Federal Tax Deductions and the Demand for Local Public Goods

Abstract

The United States tax system allows taxpayers to deduct state and local taxes from their taxable incomes. Using local referendum results, we first document a positive relation between the demand for public goods and the share of residents deducting local taxes. Based on this evidence, we develop a theoretical model of public goods capitalization that accounts for the deductibility of taxes. We provide empirical support for the model using cross-sectional and temporal variation in local tax deductions, thereby confirming that federal tax deductions increase the demand for local public goods. Because the incidence of this fiscal subsidy increases with income and wealth, our results provide new insights into the equity of the current tax system.

This paper is joint work with Brent W. Ambrose (Institute for Real Estate Studies, Penn State University)

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