

# ACCEPTING THE LIMITS OF TAX LAW AND ECONOMICS

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*This Article explores the limits of tax law and economics, attributing them to the unique complexity of the tax optimization problem. Designers of the optimal tax system must account for the impossibility of deterring socially undesirable behavior, provide for redistribution, and minimize social costs on the basis of assumptions that are laden with deeply contested value judgments, pervasive empirical uncertainty, or both. Given these challenges, it is hardly surprising that economic theory has a much weaker connection to the content of our tax laws and their enforcement than it does to the content and enforcement of many other legal regimes. This weakness has a profound effect on the debates about the fundamental features of our tax system. It shapes the meaning of the foundational tax concepts. It affects many familiar arguments about anti-avoidance rules and sanctions. And it extends to evaluating outright tax evasion. In sum, the limits of tax law and economics shape every aspect of tax law and tax administration. At the same time, accepting these limits shifts focus to several research agendas where tax law and economics will continue to make valuable contributions to the project of improving our tax system.*

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## INTRODUCTION

Congress holds endless hearings about efficiency of the tax system.<sup>1</sup> Lawyers continuously argue about efficiency of tax rules and sanctions. And just about every tax professor in the country introduces her students to the world of tax by articulating the goals of equity, administrability, and—you guessed it—efficiency.<sup>2</sup> Efficiency is important. Efficiency is desirable. Efficiency is good.

Yet, efficiency maximization—the ultimate goal of law and economics—has had little impact on the content of the Internal Revenue Code. A more robust and expansive welfare maximization approach has had only a marginal influence as well. There is a substantial divergence between general law and economics and tax law and economics in terms of both their analytical tool kits and their impact on the design of real-life regulatory regimes. The reasons for this divergence and its implications for tax policy are the focus of this Article.

The reach of tax law and economics is more limited than the reach of general law and economics, and this is no accident. The task of designing the optimal tax system is immensely more difficult than

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<sup>1</sup> See, e.g., *Does the Tax System Support Economic Efficiency, Job Creation, and Broad-Based Economic Growth?: Hearing Before the S. Comm. on Fin.*, 112th Cong. 3 (2011) (statement of Sen. Orrin G. Hatch, Ranking Member, S. Comm. on Finance) (discussing the need for tax reform); *Tax Reform: Historical Trends in Income and Revenue: Hearing Before the S. Comm. on Fin.*, 111th Cong. 13 (2010) (statement of Dr. Thomas A. Barthold, Chief of Staff, Joint Comm. on Taxation) (discussing the efficiency consequences of eliminating the tax code's double taxation of corporate income).

<sup>2</sup> See, e.g., Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440, 498 (2009) (referring to “the traditional tax policy goals of equity, efficiency, and administrability”).

the task of designing the optimal competition policy, corporate law, securities regulation, and so on. The additional complexity arises due to three related problems (or challenges). One of the three is well understood; the other two are much less appreciated. While one or two of these problems could be successfully addressed in isolation, the combination of the three makes the economic analysis of tax rules and sanctions uniquely complex.

The first problem arises because taxation is fundamentally different from pollution, speeding, and other externality-producing activities that are the primary focus of law and economics. Individuals' responses to taxation are inefficient not only because they give rise to negative externalities. Rather, these responses are wasteful because they are nonconsensual money transfers from the government to taxpayers that are conceptually similar to theft, insider trading, price fixing, and the like. All these transfers are inefficient even if they produce no negative externalities. And almost all these transfers may be fully deterred at some cost. Not surprisingly, the optimal legal regime for nonconsensual money transfers reflects the tradeoff between the greater benefits of stronger deterrence and its greater costs. While this analytical approach has been suggested only for a few anti-trust violations, it applies in many other settings where nonconsensual money transfers take place.<sup>3</sup>

But not in tax. Inefficient responses to taxation cannot be fully deterred at any cost. Even if anti-avoidance rules eliminate all tax shelters, taxpayers can always respond to taxes by working less, saving less, selling or buying less than they would have done otherwise. No legal rule can deter any of these responses. Yet their social costs may be just as great as the costs of the most outrageous tax reduction schemes. Therefore, while stronger anti-avoidance rules certainly increase the cost of running a tax system, their social benefits are uncertain. If so, an optimization strategy that trades off the costs and benefits of greater deterrence cannot be deployed in the tax setting.

This *undeterrability problem* can be solved by making responses to taxation impossible. A lump-sum tax imposes a burden that is unchanged no matter what a taxpayer does. This perfectly efficient tax has been known to economists for decades, yet it has found no practical application. A nonuniform lump-sum tax based on immutable taxpayer characteristics such as earning ability is impossible to implement because these characteristics are unobservable. A uniform lump-sum tax is easily administrable but entirely unsatisfactory because it has extremely unappealing distributive consequences.

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<sup>3</sup> See Alex Raskolnikov, *Irredeemably Inefficient Acts: A Common Threat to Markets, Firms, and the Fisc 10–11* (Feb. 1, 2013) (unpublished manuscript) (on file with author).

This brings us to the second (and well-known) challenge of tax law and economics. While the general law and economics analysis typically focuses on efficiency alone, any plausible theory of an optimal tax and transfer system must address redistribution. This *redistribution problem* is particularly difficult in light of the undeterrability problem. Quite simply, it is impossible to fully resolve both.

But it is possible to reach a compromise. The optimal tax theory balances the benefits of redistribution against the inevitable costs of tax-induced distortions to produce a welfare-maximizing regime. That theory is the crown jewel of public economics. It is also profoundly different from the economic analysis of externalities and other market failures that provides a foundation for general law and economics. That general analysis produces extremely powerful and intuitive insights based on just a few assumptions that are easy to understand and fairly easy to accept, at least as working hypotheses—the assumptions of rational behavior and social welfare maximization. In contrast, the optimal tax theory does not get off the ground until, in addition to making the same two assumptions, one agrees that ability (or some other attribute) is the appropriate basis of redistribution, chooses a proxy for the abstract and unquantifiable concept of ability, develops a view about the optimal extent of redistribution, agrees on the parameters that determine its cost, and settles on the manner in which that cost will be traded off against the redistributive benefit, not to mention deciding whether the optimization problem should focus on national or global welfare. Each of these decisions is laden with deeply contested value judgments, profound empirical uncertainty, or both. Efforts to reduce tension by incorporating alternative views make the theory completely intractable.

The result of this immense complexity, uncertainty, and value dependence is unsurprising: Our tax system has little in common with the optimal tax regime, at least in its canonical form. That regime—the nonlinear labor income tax—has no tax on capital income, no realization requirement, no corporate tax, no wealth-transfer tax of any kind, no national borders, and none of the hodgepodge of exemptions, deductions, and credits found in the Internal Revenue Code.

This gap between the real and the ideal is at the heart of the third problem of tax law and economics—the *baseline problem*. Most of the general law and economics arguments depend critically on the close connection between the ideal baseline of a perfectly efficient system and the actual set of legal rules and sanctions under consideration. This close connection is missing in the tax setting. Therefore, the omnipresent second-best problem is much more severe in tax than it is in other areas of economic regulation. It may be plausible for secur-

ities scholars to assume that capital markets are generally efficient.<sup>4</sup> It may be reasonable for competition law scholars to posit that the economy is generally competitive.<sup>5</sup> And it may be sensible for environmental law scholars to conclude that Adam Smith's "invisible hand" guides the market in pollution permits to their efficient allocation.<sup>6</sup> But it is completely implausible for tax scholars to assert that our tax rules and sanctions are anywhere close to optimal. Therefore, arguments about changing these rules in order to approximate the welfare-maximizing system are particularly weak in tax.

Accepting the limits of tax law and economics has profound implications. Without an optimal system serving as a guidepost, it is impossible to answer the basic tax policy questions with the same strength of conviction that is customary (and relatively more defensible) in law and economics generally. Should the tax on capital gains be lower or higher than it is today (and should it be progressive, flat, regressive, or even negative)? Should the corporate tax rate be reduced? Should dividends be subject to ordinary income tax rates, reduced rates, or not taxed at all? Should the United States adopt a territorial tax regime? What about the estate tax that has remained on life support for the past decade? These questions are not about some obscure and inconsequential sections of the Internal Revenue Code; they go to the core of our tax system. Yet none can be answered based on the same type of reasoning that law and economics scholars routinely deploy when addressing other areas of economic regulation—reasoning based on the goal of achieving a socially optimal legal regime.

Accepting the limits of tax law and economics has many other implications for the fundamental tax policy concepts and debates. The single most important concept of the economic analysis of law—efficiency—has very different meanings when deployed in and out of tax. When nontax scholars critique a rule as "inefficient," they usually

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<sup>4</sup> See Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 907 (1989) (referring to "the academic support for the efficient markets hypothesis"); see also Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 968 (1991) (explaining that "the legal presumption of semi-strong form efficiency for stocks traded on the national exchanges may still be warranted" despite critiques of the hypothesis's empirical underpinnings). Scholars have offered several interpretations of what "efficient" means in this context, but this variety of interpretation does not detract from the plausibility of the basic assumption. See, e.g., Ayres, *supra*, at 968–69 (distinguishing between informational efficiency and fundamental efficiency); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 766–71 (2006) (distinguishing between efficient markets characterized by accurate pricing and effective markets characterized by a corrective price mechanism).

<sup>5</sup> See, e.g., HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 19–20 (3d ed. 2005).

<sup>6</sup> Robert W. Hahn & Robert N. Stavins, *Incentive-Based Environmental Regulation: A New Era from an Old Idea?*, 18 *ECOLOGY L.Q.* 1, 7 & n.26, 8–10 (1991).

mean that the rule is inconsistent with the optimal system. An alternative rule that is not similarly deficient is clearly superior. In contrast, referring to a tax rule as “inefficient” can only mean that it is distortive. But any alternative rule that produces equal revenue would be distortive as well, though perhaps less so. A choice between two distortive rules does not promise nearly as great a payoff as a choice between a nonoptimal and optimal provisions.

The ongoing debate about the relevance of horizontal equity is another controversy affected by this Article’s inquiry. Horizontal equity is wholly superfluous in a welfarist analysis of the optimal tax system, yet it has remained important in evaluating the existing one. Appreciation of the wide gap between the existing and the optimal, combined with the pressing need to evaluate actual policies and reforms, explains the strong appeal of horizontal equity in real-life tax policy debates. The same appreciation sheds light on the practical relevance of a fundamental theoretical claim that the rate structure should be the only redistributive tax instrument. This claim is an integral part of the optimal tax theory. But this theory’s divergence from reality suggests that we should be cautious in implementing one particular theoretical prescription. The same divergence presents a significant challenge to the economic analysis of tax evasion.

The gap between tax theory and reality has other, less dramatic implications as well. It means that many familiar legal arguments that generally have strong efficiency foundations have no such foundations in the tax setting. Should policymakers be careful not to overreach in designing tax anti-avoidance rules? Should slight violations of tax laws be subject to light punishment? Does it matter that a tax offender eventually found liable may have been right or that addressing his violation helped to clarify the tax law? Should tax penalties be based on the amount of tax underpayment? None of these questions may be answered based on efficiency considerations in the simple, intuitive, and convincing manner that is available outside of tax.

These conclusions suggest that the reach of tax law and economics is limited indeed. But they by no means undermine the value of economic analysis of taxation. Revenue estimates of various reforms as well as empirical studies of all sorts of elasticities and behavioral effects supply policymakers with crucial and highly useful information. Moreover, public finance scholars are developing models that have a closer connection to the real world and are more useful in its evaluation than the canonical optimal tax formulas. These studies, estimates, and models, however, are the province of economists, not lawyers. While important, they cannot form the core research agenda of tax law and economics. What can?

The answer lies in recognizing the unique advantages of economically oriented tax scholars. The first such advantage becomes apparent as soon as the focus shifts from the lofty goal of devising the optimal tax system to a more modest objective of evaluating incremental reforms. This is where economic theory has a reasonably close connection to reality. Economists have developed tools for assessing incremental changes, and these tools are particularly useful when analysts set aside contestable questions of distributive justice and focus on efficiency alone. In order to apply these tools, however, the analyst must understand the existing and possible future distortions created by any given rule and its potential revision. Tax lawyers know and understand tax rules—both in theory and in practice—much better than public finance economists ever could. This understanding, combined with the grasp of the economic costs of distortions, is a unique comparative advantage of tax law and economics scholars. The same is true of their deep appreciation of uncertainty created by most tax rules and its effects on these rules' real-life operation. Finally, tax law and economics scholars are institutionally well positioned to evaluate tradeoffs between efficiency and other considerations. These are the areas of inquiry where tax law and economics has the most to offer. Not surprisingly, these are the areas where tax law and economics scholars have made—and will continue to make—many valuable contributions.

Part I of this Article identifies the three unique problems facing tax law and economics and explains the resulting limitations of the economic analysis of tax rules and sanctions. Part II investigates the wide-ranging implications of these limitations. Part III asks whether tax law and economics has a continuing vitality in light of its limitations, answering this question with a definite (if qualified) “yes.”

## I

### EXPLAINING THE LIMITS OF TAX LAW AND ECONOMICS

A casual observer is likely to conclude that the economic analysis of taxation is similar to the economic analysis of many other areas of the law dealing with commerce and finance. The subject of analysis is always some form of economic activity. Scholars pay much attention to efficiency, transaction costs, and externalities.<sup>7</sup> They draw direct

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<sup>7</sup> See Kyle D. Logue & Joel Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability*, 63 TAX L. REV. 797, 797–98 (2010).

analogies between tax and other areas of economic regulation.<sup>8</sup> And they analyze tax law violations jointly with other legal breaches.<sup>9</sup>

A closer look reveals, however, that tax law and economics is very different from nontax (or general) law and economics. The same terms have different meanings.<sup>10</sup> Analogies are either misguided or do not extend to the content of the law.<sup>11</sup> And joint deterrence analysis of tax and nontax violations is possible only if the analyst sets aside the critical tax policy question.<sup>12</sup> None of this is accidental. The fundamental nature of socially undesirable behavior is different in tax. The manner in which legal rules may affect that behavior is different as well. Most importantly, the social goal that justifies the tax regime is different from the goals underlying competition law, environmental law, corporate law, and securities regulation, to take some examples. These differences give rise to three unique problems faced by scholars engaged in the economic analysis of tax law. These problems are the focus of this Part's analysis.

### A. The Undeterrability Problem

The economic analysis of tax rules and sanctions (discussed in detail below) is highly technical, hardly intuitive, and altogether different from the general law and economics approach. This divergence is puzzling. Do tax law and economics scholars really need to reinvent the wheel? Why not follow the lead of their economically oriented counterparts studying other areas of the law dealing with economic regulation? The answer, it turns out, can be reached only in several steps. The first step is to consider whether the basic analytical framework of law and economics applies to tax. We now turn to that framework.

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<sup>8</sup> See, e.g., *id.* at 798–801 (analogizing between the optimal tort liability and the optimal tax remittance regimes); Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241, 267 (2007) (analogizing between tax rules and tort rules).

<sup>9</sup> See, e.g., Louis Kaplow, *The Optimal Probability and Magnitude of Fines for Acts that Definitely Are Undesirable*, 12 INT'L REV. L. & ECON. 3, 3–5 (1992) (proposing a model for analyzing inefficient acts, such as common crimes, parking violations, and tax evasion).

<sup>10</sup> See *infra* notes 199–206 and accompanying text (discussing the term “efficiency”).

<sup>11</sup> See, e.g., Logue & Slemrod, *supra* note 7, at 855 (limiting the analogy to tax administration rather than the content of the substantive tax rules); Logue, *supra* note 8, at 267 (offering arguments based on the assumption of welfare-maximizing rules, an assumption that may be plausible in the tort setting but is implausible in tax).

<sup>12</sup> See Kaplow, *supra* note 9, at 9–10 (modeling the total harm caused by, for instance, parking violations and tax evasion without focusing on the fundamental difference between the nature of external harm produced by these two offenses). For a discussion, see Alex Raskolnikov, *Are Graduated Tax Penalties Efficient?* 9 (Sept. 15, 2012) (unpublished manuscript) (on file with author).



### 1. *The Basics of Law and Economics*

The basic law and economics framework is built on two fundamental premises. First, individuals are assumed to be rational actors maximizing their utility (or wellbeing).<sup>13</sup> Second, it is assumed that the objective of the legal system is (under the positive strand) or should be (under the normative strand) to maximize social welfare viewed as an aggregation of the welfare (utility) of each member of society.<sup>14</sup> Both assumptions are controversial;<sup>15</sup> neither is questioned in this Article.

If both assumptions are accepted, it is easy to justify state intervention in private affairs.<sup>16</sup> At the most basic level, government and the rule of law are needed to prevent the Hobbesian war of all against all.<sup>17</sup> Beyond this minimal role, regulation can increase social welfare, broadly speaking, in two ways. First, law can enable people to enter into and perform mutually beneficial transactions that would be impossible otherwise. Second, government can help align private and social costs and benefits where they would otherwise diverge. The former rationale underlies the economic analysis of contract law, commercial law, and corporate law, to name a few. The latter motivates the analysis of tort law, property law, environmental law, and a number of other legal regimes. Because tax law clearly does not aim to resolve the problems arising from interpersonal contractual negotiations, the following discussion focuses on the economic solutions to misalignments of private and social costs and benefits.

The fundamental cause of such misalignments is externalities—the “effect[s] of one person’s decision on someone who is not a party to that decision.”<sup>18</sup> Externalities may greatly reduce social welfare in light of substantial transaction costs facing economic actors.<sup>19</sup> Thus, legal rules and sanctions are needed to induce rational individuals to internalize the costs they impose on others when it is too costly for all

<sup>13</sup> See Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHL-KENT L. REV. 23, 23 (1989) (describing how the rational-actor model “assumes that a person can perfectly process available information about alternative courses of action, and can rank possible outcomes in order of expected utility”).

<sup>14</sup> See Eric A. Posner, Essay, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 833–34 (2003).

<sup>15</sup> See *id.*; Ellickson, *supra* note 13, at 23.

<sup>16</sup> See RONALD H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 24 (1988).

<sup>17</sup> See THOMAS HOBBS, *LEVIATHAN*, ch. 13, § 9, at 84 (John Gaskin ed., Oxford Univ. Press 1998) (1651).

<sup>18</sup> COASE, *supra* note 16.

<sup>19</sup> The focus on externalities comes from A.C. Pigou. See ALFRED CECIL PIGOU, *THE ECONOMICS OF WELFARE* 192–203 (4th ed. 1932). The importance of transaction costs in the persistence of externalities is the contribution of Ronald Coase. See COASE, *supra* note 16, at 15 (“What my argument does suggest is the need to introduce positive transaction costs explicitly into economic analysis so that we can study the world that exists.”).

involved to negotiate the optimal solution. Once rational actors take externalities they produce into account, their privately optimal choices become socially optimal as well.<sup>20</sup> This cost-internalization goal may be accomplished in a variety of ways depending on the costs of relevant information and enforcement. But in every case, substantive legal rules and sanctions for their violations are considered jointly. The reason is obvious: the most efficient legal rule would not improve social welfare if it cannot be enforced.

Law and economics scholars have found that many different legal regimes may be optimal in various settings. It may be best to adopt a strict liability system where every harm-producing act gives rise to liability. Or it may be more efficient to impose sanctions only on actions that cross a threshold beyond which the marginal external harm of behavior exceeds its marginal private benefit. It may be optimal to impose sanctions only after the harm occurs or earlier when a risk of harm arises. In the former case, sanctions are usually called damages, and they may be equal to the actual external harm or to the loss sustained by some actors. In the latter case, sanctions reflect the expected external harm and are referred to as fines, taxes, or penalties. In addition, given uncertain detection of violations, the so-called damages multiplier is needed to provide sufficient deterrence, whether sanctions are based on harm, loss, or risk of harm.<sup>21</sup> Finally, a number of considerations determine the optimal specificity of legal rules.<sup>22</sup>

Each of the preceding sentences can be easily turned into a book chapter of detailed analysis.<sup>23</sup> The discussion may become subtle and some of the conclusions may turn out to be counterintuitive. The choice between alternative regimes may turn on information that is not readily available. Taking imperfections of human decisionmaking into account may make conclusions indeterminate. In other words, the basic framework does not provide ready solutions for every real-life problem. Nonetheless, this framework is remarkably powerful in connecting the most technical legal rules to the fundamental economic reasons for government regulation.

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<sup>20</sup> The insight that in the absence of transaction costs a privately optimal solution would be socially optimal is known as the Coase Theorem. See Logue & Slemrod, *supra* note 7, at 797.

<sup>21</sup> For a discussion of this principle and its limitations, see Richard Craswell, *Deterrence and Damages: The Multiplier Principle and Its Alternatives*, 97 MICH. L. REV. 2185, 2191–92 (1999).

<sup>22</sup> See Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 272 (1974); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 562–68 (1992).

<sup>23</sup> In fact, this has been done on more than one occasion. For an excellent introduction to these issues, see A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* (3d ed. 2003).

For instance, the Resource Conservation and Recovery Act (RCRA) provides a complex and detailed scheme for managing hazardous waste.<sup>24</sup> Regulations under this act are even more complex and detailed. One of these regulations requires owners and operators of treatment, storage, and disposal facilities to take reasonable care to keep unauthorized persons from entering the active portion of the facility where an injury may occur—a requirement usually met by erecting a physical barrier and controlling all access routes, among other things.<sup>25</sup> This provision is an example of a threshold-type, act-based regime. It is threshold-type because not all harm to third parties leads to sanctions. It is act-based because the rule may be violated (and the sanctions may be imposed) even if no harm actually occurs.

It does not take long to connect the physical barrier requirement to the fundamental externality problem. Hazardous waste is dangerous to people's health. Unsuspecting third parties may come in contact with hazardous waste if not warned. Without regulation (by RCRA or the tort law), an owner of a hazardous waste facility will not take the costs to these third parties into account in designing and operating the facility, producing a negative externality. If full compensation of injured parties is difficult for any reason, it is better to reduce the risk of such externality rather than to wait for harm to occur. A physical barrier requirement is one of many reasonable ways of doing so. Voilà! This exercise of connecting the specific regulatory rule to the basic externality problem has a strong Six Degrees of Kevin Bacon quality.<sup>26</sup> And it usually does not take six steps to connect the most technical sub-substatutory provision to the fundamental reason for the government intervention.<sup>27</sup>

This section started with describing the basic assumptions underlying economic analysis of law and ended with connecting some of the fundamental insights of that analysis to a particular provision of a detailed regulatory regime. All of this took about one thousand words. The basic approach of law and economics clearly has much to offer.

## 2. *Why What's Good for Environmental Law Isn't Good for Tax*

Focusing on what works seems like a good place to start. Why should the tax inquiry not follow the same logic? Why what's good for environmental law isn't good for tax?

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<sup>24</sup> See 42 U.S.C. § 6902 (2006).

<sup>25</sup> 40 C.F.R. § 265.14 (2011).

<sup>26</sup> For an explanation of the Six Degrees of Kevin Bacon game, see *Six Degrees of Kevin Bacon*, WIKIPEDIA.ORG, [http://en.wikipedia.org/wiki/Six\\_Degrees\\_of\\_Kevin\\_Bacon](http://en.wikipedia.org/wiki/Six_Degrees_of_Kevin_Bacon) (last updated Jan. 17, 2013).

<sup>27</sup> The same is true of sanctions. See *infra* text accompanying notes 219–23.

In short, because tax is fundamentally different from pollution control, traffic regulation, or any other regime whose optimal design depends on internalizing externalities and minimizing transaction costs. The analysis of all these regimes begins by positing that private benefits are also social benefits and private costs are also social costs. Therefore, when private actors are forced to take all the costs and benefits of their actions into account, privately optimal conduct becomes socially optimal as well.<sup>28</sup> Rational individuals acting in their own self-interest unwittingly—and inescapably—maximize social welfare.

This identity of private and social benefits and costs does not exist in the case of intentional, nonconsensual transfers, especially money transfers. These transfers may take many forms, but the most obvious one, and the easiest one to consider first, is money theft.

The first important point about theft is that, while the thief realizes a private gain and the victim incurs a private loss, these gains and losses are always equal and offsetting.<sup>29</sup> From society's perspective, money is just moving around. In economic terms, this money movement is a mere transfer—it gives rise to no social cost or benefit.

If so, is there an efficiency-based reason to regulate theft? Most definitely so, as Gordon Tullock explained in a seminal article.<sup>30</sup> While the transfer of money resulting from theft produces no net social gains or losses, the resulting private gains and losses are very real to the parties involved. A thief has a strong incentive to expend real resources to carry out the theft. The victim has an equally strong incentive to expend real resources to prevent it. I will refer to all these expenditures as the *transfer costs*. For thieves, these costs include expenditures on lock-breaking equipment, on hiding and disposing the loot, and so on. For victims, the transfer costs include the price of better locks and surveillance cameras, the value of time spent on guarding their possessions, and the like.<sup>31</sup>

All transfer costs are pure social waste. Even if victims are ignorant of possible theft, the thief's transfer costs alone make theft socially undesirable (the transfer itself netting out to zero). Of course, victims are unlikely to be (or remain) ignorant, so they incur the transfer costs as well. Tullock emphasized that these costs may easily

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<sup>28</sup> See COASE, *supra* note 16, at 14.

<sup>29</sup> This statement ignores the possibility that the thief's utility gain may exceed the victim's utility loss due to their different wealth and the declining marginal utility of money. At least on average, this possibility is unlikely to produce meaningful efficiency gains for most theft-like activities considered below. For a detailed discussion, see Ras-kolnikov, *supra* note 3.

<sup>30</sup> Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224, 230 (1967).

<sup>31</sup> *Id.* at 230–31.

surpass the amount of the potential transfer.<sup>32</sup> No wonder most societies have made theft illegal and subjected it to heavy punishment.

What does this have to do with tax law? Quite a bit, as Tullock himself pointed out.<sup>33</sup> The first connection is obvious: tax evasion has a strong resemblance to theft. Evaders essentially steal from the government—that is, from all compliant taxpayers. The transfer costs related to tax evasion are real social losses, and they are likely to be substantial. Tax evasion, however, is not the only response to taxation that gives rise to social costs.

If lawmakers decide to tax oranges, taxpayers will buy fewer oranges. If lawmakers choose to tax wages, taxpayers will work less. With the exception of a lump-sum tax—a fixed levy on each taxpayer that does not depend on anything the taxpayer does—any tax that can be implemented in practice leads to behavioral distortions. Taxpayers change their choices compared to the hypothetical world without taxes (or, more precisely, the world with a lump-sum tax equal to any given taxpayer's actual tax burden) in order to reduce their tax liability.<sup>34</sup> That reduction in one's tax burden is a money transfer from the rest of society to the taxpayer, and this transfer gives rise to social losses—the transfer costs. Working less sounds nothing like tax evasion, but from the economic perspective, the two are very similar. In each case, taxpayers keep money that would have otherwise gone to the government. In each case, taxpayers incur transfer costs to retain more money while the government incurs transfer costs to increase tax revenues (by expending resources to reduce evasion or behavioral distortions). And in each case, no socially useful activity takes place. That is why “from an efficiency point of view, it does not matter whether or not the underlying activity is legal.”<sup>35</sup>

The transfer costs come in many shapes and sizes. A loss of individual utility from choosing a suboptimal course of action in order to save taxes is the so-called deadweight loss. It arises every time a taxpayer's decision is tax motivated. Other transfer costs include expenses for lawyers and accountants incurred to minimize one's taxes, costs of hiding income (offshore or under a mattress), risk-bearing losses related to taking uncertain tax positions,<sup>36</sup> and so on. Whatever form they take, the transfer costs always reduce social welfare. Their

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<sup>32</sup> See *id.* at 231.

<sup>33</sup> See *id.* at 228 (comparing theft to a lump-sum tax).

<sup>34</sup> To simplify the exposition going forward, I will omit similar caveats. That is, I will focus on the substitution effect caused by distortive taxation and ignore the partially or fully offsetting income effect.

<sup>35</sup> Wojciech Kopczuk, *Tax Simplification and Tax Compliance: An Economic Perspective*, in BRIDGING THE TAX GAP 112 (Max B. Sawicky ed., 2005).

<sup>36</sup> See Kaplow, *supra* note 9, at 3.

socially optimal amount is zero, and so is the socially optimal amount of tax-motivated decisions giving rise to these costs.

It is now clear why the basic law and economics approach does not work in tax. That approach is well suited for activities that are socially desirable at some level. Even though driving leads to auto accidents and manufacturing produces pollution, social welfare would certainly not be maximized if we eliminate socially costly accidents and pollution by prohibiting all driving and all manufacturing. But if someone invented a vaccine that could be administered to all newborns to make them completely unresponsive to taxes, that would create a certain and huge efficiency gain.<sup>37</sup> The optimal response to taxation is no response. The optimal amount of tax-induced behavioral distortions is zero. So, the basic law and economics analysis designed to determine the optimal *nonzero* amount of an activity producing both social costs and social benefits has nothing to offer to tax law and economics.

One may object by pointing out that tax dollars raised by the government are presumably spent in a welfare-increasing manner, such as by funding public goods. If so, the cost of taxation is connected to the benefit of public spending, just like the cost of driving is tied to its benefits. This objection would be misguided. While auto accidents are indeed the inevitable cost of driving, tax-induced distortions are not the inevitable cost of providing for public goods. In theory, the government can raise revenue with an instrument that produces no distortions—the lump-sum tax. While we may (and do) reject this tax for good reasons, its availability underscores the fundamental difference between nonconsensual money transfers and externality-producing activities. The basic law and economics analysis developed to optimize the latter is ill suited for optimizing the former.

Before proceeding further, it is important to bracket a particular kind of taxes. As A.C. Pigou noted almost a hundred years ago, any activity that may be optimally controlled using rules of legal liability, damages, and sanctions may be regulated by taxes as well.<sup>38</sup> Examples of cost-internalizing taxes (now called Pigouvian) include the so-called sin taxes,<sup>39</sup> pollution taxes,<sup>40</sup> and tax incentives of all kinds.<sup>41</sup>

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<sup>37</sup> A vaccine against addiction is, apparently, very close. See Douglas Quenqua, *An Addiction Vaccine, Tantalizingly Close*, N.Y. TIMES, Oct. 4, 2011, at D1.

<sup>38</sup> See PIGOU, *supra* note 19, at 192.

<sup>39</sup> See, e.g., Ruth Mason, *Federalism and the Taxing Power*, 99 CAL. L. REV. 975, 991 n.86 (2011).

<sup>40</sup> See, e.g., Amy Sinden, *Allocating the Costs of the Climate Crisis: Efficiency Versus Justice*, 85 WASH. L. REV. 293, 303 (2010).

<sup>41</sup> See, e.g., Deborah H. Schenk & Andrew L. Grossman, *The Failure of Tax Incentives for Education*, 61 TAX L. REV. 295, 308 (2008) (discussing education tax incentives and their Pigouvian justification).

Pigouvian taxes are subject to the same general law and economics analysis that applies to pollution controls and speed limits. The rest of this Article focuses on taxes that are not Pigouvian. These taxes—imposed to raise revenue rather than to optimize the level of a particular externality-producing activity—present the unique problems of tax law and economics.

### 3. *Searching for a Better Fit*

Pigouvian taxes aside, tax-motivated actions are always inefficient.<sup>42</sup> In that, however, they are not unique. The economic analysis of tax-motivated distortions applies to theft as well. While this is hardly recognized in the literature, it is even less understood that these two activities belong to a unique and distinct category of actions. Other examples include price fixing and bid rigging, insider trading and market manipulation, churning and scalping, embezzlement and option backdating.<sup>43</sup> All these acts are intentional, nonconsensual money transfers subject to Tullock's analysis of theft. All are irredeemably inefficient for the reasons already discussed. And all are different from pollution, speeding, and similar externality-producing activities that can be made efficient by forcing actors to account for the external harms they produce. Theft-like activities may not be made efficient in a similar fashion (or in any other manner). That is why I call them *irredeemably inefficient* (or just *irredeemable*) acts.<sup>44</sup>

While almost all irredeemable acts are illegal, the law's distaste for these acts is measured. They are subject to rules that could be broadened (that is, expanded to cover more possible irredeemable acts) and to sanctions that could be increased. The law's restraint has a clear efficiency rationale. I will use price fixing and churning as examples to demonstrate this point that applies to all irredeemable acts.

So-called "naked" price fixing is a coordinated price increase by competitors that is "unrelated to any organization of production or distribution."<sup>45</sup> It is an intentional, nonconsensual transfer of money from consumers to the colluding firms—a transfer clearly incompatible with the ideal baseline of a perfectly competitive economy. Price fixing leads to deadweight loss because it distorts consumer choice by encouraging consumers to substitute away from the items subject to

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<sup>42</sup> Needless to say, if the tax collector dumps the revenues he collects into the ocean, tax-motivated acts are socially desirable as they preclude a senseless destruction of value (the taxpayers' wellbeing is reduced without an offsetting benefit to anyone). The taxation problem in this case is entirely uninteresting, however, as the optimal solution for everyone is to pay zero taxes and for the government to disappear.

<sup>43</sup> For a discussion, see Raskolnikov, *supra* note 3, at 12–16.

<sup>44</sup> *Id.* at 2–3.

<sup>45</sup> HOVENKAMP, *supra* note 5, at 195.

the price fixing. It also gives rise to other transfer costs that are the primary focus of Tullock's original analysis.<sup>46</sup> Price fixing is an irredeemably inefficient act, it is always welfare reducing, and its optimal amount is zero. Yet the law hesitates. It only condemns price increases that result from an "agreement" to fix prices.<sup>47</sup> The term "agreement" probably does not extend to implicit understandings and certainly does not reach conscious parallelism.<sup>48</sup> Why so?

Simply put, because prices may increase for many reasons, and most of these reasons have nothing to do with collusion. If demand rises or input costs increase, all firms in the industry will raise prices even if the market is perfectly competitive. Mistakenly labeling competitive price elevations as oligopolistic (irredeemable) acts and subjecting them to sanctions will inhibit competition, reducing social welfare. Yet such mislabeling is inevitable given real-world imperfect enforcement. I refer to the social welfare loss resulting from such mislabeling as the *mislabeled cost*.<sup>49</sup> Broader legal rules and greater sanctions for price fixing would deter it to a greater extent, reducing its social cost (and giving rise to the deterrence benefit) but increasing the mislabeling cost. An optimizing policymaker would design the price-fixing rules and sanctions while taking account of both the marginal benefit of greater deterrence and the marginal increase in the mislabeling cost.<sup>50</sup>

This analysis is known—though hardly well articulated—in the literature.<sup>51</sup> It is also incomplete because any increase in deterrence leads not only to a greater mislabeling cost but also to a greater transfer cost from undeterred irredeemable acts. It is easy to engage in price fixing if competing firms can comply with the law by simply not signing a collusive contract. It is much costlier to fix prices if the only way to avoid liability is to have no communications with other potential cartel members.<sup>52</sup> Needless to say, there will be fewer price-fixing

<sup>46</sup> See Tullock, *supra* note 30, at 228–32.

<sup>47</sup> See HOVENKAMP, *supra* note 5, at 166–67.

<sup>48</sup> See *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 554 (2007) (“[M]ere interdependence of basic price decisions is not conspiracy.”); *Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 227 (1993) (stating that “conscious parallelism” is “not in itself unlawful”).

<sup>49</sup> While Louis Kaplow uses the term “chilling cost” to refer to the same concept, *see, e.g.*, Louis Kaplow, *An Economic Approach to Price Fixing*, 77 ANTITRUST L.J. 343, 366–70, 414–16 (2011), that term is frequently used to refer to any cost of over-deterrence, usually while discussing acts that are not irredeemably inefficient. The term “mislabeled cost,” in contrast, highlights the mislabeling problem that is particularly important (if not unique) for regulation of irredeemable acts.

<sup>50</sup> See *id.* at 346, 415. In addition, the policymaker will take into account the “costs of operating the [regulatory] regime.” See *id.* at 346.

<sup>51</sup> See *id.* at 366 (“The chilling of desirable behavior is a concern that strongly motivates past discussions of price-fixing rules but almost always remains implicit . . .”).

<sup>52</sup> For a more detailed and realistic example making the same point, see *id.* at 361.



conspiracies in the latter case. Nevertheless, there will be some, and the undeterred conspirators will incur high transfer costs. This “bad things getting worse” effect of stronger deterrence is often ignored in the competition law literature.<sup>53</sup> There is not even a term to describe the cost of this phenomenon. I will refer to it as the *resistance cost*, alluding to the undeterred offenders who resist the government’s efforts to eliminate irredeemable acts.<sup>54</sup>

Churning—trading by securities brokers in order to enrich themselves rather than to benefit their clients—is subject to the same analysis.<sup>55</sup> Churning gives rise to a deadweight loss and other transfer costs because clients hire fewer brokers and give the brokers they hire less discretion out of fear of churning. This undermines the efficiency of capital markets. While churning is always welfare reducing, it is illegal only if it is “excessive.”<sup>56</sup> Expanding this limitation, for instance by adopting a rule that a client’s accusation of churning is sufficient for a broker’s conviction, would surely deter more churning, especially if the rule is accompanied by a hefty fine. But this expansion will also give rise to a large mislabeling cost. Honest brokers whose services support an efficient capital market would abandon discretionary trading to avoid being mistakenly held liable for churning. Moreover, the few intransigent brokers will incur high resistance costs as they strive to keep their churning undetected.

These examples reveal the structure of the economic approach to designing optimal legal rules and sanctions for irredeemably inefficient acts—the structure that is quite different from the analysis of pollution, speeding, and the like. First, the analyst defines the ideal baseline. In antitrust, it is perfect competition; in securities regula-

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<sup>53</sup> Kaplow does allude to some instances of the “bad things getting worse” phenomenon in his recent work, but he neither generalizes his examples nor incorporates them in the basic tradeoff underlying his analysis. *See id.* at 361 (noting that “successful interdependent oligopoly pricing can be worse than old-fashioned explicit cartels because the latter might be able to rationalize production and thus achieve some efficiencies that will not result from mere coordinated price elevation”); *cf. id.* at 346 (“An economic approach to regulating oligopolistic price elevation . . . seeks to determine liability and apply sanctions based primarily on the deterrence benefits that result as well as any chilling of desirable behavior that may arise, in addition to the costs of operating the regime.”). It does not appear that Kaplow includes the transfer costs incurred by undeterred oligopolists in the “costs of operating the regime.” *Id.*

<sup>54</sup> It is worth noting that risk-bearing losses—costs incurred by undeterred offenders—are wellknown in the literature. *See, e.g.,* Kaplow, *supra* note 9, at 9. These losses are one component of the resistance cost. However, that cost includes many other components.

<sup>55</sup> *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1097 (5th ed. 2004).

<sup>56</sup> *See, e.g.,* *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 820 (9th Cir. 1980). For a discussion, see LOSS & SELIGMAN, *supra* note 55, at 1097–1101.

tion, it is the efficient capital market.<sup>57</sup> Second, the analyst singles out irredeemable acts. Third, she identifies activities that are part of the ideal baseline but that generate outcomes similar to those produced by irredeemable acts. These are the activities that will be occasionally mislabeled as irredeemably inefficient and increasingly burdened by stronger deterrence. Finally, the analyst sets the optimal legal rules and sanctions by balancing the marginal benefit of greater deterrence of irredeemable acts and the marginal mislabeling and resistance costs.<sup>58</sup> Because tax-motivated actions are irredeemable acts, the same approach should be much more useful in the tax setting than are inquiries focused on externalities and transaction costs. And it is, but only to a point.

#### 4. *The Undeterrability Problem*

In one respect, the analysis of tax rules and sanctions is simpler than the economic analysis of other irredeemably inefficient acts. In another respect, however, it is much more complex.

The simplicity is due to the fact that the mislabeling cost is absent in the tax setting. That cost is the cost of deterring a socially desirable activity that looks similar to an irredeemable act. Recall that in the tax setting, the irredeemable act is a distorted, tax-motivated decision—a decision that would have been different if the tax did not apply. Its benign counterpart is an act that would *not* have changed whether the tax burden were present or not. By definition, that benign act cannot be deterred by a threat that the tax would be imposed on it due to a mistaken conclusion that the act is tax-motivated (irredeemable). Granted, the mislabeling cost reemerges if we introduce penalties for tax underpayments. But in the basic scenario, this cost does not exist.

The resistance cost, however, presents a problem because it does not vary in the same predictable manner as it does for other irredeemable acts. A few examples will demonstrate this point. Consider a broker who wants to churn her customers' accounts. If churning is illegal but very difficult to prove (or if the sanctions are very low), the broker would take some care to avoid liability, but the cost of this care (the resistance cost) plus the expected sanction would be small compared to the benefit of extra fees. As the anti-churning rule is made increasingly more difficult to evade (or as the sanctions for churning increase), the point is reached when the gamble is not worth it for the

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<sup>57</sup> See, e.g., HOVENKAMP, *supra* note 5, at 19 (“The social cost of monopoly is the difference in social value between a monopolized market and a competitive market. It is not the difference in social value between a monopolized market and no market at all.”).

<sup>58</sup> Needless to say, the cost of enforcing legal rules and penalties should also be taken into account, just as it should when regulating speeding, pollution, and other externality-producing activities.

broker and she decides not to churn. At this point, the deterrence benefit arises, the resistance cost becomes zero, but the mislabeling cost is relatively large. When more than one broker contemplates churning, the point at which compliance becomes privately optimal need not be the same for all brokers, and it will certainly not be optimal to assure full compliance by all brokers because the mislabeling cost will be extremely high in that case. But if we really wanted to deter all churning, we could do so.<sup>59</sup> Once this is clear, we can decide what level short of full compliance is socially optimal while keeping the mislabeling and resistance costs in mind.

Consider now a taxpayer who holds an appreciated security that she would like to sell, except that she does not want to pay the tax that would be due upon the sale. If the taxpayer can easily replicate the economic effect of a sale without actually selling—say, by engaging in a short-against-the-box trade—she will incur the resistance cost of learning about this trade or, more likely, hiring someone who can advise her about it. The tax-motivated irredeemable act (the decision to retain the unwanted security) will not be deterred (the deterrence benefit will not materialize). The act's social cost (the cost of lost tax revenue) will arise, but the taxpayer will incur only a small resistance cost.

Of course, Congress can pass a law treating the short-against-the-box trade as an actual sale, eliminating an easy—that is, low cost—strategy of avoiding the tax (it did).<sup>60</sup> But other, more costly strategies may emerge. Tax planners may develop partial hedges that will allow taxpayers to keep only a fraction of the undesirable economic exposure while avoiding the tax on the gain (they did).<sup>61</sup> Tax lawyers may then decide (as they did) that as long as a taxpayer retains, say, ten percent of the original economic exposure, the partial hedge “works” (allows the taxpayer to avoid the tax while eliminating most of the economic exposure to the appreciated security). Entering into these hedges will require more documentation and higher fees. Besides, these hedges will not put the taxpayer in the most desirable position because they will not eliminate all of her economic exposure. The taxpayer's resistance cost will increase without any offsetting deterrence benefit (no tax revenue is collected).

Congress can then focus on these partial hedges (or on penalties for engaging in partial hedges that ultimately lose in court). It may

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<sup>59</sup> The point that high enough sanctions lead to full (though not necessarily socially optimal) compliance is well understood in the optimal deterrence literature. See, e.g., Kaplow, *supra* note 9, at 3 (“In some cases, complete deterrence may be optimal in light of the benefits of eliminating all risk-bearing costs.”).

<sup>60</sup> See I.R.C. § 1259 (2006).

<sup>61</sup> For a discussion, see David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1345–59 (2001).

decide, for instance, that keeping only ten percent of the economic exposure is insufficient to avoid a realization of gain. Nothing would stop Congress from defining a partial hedge that “works” as leaving the taxpayer with twenty, fifty, or even ninety percent of the economic exposure, forcing taxpayers to move farther and farther away from their preferred tax avoidance strategy. At some point, the private benefit from tax savings will be certainly outweighed by the cost of hiring lawyers, entering into complicated partial hedge transactions, and litigating them in court. Just like in the churning example, tax-motivated hedging will be deterred fully, and the resistance costs of hiring advisers and executing partial hedges will be eliminated.<sup>62</sup>

The same is not necessarily true, however, of another resistance cost component—the deadweight loss. That is because instead of deciding to abandon the wasteful hedging effort, sell the security, and pay the tax (the equivalent of a broker’s decision to abstain from churning), the taxpayer may decide to forgo the sale altogether. This would be the most costly tax-avoidance strategy. If it were not, the taxpayer would have chosen it over increasingly unsatisfactory partial hedging long before Congress dramatically expanded the partial hedging rule. Nonetheless, as long as the private cost of forgoing the sale is less than the private cost of paying the tax, the taxpayer will not sell.

Availability of this last-resort option of forgoing the sale reveals a fundamental problem. We can be certain that stronger deterrence of tax-motivated hedging will eventually deter all such hedging, just like stronger deterrence of churning will eventually deter all churning. But it is altogether unclear whether full deterrence of tax-motivated hedging will eliminate the resistance cost and give rise to the deterrence benefit, while it is certain that full deterrence of churning will do so.

This is not because a broker deterred from churning will necessarily become a faithful agent of his customer. Brokers have other ways of cheating customers (cherry-picking is one example),<sup>63</sup> and a broker deterred by anti-churning rules may try those other ways instead. Similarly, a taxpayer deterred from tax-free hedging may try other poten-

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<sup>62</sup> Daniel Shaviro made a similar point while speaking about “total transaction costs” of tax-motivated deals. See Daniel N. Shaviro, Commentary, *Evaluating the Social Costs of Corporate Tax Shelters*, 55 TAX L. REV. 445, 446–48 (2002). Shaviro did not define the term “total transaction costs,” but he appeared to use this term as a synonym of a previously defined term “tax planning costs” that include the “cost to promoters and taxpayers of developing, marketing, and executing the strategies,” as well as “taxpayer and government costs of audit and litigation incurred by reason of the use of these strategies.” *Id.* at 446.

<sup>63</sup> See, e.g., SEC v. K.W. Brown & Co., 555 F. Supp. 2d 1275, 1303–04 (S.D. Fla. 2007) (explaining that cherry-picking occurs when a broker trades alongside her customers and takes advantage of the cheapest execution prices while burdening the customers with the least favorable ones).

tially nontaxable diversification strategies such as entering into so-called “mixing bowl” partnerships.<sup>64</sup> Needless to say, the government may then address those alternatives as well. It can stop cherry-picking just like it can stop churning. It can stop mixing bowls just like it can stop tax-free hedging. In other words, the government can try to deter all irredeemably inefficient acts in either setting.

But while the government may succeed in that pursuit in the securities regulation arena at least in theory, it cannot possibly succeed in tax. This is because the taxpayer may engage in irredeemable, tax-motivated acts that cannot be made illegal. To repeat an earlier example, if lawmakers decide to tax oranges, taxpayers will buy fewer oranges. If lawmakers choose to tax wages, taxpayers will work less. For obvious reasons, making *not* buying an extra orange and *not* working an extra hour illegal is not a viable policy option. Yet both of these responses to taxation are irredeemable acts. Clearly, it is impossible to deter them, even in theory. In that sense, tax-motivated acts are undeterrable.

This *undeterrability problem* exists for a very basic reason: rational individuals respond to incentives, including those created by law. In every other setting, the very reason for enacting efficiency-maximizing legal rules is to initiate such responses.<sup>65</sup> This is true whether the rule addresses irredeemable acts or aims at negative externalities and whether it tackles commissions or omissions. But a tax is perfectly efficient only if it leads taxpayers to *not* respond to it. Yet, as long as the tax is imposed on something that the government cannot perfectly observe, persuading private actors to ignore incentives inevitably created by a tax regime is an impossible task.<sup>66</sup> If so, the socially undesirable phenomenon—taxpayers’ responses to taxation—may never be fully deterred.

Another way to illustrate the undeterrability problem is to imagine how the government could deploy its generally successful social optimization approach in the tax setting. Many potentially harmful activities are regulated by a standard, such as reasonableness.<sup>67</sup> At least in the law and economics interpretation, this standard serves as a proxy for the relevant cost-benefit inquiry.<sup>68</sup> For instance, the reason-

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<sup>64</sup> See, e.g., Bradley T. Borden & Douglas L. Longhofer, *The Effect of Like-Kind Property on the Section 704(c) Anti-Mixing Bowl Rules*, 27 REAL EST. J. 131, 131 (2011).

<sup>65</sup> See Ehrlich & Posner, *supra* note 22, at 260; Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157, 159 (2003).

<sup>66</sup> The government cannot recognize inefficient, tax-motivated decisions because it cannot resolve a counterfactual inquiry into what each taxpayer would have done in the absence of tax (short of subjecting every taxpayer to a lie detector tests and testing every decision that may possibly affect tax liability—and there are a lot of those!).

<sup>67</sup> See Ehrlich & Posner, *supra* note 22, at 261.

<sup>68</sup> See *id.* at 258, 277.

able care standard of tort law implies a comparison between the expected costs of accidents and the costs of taking precaution.<sup>69</sup> A decisionmaker's conclusion about the likely balance of costs and benefits in a particular case comes from observing others engaged in a comparable potentially harmful activity. A similar reasoning applies to the motorist who must drive at a reasonable speed, the employer who must provide reasonable accommodations to the disabled, the broker who must execute a reasonable (not excessive) number of trades, and so on. Suppose the government imposes a tax on labor income and realizes that this tax creates inefficient private incentives to work less. Can anyone seriously suggest to counter these incentives by legally requiring taxpayers to work a reasonable number of hours? What cost-benefit calculus would underlie this inquiry? Which taxpayers would provide the relevant comparison?

It is worth repeating that some tax anti-avoidance rules do succeed in deterring certain tax-motivated responses.<sup>70</sup> The limited success of these rules does not negate the undeterrability problem. *Some* responses to taxation can be deterred. *All* such responses never can be.

In sum, the intuitive tradeoff underlying the optimal regulation of price fixing, churning, and other irredeemably inefficient acts does not apply in the tax setting. The undeterrability problem reveals that the relation between the deterrence benefit and the mislabeling and resistance costs is profoundly unclear in tax. While tax-motivated acts are much more similar to price fixing and churning than they are to speeding and polluting, they are not similar enough.

## B. The Redistribution Problem

The undeterrability problem may startle an analyst used to thinking about traffic safety and environmental protection, but to a public finance economist, it is old news.<sup>71</sup> The economic theory of taxation recognized and solved this problem long ago. The solution is quite radical. Given that one cannot deter all tax-motivated responses, one should make them impossible. The only way to do this is to construct

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<sup>69</sup> See *id.* at 277. This comparison is captured in the famous Learned Hand formula. See *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

<sup>70</sup> One such rule (the anti-hedging rule discussed above) successfully deters at least some tax-free hedging while relying on concepts similar to reasonableness in their vagueness. These concepts include "substantially fixed," I.R.C. § 1259(d)(1) (2006), and "substantially all," *id.* § 1259(d)(2). Another rule, the "reasonable compensation" test, discussed below, expressly embraces the reasonableness standard. See *infra* text accompanying notes 95–99.

<sup>71</sup> The point that this problem is what separates tax from other irredeemably inefficient acts, however, is part of this Article's contribution.

a tax system in which the tax burden does not depend on anything a taxpayer does. This tax system is wellknown: it is the lump-sum tax.<sup>72</sup>

The uniform lump-sum tax is perfectly efficient, very easy to administer, and wholly unattractive as a policy prescription.<sup>73</sup> Its fundamental limitation is that it cannot be used for redistribution.<sup>74</sup> This self-evident statement highlights a major burden of the tax system, a major challenge for its designers, and a major reason for the limits of tax law and economics.

According to the prevailing view in law and economics,<sup>75</sup> designers of legal rules (especially rules affecting commerce and finance) should focus only on efficiency maximization.<sup>76</sup> If the tax system could be designed in the same way—if, for instance, there was some other regime (say, insurance law) that would carry the redistribution burden—then uniform lump-sum tax would be a perfect solution. Alas, no such other system exists in practice or in theory. Moreover, the main argument supporting the view that tort law, corporate law, and contract law, for instance, should focus solely on efficiency is that redistribution is better accomplished through the tax system. In essence, the nontax law and economic scholars affirmatively place the burden of assuring appropriate redistribution on tax policy designers.<sup>77</sup> Yet, the need to provide for redistribution—the *redistribution problem*—immensely complicates the tax analysis. At the most basic

<sup>72</sup> See N. Gregory Mankiw et al., *Optimal Taxation in Theory and Practice*, 23 J. ECON. PERSP. 147, 149 (2009).

<sup>73</sup> See *id.*

<sup>74</sup> This is true because a uniform tax imposes the same tax burden on every taxpayer. A non-uniform lump-sum tax based on each taxpayer's ability (also known as the endowment tax) is redistributive, but it is so unrealistic that it is virtually impossible to make comparisons to it. See David Hasen, *Liberalism and Ability Taxation*, 85 TEX. L. REV. 1057, 1058 (2007).

<sup>75</sup> See Tomer Blumkin & Yoram Margalioth, *On the Limits of Redistributive Taxation: Establishing a Case for Equity-Informed Legal Rules*, 25 VA. TAX REV. 1, 2 (2005) ("That '[r]edistribution is accomplished more efficiently through the income tax system than through the use of legal rules' seems to be the prevailing norm in the law and economics literature . . . ."); Logue & Avraham, *supra* note 65, at 158 (making a similar statement).

<sup>76</sup> See Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 821 (2000); Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 675 (1994). But see Blumkin & Margalioth, *supra* note 75, at 2; Logue & Avraham, *supra* note 65, at 160; Terrance O'Reilly, *Principles of Efficient Tax Law: Apocrypha*, 27 VA. TAX REV. 583, 597–600 (2008); Chris William Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797, 797 (2000).

<sup>77</sup> Even the commentators who believe that legal rules should take distributional consequences into account to some extent and under some circumstances share the view that the tax system should be the primary (or at least substantial) redistributive mechanism. See Blumkin & Margalioth, *supra* note 75, at 2, 29; Logue & Avraham, *supra* note 65, at 166–67; Sanchirico, *supra* note 76, at 804.

level, it rules out the uniform lump-sum tax. Without this tax, the undeterrability problem cannot be solved.

Despite the unique complexity of the tax optimization challenge, public finance economists found an ingenious solution. They developed a theory that addresses both of the seemingly insurmountable obstacles just considered: the undeterrability problem and the redistribution problem. That theory is the focus of the analysis in the remainder of this Part.

### C. The Baseline Problem

#### 1. *The Optimal Income Tax Solution*

The ingenious solution is the optimal income tax theory based on the seminal work of James Mirrlees.<sup>78</sup> If there is one canonical, widely accepted theory of optimal taxation, Mirrlees's theory is it.<sup>79</sup> It has been developed and extended by numerous scholars. Its fundamental conclusion that the optimal tax is a progressive, nonlinear tax on labor income is as widely accepted in public economics as any. And the argument that this tax is superior to all alternative tax systems has survived for over four decades without widespread dissent.<sup>80</sup>

The basic optimal income tax model has many well-known limitations. It is static and, therefore, has no savings and no wealth transfers at death.<sup>81</sup> Individuals are assumed to be identical in all respects except for their earning ability.<sup>82</sup> The argument about the superiority of the model's tax over any other tax relies on assumptions that are not particularly realistic.<sup>83</sup> And the key part of the prescription (the sub-

<sup>78</sup> See James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175, 175–76 (1971).

<sup>79</sup> See, e.g., Mankiw et al., *supra* note 72, at 150 (“[T]he Mirrlees approach . . . has become the dominant approach for tax theorists.”); Joel Slemrod, *Optimal Taxation and Optimal Tax Systems*, 4 J. ECON. PERSP. 157, 157 (1990) (“The theory of optimal taxation has . . . been the reigning normative approach to taxation.”).

<sup>80</sup> In the past decade, the dissent appears to be on the rise, however. See Peter A. Diamond & Emmanuel Saez, *The Case for Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165, 181–83 (2011).

<sup>81</sup> See, e.g., Nicholas Stern, *The Theory of Optimal Commodity and Income Taxation: An Introduction*, in THE THEORY OF TAXATION FOR DEVELOPING COUNTRIES 22, 37 (David M. Newbery & Nicholas Stern eds., 1987). Extensions of the basic model to multiple periods have not yielded well-accepted policy prescriptions. See LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 221–30 (2008).

<sup>82</sup> See, e.g., Stern, *supra* note 81, at 36. In other words, the possibility that some individuals like chocolate ice cream while others prefer vanilla (or, more importantly, that high ability individuals may have different preferences from low ability types) is disallowed by the model.

<sup>83</sup> These assumptions are that utility is weakly separable in consumption and leisure and that all taxpayers are identical except for variation in their wage rate. See, e.g., Diamond & Saez, *supra* note 80, at 180. The weak separability means, *inter alia*, that there are no such things as leisure substitutes or complements. That is, fishing rods and downhill skis are not associated with leisure more than, say, office clothes and take-out lunches. It



stantial demogrant) is not going to be implemented until public finance economists gain full control of the government. Nonetheless, the optimal income tax theory is the best public economics has to offer. It is the most reasonable choice for the ideal baseline.

The optimal income tax theory embraces the redistribution challenge. It also accepts the undeterrability problem, that is, the inevitability of distortions and deadweight losses. The theory's main focus is on optimizing the tradeoff between redistribution and distortion.<sup>84</sup>

In the basic setup, redistribution is desirable because taxpayers are assumed to have declining marginal utility of income.<sup>85</sup> Redistributing from high-income taxpayers to low-income taxpayers increases overall welfare because the latter gain more utility from the transfer than the former lose.<sup>86</sup> If this were the only consideration, a utilitarian social welfare function (SWF) would call for complete equality of incomes. The reason it does not (and neither does any other SWF) is that taxing labor income of high-income earners induces them to work less—their choice between labor and leisure is distorted in favor of leisure.<sup>87</sup> The resulting deadweight loss offsets the benefit of redistribution, giving rise to the optimal tax system consisting of a fixed cash grant to each taxpayer (the so-called demogrant) and a schedule of constant or declining marginal rates.<sup>88</sup> The overall system is progressive, however, because average rates rise with income.<sup>89</sup>

Because the optimal income tax theory addresses both the redistribution and the undeterrability problem, it allows us to make another attempt to follow the general economic approach to regulating irredeemable acts. Up to this point, the discussion implicitly assumed the lump-sum tax as the ideal baseline. *Every* tax-motivated decision was viewed as a deviation from the ideal. That approach faltered in

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also means that when two taxpayers with equal income choose to spend it in different ways (say, one buys a modest car and a house in an excellent public school district while another buys a luxurious car and a house in a mediocre public school district), their choices convey no information about their respective abilities. For reasons to question this assumption, see sources cited *infra* note 242.

<sup>84</sup> See, e.g., Mankiw et al., *supra* note 72, at 150.

<sup>85</sup> While this assumption, as well as the assumption that all individuals have the same utility function, is widely accepted in public economics, its empirical foundations are weak. See Daniel Friedman & Shyam Sunder, *Risky Curves: From Unobservable Utility to Observable Opportunity Sets 2* (Cowles Foundation, Discussion Paper No. 1819, 2011), available at <http://ssrn.com/abstract=1858769>. The declining marginal utility of income assumption is unnecessary, however, if the social planner is assumed to have any social welfare function that is more egalitarian than the utilitarian one, or if the planner assigns different individuals different welfare weights.

<sup>86</sup> See Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 NAT'L TAX J. 135, 137 (1996).

<sup>87</sup> See *id.*

<sup>88</sup> See Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1945 (1987).

<sup>89</sup> See *id.*

light of the undeterrability problem. What if we adopt the optimal income tax as the ideal baseline instead?

This baseline would be different from every baseline considered thus far (the lump-sum tax included) because the optimal income tax baseline incorporates a distortion. Given that baseline, tax-motivated reductions in labor effort are *not* irredeemable acts because, by definition, they are part of the ideal base case. With the labor-leisure distortion addressed by the choice of baseline, developing legal rules and sanctions aimed at reducing the same distortion is unnecessary (as well as impossible). All other tax-induced distortions, however, are welfare reducing irredeemable acts. We can study legal rules and sanctions aimed at deterring them in the usual fashion.

Because the optimal income tax is a nonlinear tax on labor income, taxpayers subject to this tax have three ways of reducing their tax burdens other than by working less. They can cheat, for example, by failing to report their wages to the government. They can disguise their labor income as capital income (which is not burdened by the ideal income tax). Or they can shift their income to other taxpayers who are subject to lower marginal tax rates.

Any tax lawyer can immediately recognize that the analysis is starting to get traction at this point. Underreporting of wages, recasting of wages as capital income, and income shifting among taxpayers are all wellknown problems of real-life tax planning and tax administration.<sup>90</sup> I will focus on the labor-capital distortion to avoid repetition.

The U.S. tax system gives rise to this distortion for two reasons. First, Social Security taxes apply only to labor income.<sup>91</sup> Second, capital income in the form of long-term capital gains is taxed at a lower rate than the top marginal rate for ordinary income such as salaries and wages.<sup>92</sup> The former disparity has led to a controversy involving compensation of owner-employees of so-called S corporations.<sup>93</sup> The latter is responsible for a host of rules dealing with incentive compensation as well as to the latest debate about the taxation of carried interest earned by private equity managers.<sup>94</sup> Because the Social Security tax is the kind of labor income tax contemplated by the optimal in-

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<sup>90</sup> See David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 222 (2002).

<sup>91</sup> Specifically, they apply to "remuneration for employment." I.R.C. § 3121(a) (2006).

<sup>92</sup> Compare *id.* §1(a) (marginal rates for ordinary income), with *id.* §1(h) (lower rates for long-term capital gains). Dividends are also taxed at a reduced rate at the moment.

<sup>93</sup> See Kirsten Harrington, *Employment Taxes: What Can the Small Businessman Do?*, 10 AKRON TAX J. 61, 70 (1993).

<sup>94</sup> See, e.g., Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3–7 (2008); David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 715–20 (2009).

come tax literature, the following discussion focuses on the S corporation controversy.

That controversy has arisen because when an entrepreneur structures her business as a wholly owned S corporation, she has a strong incentive to minimize her compensation and to distribute cash out of the corporation to herself as a dividend.<sup>95</sup> Wages are subject to the Social Security tax but dividends are not, hence the incentive to disguise the former as the latter.<sup>96</sup> The courts have adopted the “reasonable compensation” test to determine whether the salary paid by an S corporation to its owner-employee is adequate (that is, whether no part of labor income has been shifted to capital income distributed as a dividend).<sup>97</sup>

This test can be analyzed in the same fashion as the “agreement” requirement for price fixing and the “excessive trading” threshold for churning. If we broaden the “reasonable compensation” test—for instance by changing it to a “reasonably high” or just “high” compensation standard—more owner-employees who understate their compensation for tax reasons would lose the benefit of their tax planning. That is, more irredeemably inefficient acts would be deterred. On the other hand, some owner-employees who set their compensation without thinking about taxes would be forced to pay the Social Security tax on part of their dividend income mislabeled as compensation. That is, a broad “high” compensation test would impose a greater tax burden on capital income. That burden is inefficient because capital income tax is not part of the ideal baseline. Therefore, the “high” compensation standard would give rise to a larger mislabeling cost compared to the existing “reasonable compensation” test. The resistance cost would also change in exactly the same manner as was described earlier while discussing churning brokers.<sup>98</sup> In fact, the tax compliance literature appears to be the only area of law and economics where the importance of the resistance cost is well understood.<sup>99</sup> Balancing the marginal benefit of deterrence (the social

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<sup>95</sup> See, e.g., Harrington, *supra* note 93, at 61–79; Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 745, 798–801 (2008).

<sup>96</sup> See Harrington, *supra* note 93, at 70. Employment taxes are paid in part by the employer and in part by the employee. See *id.* at 61–62. Where the corporation’s sole owner happens to be its only employee, that division becomes extremely tenuous.

<sup>97</sup> See, e.g., *Watson v. United States*, 668 F.3d 1008, 1016–18 (8th Cir. 2012).

<sup>98</sup> See *supra* text accompanying note 59. That is, broad enough rules will deter all character conversion.

<sup>99</sup> While the phenomenon giving rise to the resistance cost has no accepted name even in that literature, it has been referred to as the “shelters getting worse” problem, Weisbach, *supra* note 90, at 237, the “distortionary effect,” David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88, 100 (2002), and the “boomerang effect,” Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 279 (2002). The costs reflecting some components of the resistance cost have been referred to as the “dissipation costs,” Philip A. Curry et al., *Creating Failures in the*

benefit of additional tax revenue) and the marginal mislabeling and resistance costs would enable a policymaker to set the optimal legal rule regarding compensation of S corporation owner-employees.

The same analysis applies to evaluating how much of private equity managers' carried interest should be subject to ordinary income rates and whether some shifting of labor income among taxpayers should be allowed. In the former case, the mislabeling cost arises due to an imposition of tax on capital income; in the latter, due to a deviation from the optimal nonlinear schedule of marginal tax rates.

The cost-benefit analysis just described would also guide policymakers in designing the sanctioning regime. For instance, increasing penalties for violating the "reasonable compensation" test would deter more S corporation owner-employees from understating their compensation, just like replacing "reasonable" with "high" compensation test would do. The tradeoff between the deterrence benefits and the mislabeling and resistance costs is exactly the same.

Is this the answer? Can we rethink the design of optimal tax rules and sanctions by following the analytical path illuminated by the economic analysis of irredeemable acts suggested above? Unfortunately, no such rethinking can occur. The baseline is at the root of the problem.

## 2. *The Baseline Problem*

The optimal income tax baseline is clearly closer to the actual tax system than the lump-sum tax baseline could ever be. But it is not close enough. Only a tiny fraction of the actual tax rules may be explained by reference to the optimal income tax baseline. At the same time, the fundamental features of our tax system lack any connection to it.<sup>100</sup>

The optimal income tax is a tax on labor income. Yet, the Internal Revenue Code imposes taxes on capital income as well. How can we analyze the details of capital income tax rules if any such tax is a violation of the ideal baseline? This is hardly the only problem. Our capital income tax is transaction-based due to the realization requirement. That requirement leads to numerous distortions in the choice of capital investments. Besides, one form of realization-based capital

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*Market for Tax Planning*, 26 VA. TAX REV. 943, 948 (2007), "the inframarginal cost[s] of evasion," Louis Kaplow, *Optimal Taxation with Costly Enforcement and Evasion*, 43 J. PUB. ECON. 221, 233 (1990), the "avoidance costs" combined with the "deadweight loss that results when taxpayers switch to untaxed transactions," Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503, 515–16 (2004), and, seemingly interchangeably, the "tax planning cost" and the "transaction cost," Shaviro, *supra* note 62, at 446, 448.

<sup>100</sup> In Kaplow's words, "there is little basis for supposing that a conventional income tax is even approximately optimal." KAPLOW, *supra* note 81, at 232.

income—that earned by the so-called C corporations—is subject to a double tax, at least in theory. And corporate income (as well as other capital income) earned in a cross-border setting is taxed under its own set of rules.

Suppose we consider the optimal rule for allocating interest expense by U.S. multinational corporations. In undertaking this task, we would be so far from the optimal income tax baseline that the effort to reference it would be decidedly doomed. There is no optimal theory of international taxation (there is not even an agreement on whether national or worldwide welfare should be the subject of optimization). There is no optimal theory of corporate tax, no optimal theory of the realization requirement, and no optimal theory of capital income taxation.<sup>101</sup> In considering interest expense allocation rules, we would be four levels removed from the optimal labor income tax, and each level appears to be completely impenetrable to optimization, at least for now.

In light of these challenges, it is no surprise that attempts by tax law and economics scholars to devise an approach to optimizing actual tax rules and sanctions are exceedingly rare. While many legal academics use economic tools to analyze the existing tax system, almost none of these analyses are grounded in any kind of an optimal regime.<sup>102</sup> There is simply no tax literature addressing the main inquiry of the general law and economics movement.

Louis Kaplow and David Weisbach have each tried to connect the vast theory of public economics to the task of optimizing tax rules and sanctions that exist in the real world. Each has made progress, but neither has ultimately succeeded.

Kaplow's approach begins with a social welfare function fully reflecting society's distributive preferences. This function has a certain value given any set of legal rules and the extent of their enforcement.<sup>103</sup> We then evaluate an adjustment. For instance, we consider making the rules more complex in order to distinguish between deductible business and nondeductible personal expenses or to include

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<sup>101</sup> For a description of promising recent research, see *infra* text accompanying notes 240–43.

<sup>102</sup> See, e.g., Logue, *supra* note 8, at 246–47 (analyzing the efficiency of tax penalties while assuming that the underlying rules are optimal without investigating this assumption); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 570–74 (2006) (arguing for reforming penalties without investigating optimality of the rules the penalties enforce); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 6 (1992) (concluding that “whether by accident or design, the realization and recognition rules in the Code have some tendency to promote efficiency” while stopping far short of asserting that these rules are part of the optimal tax system).

<sup>103</sup> See Kaplow, *supra* note 86, at 136.

the value of certain fringe benefits in income.<sup>104</sup> The greater the complexity and the precision of the tax system, the closer we are to the ultimate goal of maximizing the value of the SWF. Lack of precision has equity and/or efficiency costs that can be measured by comparing the SWF values of less and more precise systems as well as by undertaking the standard deadweight loss analysis.<sup>105</sup> But complexity is costly as well.<sup>106</sup> By comparing the costs of complexity and the increase in the SWF value and/or the reduction in deadweight loss from greater precision, we can decide whether a more complex system is worth achieving.<sup>107</sup> Analysis of enforcement follows the same path.<sup>108</sup>

Kaplow does not say whether this approach can be used to reach the optimal system or only to consider whether certain changes would be welfare increasing. He explains that the optimal income tax framework, "which has been employed successfully to analyze the problem of the optimal extent and form of redistribution, can be used to illuminate the problems of complexity and enforcement."<sup>109</sup> Assuming optimization is possible, Kaplow's approach could be summarized in the following four steps: choose the SWF, consider alternative legal regimes, ascertain the respective SWF values for these alternative regimes in light of the cost of achieving each, pick the one with the highest value net of cost.<sup>110</sup>

The major appeal of this approach is quite obvious: in contrast with the standard optimal income tax theory, the details of the actual tax law and tax enforcement are very much in the picture.<sup>111</sup> If we can determine what should be a deductible business expense or a tax-free fringe benefit using Kaplow's method, we can evaluate any other tax rule as well. The same is true of the structure and magnitude of sanctions.

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<sup>104</sup> See *id.*

<sup>105</sup> See *id.* at 140 (evaluating the equity effect by comparing SWF values); *id.* at 143 (evaluating the efficiency effect by undertaking the "usual" deadweight loss analysis).

<sup>106</sup> See *id.* at 140.

<sup>107</sup> See *id.*

<sup>108</sup> See *id.* at 144–47. It is unclear, however, how an analyst would identify which specific rules should be potential targets of reforms. Kaplow refers to such rules as those arising from incidental discrimination resulting from administrative complexity, costly enforcement, and so on. *Id.* at 135. Presumably, one needs to specify an ideal/optimal tax system before being in a position to identify which rules deviate from it. The optimal tax system Kaplow has in mind is the optimal income tax. Problems with using that system as the basis of evaluating actual tax rules and sanctions have been already discussed.

<sup>109</sup> *Id.* at 137–38.

<sup>110</sup> If all inequity is fully replaced by inefficiency, the analysis is reduced to the standard deadweight loss calculations for any particular regime.

<sup>111</sup> See Kaplow, *supra* note 86, at 138 (giving examples of distinguishing between business and personal expenses, evaluating fringe benefits, and taxing imputed income from housing); *id.* at 144 (referring to higher audit rates, more intensive audits, greater information reporting, and a range of penalties).

Yet Kaplow's approach is unlikely to help in evaluating the efficiency of actual tax provisions, let alone in reforming them with the aim of achieving the welfare-maximizing regime. The main problems are its level of generality, its information demands, and its indeterminacy.

Kaplow's approach, no doubt, is entirely consistent with welfare economics. In fact, economic analysis of any area of the law may be performed in the same way. Should a particular regulatory regime be strict liability or threshold-based? Should sanctions depend on acts or harms? Should there be something like the RCRA for managing hazardous waste and, if so, should it have the physical barrier requirement described above? To answer each question, we can plug the alternative specifications into the preferred SWF and choose the regime with the higher value. The entire law and economics enterprise may be supplanted by this approach.

The reason this has not happened is obvious: articulating more specific prescriptions has a very strong appeal. Legislators, judges, and administrators may understand the concept of externalities and transaction costs and even have intuitions about their likely magnitude in a particular setting. These policymakers may be fairly confident that in some situations an act-based regime is preferable to a harm-based regime because, for instance, many offenders will be judgment proof if the latter system is chosen.<sup>112</sup> Regulators may even have a reasonably good grasp of the tradeoffs involved in the basic cost-benefit analysis. But no decisionmaker would be moved by an appeal to resolve legal and policy questions by comparing the values of social welfare functions.<sup>113</sup>

Kaplow himself realizes this well. While he retains his commitment to welfare economics in analyzing a variety of antitrust rules, he successfully develops much more certain and fine-grained prescrip-

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<sup>112</sup> Sanctions in act-based regimes are generally lower than in harm-based ones because act-based sanctions reflect expected harms (or losses) rather than the actual ones.

<sup>113</sup> The use of an SWF-based approach to design optimal enforcement strategies entails further complications. The main problem is that such an approach would rely heavily on assumptions about the optimal legal regime. Unfortunately, there appears to be no grounding for some of the important assumptions that would need to be made. For instance, it is unclear how the SWF-based optimization would incorporate uncertainty. Perhaps we can assume that the SWF is optimized if all taxpayers "fully" comply with the law. Or we can assume that it is optimized if taxpayers take positions that have a fifty-fifty chance of being upheld. In the former case, a somewhat uncertain position (seventy- to eighty-percent likelihood of success in litigation) is not welfare-maximizing; in the latter case, it is. It is also unclear why we should assume that the SWF is maximized with full compliance, given that full compliance never justifies its costs. If, however, we posit that the optimized SWF incorporates some noncompliance, it will be unclear how to determine whether any individual act of noncompliance is consistent with the optimized SWF. If it is, the act is welfare-maximizing and should not be penalized; otherwise, it should.

tions based on intuitive balancing of specific costs and benefits.<sup>114</sup> Even though that simpler balancing still imposes significant information demands on decisionmakers, there is little doubt that it is much more plausible as a guide for antitrust policy than the suggestion to compare social welfare functions reflecting various versions of a rule. Kaplow's insistence on such comparisons in evaluating tax rules and sanctions suggests that he sees no way of simplifying the tax inquiry along the lines of his antitrust analysis.

A more recent, extensive, and far-reaching line of Kaplow's work may be viewed as another effort to connect tax law theory and practice. This view would be mistaken, however, as Kaplow himself recognizes. The work in question is based on the concept of a distribution-neutral income tax adjustment that allows an analyst to separate, under certain assumptions, efficiency and distributive consequences of any policy, including many possible tax reforms.<sup>115</sup> This separation produces many benefits. It brings much-needed conceptual clarity to all sorts of reform proposals. It reveals that some well-known fundamental insights apply more broadly than was generally believed. It also allows nontax scholars to focus on the areas of their expertise by setting aside questions of redistribution that are left to be addressed by the optimal tax theory. But the distribution-neutral income tax adjustment method is based on a tax system that does not exist, and it relies on an adjustment that cannot be made in practice.<sup>116</sup> Furthermore, the distribution-neutral income tax adjustment approach does not free policymakers from the need to deploy SWF analysis in order to evaluate the distributive effects of various policies. For all these reasons, as Kaplow notes, "the distribution-neutral construct is primarily an analytical device, not a specific policy prescription to be followed precisely or otherwise."<sup>117</sup>

Weisbach uses a different strategy. In a brief and little-known essay, he identifies the main problem with the standard approach to evaluating tax rules and sanctions and suggests an intriguing alternative.<sup>118</sup> "Assuming that there are set categories of evasion and avoid-

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<sup>114</sup> See *supra* text accompanying notes 49–50.

<sup>115</sup> See KAPLOW, *supra* note 81, at 25–31.

<sup>116</sup> Even economists (who generally tend to be less constrained by implementation difficulties than lawyers are) have expressed this view. See, e.g., BEV DAHLBY, *THE MARGINAL COST OF PUBLIC FUNDS: THEORY AND APPLICATIONS* 46 (2008) ("[I]t is highly unlikely that the required tax adjustments reflecting individuals' marginal benefits are ever applied in practice."); Agnar Sandmo, *Redistribution and the Marginal Cost of Public Funds*, 70 J. PUB. ECON. 365, 375 (1998) (concluding that the distribution-neutral adjustment of nonlinear income tax "seems hardly realistic").

<sup>117</sup> Louis Kaplow, *An Optimal Tax System* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 17214, 2011), available at <http://www.nber.org/papers/w17214>.

<sup>118</sup> See David A. Weisbach, *Corporate Tax Avoidance*, in *PROCEEDINGS OF THE 96TH ANNUAL CONFERENCE ON TAXATION*, NATIONAL TAX ASSOCIATION 9, 9 (David Merriman ed.,



ance, as is done in most of the literature [that is, assuming that some transactions, events, etc. should be taxable while others should not],” Weisbach writes, “assumes the central problem. . . . Instead, we must determine which responses to taxation will be treated in various fashions based directly on the welfare consequences of such treatment.”<sup>119</sup>

To make this determination, Weisbach proposes to use either of the two related tools for evaluating such consequences: the marginal efficiency cost of funds (MECF) analysis and the taxable income elasticity approach.<sup>120</sup> Focusing on the former, Weisbach reminds the readers that the MECF of various changes in legal rules and sanctions depends on four variables: the marginal burden imposed by the change on taxpayers, the marginal change in the costs of compliance, the marginal revenue raised by the change, and its marginal administrative costs.<sup>121</sup> In its simplest form, MECF is the sum of the first two of these values divided by the difference between the second two. The standard MECF analysis concludes by suggesting that in evaluating any marginal tax or tax enforcement reform, we should pursue changes in policy instruments with the lowest MECF because it would allow us to raise revenue at the lowest social cost.<sup>122</sup>

Weisbach goes further. His key insight is that in deciding which taxpayer acts should be legal and which should not, that is, what is the optimal content of the tax law (or at least its numerous anti-avoidance rules),

[d]isallowed evasion is simply the class of responses to taxation that it is efficient to prevent. Tax rules preventing these activities have a low MECF. Allowable avoidance activity is the class of responses to taxation that are efficient to allow. Tax rules that would disallow these activities would have a high MECF. . . . Disallowed evasion is likely to include those activities that are relatively cheap to prevent or that would lose a lot of revenue if allowed. For example, failing to file a return or filing false returns, if allowed, would lose substantial revenue and, therefore, must be treated as disallowed evasion. Working less, while potentially creating a large revenue loss, would be difficult or impossible to prevent, and, therefore, falls into the class of allowed avoidance.<sup>123</sup>

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2004). As of January 30, 2013, the essay has been cited three times in the Westlaw Law Reviews database, and once by a paper posted on SSRN. The SSRN citation is one of only two English-language (and three total) citations in Google Scholar.

<sup>119</sup> *Id.* at 9.

<sup>120</sup> *Id.* at 10.

<sup>121</sup> *Id.*

<sup>122</sup> See, e.g., Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF STAFF PAPERS 172, 188–89 (1996).

<sup>123</sup> Weisbach, *supra* note 118, at 12. While Weisbach claims that “[i]t is easy to imagine how the avoidance/evasion type regime we have arises from this analysis,” *id.*, this view appears to be too optimistic. To take Weisbach’s own example, some return filing violations are indeed cheap to prevent. Others, such as violations by the so-called “informal

This strategy appears promising because it is focused on the right questions and seems more plausible than Kaplow's approach. Surely a marginal burden of a change in the economic substance doctrine or an amendment to corporate reorganization rules will not be known precisely, and neither will the marginal change in revenue resulting from such revisions. But we make related estimates all the time in evaluating revenue effects of new legislation.<sup>124</sup> So it is conceivable that the MECF of various marginal changes could be estimated with reasonable precision.<sup>125</sup>

Unfortunately, Weisbach's suggestion cannot resolve the fundamental disconnect between the actual tax regime and the design of optimal tax rules and sanctions. The main problem is that MECF is the analysis of *marginal* changes.<sup>126</sup> It is of little help in reaching the social optimum—the ambition of the general law and economics analysis. In fact, economists Joel Slemrod and Shlomo Yitzhaki, on whose MECF analysis Weisbach relies, are careful to emphasize this point:

Although marginal analysis can be helpful for evaluating small changes in the tax system, it cannot handle the grand design of the tax system. Because of the nature of the system—namely, the non-continuity of administrative costs, nonconcavity of the revenue constraint, nonconcavity of deadweight loss, and increasing returns to scale in tax administration—changes to it cannot be evaluated by deriving marginal conditions in a well-behaved optimization problem. In order to compare the actual level of the social welfare function under different tax regimes, one may have to resort to simulation models.<sup>127</sup>

Comparing the levels of the social welfare function in various regimes is, of course, precisely what Kaplow instructs us to do.<sup>128</sup>

In sum, Kaplow reasons from the general to the specific. He demonstrates how comparing SWF values may allow us to choose among any particular set of tax rules or penalties. The method is too abstract and indeterminate to be of practical use. Weisbach starts with

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suppliers," are notoriously difficult to detect. The actual solution to this problem is to tolerate a considerable amount of evasion by these taxpayers. See Joel Slemrod, *Small Business and the Tax System*, in *THE CRISIS IN TAX ADMINISTRATION* 83–84, 86 n.39 (Henry J. Aaron & Joel Slemrod eds., 2004). If our rules followed Weisbach's approach, we would make nonpayment of taxes by informal suppliers legal.

<sup>124</sup> See Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 *TAX NOTES* 221, 238 (2000).

<sup>125</sup> The precision of the revenue estimates is debatable. But so is policymakers' ability to decide whether a negligence or strict liability regime is more appropriate in a particular area on efficiency grounds or to make necessary determinations in other areas subject to the general law and economics analysis.

<sup>126</sup> See Jonathan Shaw et al., *Administration and Compliance*, in *DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW* 1100, 1108 n.4 (Sir James Mirrlees et al. eds., 2010).

<sup>127</sup> Slemrod & Yitzhaki, *supra* note 122, at 192.

<sup>128</sup> See Kaplow, *supra* note 86, at 137–40.

the specific and generalizes. He attempts to use marginal analysis to arrive at the optimal system. This move cannot be made without making assumptions that are, as Slemrod and Yitzhaki point out, unjustified. These are the only efforts to develop an approach to assessing the actual tax rules and sanctions by reference to the optimal tax regime.

Kaplow's and Weisbach's important but ultimately unsuccessful efforts to overcome the baseline problem reveal the limits of the economic analysis of taxation. The core ideas of general law and economics are simple and easy to grasp. Economic analysis of law has been remarkably successful not only in using these ideas to devise socially optimal systems but in reforming the actual legal regimes as well. These successes include important Supreme Court cases,<sup>129</sup> significant statutory developments,<sup>130</sup> and fundamental shifts in entire legal regimes.<sup>131</sup>

In contrast, the reasoning used by Kaplow and Weisbach is technical and complex. There is nothing intuitive about the social welfare function and the marginal efficiency cost of funds. Despite complexity, these concepts are hardly helpful to decisionmakers interested in improving the actual tax system. No wonder the debate between economically oriented legal scholars on the one hand, and policy-focused tax practitioners (as well as, I suspect, the vast majority of legal academics) on the other, evokes the metaphor of ships passing in the night.

### 3. *Like Ships Passing in the Night*

Faithful to the core ideas of public economics, Weisbach sees all tax-motivated actions as socially undesirable. He sees the relevant boundary not between legal and illegal acts but between tax-motivated and nontax-motivated decisions. Not surprisingly, he explains to the less economically oriented analysts pondering how to separate accept-

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<sup>129</sup> See, e.g., *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 881–82 (2007) (overruling the per se rule against vertical price restraints under the Sherman Act on the ground that “respected economic analysts . . . conclude that vertical price restraints can have procompetitive effects”); *Basic Inc. v. Levinson*, 485 U.S. 224, 241–47 (1988) (upholding lower courts’ application of a “rebuttable presumption of reliance, supported in part by the fraud-on-the-market theory” to public statements made by the corporate defendant).

<sup>130</sup> See Ian Ayres, *Valuing Modern Contract Scholarship*, 112 *YALE L.J.* 881, 886 (2003).

<sup>131</sup> See Patrick Van Cayseele & Roger Van den Bergh, *Antitrust Law*, in 3 *ENCYCLOPEDIA OF LAW AND ECONOMICS* 467, 467 (Boudewijn Bouckaert & Gerrit De Geest eds., 1999) (concluding that “[i]n the USA economic views on competition theory have had a much clearer impact on antitrust law: legal rules tend to change when the underlying economic theory changes”); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 *GEO. L.J.* 439, 441–42 n.5 (2001) (arguing that corporate law worldwide is converging toward the set of rules aimed at maximizing long-term shareholder value and, therefore, social welfare, as advocated by most law and economics scholars).

able tax planning from illegal tax shelters that their approach misses the point:

[T]ax planning, all tax planning, not just planning associated with traditional notions of shelters, produces nothing of value. Nothing is gained by finding new ways to turn ordinary income into capital gain, to push a gain offshore, or to generate losses. . . . Tax planning is actually far worse than that. It is almost always positively bad for society—it is worse than worthless.<sup>132</sup>

Weisbach is surely right. Every instance of tax planning is a socially costly irredeemable act.

Michael Schler (and, I am sure, many others) is perplexed by Weisbach's argument.

Surely there is nothing wrong in a democracy for Congress to determine that there is less tax due if a transaction is done one way rather than another way, even if the result may be economic inefficiency. . . . Using Weisbach's terminology, if Congress enacts a tax credit for backflips [a metaphor for purely wasteful activity], Congress has determined that backflips are socially desirable. If a taxpayer learns to do backflips and earns the credit, it is doing nothing wrong. On the contrary, in the view of Congress, the taxpayer adds to the overall social welfare.<sup>133</sup>

Congress decides what is good and bad for society, Schler asserts. If Weisbach wants to call congressional choices efficient, or welfare improving (or groovy for that matter), he can certainly do so. But whatever rule Congress enacts, acting consistently with congressional intent is desirable even if the only reason for doing so is tax minimization. If so, the only thing left to consider on a case-by-case basis is whether actions of a particular taxpayer are consistent with congressional intent. Needless to say, economic analysis has little to contribute to this inquiry.

Kyle Logue goes even further than Schler. Logue studies the effects of legal uncertainty on the design of optimal tax penalties.<sup>134</sup> Before starting this analysis, he states:

[I]t is assumed throughout this article that the federal tax laws, as ultimately interpreted by a court, represent the will of Congress and are therefore presumptively social-welfare-maximizing. . . . [T]o render the deterrence analysis tractable, these assumptions—that Congressional intent is welfare maximizing and that courts are always right—are necessary.<sup>135</sup>

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<sup>132</sup> Weisbach, *supra* note 90, at 222.

<sup>133</sup> Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 385 (2002).

<sup>134</sup> See Logue, *supra* note 8, at 242.

<sup>135</sup> *Id.* at 258–59.

The assumptions Logue views as necessary for the economic analysis of tax enforcement reverse the usual relation between economics and the law. The logical sequence is to examine behavior, evaluate its costs and benefits, and then design legal rules and sanctions to minimize net social costs. This is precisely how law and economics scholars have approached the question. With this approach, actions are illegal because they are socially harmful.<sup>136</sup> In contrast, under Logue's assumptions, actions are socially harmful because they are illegal.<sup>137</sup> The problem with this reversal is that if one defines social harm as the violation of legal rules, it is impossible to design legal rules with the goal of minimizing the social harm produced by their violations.<sup>138</sup>

Logue, Schler, and Weisbach are among the most thoughtful and knowledgeable tax analysts of the day. Their complete failure to engage each others' arguments is staggering.<sup>139</sup> And its cause is quite apparent—the baseline problem. Weisbach's implicit baseline is not even the optimal income tax but the lump-sum tax. He views all tax-motivated decisions as wasteful. Schler does not see the implicit lump-sum tax baseline as having any relevance to the discussion. This baseline is so far removed from the realities of our tax system that it is wholly unhelpful to make arguments by reference to it. If an economist views a tax-motivated sale of a depreciated security and a tax-motivated lease-in, lease-out transaction that generates tax savings from mere paper shuffling as potentially equally problematic, the economist has nothing useful to say to people concerned with improving the actual tax rules. Logue resolves the baseline problem by assuming it away.

This state of affairs is uninspiring but not unexpected. The chasm between economic theory of optimal taxation and the legal analysis of the actual tax system is vast.<sup>140</sup> The unquestionable success of public economics in addressing the undeterrability and redistribution problems is not sufficient to supply a realistic approach to opti-

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<sup>136</sup> See, e.g., Louis Kaplow, *Optimal Deterrence, Uninformed Individuals, and Acquiring Information About Whether Acts Are Subject to Sanctions*, 6 J.L. ECON. & ORG. 93, 96 (1990).

<sup>137</sup> Logue, *supra* note 8, at 257–61.

<sup>138</sup> Logue acknowledges that Congress can mismanage the tax system, but he defends his assumption as necessary and explains that “if one is especially troubled by the quality of Congress's tax lawmaking record or by the courts' performance in tax cases, those issues should be addressed directly.” *Id.* at 259. Addressing the quality of lawmaking is, of course, the core of the normative strand of law and economics.

<sup>139</sup> Schler's article is a direct response to Weisbach's. See Schler, *supra* note 133, at 327. Logue does not explicitly address Weisbach's arguments. However, his conclusion that the only way to conduct economic analysis of tax sanctions is to assume away the problem of designing optimal tax rules means that he views the fundamental law and economics enterprise of optimizing outcomes by simultaneously designing rules and sanctions—an enterprise Weisbach is very much engaged in—as impossible in the tax setting.

<sup>140</sup> Economists interested in the connection between theory and actual laws and institutions fully appreciate the magnitude of the gap. See *infra* note 183.

mizing the existing tax rules and sanctions. The optimal income tax baseline is not a solution. In fact, the limitations of the optimal tax theory are at the core of the limits of tax law and economics. These limitations exist for a reason, and they will not disappear any time soon, as the next section explains.

4. *Choices, Judgments, Information—The Unique Challenges of Tax Law and Economics*

In order to understand the remarkable power of the economic analysis of law, one needs to go no further than the first paragraph of this Article's introduction to law and economics.<sup>141</sup> That paragraph grounds much of the later discussion in two basic assumptions. First, society consists of rational individuals maximizing their utility. Second, the social objective is to maximize overall wellbeing. While the very same paragraph states that both assumptions are controversial, they are fairly easy to understand and accept, at least as working hypotheses. More importantly, these assumptions are much easier to understand and accept than the choices, judgments, and empirical conclusions discussed below.

The key point underlying the success of law and economics is this: almost all of the most powerful, intuitive, and therefore influential insights generated by the economic analysis of law can be derived based on *just* the two basic assumptions combined with a few self-evident observations.

In contracting settings (that is, where face-to-face negotiation is possible), it is hardly controversial that the bargaining parties will often have asymmetric information.<sup>142</sup> It is equally self-evident that many agreements extend over time and involve sequential investments by the contracting parties. Bingo! These observations plus the two basic assumptions are all a legal economist needs to identify the holdup problem, the moral hazard problem, the adverse selection problem, the agency problem, and the more general problem of incentive incompatibility.<sup>143</sup> These core insights go a long way toward explaining (in the positive version) or reforming (in the normative version) contract law, commercial law, insurance law, parts of securities regulation, and so on. In fact, three versions of the agency problem allow a legal economist to explain or revise the content of almost the entire corporate law.<sup>144</sup>

<sup>141</sup> See *supra* Part I.A.1.

<sup>142</sup> See, e.g., Posner, *supra* note 14, at 833.

<sup>143</sup> See, e.g., Juliet P. Kostritsky, *Uncertainty, Reliance, Preliminary Negotiations and the Holdup Problem*, 61 SMU L. REV. 1377, 1386 n.75, 1398 (2008).

<sup>144</sup> These three agency problems exist between (i) shareholders and managers, (ii) debt-holders and equity-holders, and (iii) majority owners and minority owners of corporations. See, e.g., George S. Geis, *Internal Poison Pills*, 84 N.Y.U. L. REV. 1169, 1171 (2009).

In settings where contracting is impossible due to high transaction costs, the phenomenon of negative (and positive) externalities follows directly from the rational individual assumption. That phenomenon, in turn, explains the tragedy of the commons and anticommons,<sup>145</sup> the undersupply of public goods and the difficulty of their pricing,<sup>146</sup> the existence of property rights,<sup>147</sup> and the content of many areas of government regulation ranging from environmental law<sup>148</sup> to occupational safety to food safety.<sup>149</sup>

All of this does not mean that the entire law and economics enterprise is a child's play with a few basic concepts. It does not mean that identifying the fundamental problems and tensions just described leads to self-evident solutions. It does not mean that we have all the information needed to translate our understanding of these problems and tensions into specific policy prescriptions or that such information may be easily obtained in the future. It does not mean that law and economics is not full of vigorous theoretical debates. Nor does it mean that economic theory has stopped evolving such that no new insights need to be incorporated into policy prescriptions developed by law and economics scholars. But it does mean that a few fairly modest assumptions provide economic analysis of law with an enormous analytical power, power that for the past several decades has been unmatched by any other conceptual approach to legal analysis.

Before a reader rushes to object to my repeated characterization of the fundamental premises of law and economics as “fairly modest” and “fairly easy to understand and accept,” let us consider what kinds of assumptions are needed to get the economic analysis of taxation off the ground.

To begin with, the analyst must assume rational, utility-maximizing actors and the social goal of welfare maximization.<sup>150</sup> The analyst must also assume perfect capital markets<sup>151</sup> and perfectly competitive

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<sup>145</sup> See MICHAEL HELLER, *THE GRIDLOCK ECONOMY* 1–2 (2008) (explaining the tragedy of the anticommons); Garrett Hardin, *The Tragedy of the Commons*, 162 *SCIENCE* 1243, 1244–45 (1968) (articulating the tragedy of the commons).

<sup>146</sup> See Clayton P. Gillette & Thomas D. Hopkins, *Federal User Fees: A Legal and Economic Analysis*, 67 *B.U. L. REV.* 795, 801, 838 (1987).

<sup>147</sup> See Harold Demsetz, *Toward a Theory of Property Rights*, 57 *AM. ECON. REV.* 347, 347–49 (1967).

<sup>148</sup> See Daniel C. Esty, *Revitalizing Environmental Federalism*, 95 *MICH. L. REV.* 570, 593–97 (1996).

<sup>149</sup> See Peter Huber, *The Old-New Division in Risk Regulation*, 69 *VA. L. REV.* 1025, 1098–99 (1983) (critically discussing externality-based justifications for regulating food additives, occupational health, and aircraft safety).

<sup>150</sup> See, e.g., Logue & Slemrod, *supra* note 7, at 806.

<sup>151</sup> See, e.g., Joseph E. Stiglitz, *Pareto Efficient and Optimal Taxation and the New New Welfare Economics*, in 2 *HANDBOOK OF PUBLIC ECONOMICS* 1034, 1034 (Alan J. Auerbach & Martin Feldstein eds., 1987). Perfect capital markets mean that “all investors obtain the same return.” *Id.*

economy.<sup>152</sup> Once the uniform lump-sum tax is ruled out on distributional grounds, the analyst must tackle the redistribution problem.

At this point, one needs to decide what should be the basis of redistribution. There is no obvious answer to this question, and there is nothing in economic theory that gives economists a particular advantage in formulating possible answers and choosing among them. Maybe we should redistribute based on ability, maybe based on benefits, sacrifice, opportunities, luck, sunny disposition, good looks, or something else. This seems like a question for moral philosophers. Yet a book entitled *Tax Philosophers: Two Hundred Years of Thought in Great Britain and the United States* describes the views of Smith, Mill, Seligman, Edgeworth, Pigou, Fisher, Vickrey, Kaldor, and Keynes, among others<sup>153</sup>—all prominent economists of their day.<sup>154</sup> This is no accident. Economists must choose the basis of redistribution because without this choice, the analysis stops in its tracks. Yet for whatever reason, Kant and Hegel, Nietzsche and Kierkegaard, Rawls, Raz, and Dworkin have not been particularly interested in addressing the question.<sup>155</sup> So economists did the best they could, settled on ability to pay as the answer, and proceeded with the analysis.

That choice alone, it seems, is not just more contestable than the rational behavior assumption; it reflects a different order to contestability. It involves value judgments about what constitutes a just society, what citizens owe to each other, and what limitations on liberty are acceptable, to name a few. Granted, some of these questions are also raised when one assumes that the society's goal is welfare maximization. But that assumption must also be made to proceed with

<sup>152</sup> See, e.g., Stern, *supra* note 81, at 26.

<sup>153</sup> See generally HAROLD M. GROVES, *TAX PHILOSOPHERS: TWO HUNDRED YEARS OF THOUGHT IN GREAT BRITAIN AND THE UNITED STATES* (Donald J. Cattan ed., 1974).

<sup>154</sup> To be sure, Adam Smith authored *The Theory of Moral Sentiment* and held the Chair in Moral Philosophy. Economics and moral philosophy have “affinity by birth.” Jagdish Bhagwati, *Markets and Morality*, 101 AM. ECON. REV.: PAPER & PROC. 162, 162 (2011). But economics became an independent discipline by the mid-nineteenth century, see *id.*, well before many of the scholars mentioned in the text published their contributions.

<sup>155</sup> The discussion of the ability to pay principle by two moral philosophers who recently focused on taxes and justice is dominated by reciting the views of economists such as Mill, Pigou, Walker, and so on as well. See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP* 20–30 (2002). This is quite understandable. While Rawls and Dworkin certainly have a lot to say about inequality, their discussions have only a highly attenuated connection to tax policy. See Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 TAX L. REV. 229, 273 (2011) (“Applying Dworkin’s theory to taxation raises some questions about the implications of the theory.”); Linda Sugin, *Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands from Tax Systems*, 72 FORDHAM L. REV. 1991, 1994 (2004) (“Rawls wrote a great deal about economic justice generally, but very little about taxation in particular, and what he did say is puzzling.”). For a discussion of various inconsistent interpretations of Kant’s brief and general views on taxation and inequality, see Gary Banham, *Kant and the Ethics of Taxation*, 13 J. ACCT. ETHICS & PUB. POL’Y 301, 347–69 (2012).



economic analysis of taxation. In any case, choosing the ability to pay as the basis for redistribution is just the beginning.

Making this choice does not get the economic analysis of taxation very far. Ability is an abstract and unquantifiable concept.<sup>156</sup> Economists need a more practicable proxy to work with. What should it be? There are more plausible answers than one might expect. The candidates include wages, wealth, returns to savings, consumption in general, consumption of certain items, height, LSAT scores, and so on. An economist might say that if each of these characteristics is a plausible (and, importantly, unique in a sense of not being a replication of any other characteristic) reflection of ability, then all of them should be used as proxies.<sup>157</sup> That is a nice move, but as a practical matter using more than one of these characteristics makes the analysis extremely difficult, and using more than a few makes it completely intractable.<sup>158</sup> It is no accident that the canonical optimal income tax theory uses a single proxy for ability: the wage rate. Even in that case, the theory has to rely on simulations because no useful general solutions are available.<sup>159</sup>

Selecting the proxy for ability to pay is neither trivial as an empirical matter nor judgment-free. Just imagine the political fallout if a presidential candidate proposes to vary the tax burden based on one's height (as two economists recently considered).<sup>160</sup> But settling on the wage rate as the basis for redistribution only brings an economist to an even more challenging question: how much redistribution is appropriate? Needless to say, economics is not the discipline that can answer this question.

To economists' credit, they found a way to address this complication. The social welfare function may take any number of forms from

<sup>156</sup> See Slemrod, *supra* note 79, at 163 (explaining that tax on ability is ruled out by the optimal income tax theory because "ability is impossible for the government to observe"); *id.* at 168 (referring to ability as "unobservable and practically unmeasurable").

<sup>157</sup> For the seminal paper making this argument, see George A. Akerlof, *The Economics of "Tagging" as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning*, 68 AM. ECON. REV. 8, 8 (1978).

<sup>158</sup> See, e.g., Wojciech Kopczuk, *Redistribution When Avoidance Behavior Is Heterogeneous*, 81 J. PUB. ECON. 51, 57 (2001) (explaining that the "general model of linear taxation in [the foundational work of Peter Diamond and James Mirrlees] does not assume identical utility functions and thus allows for types of heterogeneity other than just skill differences. However, generality of that approach makes it difficult to isolate consequences of distributional characteristics.").

<sup>159</sup> See, e.g., John Creedy, *Personal Income Taxation: From Theory to Policy*, 42 AUSTL. ECON. REV. 496, 501 (2009) ("[E]ven with simple forms for the social welfare function, the utility functions and the wage rate distribution, explicit solutions [to the tax optimization problem] are not available. Numerical simulation results . . . are therefore ubiquitous in the optimal tax literature.").

<sup>160</sup> See N. Gregory Mankiw & Matthew Weinzierl, *The Optimal Taxation of Height: A Case Study of Utilitarian Income Redistributions*, 2 AM. ECON. J.: ECON. POL'Y 155, 156 (2010).

utilitarian (everyone's utility counts equally) to maximin (maximizing the utility of the worst-off (minimal utility) individual).<sup>161</sup> It turns out that the optimal tax theory yields largely the same answers in either case: the optimal system includes a demogrant and constant or declining marginal rates.<sup>162</sup> As one would expect, the demogrant and the rates are higher for the maximin SWF than for the utilitarian one,<sup>163</sup> but these are secondary questions. The optimal tax is still a tax on labor income, and the rate schedule still has the same structure.<sup>164</sup>

This is a powerful result because it incorporates widely diverging views of justice and equality. But this result falters on the empirical side. Picking a social welfare function and choosing the wage rate as the basis for redistribution, it turns out, is not enough to generate firm conclusions. One also needs to assume a shape of the distribution of abilities (wage rates) in the society. This is an empirical guess. The traditional assumption has been that this distribution is lognormal.<sup>165</sup> But when Emanuel Saez asserted that the existing data suggest that high-ability individuals are better described by the Pareto distribution, one of the main theoretical results—declining marginal rates—flipped.<sup>166</sup> Saez, now joined by Peter Diamond, continues to argue that the Pareto distribution is a more plausible reflection of reality.<sup>167</sup> Other leading economists defend the lognormal distribution assumption.<sup>168</sup> Forty years after James Mirrlees founded the optimal income tax theory, it remains unclear whether the marginal rates should increase or decline with income, even if we accept the theory's many contestable assumptions.

Moreover, incorporating a wide variety of distributional preferences in the social welfare function does not mean that the standard optimal tax theory takes *full* account of possible distributional preferences or reflects *all* views of fairness and justice. As to the former, distributional preferences more egalitarian than maximin and more libertarian than utilitarianism are generally ignored.<sup>169</sup> As to the latter, normative judgments about the appropriate basis for redistribu-

161 See Bankman & Griffith, *supra* note 88, at 1915–16; Kaplow, *supra* note 86, at 137.

162 See Bankman & Griffith, *supra* note 88, at 1945.

163 See *id.* at 1955.

164 See *id.* at 1954.

165 See, e.g., MATTI TUOMALA, OPTIMAL INCOME TAX AND REDISTRIBUTION 95 (1990); see also Mankiw et al., *supra* note 72, at 157 (stating that a lognormal distribution has traditionally been used to describe the distribution of abilities in society).

166 See Emmanuel Saez, *Using Elasticities to Derive Optimal Income Tax Rates*, 68 REV. ECON. STUD. 205, 226 (2001). Pareto distribution is “thicker” at high ability values (i.e., it has relatively more taxpayers with very high ability). See Mankiw et al., *supra* note 72, at 152. Estimating the distribution of ability is “a task fraught with perils.” *Id.*

167 Diamond & Saez, *supra* note 80, at 168–71.

168 See Mankiw et al., *supra* note 72, at 152.

169 See KAPLOW, *supra* note 81, at 44–45.

tion and the reasonable (and acceptable) proxies for ability obviously precede the decision about the shape of the social welfare function.

This line of argument may be easily extended further. There is continuing uncertainty regarding the optimal taxation of capital income. The prevailing view still appears to be that capital income should not be taxed at all,<sup>170</sup> but there are recent arguments in favor of its progressive as well as regressive taxation.<sup>171</sup> The choice, again, depends on the assumptions that are far from uncontroversial and very far from being generally accepted in the field.

Difficult questions just keep on coming. A theory of optimal taxation is woefully incomplete without addressing the treatment of cross-border transactions. Economists tackling these questions realized long ago that policy prescriptions differ dramatically depending on whether the optimization problem is focused on national or global welfare.<sup>172</sup> This is yet another challenge that nontax law and economics scholars simply do not face. Those writing about tort law, corporate law, contract law, competition law, securities regulation, and so on do not seem to worry about global welfare too much. One nontax area where it is impossible to ignore cross-border flows of capital, goods, and services is trade regulation. Fortunately for law and economics scholars studying international trade, the economists' answer is that maximization of national and global welfare lead to the same policy prescription—free trade.<sup>173</sup> The same is certainly not true in tax. Yet the choice of national versus global welfare determines the analysis of an entire set of rules for taxation of inbound and outbound transactions. Needless to say, that choice is neither self-evident nor uncontested.

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<sup>170</sup> See, e.g., Roger Gordon & Wei Li, *Tax Structures in Developing Countries: Many Puzzles and a Possible Explanation*, 93 J. PUB. ECON. 855, 855 (2009); Thomas Piketty & Emmanuel Saez, *A Theory of Optimal Capital Taxation 1* (unpublished manuscript) (on file with author) (“According to the profession’s most popular theoretical models, optimal tax rates on capital should be equal to zero in the long run . . .”).

<sup>171</sup> See, e.g., KAPLOW, *supra* note 81, at 228–29 (describing a rationale for a regressive capital income tax developed in the new dynamic public finance literature); Diamond & Saez, *supra* note 80, at 177 (concluding that “capital income should be taxed”); Slemrod, *supra* note 79, at 161 (explaining that under various empirical assumptions, capital income should either be taxed, not taxed, or subsidized); Stiglitz, *supra* note 151, at 1031–33 (explaining why under certain assumptions, capital income should either be taxed or subsidized if either of the two famous partial equilibrium models establishing the standard zero tax on capital income result—one of the models being coauthored by Stiglitz himself—is extended in a general equilibrium setting).

<sup>172</sup> See, e.g., Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 277, 280, 284 (2001) (arguing that international income tax policies should be guided by concern for national welfare).

<sup>173</sup> See, e.g., Paul Krugman, *What Should Trade Negotiators Negotiate About?*, 35 J. ECON. LIT. 113, 113, 115 (1997). The so-called “optimal tariff” argument is an exception that appears to be increasingly irrelevant in the globalized economy not dominated by any particular country. See *id.* at 113 n.1.

These are the challenges of public finance and its legal cousin, tax law and economics. These challenges make the tax optimization problem uniquely complex. They underlie the emerging critiques of the canonical optimal tax theory. No doubt, these challenges are among the core reasons (if not the core reason) for the particularly wide gap between that theory and the real-life tax system.<sup>174</sup> The next Part addresses the far-reaching implications of these conclusions.

## II

### UNDERSTANDING THE IMPLICATIONS OF THE LIMITS OF TAX LAW AND ECONOMICS

In order to fully appreciate the policy implications of the challenges and limitations discussed in the previous Part, one needs to recall the standard normative approach of law and economics. The analyst begins with designing a socially optimal legal regime. He then makes one of two arguments in favor of bringing actual legal rules and sanctions closer to the optimum. First, he may argue that *if* policymakers care about maximizing efficiency, then they should adopt this or that reform.<sup>175</sup> Given the well-known problem of second best, this argument must account for the difference between the actual legal

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<sup>174</sup> One may argue that another factor distinguishing taxation from other areas of economic regulation is the political salience of tax policy. This argument may indeed explain many features of the Internal Revenue Code, such as double taxation of corporate income, mortgage interest deduction, and numerous rifle-shot tax benefits, to take just some examples. But legal academics almost uniformly view these provisions as misguided. See, e.g., Adam Chodorow, *Economic Analysis in Judicial Decision Making—An Assessment Based on Judge Posner's Tax Decisions*, 25 VA. TAX REV. 67, 103 n.5 (2005) (referring to numerous rifle-shot and similar provisions as inconsistent with the goal of efficiency); Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 615–16 (1990) (acknowledging that “[c]ommentators frequently criticize the double taxation of corporate income as contrary to the tax policy goals of equity and efficiency” and that “[t]he implications of double taxation on equity and efficiency have led many to conclude that distributed corporate income should be relieved from the burden of the corporate tax,” while questioning these conclusions); Dennis J. Ventry, Jr., *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROBS. 233, 278, 282 (2010) (stating that “[t]he economic case against the [mortgage interest deduction] . . . is indisputable” and arguing that “[a]ssuming that national policymakers and the American public still consider homeownership a worthy goal, repealing the [mortgage interest deduction] would remove an obstacle to achieving that objective”). While a repeal of all these provisions is extremely unlikely for political economy considerations, economists and tax law and economics scholars are all but united in viewing these provisions as bad tax policy. In contrast, tax law and economics scholars almost uniformly reject the optimal tax theory as a practical policy guide—a view that cannot be explained by political salience of taxation and similar considerations.

<sup>175</sup> See, e.g., Richard Craswell, *In That Case, What Is the Question? Economics and the Demands of Contract Theory*, 112 YALE L.J. 903, 911 (2003); Richard A. Posner, *The Problematics of Moral and Legal Theory*, 111 HARV. L. REV. 1637, 1669–70 (1998) (“What the economist can say, which is a lot but not everything, is that if a society values prosperity (or freedom or equality), these are the various policies that will conduce to that goal, and these are the costs associated with each.”).

regime under consideration and the socially optimal one.<sup>176</sup> Alternatively, the analyst may explicitly ground the normative argument in the positive claim. Corporate law (commercial law, securities regulation, etc.), he might say, is generally efficient. Whether or not the decisionmaker cares about efficiency, it appears that “the system” does. Changing a particular rule in this or that direction is a good idea because it will bring the legal regime even closer to the welfare-maximizing one. The common feature of both arguments is obvious: the closer the actual legal regime is to the optimal one, the more persuasive these arguments are.

Law and economics scholars in tort law, antitrust law, corporate law, and securities law have claimed that each of these regimes is fairly close to the welfare-maximizing one.<sup>177</sup> Whether or not one agrees with these claims, they have some (and in some cases considerable) plausibility. The same is demonstrably not true of tax. Therefore, each of the normative law and economics arguments just described is significantly weaker in tax than elsewhere. This weakness has a profound effect on the debates about the fundamental features of our tax system. It shapes the meaning of the foundational tax concepts. It affects the familiar arguments about anti-avoidance rules and sanctions. It even extends to evaluating outright tax evasion. In sum, every aspect of the tax system is affected by this weakness. And so is the economic analysis of many other areas of the law.

#### A. The Implications for the Fundamental Tax Policy Choices

The earlier discussion used a rule dealing with interest expense allocation to highlight the difficulty of evaluating specific tax provisions from the optimal tax perspective.<sup>178</sup> While this difficulty is indeed profound, the problem is much more serious than being unable to connect an obscure rule affecting relatively few taxpayers to the solid foundations of economic analysis. Rather, the problem is that many fundamental features of our tax system cannot be analyzed on the basis of the optimal tax theory, at least in its canonical form.

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<sup>176</sup> See, e.g., Posner, *supra* note 14, at 853 (“When economics was . . . able to say that contract law was essentially efficient but for some tweaking here and there, it had the potential to influence decisionmakers, for it worked with the past, not against it . . .”). If the actual regime is nowhere close to the optimal one, any efficiency-based argument is at best a marginal claim and should be evaluated alongside all other possible marginal improvements. See *infra* text accompanying notes 251–59.

<sup>177</sup> See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 102, 303 (1991); HOVENKAMP, *supra* note 5, at 60; WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 26 (1987); Hansmann & Kraakman, *supra* note 131, at 441–42 n.5; Henry Hansmann & Reinier Kraakman, *Reflections on the End of History for Corporate Law* 7 (Yale Law & Econ. Research Paper No. 449, 2011), available at <http://ssrn.com/abstract=2095419>.

<sup>178</sup> See *supra* Part I.C.2.

Debates about these features have preoccupied academics, politicians, and voters for decades, and these debates are as vigorous today as they have ever been. How acceptable is the current situation when nearly half of all taxpayers pay no income tax? Should the tax on capital gains be lower or higher than it is today (and should it be progressive like the tax on labor income or flat)? Should the corporate tax rate be lowered? Should dividends be subject to ordinary income tax rates, reduced rates, or not taxed at all? Should the United States continue with its effort to tax at least some income of its subjects worldwide, or should it switch to a territorial system? What about the estate tax that has remained on life support for the past decade? Answering these questions involves major tax policy decisions. Yet none of these decisions can be made based on the standard normative approach of law and economics because the optimal tax theory is so far removed from reality. The argument that “the system” reveals a preference for welfare maximization is completely implausible in tax. Even if a policymaker cares about efficiency, the second-best problems are so severe that taking steps that would bring us closer to the optimal regime may well be welfare reducing. Whatever may be used as a guide for assessing reforms of actual tax rules and sanctions, the optimal tax theory is not it.<sup>179</sup>

Economists occasionally point out that over the past several decades, tax systems of many developed countries have changed in the direction that is broadly consistent with the optimal tax theory prescriptions. Top marginal rates have declined, the tax burden on capital income has decreased, and a value-added tax (a close relative of a labor income tax) has become increasingly widespread.<sup>180</sup> Even assuming a causal relation between the optimal tax theory and these

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<sup>179</sup> As Martin Feldstein pointed out decades ago, “[e]verything we know about the theory of economic policy in other areas reminds us that optimal piecemeal policies cannot be made by haphazard steps in the direction of the global optimum, that a constrained second-best policy cannot be guided by the conclusions of an unconstrained optimization.” Martin Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 77 (1976). While the law and economics literature has mostly relied on Feldstein’s analysis in studying legal transitions, the article’s spirit foreshadowed the MECF-type approach discussed in detail below. See *infra* text accompanying notes 251–60.

<sup>180</sup> See, e.g., Creedy, *supra* note 159, at 497–98 (referring to the “reduction in the number of marginal tax rates and the degree of rate progression”); Gordon & Li, *supra* note 170, at 855–56 (arguing that while “no taxes on capital income [and] uniform taxes on consumption . . . are not consistent with any existing tax structures, they are not sharply inconsistent with observed tax policies among the most developed countries”). Several countries have recently adopted tax systems that appear relatively close to the optimal tax regime. See Alan J. Auerbach & Kevin A. Hassett, *Conclusion*, in *TOWARD FUNDAMENTAL TAX REFORM* 149, 150 (Alan J. Auerbach & Kevin A. Hassett eds., 2005). A detailed examination of these systems—including the extent of their similarity to the optimal tax theory prescriptions—awaits future research. See *id.*

changes,<sup>181</sup> this argument establishes a much weaker connection between theory and reality than the link that is assumed to exist in corporate law, antitrust law, securities law, and so on. Quite clearly, this connection sheds light on only a few of the fundamental questions raised in the previous paragraph. And it fails to illuminate the myriad of more specific tax rules altogether. Here, the contrast with the general law and economics scholarship and with the earlier RCRA example that used a few simple steps to connect the physical barrier requirement to the ultimate goal of controlling externalities is particularly stark.<sup>182</sup>

Another way of making the same point would be to take the optimal tax theory as seriously as nontax law and economics scholars take the ideals of a competitive economy or an efficient capital market. This approach would readily lead to many clear answers. Given that the optimal income tax has no tax on capital income, the corporate tax, the dividend tax, and the capital gains tax should be abolished. The estate tax should be repealed as well because it is certainly not a part of the canonical optimal system. Instead of worrying about millions of taxpayers shielded from income tax by personal exemptions and standard deductions, the government should write a uniform check to every taxpayer in the country, Bill Gates and Warren Buffet included. While we are at it, we should get rid of the increasing marginal rates because they are inconsistent with the classic optimal tax theory. As for the worldwide versus territorial taxation, we should probably stick to the worldwide regime (for labor income); or not—it is hard to say given the lack of a theoretical foundation.

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<sup>181</sup> As economists understand well, “[e]stablishing a clear rationale for each policy action is, of course, far from straightforward and the social welfare functions which play a fundamental role in optimal tax theory seldom represent the varied objectives of politicians.” Creedy, *supra* note 159, at 498.

<sup>182</sup> For instance, some influential judicial decisions expressly relied on economic reasoning for their main holdings. See, e.g., *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947) (setting forth the famous Learned Hand formula for negligence); *United States v. Addystone Pipe & Steel Co.*, 85 F. 271, 278, 282–83 (6th Cir. 1898), *aff’d*, 175 U.S. 211 (1899) (establishing the foundation of economically focused antitrust doctrine). Many cases reveal a remarkable familiarity of judges with the relevant law and economics scholarship. Even a cursory review of major antitrust, corporate, and securities cases reads as a “Who’s Who” of the law and economics writings of the day. Judges—and Justices—apparently study not only major law reviews but the leading economic journals as well. See, e.g., *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 890–93, 920 (2007) (referring to articles published in the *Quarterly Journal of Economics*, *Journal of Political Economy*, and *RAND Journal of Economics*, as well as the *Review of Industrial Organization*, not to mention the *Journal of Law and Economics*). Scholars argue that entire areas of the law (in all of their detail) are broadly consistent with efficiency maximization. See sources cited *supra* note 177. Even when Eric Posner asserted that economic analysis of contract law has generally failed on both the positive and the normative dimensions, he recognized that numerous contract law doctrines have efficiency-maximizing effect at least under some conditions. See Posner, *supra* note 14, at 834–44. No such statements are possible about the vast majority of tax rules and sanctions.

This, of course, is a caricature, but it demonstrates an important point. To the extent the persuasive power of law and economics comes from references to ideal regimes (as it does in many other areas of economic regulation), the law and economics arguments in taxation are weak. While this conclusion is hardly revolutionary even among economists,<sup>183</sup> some of the leading tax law and economics scholars continue to invoke the goal of welfare maximization in discussing the existing legal rules.<sup>184</sup> To be sure, these invocations are limited. Not many economically oriented tax scholars insist that we interpret the economic substance doctrine or the straddle rules by referencing the optimal regime. This, however, only reinforces the point. Many commercial and corporate law scholars certainly do evaluate specific legal rules and sanctions by making this very reference.<sup>185</sup>

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<sup>183</sup> Quite a few economists who have taken a sober look at the practical usefulness of the optimal tax theory share this view. See, e.g., James Alm, *What Is an "Optimal" Tax System?*, 49 NAT'L TAX J. 117, 117 (1996) ("This paper argues that previous attempts to derive an 'optimal tax system' are largely irrelevant to practical tax design, because they typically ignore a range of considerations reflecting fiscal and societal institutions that are essential elements in the normative and positive analysis of taxation."); Creedy, *supra* note 159, at 497 ("[M]any of the strong results from [optimal] tax analyses . . . are best interpreted as demonstrating that in fact they are most unlikely to apply in practice."); *id.* at 503 ("Ultimately[,] . . . many of the results of [the optimal] tax analyses are negative or too broad to offer specific policy guidance."); Piketty & Saez, *supra* note 170, at 1 ("Few economists however seem to endorse such a radical policy agenda. Presumably this reflects a lack of faith in the standard models and the zero-capital tax results. . . . We view the large gap between optimal capital tax theory and practice as one of the most important failures of modern public economics."); Agnar Sandmo, *Optimal Taxation: An Introduction to the Literature*, 6 J. PUB. ECON. 37, 45 (1976) ("Thus, although there do exist interesting cases in which uniform taxation is optimal, these must definitely be considered as exceptions. In the general case it is not easy to see the structure of taxation which follows from the general optimality conditions."); Slemrod, *supra* note 79, at 167 ("Although optimal taxation theory is useful for analyzing some aspects of [issues such as tax simplification, tax enforcement, taxation of capital gains, value-added taxation, and accounting for inflation], in many cases it cannot address the principal questions.").

<sup>184</sup> See, e.g., Kaplow, *supra* note 86, at 137–38 (conceding that the analysis based on comparisons of social welfare functions is "daunting," but asserting that "there really is no other choice"); Daniel N. Shaviro, *In Defense of Requiring Back-Flips*, 26 VA. TAX REV. 815, 815 (2007) (asserting, in a brief response to Leo Katz's paper, that "socially optimal rules (given all of the underlying constraints) might actually do the opposite [of what Katz assumes they should do], by using filters that end up catching what are in some sense the less bad transactions. This reflects that the rules' proper aim is not to make ethical judgments about or between tax-motivated transactions, but to minimize overall social harm from deadweight loss."); Weisbach, *supra* note 99, at 89–90 (critiquing the prevailing analysis of anti-tax-avoidance doctrines as failing to articulate "the optimal content of the law," evaluating the optimal content of these doctrines based on the assumption that "tax laws . . . maximize the welfare of . . . citizens").

<sup>185</sup> See, e.g., Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI-KENT L. REV. 33, 40–41, 45, 53–54 (2003) (evaluating numerous models based on whether they maximize social welfare and concluding by evaluating appropriateness of every existing defense in actions involving liquidated damages from a welfarist perspective); Hansmann & Kraakman, *supra* note 131, at 441–42 n.5, 455–56 (grounding particular board struc-



Another implication of the limits examined in the previous Part is greater uncertainty regarding the appropriate place of distributional considerations in the tax system design. Recall that the standard view points to tax as the exclusive domain of redistribution.<sup>186</sup> The tax system is complex, however. Which part(s) of that system should deal with distributive considerations? Deborah Schenk summarizes the prevailing answer concisely: “Theoretically, the ideal distribution of the tax burden could be maintained by [an] adjustment in the rates. Thus, base changes can be considered independent of distributional concerns.”<sup>187</sup> This conclusion allows Schenk to ignore distributive questions while studying a reform of the realization requirement. Weisbach relies on the same conclusion to exclude distributive issues from his analysis of line drawing.<sup>188</sup> And Kaplow presents the most general form of this argument while explaining (under certain assumptions already mentioned)<sup>189</sup> why even in the presence of a *nonoptimal*, nonlinear labor income tax differential commodity taxation aimed at achieving distributive goals violates the Pareto principle.<sup>190</sup> While these scholars certainly recognize that the argument has limitations,<sup>191</sup> their overall suggestion is that, in Weisbach’s words, “[p]olicymakers should draw lines efficiently and use rates to redistribute income.”<sup>192</sup>

Recognizing the limits of tax law and economics reveals an additional weakness of this approach. The fundamental reason for these limits is the optimal tax theory’s failure to incorporate distributive considerations in a manner that reflects some deeply and widely held beliefs. Given the theory’s limitations, a suggestion that wide swaths of the actual tax system should be designed while ignoring redistribution because that is what the theory prescribes does not appear to be particularly persuasive. Why should we rely on one of the theory’s central conclusions if we cannot rely on the theory’s overall results?

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tures, greater reliance on independent directors in resolving conflicts of interest, and proxy rule amendments, among other legal reforms, in the ultimate goal of maximizing shareholder value, a goal which they justify as “best serv[ing]” social welfare); Hansmann & Kraakman, *supra* note 177, at 8–9 (listing further developments in that direction over the past fifteen years); *see also* sources cited *supra* note 177; Kaplow, *supra* note 49, at 344.

<sup>186</sup> *See supra* text accompanying notes 75–77.

<sup>187</sup> Schenk, *supra* note 99, at 519–20 (footnotes omitted).

<sup>188</sup> *See* David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1676–79 (1999).

<sup>189</sup> *See supra* note 83.

<sup>190</sup> *See* KAPLOW, *supra* note 81, at 122–23 (“[A]s a first approximation and as a useful benchmark for analysis, redistribution should be confined to the [labor] income tax and direct transfer programs whereas other government policies [including potentially redistributive commodity taxes and taxes on capital income] should be assessed solely on efficiency grounds.”).

<sup>191</sup> *See, e.g., id.* at 135–41; Weisbach, *supra* note 188, at 1677–78.

<sup>192</sup> Weisbach, *supra* note 188, at 1679.

Fully appreciating the magnitude of the gap between the optimal tax theory and the real tax system sheds light on another debate: the disagreement about the need for (and even the coherence of) the fundamental tax policy concept of horizontal equity. Some of the leading public finance economists have tried for decades to provide a rigorous theoretical foundation for the intuitively appealing norm that likes should be treated alike.<sup>193</sup> Kaplow argues that these efforts are misguided, logically inconsistent, and violate the Pareto principle.<sup>194</sup> The beauty of a social welfare function, he emphasizes, is that it *fully* captures society's distributive preferences. Introducing any other parameters affecting distribution is both unnecessary and counterproductive. Therefore, horizontal equity should be understood "as a proxy indicator that helps to identify potential problems in the tax system,"<sup>195</sup> such as incorrect measurement of the ideal tax base.<sup>196</sup> The way to address these problems, therefore, is through the standard social welfare maximization analysis in which horizontal equity has no place.

Kaplow's critique is persuasive. But it becomes inapplicable as soon as one abandons the ultimate goal of welfare maximization. Once one concedes that answers based on SWF comparisons are practically unachievable and/or normatively contestable, horizontal equity becomes a valuable criterion indeed. This criterion identifies questionable features of the tax system that may be evaluated based on whatever approach one uses in order to assess incremental changes<sup>197</sup> and however one resolves distributive questions.<sup>198</sup> The continuing and widespread use of horizontal equity in tax policy discussions, therefore, is further evidence that the optimal tax theory has little impact on the real-world tax policy.

Finally, the least dramatic, but perhaps most important, implication of the previous Part's analysis is the need to be especially careful

<sup>193</sup> For a review, see Alan J. Auerbach & Kevin A. Hassett, *Tax Policy and Horizontal Equity*, in *INEQUALITY AND TAX POLICY* 44, 44–48 (Kevin A. Hassett & R. Glenn Hubbard eds., 2001).

<sup>194</sup> See Louis Kaplow, *Commentary*, in *INEQUALITY AND TAX POLICY*, *supra* note 193, at 75, 81. The efforts to incorporate horizontal equity into the standard social welfare maximization problem, he explains, are "in conflict with the very core of welfare economics." *Id.* at 91.

<sup>195</sup> *Id.* at 85.

<sup>196</sup> *Id.* at 89.

<sup>197</sup> For a discussion of such an approach, see *infra* text accompanying notes 251–58.

<sup>198</sup> Thus, when Kaplow argues that horizontal equity problems should be addressed through "measure[s] . . . derived from the same principles that motivate *our* tax regime and guide us in identifying the *ideal* tax base," Kaplow, *supra* note 194, at 89 (emphasis added), he may be unduly optimistic about the commonality of principles underlying the real tax system on the one hand and the optimal tax theory on the other. For a view that horizontal equity is unhelpful even as a practical tool used by policymakers who do not pursue the welfare optimization objective, see Schenk, *supra* note 99, at 519.

when using (or interpreting) the single most essential word of law and economics—efficiency. When the optimal tax literature argues that a particular tax instrument is inefficient, the argument means that the instrument is not part of the optimal system. This is exactly how the word efficiency is used in the general law and economics scholarship. Thus, an argument that certain price maintenance arrangements may be efficient means that they may be part of a competitive (welfare-maximizing) economy.<sup>199</sup> A suggestion that direct worker participation in corporate affairs is inefficient means that it moves the governance regime away from the welfare-maximizing one.<sup>200</sup> More examples are easily available.<sup>201</sup> Efficient means consistent with welfare maximization.

But when tax scholars argue that certain foreign tax credit and income deferral rules,<sup>202</sup> realization rules,<sup>203</sup> basis adjustment rules,<sup>204</sup> or interest taxation rules<sup>205</sup> are inefficient, they cannot possibly refer to the welfare maximization criterion. As the optimal tax system has no national borders and no capital income tax, any reference to welfare maximization in discussing all these issues would be completely groundless. The meaningful interpretation of the term “inefficient” in all these contexts would equate it with the term “distortive.”<sup>206</sup> This interpretation by no means makes the claims about efficiency vacuous or useless. But it certainly diminishes the normative power of efficiency-based tax arguments compared to the identically worded arguments made by law and economics scholars studying other areas of economic regulation.

## B. The Implications for Tax Enforcement

The disconnect between the optimal tax theory and the actual tax system yields more startling results when the inquiry turns to tax en-

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<sup>199</sup> See Van Cayseele & Van den Bergh, *supra* note 131, at 467, 486–87.

<sup>200</sup> See Hansmann & Kraakman, *supra* note 131, at 445.

<sup>201</sup> See, e.g., Edlin & Schwartz, *supra* note 185, at 45 (“The *optimal* contract thus contains an implicit damage multiplier that can exceed one. Edlin therefore shows that penalties sometimes are necessary to induce *efficient* investment.” (emphasis added)); Posner, *supra* note 14, at 834 (summarizing the normative strand of law and economics of contract law as assuming that “contract law should be efficient,” that is, consistent with “the optimal outcome”).

<sup>202</sup> See Daniel Shaviro, *The Case Against Foreign Tax Credits*, 3 J. LEGAL ANALYSIS 65, 68 (2011).

<sup>203</sup> See Shaviro, *supra* note 102, at 5.

<sup>204</sup> See Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes?*, 20 VA. TAX REV. 499, 511 (2001).

<sup>205</sup> See David A. Weisbach, *Reconsidering the Accrual of Interest Income*, 78 TAXES 36, 47 (2000).

<sup>206</sup> Sometimes this interpretation is explicit, see, e.g., Shaviro, *supra* note 202, at 68; Shaviro, *supra* note 102, at 5; Weisbach, *supra* note 205, at 47; sometimes it is not, see Burke & McCouch, *supra* note 204, at 511.

forcement. Yet again, the nonoptimality of the U.S. tax system's major features, not to mention the myriad of particular rules, is at the core of the problem.

Consider Daniel Shaviro's analysis of corporate tax shelters.<sup>207</sup> He compares the so-called loss generators with the aggressive use of derivatives. The problem with loss generators, he points out, is that they reduce corporate tax rate only on certain investments that produce "shelterable taxable income."<sup>208</sup> Derivatives, in contrast, reduce this rate without creating allocative distortions, essentially amounting to a corporate tax rate cut.<sup>209</sup> Given that difference, and implicitly assuming that the loss generators and derivatives-based strategies are equally likely to be illegal, Shaviro concludes: "[I]f I were a government policymaker, I certainly would be inclined to focus more on the loss generators than on [derivatives-based strategies] that arguably promote[] a desirable aim."<sup>210</sup> That aim is the elimination of an inefficient corporate income tax.

This is a hesitant recommendation. Why focus on derivatives at all if their use (even though possibly illegal) promotes a desirable aim of corporate integration? The reason for the hesitation, no doubt, is the conflict between Shaviro's commitment to welfare economics and his commitment to the rule of law. Wojciech Kopczuk, an economist, has no such conflict, so his conclusion is much more unequivocal. He considers tax evasion by the poor and concludes that under certain conditions it is socially desirable.<sup>211</sup> If having a relatively more progressive rate schedule makes a socially optimal amount of redistribution more costly than having a relatively less progressive schedule combined with some tax evasion at the bottom of the income scale, Kopczuk concludes, then allowing that evasion is optimal.<sup>212</sup> Not just acceptable (because, for instance, eliminating it would be costly), optimal! Note that Kopczuk is not a revolutionary calling for an uprising of the underprivileged class. His conclusion is a direct extension of the optimal income tax framework.

The same logic inexorably applies to the question addressed by Shaviro. If corporate tax is not part of the optimal tax system (and it

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<sup>207</sup> See Shaviro, *supra* note 62, at 452–53.

<sup>208</sup> *Id.* at 452. Examples of such income include foreign-source passive income and capital gains. *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> *Id.* at 453.

<sup>211</sup> The key factor is whether tax evasion (referred to by Kopczuk as "avoidance") behavior is heterogeneous and, if so, whether it varies among taxpayers of various ability independently from the variation in their incomes. See Kopczuk, *supra* note 158, at 53–54.

<sup>212</sup> See *id.* at 51, 61–68 (concluding that "[a]s long as avoidance is more easily accessible to individuals to whom one wants to redistribute income, its existence may be welfare improving" and that "[u]nder these circumstances it is optimal not to eliminate avoidance [such as a failure to report tip income], even though it might be costless to do so").

certainly is not), the optimal taxpayer response to corporate tax is to evade it. Moreover, the optimal government response to this evasion is to allow it. The same is true of capital income tax more generally. There is simply no need to enact rules dealing with derivatives, tax-free hedging, or any other means of reducing the inefficient capital income tax. Without such rules, taxpayers will escape this tax with impunity, improving the tax system's efficiency.<sup>213</sup> This is hardly an appealing conclusion for anyone with a J.D.

But suppose one follows in Shaviro's footsteps and declines to endorse clear violations of the law on welfarist grounds. The limits of tax law and economics extend to many less drastic arguments related to tax enforcement as well. Many of these arguments are often made by tax judges, lawyers, and legal academics, and they sound just like the arguments frequently made in discussing enforcement of other legal regimes. These arguments are presumed to be so self-evidently correct that no justification is usually offered. Yet, while the arguments about the appropriate design of rules and sanctions generally have strong efficiency foundations, they lack such foundations when made in the tax context.

One familiar argument is that in any threshold-type regime (that is, in any regime that involves a line separating legal from illegal behavior) policymakers should exercise restraint in designing the threshold. If the speed limit is set at twenty miles per hour, if the environmental regulation demands zero emissions, many actions whose marginal (private and social) benefits exceed marginal (private and social) costs would be illegal and deterred by a threat of sanctions.<sup>214</sup> This would be a clearly inefficient result. For irredeemably inefficient acts, if every contemporaneous price increase is treated as collusive, if any unhappy customer accusing her broker of churning receives damages, a lot of socially useful economic activity will be negatively affected.<sup>215</sup> All these examples remind policymakers about the danger of overdeterrence—the possibility of reducing social welfare as a result of overbroad rules.

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<sup>213</sup> Weisbach offers four possible reasons to deter tax evasion of inefficient taxes. See Weisbach, *supra* note 99, at 111–12. He recognizes, however, that the reasons are “speculative” and may or may not stand up to greater scrutiny. *Id.* at 111. Moreover, three out of the four reasons rely on considerations that are well beyond the basic analysis supporting reform proposals in most areas of economic regulation.

<sup>214</sup> See, e.g., Richard A. Epstein, *The Moral and Practical Dilemmas of an Underground Economy*, 103 YALE L.J. 2157, 2171 (1994) (criticizing the Superfund rules as “a system of massive overdeterrence in which private parties are asked to spend thousands of dollars in order to avoid pennies’ worth of environmental harm”).

<sup>215</sup> See, e.g., Kaplow, *supra* note 49, at 366–70.

The concern with overbroad rules is a constant refrain in tax policy debates,<sup>216</sup> but it cannot be justified in the manner just described. While it is indeed inefficient to set the highway speed limit at twenty miles per hour and to treat all contemporaneous price increases as collusive, it is not necessarily inefficient to require taxpayers to recognize gains from hedging their appreciated securities (to continue with an earlier example) if they eliminate all, most, or only some of their economic exposure. The partial hedging rule protects the realization requirement, which is itself part of the capital income tax. Let us assume that making this rule stricter would lead to a greater overall tax burden on capital income.<sup>217</sup> Could this burden become too high, just like the speed limit could become too low?

This question has no clear answer. Without a theory of taxation of capital income and a theory of realization-based (rather than accrual-based) taxation, how can one decide what tax burden is too high or when realizations are too frequent? While the canonical optimal tax theory has no tax on capital income, it is far from clear that reducing the existing capital income tax is a welfare-increasing move, especially when it is accomplished by the change in partial hedging rules rather than an across-the-board cut in the capital gains tax rate.<sup>218</sup>

Turning from the claims about the content of legal rules to the arguments about the design of tax sanctions brings no relief. One such argument is that slight violations should face light punishment while egregious violations should be subject to severe sanctions.<sup>219</sup>

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<sup>216</sup> See, e.g., James N. Calvin et al., *Examining the Straddle Rules After 25 Years*, 125 TAX NOTES 1301, 1305–06 (2009) (criticizing the overbreadth of straddle rules); Marie Sapirie, *Final Foreign Tax Credit Generator Regulations Released*, 132 TAX NOTES 227, 227 (2011) (reporting on concern with the overbroad foreign tax credit generator regulations); Frederick N. Vinson, *Overhauling the Taxation of Financial Derivatives Transactions*, 132 TAX NOTES 1369, 1370 (2011) (stating that “the passive activity loss rules have been heavily criticized as overbroad”).

<sup>217</sup> If it does not, there is clearly no reason for concern with an overbroad rule as it has no effect on the tax burden, or even lightens it.

<sup>218</sup> Importantly, this is not an argument suggesting that the partial hedging rule should (or should not) be expanded. Rather, it is an assertion that one cannot argue in favor of limiting the breadth of tax anti-avoidance rules by invoking the optimal tax regime.

<sup>219</sup> See, e.g., *United States v. U.S. Gypsum Co.*, 438 U.S. 422, 441 (1978) (“[S]alutary and procompetitive conduct lying close to the borderline of impermissible conduct might be shunned by businessmen who chose to be excessively cautious in the face of uncertainty regarding possible exposure to criminal punishment for even a good-faith error of judgment.”); Edward D. Cavanagh, *Detrebling Antitrust Damages: An Idea Whose Time Has Come?*, 61 TUL. L. REV. 777, 780, 839 (1987) (explaining that heavy sanctions discourage efficient behavior by imposing a cost on “playing it too close to the line” and that making treble damages discretionary would reduce damages in cases presenting close questions of law or fact). The same argument is routinely made in the tax setting. See, e.g., *Texas State Bar Tax Section Comments on Proposal to Require Reporting of Uncertain Tax Positions*, 2010 TNT 105–22 (“Large penalties such as those imposed under Sections 6707 or 6707A, applicable only in circumstances that the Service considers potentially abusive, are inappropriate for a disclo-

While terms like “egregious” (and its many synonyms and antonyms) are used in several different ways, many commentators differentiate between slight violations that barely cross the legality threshold and egregious violations that are far removed from this threshold.<sup>220</sup> If the law is uncertain, slight violations have a substantial chance to be found legal on review while egregious ones are almost certainly illegal.<sup>221</sup>

The argument in favor of light sanctions for slight violations may make sense if legal rules are (roughly) socially optimal. Imagine that a fifty-five miles per hour highway speed limit is optimal. This means that, on average, the marginal benefit of driving at fifty-five miles per hour is equal to its marginal cost, while for higher speeds, the cost exceeds the benefit. If so, it is quite plausible to assume that the higher the speed above the limit, the greater the excess of the social cost over social benefit. In order to deter increasingly costly behavior (more egregious speeding), higher speeds should lead to higher fines, as they usually do.<sup>222</sup> Penalties for violating the RCRA physical barrier requirement reveal a similar pattern.<sup>223</sup>

The same argument makes little sense in tax. Suppose that the partial hedging rule prohibits taxpayers from hedging “substantially all” of their economic exposure to the appreciated security, and assume that the term “substantially all” is generally interpreted to mean something around 90%. Needless to say, no one can possibly claim that the “substantially all” rule is socially optimal—precisely, roughly, or even remotely. Therefore, there is nothing to say about the social cost of hedging 89%, 91%, or 99.9% of economic exposure. Whatever considerations may support heavier sanction in the latter case, efficiency is not one of them, at least not for the same clear rea-

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sure requirement applied routinely and broadly to so many taxpayers, except in the most egregious circumstances.”).

<sup>220</sup> See, e.g., Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1544 (1983) (“Intentional fault is gross because once the injurer decides to disobey the legal standard it pays to fall far short of it.”).

<sup>221</sup> See John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 980 (1984) (“In most situations where the defendant can choose from a range of possible actions, the probability of being held liable varies with the egregiousness of the defendant’s conduct.”).

<sup>222</sup> See, e.g., MASS. GEN. LAWS. ch. 90, § 20 (2010) (imposing increasing fines for greater speeds in excess of the speed limit). This explanation is incomplete, but it suffices to demonstrate the close connection between the design of sanctions and the fundamental problem of negative externalities in the world of transaction costs. The reason for incompleteness is that even a fixed statutory fine produces graduated expected sanctions if the law is uncertain (as it always is) because substantial violations are more likely to be found illegal on review than the minor ones. See Raskolnikov, *supra* note 3, at 25–26.

<sup>223</sup> See U.S. EPA, RCRA CIVIL PENALTY POLICY 18 (2003), available at <http://www.epa.gov/compliance/resources/policies/civil/rcra/rcpp2003-fnl.pdf>. Under these guidelines, “major” deviations are subject to sanctions that are as much as one hundred times higher than fines for “minor” deviations. See *id.*

sons that support graduated speeding fines and environmental penalties.

Many other familiar arguments about penalties and enforcement encounter similar problems for similar reasons when made in the tax context. It is not at all clear why light punishment in close cases is justified by tax law's uncertainty,<sup>224</sup> by the possibility that the taxpayer may have been right,<sup>225</sup> or by the social benefit of converting unclear standards into clear rules that arises from taxpayers taking plausible but uncertain positions.<sup>226</sup> All these arguments falter because while there is indeed a social benefit from resolving uncertainty by converting a vague "reasonable speed" standard into a precise—and socially optimal—fifty-five miles per hour rule, there is no benefit from converting a vague "substantially all" tax hedging standard into a more precise "90% of total economic exposure" rule. The reason is painfully obvious by now: in contrast with the speeding example, neither the vague tax standard nor the clear tax rule has any connection to optimality. If so, there is nothing to be gained from converting one into another while the real social costs of tax litigation needed to accomplish this conversion clearly reduce social welfare.

Even the seemingly unassailable conclusion that tax penalties should take the amount of tax underpayment into account is in doubt given the disconnect between the actual and the optimal tax systems. While the link between the magnitude of sanctions and the external harm from the offense is at the core of the general economic analysis

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<sup>224</sup> This is a common justification in tax and elsewhere. See, e.g., Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1513 (1996) (addressing the argument that fairly high sanctions should not be imposed for securities law violations if "the standard of conduct cannot be made sufficiently clear"); Gergen, *supra* note 99, at 278 ("[F]ew support imposing severe sanctions for violations of indeterminate legal standards."); Marie Sapirie & Shamik Trivedi, *Economic Substance Directive Limits Strict Liability Penalties*, 132 TAX NOTES 339, 340 (2011) (citing a practitioner expressing a similar view).

<sup>225</sup> See Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters*, in TAX AND CORPORATE GOVERNANCE 229, 240 (Wolfgang Schön ed., 2008); *ABA Tax Section Recommends Overhaul of Tax Penalty Regime*, 2009 TNT 75-25 (stating as one of its guiding principles the proposition that "[p]enalties should not be imposed to punish conduct which is proper, reasonable, appropriate, or not clearly prohibited"). John Calfee and Richard Craswell expressed a similar point by asserting that "a positive (or, at least, non-negative) correlation between the likelihood of liability and the social costs of a defendant's behavior could be the definition of a minimally rational legal system." Calfee & Craswell, *supra* note 221, at 970.

<sup>226</sup> For an example of this argument in the tax setting, see M. Carr Ferguson, *How to Save the Corporate Income Tax*, 132 TAX NOTES 951, 952 (2011). For the general argument, see William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 236 (1979) ("Rule creation [through development of precedent] is not desired in itself . . . but is a means of particularizing the standards of socially desired behavior in order to promote compliance with them."). Richard Posner's current views about the common law's ability to develop efficient rules are fairly pessimistic. See Anthony Niblett et al., *The Evolution of a Legal Rule*, 39 J. LEGAL STUD. 325, 330 (2010).



of deterrence,<sup>227</sup> the connection between the external harm and the magnitude of tax underpayment is extremely weak. The external harm from a tax-motivated act is the cost of raising the revenue lost due to that act plus the amount of the money transfer (the tax savings). The first component of this sum is very difficult to measure, making the first-best, harm-based sanctions unrealistic. This problem is not unique to taxation, however. A familiar second-best solution is to base sanctions on plaintiff's losses rather than on the external harms from the defendant's conduct.<sup>228</sup> Because the loss in the tax setting is the underpayment of tax, loss-based tax sanctions would tie the amount of penalty to the magnitude of the underpayment. This is precisely what the Internal Revenue Code does.<sup>229</sup>

Unfortunately, this second-best solution is particularly implausible in tax. The plaintiff's loss is often the main (or at least a significant) component of the external harm from securities, antitrust, environmental, and other violations. But the plaintiff's (i.e., the government's) loss of tax dollars is a very poor proxy for the overall external harm from tax underpayments.

Imagine a simple tax regime consisting of a wage tax (of a kind envisioned by the optimal tax theory) and a capital income tax of any kind. Consider whether a penalty for a \$200 understatement should be greater than a penalty for a \$100 understatement. It should if the external harm in the former case is greater than in the latter.<sup>230</sup> Is this likely to be the case?

To answer this question, we need to know what type of income would be taxed less due to the understatement. A reduction in tax on labor income is clearly socially costly, but a reduction in capital income tax may not be.<sup>231</sup> Moreover, we need to know what is the government's response to the understatement. If the government responds to a reduction in capital income tax by increasing tax on labor income, the understatement moves the system toward the optimum and may be socially beneficial. If the government responds to a

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<sup>227</sup> See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 180 (1968).

<sup>228</sup> See, e.g., 15 U.S.C. § 15 (2006) (establishing liability for any person "injured in his business or property by reason of anything forbidden in the antitrust laws" equal to "three-fold the damages [i.e., losses] by him sustained"); Alexander, *supra* note 224, at 1490 (explaining that the damages recoverable by investors under Section 11 of the Securities Exchange Act of 1934 and Rule 10b-5 are based on calculations of hypothetical losses incurred by investors).

<sup>229</sup> See I.R.C. §§ 6662, 6662A, 6663 (2006).

<sup>230</sup> This statement ignores possible variations in various probabilities (such as the probability of detection and the probability of conviction). This is done both to simplify the exposition and because no general statement regarding these probabilities can be made.

<sup>231</sup> This *may* be so because the optimal system does not tax capital income. See Mankiw et al., *supra* note 72, at 167. The hesitation is due to the second-best problem.

reduction in labor income tax with an increase in tax on capital income, the social cost is likely to be large because the “right” income is taxed less while the “wrong” income is taxed more than before. So should a penalty for a \$200 understatement be greater than the sanction for a \$100 understatement in this simple system? It depends.

Our actual tax system is immensely more complex than the one just considered. The uncertainties discussed in the previous paragraph pale in comparison to the uncertainties arising from the real-life tax avoidance and evasion. Yet it is impossible to make any generalizations about the social cost of tax understatements without knowing what kind of income is taxed less and how the government responds to this tax reduction. Therefore, the link between the size of a tax understatement and the magnitude of the related penalty is difficult to defend.

These are sobering conclusions. The gap between the canonical optimal tax theory and the real world of taxation affects the economic analysis of every aspect of the tax system. It has significant implications for the meaning of the basic economic concepts, the design of the fundamental structural features, the breadth of every legal rule found in the Internal Revenue Code, and the evaluation of responses to tax avoidance and evasion. As the next section explains, the implications of this gap extend well beyond tax.

### C. The Implications for the Economic Analysis of Law

Recall that the great goal of the law and economics’ normative project is to design optimal regulatory regimes. The specific suggestions aimed at accomplishing this goal are most persuasive if the existing regulatory systems are fairly close to the ideal ones. At least in certain areas dealing with economic regulation, this relatively close connection appears plausible. Until one thinks about taxes.

For instance, securities law scholars typically assume that the U.S. capital markets are generally efficient. This assumption is much less realistic, however, if one remembers that the U.S. tax rules reduce market liquidity,<sup>232</sup> preference some assets over others,<sup>233</sup> lead to creation of financial instruments that would not exist in a tax-free world,<sup>234</sup> and so on. One may still argue that capital markets are effi-

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<sup>232</sup> The so-called lock-in effect resulting from the realization requirement induces taxpayers to retain their appreciated assets well past the point when they would have liked to sell them. See, e.g., Yoseph M. Edrey, *What Are Capital Gains and Losses Anyway?*, 24 VA. TAX REV. 141, 172 (2004).

<sup>233</sup> Tax-exempt bonds, for instance, have a preferential tax treatment, as do growth stocks compared to dividend-paying stocks.

<sup>234</sup> See, e.g., Schler, *supra* note 133, at 355 (describing contingent convertible debt that is very similar to ordinary convertible debt except for the additional contingency added solely to achieve a better tax result).

cient in the sense that they reflect all available information (including the tax rules). But a claim that these markets allocate capital to its highest valuing users<sup>235</sup> cannot be defended once one takes taxes into account. Economists recognized long ago that this line of reasoning extends to the analysis of Pigouvian taxes and subsidies, optimal anti-monopolization policies, and so on.<sup>236</sup> Thus, the argument that the second-best problems exist in many areas of economic regulation is not new. Perhaps these problems may not appear particularly severe as long as one limits the inquiry just to competition policy, corporate law, or securities regulation. But the second-best problems certainly loom large once one remembers that distortionary and highly suboptimal taxes are certain to affect the behavior of relevant individuals and firms.<sup>237</sup>

Another fundamental problem of law and economics' social optimization project has to do with redistribution. As the redistributive solution produced by the optimal tax theory fails to reflect actual redistributive policy, the claim that the tax and transfer system is the only appropriate redistributive domain comes into question. If so, the vast amount of law and economics scholarship that has ignored redistribution in assessing (and attempting to reform) corporate, commercial, competition, and securities law<sup>238</sup> suffers from a significant deficiency. So it is hardly surprising that one of the leading Chicago-school economists concludes that "[t]he failure to develop a satisfactory framework within which to analyze redistribution makes law and economics analytically incomplete."<sup>239</sup> The challenges of tax law and

<sup>235</sup> See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1074 (1990).

<sup>236</sup> See, e.g., David M. Newbery, *Growth, Externalities and Taxation*, 37 SCOT. J. POL. ECON. 305, 319–24 (1990) (explaining why tax-induced distortions are likely to have complex and varying interdependencies with trade policy, competition policy, and externalities). Jagdish Bhagwati made the point most emphatically by pointing out that even activities that are definitely inefficient may increase social welfare given their interaction with preexisting distortions. Jagdish N. Bhagwati, *Directly Unproductive, Profit-Seeking (DUP) Activities*, 90 J. POL. ECON. 988, 992 (1982) (giving examples of the "paradox of beneficial outcome" from definitely undesirable profit-seeking activities as well as a related "subsidiary paradox").

<sup>237</sup> The reverse is also true and well understood in public economics. See, e.g., Stiglitz, *supra* note 151, at 1036 ("The optimal tax structure thus might be markedly different in an economy with monopolies, externalities, and other imperfections."). Needless to say, this realization further weakens the normative power of tax policy arguments made by reference to social welfare maximization.

<sup>238</sup> See David A. Weisbach, *Should Legal Rules Be Used to Redistribute Income?*, 70 U. CHI. L. REV. 439, 439 (2003) ("The overwhelming majority of law and economics scholarship looks solely to efficiency to evaluate legal rules.").

<sup>239</sup> James J. Heckman, Commentary, *The Intellectual Roots of the Law and Economics Movement*, 15 LAW & HIST. REV. 327, 332 (1997). The reason for this failure is, no doubt, the difficulty of incorporating redistributive concerns into efficiency-based analysis of legal rules.

economics, it turns out, have profound implications for the entire law and economics movement.

### III

#### BEYOND THE LIMITS

The limits of tax law and economics are, no doubt, substantial. But they are not all-encompassing. They do not affect many research agendas in public economics. Nor do they extend to all economic analysis of tax rules and sanctions.

#### A. The Benefits of the Economic Analysis of Taxation

To begin with, the optimal tax theory itself is not cast in stone. References to the “canonical” or “classic” optimal tax theory throughout this Article are not verbiage. A serious effort is underway to reexamine the theory’s fundamental conclusions in order to make them more relevant to the real world. Scholars are developing a “realistic, tractable, and robust theory of socially optimal capital taxation.”<sup>240</sup> They are reexamining the traditional assumptions that are responsible for some of the unrealistic theoretical results.<sup>241</sup> New research is reconsidering whether some easily observable taxpayer characteristics provide unique information about ability, with intriguing and somewhat unexpected conclusions.<sup>242</sup> Recent work incorporates a more nuanced understanding of individuals’ responses to taxation. Again, the findings challenge the accepted wisdom.<sup>243</sup> For those interested in improving the actual tax system, these are promising trends. If successful, these developments may free tax law and economics from its limitations, or at least loosen them.

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<sup>240</sup> Piketty & Saez, *supra* note 170, at 1. Importantly, the theory being developed addresses not only the optimal taxation of capital income but the optimal taxation of capital transfers as well. See also Juan Carlos Conesa et al., *Taxing Capital? Not a Bad Idea After All!*, 99 AM. ECON. REV. 25, 26 (2009) (developing a model in which “endogenous labor supplied differentially over the life cycle is crucial in driving” the conclusion that capital income should be taxed at a high flat rate).

<sup>241</sup> The assumptions being reexamined include the lognormal distribution of high-end abilities, see Diamond & Saez, *supra* note 80, at 168–71, and the irrelevance of the extensive margin elasticity of labor supply, see *id.* at 175–77.

<sup>242</sup> See Jukka Pirttila & Ilpo Suoniemi, *Public Provision, Commodity Demand and Hours of Work: An Empirical Analysis* 19–20 (CESifo, Working Paper No. 3000, 2010), <http://ssrn.com/abstract=1582847>; Roger H. Gordon & Wojciech Kopczuk, *The Choice of the Personal Income Tax Base* 9 (Aug. 26, 2010) (unpublished manuscript) (on file with the author). For instance, it appears that rather than allowing a deduction for property taxes, we should increase income tax liability of taxpayers with higher property tax payments. See *id.*

<sup>243</sup> See Raj Chetty, *Is the Taxable Income Elasticity Sufficient to Calculate Deadweight Loss? The Implications of Evasion and Avoidance*, 1 AM. ECON. J.: ECON. POL’Y 31, 31 (2009) (arguing that “the efficiency cost of taxing high income individuals is not necessarily large despite evidence that their reported incomes are highly sensitive to marginal tax rates.”).

The empirical tax research is also invaluable (even if often controversial). Estimating labor supply elasticity sheds light on the fundamental tradeoff between redistribution and distortion.<sup>244</sup> Measuring taxable income elasticity reveals the extent of all individual responses to taxation.<sup>245</sup> And determining the salience of various tax instruments helps policymakers to account for taxpayers' deviations from rational behavior (in the technical sense of this term).<sup>246</sup> The benefits of this and similar work are too obvious to require further elaboration. They are also largely unaffected by the conclusions reached in the previous Part.

Furthermore, economic analysis remains extremely useful in revealing the interplay between the tax rules, microeconomics and finance theory, and the actions of rational taxpayers. The resulting insights include understanding (under certain assumptions) the incentives for deferral,<sup>247</sup> the equivalence of a current deduction of an investment with a tax exemption of the investment's yield,<sup>248</sup> and the ability of individuals to escape income taxation of risky returns,<sup>249</sup> to name a few.<sup>250</sup> These and similar contributions are undiminished by the limitations of the optimal tax theory.

The economic analysis of incremental reforms is also promising. The marginal efficiency cost of funds approach (and the related taxable income elasticity analysis) provides policymakers with a method of choosing among a large menu of possible revenue raising measures, including changes in legal rules, sanctions, rates, and so on. The MECF approach explicitly disavows claims to optimality focusing only on incremental (that is, marginal) changes instead.<sup>251</sup> This limited goal makes the conclusions more robust and more practical.

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<sup>244</sup> See Emmanuel Saez et al., *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LIT. 3, 3 (2012).

<sup>245</sup> See Chetty, *supra* note 243, at 31.

<sup>246</sup> See, e.g., Raj Chetty et al., *Salience and Taxation: Theory and Evidence*, 99 AM. ECON. REV. 1145, 1175 (2009).

<sup>247</sup> See, e.g., MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY 23–25, 61–64 (2005).

<sup>248</sup> See E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300, 302 (1948). For a review, see David A. Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 21–23 (2005).

<sup>249</sup> See Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388, 391–92 (1944). For a review, see Weisbach, *supra* note 248, at 8–19.

<sup>250</sup> Another example of this work is the model demonstrating that (under certain assumptions) a particular presumptive taxation regime taxes capital income in the same manner as this income is taxed under the realization requirement while avoiding the distorting lock-in effect produced by realization. See Alan J. Auerbach & David F. Bradford, *Generalized Cash-Flow Taxation*, 88 J. PUB. ECON. 957, 958–59, 975 (2004); Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167, 167–69, 177–78 (1991).

<sup>251</sup> See Slemrod & Yitzhaki, *supra* note 122, at 175.

It is important, however, to appreciate the limitations of the MECF analysis. First, it is not entirely clear which real-life policy changes are incremental.<sup>252</sup> Second, the MECF calculations depend on the marginal value to the taxpayer of a dollar of tax saved—a parameter that requires context-specific empirical estimation.<sup>253</sup> Third, because the MECF framework is built on the assumption that private and social costs are identical, it cannot incorporate externalities and even fines into the analysis.<sup>254</sup> Fourth, the conclusion that the government may lower the overall deadweight loss by reducing its reliance on high-MECF instruments and increasing its reliance on low-MECF instruments is rigorously proven only when the instruments in question are various excise taxes. As Terrance O'Reilly emphasized, whether the same conclusion holds for other policy instruments is far from clear.<sup>255</sup>

Finally, the MECF measures only the *efficiency* cost of raising revenue. A broader concept called the marginal cost of funds is designed to balance efficiency and equity. The marginal cost of funds “is just the MECF . . . weighted to reflect distributional consequences.”<sup>256</sup> While this explanation appears quite straightforward, the requisite weighting is nothing of the kind. It was first proposed in a brief essay forty years ago<sup>257</sup> and remains largely undeveloped to this day. Many of the difficulties with incorporating redistribution into the optimal tax theory arise in specifying the marginal cost of funds as well.<sup>258</sup> Not surprisingly, a recent book dedicated entirely to the marginal cost of funds analysis spends about three pages on distributional issues without reaching any firm conclusions.<sup>259</sup>

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<sup>252</sup> The intuition underlying this approach—that government should pursue tax policy instruments that allow it to raise additional revenue at the lowest social cost—applies to nonincremental changes as well. See Shaw et al., *supra* note 126, at 1108 n.4. Reliance on an intuition, however, is not the same as a grounding in a precise economic theory.

<sup>253</sup> See Slemrod & Yitzhaki, *supra* note 122, at 187.

<sup>254</sup> See Shaw et al., *supra* note 126, at 1111.

<sup>255</sup> See O'Reilly, *supra* note 76, at 614–15.

<sup>256</sup> See Shaw et al., *supra* note 126, at 1110.

<sup>257</sup> See Martin S. Feldstein, *Distributional Equity and the Optimal Structure of Public Prices*, 62 AM. ECON. REV. 32 (1972). In a paper published just a few years later, Feldstein expressed considerable reservations about the possibility of balancing equity and efficiency considerations in the analysis of incremental reforms (as opposed to the optimal tax theory). See Feldstein, *supra* note 179, at 99–100 (“The problem of selecting the optimal . . . extent of partial reform requires balancing the traditional welfare loss against the horizontal inequities of arbitrary individual losses. There is no clearly compelling procedure for such a balancing, nothing that follows naturally from traditional economic theory in the way that the generalized utilitarian criterion . . . does for balancing traditional efficiency and distributional concerns.”).

<sup>258</sup> See Slemrod & Yitzhaki, *supra* note 122, at 190–92 (concluding that incorporating vertical equity into the analysis requires a choice of SWF or distributional weights and that taking account of other aspects of fairness and justice may be impossible altogether).

<sup>259</sup> See DAHLBY, *supra* note 116, at 38–42.

In short, the MECF is not a silver bullet. But it is a valuable tool that allows economists to evaluate (even if roughly) the efficiency implications of many real reforms. Presumably, democratically elected policymakers may then incorporate distributional preferences of the electorate into the tax reform analysis however they can. While disagreement about the appropriate extent of redistribution is all but assured, any reasonable tax reformer should be interested in the economic costs of various policy options. The MECF analysis can provide the reformer with estimates of these costs.

The research agendas just described have already yielded many valuable insights and promise to reveal many more. But scholars pursuing these agendas are economists, not lawyers. They neither have nor need a deep and comprehensive understanding of legal rules and sanctions. At the same time, most economically sophisticated tax lawyers cannot match the level of empirical and modeling skills of the leading public finance economists.<sup>260</sup> It makes no sense for tax law and economics scholars to circumvent the limits of their field by attempting to become economists themselves. This does not mean, however, that it is futile for these scholars to pursue economic analysis of tax law, as discussed next.

## B. The Enduring Value of Tax Law and Economics

The first area of research where tax law and economics can be (and has been) productive becomes obvious as soon as one concludes that the most useful tool offered by economists to policymakers is the MECF (and similar) analysis. That analysis depends on comparing projected and actual revenue changes resulting from incremental reforms. In order to perform this comparison, an analyst must know what reforms are possible and how taxpayers are likely to respond to them. Economists can give only very rudimentary answers to each of these questions because they lack detailed knowledge of tax rules and the ways these rules work in practice. Economically sophisticated tax scholars, in contrast, are experts in both areas.

Economists examine the tax system from sixty thousand feet. At that altitude, they can discern only a few potential incremental adjustments such as slight changes in tax rates or audit rates. But a repeal of the capital gains preference, a switch from realization-based to mark-to-market taxation, or corporate integration, to take just some examples, are not incremental changes. The MECF approach is ill suited

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<sup>260</sup> Thus, it is not surprising—and is entirely sensible—that empirically trained tax law academics study the court system rather than the tax system. See NANCY STAUDT, *THE JUDICIAL POWER OF THE PURSE: HOW COURTS FUND NATIONAL DEFENSE IN TIMES OF CRISIS* 2–9 (2011).

for their evaluation. Moreover, dramatic changes are rarely possible as a practical matter.

Needless to say, there are plenty of possible reforms that are both incremental and realistic. For instance, instead of evaluating an adoption of the mark-to-market taxation, one may inquire into the marginal efficiency cost of raising revenue by strengthening the already discussed hedging rules,<sup>261</sup> or the wash sale rules,<sup>262</sup> or the straddle rules,<sup>263</sup> each of which are essential to having a meaningful realization requirement. In order to do this, however, one needs to know all of these rules quite well. Very few economists have heard about any of them, none (I would guess) understands them in great detail. Without this understanding, it is impossible to evaluate the distortionary costs of changing these rules.

To be sure, many tax academics who are not enthralled by economic analysis have a full mastery of these rules. But ignoring economic reasoning would lead these academics to miss the rules' essential common feature—the fact that all of them are risk based.<sup>264</sup> While these academics may analyze the rules by inquiring into congressional intent, discerning the structure of the Internal Revenue Code, or trying to determine what it really means to sell an asset, tax law and economics scholars focus on the risk-bearing deadweight loss the rules impose. Needless to say, this loss—along with other costs—must be taken into account in evaluating the distortive effects of these rules and the likely MECF of their revision.

Deep knowledge of tax rules is not the only comparative advantage of tax law and economics scholars. Equally valuable is their sophisticated understanding of taxpayer responses to these rules. Without it, an analyst undertaking the MECF-type analysis engages in pure speculation. For example, one cannot estimate the distortions produced by adoption of the so-called Flat Tax<sup>265</sup> unless one realizes how easy it will be for taxpayers to plan around it. But in order to anticipate these tax reduction strategies, one needs to be steeped in the existing tax minimization techniques. One also needs to understand the economic effects of the Flat Tax on domestic and cross-border transactions—something that requires a fair bit of economic thinking. Not surprisingly, tax law and economics scholars made extremely valuable contributions to evaluating the Flat Tax proposal—

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<sup>261</sup> I.R.C. § 1259 (2006).

<sup>262</sup> *Id.* § 1091.

<sup>263</sup> *Id.* § 1092.

<sup>264</sup> See Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. PA. L. REV. 1181, 1205 (2008); *id.* at 1183 (defining risk-based rules as “provisions that grant tax benefits only to those who accept a certain amount of risk”).

<sup>265</sup> See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995); see also *The Freedom and Fairness Restoration Act of 1995*, H.R. 2060, 104th Cong. (1995).



contributions that required their unique combination of skills.<sup>266</sup> That skill set also allowed economically sophisticated tax academics to assume leading roles in the studies of corporate integration,<sup>267</sup> realization,<sup>268</sup> and financial instruments reform.<sup>269</sup>

The same is true for more modest regulatory changes. If one wants to evaluate the cost of raising revenue by adjusting the hedging rules, one needs to understand the frictions that constrain tax planning around these rules.<sup>270</sup> One also needs to realize that these are risk-based rules giving rise to a unique form of tax planning (and a unique social cost) that may or may not be affected by a particular rule change.<sup>271</sup> Again, the analyst needs to understand how complicated rules work in practice while focusing on the resulting distortions—something that tax law and economics scholars are especially equipped to do.

Another major research agenda for which tax law and economics scholars are well suited is the study of tax avoidance. Not as this term is understood by economists, but as it is used by lawyers, policymakers, and the Internal Revenue Code. Economists use the term avoidance to describe legal responses to taxation, contrasting it with evasion, which is clearly illegal.<sup>272</sup> While economists occasionally mention a gray area of legal uncertainty between evasion and avoidance, forty

<sup>266</sup> See Joseph Bankman & Michael L. Schler, *Tax Planning Under the Flat Tax*, in *TAXING CAPITAL INCOME* 245 (Henry J. Aaron et al. eds., 2007); David A. Weisbach, *Ironing Out the Flat Tax*, 52 *STAN. L. REV.* 599, 600–03 (2000).

<sup>267</sup> See generally U.S. DEP'T OF TREASURY, *INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE* (1992), reprinted in Michael J. Graetz & Alvin C. Warren, *INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS* (1998); William D. Andrews, *Reporter's Study of the Taxation of Corporate Distributions*, in *AM. LAW INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS* (1982); Edward D. Kleinbard, *Designing and Income Tax on Capital Income*, in *TAXING CAPITAL INCOME* (Henry J. Aaron et al. eds., 2007); ALVIN C. WARREN, JR., *AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION* (1993).

<sup>268</sup> See Schenk, *supra* note 99, at 518.

<sup>269</sup> See, e.g., David M. Schizer, *Balance in Taxation of Derivative Securities: An Agenda for Reform*, 104 *COLUM. L. REV.* 1886, 1890 (2004); Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 *TEX. L. REV.* 243, 245 (1992); Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 *STAN. L. REV.* 569, 569 (1993).

<sup>270</sup> See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 *COLUM. L. REV.* 1312, 1396 (2001).

<sup>271</sup> See Raskolnikov, *supra* note 264, at 1205.

<sup>272</sup> Thus, failing to report cash income and claiming nonexistent dependents is evasion; working less or buying tax-exempt bonds is avoidance.

years of economic modeling of tax enforcement have failed to produce any scholarship exploring that gray area.<sup>273</sup>

Needless to say, that gray area is of great interest to legal academics. It is the focus of the vast literature on tax shelters. It continues to command significant attention from Congress, the Treasury Department, and the IRS.<sup>274</sup> And there is no reason to expect that this gray area—which tax academics call avoidance (in contrast with legal tax planning)—is likely to diminish in importance any time soon. So it is no surprise that tax law and economics scholars have been at the forefront of the economic analysis of legal (specifically, tax) uncertainty.<sup>275</sup> While no consensus about the appropriate structure of tax sanctions and other enforcement tools has emerged thus far, our understanding of available options and tradeoffs has been greatly enhanced by this analysis.

The third comparative advantage of tax law and economics scholars is institutional. Public finance economists inhabit an intellectual environment characterized by diverse areas of substantive inquiry that are examined with a uniform conceptual approach. In contrast, tax law and economics scholars are inevitably exposed to historical, philosophical, political, and doctrinal analyses, to name a few. This is true even if one focuses on tax scholarship, not to mention the range of methodological commitments in the legal academy as a whole. To the extent that real-life policy choices are determined by an agglomeration of political, economic, historical, and other considerations, tax law and economics scholars have a comparative advantage over public finance economists in combining rigorous economic theory with noneconomic concerns.<sup>276</sup> Examples of this work are easy to find.<sup>277</sup>

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<sup>273</sup> A recent work-in-progress is one of the very few attempts to change this state of affairs. See David Ulph, *Avoidance Policies—A New Conceptual Framework* (Oxford Univ., Ctr. for Bus. Taxation, Working Paper No. 09/22, 2009) (on file with author).

<sup>274</sup> The continuing saga with the codification of the economic substance doctrine is the prime example. See Martin J. McMahon, Jr., *Living with the Codified Economic Substance Doctrine*, 128 TAX NOTES 731, 731 (2010).

<sup>275</sup> A few examples of this substantial and growing literature include Mark P. Gergen, *Uncertainty and Tax Enforcement: A Case for Moderate Fault-Based Penalties*, 64 TAX L. REV. 453 (2011); Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017 (2009); Logue, *supra* note 8; Shaviro, *supra* note 225; Raskolnikov, *supra* note 12.

<sup>276</sup> This is not a new point. See, e.g., Michael A. Livingston, *Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy*, 83 CORNELL L. REV. 365, 390 (1998).

<sup>277</sup> One example is Michael Graetz's reinvigoration of the debate about choosing national rather than worldwide welfare as a basis for economic analysis (in which Graetz considered historical, political, and fairness-based arguments). See Graetz, *supra* note 172, at 284. Another example is Alvin Warren's classic debate with William Andrews about the choice between an income and a consumption tax (in which Warren focused on the interaction of economic analysis with fairness-based and broader political theory considerations). See Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081, 1081–83 (1980).

Finally, economically sophisticated tax academics are particularly well positioned to explain economic theories in terms accessible to a broader legal audience and to examine the assumptions underlying these theories. Economic models of taxation are complex, the meaning of their assumptions is far from obvious, and the inevitable professional lingo is a challenge to the uninitiated. For instance, what exactly does it mean, as the earlier-quoted MECF discussion stated, that the tax optimization problem is “well-behaved”?<sup>278</sup>

Some of the best work in tax law and economics has been in this “explain and explore” genre. Not surprisingly, there is a vigorous debate about the robustness of the models, the applicability of their prescriptions, and the realism of their assumptions.<sup>279</sup> But for obvious reasons, this debate is invaluable in advancing our understanding of the economic analysis of taxation and its implications for tax policy and tax reform.

This discussion does not necessarily cover every area of research where tax law and economics may succeed despite its limitations. There is no need for an exhaustive enumeration. Considering just the agendas discussed here leads one to an inevitable conclusion: tax law and economics is a viable and valuable field of study that is vitally important for the project of improving our tax system.

#### CONCLUSION

This Article explains the limits of tax law and economics, identifies their origins, and explores their implications. For those who reject the basic assumptions underlying the economic analysis of law, this Article’s inquiry misses the point. For the rest, the Article’s main suggestion is to take the normative claims about the design of tax rules and sanctions with a large grain of salt when these claims are based on references to the optimal tax system.

What follows from this suggestion is not paralysis but a shift in focus. Many changes to the actual tax system are incremental and should be evaluated as such. A deep knowledge of tax law and a sophisticated understanding of tax planning are crucial for an informed economic analysis of incremental reforms. Tax law and economics scholars are uniquely well positioned to perform this analysis. An economic study of legal uncertainty and tax avoidance is another area

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<sup>278</sup> See *supra* text accompanying note 127.

<sup>279</sup> See, e.g., Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1414–17 (2006); Chris William Sanchirico, *A Critical Look at the Economic Argument for Taxing Only Labor Income*, 63 TAX L. REV. 867, 867–68 (2010); Chris William Sanchirico, *Tax Eclecticism*, 64 TAX L. REV. 149, 149–54 (2011); Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 STAN. L. REV. 745, 746–50 (2007); Weisbach, *supra* note 248, at 1–8; Bankman & Griffith, *supra* note 88, at 1906–07; O’Reilly, *supra* note 76, at 584–87.

where economically oriented tax scholars have a comparative advantage. The same is true of their ability to consider a broad range of values and approaches in assessing economic arguments. This is just a partial list of the important areas of inquiry unaffected by the limits of tax law and economics. These limits constrain the economic analysis of tax policy, but they do not negate it.

At the same time, these limits reach beyond tax. The chasm between the ideal and the actual tax systems, combined with the pervasive influence of taxes on every area of economic regulation, is a challenge to the entire law and economics movement. Whether one considers optimal Pigouvian taxes and subsidies, optimal anti-monopolization policies, or any other government intervention, one must recognize that ignoring the tax system can—and most likely does—significantly impact the results. The limits of tax law and economics transcend tax policy, extending to all aspects of the economic analysis of law. If so, this Article's emphasis on the promising research agendas in tax law and economics has clear implications for the entire law and economics project.