CHAPTER 4

Prudential Concerns (I): Public Finance Considerations

The Analytical Framework: A First Statement of the Argument

Traditional regulatory commands impose direct costs on the regulated parties, which they might or might not ultimately bear, while compliance with these commands distributes benefits more or less broadly. Similarly, traditional taxes impose costs either on those who directly pay the relevant tax or on some other parties, depending on the incidence of the tax, while the funds raised through taxation are expended in a fashion that distributes benefits to broad or narrow groups. User fees do not impose net costs on any service user. Users may gain surplus, valuing the service more than the price of receiving it, but they will not pay more than the service is worth to them. (This phenomenon will hold true, at least tautologically, if one has a choice about whether to bear user fees. If, instead, the governmental entity charges compulsory fees or imposes benefit taxes on those citizens it believes particularly benefit from a program, as the government will typically do when it is difficult to exclude some beneficiaries from enjoying the benefits of services whether or not the beneficiaries pay for the services, it is of course possible that some people will be charged more than they gain from the program.) Third parties, again a narrow or broad range, who contribute nothing to financing a particular program may nonetheless receive some of the benefits from a program fully funded by user fees. (For example, one could imagine charging national park users entrance fees that covered costs of maintaining and preserving the parks. Users would, tautologically, bear no net costs since benefits would be at least equal to fees to the prospective users, or they would forbear from use. But some nonusers might benefit as well, for example, because the value of their implicit option to visit the park site would be increased if user fees served to preserve the park.) Government inaction permits defined citizen groups to bear certain costs; one might correlatively describe those who are relieved from the obligation to pay taxes that would fund a more interventionist alternative as benefiting from inaction if the baseline were such that would-be taxpayers expected to bear higher taxes.

Whenever the regulatory option is employed, the first consideration ought therefore to be whether costs have been imposed on parties in a sensible way, compared to the alternative distributions of costs. In a sense, all that is asked is which form of levy is most desirable; alternative taxes are simply compared in terms of fairness, administrative efficiency, and allocative effects.[1] My sense is that opponents of regulatory taxation have typically slighted the possible advantages of regulatory taxes, particularly along the allocative dimension. In some cases, regulations may be a more allocatively neutral means to raise revenues than broad-based taxes.

Kaplow and Shavell note, quite correctly, that the income tax dominates, in efficiency terms, any regulation (or private law rule) imposed on a party to redistribute, levied by virtue of wealth or income, given certain restrictive assumptions.[2] Thus, to take the simplest case, if, to redistribute income, richer defendants in tort cases are made to pay higher damages than poorer ones, the higher damage judgments will, in effect, increase the marginal income tax rate on a probabilistic basis for those who would be harmed by this practice. The practice will thus have all the disincentive effects of an explicit increase in marginal rates plus the allocative problems inherent in overdeterring harm-causing activity by overstating damages.

The point is correct, in terms of actual incentive effects, only if one assumes—quite unrealistically—that as a behavioral matter, people will assess their taxes on a rational expected-tax basis, treating taxes that are certain to be levied on income and low-probability damage judgments that will be levied on income if they happen to be found liable in precisely the same way. It is likely, though, that rational agents with ordinary information-processing limits who are considering whether to take higher paying but more annoying jobs will measure the increase in wages net of the taxes the agents are certain to pay given published income tax rates; hence, they

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1. Thus, one should attempt to ascertain whether people have been justly selected to bear the costs, whether the costs are imposed in an administratively efficacious way, and whether the imposition of costs through this mechanism is more or less likely to alter the behavior of parties who will have to bear the costs in an undesirable way.

2. See Steven Shavell and Louis Kaplow, "Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income," *J. of Legal Studies* 23 (1994): 667.

face income tax-based disincentives to move to the more productive setting. Whether the rational agents will also measure raises net of the expected increase in damage judgments that they will face if they become richer on the off-chance that they happen to be defendants in tort suits is not at all obvious. Attention to distribution in tort suits might therefore function as a perennially unanticipated ex post tax with few allocative effects. Nonetheless, the point remains valid on the odd assumption that agents have perfect foresight and perfectly process information about low-probability events.

It is important to note as well that Shavell and Kaplow are criticizing only those regulations (or private law rules) that are themselves allocatively inefficient and (to foreshadow a point to which I return in more detail) that predictably bear more heavily on actors when income increases. Regulations (and private law rules) might meet classic redistributive egalitarian ends but be (at least equally) motivated by their favorable or neutral impact on behavior. Monopolists' price regulations, for example, might typically redistribute from richer to poorer citizens but also decrease the untoward allocative effects of (non-price-discriminating) monopolistic pricing. An income tax used to fund low-income housing programs will have some adverse allocative impact on work and savings decisions; an ideal rent-control statute, eliminating only the capacity of landlords to charge scarcity rents on already-existing units, has few adverse allocative effects on the taxpayer side, though it arguably misallocates among buyers, assuming one wants to ration the scarce good by willingness to pay.

Moreover, though regulations may often seem unfair in horizontal equity terms, it is far from clear that broad-based tax-and-spend programs should invariably seem any less unfair, in part because broad-based tax programs are imperfectly administered. More subtly, though, a broad-based tax-and-spend program may allow those who are in fact particularly responsible for social problems to spread the costs of solving them to others not responsible for the problems or permit concentrated beneficiaries of certain programs to evade the responsibility to pay explicit or implicit user fees/benefit taxes. Similarly, such broad-based programs may allow parties who ought to bear costs privately, because the state should remain inactive, to force others to share losses.

At the same time, it is important to consider the relative efficacy of providing benefits to a target population by regulating private action rather than direct action by the state. If, for example, the regulated party must provide a service, would it do so more or less effectively than the state itself?[3] Even in cases in which it is clear that the private party would better provide the relevant benefit, the question remains whether the private party would better provide the benefit if uncompensated than if compensated.[4] There may well be situations in which private parties will misdesign service programs if the government fully compensates them for all their expenditures. It is not obvious, for example, that if the state agrees to defray the costs to store owners who retrofit their buildings, it will be able effectively to monitor the level of expenditures for reasonableness and/or fraud. Moral-hazard and other problems may often render compensation undesirable.

There are also political-process issues inevitably lurking in the choice among these goal-meeting options, which I address in the next chapter. Those interested in improving the functioning of collective decision making have typically emphasized the virtues of systems that make the cost of implicit government programs more transparent and illustrate more clearly who wins and loses each time the government acts. Furthermore, these scholars have argued that regulation is likely to be less transparent than other forms of government action.[5] Furthermore, state bureaucrats

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3. For example, will store owners do a more or less cost-effective job than a state authority in retrofitting stores to make them accessible to those with mobility impairments? If the regulated party must provide a service at a regulated price, will this aid targeted beneficiaries more or less than would direct government aid in purchasing the good or service at market prices, whether through cash grants or vouchers? For another discussion of this issue, in draft at the same time that I was first presenting these ideas, see Julie A. Roin, "Reconceptualizing Unfunded Mandates and Other Regulations," 93 *NW. U. L. Rev.* 351 (1999).

4. In some situations, it is the only question. Where the regulated party is simply asked to forbear from taking certain steps (e.g., where a local government adopts a restrictive zoning plan; where the state or federal government enacts restrictive conservation regulations), the relevant question is not whether the government will directly supply a superior substitute service (e.g., public parks that somehow make up for the loss of green space that restrictive zoning might otherwise preserve) but whether the benefits of forbearance would be equally available if the state purchased agreements from the relevant private parties to forbear from conduct (e.g., nondevelopment servitudes from otherwise-zoned property owners) or otherwise compensated them for the losses sustained as a result of the restrictive regulations.

5. As Justice Scalia says in the *Pennell* dissent,

> Of course all regulation effects wealth transfers. When excessive rents are forbidden . . . landlords as a class become poorer and . . . at least incumbent tenants as a class become richer. Singling out landlords to be the transferors may be within our traditional constitutional notions of fairness, because they can plausibly be viewed as the source or the beneficiary of the high-rent problem. Once such a connection is no longer required, however, there is no end to the social transformations that can be accomplished by so-called "regulation," at great expense to the democratic process.

facing constrained money-denominated budgets will allocate resources improperly if they can obtain certain goals off budget. Less cost-effective programs might be chosen over more cost-effective ones in which actual dollars must be spent.[6] I question these assumptions but argue that there may be some distinct process problems inherent in using regulation.

The Burden Side

I have emphasized throughout this book that a government may confront what it perceives to be a social problem in four main ways, each of which imposes costs on different groups. The state entity may simply decide to do nothing and let private actors bear losses it might otherwise choose to avert.[7] It may decide to run a program (directly or by contracting service provision out to a private operating entity) but charge users directly, particularly if would-be users could be readily excluded from receiving the relevant service, or through a benefits tax if users could not be readily excluded.[8] The state may regulate conduct that is otherwise problematic to

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> The politically attractive feature of regulation is not that it permits wealth transfers to be achieved that could not be achieved otherwise; but rather that it permits them to be achieved "off-budget," with relative invisibility and thus relative immunity from normal democratic processes. . . . Subsidies for . . . groups may well be a good idea, but because of the operation of the Takings Clause our governmental system has required them to be applied, in general, through the system of taxing and spending, where both economic effects and competing priorities are more evident." (*Pennell v. City of San Jose,* 22–23)

Others argue that regulation is bad in process terms because it is all too transparent that it can be used by the majority to impose all the costs of a program on subgroups of the population. This phenomenon causes majorities to misassess whether benefits are worth their cost (since they do not privately bear these costs in any case) and to focus their political attention less on the public good than on their more particular aims.

6. See, e.g., Posner, *Economic Analysis,* 58–59.

7. Here are some examples of inaction strategies: Cities need not enact zoning plans; parties that would have benefited if their neighbors were more restricted in how they could use property would then suffer losses (and would suffer still more losses if the state narrowed its nuisance law), either because they had to expend funds to purchase negative equitable servitudes or because the value of their property would fall. The federal government need not maintain the National Park Service, funded through taxes; it could auction off existing parkland to private developers, who could choose to charge entrance fees or to sell the land off to mining interests if that proved more profitable. Would-be park users (as well as those with political commitments to naturalism and those with a desire to maintain use options for themselves or their descendants) would bear costs they do not now shoulder.

8. The federal government could maintain national parks but charge those who visit the parks an unsubsidized price; it could do so whether it operated the parks or contracted out operations to a private entity that was contractually obliged to operate the land as a park.

avert the problem.[9] The government may establish a wide variety of taxes to fund perceived needs—taxes on income, consumption, consumption of certain items,[10] real property, personal property, imports (tariffs), excess profits,[11] profits earned by some or all sorts of corporate entities, gifts, or

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The federal government could build dams to increase water supplies but charge water users unsubsidized prices. Cities could collect taxes earmarked for fire protection based on the projected costs of fire fighting: high-rise owners might pay more, as might those with less fireproof buildings. Air-quality control projects, whose users are not readily excluded, might be funded by some combination of benefit taxes (set highest for those residing in areas in which air quality is otherwise most problematic, e.g., because the area is located in a basin that typically traps pollutants) and implicit nuisance fees (surcharges for activities that most compromise air quality).

9. Municipalities may enact zoning plans; the federal government may mandate that habitats necessary to preserve the viability of certain species be maintained by those who own the sensitive habitats; emissions from cars and power plants may be limited; fire-fighting costs may be limited by enacting a building code that mandates more and better sprinklers or fire-retardant materials.

10. There might be fairly broad-based sales taxes with relatively few or no exemptions or sales taxes levied on a rather narrow list of items (usually luxury taxes). A sales tax, whether broadly or narrowly based, might be direct (as most state and municipal sales taxes are now, as VATs would be if enacted) or implicit (as is the denial of an otherwise-available deduction for certain items in the federal income tax). Thus, one could think of the denial in §280F of the Internal Revenue Code of full deductions for otherwise-deductible luxury cars as a form of federal luxury sales tax on those items. Naturally, there is some question about whether the deduction restriction acts as an implicit tax or better implements a more ideal income tax. Some would argue that in cases in which taxpayers embed unneeded consumption benefits in their business expenditures by purchasing products of which only some more austere version is actually necessary to generate income, net taxable income is best measured net only of that portion of the spending needed to generate the income.

This dilemma simply states the common problem in distinguishing tax expenditures (deliberate forbearance from the collection of taxes, designed to encourage particular activity and often replacing explicit programs for spending on the same activity) from appropriate deductions: Do deductions for health care expenditures (or noninclusion of health insurance benefits in income) act as an implicit government-funded health care program, or do they realize the goal of measuring income properly by excluding from income funds expended to return taxpayers to some premorbidity baseline of good health? For general discussions of the ambiguity of the tax-expenditure concept, see, e.g., Boris Bittker, "Accounting for Federal 'Tax Subsidies' in the National Budget," *Nat. Tax. J.* 22 (1969): 244; Boris Bittker, "The Tax Expenditure Budget—A Reply to Professors Surrey and Hellmuth," *Nat. Tax. J.* 22 (1969): 538. For discussions of the issue in relationship to health care, compare William Andrews, "Personal Deductions in an Ideal Income Tax," *Harvard L. Rev.* 86 (1972): 309 (medical care deduction is needed to measure income properly), with Mark Kelman, "Personal Deductions Revisited: Why They Fit Poorly in an 'Ideal' Income Tax and Why They Fit Worse in a Far from Ideal World," *Stanford L. Rev.* 31 (1979): 831, 858–79 (availability of the medical care deduction misstates taxpayers' relative incomes).

11. Some taxes are clearly directed at excess profits (or economic rents)—e.g., the federal government levied a tax on excess profits in the oil industry in the mid-1970s, when worldwide crude prices rose dramatically in part as a result of OPEC's success in restricting production. It is possible, of course, to view existing progressive rate structures in routine income

bequests. In each case, it is vital to consider first whether the parties who will bear costs will change behavior in a desirable or undesirable way to avoid bearing costs. It is also necessary to consider whether it is unduly administratively costly to impose costs on private parties in the chosen fashion and, finally, whether the choice of parties to bear costs comports with fairness norms.

1. What Will the Parties Do to Avoid Bearing the Costs?

There is no categorical response to each form of policy instrument that permits evaluation of the efficacy of these policies in some general sense. Thus, for example, the behavioral response to the imposition of sales taxes is not always the same but will typically depend on more particular empirical facts, most notably the sales tax level and the demand elasticity for the taxed good. Nonetheless, it is helpful to think about citizens' prototypical behavioral responses to each sort of government program.

(a) Government inaction

Broadly speaking, private actors can evade the costs of government inaction only by either altering their behavior so that these costs are reduced or by insuring against loss. At times, of course, each citizen will internalize all or nearly all the costs of government inaction. (Imagine a fire department's refusal to tend to fires in remote areas unless risks to other property owners were substantial.) At other times, the citizen might have some private incentive to reduce a problem about which the government was passive but would still not bear all relevant social costs. (Imagine the municipality refusing to dispose of garbage. Particular property owners will bear some but not all costs if they continue to generate substantial levels of garbage that are not disposed of, but neighbors will bear some costs as well.)[12]

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tax systems as a method for imposing an administratively imperfect tax on economic rents: in this view, higher earners typically earn returns in excess of those needed to induce the earners to supply the specialized labor they would provide at lower net wage rates, so that (relatively) high marginal tax rates simply transfer some of those rents to public users. See Barbara Fried, *The Progressive Assault on Laissez Faire: Robert Hale and the First Law and Economics Movement* (Cambridge: Harvard University Press, 1998), 149–59 (detailing the history of this idea among progressive economists).

12. There are certainly times when it appears that the incentives for the private party to reduce the problem are sufficiently powerful for it to take socially optimal steps, even though a social surplus is generated when it does so. Thus, private owners might be trusted to select optimal strategies to deal with rodent infestation, even though others will benefit if they get rid of the rodents; this decision depends on whether there is incremental value to taking certain precautionary expenditures that might be irrational for owners themselves to take.

Generally speaking, the government will adopt an inaction strategy because it feels that allowing private parties to bear certain costs will induce them to take the desirable (from a social perspective) step of avoiding the costs because private parties are the cheapest cost-avoiders.[13]

However, the fact that an explicit government program may increase social losses compared to an inaction strategy (e.g., through creating moral-hazard problems) does not mean that such is the case. There will be nothing resembling strong empirical consensus in trying to identify situations in which moral-hazard problems are most pronounced. For example, Federal Emergency Management Agency relief programs may or may not unduly encourage parties to overbuild in areas atypically subject to natural disaster.[14] Similarly, some would argue that if the problem is to reduce the ill consequences of unemployment, the best strategy is inaction, since only then will workers face appropriate incentives to shorten or avoid spells of unemployment. However, as an empirical matter, unemployment insurance may or may not in fact substantially increase the incidence and duration of unemployment.[15] Moreover, the optimal duration of job search is not obvious. Thus, it is necessary to know not only the behavioral impact of a move from the tax-and-spend program to inaction but also how the shift should be evaluated. In some sense, one would think that the norm here might be relatively clear: a party should continue to search only when

13. In this sense, it might be more apt, conceptually, to argue that the virtues of the inaction strategy are virtues not on the implicit tax side but on the implicit spending side. Those who are burdened by government inaction also benefit from the steps that are taken—by the burdened parties themselves—to minimize the social problem that is deliberately left to be dealt with privately rather than solved through some more explicit collective program. The arguments in favor of inaction are typically that private parties will do a better job solving the problem in a less costly fashion or that, distributively, no one else ought to bear the relevant costs. One can describe this argument, then, as saying either that there will be favorable rather than perverse responses to the tax or that the spending party will be more effective than a government provider or regulator.

14. A typical, nonempirical argument asserting that such programs will have this untoward effect is found in Saul Levmore, "Coalitions and Quakes: Disaster Relief and Its Prevention," *U. of Chicago L. School Roundtable* 3 (1996): 1, 7–8.

15. Compare, e.g., Martin Feldstein, "Temporary Layoffs in the Theory of Unemployment," *J. of Pol. Econ.* 84 (1976): 917, and Robert Moffitt and Walter Nicholson, "The Effect of Unemployment Insurance on Unemployment: The Case of Federal Supplemental Benefits," *Rev. of Econ. and Stat.* 63 (1982): 1 (both arguing that unemployment insurance has substantial effects on unemployment and unemployment duration), with Daniel S. Hammermesh, *Jobless Pay and the Economy* (Baltimore: Johns Hopkins University Press, 1977), 32–39, and Stephen T. Marston, "The Impact of Unemployment on Job Search," *Brookings Papers on Econ. Activity* 13 (1975) (offering low estimates of impact of unemployment insurance).

the expected prospective increase in discounted lifetime income (broadly defined so that all improvements in, for example, job satisfaction are monetized) that increased search would generate are greater than the losses from not working. If unemployed workers are spared (some substantial portion of the) losses as a result of government-provided insurance, they will oversearch. But in the absence of perfect capital markets, which would permit them to borrow readily against the higher future earnings increased search might bring, it is not clear that unemployed workers will not accept new job offers prematurely as a result of liquidity constraints unless the state insures them against wage loss.[16]

Even if a program causes social losses to rise, it does not automatically permit the conclusion that the program reduces social welfare. It might be desirable to redistribute a lower net social product. Thus, for example, casualty insurance may at least marginally increase casualties and hence social costs but still increase social welfare because the insurance better distributes losses, given both loss aversion and the declining marginal utility of income.

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16. Similarly, the provision of public welfare (e.g., AFDC or food stamps) may or may not increase birthrates or dependency relative to the inaction (no welfare) strategy. Compare, e.g., Charles Murray, *Losing Ground: American Social Policy 1950–1980* (New York: Basic Books, 1984) (arguing that welfare increased dependency and illegitimate births), with David Ellwood and Laurence Summers, "Poverty in America: Is Welfare the Answer or the Problem?" in *Fighting Poverty: What Works and What Doesn't,* ed. S. Danziger and D. Weinberg (Cambridge: Harvard University Press, 1986) (welfare's muted impact on withdrawal from labor force, long-term dependency, and birthrates).

Even if the effects on, for example, fertility were less ambiguous, it is important to recall, once again, that policymakers must understand their own preferences as well as come to conclusions about the empirical impact of different governmental decisions. If it were assumed, for argument's sake, that the behavioral effect of a cutoff of transfer payments (whether AFDC historically or TANF today) would be to reduce fertility to some extent, it would be necessary to know how to evaluate whether such a reduction was a desirable or undesirable behavioral outcome. One would have to decide whether the ideal fertility rate (for those whose fertility rates would fall) should reflect policymakers' preferences and/or the preferences of the women whose decisions would change if the government substituted inaction for a tax-and-spend program to deal with the problem of poverty. If the latter were the case, one would also have to decide how to judge what these women's ideal preferences are, given that the preferences differ under each sort of background circumstances. Some might argue, for example, that the ideal fertility rate is the rate that mothers themselves desire in a world in which their personal financial circumstances do not change depending on the number of children they have, but this view is hardly uncontroversial: for most parents who receive no explicit public assistance, children are (at least somewhat) costly. See, generally, Christopher Jencks and Kathryn Edin, "Do Poor Women Have a Right to Bear Children?" *American Prospect* 20 (1995): 43 (the sorts of controls that would realistically dampen fertility—e.g., compulsory Norplant implants and forced sterilization—are all politically unacceptable).

Inaction is generally thought to be a poor strategy when coordination problems among private actors prevent the formation of private consortia that would establish appropriately scaled solutions. But there are certainly controversies about the situations in which such coordination problems exist, even when virtually everyone would concede that scattered individual efforts to minimize social costs would be inapt.[17]

(b) User fees

Private parties can evade voluntary user fees simply by not purchasing the government service. As long as third parties would not significantly benefit if the services were purchased by users, and as long as the public provider is not wary, for paternalistic reasons, of the wisdom of the decision maker's failure to purchase, this response is typically unproblematic. The service is presumptively not worth its cost to people who choose not to avail themselves of the service.

Obviously, though, in many situations in which the government chooses to employ user fees, third parties also gain from the use.[18] If third parties benefit, of course, the actor's decision to forgo the purchase of the government's service may be privately rational but socially undesirable: subsidized provision theoretically dominates in such cases. Administrative difficulties will abound, though, when one tries to determine the appropriate size of the subsidy or weigh the dangers of overconsumption with a subsidy against the risk of underconsumption without one. The degree to which third parties really benefit, for example, from having educated compatriots is open to both empirical and philosophical question.[19]

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17. The classic example of a good that theorists predict would be undersupplied by private parties is lighthouses, yet some argue that private parties will solve coordination problems even in providing that quintessentially public good. R. H. Coase, for example, argued that shipwrecks would be prevented by fee-for-service privately operated lighthouses ("The Lighthouse in Economics," *J. of L. and Econ.* 17 [1974]: 357, 375).

18. Thus, to reiterate an earlier example, users of national parks who pay to preserve them help maintain them for those with political attachments to their maintenance and those who wish to preserve an option for use by themselves or their descendants; neither of these second two groups is readily identified or, even if identified, charged. Similarly, third parties may benefit from other citizens' decisions to purchase state-provided schooling (or drug and alcohol rehab services or psychological counseling that reduces abusiveness), but it is easiest both to identify and exact a fee from the primary recipient of the service.

19. Some of the philosophical questions about user fees may be quite intractable. The question of whether particular people benefit so atypically from a government program that it is appropriate for them to bear its costs depends on highly contested assumptions about the degree to which individuals within communities are altruistically linked as individuals and/or

(c) Regulation

Regulatory evasion strategies are complex and must surely be considered on a case-by-case basis. For example, regulations that demand that certain costly benefits be provided to certain employees might induce parties to avoid hiring those potential employees.[20] If it is too costly to provide the property, services, or cash that a government seeks to exact when property is developed, the property owner might choose not to proceed with development. Demands to preserve still-fragile, high-quality natural environments or man-made ones (e.g., historic-preservation ordinances) might induce parties to destroy[21] the sorts of environments regulators want to preserve before they are subject to preservation requirements.[22] Similarly,

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all subsumed in some broader community. Take the classic public good, defense. Assume that as an empirical fact, individuals living in New York City are more likely to be killed by nuclear attacks than those living in Montana. The question of whether an attack that kills New Yorkers is a nondifferentiable attack on the United States, so that all citizens benefit from averting such an attack, or an attack of most concern to a subset of Americans is not just empirical but complex and normative.

20. Thus, one would expect that regulations forbidding low-cost discharge would have some disemployment effect; that antidiscrimination rules that made it more likely that one would be sued if one discharged protected rather than unprotected employees would have some negative effect on the employment levels of protected workers; that the ADA's requirement to accommodate disabled workers without charging them the costs of accommodation would lead to some disemployment effects on disabled workers; that the requirement that employers pay workers some minimum wage would block the employment of at least some workers who would willingly work for a lower wage. As I note in the text, the direction of these effects is far clearer than their magnitude.

21. One might also argue, as Donald Wittman did, that historic-preservation regulations would, at the margin, induce parties not to create interesting buildings since building a high-quality building might ultimately subject the parcel owner to income-reducing regulation. See Wittman, "Liability for Harm or Restitution for Benefit?" *J. of Legal Stud.* 13 (1984): 57, 74–75. But it seems unlikely, given typical discount rates for low-probability events in the distant future, that the magnitude of that undesirable behavioral impact would be great. A builder is, in essence, assessing whether the income stream from the property is likely to be adversely affected if his better plan is declared worthy of preservation some fifty to a hundred years hence and there is some use at that point that is economically preferable to preservation. The present value of income streams in the distant future is typically quite low given prevailing interest rates, and the capacity to predict which buildings will be subject to regulation in a few generations is so poor that the event may simply be ignored.

22. Buzz Thompson emphasizes this problem in relationship to the Endangered Species Act. See Barton H. Thompson Jr., "The Endangered Species Act: A Case Study of Takings and Incentives," *Stanford L. Rev.* 49 (1997): 305. Particularly in situations in which regulators give developers a long lead time before declaring particular properties off-limits rather than imposing unforeseen requirements rendering property undevelopable, citizens may rush to develop before the ban takes effect. Where, as in the case of the ESA, nondevelopment will not be ordered until a species is listed as threatened or endangered, developers aware that

regulatory demands to serve certain existing customers at lower prices may induce sellers to avoid entering ongoing buyer-seller relationships with those customers.

The critical question in each case is magnitude. Thus, for example, the ADA's demand that employers accommodate disabled workers almost surely has some disemployment effect on disabled workers, assuming (quite reasonably) that supplementary antidiscrimination norms that forbid hiring discrimination against those with disabilities are imperfectly enforceable, but the size of such disemployment effects is very difficult to discern.[23]

At times, though, regulations may better minimize adverse behavioral responses than any conceivable general tax could. Exactions, which are

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they may own crucial, ecologically sensitive sites will be tempted to develop before regulations are put into place. In such cases, the ability of the regulators to guarantee that developers will lose nothing if the most socially valued use turns out to be nondevelopment (whether through voluntary purchase or the Takings Clause) might forestall inappropriate development.

It may be the case, though, that when developers rush to develop to evade uncompensated regulation, they heighten the regulating public's political sensitivity to problems that might otherwise escape appropriate attention. In Palo Alto today, one might argue that the appropriate decision to preserve the town's atypically large prewar housing stock was precipitated by moves toward the rapid destruction of that stock. Had the homes disappeared at a more natural pace, public awareness of the impact of the attrition may have been far lower. Moreover, at any point in time, adopting rules that would seemingly serve only to protect small numbers of homes might seem foolish. At the (natural) margin, the destruction of the homes is trivial. Only when looked at as an aggregate phenomenon, as when the rush to evade potential restriction occurs, is its importance appreciated.

23. See Peter David Blanck, "Assessing Five Years of Employment Integration and Economic Opportunity under the Americans with Disabilities Act," *Mental and Physical Disability L. Rep.* 19 (1995): 384, 386 (employment levels for the four thousand mentally retarded children and adults in Oklahoma who were the subjects of the author's ongoing longitudinal survey improved from 1989 to 1994; unemployment rates in the state generally stayed around 6.8 percent, while unemployment among the surveyed group dropped from 39 percent in 1990 to 21 percent in 1994). See also Jay Mathews, "More Disabled Hired, Census Study Shows; Federal Law Created Jobs, Access to Buildings," *Washington Post,* Jul. 26, 1996, F3 (detailed census data showed that the percentage of Americans with severe disabilities who were employed had risen from 23.3 percent in 1991 to 26.1 percent in 1994). But see S. Rosen, "Disability Accommodation and the Labor Market," in *Disability and Work: Incentives, Rights and Opportunities,* ed. C. L. Weaver (Washington, D.C.: AEI Press, 1991), 18, 22 (finding little evidence that antidiscrimination law increases employment of the disabled, though not suggesting that such legislation decreases employment). I am skeptical about whether there is as yet any good information on such disemployment effects, particularly information that distinguishes among all relevant groups of workers with disabilities. I would expect these disemployment impacts to be most significant, if they exist at all, among workers with certain forms of emotional disabilities and chronic fatigue problems who might seek work-pace and work-continuity accommodations rather than additional physical equipment.

essentially taxes negotiated ex ante with a potential developer, can be designed to capture location-specific economic rents. As a consequence, the exactions may well avoid shifts in desirable development plans or jurisdictional flight.

Naturally, the worry is that the locality will be tempted to impose exactions ex post on any supernormal profits that cannot now be earned in another jurisdiction, though doing so will create undesirable disincentives to create the supernormal profits in the first instance.[24] Imagine, for example, a store seeking a larger parking area needed to serve its atypically large and loyal customer base. The municipality might be tempted to exact concessions that strip (nearly all) the locationally specific supernormal profits (e.g., goodwill not fully transferrable to another site), though such a strategy would in fact have perverse effects on productive activity in the long run if other store owners recognized that they would be subject to confiscatory taxes if and when they needed to deal with the city (whether to expand a parking lot, extend a building, change infrastructure, and so forth).

But exactions that deliberately act as traditional tax substitutes (rather than user-fee substitutes) might not seize the supernormal profits that a party created. Ideally, these exactions should attempt to seize the supernormal profits that derive from locational rents that no particular

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Similarly, some claim that hiring has been blunted by making it more costly to fire employees generally or some subset of employees. See, e.g., James N. Dertouzos, Elaine Holland, and Patricia Ebener, *The Legal and Economic Consequences of Wrongful Termination* (Santa Monica: Rand, 1988).

Whether the minimum wage results in high levels of disemployment, particularly among teenagers, has been the subject of enormous controversy. Compare, e.g., Finis Welch, "Minimum Wage Legislation in the United States," *Econ. Inquiry* 12 (1974): 285 (minimum wage causes substantial disemployment), with David Card and Alan B. Krueger, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania," *Am. Econ. Rev.* 84 (1994): 772 (disemployment effects are insignificant). For an excellent critical summary, focusing especially well on nonregulatory options that might serve the purported ends of the minimum wage more effectively, see Daniel Shaviro, "The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy," *U. of Chicago L. Rev.* 64 (1997): 405.

24. The insight that government action that appears unexceptionably desirable ex post may cause problems as long as the government cannot assure actors that it will prospectively restrain from taking parallel steps in the future is most associated with Finn E. Kydland and Edward C. Prescott, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *J. of Pol. Econ.* 85 (1977): 473. Thus, for example, expropriating any particular patent holder is efficient ex post: the invention has already been created, and charging any positive price to diffuse the information, as a patent-holding monopolist will, would result in underconsumption of the information given that diffusion has a near-zero marginal cost. But future inventors might well mistrust assurances that returns to their inventions will be protected.

landholder does anything to develop. A developer who chooses to build a subdevelopment in one (atypically desirable) political jurisdiction rather than another (less desirable) one will not be dissuaded from doing so if the tax imposed in the superior jurisdiction is not high enough to lower the value of the underlying land to him. A tax on such locational rents should, if anticipated, bear not on the developer but the landholder from whom the property is purchased. It may well be the case, though, that because the precise size of exactions is unknown ex ante, developers may often overpay for land (not receiving an appropriate discount to account for the actual typical taxing practice).[25]

Similarly, maximum price controls directed solely at scarce goods whose supply cannot reasonably increase or solely at goods that have already been produced will have an impact only on how the available goods are rationed among buyers but will not induce sellers/producers to alter their conduct. Obviously, the question of whether typical local rent-control statutes do or do not meet this description is heated.[26]

It seems clear, however, that regulations can be tailored in ways that have more or less undesirable impacts on behavior. In certain forms, a regulatory scheme may affect behavior in less troublesome ways than an equivalent general tax, while in others, the regulation's impact might be far more troubling. I understand that this claim seems to violate the standard public-finance supposition, associated with Stiglitz, that even traditional Ramsey excise taxes—levied on goods for which demand is inelastic—are less efficient than income taxes unless the excise tax is levied in such a fashion that it corrects for the leisure/work trade-off distortion inherent in an income tax (e.g., by taxing goods that are complementary to leisure and hence implicitly taxing otherwise untaxed leisure).[27]

25. It is then an interesting question whether developers could successfully evade exactions by arguing that they cannot afford to build at prevailing market prices or receive construction financing if charged the typical exaction. (The overpayment may be corrupt—i.e., there are effective kickbacks—or simply a function of incompetence.)

26. Compare, e.g., Richard Ault, "The Presumed Advantages and the Real Disadvantages of Rent Control," in *Rent Control: Myths and Realities,* ed. W. Block and E. Olsen (Vancouver: Fraser Institute, 1981) (opposing rent control), with Weitzman, "Economics and Rent Regulation," 975 (supporting rent control).

27. This position is described well in Joseph Stiglitz, "Pareto Efficient and Optimal Taxation and the New New Welfare Economics," in *Handbook of Public Economics,* ed. Alan Auerbach and Martin Feldstein (Amsterdam and New York: North-Holland, 1987), 991, 1023–27. Put more formally, the argument is that as long as the utility function can be separated between consumption and leisure, Pareto-efficient tax structures do not tax commodities. If the utility functions are inseparable, it would be possible, by taxing commodities for which the utility functions are inseparable, to tax higher-ability individuals without having them try to disguise themselves as lower-ability individuals.

First, though, it is not nearly so inevitable that the burden of regulations increases as income increases; in virtually any case in which a classical commodity excise tax is assessed, payers will recognize that they bear both a tax on increasing income (since they will spend some of that income on excise-taxed items) and the excise tax itself, which will have some distortionary impact on consumption decisions. It is not clear, though, that parties would or should believe each of their regulatory obligations will invariably increase if they earn more.[28]

Moreover, even in cases in which regulatory burdens (like excise tax burdens) typically increase with income, I believe that Stiglitz's argument is correct only on the highly unrealistic supposition that taxpayers both know their consumption plans at the time they make work/leisure trade-off decisions and can integrate this knowledge properly. If taxpayers do not meet these conditions, they will not treat the particular excise taxes as implicit increases in their income tax rates.[29]

Not only does Stiglitz's argument assume an unrealistically high level of foresight about how the money one earns will be used, but his argument also assumes cognitive processing capacities at odds with what I believe has been demonstrated in a good deal of cognitive psychological literature. I think there is substantial (concededly ambiguous) evidence that people solve choice problems sequentially and in a compartmentalized or bracketed manner when such problems are in some sense difficult.

People solve problems sequentially in the sense that they solve the relatively easy aspect of the whole, complex problem first and then become anchored to that solution, so that by the time they solve the second part of the problem, it is difficult to change their choices. I believe this concept is the single best explanation for such phenomena as the contrast effect, demonstrated in experiments such as one in which persons asked to choose between a Mark Cross pen, a low-quality pen, and six dollars choose the Cross pen over the money more frequently than those not offered the low-quality pen. The sequentialist account of this behavior is that the experi-

28. For example, the size of the optimal exaction the owner in the *Dolan* context faces does not depend on the profitability of the hardware store but on the size of the locationally specific rent. The Dolans will not, for example, face an incomelike tax on earning more profits by increasing the number of hours the store is in operation. Similarly, the losses borne by owners facing newly restrictive zoning plans are not obviously income elastic.

29. I made precisely the same argument in criticizing Shavell and Kaplow's claim in "Why the Legal System Is Less Efficient" that the income tax dominates liability rules as a redistributive mechanism (see chap. 4, n. 2) although I believe that their assumption that people will anticipate higher liability judgments in making work/leisure trade-offs is even more unrealistic than Stiglitz's assumption that parties will rationally anticipate the degree to which discretionary earnings will be partly eaten up by excise taxes.

mental subjects first choose the Cross pen over the other pen (almost instantaneously, in their minds) and then become anchored to the choice of the Cross pen before making the more difficult choice between the pen and the cash.[30]

People solve problems in a compartmentalized or bracketed fashion in the sense that they often fail to integrate two decisions that, were they integrated, would appear to a noncompartmentalizer to create an outcome identical to an alternative single decision. I believe that this is the single best explanation for the apparently irrational aspects of risk-seeking behavior of defendants in civil suits.[31] It is also the best explanation for

30. See Mark Kelman, Yuval Rottenstreich, and Amos Tversky, "Context-Dependence in Legal Decisionmaking," *J. of Legal Stud.* 25 (1996): 287, 288–89.

31. For a discussion of such risk seeking, see Jeffrey J. Rachlinski, "Gains, Losses, and the Psychology of Litigation," *Southern California L. Rev.* 70 (1997): 113. I should note that the evidence from actual market behavior that Rachlinski adduces (see pp. 150–60), would and should not wholly persuade a traditional expected-utility theorist that defendants are in fact risk seekers. Defendants may well offer settlements less than those plaintiffs are willing to accept because settling a suit with a single plaintiff may expose them to further losses, while a plaintiff will receive all of the settlement offer, net of attorney fees. Thus, imagine a suit in which the defendant believes there is a 50 percent chance of losing a hundred thousand dollars and a 50 percent chance of being exonerated; he will not offer as much as fifty thousand dollars to settle if settling will cost him an additional thirty thousand dollars in expected costs from encouraging additional plaintiffs. Rachlinski asserts such secondary costs will increase the stakes but not alter the risk analysis. The risk analysis would be unchanged only if losing the suit in court would cost an additional sixty thousand dollars in secondary costs, so that the expected value of going to trial rose by the same thirty thousand dollars. But settling and losing may or may not pose much more similar secondary costs. Furthermore, Rachlinski's claim that defendants lose a great deal as a class by failing to settle depends on his questionable assumption that they typically pay the high judgments that are reported rather than appealing or renegotiating those huge judgments that so drive his data. In a variety of ways, the experimental evidence he proffers seems less ambiguous but is subject to the typical objections to the external validity of such experimental research.

Assume, though, that defendants in litigation are risk seekers, refusing to accept settlement offers that risk-averse or risk-neutral parties would accept. They thus behave according to the descriptive dictates of prospect theory, preferring risks when they face losses from a baseline while remaining averse to risks in relationship to gains from that baseline. That behavior is not irrational, although it is not the behavior predicted by traditional expected-utility theorists who believed that people were risk averse but were decreasingly so as income increased: the fact that people's utility schemes are path dependent so that losses and gains from prior positions are asymmetrical does not violate deep rationality norms. Defendants are clearly irrational in doing so only in the limited sense that if they did not compartmentalize choices, they could increase their utility by (nearly) simultaneously settling the case and gambling with the remainder of the money at stake if they went to trial in some gambling event with lower transactions costs than a trial. Thus, rather than turn down the settlement offer of fifty thousand dollars, the risk seeker ought to accept it and gamble another fifty thousand dollars on a 50 percent odds bet paying one hundred thousand dollars 50 percent of the time. But if defendants separate the two decisions, they would be doing *two* things that certain forms of otherwise puzzling consumption-diversification decisions.[32]

It strikes me that it is behaviorally plausible to think that people consider working more (or taking a higher-paying job) net of (relatively easily computed) income taxes or that they consider buying a more or less expensive (excise-taxed or untaxed) good but that their capacity to integrate the two decisions is limited. Such is the case in part because processing the impact of the excise tax on the work decision is simply so cognitively complex ("If I work more or take a higher-paying job, I will consume more, and some of what I will consume will be goods subject to excise taxes, unless I substitute untaxed goods for taxed goods, in which case I must still recognize that my increase in real earnings will be diminished through deadweight loss.") More important, perhaps, in terms of implicit sequencing, it seems plausible to believe that once people make their work/leisure decisions after processing income tax information, the choice to work stays anchored. In terms of compartmentalization or bracketing, it would seem most plausible that in making the decision of whether to substitute work for leisure, the fact that excise and earnings-directed taxes could be combined into a single tax on earnings will not be salient to many decision makers.

Furthermore, it is clear that an income tax that identified economic rents and taxed them more heavily than nonrent earnings would be allocatively superior to a general income tax, and regulations may function as an implicit income tax identifying rents only. Thus, though it would not be administrable, it would surely be preferable in efficiency terms to tax, for example, a professor more on her rents as a professor than on her marginal

cause utility loss if they followed the seemingly rational cost-minimizing strategy. First, they would accept a certain loss by settling the case; then, they would gamble seeking a gain. Defendants would simply not bracket the decision to settle and gamble as a single decision: seeking risk as to losses in the cheapest way possible. Compartmentalization may conceivably be a function of limited cognitive resources (if one is to integrate the decisions, one will have to calculate precise estimates of litigation probabilities and damage distributions, which may be very difficult); it may conceivably result from a more profound psychological tendency to divide the world into incommensurable spheres of activity.

32. Children selecting Halloween candy "diversify" their candy portfolios when offered two pieces of two distinct candies at a single house but select their favorite candy two successive times if offered one piece of candy at two successive houses, though if their desire were to diversify their candy holdings, they should do so whether the choice was simultaneous or sequential. See Daniel Read and George Lowenstein, "Diversification Bias: Explaining the Discrepancy in Variety Seeking between Combined and Separated Choices," *J. of Experimental Psychol.: Applied* 1 (1995): 34, 45–46. A visit to a single house seems to constitute the appropriate mental bracket.

consulting income (assuming higher disutility in generating that income) rather than taxing her whole income at a single rate; regulations may impose, in an approximate way, such a differentiated tax.

Still, recognition of the possible adverse allocative effects of regulation should lead to greater care in analyzing existing regulatory programs. If, for example, the ADA imposed only a uniform cost-based, per-employee accommodation requirement on all employers, the act would function, in essence, like an enterprise tax whose size was based on the number of disabled employees employed by a firm. The standard assumption is that such a tax (to the extent it were not evaded by failing to hire those with disabilities) would be borne dominantly by the firms' consumers, who would, to some modest extent, substitute goods produced by firms with fewer disabled employees for those produced by firms with more, depending on demand elasticities for the relevant goods.[33] (Firms with atypically high numbers of disabled employees compared to other firms within an industry would be expected to bear a disproportionate share of the tax. Profitability is decreased to the extent that one bears costs that do not affect typical industry costs and hence prices.) To the extent that one accepts my view that a hidden excise tax would not have an especially strong impact on work incentives, since there would be very limited recognition of the fact that one would not retain all of one's marginal earnings given the higher prices of consumed goods, this sort of implicit enterprise tax would typically have less perverse incentive effects than an increase in broad-based income taxes that might be used to fund a general governmental program to make workplaces more accessible. An implicit

33. If the accommodation tax were based not on the number of disabled employees but the number of workers generally, there would be no disincentive to employ workers with disabilities. In that sense, of course, one would prefer that sort of tax to a tax on employers of those with disabilities if disemployment effects were of significant magnitude. Consumers would, however, substitute goods produced by less labor-intensive firms for those that were more labor intensive, again depending on demand elasticities given relevant price changes.

But the firms would have no incentive to integrate workers with disabilities into the firm or to learn how to lower accommodation costs if the tax were a requirement to spend a certain amount accommodating however many disabled employees the firm happened to have, based on the aggregate number of employees. The ADA rightly tries to induce employers and employees with disabilities to solve the embodied employees' particular problems in working effectively given the use of the traditional, unaccommodating production technique; merely mandating that a firm spend a certain amount of money on disability-related projects (depending on the size of its workforce) may be reasonable on the implicit tax side, but it appears an extremely poor implicit spending program, providing no real incentives for employers to work to integrate people whose productive capacity is wasted in the absence of more imaginative workplace organization.

enterprise tax would, however, like any excise/retail sales tax, presumably be more regressive and hence distributively problematic.

What is both clear and significant, though, is that the ADA regulatory tax as currently formally interpreted—demanding cost-unlimited accommodations at least as long as they do not threaten the viability of the entity that bears them—acts (in theory) as a nearly 100 percent tax on profits above normal profits (those sufficient to sustain a firm's viability). Such a tax would seem, if actually imposed, to act as a considerable disincentive to earn supernormal profits (e.g., through innovation or atypically good management) and hence would seem to have extremely perverse behavioral effects. The firm is told, in essence, that if it earns supernormal profits, it must hire unlimited numbers of disabled employees, accommodating them at any cost, until all the supernormal profits are dissipated. In reality, of course, courts have not ordered hyperprofitable companies to disgorge anything resembling 100 percent of their supernormal profits to accommodate the most seriously disabled potential employees.[34]

Nonetheless, one would imagine that if one were choosing, in terms of behavioral neutrality, between an across-the-board excise tax, increases in the ordinary income tax to fund a general workplace-accessibility program, and an implicit income tax with no obvious rate limits levied on supernormal profits, the excise tax and ordinary income tax would typically cause less deadweight loss.[35] Any regulatory tax whose size varies, without any ascertainable preset limits, with firm profitability poses a considerable danger of blunting appropriate incentives both to innovate and to reduce production costs, particularly if there is a nontrivial probability that an entity will believe itself subject to the tax.

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34. The formalistic legal explanation the courts would generally offer is that employees are not otherwise qualified if they need atypical accommodations, even though such accommodations are, formally, reasonable given that *reasonableness* is defined in terms of entity viability.

35. The concept of deadweight loss or excess burden is commonplace in analyzing explicit taxes. It refers to the difference in welfare levels that taxpayers and the tax-collecting authority would reach if taxpayers were subjected to a nonevadable head tax of the same size as the particular tax they might choose to evade and the welfare levels attained given the taxpayers' choices in a world in which the tax burden can be minimized. See, e.g., Harvey Rosen, *Public Finance,* 4th ed. (Chicago: Irwin, 1995), 303. Thus, for example, if good *X* is subject to sales tax *T* and good *Y* is not, and the consumer *Z* prefers *Y* to *X* at *X*'s market price + *T* but not at *X*'s market price, then *Z* has lost, through tax-evasion strategies, the difference in the value between goods *X* and *Y*. That difference is less than *T* (or the consumer would choose to pay the tax), but the tax collector does not receive *T* since the tax is evaded: there is a deadweight loss here since no one receives that difference.

(d) Explicit taxes

The excess costs of traditional explicit taxes, while the subject of an extensive public-finance literature, are themselves no easy matter to ascertain. In weighing the choice between implicit and explicit taxes, though, one must remain aware that explicit taxes often distort behavior, though the magnitude and social costs of the changes in behavior are disputed.[36]

2. A Brief Note on Administrative Concerns

In thinking about administrative cost concerns, it is important to recognize that it is not appropriate simply to compare the administrative costs of one of the broad-based taxes generally to the administrative costs of subjecting a party to regulation. Comparisons must be made of the marginal administrative costs that will be borne if tax proceeds are simply raised (to finance a new spending program) or if requirements are altered for the way an already-regulated party must behave to meet a new goal.[37]

36. If, for example, the government imposes either income or consumption taxes that fall on wages, taxpayers will, to some uncertain extent, substitute (untaxed) leisure and nonmonetized household-created commodities for (taxable) income and market-based consumption. If income (or bequests) are taxed, people will (to some uncertain extent) substitute present for future consumption. Moreover, differential taxation of capital (e.g., as a result of distinct depreciation schedules for different sorts of capital goods, capital gains treatment for some but not all investments, tax exemption of the return to investments in residential housing) may also lead to substantial misallocation of capital. Double taxation may alter behavior as well. Businesses will evade, to some extent, the corporate income tax by retaining earnings (even when the internal rate of return on the earnings is lower than the market rate of return) or by organizing outside the corporate form.

37. Naturally, there will be many situations in which a party is effectively regulated as to a certain form of conduct. It is also the case that there will be (some) situations in which the general tax that would be chosen is not simply an increase in a preexisting tax but a new or more tailored tax designed to cope with a particular problem. Thus, for example, assume that the San Jose City Council in the *Pennell* context decided to fund relief for hardship tenants not by simply increasing the existing local sales or property tax but by levying (a) a general tax on residential property owners only or on some subgroup of residential property owners who rented out their property or some subgroup of either or both these subgroups that held land whose value had changed rapidly, in the view of the taxing authority, as a result of external development that increased land rent rather than development by the parcel owners themselves; (b) an excess-profits tax on residential or all property owners, measured in any of a variety of ways; (c) a progressive income tax that had not previously existed because the city did not believe it operated other programs that were intended to redistribute from richer to poorer citizens. Inaugurating any of these complex taxes might well be costly for both taxpayers and the city bureaucracy; whether the costs would be higher than stabilizing rents for a small subset of hardship tenants is obviously difficult to say, but judgments about such administrative cost differentials will surely be germane.

It is fairly apparent that it will not typically be administratively costly to increase, marginally, the amount of funds collected through general taxes once they are in place. Taxpayers who must simply multiply their taxable base (whether it is income, real property, consumption, or whatever) by a somewhat higher number if taxes are raised will probably bear few administrative burdens.[38]

Conversely, if the state enacts a truly new regulation rather than a more stringent application of existing regulations,[39] administrative costs could be substantial. Employers or public-accommodation owners who must comply with a wholly novel regulation must themselves learn about the regulation and be monitored for compliance by a new, nontax bureaucracy. Increasing tax revenues will ordinarily therefore be a less costly revenue-raising method, in purely administrative terms, than any other option the government entity might choose to deal with a problem.

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38. It is not entirely unambiguous that merely increasing tax rates is administratively costless. It is conceivable that as marginal rates reach some threshold (which they may reach to fund more explicit tax-and-spend programs), the advantages of minimizing the size of the taxable base grow and that efforts at reducing taxes therefore grow. These efforts are administratively costly for taxpayers and necessitate a larger state bureaucracy to counter evasion. (Even if there is no threshold, one might argue that the return to evasive activity increases continuously with increases in rates, so that more such activity would be taken.) There may well be rate thresholds for different taxpayers below which the administrative costs of evasion are not worth bearing. Beyond the threshold, though, the tax is worthwhile to evade, and once one has borne the initial fixed investment in evasion, tax compliance becomes considerably more costly for both payer and collector. Assume, for example, that a tax preparer costs one hundred dollars for his minimum chunk of time and that for that fee he can effectively understate your taxable base by a thousand dollars. Until tax rates reach 10 percent, taxpayers will not hire him, but once rates reach that level, administrative costs rise apace. (The government must try to counter his efforts. It may be worth paying him twenty dollars more to try to understate the base by an additional $250, though taxpayers would not have hired him had rates not risen to a certain point.)

It is possible, of course, not to raise marginal rates but instead to increase average rates if the revenue target increases, thereby even lowering marginal rates. This point is emphasized in Joseph Bankman and Thomas Griffith, "Social Welfare and the Rate Structure: A New Look at Progressive Taxation," *California L. Rev.* 75 (1987): 1905. Thus, increasing tax revenues may not necessitate raising marginal rates (and the concomitant advantage of evasion).

39. I do not mean to suggest that there is a clear line between new and more stringent regulatory regimes. Since, for example, developers already require building permits to proceed with development, one could presumably say that the enactment of a regulatory scheme to meet a newly perceived public end (e.g., historic preservation or maintenance of an affordable housing stock) subjects developers to a mere extension of a preexisting regime. But the relevant question is what developers must do to insure that they comply, persuade the regulatory body that they have taken adequately compliant steps, or avoid substantive compliance. Presumably, for example, hiring experts to testify about the historical insignificance of a building one wants to demolish is costly, and it is not markedly less costly because one already needed to fill out forms for a building permit.

3. Fair Distribution of the Tax Burden

Implicit and explicit taxes are borne by different citizens. In each case, it must be determined, as best as possible, not only who pays the tax (or bears the required costs) but who ultimately bears the burdens. Whether the actual tax burden has been distributed fairly then must be judged.

For some people, the question of fairness reduces to the question of whether the proposed tax-and-spending program moves the overall distribution of income closer to an optimal level, generally evaluated according to some welfarist criterion. (Such theorists are traditionally said to attend to issues of vertical equity.) Some such welfarists believe a Rawlsian maximin distribution is to be preferred to others.[40] Some might believe the distribution must be adequately egalitarian to insure universal participation in the community's political and social culture. More traditional utilitarians might believe the marginal utility of money decreases so that greater levels of equality are always to be preferred, all else equal.

In these consequentialist views, every tax-and-spending program (implicit or explicit) is merely an opportunity for the government to redistribute income toward an optimal outcome. Most commentators who judge fairness by looking at the resulting income distribution typically assume that the tax is more desirable to the degree that it increases posttax equality, setting aside the disincentive impact of such redistributions. While there are a variety of principles to assess whether a particular post-program distribution is superior either to the preprogram distribution or to alternative postprogram ones, most judgments about taxes are simply judgments about relative progressivity, usually based on a classic utilitarian welfarist assumption that the marginal utility of income declines ex post so that parties would be risk averse ex ante.[41]

Kaplow argues that there are no coherent consequentialist distributive principles that are not in the final analysis utilitarian, at least as long as one is unwilling to disclaim the Paretian principle that any end state pre-

40. In such a conception, society is duty bound to maximize the welfare levels of members of the worst-off social class.

41. Naturally, a general preference for some sort of progressivity does not really answer the question of how ideal tax programs ought to be shaped: Hare, arguing against the Rawlsian maximin criterion, notes that the ideal distribution for reasonably risk-averse parties, unlike the infinitely risk-averse parties Rawls posited, might be one with a floor rather than one that maximized the income of those in the lowest class. See, e.g., R. M. Hare, "Rawls' Theory of Justice," in *Reading Rawls: Critical Studies on Rawls'* A Theory of Justice, ed. Norman Daniels (Stanford: Stanford University Press, 1989).

ferred by all parties to another end state should be adopted.[42] Kaplow's argument is straightforward. He posits situations in which every party prefers an outcome that might violate some other norms (outcome egalitarianism; horizontal equity, and so forth) and asks whether one would really willingly overrule the preference for the outcome. If not, of course, the independent principles seem to have no weight. Thus, for example, he asks whether any sort of ostensible outcome egalitarian would prefer greater income equality in a situation in which all parties preferred, at least ex ante, that the more inegalitarian outcome be chosen. Imagine, for instance, choosing between a distribution of some sum marginally less than 50 for A and marginally less than 50 for B and a 60–40 distribution, where either A or B could receive the larger share, where both parties are risk neutral and hence clearly would prefer the second distribution. All arguments that the unanimous expressed preference for the less egalitarian regime should be ignored are, in Kaplow's view, reducible to utilitarian arguments (e.g., the choice would be regretted or is the product of ex ante misperception).

The argument seems true but somewhat trivial as framed. The Paretian principle has no independent role once one incorporates the possibility of ex ante error or preference instability (regret). The fact that A and B both choose the more inegalitarian distribution has independent weight for a Paretian but not for a utilitarian, who substitutes corrected judgments of utility for ex ante ones. Thus, there is reason to doubt Kaplow's statement that individuals' "judgment may be questioned. . . . Accepting [this] criticism does not seriously affect the present argument. One could substitute 'corrected' preferences for actual preferences. . . . The policy maker could consider individuals' 'true' utility rather than perceived utility. . . . [T]he Pareto principle applied to these adjusted preferences would conflict with each anti-utilitarian norm but would be consistent with utilitarianism applied to the adjusted preferences."[43] The Pareto principle simply cannot remain a preference-based, noncontroversial individualistic principle if it is translated into a perfectionist utilitarian principle that no reform should be rejected that actually improves everyone's lot. The adjusted-preference-based utilitarian is just as willing as Kaplow's hypothetical egalitarian in a bind to seek an end state different from that which all subjects choose. Non-preference-based utilitarianism is grounded in all

42. See Louis Kaplow, "A Fundamental Objection to Tax Equity Norms: A Call for Utilitarianism," *Nat'l. Tax J.* 48 (1995): 497.

43. Kaplow, "Fundamental Objection," 504–5.

the sorts of vaguer justifications (egalitarianism, perfectionism, and so on) that Kaplow wants to contrast with Paretian utilitarianism. Judgments that A and B either should want or will actually come to have wanted a more egalitarian outcome because the ex post hierarchy is inconsistent with the development of appropriate community or self-respect or because equality is more consistent with some version of human flourishing are, in essence, just hedonically grounded restatements of the vague ethical principles he wants to avoid. Kaplow seems to confuse a workable utilitarianism with human-centered hedonic consequentialism: such consequentialists, like utilitarians, indeed evaluate end states depending on their impact on human happiness, but utilitarians, more narrowly, look to choice satisfaction.

Others adopt some sort of historical-process criterion in evaluating fairness. In such a view, the posttax distribution may be deemed more just to the degree that it corrects injustices that had occurred in generating the pretax distributions. Or, to take a more libertarian view, the posttax distribution is more just if it does no more than correct for rights violations that had occurred in generating the pretax distribution.

Historical-process theorists often express a preference for both regulation and user fees/benefit taxes in certain cases. In this view, it might be appropriate for parties to bear the costs of a government program, regardless of their relative wealth, insofar as they are the particular source of the problem the government seeks to ameliorate or if they benefit from the program in atypical ways. In that sense, regulation substitutes for tort law (in situations in which the plaintiff class would be too expensive to aggregate); the cost of regulatory compliance is no different, conceptually, than a tort judgment. The regulation corrects the unjust preregulatory distribution of income (the "tortfeasor's" preregulatory income is unjustly inflated because he has not had to pay the damages that he would owe except for the administrative costs of collecting them).[44]

At the same time, user fees/benefit taxes may be appropriate in cases in which there is no reason for the government to subsidize the goods and services that it happens to provide to solve coordination, nonexclusivity, or other problems that make private provision of such goods or services

44. Naturally, it would be best if the implicit plaintiffs benefited from the regulatory expenditures since only then would the postregulatory distribution correspond to the distribution that would have occurred in a just world, free from wrongdoing. For now, however, I focus only on the implicit tax side and hence am concerned with the disgorgement of wrongful gains rather than with compensation for wrongful losses.

impractical. In such cases, it would be unjust for the government to subsidize consumers who happen to prefer to consume goods that are provided by the state since doing so would raise these consumers' real, effective incomes above the level of those who had identical claims on consumption goods given the historical process of generating a preprogram distribution.

Fairness in the tax context has also been taken by many to require equal treatment of all those who are identically situated. This horizontal equity injunction may be empty both normatively and descriptively: no two people are really situated completely identically, and even if they were identical along all dimensions deemed relevant to taxpaying capacity, it is not clear why it would be vital to treat them the same way if there were significant gains from treating them differently. Assume, for argument's sake, that A and B were thought equal in terms of taxpaying capacity if each received the same value of commodities from their employer; assume, too, though that A received a higher portion of his compensation in the form of fringe benefits that were administratively costly to evaluate for tax-collecting purposes.[45] While there might be some reasons to tax A and B equally—for example, for efficiency reasons, it might be desirable to discourage people from overconsuming nontaxable fringe benefits—these reasons would seem simply to compete with the reasons to tax them differently (e.g., it is costly to tax A as much as B).[46]

It may well be the case that what are thought to be intuitions to treat equals equally are actually stand-ins for more particular prudential judgments. For example, one may believe that it is inefficient to tax similarly situated parties differently, since doing so will lead people to substitute untaxed for taxed activities, breaching standard norms against allocative

45. For these purposes, I ignore the difficulty of assessing whether two taxpayers should be judged equal when the cost of providing compensation is equal or when the market values of the goods the employees receive are the same: are two taxpayers similarly situated when each receives the same money salary but one also receives goods with zero or very low marginal cost of provision to that particular employer (e.g., an airline employee given the right to use empty seats on flights)?

46. See Louis Kaplow, "Horizontal Equity: Measures in Search of a Principle," *Nat'l. Tax J.* 4 (1989): 139.

As a practical matter, injunctions to attend to horizontal equity often are interpreted to mean that government programs (including tax programs) ought not reverse the rank order of citizens' pretax/preprogram utility positions. See, e.g., Martin Feldstein, "On the Theory of Tax Reform," *J. of Pub. Econ.* 6 (1976): 77, 79; A. B. Atkinson, "Horizontal Equity and the Distribution of the Tax Burden," in *The Economics of Taxation,* ed. Henry Aaron and Michael Boskin (Washington, D.C.: Brookings Institution, 1982). But such a translation of the horizontal equity norm is highly problematic. First, it implies that even trivial utility reversals are far more significant than massive alterations in the size distribution of income. Thus, for example, assume the pretax distribution of income is 100, 10, 9: the injunction to inefficiency.[47] One might also believe that a polity that can draw arbitrary distinctions among taxpayers or among program beneficiaries will enact programs that favor particular interest groups, without regard to the social benefits of such programs.[48] Similarly, general norms against arbitrariness may help enforce norms against discrimination on the basis of membership in socially disadvantaged castes. It may be more difficult to prove legislative hostility or even indifference to members of a socially disadvantaged group than to forbid programs in which particular citizens are treated worse without any obvious justification.[49] Arbitrary taxes might be unpredictable as well, and to the degree that citizens are risk averse and hence prefer a state in which they are able to predict posttax income with less dispersion, the imposition of such taxes might decrease utility.[50] Finally, as noted in my prior discussion of equal protection in taxation, horizontal equity norms may stand in for norms against undue govern-

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attend to horizontal equity implies that a posttax distribution of 102, 8.9, 8.91 is highly problematic, while distributions of 11, 10, 9 or 60, 50, 9 are not. See Kaplow, "Horizontal Equity." One might choose instead to attend not just to reversals but the level of movement of all parties from their status quo ante position (measuring not so much reversals as the resemblance of pre- and posttax distributions). See Harvey S. Rosen, "An Approach to the Study of Income, Utility, and Horizontal Equity," *Q. J. of Econ.* 98 (1978): 307, for an index that attempts to achieve this goal. By measuring level of movement, though, horizontal equity norms seem to forbid precisely what vertical equity may demand (increases in equality that make the pre- and posttax distributions dissimilar). Second, and more important, any norm that emphasizes the importance of maintaining the pretax distribution implies that the status quo ante has some normative force that it simply does not deserve.

47. Kaplow, "Horizontal Equity," 149.

48. Joseph Stiglitz, "Utilitarianism and Horizontal Equity: The Case for Random Taxation," *J. of Pub. Econ.* 18 (1982): 1. Presumably, this idea is troublesome both because governmental entities should adopt only cost-justified programs and because of the worry that, to some uncertain extent, interest groups will waste undue resources in seeking distributive transfers if such narrow programs are available. This second apprehension is basic to those who fear the formation of a rent-seeking society and attribute slowdowns in productivity growth to the attractiveness of rent seeking. See generally Mancur Olson, *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982), and James M. Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (College Station: Texas A&M University, 1980).

49. See, e.g., Richard Musgrave, "Optimal Taxation, Equitable Taxation, and Second-Best Taxation," *J. of Pub. Econ.* 6 (1976): 3.

50. Kaplow, "Horizontal Equity," 145–46. See also G. Brennan, "Horizontal Equity: An Extension of an Extension," *Public Finance* 26 (1971): 437. The idea that a violation of horizontal equity in taxation is essentially equivalent to undue risk imposition may motivate the belief that the Takings Clause should be understood as mandating publicly provided insurance against the risk of unexpected government actions that alter the value of owners' holdings. The question then arises of whether there are significant market failures in the provision of insurance against takings that make it appropriate for the state to insure against its own conduct rather than to expect risk-averse private parties to do so. The insurance perspective

mental privacy intrusions. Justifying what might otherwise seem to be arbitrary distinctions in treatment between individuals might depend on state authorities knowing details of citizens' lives (their preferences, their responsiveness to particular taxing schemes) that could be discovered only by detailed inquiry into their plans and feelings. The desire to protect citizens' impersonal relationship with the public bureaucracy may in part motivate the preference for having tax burdens turn only on a small number of readily publicly observable facts.

It is plausible that the conventional taxes will typically dominate all other methods of government conduct in terms of these underlying horizontal equity concerns, whether allocative efficiency, interest group capture,[51] discrimination, risk imposition,[52] or impersonality. But it is important to recall that conventional taxes are hardly immune from these problems.

People frequently worry about restrictive regulations on the development of vacant land.[53] From the vantage point of those who have already developed, an empty lot is frequently most valuable left empty (as a greenspace, no-noise, no-congestion buffer), though it is dubious whether the

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on takings was initially embodied in Lawrence Blume and Daniel L. Rubinfeld, "Compensation for Takings: An Economic Analysis," *California L. Rev.* 72 (1984): 569; and Kaplow, "Economic Analysis of Legal Transitions," 509. Kaplow alone emphasized the degree to which risk-averse parties ordinarily would be expected to insure privately unless there were reasons to suspect that such a private market would fail.

51. In subsequently discussing political-process issues, I will examine in more detail whether taxes are inherently less likely to be imposed on insular subgroups (identified on the basis of ascriptive traits or not). I have already discussed the issue of whether conventional taxes are atypically efficient, noting that it is certainly possible to tailor regulations that are atypically unlikely to misallocate resources.

52. As a general matter, risk is imposed by taxes or by regulation both when citizens are uncertain about how norms will apply to particular cases because there is no general rule and when citizens are unsure about their factual circumstances. I suspect some commentators overestimate the degree to which certain forms of regulation pose unique risks because these scholars are thinking only of legal uncertainty. The risk inherent in regulations like exactions is of the first sort and may well be more obvious; there is no rule that describes how much will be exacted given some obvious features of the taxpayer's situation. Similarly, the prototypical isolated taking of a parcel implements a rule in only the loosest sense (one's property will be taken if needed), but the rule cannot help predict whether property will be needed based on its observable characteristics. But perfectly certain, perfectly general rules can generate just as much factual risk. One may know that taxes will be set at 10 percent of assessed value on houses purchased after the year 2000 (an observable feature of the home, specified in the statute) and at only 5 percent on those purchased before then but know so little about the likelihood of purchasing after 2000 that estimates of expected lifetime posttax income are just as dispersed as they would be if the only risk were expropriation based on unannounced or unannounceable factors.

53. This is the main substantive theme in William A. Fischel, *Regulatory Takings: Law, Economics, and Politics* (Cambridge: Harvard University Press, 1995), esp. 52–53, 278, 282, 287–88.

empty lot is worth enough to those who have already developed to bid more for a nondevelopment servitude than would-be users would bid.[54] Given this situation, those who own already-developed property, the typical voters in local elections, might simply choose to regulate against development without offering compensation. Those who suggest more vigorous policing of such problematic regulatory takings suggest that they are most vulnerable once it is recognized that they violate horizontal equity norms that would forbid treating taxpayers differently depending on when they acquired property.[55] Substantively, of course, these regulations may indeed burden newcomers in ways for which these horizontal equity norms may stand in. There might be a form of undue capture by a dominant and identifiable group, status-based discrimination (if newcomers are different), or burdens on protected rights (of mobility) or inefficiency (if the local government rejects a more efficacious means of meeting an end because doing so spreads the burden more broadly).

But the idea that regulation uniquely poses these problems seems farfetched. The municipality might well charge substantial user fees for new infrastructure while having provided and maintaining the infrastructure for existing owners out of general funds. Similarly, the government might selectively impose an inaction strategy by refusing to extend services to those who would live in new developments that are (at least arguably) similarly situated to the old-timers' developments (e.g., traffic lights to ease exiting a subdevelopment might not be built even though such lights have been maintained in similar situations; the city might not build a conveniently located school or acquire nearby parkland although the community is generally filled with parks).[56] Arguably though, the nondevelopment strategy is most immune to

54. A standard rationale for demanding compensation is that it forces the legislature to determine whether the proposed regulation is genuinely efficient. It is efficient if and only if the legislature is willing to pay as much to obtain the regulatory end state as someone else would pay to avoid it. For classic discussions, see, e.g., Blume and Rubinfeld, "Compensation," 569, 620–23; Thomas J. Miceli and Kathleen Segerson, "Regulatory Takings: When Should Compensation Be Paid?" *J. of Legal Stud.* 23 (1994): 749, 753–54; Joseph L. Sax, "Takings and the Police Power," *Yale L. J.* 74 (1964): 36, 62–67.

55. Whether these regulations genuinely violate some workable general norm against treating equals unequally is dubious. Given the fact that the marginal cost of development generally exceeds its average cost given escalating congestion, the regulated and unregulated parties are not obviously similarly situated. For the standard account of increasing congestion costs, see George S. Tolley, "The Welfare Economics of City Bigness," *J. of Urb. Econ.* 1 (1974): 324.

56. On the spending side, municipal decisions might also favor insiders over newcomers, and taxes might be raised a good deal to fund services of little or no moment to the newcomers. A general tax-and-spend program to finance an expensive restoration of a historic district might effectively transfer funds from general taxpayers (of whom a significant number might be newcomers) to a subgroup of long-time residents living near the historic district.

democratic counterpressure. Once the old residents allow development, they will have to face a significant number of countervoters, while there may be a very small number of owners of undeveloped parcels as long as development is thwarted, but it is easy to construct completely plausible scenarios in which (relatively) isolated, (relatively) small communities are just as vulnerable as isolated parcel owners.[57]

Generating Benefits: A Catalog of the Basic Options

The government may generate benefits by providing a valued service either directly or by inducing others to perform that service by paying them to do so (privatized state service delivery) or providing funds for the direct consumers of the goods to pay them for doing so (vouchers). In all three of these cases the state has adopted a tax-and-spend program. The state might also mandate that a private party provide the relevant service for free or, if the party provides the service in any case, that it do so at controlled prices. In both these cases, the state has adopted a regulatory option.[58] The government may also generate benefits by forbidding certain

57. Conventional taxes have certainly not been immune to the substantive problems that those concerned with horizontal equity typically emphasize, though every substantive problem does not arise each time there is a breach of the horizontal equity norms.

Property taxes, for example, historically covered both real and personal property but by the early twentieth century bore almost exclusively on real property. While such differential treatment of real and personal property might well be inefficient (leading to overinvestment in personal property) or even pose group-capture problems (to the uncertain extent that those who held land were differentiable in politically salient ways from other citizens), it is unlikely that this treatment posed problems of undue risk imposition, group-based discrimination, or undue intrusiveness. (On the contrary, one of the bases for the attack on personal property taxation was that it was incompatible with unintrusive administration.) Distinctions, though, in rates or exemptions within the class of real property (e.g., late-1970s tax revolters' distinctions in such enactments as Proposition 13 between old and new homeowners; distinctions between tax rates on farm and urban land that were more prevalent in the first third of the twentieth century) may be far more problematic in terms of interest-group politics and perhaps even (at least mild levels of) risk imposition (on the assumption that it is more difficult to predict how mobile one is likely to be than the value of the property one is likely to own). For a fuller discussion of the history of property taxation, see Glenn Fisher, *The Worst Tax? A History of the Property Tax in America* (Lawrence: University Press of Kansas, 1996).

58. Thus, for example, the government could itself retrofit public accommodations to make them accessible to people with particular mobility limitations, hire private firms to do so, order public-accommodation owners to do so but compensate them for their expenditures, or simply order public accommodation owners to do so. (As I note later, compensation may be tendered for actual expenditures, on a cost-plus or cost-only basis, or for typical expenditures that would be needed to meet the regulatory mandate, which would be equivalent to the loss in market value of the property if the regulated party bore all of the costs of

conduct in which a party would otherwise engage that makes some or all other citizens worse off (e.g., building above a certain height or destroying historically significant buildings). Again, the government may avert unwanted conduct through a tax-and-spend method, paying parties to forbear from such conduct either by purchasing negative servitudes ex ante or compensating for the regulatory taking ex post. The government could also adopt the regulatory option, simply forbidding the conduct without compensation.[59]

There is an extensive literature reviewing the choice between public provision and private provision of services. Advocates of increasing levels of privatization of even those services that would remain monopolized (e.g., prisons, electric utilities) frequently argued that the state would be better off contracting with profit-seeking bidders to provide services. Such advocates highlight the extent to which profit seekers have strong incentives to reduce service delivery costs to maximize the spread between revenues and costs, while public providers will lower costs only insofar as they fear they may bump up against loose budget constraints dictated by political resistance to tax increases.[60] Opponents of privatization focused on

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meeting the mandate.) The first three involve taxing and spending; the last is traditional regulation. I suppose one could even imagine a system in which those who made services available for customers with disabilities could charge them some of the costs of providing those services with a regulated maximum price, but I do not think price regulation meets any of the genuine regulatory aims here.

59. There will also be ambiguous cases in which a goal could be met through forbearance or through service provision. For example, a private party could meet a requirement to maintain water quality in a certain area by failing to use the water or by purifying it after use (and the state could compensate or not for the costs borne in either case). Requirements that habitats be preserved to maintain the population levels of particular species might be met by nondevelopment or through conduct that compensates for otherwise harmful changes in the initially favorable environment. Thus, for example, a utility might protect the ozone layer by complying with regulations demanding burning of less coal or cleaner coal or by engaging in compensatory reforestation projects.

60. For some standard arguments favoring privatization, see generally, Emanuel S. Savas, *Privatization: The Key to Better Government* (Chatham: Chatham House, 1987); Anthony E. Boardman and Aidan R. Vining, "Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed, and State-Owned Enterprises," *J. of L. and Econ.* 32 (1989): 1. Some economists who are generally wary of the capacity of government enterprises to perform effectively attribute much of this slack to their immunity from competition. See, e.g., Douglas W. Caves and Laurits R. Christensen, "The Relative Efficiency of Public and Private Firms in a Competitive Environment: The Case of Canadian Railroads," *J. of Pol. Econ.* 88 (1980): 958. Conversely, others believe that perverse managerial incentives in the public sector lead state-firm managers to deviate more from a wealth-maximizing strategy than do private firm owners, regardless of the levels of market competition, thereby causing lower rates of productivity growth in state firms even in cases in which

the state's difficulty in monitoring service-provision quality and the provider's perverse incentives to reduce service quality if doing so would reduce cost, given these monitoring problems. Opponents also frequently note that most of the private entities' cost advantages could be achieved by the state if it chose to engage in social-welfare-destructive, wage-minimizing strategies.[61]

Advocates of privatization have been even more fervent in urging that state monopolies be replaced by competitive private providers or a mix of competing private and public providers whenever it is feasible to employ multiple providers. Thus, for example, public schools could be replaced by a mix of private and public schools that competed for consumers' patronage,[62] though the state might still fund (as much) school spending (as it currently does) through vouchers that gave each family the equivalent of its share of the current school budget.[63] But the conflict between those who urge the continuation of state provision monopolies and those who urge that vouchers be given for use in purchasing privately provided services is not, in the final analysis, directly germane to the choice between regulation and taxing and spending: all of these programs are tax-and-spend programs.

The literature is germane though, to the extent to which it is persuasive in arguing that in at least some cases dispersed private profit-maximizing providers are more cost-effective than a monopolistic government

static productivity levels are comparable to those in private firms. See Isaac Ehrlich, Georges Gallais-Hamonno, Zhiquiang Liu, and Randall Lutter, "Productivity Growth and Firm Ownership: An Analytical and Empirical Investigation," *J. of Pol. Econ.* 102 (1994): 1006.

61. See, e.g., Paul Starr, "The Limits of Privatization," in *Prospects for Privatization,* ed. Steve H. Henke (New York: Academy of Political Science, 1987), 124; Joseph F. Field, "Making Prisons: An Improper Delegation of a Governmental Power," *Hofstra L. Rev.* 15 (1987): 649, 663 n. 115 (private prison companies would be free to hire nonunion workers at less money than the wages paid to union staff).

62. For a standard argument that such a system would improve the quality of school services, see Myron Lieberman, *Privatization and Educational Choice* (New York: St. Martin's Press, 1989), 152–229.

63. Vouchers would be set at the pro rata share only on the incorrect assumption that spending levels do not vary per pupil; naturally, though, it would be necessary to give families whose children received costlier services (e.g., special-education-eligible pupils) higher vouchers if the goal were to alter only the service provision side rather than the subsidy to users.

In a similar fashion, public housing could be replaced by vouchers permitting parties to buy or lease privately owned units. The postal monopoly could admit competitors but continue to operate, or the government could get out of the mail-delivery business altogether and subsidize those users who might suffer in what the state feels is an unacceptable fashion if forced to bear full market costs for mail delivery.

provider with a relatively loose budget constraint to induce cost-cutting, for it will always be the case that when regulation rather than direct provision of services is chosen, services will be provided by dispersed private providers (most of whom will be profit-motivated entities). Thus, if it is believed that dispersed private providers will deliver accessibility services more cost-effectively than the state or even a handful of private entities with which the state contracts to do retrofitting, particularly since the optimal strategies for service delivery may so radically differ among establishments, then forcing private parties to deliver these services may mean that they will be created more cost-effectively. Public-accommodation owners should compete (in cost terms) to meet regulatory demands most efficaciously; minimizing production costs, whether mandated or not, will increase firm profitability. Of course, though, dispersed private providers could be forced to provide services, just as they are under classic regulatory schemes, but be compensated for the costs they bear, or the state could contract with a wide range of bidders to provide services, so that a simple preference for dispersed provision does not really dictate a preference for uncompensated regulation.

To make that argument, one must believe not only that the private party will (at least sometimes) provide the services more efficiently than would a public provider but that in the event that the party is compensated for providing the services, some of these efficiency advantages will be lost. Imagine in this regard that the state is deciding whether to compensate (a) service providers,[64] (b) those ordered to forbear from certain conduct, and (c) parties who might meet regulatory goals either through forbearance or conduct.[65]

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64. The example I will continue to use is public-accommodation owners who must retrofit their buildings to increase access opportunities for people who are physically unable to use the buildings in their current form.

65. An example on which one might focus is a regulatory requirement to preserve a viable habitat that stabilizes the population of an endangered species. This requirement might be met through either nondevelopment or compensatory conduct.

I do not discuss in the text the price-control cases. Presumably, though, advocates of the most prominent price-control program—rent control—believe that the program is more efficacious than the standard tax-and-spend alternative (vouchers) in gaining continued access to housing for current occupants, assuming that the dominant goal of such statutes is to allocate housing to current occupants when they could no longer afford market rates. (The fact that current occupants are typically not allowed to sublet at market rates implies that this effort does not seek to redistribute income to tenants in possession but to preserve certain sorts of public goods: neighborhood stability or a particular class mix in a jurisdiction.)

Imagine, too, in the first and last case, that the government (a) compensates on a cost-plus basis, (b) compensates only for costs that are actually borne, or (c) compensates without regard to the particular costs the entity bears but rather more typical ones (the decline in the market value of the relevant property or business caused by the initial enactment of a completely unanticipated regulation). In the second, pure forbearance case, it would appear that the state would compensate, if it were to compensate, only on the third basis (the decline in market value that occurred when the unanticipated regulation was enacted). Compensation should be expected to pose distinct problems in the three classes of cases. I believe that the problems would typically be most severe in cases in which the private entities must—or might—actively provide services to meet some public goal.

(a) Cost-plus and pure cost compensation

The difficulties with cost-plus compensation schemes are familiar, largely from the Department of Defense's experience with cost overruns and inefficient weapons procurement.[66] While it is theoretically possible for auditors to determine that the private entity has spent more than a reasonable amount producing the good or delivering the service for which the government agrees to pay, the monitoring state will always be fighting against the entity's perverse incentives to increase the cost of service provision. If the profit level is set at a percentage of costs, the incentive of the entity both to

From the vantage point of rent-control proponents, vouchers will do little good. The supply of housing in a particular area is inelastic in the moderately long run, so that price is simply set by the demand price of the marginal buyer seeking housing. Giving vouchers to some subset of poor housing consumers will simply inflate the market price further but cannot induce the construction of more units (which, by hypothesis, cannot be created in the moderately short run).

66. For classic discussions of cost-plus-fixed-fee (CPFF) contracts and variants, such as redeterminable fixed-price contracts and incentive contracts (in which sellers and the government share the risks of cost overruns), see Frederic M. Scherer, *The Weapons Acquisition Process: Economic Incentives* (Boston: Div. of Research, Graduate School of Business Administration, Harvard University, 1964), 132–40, 184–90, 268–70, 313–25 (mechanisms to attain efficiency at both design phase and production phase are largely ineffective in reducing costs; though firms do compete with producers of close substitute weapon systems and compete for budgetary allocations, they do so largely by trying to increase performance quality); J. Ronald Fox, *Arming America: How the U.S. Buys Weapons* (Cambridge: Harvard University Press, 1974), 165–68, 231–32 (cost overruns were widespread, incentives to reduce costs were weak under CPFF systems and variants thereof).

increase actual costs and overstate what it has spent is most obvious.[67] Thus, if the government agrees to pay a retrofitting public-accommodation owner whatever is spent to retrofit plus some percentage of the amount spent, it will be especially administratively difficult to stop the owner from increasing spending. If landholders could receive a particular level of compensation to let their land remain undeveloped but could receive a good deal more if they spent money to restore the property to a species-preserving state, they may choose development and restoration though it is socially more costly.

A firm's profit from complying with some regulatory mandate could obviously be set at a constant dollar level rather than as a percentage of spending. Such a cost-plus scheme would seem, at first blush, to function just like a simple cost-compensation scheme. It would appear to provide no incentives to reduce expenditures and in that sense would seem to be dominated by uncompensated schemes in which the incentives to reduce expenditures would be strong,[68] but it would not seemingly provide any obvious incentives to increase them. Assuming the rate of return on capital in alternative projects is greater than zero, increasing input expenditures in situations in which one will not receive added profits is ordinarily undesirable. But the firm does not increase expenditures using its own capital when it receives compensation for costs or compensation for costs plus some fixed dollar amount; the government ex post provides a no-interest loan, available solely for these purposes. Moreover, as Scherer notes, firms' opportunity costs in utilizing highly specialized human and physical capital are often low during procurement downturns, and keeping an inventory of, for example, engineers fully employed when unneeded may redound to the firm's long-term benefit.[69]

In practice, the incentives may be even more perverse. First, those who worry that managers are imperfectly monitored by profit-seeking shareholders have long been concerned that managers may tend to maxi-

67. Such costs-plus-a-percentage-of-costs contracts were used in military procurement in World War I but were thought so prone to abuse that they were banned both by the First War Powers Act of 1941 (P.L. 354, 77th Cong. [55 Stat. 838–39]) and the Armed Service Procurement Act of 1948 (10 U.S.C. 2306 [a]).

68. There is a moral-hazard problem in insuring service providers fully for the losses they will actually sustain in service provision; there is little reason for them to minimize these losses.

69. See Scherer, *Weapons Acquisition Process,* 184–88. Moreover, the firm may be able to allocate its high indirect costs to a contract if its direct costs rise and may be able to justify higher cost estimates on future contracts. See Fox, *Arming America,* 232.

mize the size of the entity they manage to enhance prestige or power, making expenditure increases desirable.[70] Where, as here, shareholders are not in conflict with managers whose selfish interest is to increase the size of the budgets (and presumably staff) that they control, it would appear reasonable to fear unwarranted spending. Second, it may be possible for the firm as an entity or individuals within the firm to benefit selfishly from the expenditures that are recompensed, even though these expenditures ostensibly benefit only outsider third-party contractors. Auditors may be unable to identify all instances of explicit or implicit selfish appropriation of overcharges and overspending. Thus, for example, if the retrofitting public-accommodation owner pays an outside contractor unduly high fees to build a ramp but receives direct or indirect kickbacks or the contractor is related in some sense either to the entity or to individual managers therein, the retrofitting entity's decision makers will not be indifferent between both spending and receiving more and spending and receiving the lowest possible amount needed to provide the relevant accommodations. Finally, any cost-based compensation system generates considerably more administrative costs than does an uncompensated system,[71] since reviewing claims will inevitably be costly.

(b) Compensating based on typical losses

If the state chooses to compensate an owner who must or may provide a service to generate relevant benefits based on the projected costs a typical owner is expected to bear, there will be (generally) desirable incentives to reduce actual spending levels below the projected typical rates. The state might adjust compensation rates downward once it sees that entities can meet goals more cheaply than initially believed, wiping out the firm's gains from becoming more efficient than the state had predicted. Still, it seems implausible that nonconspiring entities would fail to try to achieve cost

70. The classic work suggesting that managers seek to maximize enterprise size rather than profits is William Baumol, *Business Behavior, Value and Growth* (New York: Macmillan, 1959). For a typical skeptical response suggesting that performance matters at least as much as size in determining managerial compensation, see, e.g., Frank H. Easterbrook, "Managers' Discretion and Investors' Welfare: Theories and Evidence," *Delaware J. of Corp. L.* 9 (1984): 540, 560–62.

71. Obviously, as Michelman noted long ago, compensation is always costly: in his calculus, one pays compensation when and only when these administrative costs are lower than the demoralization costs that would occur in the absence of compensation. For now, my point is simply to note that, in prudential terms, a system of compensating service providers will require a cost-control bureaucracy.

savings simply to avoid disclosing otherwise private information about minimum service-provision costs. Each firm can hope to benefit by being (relatively) uniquely efficacious, and each will know it will be harmed if others disclose their efficaciousness through cost-cutting conduct whether or not the firm that is considering cutting costs actually attempts to cut costs: failing to cut costs is thus a reasonable strategy only if all entities coordinate the strategy. Assuming, then, that cost-reducing incentives would work, one still must ask whether they would be desirable. They should, at least as long as the regulator can monitor the quality of service provision to insure that the party has not reduced costs by reducing quality. (Naturally, though, a precisely parallel monitoring problem besets regulators who do not compensate at all, since the parties they regulate will have an identical interest in reducing compliance costs.)

But if there are substantial variations between the relevant settings or substantial uncertainty before the fact about what costs will be generated, the administrative costs of determining an appropriate figure will be enormous. Homogeneous regulated parties will tend to overstate projected costs to administrative agencies, which would presumably typically have less information than the parties about their least-cost regulatory options. Though the social costs of service provision will not obviously increase if the regulated parties are systematically overcompensated, the state will spend (and therefore tax) more than it must to obtain the desired benefits. The excess taxation doubtless creates needless efficiency losses. Moreover, there will be excess rent-seeking entry into those industries where overcompensation is greatest.[72] To the degree that the regulated parties are sig-

72. It appears that in the cases I have described, overcompensation will act as a lump-sum subsidy with no impact on marginal costs and hence will not lower prices for the products produced by the regulated party. In such a case, short-run excess profits and rent-dissipating entry would be expected. For an exploration of a market in which the persistent availability of excess profits leads to dissipation of such rents through excess, wasteful entry, see Ian Ayres, "Further Evidence of Discrimination in New Car Negotiations and Estimates of Its Cause," *Michigan L. Rev.* 94 (1995): 109, 144–45 (sellers charge African American and female buyers a price closer to the buyers' reservation price than to sellers' costs; the excess profit that the sellers can earn is not dissipated by competition from other sellers willing to offer lower prices but leads to excessive entry into the car dealership market). However, if considering a compensation scheme that subsidized the provision of each unit sold (e.g., by requiring a safety feature attached to each good whose cost of installation would be overpaid for by the state), the effects would be more complex. If the subsidy were uniform, it should be passed along to consumers of the good, and the adverse efficiency effect would simply be the unwarranted substitution of this good for other products that were not subsidized. If the subsidy varied, some firms would still earn excess profits, and rent-dissipating entry would still be expected.

nificantly heterogenous, establishing an appropriate schedule of payments also will be difficult, and a random pattern of subsidies and penalties to competitive firms might well distort capital flow. The biggest problem, though, whether producers are homogeneous or heterogeneous, is that they may well find that the greatest return on investment they can receive is not the return to cost-effective innovation in service delivery but investment in hiring various advocates to overstate effectively the appropriate compensation rate: not only must the deadweight loss from these unproductive investments be accounted for, but the state will also have to spend more to counter overstated claims, knowing they will be well supported by consulting engineers and their attorney spokespeople.

Seemingly, compensation poses the fewest direct, nonadministrative efficiency costs when the state achieves desired benefits by demanding that parties forbear from particular conduct. Parcel owners forbidden to build above a certain height simply cannot obtain the relevant benefits more cheaply than by the method they are ordered to use. It is true that compensating them for the typical costs of compliance (the drop in market value of the property from unzoned to zoned state) might cause some moral-hazard problems, but it is dubious whether such effects will be significant. Compensating an owner for a typical parcel-specific taking (e.g., seizing the fee to build a road) indeed makes it more likely, at the margin, that owners will not reduce social losses by minimizing development even when the probability of eminent domain increases. Similarly, owners of parcels ultimately subject to a building-height restriction may be unduly indifferent to whether they take steps that increase the spread between the unzoned and zoned value of the parcels if they are fully insured against that loss. One can readily hypothesize examples of these sorts of steps: developers might develop part of their property so that scenic views would be blocked if only the short buildings permitted by the zoning plan were built elsewhere on the land; developers might prepare land or build foundations or other infrastructure that would sustain high-rise development but are unnecessary for permitted buildings and receive compensation that reflects the fact that the land is, in the absence of regulation, especially suited for high-rise development. But it is far less clear that the magnitude of the actual moral-hazard problem is large enough to be of concern. It is obvious as well that the need to compensate generates transactions costs; whether or not owners take steps that increase the actual spread between regulated and unregulated value, they will surely attempt to overstate what that spread is (expending resources to do so persuasively), and the state will expend resources first countering and then adjudicating these exaggerated claims.

One suspects, though, that the most persuasive reason not to compensate in the pure forbearance cases is distributive rather than efficiency oriented, based on the supposition that the demand for forbearance precludes the parcel owner from impoverishing others unjustly through activity that is privately advantageous. Compensation is generally provided in the opposite circumstances—when society has unduly impoverished the parcel owner for its own collective advantage.