Constitutional Dimensions of State and Local Tax Deductibility

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President Reagan's proposal to eliminate the deduction of state and local taxes for the purpose of assessing federal income taxes will vastly enlarge the scope of the federal government, unduly burden state and local governments, and greatly harm the federal system. The essence of the federal idea is that there are arenas of government that must not be invaded by other governments. Yet the Treasury Department would have us believe that the most fundamental activities of state and local governments are in some significant sense paid for by the federal government through "subsidies" provided by the federal tax code.

Sixteen days into his first term in office, President Ronald Reagan addressed the nation on television and set forth a theory of government which has shaped his administration ever since. That theory has profoundly changed the direction of American government generally. Reagan said:

> There were always those who told us that taxes couldn't be cut until spending was reduced. Well, you know, we can lecture our children about extravagance until we run out of voice and breath. Or we can cut their extravagance by simply reducing their allowance.

Not everyone would immediately recognize this as a theory of government, but it was surely that, and was meant to be. In the tradition of the framers of the U.S. Constitution, and with an assessment of man's weaknesses not different from theirs, President Reagan was addressing the central question of how the powers of government—for him it was more a matter of governmental activity—might be limited.

The framers began by dividing the federal government into three branches, with the clear intent that there be an equal division of power between the executive and legislative branches. This separation of powers reflected the eighteenth-century British arrangement. This model was also followed with respect to the all-important issue of taxes and spending. The U.S. Constitution provides the Congress with the power to raise money and specifies that within the Congress, "All Bills for raising Revenue shall originate in

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the House of Representatives." The Constitution empowers the president to serve as commander-in-chief of the armed forces, but again, following the British pattern, it expressly provides that, with respect to the army, "no Appropriation of Money to that Use shall be for a longer Term than two Years." This is to say that the commander-in-chief is to be kept on 24-month rations. And so we might go through the breadth of that imcomparable document, 200 years old in 1987, uncovering limits on taxing and spending powers.

Might we take the measure of the president's ingenuity in pursuit of not dissimilar purposes? By the time he became president, Reagan had come to the judgment that the federal government had grown much too large, and would continue to do so unless some radical restraint is placed on the Congress, and for that matter the executive as well.

He proclaimed his purpose in his third week in office and attained it in his seventh month, with a tax cut that radically reduced the revenues of the federal government, bringing about a sustained deficit. The purpose of the deficit was elemental. It was to put in place a permanent process of seeking reductions in existing federal programs and of resisting the establishment of new ones.

The concept, however, was more inspired than the execution. In fact, the execution was considerably blundered. Much too large a deficit was created. This deficit began to compound and to assume a life of its own. In the first four years of the Reagan administration, the national debt all but doubled to $1.5 trillion. In the next four years, another trillion dollars is likely to be added to the deficit.

One result is that interest payments on the debt have become the fastest growing item in the federal budget. In short order now, it will require a sum equal to half the revenue of the personal income tax just to pay the interest on the debt, a transfer of wealth from labor to capital that has no precedent in the annals of this republic. In the situation where the real rate of interest is greater than the real rate of economic growth, the national debt compounds at an explosive rate. This is now the case and is likely to remain so for years.

If I describe the president's concept as inspired, it is not because I admire the way it is working out. I do not. The execution has been so mismanaged that sooner or later it will probably lead to calamity. Consider that today, for the first time since 1914, when World War I led to the liquidation of European holdings over here, the United States has become a net debtor nation. We have dissipated our capital and could be on the verge of losing much of our industry. Even so, one has to admire the sweep of the Reagan revolution.

Not sixteen years ago, as a member of the Cabinet of another Republican president, I helped craft a legislative program which called for the federal government to assume all the welfare costs of states and localities, to share its revenue with those states and localities, and to give them greater control over manpower programs. The federal government adopted revenue sharing, a program designed to keep initiative alive in states and localities. The federal government established Supplemental Security Income (SSI), which asserts that social insurance is a national responsibility. Whatever else, the proposals reflected a feeling for federalism.

When state and local officials meet today, they spend much of their time talking about proposed federal program cuts and asking how to prevent them or limit them. This is what they are supposed to be doing. The Republican leadership of the Senate is doing much the same. In all likelihood, we will still be doing this a decade hence.

There is an irony here. Because the debt has grown so great, the cost of the federal government, as a proportion of the gross national product, is now larger than it has ever been in peace-time history. But the domestic budget, especially the portion allocated to states and localities, is now under permanent pressure and will remain so. Small victories come in terms of keeping programs from being cut, or of keeping cuts from being too great. As for the chance of major policy changes, George Will recently estimated their likelihood as having gone from "not very" to "are you kidding?"

This is why attention should be drawn to one subject about which our cities and states can and ought to make a difference. This concerns a presidential proposal of constitutional dimension that has not yet been adopted, but may well be in the near future.

In his 1984 State of the Union address, the president proposed to present the Congress with a major overhaul of the tax system. A first step was taken in November when the U.S. Treasury Department published a three-volume report entitled "Tax Reform for Fairness, Simplicity, and Economic Growth." This was followed by a second Treasury Department report similarly titled and issued in May 1985.

In many ways, the basic proposal contained in these reports is altogether admirable. One can call it the pure theory of taxation. One can also call it a *festschrift* for Stanley Surrey, President John F. Kennedy's renowned Assistant Secretary of the Treasury, who preached the gospel of a tax code that would be neutral with respect to individual or corporate economic choices.

Part of the proposal, however, embodies a profound constitutional error. This is the proposal to eliminate the deduction of state and local taxes for the purpose of assessing federal income taxes.

It would be the huge irony of President Reagan's administration if, having started out to reduce the size of the federal government, it ended up putting in place a principle that can only vastly enlarge the scope of the federal government. Yet that is what is at issue here.

The framers of the U.S. Constitution had more thoughts about power than merely its limitation. They recognized and accepted the reality of the power embodied in government, and they sought not only to ensure that it was limited but to ensure also that it was shared. This was the system we call federalism. It was not copied from anyone. It was wholly an American innovation, and it is precious.

In the debate over the president's tax proposals, much depends on our getting this straight in our minds. Federalism is not a managerial arrangement that the framers hit upon because the country was big and there were no telephones. Federalism is not a form of decentralization with which large corporations occasionally experiment when things get clogged at the top. Federalism is not an arrangement of necessity forced upon the men at Philadelphia by the cantankerous parochialism of the Yankees and the Yorkers and the Southern gentry.

In some measure it was these things, but it was larger than any. As Daniel J. Elazar shows in a recent issue of *This World* magazine, federalism was a fundamental expression of the American idea of covenant. Americans rejected "the notions of the general will and the organic state common among their European contemporaries."[1] In our formal Constitution, we opted instead for the principle declared in the Mayflower Compact, namely, that we solemnly entered a covenant, one with the other, to govern *together*. The word "federal" derives from the Latin *foedus*, which Elazar tells us is simply the Latin word for "covenant."[2]

> This concept of covenant, of a lasting yet limited agreement between free men or between free families of men, entered into freely by the parties concerned to achieve common ends or to protect common rights, has its roots in the Hebrew Bible. There the covenant principle stands at the very center of the relationship between man and God and also forms the basis for the establishment of the holy commonwealth. The covenant idea passed into early Christianity only after losing its political implications. Its political sense was restored during the Protestant reformation, particularly by the Protestant groups influenced by Calvin and the Hebrew Bible, the same groups that dominated the political revolutionary movements in Britain and America in the seventeenth and eighteenth centuries. Much of the American reliance upon the covenant principle stems from the attempts of religiously-inspired settlers on these shores to reproduce that kind of covenant in the New World and to build their commonwealths upon it. The Yankees of New England, the Scotch-Irish of the mountains and piedmont from Pennsylvania to Georgia, the Dutch of New York, the Presbyterians, and to a lesser extent, the Quakers and German Sectarians of Pennsylvania and the Middle States were all nurtured in churches constructed on the covenant principle and subscribing to federal theology as the means for properly delineating the relationship between man and God (and, by extension, between man and man) as revealed by the Bible itself.[3]

The essence of the federal idea is that there are arenas of government that must not be invaded by other governments. Now this is not a rigid compartmentalization. All membranes in the federal system are permeable, but they are not to be ripped. Nowhere is this more important than in the sphere of taxation, wherein the initiative and independence of different spheres of government commences. Yet this is what the proposal contained in both

[1]Daniel J. Elazar, "America and the Federalist Revolution," *This World*, No. 10 (Winter 1985): 68.
[2]Ibid., 66.
[3]Ibid., 65-66.

Treasury Department reports would do.

Last year, the deduction for state and local taxes reduced federal taxes by $28.5 billion; in 1988, according to the Treasury Department, it would reduce federal taxes by $34 billion. This is a large sum, and it introduces a question of first importance: how much would the actual burden of state and local taxes increase if the deduction were repealed?

We do not have precise figures, but state and local governments raised about $310 billion in round numbers through taxes last year. The proposed change in the federal tax code, then, would increase the real burden of these state and local taxes by about 10 percent.

The arithmetic is easy. The federal deduction reduces the "real" cost of state and local taxes by upwards of 10 percent. For persons in higher tax brackets, the cost is correspondingly greater. This would certainly lead to a good deal of migration out of high-tax jurisdictions. Indeed, the Treasury proposal states outright that those who do not like the extra costs the administration proposal would impose "are free to locate in the jurisdiction which provides the most amenable combination of public services and tax rates. Taxpayers have increasingly 'voted with their feet' in recent years."[4]

In November 1984, I wrote a short article on the subject for the editorial page of *The New York Times*.[5] My first draft began: "If you are looking for an apartment in Manhattan, help is on the way." On second thought, I decided this was too alarmist and took the sentence out. I wish now that I had not taken it out.

The proposal will convulse the finances of school districts, that most quiet, efficient, and public-regarding of all spheres of American government. And it will work perversely. More and more, the nation will turn to the federal government for the resources it needs, the very opposite of the principle of the Reagan revolution. (In 1979, California passed Proposition 13 and had to cut local property taxes. The year previous, the state had contributed 40 to 45 percent of all local school district revenues. The year after, the state was called on to contribute 65 to 70 percent of all school funding.)

This also is the very opposite of the principle of federalism. Nothing is so revealing as the language of the Treasury proposal. Over and again the deduction for state and local taxes is referred to as a federal "subsidy:"

> The deduction is sometimes defended as a subsidy. . . . There is no more reason for a Federal subsidy for spending by State and local governments than for private spending. . . . There is no reason to provide implicit Federal subsidies for spending of State and local governments by allowing deduction for their taxes. . . . Moreover, the deduction for State and local taxes is not an efficient subsidy. . . . In order to be evenhanded and avoid [a] distributionally perverse

[4]U.S. Department of the Treasury, "Tax Reform for Fairness, Simplicity and Economic Growth," Volume 2 (November 1984), p. 63.

[5]Senator Daniel Patrick Moynihan, "Tax Changes That Would Hurt New York," *The New York Times*, 21 November 1984.

pattern of subsidies, no itemized deductions should be allowed for taxes and fees paid to State and local governments.[6]

The Treasury Department would have us believe that the most fundamental activities of state and local governments are in some significant sense paid for by the federal government.

A century ago we understood this. On 1 July 1862, President Abraham Lincoln signed the Revenue Act of 1862, the first national income tax, a 3 to 5 percent tax to finance the Union effort in the Civil War. Section 91 of that act provided that "all other national, state and local taxes . . . shall first be deducted" to determine a taxpayer's liability for the income tax—and this under the most pressing emergency conditions ever faced by our country.

In 1862, the chairman of the House Ways and Means Committee was Justin Smith Morrill. (In the same year, Representative Morrill wrote what we know as the "Morrill Act," providing federal lands to establish state land-grant colleges.)

Chairman Morrill, reporting the tax bill, explained that, as a matter of simple logic, the deduction would be necessary both to avoid double taxation and to preserve a principle of federalism:

> It is a question of vital importance . . . that the General Government should not absorb all [the states'] taxable resources—that the accustomed objects of State taxation should, in some degree at least, go untouched. . . . Otherwise, we might perplex and jostle, if we did not actually crush, some of the most loyal States of the Union.[7]

Will not this proposal perplex and jostle, if not actually crush? Will it not produce this huge and final irony: that the transfer of revenue resources to Washington, D.C., inevitably concentrates more resources in the federal government, which will grow ever larger?

State and local governments do not have to accept this. What is at issue are their budgets, their basic services, and their fundamental relationship to the federal government—all in the service of an abstract theory of taxation.

On 23 March 1985, the National League of Cities passed a resolution on this issue. It begins:

> The provision of the Federal income tax code that allows taxpayers to deduct their state and local tax obligations from their Federal taxable income is a fundamental statement of the historical right of state and local governments to raise revenues and of individuals not to be double taxed.

The resolution describes this provision of the federal income tax code as the

[6]U.S. Department of the Treasury, "Tax Reform for Fairness, Simplicity and Economic Growth," Volume 1 (November 1984), pp. 78–80.
[7]*Congressional Globe*, 12 March 1862.

largest single federal "tax expenditure" item directly affecting cities.

Now "tax expenditure" is a term that implies that if the federal government allows individuals to keep some of their income, it is somehow giving them that income. This is a curious proposition from the present administration, but that is what it says. Put differently, if we let you keep it, it is something we have given you; it somehow belonged to us in the first place.

I do not believe this. I do not think that the framers had this in mind in Philadelphia in 1787. I do not think it should be called a tax expenditure, and I do not think we should let the Treasury Department get away with calling it a federal "subsidy." In diplomacy, this is known as semantic infiltration: if the other fellow can get you to use his words, he wins.

This article began on a large theme and will close on one. Thirteen days after President Reagan stated his theory of federal spending, he presented an equally large proposition about federal taxes. In an address to a joint session of the Congress on 18 February 1981, he said:

> The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change.

This is not possible. It sounds good but it does not happen. Any tax affects the economy and changes society to some degree. A "neutral" tax proposal, such as the one the Treasury Department has offered, will have pervasive effects on the economy and the society. There is no avoiding this, only disguising it. I happen to prefer John F. Kennedy's formulation, that to govern is to choose, and I would choose not to assault federalism in the manner proposed by the Treasury Department.