *supra* note 25, at 215–16 (noting view that “locally adopted regulation more likely approaches the ideal of consonance with citizen preferences”); McConnell, *supra* note 59, at 1494. *But see* Shaviro, *supra* note 6, at 960 (stating that these arguments “have some validity but relatively limited consequences”).

services to nationalized services. So these taxpayers should, if anything, be happy to take up federal slack with state wind.

Research by tax scholars and psychologists suggests, however, that things are rarely so clear cut.<sup>68</sup> In some experiments, voters were unlikely to treat different groups of taxes with identical incidence as a single interchangeable mental category, "tax."<sup>69</sup> That result is contrary to our initial assumption that taxpayers are likely indifferent to different allocations between federal and state taxes in their overall tax burden. Study participants were similarly unlikely to be able to keep track of both the taxes and the benefits those taxes bought, a phenomenon the researchers dubbed the "isolation effect" or the "disaggregation bias."<sup>70</sup> The real-world prediction that flows from these effects is that voters will be discontent about decreased federal services, but also hostile to higher state taxes. That is, taxpayers will fail to put together the fact that their taxes and services have shifted from the federal level to the state level; they will more likely notice, and be angry at, higher state taxes and lower federal services. That is especially likely if state taxes are highly "salient," or imposed in a form very noticeable by the taxpayers. Thus, they may resist new state taxes, even if to pay for services shifted from the federal level. So federal tax cuts may simply lead to smaller government, even if the actual preference of the electorate is for more regulation.<sup>71</sup>

The deduction responds to this type of problem by tying any decrease in federal tax levels to higher state tax levels.<sup>72</sup> Of course, the effectiveness of the deduction itself is probably also limited by the isolation effect. The deduction will likely not be fully effective at lessening the sting of higher state taxes, because many taxpayers will not

---

68. See, e.g., EDWARD J. MCCAFFERY & JONATHAN BARON, THINKING ABOUT TAX 2–4 (2004), available at <http://ssrn.com/abstract=567767> [hereinafter MCCAFFERY & BARON, THINKING]; William Simonsen & Mark D. Robbins, *The Influence of Fiscal Information on Preferences for City Services*, 37 SOC. SCI. J. 195, 196 (2000) (summarizing mixed data on whether citizens recognize that higher services require higher taxes).

69. EDWARD J. MCCAFFERY & JONATHAN BARON, THE HUMPTY DUMPTY BLUES: DISAGGREGATION BIAS IN THE EVALUATION OF TAX SYSTEMS 6 (2002), available at <http://papers.ssrn.com/abstract=298648> [hereinafter MCCAFFERY & BARON, HUMPTY DUMPTY]; EDWARD J. MCCAFFERY & JONATHAN BARON, THE POLITICAL PSYCHOLOGY OF REDISTRIBUTION 26–28 (2005), available at <http://ssrn.com/abstract=695305> [hereinafter MCCAFFERY & BARON, REDISTRIBUTION].

70. MCCAFFERY & BARON, REDISTRIBUTION, *supra* note 69, at 32, 36; Simonsen & Robbins, *supra* note 68, at 207–10 (finding that providing taxpayers with additional information about tax levels changes their previously stated preferences for services); Soren Winter & Poul Erik Mouritzen, *Why People Want Something for Nothing: The Role of Asymmetrical Illusions*, 39 EUR. J. POL. RES. 109, 110–12 (2001) (describing studies showing voters with internally inconsistent opinions about taxing and spending sides of public fiscal policy).

71. See MCCAFFERY & BARON, REDISTRIBUTION, *supra* note 69, at 47–48.

72. See Gillette, *supra* note 10, at 1052–53 (noting that the federal government uses matching grants to ensure that its contribution to the state will not be used simply to decrease the state's tax burden).

The economics literature suggests in fact that in many cases these types of "matching" grants prompt even more spending by the recipient than we would expect from purely rational behavior. James R. Hines, Jr. & Richard H. Thaler, *Anomalies: The Flypaper Effect*, 9 J. ECON. PERSP. 217, 218–20 (1995) (summarizing studies). Some economists theorize that this disparity may be due to failure either of the general public or of representatives to keep separate "mental accounts" of the grant benefits and their budgets as a whole. *Id.* at 222–24.

associate their higher state bill with the lower federal bill. But a purely devolutionary deduction can also make use of the disaggregation bias. To maximize the usefulness of the deduction, the federal government could allow the deduction to recognize as wide a variety of state taxes as the states can invent. By spreading its tax burden over many small taxes, each with its blow somewhat cushioned by a federal deduction, the state might rather reduce the salience of its tax burden.<sup>73</sup> That, in turn, may make it feasible that the decline in federal revenue will actually be matched by a corresponding expansion of state proceeds.

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

Even so, that leads us to the question of whether we ought to manipulate, rather than try to dispel, voter misconceptions. The deduction here seems both to respond to and also trade in the fact of taxpayer cognitive biases. Biases are not necessarily inflexible; research suggests individuals can be “debiased.”<sup>74</sup> Other commentators argue that, given proper incentives, the market will iron out bias, or some individuals may attempt to overcome cognitive bias either on their own or with the help of feedback from nongovernmental sources.<sup>75</sup> It seems unwise, and perhaps even illegitimate, to make social policy whose basis depends on ignorance or misunderstanding. If we are committed to devolution, then, the better route might be to educate or motivate voters, not to manipulate their perceptions.<sup>76</sup> Thus, there is another front for more and better empirical work: how can we make debiasing work, and can we make it work at a cost of less than the deduction’s \$75 billion sticker?

### C. Spillovers

There is one last aspect of the state subsidy view we have not yet considered. Local spending, we have seen, can serve not only residents of the locality but also their neighbors. The present wisdom is that each such locality is undermotivated to produce these kinds of “spillover” benefits.<sup>77</sup> Supposedly, states do not internalize the gains their spending provides to others.<sup>78</sup> If that is true, then they will have no particular incentive to allocate their resources in a way that people who reside outside their own

---

73. MCCAFFERY & BARON, THINKING, *supra* note 68, at 26.

74. *Id.* at 14, 18; Linda Babcock, George Loewenstein & Samuel Issacharoff, *Creating Convergence: Debiasing Biased Litigants*, 22 LAW & SOC. INQUIRY 913, 916 (1997).

75. On the latter argument, see Jonathan Klick & Gregory Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90 MINN. L. REV. 1620, 1624–26, 1652–53 (2006).

76. MCCAFFERY & BARON, REDISTRIBUTION, *supra* note 69, at 60.

77. Ellickson, *supra* note 10, at 1554.

78. Gillette, *supra* note 10, at 1044 nn.60–61; see also Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1147 (1996) (making this argument outside of the tax context).



borders can enjoy.<sup>79</sup> The deduction, in this view, might make up for what would otherwise be an underproduction of good spillovers.<sup>80</sup> Of course, there are some administrative challenges in making sure that the deduction is cost effective (for example, in targeting it to jurisdictions that benefit their neighbors the most), but these perhaps are not insuperable. The larger difficulty for this theory, I suggest here, is that it is wrong that states do not internalize the benefits of the spillovers they produce. In particular, states can use spillovers as a way of bribing nonresidents not to move in, which can benefit the state in two distinct ways.

### 1. The Benefits of Bribery

The first benefit to states flows from the fact that in a nation where interstate movement is inefficient, states can in theory export some of their tax burden.<sup>81</sup> To see how this works, start with a model where there are no frictions. To take a simple example, sales taxes are a classic way that a state can pay for some of its services with money supplied by outsiders—tourists and other short-term visitors—who consume relatively little in the way of some services, such as education and health care.<sup>82</sup> Hotel taxes are an especially good example since, generally they only indirectly affect the state's own residents.<sup>83</sup> But in a frictionless republic, the sales-tax state's citizens would not be able to realize the benefits of exporting their tax.<sup>84</sup> The hotel-tax state is a bargain relative to its neighbors, so that their citizens now move into the state, consuming services, driving up the cost of real estate, and driving down wages.<sup>85</sup>

The hotel-tax jurisdiction has two main options in the frictionless republic, neither very likely to succeed in allowing it to export its tax burden. First, it can simply pay a cash bribe to prospective immigrants to stay home.<sup>86</sup> Since the transaction costs of

---

79. Briffault, *supra* note 39, at 540–41; Ellickson, *supra* note 10, at 1554–55; Gillette, *supra* note 10, at 1046–47.

80. See Gillette, *supra* note 10, at 1046 n.61; Kaplow, *supra* note 4, at 480–83; Stark, *supra* note 10, at 1408; cf. Yorio, *supra* note 6, at 1280–81 (arguing that deduction increases beneficial spillovers without noting internalization problems).

81. I should note here that the possibility of tax exporting is not necessarily a policy outcome to be avoided at the cost of other goals. See, e.g., Shaviro, *supra* note 6, at 961–63 (arguing that tax exporting is at least unobjectionable in some circumstances). But for our purposes, the fact that some of a jurisdiction's costs are 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. See Kaplow, *supra* note 4, at 422.

82. See Shaviro, *supra* note 6, at 911.

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

84. See Gillette, *supra* note 10, at 1046 n.61; Kaplow, *supra* note 4, at 480–83; Stark, *supra* note 10, at 1408; cf. Yorio, *supra* note 6, at 1280–81 (arguing that the deduction increases beneficial spillovers without noting internalization problems).

85. See Russell R. Krellove, *Efficient Tax Exporting*, 25 CANADIAN J. ECON. 145, 154 (1992); cf. Shaviro, *supra* note 6, at 908 (describing the distortionary effects of tax exporting).

86. Cf. Robin Boadway & Frank Flatters, *Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent Results*, 15 CANADIAN J. ECON. 613, 627 (1982) (describing the possibility of using federal-level grants to equalize tax revenues, and thereby make investors indifferent about where to allocate capital).

direct bargaining are likely to be immense, it would have to use some central authority to distribute its bribes; the federal government seems like a fine candidate. But even if transaction costs can be minimized, bribery should not really work, because no rational, fully-informed carpetbagger will accept a bribe of less than the value of the bargain she would be getting in good old Hotel Tax City (HTC). The State might also try another form of bribery—producing its services in a way that can also be used relatively costlessly by the neighbors who are bearing its tax burden. Again, though, that does not quite work. Having a clean, accessible, and safe vacation spot next door, filled with well-educated potential employees, is dandy. But, all else being equal, it is not as good as living there.

Frictions make bribery and deception viable strategies. If the benefit of living in HTC is \$100, and it costs \$50 to move there, a successful bribe obviously costs only \$50, which may make HTC's tax-exporting scheme economically viable. Probably of greater significance is the fact that prospective immigrants likely cannot easily get an accurate estimate of the value of living in HTC, and even with complete information may face cognitive problems in understanding and accurately evaluating the information they acquire. Information about alternative jurisdictions is expensive to gather and hard to interpret.<sup>87</sup> 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.<sup>88</sup> As we will see, localities have conflicting incentives on whether or not 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 tradeoffs.<sup>89</sup> And, as we saw, citizens may have trouble keeping together in their minds both the taxing and spending sides of the ledger in the respective jurisdictions. If the "endowment effect" is real,<sup>90</sup> we can expect many individuals to overestimate the value of the services that they are already receiving.

Thus, even in a two-jurisdiction model, in which bundling problems are nonexistent and decision costs are relatively low, a successful bribe probably could be priced at considerably below the per capita fiscal advantage of tax exporting. That is crucial for larger models, in which the number of prospective immigrants widens far beyond the small group of neighbors upon whom a jurisdiction is able to impose its own costs. The bribery story seems even more plausible if we think that moving and information-gathering costs increase with distance, so that even as the circle of jurisdictions laden with potential newcomers widens, the bribe necessary to keep them at bay diminishes.<sup>91</sup>

---

87. Bratton & McCahery, *supra* note 25, at 235; Shaviro, *supra* note 6, at 964–65.

88. See Sheryll D. Cashin, *Localism, Self-Interest, and the Tyranny of the Favored Quarter: Addressing the Barriers to New Regionalism*, 88 GEO. L.J. 1985, 1988 (2000); Wallace E. Oates, *On Local Finance and the Tiebout Model*, 71 AM. ECON. REV. 93, 93 (1981).

89. See Bratton & McCahery, *supra* note 25, at 223–25; Shaviro, *supra* note 6, at 964–65.

90. Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990); Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980) (discussing the endowment effect theory).

91. As I suggested, this analysis also implies that states have an interest in deceiving outsiders about the mix of benefits and burdens they offer to their residents. By increasing information costs and uncertainty, a jurisdiction can lower the bribe it will have to pay to keep

In addition to permitting tax exporting, spillovers enable a state to provide services to its citizens without also having to pay for free riders. Any jurisdiction that offers public services will be likely to attract migrants.<sup>92</sup> Migrants may be from lower-tax jurisdictions, or they may simply be latecomers who want to enjoy the fruit of the state's earlier investments in developing the capacity and know-how to deliver a given service.<sup>93</sup> One way the state can fend off the newcomers is to bribe them to stay at home. And one way of offering a bribe is for the state to deliver its services in a way that the would-be immigrant can enjoy without moving in. In a frictionless world, of course, that would not result in any gains for the service-providing state; bribes would have to equal the benefits of residency.<sup>94</sup> But our nation is not so slippery as that. Moving is expensive, information about where and when to move is costly, and citizens often overvalue what they have relative to what they might get.<sup>95</sup>

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

## 2. Why Not Zoning?

It might be argued, though, that states do not actually use bribes, because bribes are an inferior tool for achieving the same ends that could be accomplished through restrictive zoning. Localities can use zoning to force potential newcomers to consume more housing than they can afford and to pay enough property tax to cover any services they might consume.<sup>96</sup> Here, though, we see a significant difference between state and local incentives: the states, at least at present, do not zone.<sup>97</sup> So bribery is a significant factor in state-level fiscal decisions.

At the local level, many jurisdictions cannot effectively employ restrictive zoning. Because exclusive zoning depends on restricting the number of people who can occupy a parcel of land, it is not useful in wealthy but already densely populated areas, such as

---

away newcomers. States should want to spend most on services whose value to outsiders is especially opaque—education, for instance, seems a plausible candidate. *See* Bratton & McCahery, *supra* note 25, at 236 (observing the difficulty for “consumers” in identifying the quality of education a jurisdiction produces); *cf.* Fennell, *supra* note 57, at 2–3 (observing that legal scholars have struggled to measure quality of education services). This incentive is significant for the impact of the deduction on the transparency of local government, as I detail in the next Part.

92. *See* Katherine Baicker, *The Spillover Effects of State Spending* 16–17 (Nat'l Bureau of Econ. Research, Working Paper No. 8383, 2001).

93. *See* Roderick M. Hills, Jr., *Poverty, Residency, and Federalism: States' Duty of Impartiality Toward Newcomers*, 1999 SUP. CT. REV. 277, 304–07.

94. This is the case unless the service is a true public good—that is, its value to the producer is not reduced by additional consumers.

95. *See supra* text accompanying notes 87–90. It is worth mentioning that the state cannot choose simply to refuse to pay benefits to new arrivals. *Saenz v. Roe*, 526 U.S. 489, 498–507 (1999) (holding unconstitutional California statute limiting new residents' welfare benefits to the amount receivable in state of former residence).

96. *See* FISCHER, *supra* note 58, at 51–57 (2001); Cashin, *supra* note 88, at 2012–13, 2015; Fennell, *supra* note 58, at 68; Bruce W. Hamilton, *Property Taxes and the Tiebout Hypothesis: Some Empirical Evidence*, in *FISCAL ZONING AND LAND USE CONTROLS* 13, 14–18 (Edwin S. Mills & Wallace E. Oates, eds., 1975).

97. DANIEL R. MANDELKER, *LAND USE LAW 1-1 to 1-2* (5th ed. 2003); PATRICK J. ROHAN, *ZONING AND LAND USE CONTROLS 1-10* (Eric Damian Kelly ed., rev. ed. 2005).

Manhattan or San Francisco. In other regions exclusive zoning is unlawful or restricted by judicial supervision.<sup>98</sup> Although would-be migrants do not have standing in federal court to challenge exclusive zoning in a jurisdiction where they do not reside,<sup>99</sup> a zoning jurisdiction runs the risk that its state will take a broader view of the rights cognizable in state court.<sup>100</sup> Further, zoning is not effective at shifting costs onto neighbors who can afford to respond by moving into the would-be exporter. Exclusive zoning also has social costs, such as lost diversity, that some jurisdictions may recognize as significant.<sup>101</sup> Finally, it may be that bribery is cost-effective even in addition to exclusive zoning.

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

#### D. Why Not Direct Spending?

From this sketch, it does not look like any of these three possible tax subsidy arguments is particularly overwhelming. But suppose we thought one or more of them was reasonably persuasive. We might then ask, with Professor Kaplow, why bother with state taxes at all? Kaplow argues that direct federal grants to the states could serve the same ends as the deduction without some of the attendant distortions.<sup>102</sup> Obviously, the debate over using the tax system for policy objectives is a subject much larger than I can do justice to here. An abbreviated glance, however, suggests at least some potential role for deductions alongside direct expenditures.

Perhaps Kaplow's most trenchant argument is his claim that direct grants would allow for more accountability on the part of state officials who take receipt of the grant moneys and decide how to spend them.<sup>103</sup> He may be thinking of the many strings, including judicial oversight, that often come with federal grants. But, again, assuming that is an attractive approach, it is at least conceivable to design a similar structure around tax expenditures.<sup>104</sup> Consider two long-standing tax subsidies: the charitable

98. ROBERT R. WRIGHT & MORTON GITELMAN, *LAND USE IN A NUTSHELL*, 219–254 (4th ed. 2000).

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

100. See Helen Hershkoff, *State Courts and the "Passive Virtues": Rethinking the Judicial Function*, 114 HARV. L. REV. 1833, 1836–37, 1852–59, 1881–97 (2001) (noting that state courts sometimes take a broader view of standing than do federal courts, and setting out a detailed rationale for that approach).

101. See Fennell, *supra* note 57, at 85.

102. Kaplow, *supra* note 4, at 484–86; see also Gillette, *supra* note 10, at 1067, 1074 (arguing that direct grants would be preferable to deduction for municipal bonds for subsidizing local spending because grants would minimize distortions).

103. Kaplow, *supra* note 4, at 485–86.

104. See generally Mary L. Heen, *Reinventing Tax Expenditure Reform: Improving Program Oversight Under the Government Performance and Results Act*, 35 WAKE FOREST L. REV. 751

deduction and exemptions, centered around section 501<sup>105</sup> of the Code, and the Low-Income Housing Tax Credit (LIHTC).<sup>106</sup> Both offer potential models for how favorable tax treatment can mimic the accountability and transparency of direct spending programs. Under both programs, the IRS actively monitors the behavior of recipients.<sup>107</sup> While not all the results of the IRS's enforcement activities are made public, the process of complying with IRS mandates produces vast amounts of public information, such as the Form 1023s prepared by entities applying for exempt status and annual Form 990 returns filed by those entities.<sup>108</sup> These forms are now collected online,<sup>109</sup> and offer taxpayers—as well as prospective donors or business partners—a window into the finances, charitable objectives, and internal governance structures of various charities. At the same time, the IRS is not alone in its enforcement and monitoring efforts. Under both programs, the IRS draws significantly on the expertise and eyes of the public<sup>110</sup> and regulatory partners—state attorneys general in the case of exempt entities, and the Department of Housing and Urban Development and state housing finance agencies in the case of the LIHTC.<sup>111</sup>

The analogy to exempt entities suggests another possible strength of subsidizing states with tax deductions rather than grants: the size of the subsidy is dictated by market decisions, rather than by Congress. Recall that one of the premises of the state-subsidy rationale was that it helped to restore to states the political autonomy to set their own fiscal policy, a freedom somewhat compromised by collective action problems. That goal seems incompatible with direct subsidies: If the federal government collects the revenues on behalf of the states, how does it know what allocation of funds would duplicate what would have been the states' original preferences? Once the money is collected, the individual states are unlikely to claim that they are uninterested in distributing it to their citizens; no one turns down free

---

(2000); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004).

105. 26 U.S.C.A. § 170, 501–527 (2006).

106. See generally U.S. DEP'T OF HOUS. & URBAN DEV., *HOME and Low Income Housing Tax Credits (LIHTC)* (Aug. 30, 2004), available at <http://www.hud.gov/offices/cpd/affordablehousing/training/web/lihtc/> (last visited Mar. 25, 2007) (providing a review of the LIHTC and its mechanics); Andrew Zack Blatter & Elena Marty-Nelson, *An Overview of the Low Income Housing Tax Credit*, 17 U. BALT. L. REV. 253 (1988); Brian Galle, *Preserving Federally Assisted Housing at the State and Local Level: A Legislative Toolkit*, 29 HOUS. L. BULL. 183 (1999) (discussing the tax credit in the context of low-income housing preservation policy); Sagit Leviner, *Affordable Housing and the Role of the Low Income Housing Tax Credit Program: A Contemporary Assessment*, 57 TAX LAWYER 869, 871–75 (2004).

107. See, e.g., MICHAEL I. SANDERS, *JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS*, 416–38 (2d ed., Wiley 2000) (summarizing federal tax considerations in LIHTC transactions); IRS, DEP'T OF THE TREASURY, *INTERNAL REVENUE MANUAL PART 7: RULINGS AND AGREEMENTS*, available at <http://www.irs.gov/irm/part7/index.html> (last visited Mar. 25, 2007) (setting out IRS enforcement procedures for exempt entities); IRS, *IRS LOW INCOME HOUSING TAX CREDIT DRAFT AUDIT TECHNIQUE GUIDE* (June 1998) (on file with author).

108. See 26 U.S.C.A. § 6104(a)(1), (d)(1) (2006).

109. GuideStar, <http://www.guidestar.org> (last visited Mar. 25, 2007).

110. E.g., IRS News Release FS-2002-10 (Mar. 29, 2002), available at <http://www.irs.gov/pub/irs-news/fs-02-10.pdf> (describing the IRS's procedures for obtaining enforcement tips from general public).

111. E.g., IRS Form 8823, *Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition* (2005), available at <http://www.irs.gov/pub/irs-pdf/f8823.pdf>.

money.<sup>112</sup> One possibility is that we could allocate federal money according to the extent to which states actually redistribute their own money, much as the charitable deduction in effect rewards charities in proportion to the amount of public support they can garner.<sup>113</sup> The current deduction superficially seems to do just that, since it rewards states in rough proportion to the extent to which they impose their tax burden on wealthy itemizers.<sup>114</sup>

There is, however, a problem with this argument. State tax revenues speak only to the intake side of the balance sheet; we do not know what states do with the money they raise.<sup>115</sup> It seems fairly plausible that states shift both taxes and services to high earners.<sup>116</sup> That is, although states may tax more heavily because of the deduction, they might not *redistribute* the tax income in the way they would have preferred absent collective action barriers. Professor Stark argues to the contrary, claiming that many state constitutions require some equity in education expenditures, and noting that the U.S. Constitution prohibits discrimination based on race, thereby putatively limiting a state's ability to channel its tax dollars to selected groups.<sup>117</sup>

With due respect to Professor Stark, these are unconvincing arguments. Federal constitutional scrutiny of class-based state spending is minimal,<sup>118</sup> and is not heightened by the fact that class differences may overlap with racial differences.<sup>119</sup> Notably, the U.S. Supreme Court has upheld large disparities in state allocations of education spending.<sup>120</sup> State constitutional rulings have largely set minimum standards for all school districts without capping what wealthier districts can spend on themselves.<sup>121</sup> And there are few, if any, limits anywhere on how and in what

112. See Lynn A. Baker, *The Spending Power and the Federalist Revival*, 4 CHAPMAN L. REV. 195, 201–04 (2001).

113. See David E. Wildasin, *Income Redistribution in a Common Labor Market*, 81 AM. ECON. REV. 757, 761–65 (1991).

114. On the increasing value of the deduction to higher-income taxpayers, see *supra* text accompanying notes 21–22.

115. To be a bit more precise, we do know that states for the most part do not spend their money on programs typically defined as redistributive, such as pure transfer payments. PETERSON, *supra* note 59, at 211. We do not have good data about the distributive effects of other forms of state spending.

116. *Cf.* Chernick, *supra* note 22, at 98 (finding doubtful, if any, correlation between progressive taxation and progressive spending).

117. Stark, *supra* note 10, at 1426–27.

118. *E.g.*, FCC v. Beach Comm., 508 U.S. 307, 313–14 (1993) (“Whether embodied in the Fourteenth Amendment or inferred from the Fifth, equal protection is not a license for courts to judge the wisdom, fairness, or logic of legislative choices. In areas of social and economic policy, a statutory classification that neither proceeds along suspect lines nor infringes fundamental constitutional rights must be upheld against equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification.”)

119. See McCleskey v. Kemp, 481 U.S. 279, 297–99 (1987) (rejecting the argument that facially neutral policy with incidental disparate impact on protected minority group violated Constitution); see also Washington v. Davis, 426 U.S. 229, 239–42, 248 & n.14 (1976) (holding the same).

120. See San Antonio Indep. Sch. Dist. v. Rodriguez, 411 U.S. 1, 28–44 (1973).

121. See Laurie Reynolds, *Skybox Schools: Public Education as Private Luxury*, 82 WASH. U. L.Q. 755, 756–61 (2004); Avida Y. Cover, Note, *Is “Adequacy” a More “Political*

neighborhoods a locality can allocate its money for jobs, policing, parks, clean streets, filled potholes, or on how it chooses between services with obvious distributive implications, such as highways versus public transit, workplace safety and health inspectors versus securities regulators.<sup>122</sup> Moreover, to the extent that jurisdictions may want to discourage free riding by indigent newcomers, the jurisdictions have an incentive to allocate service dollars in ways that will benefit those with more wealth.

So allocation has no obvious workable shortcut, and it is a serious conceptual problem. The deduction seems an attractive alternative to grants if its goal is to restore spending discretion—and therefore political autonomy—to states hamstrung by collective action problems. But it appears clear that any distribution of money for redistribution will be allocated according to a federal formula highly unlikely to capture the actual preferences of each state.

Another criticism of the deduction is that it may not be a particularly efficient tool for delivering money to state governments.<sup>123</sup> Unlike a simple grant, the deduction does not necessarily deliver money to states on a dollar-for-dollar basis; instead, it relies on some alchemy of the political views of deduction recipients and responses by state officials. The perceived after-federal-tax cost of a state tax to a state voter may be hard to calculate, especially in light of possible future federal changes. This uncertainty arguably reduces the value of the deduction in a way that cash in hand certainly does not. However, the deduction might also actually buoy federal revenues. Remember that the deduction, especially in its current form, is most valuable to high-income states. At the moment, most of the highest-earning states are net federal tax exporters.<sup>124</sup> The deduction counter-balances that disparity (hence, the support of Mario Cuomo).<sup>125</sup> And the federal income tax is likely considerably more salient than most federal expenditures, especially for higher-wage earners who do not receive Social Security, Medicare, Medicaid, or AFDC benefits. Thus, voters in high-earning states may notice their diminished federal tax burden rather more than they notice a collection of small federal benefits. So, the deduction could make voters in these net-payer states more willing to shoulder their high combined net tax burden. Cognitive biases, in short, might allow the deduction to do much more work in facilitating federal spending than its pure dollar value.<sup>126</sup> But it could also leverage much less. More data undoubtedly would be welcome here. We do know, though, that cooperative spending programs are

---

*Question” than “Equality?”: The Effect of Standards-Based Education on Judicial Standards for Education Finance*, 11 CORNELL J.L. & PUB. POL’Y 403, 409–11 (2002).

122. See Briffault, *supra* note 39, at 536; Clayton P. Gillette, *Equality and Variety in the Delivery of Municipal Services*, 100 HARV. L. REV. 946, 950 (1987) (reviewing CHARLES M. HAAR & DANIEL W. FESSLER, *THE WRONG SIDE OF THE TRACKS: A REVOLUTIONARY REDISCOVERY OF THE COMMON LAW TRADITION OF FAIRNESS IN THE STRUGGLE AGAINST INEQUALITY* (1986)).

123. I am grateful to Professor Ron Pearlman for his thoughtful arguments on this point.

124. See Tax Foundation, *Federal Taxing and Spending By State*, available at <http://www.taxfoundation.org/taxdata/topic/92.html> (last visited Mar. 25, 2007).

125. See, e.g., Boadway & Flatters, *supra* note 86, at 630–31; Daniel J. Mitchell, Heritage Foundation, *The Deduction for State and Local Taxes Undermines Tax Reform and Subsidizes High-Tax States* (July 25, 2005), <http://www.heritage.org/Research/Taxes/em974.cfm> (arguing that deduction supports state tax revenues in richest states); see *supra* text accompanying note 41.

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

not one hundred percent efficient, either, since they entail significant bureaucratic costs. So it is not clear at the moment that the deduction is a comparatively inefficient way of delivering federal monies.

On the other hand, it seems as though there ought to be room for *both* grants and tax expenditures as tools of federal subsidy. Public choice theory and everyday experience suggest it is probably very difficult politically to remove a large deduction, enjoyed by politically powerful wealthy taxpayers, from the federal income tax.<sup>127</sup> At least some benefits financed through direct expenditure are not comparably resilient. Thus, tax subsidies can be rather more stable than direct spending.<sup>128</sup> That stability obviously makes planning and reliance easier for those affected by the federal program. Further, stability can save the federal government money. I have noted elsewhere that a prospective regulatory partner contemplating working together with the federal government in exchange for financial gain is likely to demand a premium for uncertainty.<sup>129</sup> Changes in federal policy may lock the partner into continuing a course that, while unprofitable, is less disadvantageous than abandoning sunk investments and starting over.<sup>130</sup> The rational partner wants to be paid against the possibility of that outcome.<sup>131</sup> A more reliable federal promise, such as policies enacted through the tax system, can make the uncertainty premium lower. In some circumstances these

---

127. See, e.g., Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 518–19 (1998); Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159, 1200–1225 (2006); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971), reprinted in ADMINISTRATIVE LAW ANTHOLOGY 399, 402–03 (Thomas O. Sargentich ed., 1994).

128. See Gillette, *supra* note 10, at 1080 (noting that tax exemptions are “less susceptible of political machinations that could disfavor certain localities” than are grants); Hines & Thaler, *supra* note 72, at 223 (describing a behavioral phenomenon in which taxpayers are much more averse to an increase in tax than they are favorably inclined to a decrease in tax of same amount); Zelinsky, *supra* note 16, at 805. In addition to these political economy effects, a deduction is more politically resilient than some direct expenditures as a result of some quirks in the congressional rules. Whereas a deduction need only be enacted once, albeit subject to CBO scoring, see PHILIP D. OLIVER, TAX POLICY: READINGS AND MATERIALS 1074–75, 1081–90 (2d ed. 2004), discretionary spending is subject to annual appropriations, Sandy Streeter, Congressional Research Service, *The Congressional Appropriations Process: An Introduction* 24–25 (Sept. 8, 2006), available at <http://www.senate.gov/reference/resources/pdf/97-684.pdf>. This puts legislative inertia in the corner of the deduction, which requires an affirmative act of Congress to shut it off. Further, direct grants must run a double committee gauntlet in each House—they must both be authorized and appropriated. Bill Heniff, Jr., Congressional Research Service, *Overview of the Authorization-Appropriations Process* 1–2 (July 23, 2003), available at <http://www.senate.gov/reference/resources/pdf/RS20371.pdf>. In contrast, tax subsidies begin and end only in the House Ways & Means Committee and the Senate Finance Committee. U.S. House of Representatives Joint Committee on Taxation, *Joint Committee Role in the Legislative Process*, <http://www.house.gov/jct/rolehist.htm>.

129. Brian Galle, *Getting Spending: How to Replace Clear Statement Rules With Clear Thinking About Conditional Grants of Federal Funds*, 37 CONN. L. REV. 155, 195 n.244 (2004).

130. See *id.* at 192; David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2564 (2005).

131. Galle, *supra* note 129, at 195 n.244.



planning benefits and cost savings should make the deduction an attractive alternative to grants, even if somewhat less efficient.

### III. NO EXIT?

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

These questions about the quality of state governance arise because the deduction significantly curtails interstate movement. For example, an individual taxpayer is considerably less likely to move in order to escape subjectively burdensome taxes if she perceives the deduction as lightening her burden,<sup>132</sup> especially if moving would be costly and somewhat risky. More generally, by shifting some revenue from the federal government to the states, the deduction may dampen interstate movement by encouraging localized investment. Although federalism provides many different baskets of taxes and services, it paradoxically makes it harder to choose among the baskets, and greatly magnifies the costs of ascertaining what each one contains.<sup>133</sup> If all spending were national, each taxpayer would know that in moving from one state to another she would be getting, roughly speaking, the same basket, and would not have to research thousands of alternatives, compare them, and decide between them before moving.

Many commentators would claim that diminished mobility will significantly reduce the efficiency of state government.<sup>134</sup> In an ideal market, taxpayers will flee inefficient or corrupt governments for those that deliver similar sets of services with less waste.<sup>135</sup> Some writers predict that even in a more realistic model, in which we recognize that there are significant frictions on interjurisdictional movement, intrastate politics can be shaped by the *threat* of exit.<sup>136</sup> An important taxpayer does not have to actually analyze all the costs and benefits of every possible other jurisdiction in order to claim credibly

---

132. See Briffault, *supra* note 39, at 545; Lynch, *supra* note 59, at 598; Stark, *supra* note 10, at 1408 & n.72.

133. See Bratton & McCahery, *supra* note 25, at 274 (describing informational problems arising from existence of multiple jurisdictions).

134. See sources cited *supra* note 59.

135. See Abraham Bell & Gideon Parchomovsky, *Of Property & Federalism*, 115 YALE L.J. 72, 103 (2005); Bratton & McCahery, *supra* note 25, at 208–09; Briffault, *supra* note 39, at 540.

136. See ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY 44–54, 120–26 (1970) (noting interdependence of exit and political influence); Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 30–31 (1995) (analyzing so-called “yardstick” effect, whereby voters evaluate performance of local politicians by reference to performance of neighboring jurisdictions); Bratton & McCahery, *supra* note 25, at 264–65; Dorf & Sabel, *supra* note 61, at 319–20, 338, 348–49.

that she will leave.<sup>137</sup> All she has to do is find one other jurisdiction that delivers one service more efficiently than her current home. The government of her home state does not know that she has not analyzed all the other factors; for all it knows, she is indifferent to them. Indeed, politicians have a professional interest in understanding human nature, so our taxpayer's elected officials may guess that she might be motivated more by heuristics than detailed cost analysis. These officials have a strong incentive to satisfy the powerful taxpayer because although her one vote may not be very important, her departure (and, of course, her campaign contributions) would be: the lost revenue would hurt the state in ways that would cost the officials more votes, and other citizens may look to her as an opinion leader.<sup>138</sup> When all the wealthy families leave (or threaten to leave) a neighborhood, few of the residents who remain are likely to conclude that the government has been doing a good job recently.<sup>139</sup> So, again, exit can be an important mechanism in chastening local governments, even if no one actually ever goes anywhere.

To this familiar argument I would add that mobility can also foster a form of taxpayer participation in government by curbing tax exporting. For the most part, we have no right to participate in the politics of a jurisdiction where we do not reside, even if it makes decisions that affect us, such as instituting a tax whose incidence we bear.<sup>140</sup> But as I have mentioned, we can force the exporting jurisdiction to take some consideration for us simply by the threat of moving there in response.<sup>141</sup> That threat may even give rise to negotiations between exporter and nonresident over what bribe the exporter must pay to prevent in-migration.

It therefore is possible that the deduction undermines the efficiency and participatory character of state and local government. The deduction diminishes the chastening force of exit, undercuts the force of threats to depart, and weakens incentives for jurisdictions to pay heed to the needs of neighbors affected by their

---

137. This point also has a broader significance for my argument. Many commenters on earlier drafts observed that the deduction's effects on mobility would seem unimportant to the extent that tax generally is not an important factor in individuals' decisions about where to live. Several empirical studies are skeptical about the impact of local tax considerations on mobility. See ALBERT BRETON, *THE ECONOMIC THEORY OF REPRESENTATIVE GOVERNMENT* 112–13 (1974); Roger J. Vaughan, *State Taxation and Economic Development*, in *STATE TAXATION POLICY* 109 (Michael Barker ed., 1983). *But see* sources cited *supra* note 54 and accompanying text. And, again, the skeptical studies take place in a universe (ours) where state and local taxes are deductible, so they may in fact support my point that the deduction significantly diminishes mobility. The more important point to take away, though, is that our working assumption is already that *actual* mobility is limited. It may be the threat of departure that serves mostly to chasten local governments, and that threat is less credible when state and local tax burdens are deductible. See Benjamin Bridges, Jr., *Allowances for State and Local Nonbusiness Taxes*, in *ESSAYS IN FISCAL FEDERALISM* 187, 214 (Richard A. Musgrave ed., 1965) (“[P]oliticians and voters believe that changes in interstate income tax differentials significantly affect citizens' choices of residence, place of work, and business location.”).

138. See Fennell, *supra* note 57, at 26.

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

140. See Kirk Stark, *The Right to Vote on Taxes*, 96 *Nw. U. L. REV.* 191, 229 (2001).

141. See *supra* text accompanying notes 134–138.

policies. These effects are particularly troubling if our main rationale for the deduction was precisely to expand the range of services offered by local governments.

However, as the tax exporting example also suggested, mobility and exit also create incentives for state governments that might cut *against* good government. The premise of the efficient exit argument is that state government must be relatively transparent, so that mobile citizens can recognize inefficiencies and move to avoid them, or threaten to move if they are not repaired.<sup>142</sup> The trouble is that in order to frustrate migration, both in and out, states may prefer to make the quality and kind of their services as opaque as possible. Of course, individual officials will always want to be able to campaign on demonstrable successes. But, in the absence of any benchmark for what constitutes “success,” and faced with substantial obstacles to acquiring that information, the average voter will have no way of assessing claims by local officials that they have far outstripped their neighbors.<sup>143</sup> And the government can always deliver essentially secret benefits—through zoning variances, property tax waivers, special regulatory rulings, and other highly opaque avenues—to important constituencies.

One might argue, on the other hand, that jurisdictions should have an incentive to offer good comparative data in order to entice wealthy newcomers. If losing successful residents hurts officials’ prospects for reelection, attracting prominent new ones should help. Admittedly, this information will be limited. Since the jurisdiction will want to attract only the wealthy, it is likely to compile only data about services that would be attractive to that group, and not about, say, transfer payments. Information may be screened in a way to keep it from those with modest means, such as by disclosing exclusively through realtors or the local Chamber of Commerce, and/or by imposing a small charge for access to the information. Moreover, information disclosure may not be effective at attracting outsiders. Prospective migrants do not know how long the transparent phase of government will last.<sup>144</sup> They may reasonably calculate that the jurisdiction does not want them to leave, and the potential inflow of less beneficial taxpayers may at some point outweigh the gains of continued openness, so that the taxpayers enticed by the possibility of open and efficient government will be stranded again. If that attitude proves widespread, there might never be a strong reason for the jurisdiction to provide good data in the first place. So exit produces only somewhat modest incentives for transparency, and even then only for some sorts of services.

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

---

142. See Bratton & McCahery, *supra* note 25, at 208–09.

143. Cf. Strahilevitz, *supra* note 39, at 970 (noting incentives for public officials to provide public with misleading data about their own performance).

144. See Fennell, *supra* note 57, at 27, 71; Richard T. Ford, *Beyond Borders: A Partial Response to Richard Briffault*, 48 STAN. L. REV. 1173, 1175 (1996); Jerry Frug, *Decentering Decentralization*, 60 U. CHI. L. REV. 253, 266–67 (1993); Gillette, *supra* note 10, at 1078.

The result is that the deduction actually diminishes any incentive for jurisdictions to generate good information about themselves.

There is a bit of a bright side, though. Mobility may also damage local government in two other fairly well-known ways. First, it will tend to undermine the possibility that each locality will develop into a strongly connected community of principle, in which the residents understand each other's needs and values and set policy after debate about issues of shared importance.<sup>145</sup> Secondly, the likelihood of frequent relocation may tend to lead voters to make political decisions based on short-term needs rather than the long-term interests of the community as a whole.<sup>146</sup> To the extent that it reduces exit, the deduction helps preserve these two values.

On the whole, though, it looks doubtful that mixing the deduction with unmediated, free-market federalism will lead to salutary developments in state governance. One response to this situation would be to shift regulation to the federal government.<sup>147</sup> But, obviously, that would often come at the expense of the experimentation and diversity benefits that accompany independent local lawmaking. So at this point, the deduction looks like a horrible choice if our goal is to encourage devolution or local redistribution, and its negative effects on local governance are surely a concern if we want to improve the equity of the federal tax base or achieve societal tax-enforcement savings.

Over the last decade, however, a number of commentators have suggested tactics for reforming federalism so as to cure some of the pathologies of its free-market form. These proposals combine federal and state regulation, sometimes along with direct popular participation, in an effort to gain the best of both worlds.<sup>148</sup> The federal government in these schemes serves as a sort of clearing house and analyst for good governmental practices.<sup>149</sup> For each policy, a federal agency sets out broad goals, which states then may pursue through their own means, but with technical and in some cases financial assistance from the feds.<sup>150</sup> As state regulators on the ground gather information about the nature of the problem and how to address it, they feed that information back to the agency, which collects the data and rates the states according to rolling sets of standards that are themselves revised in response to the developing set of information.<sup>151</sup> "Consumers" of the regulatory product—in other words, voters—

---

145. See Fennell, *supra* note 57, at 27, 71; Ford, *supra* note 144, at 1175; Frug, *supra* note 144, at 266–67; Gillette, *supra* note 10, at 1078.

146. See Cashin, *supra* note 88, at 2012.

147. Cf. Shaviro, *supra* note 6, at 952 (noting that classic Madisonian solution to defects in state governance was to shift regulatory authority to federal government).

148. See sources cited *supra* note 61; David J. Barron, *Reclaiming Home Rule*, 116 HARV. L. REV. 2255, 2340–42 (2003); Fennell, *supra* note 57, at 24–25 (describing user participation systems generally, without limitation to those coordinated by a central authority); Jody Freeman, *Private Parties, Public Functions, and the New Administrative Law*, 52 ADMIN. L. REV. 813 (2000) (describing collaborative regulation between government and stakeholders). Of course, these commentators are hardly all of one mind. To the extent that I generalize, I mostly take Dorf and Sabel as my exemplar, but other writers certainly take different positions on some of these issues.

149. See Dorf & Sabel, *supra* note 61, at 345.

150. See *id.* at 345.

151. See *id.* at 323, 345–46, 350–51. Agencies can also provide technical assistance, by analyzing relevant data and explaining how it can be used to solve problems. See *id.* at 323.

then put pressure on their local governments to meet the standards achieved by other jurisdictions.<sup>152</sup> Citizens can also participate throughout all levels of the project,<sup>153</sup> and may serve as an additional force for transparency by exposing efforts by inside players to game the system.<sup>154</sup> The result, in theory, is a system that is at once open and responsive to public input but also flexible; a system that involves localized communities of principle but that submits their conclusions for comparison against a wide variety of other viewpoints.<sup>155</sup>

Exit and the threat of exit are still a problem for these collaborative systems, however. In essence, collaboration faces a familiar tradeoff between “voice” and “exit.”<sup>156</sup> The collaborative design depends significantly on active, well-informed members of each community who will help implement each program, provide vital ground-level data, check groupthink or self-dealing by insiders, and, most significantly, study how their locality performs relative to others and demand that it match the benchmarks set by others.<sup>157</sup> But all of that is time consuming and costly. At the same time, in the collaborative system, information is very cheap (because it is gathered by the federal government) and usually rendered in a way that is designed to facilitate comparisons.<sup>158</sup> That easy flow of information relieves one of the major frictions on interstate movement. So in many cases it will be more attractive simply to move to one of the better jurisdictions than to stay home and fix what is wrong. And that possibility, in turn, may make some localities—especially those who expect that they may initially lag behind others—reluctant even to participate in a collaborative project, or more likely to game it and hide their results if they must take part to get federal funds or other benefits.<sup>159</sup> If the most attentive citizens have already left, a weaselly local government puts significant pressure on federal regulators to require real transparency,<sup>160</sup> a relationship somewhat at odds with the system’s object of reducing adversarial relationships between central and local regulators.

Cooperative theorists, recognizing this difficulty, argue that the threat of exit, again, is an effective second-best alternative to actual exit. In a highly transparent system, threats of exit by opinion leaders or revenue-generating taxpayers will be even more credible, and therefore magnify the responsiveness of local governments to the pressure of citizen scrutiny and comparison to national benchmarks.<sup>161</sup> Additionally, secret payments to these groups might be a bit harder. Although this view explains why

---

152. *See id.* at 319–20.

153. *See id.* at 316–19; Fennell, *supra* note 57, at 24–25.

154. *See* Dorf & Sabel, *supra* note 61, at 349.

155. *See id.* at 320.

156. *See* HIRSCHMAN, *supra* note 136, at 4.

157. *Cf.* Karkkainen, *supra* note 61, at 360, 363, 369.

158. Dorf & Sabel, *supra* note 61, at 321; *see also* Bratton & McCahery, *supra* note 27, at 235 n.140 (observing that “the information problem could be ameliorated through central government intervention”).

159. *Cf.* Dorf & Sabel, *supra* note 61, at 338 (noting that “some jurisdictions—or at least their leaders—will be unwilling to exchange information for fear of showing poorly in comparison”).

160. *Cf. id.* (suggesting that national regulators’ role could be to encourage reluctant localities to provide information).

161. *See* Dorf & Sabel, *supra* note 61, at 338, 348–49.

the *possibility* of exit can enhance local government, it does not seem to completely address whether exit itself might be damaging.

Thus the problem, I think, is in equilibrating the gains of the threat of exit against the perils of actual brain drain. There is an obvious analogy here to debates over voucher systems, both in education and in subsidized housing. Portable subsidies put pressure on the service provider to keep its mobile customers.<sup>162</sup> But there is a certain point at which mobility might deprive a foundering school system or housing project of those engaged and capable enough both to recognize peril or to remedy it, and leave the rest behind in a system that may be beyond repair without the aid of those who have departed.<sup>163</sup> The risks in those two situations seem, at least to this writer, large enough to be attractive only as a last resort. The difference in collaborative systems is that we have other choices. Again, collaborative systems, it is thought, enhance the “voice” of local citizens by involving them directly in regulation and providing them with low-cost access to information they can employ in the political process.<sup>164</sup> While the threat of exit might further amplify that voice, it carries too the risks I have just mentioned. In some situations, the risk that exit will collapse a locality instead of helping to reshape it may be very serious, and perhaps hard to predict beforehand. In those instances, we might prefer collaboration with relatively little possibility of exit.

It is possible that the deduction could help to create a low-exit collaborative environment. As we have seen, the deduction blunts the impact of citizen mobility without eliminating it. In the context of a collaborative system, we could view the deduction as a payment to well-informed citizens—who might otherwise be tempted to leave—to instead stay and lobby within their existing system.<sup>165</sup> Thus, it may help assure that efforts to govern transparently and collaboratively can actually achieve that end.

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

#### IV. AN ENFORCEMENT INCENTIVE?

What we have seen so far raises some questions about whether section 164 makes sense as a tax incentive. Here, though, I want to suggest another possible goal of the deduction as tax incentive, one that, to my knowledge, has not previously been suggested either in the economic or legal literature. The deduction, I argue, may facilitate socially useful efficiency gains by allowing states to free ride on federal tax enforcement efforts.<sup>166</sup>

---

162. Michael H. Schill, *Distressed Public Housing: Where Do We Go From Here?*, 60 U. CHI. L. REV. 497, 537–38 (1993).

163. See HIRSCHMAN, *supra* note 136, at 45–52; Fennell, *supra* note 57, at 26–28, 78–80, 86; cf. Richard Schragger, *Consuming Government*, 101 MICH. L. REV. 1824, 1839 (2003) (observing negative effects for residents left behind by out-migration).

164. See Dorf & Sabel, *supra* note 61, at 320.

165. For discussions of similar stay-put bribe techniques, see James M. Buchanan, *Principles of Urban Fiscal Strategy*, 11 PUB. CHOICE 1, 1 (1971); Fennell, *supra* note 57, at 48; Clayton P. Gillette, *Opting Out of Public Provision*, 73 DENV. U. L. REV. 1185, 1204–05 (1996).

166. In addition, to the extent that the deduction in fact increases the enforceability of state tax provisions, rather than simply making enforcement cheaper, the deduction also increases

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

#### *A. The Benefits of Overlapping Enforcement*

Effective tax enforcement is not cheap.<sup>167</sup> More importantly for my purposes, it comes with very substantial overhead costs. An enforcing jurisdiction must develop or recruit a team of expert investigators, analysts, auditors, and lawyers, many of whom must be conversant not only in the substantive tax law of the jurisdiction but also in the numerous ways that wealth or revenue may be invested, transported, exchanged, and concealed. That challenge has grown exponentially with the rise of international markets for capital and the development of overseas tax havens designed to make it easy to conceal ownership of property.<sup>168</sup> The international aspect of tax enforcement also means that it is not enough for states to be able to track and understand transnational financial transactions; often, the enforcing jurisdiction will also have to have some agreement with the foreign state in order to obtain any information from it at all. In the case of tax havens, securing such an agreement can be a matter of some delicacy—or, perhaps, one calling for some significant bluster.

As I have suggested, states can economize on these costs relatively easily by relying in some measure on the federal government.<sup>169</sup> Commentators on international tax arbitrage have already observed that foreign states may themselves depend on the IRS, with its relatively sophisticated information gathering, computer data analysis, and web of treaties, to collect information about the flow of international capital.<sup>170</sup> The same is surely true of our fifty states. The feds have more leverage—such as, in extreme cases, the threat of tariffs—to extract agreements from tax havens.<sup>171</sup> And relying on federal enforcement efforts can save not only these sorts of overhead costs, but also the year-

---

horizontal equity. Tax enforcement, obviously, is inequitable in that some random taxpayers may escape the payments that fall on others.

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

168. See Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1336 (1996); William F. Fox & Matthew N. Murray, *A National Retail Sales Tax: Consequences for the States*, 37 ST. TAX NOTES 287, 291 (2005); Steven Dean, *Philosopher Kings and International Tax*, 58 HASTINGS L. J. (forthcoming 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=941581#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941581#PaperDownload).

169. See Strahilevitz, *supra* note 39, at 981–82.

170. See, e.g., Avi-Yonah, *supra* note 168, at 1337–38.

171. See U.S. CONST. art. I, § 10 (prohibiting states from enacting tariffs, absent congressional approval); LOUIS HENKIN, *FOREIGN AFFAIRS AND THE UNITED STATES CONSTITUTION* 150 (2d ed. 1996) (describing limits on states' powers to establish relationships with foreign powers).

to-year costs of auditing and litigating.<sup>172</sup> It is relatively costless for the IRS, once it has detected that a taxpayer has failed to declare income from her Cayman real estate trust, to turn that data over to state authorities.<sup>173</sup> Federal authorities can even punish non-compliant taxpayers for violating state law; for example, some federal courts have held that a sentencing court can enhance a tax offender's sentence based on the combined total of state and federal taxes evaded.<sup>174</sup> Thus, the threat of federal enforcement also greatly supplements the deterrent effect of individual state enforcement efforts, leading to higher compliance even in cases where there is no investigation by anyone.

Therefore, overlapping enforcement is an attractive goal for the tax system, since it would eliminate inefficient duplication of overhead expenses across the nation. For small jurisdictions, overhead may be so large that cooperative enforcement is the only realistic alternative.<sup>175</sup> Overlap is therefore important even to jurisdictions willing to pay their own way, because the existence of another state where enforcement is known to be lax would be a sort of domestic tax haven, luring capital and other loophole seekers.

It seems fairly clear, though, that to a significant extent these benefits are only available if state and federal tax bases overlap. A state that derives its income from a sales tax collected at retailers' registers has relatively little to gain from careful federal auditing of individual income tax returns. It *will* spend lots of money, though, auditing the books of its retailers (and, probably, their suppliers, as well).

Another benefit states can realize with overlapping tax bases is simplification. A state with few disparities between its own tax system and the federal system can attract capital with the promise of lower tax-planning expenses.<sup>176</sup> Although it may make accountants unhappy, that low-disparity strategy obviously is considerably less burdensome for ordinary taxpayers.<sup>177</sup>

As a result, we may well want to encourage states to rest a fair portion of their tax burden on a base already taxed and scrutinized by the federal government. The list for individuals at present is fairly short—income taxes, estate and gift taxes, and some excises. That would transfer substantial wealth to the states, reduce tax-planning costs to citizens, and prevent a serious potential source of interstate capital leakage. But, one

---

172. See Super, *supra* note 130, at 2595.

173. See Fox & Murray, *supra* note 168, at 291.

174. *E.g.*, United States v. Powell, 124 F.3d 655, 663–64 (5th Cir. 1997), *cert. denied* 522 U.S. 1130 (1998); see United States v. Jordan, 66 F. App'x 488, 490 (4th Cir. 2003) (unpublished decision); United States v. Karamanos, 38 F. App'x 727, 731 (3d Cir. 2002) (unpublished decision).

175. See Fox & Murray, *supra* note 168, at 291.

176. See Bratton & McCahery, *supra* note 25, at 273; Super, *supra* note 130, at 2594.

177. Shaviro, *supra* note 6, at 910, 919; see Fox & Murray, *supra* note 168, at 291. On the other hand, as we saw in Part III, we should remember that the state in so doing also makes it easier for out-of-state residents to evaluate the costs and benefits of living there, which may tend to attract free riders or facilitate the flight of current residents unhappy with that balance.

Another potential effect of shared enforcement is that, as states all converge towards the federal base, they also converge towards one another. See Fox & Murray, *supra* note 168, at 291. This Article is agnostic about whether that is a desirable end; Professor Shaviro has already examined the trade-offs thoroughly. See generally Shaviro, *supra* note 6.



might ask, if overlapping tax bases is so great, why should we need to pay states to do it?

### *B. Obstacles*

It turns out there are a number of good answers to our last question, some of them theoretical, others a matter of practical politics. I will begin with what I think is the simplest, the distortionary effects of taxation. Taxes, of course, affect behavior—thus the entire notion of the tax incentive. Not all of these effects are socially desirable. For instance, depending on how a tax system treats the income of married couples, a progressive rate structure coupled with no imputed income from household work may tend to cause married, potential part-time or low-wage earners to stay home.<sup>178</sup> Those effects are magnified if two jurisdictions tax the same sets of income in similar ways. The deduction, however, blunts the incentive effects of state taxation by repaying the state taxpayer a significant percentage (his federal marginal rate) of the state tax. We could thus view the deduction as a way of permitting double taxation with somewhat lessened distortive effects.

One irony here is that some tax incentive effects are desirable—again, that is the whole point of a tax incentive. The deduction, therefore, may make it more difficult for states to achieve policy objectives through higher taxes on select behavior.<sup>179</sup> That may not be especially troublesome from a federal perspective; it helps to prevent states from constructing tax incentives that work at cross-purposes with federal goals. But, obviously, it may reduce the appeal of overlapping tax bases for the states.

Another theoretical problem the deduction may not entirely solve is the increased risk to a state's fiscal condition that can come with taxing the same base as the federal government. Suppose most state revenues come either from federal subsidies or state taxes. In the event of an economic downturn that depresses federal revenues, the federal subsidy portion of the state's budget will likely decline. If the state is depending on the same source of revenue, its tax revenues, too, will be hit hard by the downturn. A diversified tax base, like a diversified investment portfolio, could help the state avoid some of that risk. It is unclear that the deduction does much to replace the benefits of diversification. In the event of a fiscal squeeze, the deduction still comes out of the same tightening federal budget the state was depending on for other forms of subsidy, so that adjusting state taxes to draw more federal cash through the deduction will only reduce other federal contributions.

Turning to more worldly political considerations, a potential downside for state politicians in tying their own tax system to the federal system is that the link may also

---

178. See Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 20–21 (2000).

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

bind their political fortunes to federal policy.<sup>180</sup> The 2002 and 2003 tax bills plunged not only federal but also many state tax receipts deep into the red, because many states explicitly tie their income and estate tax calculations to federal methods.<sup>181</sup> Unfortunately for state office holders, many of those states have balanced-budget provisions in their constitutions or are subject to harsh discipline from financial markets and other political pressures, so that the legislatures did not have the luxury of borrowing.<sup>182</sup> They got to raise taxes and cut services, instead, which naturally endeared them to their constituents.<sup>183</sup> Of course, it is possible to tax roughly the federal base without expressly mirroring federal provisions. That approach, though, sacrifices many of the benefits of simplification—which is especially significant in a competitive world if other states are simpler—and in some cases may produce a somewhat different base. For instance, many states tax estates the federal government leaves unscathed,<sup>184</sup> and, more significantly for present purposes, many estates the federal government leaves unaudited. So getting the main benefits of overlap probably entails some political risk. The deduction can help somewhat here, in that it may soften the blow if a state is forced to raise its rates in response to enactment of new federal deductions.

The most significant obstacle to overlapping tax bases, however, is the political economy of taxing a single base at a much higher combined rate.<sup>185</sup> A diversified set of state taxes has the advantage that each tax may have a somewhat distinctive incidence, so that the collective burdens of the tax are spread across different subsets of the state population (or outsiders). If the state shifts its base to match the federal base, it is concentrating the tax burden on that particular group of taxpayers, a group already targeted by the federal government. Perhaps counterintuitively, this narrowing of the tax base may actually increase political resistance to the state tax, even though it may now be concentrated on fewer voters. That is because politics often depends not only on the numerosity of voters but also the intensity of their engagement in the political

---

180. Cf. Shaviro, *supra* note 6, at 926, 958–59 (arguing that local governments may have incentive to diverge from federal tax system in order to maintain “their own power and function”). I am grateful to Martin Ginsburg for making this point.

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

182. Briffault, *supra* note 39, at 548, 554–55; see also Super, *supra* note 130, at 2555, 2592.

183. John M. Broder, *Despite Signs of Economic Recovery, States’ Budgets are Still Reeling*, N.Y. TIMES, Jan. 5, 2005, at A12; Isaac Shapiro & Nicholas Johnson, TOTAL REVENUES FROM ALL LEVELS OF GOVERNMENT DROPS TO LOWEST SHARE OF ECONOMY SINCE 1968, CTR. ON BUDGET & POL’Y STUD. 3, 7, Jan. 15, 2004, available at <http://www.cbpp.org/1-15-04bud.pdf>.

184. Virginia Munger Kahn, *Inheriting? Don’t Forget Your State’s Tax Bill*, N.Y. TIMES, Feb. 12, 2006, Money and Business/Financial Desk, § 3, at 24 (listing thirteen states in which estates too small to be subject to the federal estate tax are taxed by the state).

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

process.<sup>186</sup> Engaged citizens will likely follow issues closely, be more likely to vote based on their issue, lobby others, and, crucially, contribute money to support their position.<sup>187</sup> Because of collective action problems, a tax that lands heavily on a smaller, easily identified group will typically face more opposition than a fiscally equivalent service cut that affects only slightly a large, diverse segment of the population.<sup>188</sup>

This effect is exaggerated by the fact that the particular federal tax we would be encouraging states to adopt, the income tax, is among the most visible. Researchers have suggested that because of a bias known as the “availability” heuristic, taxpayers prefer hidden, or less “salient” taxes to those whose incidence is obvious and well-known to the payors.<sup>189</sup> Of course, it is not that the taxpayers really “prefer” hidden taxes; it is simply that they do not oppose them as much. The income tax, in these surveys, is usually among the most salient, and therefore least popular tax.<sup>190</sup> We all know who pays our income tax bill. That increased awareness likely lowers the threshold for activating potential voters, and makes it easier for them to find like-minded opponents.

Interestingly, the bias against salient taxes implies that shifting state revenues to an income tax will increase political opposition even if the shift does not change the actual incidence of state taxes. In other words, even if the same taxpayers bear identical proportional burdens under state sales, property, and income taxes, shifting to the income tax with no net change in state revenue will make state taxes less popular. That is one reason researchers have deemed salience a “cognitive bias”; it seems to have bite even when the change in incidence is a fiscal illusion.<sup>191</sup>

A similar problem is suggested by research showing that taxpayers will support a higher overall level of taxation through a constellation of small taxes than they will through a fiscally identical single large tax. Professors McCaffery and Baron term this effect the “disaggregation” bias.<sup>192</sup> When evaluating any single tax, individuals tend to focus strongly on that tax without being able to keep in mind its combined impact with

---

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

187. In this view of voting, called “public choice” theory, most potential voters are not actively engaged in politics due to collective action problems and free rider effects. MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 21, 35 (1971). Acquiring the information necessary to act is costly, and each voter assumes that someone else will adequately advocate their position for them. *Id.* Further, it is difficult to form a successful political coalition, in part because it is hard to identify potential allies. Stigler, *supra* note 186, at 402. However, free rider effects decline as costs become larger and more visible. *Id.*

188. See OLSON, *supra* note 187, at 21–22, 31, 35; Stigler, *supra* note 186, at 401.

189. See MCCAFFERY & BARON, *THINKING*, *supra* note 68, at 5, 12–13; Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1663 (1998) (explaining cognitive impact of more “salient” facts); George Loewenstein, Deborah A. Small, & Jeff Strnad, *Statistical, Identifiable and Iconic Victims and Perpetrators* 2 (Stanford Law Sch., John M. Olin Program in Law and Econ. Working Paper No. 301, 2005), available at <http://ssrn.com/abstract=678281>.

190. MCCAFFERY & BARON, *REDISTRIBUTION*, *supra* note 69, at 20–25.

191. See Shaviro, *supra* note 6, at 957.

192. MCCAFFERY & BARON, *REDISTRIBUTION*, *supra* note 69, at 9; MCCAFFERY & BARON, *THINKING*, *supra* note 68, at 26.

other tax and spending policies.<sup>193</sup> Thus, each individual small tax looks acceptable, or in any event less unappealing than the single large tax, so that the taxpayer is willing to accept a series of small bites that cumulate to as much or more than the big one.<sup>194</sup> As a result, depending on a state's political climate, attempting to shift from many disparate taxes to principal reliance on the income tax may not be revenue-neutral.

At first pass, then, the deduction looks like it might be an effective counterweight to these problems of political economy. Especially in its current incarnation, the deduction disproportionately rewards wealthy itemizers.<sup>195</sup> But that is precisely the group—small, easily self-identified, heavily impacted by higher state income-tax rates, and (as evidenced by the capacity to itemize) relatively knowledgeable about tax—that would be most active in opposing higher state income taxes. And, assuming state taxpayers can integrate the effect of a smaller federal tax bill with the fact of a higher state tax bill, it might soften the impact of other taxpayer biases. But that last assumption already looks shaky, considering what we have already seen of the disaggregation bias.

It might also be argued that political effects cut, not against the state income tax, but instead against an overlapping federal income tax. If the unwanted burden is the combination of state and federal taxes, it may be that political resistance will be aimed at federal taxation rather than the smaller state piece.<sup>196</sup> State taxpayers might rationally prefer to see taxing and spending on the local level, where their voices are proportionately stronger and their control over expenditures correspondingly more powerful.<sup>197</sup> Self-interested voters might prefer to keep taxes local because local expenditures might look more like services and less like transfer payments to others.<sup>198</sup> Even state programs identified expressly as “welfare” or transfer payments might be seen as a way of purchasing insurance for the possibility of personal economic downturns. The same program instituted nationally might look less like insurance because the taxpayer may assume she is unlikely ever to be unemployed or without health insurance in the many distant states where her tax dollars are now developing a service-delivery infrastructure.

These tendencies might also produce reinforcing cognitive biases, such as through the “generalization effect.”<sup>199</sup> Some research, for instance, suggests that individuals respond negatively to taxation, but have less negative views about taxing for many specific programs.<sup>200</sup> The exceptions are categories like foreign aid, which are

193. MCCAFFERY & BARON, THINKING, *supra* note 68, at 25–26.

194. MCCAFFERY & BARON, REDISTRIBUTION, *supra* note 69, at 30; MCCAFFERY & BARON, THINKING, *supra* note 68, at 26.

195. See *supra* text accompanying notes 22–23.

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

197. See Shavero, *supra* note 6, at 967; Strahilevitz, *supra* note 39, at 932–33.

198. Cf. Strahilevitz, *supra* note 39, at 942–43 (“[T]he perception that the revenues collected by the federal government are used to benefit far-flung special interests undoubtedly erodes the system’s legitimacy, as well as compliance with federal income tax requirements.”) One might suspect that much the same point is actually made by Professor McConnell when he notes that individuals are more likely to feel benevolent towards those near them geographically. McConnell, *supra* note 59, at 1510.

199. MCCAFFERY & BARON, REDISTRIBUTION, *supra* note 69, at 7–9.

200. *Id.* at 39, 44.

obviously transfer payments.<sup>201</sup> It is possible that the tested individuals “generalize” their negative feelings about foreign aid to an undifferentiated tax. Similarly, taxpayers might generalize from the negative aspects of national taxation, to the point that they neglect some of the service benefits it provides them.

In this view, the deduction may actually be more useful to the federal government than to the states. State representatives should happily free ride on federal enforcement efforts, and let their congressperson deal with the headache of political groundswells. The deduction could then be a useful tactic for federal representatives to maintain support for existing revenue levels. Obviously, if popular responses to tax levels were uniform and rational, it would be impossible for the deduction to be cost-effective on that front. But again, the strongest and most energetic political opposition is likely to come from exactly that group most benefited by the current form of the deduction. The feds may not have to pay off the large group of relatively inattentive taxpayers who pay higher combined rates. More empirical research is needed, but it is possible that the deduction could, strangely, actually be a political expenditure from the federal government to itself.

### C. *Will It Float?*

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

Remember our tentative thought that the disaggregation bias might limit the effectiveness of the deduction in taking the sting from state income taxes.<sup>202</sup> The difficulty, again, is that when state voters consider a ballot proposition, or evaluate the performance of a state politician, they may tend to focus on the burden of the state tax alone, without considering the offsetting benefit they receive on their federal return. On the other hand, many taxpayers file their state and federal returns at the same time, so that they may be somewhat more likely to view the two as a whole.<sup>203</sup>

These predictions may seem hard to square with other research, which shows that states generally do adjust their tax base to take advantage of available federal deductions.<sup>204</sup> A problem with relying on those studies for our purposes, though, is that during the period of the studies, the federal deduction allowed credits not only for the income tax but also property tax and, in some studies, sales taxes.<sup>205</sup> Thus, the taxpayers were getting a credit in a highly “salient” tax, the federal income tax, and paying more in less salient state taxes. It is possible states were responding rationally to a straightforward subsidy offer. But it also is possible they were somewhat irrationally substituting hidden taxes for a salient tax, or some of both. As a result, the studies are

---

201. *Id.* at 44–45 (see Fig. 4).

202. *See supra* text accompanying notes 192–194.

203. I am grateful to Edward McCaffrey for suggesting this point.

204. *See supra* note 24 and accompanying text.

205. *Cf.* 26 U.S.C.A. § 164 Note (2006) (recounting history of statute, including 1986 amendment repealing exemption for sales tax and 2004 amendment reinstating it). Recall that our object here is to induce the states to tax primarily the same base taxed by the federal government, so we would not want to offer the deduction for property or sales taxes.

only weakly predictive of what would happen if we were to try to replace federal income taxes with equally salient state income taxes. Also, the studies do not seem to track the durability of the switches they document. It is possible that a well-informed, “rational” group of high-income taxpayers might lobby for the state to change its base to capture the federal deduction, but that over time the rest of the taxpayers would (irrationally) find the new tax so burdensome that they would demand it be switched back.<sup>206</sup>

There are, though, two uses for the deduction that would seem not seriously threatened by the possibility of fiscal illusion. One is its potential to soften the impact of tax base consolidation on high-income taxpayers.<sup>207</sup> A well-advised taxpayer is highly unlikely to complain about a new tax structure that imposes fifteen percent more state tax on her but gives her back twenty percent. The other use is that if the deduction is actually a self-defense mechanism for federal legislators, the disaggregation bias is not very important. Indeed, the disaggregation bias would help to make a discount on the federal tax bill mollify taxpayers, even if the discount is not as big as the state bill that, in theory, would otherwise threaten to crowd out federal revenue.

In sum, it is not clear that we need the deduction in order to get the benefits of shared federal and state tax enforcement. At the same time, it is not clear that we *do not*. More work in this field would be welcome. One thing that does seem reasonably clear, though, is that to the extent enforcement is a justification for the deduction, it should extend only to sources of state revenue that match the federal tax base. In our current system, that would mean keeping the deduction for state income tax<sup>208</sup> but scrapping deductions for sales and property taxes.

#### CONCLUSION

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

Still, this Article contributes some promising new leads. I have shown that the project of using deductions to shift spending to states and local governments is

---

206. Cf. W. ELLIOT BROWNLEE, *FEDERAL TAXATION IN AMERICA: A SHORT HISTORY* 174–77, 182, 192–93 (2d ed. 2004) (describing how broad reforms of 1986 Tax Act were first enacted through wide public pressure for reform, but then undermined by later bills enacted in spirit of more traditional rent-seeking); Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 *MINN. L. REV.* 913, 934 (1987) (noting that broad-based tax statutes are often followed by a number of exceptions).

207. The extent to which a switch to an income tax would disproportionately impact high-income taxpayers depends, of course, on the rate structure of the income tax, as well as whether the old revenue stream flowed mostly from, say, largely regressive sales taxes or generally progressive property taxes.

208. Another provision of the Code, allowing a federal credit for state estate taxes, would also be justifiable under this theory. These moves would also be consistent with Professor Shaviro’s argument that greater uniformity across states would lead to productive reductions in tax planning costs. Shaviro, *supra* note 6, at 911, 919.

misguided to the extent that it includes a simple federal handover of money to those governments. The deduction can substantially erode the efficiency, transparency, and democratic character of sub-national government. Thus, using the deduction to effect any shift to the states may seem almost cruelly mistaken, to the point where one is inclined to wonder whether the whole enterprise is not simply an effort to produce government that is so unlovely that citizens prefer to eliminate it entirely.

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

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

However uncertain these beginnings, I think this Article is a success if it shows that section 164 is about more than (boatloads of) money. The tax literature, while recognizing in broad terms the significance of federalism for tax policy, has been slow to integrate the insights of regulatory theory, which profoundly changes traditional ideas of federal/state relations. And non-tax scholars have given little consideration to the extent that, in a very real sense, almost all important federalism questions are really questions about tax. Certainly, as we have seen here, areas we thought far removed from tax, such as the effectiveness of local governance, prove subject to very substantial tax influences. My work here implies that tax's gravity may tug on other bodies in the federalism solar system as well. The doctrines of sovereign immunity, qualified immunity, and Tenth Amendment limits on federal "conscription" of state officials all spring, to some significant extent, from judicial concerns about the transparency of, and lines of accountability in, state government.<sup>209</sup> Even leaving aside the revenue effects of federal tax rules, the influence of the deduction on state incentives for transparency or opacity will likely seriously affect all three doctrines. Further, the ways in which taxpayers understand and integrate taxes and spending has implications for my previous work on the Spending Clause—explication of which I leave for further work.

In short, what we should think about section 164 depends on much more than the bottom of a balance sheet. Any fully considered judgment must include our philosophy of mind, our plan for the individual states' place in an international marketplace, and our optimal design for good local government. \$75 billion? That's nothin'.

---

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