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REDISTRIBUTION THROUGH DISCRIMINATORY TAXES: A CONTRACTARIAN EXPLANATION OF THE ROLE OF THE COURTS

*Erin A. O'Hara and William R. Dougan**

INTRODUCTION

Legislatures tax to raise revenues, but often a tax treats American citizens disparately. Discriminatory taxes have the effect and presumed purpose of redistributing wealth and are subject to constitutional challenge in our courts. When the tax in question redistributes uniformly from wealthy to poor individuals (i.e., progressive taxation), the courts have almost never been sympathetic to constitutional challenges based on state or federal takings, equal protection, due process, or uniform taxation clauses. Yet, when taxes redistribute in other ways, courts have used each of these clauses, as well as others, to scrutinize, and occasionally invalidate, the legislation.

Although several academics have posited normative arguments concerning various forms of discriminatory taxation,[1] little attention has focused on developing a positive theory of the constitutional treatment of federal, state, and local taxes that fall disproportionately on a minority of citizens. As a notable example, Richard Epstein recently took a strong normative stand against the constitutionality of progressive taxation, as well as other forms of redistribution, in his book *Takings*.[2] Shortly thereaf-

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[1] *See, e.g.*, WALTER J. BLUM & HARRY KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953); RICHARD A. EPSTEIN, BARGAINING WITH THE STATE 127-44 (1993) (interstate commerce); RICHARD A. EPSTEIN, TAKINGS (1985) [hereinafter EPSTEIN, TAKINGS]; CHARLES O. GALVIN & BORIS I. BITTKER, THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE? (1969); Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895 (1992) (discrimination against interstate commerce).

[2] EPSTEIN, TAKINGS, *supra* note 1. In *Takings*, Epstein advocates interpreting the Takings Clause to prohibit government programs that fail to increase the total wealth of society. *See id.* at 283-305. Additionally, and ideally, government programs should preserve the relative entitlements among citizens. *See id.* Epstein's position is based on a natural rights theory of entitlement to liberty and property. *See id.* Progressive taxation contradicts both of these norms because it is likely to enhance

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ter, however, he modified his position reluctantly to embrace progressive taxation, resigning himself, without persuasive reason, to what he viewed as the depressing factual inevitability of a welfare state.[3] This raises an interesting question that has not yet been satisfactorily answered: on what basis do American courts distinguish permissible from impermissible redistributive legislative bargains?

To better illustrate the problem, consider the following puzzles raised with the constitutional treatment of discriminatory taxation.[4] First, suppose that one citizen, Sam, earns $150,000 each year and another citizen, Joe, earns $25,000. As we all know, Sam is typically assessed a higher marginal tax rate on his income than Joe must pay on his own income. Under present Supreme Court doctrine, this progressive taxation is constitutionally permissible. At the same time, if the government confiscates Sam's real property through taxation, the uncompensated "taking" is impermissible.[5] What accounts for the distinction, given that both taxes have the effect of discriminating against Sam in favor of other persons? Second, if the legislature separates out one professional class, say bankers, for special taxation, the tax is upheld as "nonarbitrary." If instead banker Sam, in his capacity as a homeowner, is assessed a higher tax rate on his real property than the rate assessed on his neighbor, Sue, then the discriminatory tax Sam suffers is struck down as "arbitrary" and therefore unconstitutional.[6] What distinguishes these discriminatory taxes? Third, even though a county tax assessor cannot force Sam to pay higher property tax rates than his neighbors must pay, California's Proposition 13, which creates similarly disparate taxes, has been upheld as constitutional.[7] Again, why are these differential tax rates treated differently? Finally, the Supreme Court has upheld state taxes imposed on chain retailers that are assessed according to the number of stores in the chain.[8] These chain store taxes are intended to

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a mismatch of taxes and benefits from government programs. *See id.* at 295-305. Epstein also notes that there is no real cost to reading a flat tax requirement into the Takings Clause. *See id.* at 299-300.

[3] *See* Richard A. Epstein, *Property, Speech, and the Politics of Distrust*, 59 U. CHI. L. REV. 41, 87-89 (1992). In his article, Epstein offers a compromise designed for liberals and conservatives: the state can redistribute as much as it likes from rich to poor so long as it does so through general revenue taxes. *See id.* at 87-88. The only justification Epstein accepts for equalizing redistribution, however, is the "common perception" that a dollar of income is worth more to a poor person than a rich one. *Id.* at 87. We offer a positive explanation of the inevitability of some equalizing redistribution that does not center on problematic, indeed impossible, interpersonal utility comparisons. On interpersonal utility comparisons, see HERBERT KIESLING, TAXATION AND PUBLIC GOODS 298 (1992); ABBA P. LERNER, THE ECONOMICS OF CONTROL ch. 5 (1944).

[4] We defer a discussion of the specific cases that illustrate the courts' treatment of the following problems to Part III *infra*.

[5] *See* Village of Norwood v. Baker, 172 U.S. 269 (1898).

[6] *See* Allegheny Pittsburgh Coal Co. v. County Comm'n, 488 U.S. 336 (1989).

[7] *See* Nordlinger v. Hahn, 505 U.S. 1 (1992).

[8] *See, e.g.*, State Bd. of Tax Comm'rs v. Jackson, 283 U.S. 527 (1931).

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protect small local retailers from the competitive effects of large national firms. During the same period, however, one state imposed a progressive sales tax on gross receipts on the very same retailers motivated by the very same reasons, and the gross sales tax was struck down.[9] Why was the per store tax permissible but the gross sales tax problematic? A satisfactory theory of discriminatory taxation should be able to explain each of these constitutional distinctions.

We attempt to make headway toward a positive theory of discriminatory taxes by showing that the results derived from a simple social contractarian model of constitutions help to explain the courts' distinctions. Consistent with social contract theory, we view government as emerging from the consent of those to be governed by it.[10] If a constitution is properly viewed as a document reflecting a consensus among citizens regarding the best rules for society, then we expect that constitution to include, at a minimum, those rules that would receive unanimous support ex ante. In contrast to other contractarian models, however, we do not attempt to specify the precise rules by which people will choose to be governed over an indefinite period of time. We ask, instead, whether any rules or procedures are likely to be excluded by the social contract. In short, our view of constitutions is that they are *proscriptive* rather than *prescriptive.*

The key difference between our positive approach and the well-known normative contractarian analyses of wealth redistribution is that we relax the assumption of Rawlsian ignorance. In *A Theory of Justice*, John Rawls proposed that the social contract should include those redistributive rules that society would agree to if its members were positioned behind a veil of ignorance.[11] Rawls concludes that if individuals do not know their position in society or which generation they will be born into, they will agree to provide a safety net for the less fortunate. All would agree to use taxation to "preserve an approximate justice in distributive shares"[12] and to "prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity."[13]

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[9] *See* Valentine v. Great Atl. & Pac. Tea Co., 299 U.S. 32 (1936) (per curiam).

[10] Contractarian approaches vary beyond this very basic commonality. *See, e.g.*, DAVID GAUTHIER, MORALS BY AGREEMENT (1986); THOMAS HOBBES, LEVIATHAN (Penguin Books 1968); GREGORY S. KAVKA, HOBBESIAN MORAL AND POLITICAL THEORY (1986); JOHN RAWLS, A THEORY OF JUSTICE (1971). For discussions of several recent contractarian theories of jurisprudence, see JODY S. KRAUS, THE LIMITS OF HOBBESIAN CONTRACTARIANISM (1993); CHANDRAN KUKATHAS & PHILIP PETTIT, RAWLS: "A THEORY OF JUSTICE" AND ITS CRITICS 17-35 (1990).

[11] *See* RAWLS, *supra* note 10, at 136-38.

[12] *Id.* at 277.

[13] *Id.* Geoffrey Brennan and James Buchanan use assumptions of Rawlsian ignorance and risk aversion to come to quite different normative conclusions. *See generally* GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX (1980). Given that (1) individuals are ignorant about their future

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We believe that a satisfactory *positive* theory of constitutions must acknowledge that the rules agreed upon or subsequently modified will be shaped by self-interested individuals who at least attempt to predict the effect of those rules on their future social and wealth positions. Despite whatever ethical merits Rawls' normative theory may have, it does not attempt to predict or explain the outcomes of actual constitution-stage bargains. Our assumption is as stark as Rawls', but its exact opposite. We assume that in matters of taxation, individuals usually can accurately predict how proposed constitutional rules will affect them personally, and will be reluctant to agree to any rule that is likely to leave them worse off. Moreover, unlike normative contractarian theories that address the issue of the legitimacy of political institutions, we merely attempt to explain why most, but not all, redistributions of wealth would be constitutionally permissible.[14] We do not argue that the present redistribution of wealth in the United States—or anywhere else—is either desirable or defensible. Instead, we conclude only that it is the predictable consequence of the common desire of all members of society to improve the condition of themselves and their families.

In Part I, we briefly present a decision tree to motivate the theoretic discussion that follows. The tree represents the major decisions faced by citizens deciding whether to form or modify a government. In Part II, we argue that in a democratic society, wealth redistribution from rich to poor will not likely be precluded, although limits on the degree of redistribution might garner widespread support. Our simple social contractarian model also enables us to characterize the general conditions under which progressive taxes would likely be constitutionally prohibited.[15]

Democratic redistribution that does not tend systematically toward wealth equalization is more complex, and thus it is more difficult for each citizen to predict its consequences. A polity in which any temporary majority can differentially tax the corresponding minority today is one in which the tables may easily be turned tomorrow. The most that can be predicted in a society with such unstable coalitions is a condition of continued uncertainty in which each citizen must be ever-vigilant and politically

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positions regarding tax burdens and government benefits, and (2) the government, like other institutions, acts as a revenue maximizer, then rational individuals would seek to constrain exploitation by the government to the maximum possible extent. *See id.* at 1-49. The authors propose several constitutional provisions designed to hinder government revenue-raising abilities, including rate caps and prohibitions against discriminatory taxation. *See id.* at 187-205.

[14] For a discussion of the distinction between normative and contractarian theories, see KRAUS, *supra* note 10, at 2-3.

[15] We express no opinion on the wisdom of redistributive taxation; we attempt only to explain the pattern of its incidence. There is a vast literature treating progressive taxation from a normative perspective. *See, e.g.*, BLUM & KALVEN, *supra* note 1; GALVIN & BITTKER, *supra* note 1; EDWIN R.A. SELIGMAN, ESSAYS IN TAXATION ch. 10 (1931).

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active to protect his or her wealth. This unstable political environment is undesirable to everyone (with the possible exception of lobbyists), because these taxes impose "symmetric" burdens on citizens, where no one expects to systematically gain over time, although everyone bears the political costs associated with protecting his wealth. Consequently, unrestricted, symmetric, non-equalizing taxation invariably would be proscribed constitutionally.

There is a third possible category of taxes, however, comprising those that neither tend toward systematic wealth equalization nor are equally likely to burden any arbitrary or fleeting majority. As we explain in Part II.B, taxes that generate support from stable conditions will likely systematically benefit some individuals, and are therefore unlikely to be constitutionally proscribed. These latter taxes are more likely to be upheld by the courts than are the class of symmetric, non-equalizing taxes.

Virtually all taxes alter the consumption and production choices made by households and firms and are therefore inefficient. The costs of coalition formation in democratic governments, including but not limited to lobbying efforts, are an additional source of economic loss or social cost. But the American courts have not chosen to defend absolute efficiency. In Part III, we conclude that the courts instead take a minimalist approach to legislative bargains and strike down only those discriminatory taxes that almost certainly would be proscribed if considered explicitly at the constitution stage. In fact, given the costs of monitoring legislative attempts at wealth redistribution, the courts have difficulty taking even this minimalist constitutional approach. In Part IV, we posit that, instead of striking down redistributive taxes, the courts uphold these wealth transfers while working to reduce their social costs. In this sense, the courts may protect relative rather than absolute efficiency.

I. CONSTITUTION-FORMING CHOICES

Ultimately, we hope to explain why courts invalidate some discriminatory taxes while leaving the bulk of tax decisions to the legislature. Our theory requires the reader to temporarily suspend reality in order to consider the social contract that citizens might choose if each were asked to state her preferences. Of course, contractarian bargains are hypothetical rather than real. Nevertheless, when courts consider constitutional challenges to legislation, one important, perhaps overriding, consideration is the sentiment of the people. If the constitution does not specifically prohibit the legislation in question, a court must determine whether the citizens would have prohibited the legislation if they had thought about the issue at the time the constitution was formed. We postulate that judges' rough guesses about the social contract inform their constitutional decisions.

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Let us first consider the most general constitutional decisions, in order to set the stage for the more specific discriminatory tax issues we turn to later. When a society considers whether to create or alter a constitutional agreement, the citizens must first determine whether they desire any social contract at all. What forces might motivate them to bargain over a constitution, and what provisions will such an agreement contain? The answers to these questions have many important political, ethical and economic dimensions. We focus solely on one aspect of their deliberations: the level of wealth each member of the society expects to attain under the particular constitution that is chosen. We model the choice of a constitution as a solution to a cooperative bargaining game which requires unanimous agreement by all citizens for its adoption.

Figure 1 offers a decision tree representing the citizens' fundamental social contract choices. We define a social contract as an agreement among self-interested individuals governing the rules by which their behavior shall be constrained. Anarchy, then, is a situation in which the citizens have failed to agree to any social contract. It therefore provides a reference point against which to measure the gains from any particular social contract. In the language of bargaining theory, anarchy is the "no agreement" point in the set of feasible allocations of wealth. We assume no person would agree to a social contract under which he expects to be worse off than he would be in anarchy.

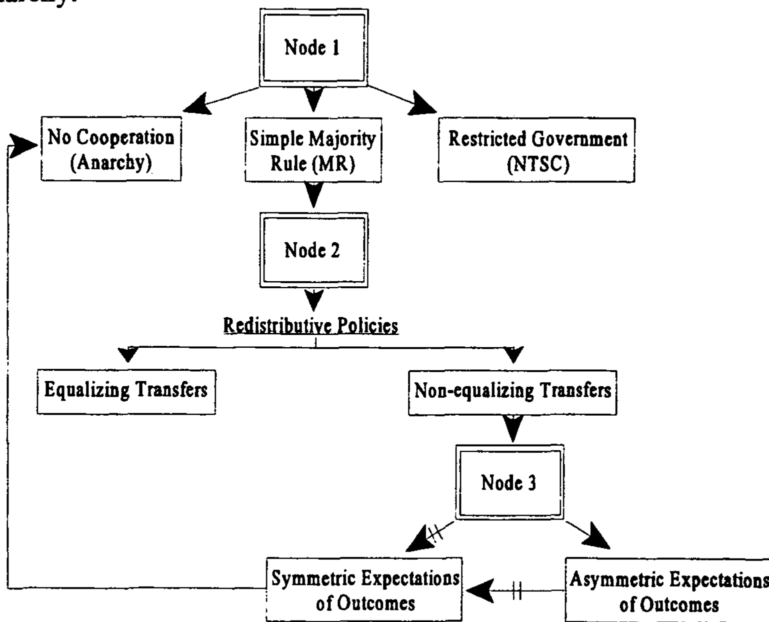

FIGURE 1

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In a state of anarchy, property claims must be actively defended by each claimant against would-be predators. Any person can choose to allocate time and other resources to creating new wealth, seizing existing wealth from others, or defending existing wealth from seizure by others.[16] In comparison to a system in which property rights are secured under the rule of law, anarchy can give rise to extensive economic inefficiency. The time and material resources devoted to seizing and defending previously created wealth is wasted from the point of view of society as a whole, since those resources could have been used to create new wealth rather than to reallocate existing wealth. A social contract that reduces the level and the cost of such redistributive activity increases society's total wealth.

Social contracts regarding property rights in wealth can take many forms. We consider two extreme contracts: (1) simple or pure majority rule (MR), in which any wealth redistribution package approved by the majority is valid; and (2) restricted government, in which everyone has an inviolable property right to his own wealth. Under a restricted government, by definition, all majority rule wealth redistributions are proscribed. Because forced transfers are prohibited under the restricted government, we hereafter refer to the restricted government as a "no transfers social contract," or NTSC. At decision node 1 in Figure 1, each citizen must rank his preference for the three possible states: anarchy, MR, and NTSC.

Of course, majority rule contracts can themselves take alternative forms. Democratic societies can, and usually do, prohibit some forms of wealth redistribution. These constitutional prohibitions can be explicit or implicit. In the United States, we have adopted a representative democracy that permits some, but not all, types or means of majoritarian redistribution. Some prohibitions are explicit; for example, the government may not prohibit the free exercise of religion[17] or deny the right to vote on the basis of race.[18] Others fall under the rubric of general constitutional restrictions which can be found in the Equal Protection, Due Process, Takings and other clauses. The courts are left with the difficult task of determining which types of redistribution are prohibited under these more general clauses.

In an effort to understand American courts' treatment of discriminatory taxes, we consider prohibitions that would command the unanimous assent of citizens who are designing a majority rule government. Our thought experiment therefore takes the following form: assume the citizens have already chosen a majority rule government. What types of democratic

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[16] An early formal model of resource allocation under anarchy is presented in Winston C. Bush, *Individual Welfare in Anarchy*, *in* EXPLORATIONS IN THE THEORY OF ANARCHY 5-18 (Gordon Tullock ed., 1972).

[17] U.S. CONST. amend. I.

[18] U.S. CONST. amend. XV, § 1.

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redistribution might the citizens unanimously agree to prohibit? Obviously, our constitution can be amended without unanimous support. But, for reasons we proffer later,[19] we contend that the courts incorporate their own constitutional prohibitions on discriminatory taxes only when they believe that over time everyone is worse off with the discriminatory tax. Ultimately, we hope to use our thought experiment to help explain constitutional interpretation.

Three caveats regarding our thought experiment must be pointed out at the outset. First, when we focus on laws that redistribute wealth among the citizens, we are primarily concerned with the effect rather than the purpose of those laws.[20] We think it impossible to glean a single "purpose" from laws supported by many citizens. Instead, we focus on the likely effects of the laws because some citizens will judge them based on their expected benefits and burdens. Second, while we focus on the original bargaining process here, our thought experiment applies at any point during democratic governance. In other words, if a new type of democratic redistribution is considered, and that redistribution will likely make everyone worse off, then the prohibition could take the form of a specific amendment to the constitution. Alternatively, the courts could strike down the innovative redistribution under the pre-existing general constitutional provisions. Finally, when we refer to unanimous agreements, we do not count the preferences of citizens who expect to benefit from the mere creation of coalition or transaction costs. Lobbyists, for example, benefit when the government enacts laws that are not stable over time. If coalitions shift, generating new demands for restructuring the redistribution, then lobbyists may experience an increased demand for their services. Aside from the lobbyists who benefit from the creation of the coalition or transaction costs, no benefits may accrue to any group of citizens over time. To survive our unanimity rule, some group must anticipate a benefit from redistribution that can be separated from the transaction costs associated with the redistribution.

To return to our inquiry, what types of democratic wealth redistribution would citizens unanimously agree to prohibit? In *Interest Group Politics Under Majority Rule*,[21] William R. Dougan and James M. Snyder

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[19] *See infra* Part IV.

[20] Our contractarian approach, therefore, differs from Robert Nozick's. To Nozick, measures are not "redistributive" unless they are motivated by a desire to redistribute. If measures are motivated by other concerns, but have the effect of redistributing wealth, Nozick classifies them as non-redistributive. *See* ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 27 (1974).

[21] William R. Dougan & James M. Snyder, *Interest Group Politics Under Majority Rule*, 61 J. PUB. ECON. 49 (1996) [hereinafter Dougan & Snyder, *Interest Group Politics*]; *see also* William R. Dougan & James M. Snyder, *Are Rents Fully Dissipated?*, 77 PUB. CHOICE 793 (1993) [hereinafter Dougan & Snyder, *Rents*].

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show that the answer turns on the critical distinction between "equalizing" and "non-equalizing" transfers. As shown at decision node 2 in Figure 1, citizens must choose whether to permit "equalizing" redistribution—wealth redistribution that tends toward equality. By definition, equalizing redistribution entails wealth transfers from the rich to the poor. The citizens must also choose whether to permit "non-equalizing" redistribution—wealth redistribution that does not tend toward equality. An example of a non-equalizing redistribution is a tax that transfers wealth from people employed in the airline industry to people living in Texas, without regard to the wealth or incomes of the employees burdened or the Texans benefitted. In the public choice literature, wealth redistribution is often referred to as "rent seeking."[22] A majority rule contract could permit one or both types of redistribution. When both types of redistribution are permitted, we refer to the contract as a pure majority rule contract. If both types of redistribution are prohibited, however, then the majority rule contract would be equivalent to an NTSC. When some but not all majority redistribution is permitted, we label the contract "limited majority rule."

While the society as a whole is better off under some social contract than it could be under anarchy, it need not be the case that every individual or group fares worse under anarchy than under any other social state. Some people may be sufficiently more successful at predation than they are at production as to make anarchy preferable to a social contract under which they receive only what they produce (the NTSC). This could occur for several reasons, but one simple reason could be that some people are endowed with substantially more resources than others. If the number of wealthy people is large relative to the number of poor people, then it is possible, although certainly not inevitable, that the typical poor person is better off attempting to take control of the assets of some wealthy person than he would be if he allocated the limited resources at his command to production. The greater the wealth disparity between the rich and poor, and the greater the ease of identifying the rich and gaining control of their assets, the smaller the likelihood that the typical poor person will agree to a social contract that precludes all forms of redistribution from rich to poor. Similarly, the greater the typical rich person's expected losses under anarchy, the more willing he will be to agree to a social contract that does not preclude such "equalizing" redistribution (MR or limited majority rule).

We do not claim that all social contracts will allow wealth redistribution. When the initial level of wealth inequality is not too great, or when the technology of predatory activity induces a high level of effort and

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[22] *See, e.g.*, MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW 120-26 (1997); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 32 W. ECON. J. 5 (1967) [hereinafter Tullock, *Tariffs, Monopolies, and Theft*].

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expenditures on both aggression and defense, anarchy may leave all individuals worse off than they would be under the NTSC. We simply observe that some social contracts that permit equalizing redistribution could command unanimous agreement even in the absence of a veil of ignorance.[23]

As elaborated in Part II, under majority rule, some degree of redistribution from rich to poor will emerge whenever votes are allocated more equally than wealth. No wealthy individual with foresight would agree to an MR constitution unless that individual thought he would be worse off under anarchy than under the tax code he expects would emerge under unrestricted majority rule. Similarly, no poor person would agree to an NTSC unless he thought he would be less effective at predation under anarchy than at production in a limited-government polity.

It is thus a fairly simple matter to see how progressive taxation could garner the unanimous consent of the governed at the constitutional stage of collective decision making. Since equalizing redistribution is a predictable outcome of majoritarian voting over tax codes, a democratic constitution that does not expressly prohibit progressive taxation should be presumed by the courts to be a legitimate policy choice, if—as we assume—a key function of the courts is to enforce the social contract.

Many types of redistribution do not systematically benefit the poor at the expense of the wealthy. Instead, they impose costs and grant benefits in ways that are essentially unrelated to people's income or wealth. A complete theory of discriminatory taxes must be able to predict which, if any, of these types of non-equalizing redistributions will be struck down by the courts on the ground that they are incompatible with the social contract. As shown at decision node 3 in Figure 1 and explained more fully in Part III, Dougan and Snyder attached great significance to the degree of "symmetry" in citizens' expectations regarding any particular policy proposal. A redistributive policy that can plausibly benefit any one voter as readily as it can benefit any other voter will generate symmetric expectations of its effects. Because every voter is equally likely to benefit from such a policy, she is also equally likely to share in its costs. When voters are risk averse, or when lobbying is costly, a policy that gives rise to symmetric expectations of its impacts is one which every voter expects, on average, will make him worse off. For that reason, every member of society who wants a democratic social contract would prefer a constitution prohibiting symmetric, non-equalizing redistribution to an otherwise identical constitu-

[23] Despite this prior consent, the people who are taxed disproportionately once the constitution is in place may nevertheless object to paying such taxes when payment is due. However, ex post objection in this context should be viewed as "post-contractual opportunism" or as an effort to free ride off the contributions of others. It is not, in our view, indicative of the terms of the social contract itself.

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tion allowing such policies.

An example may help to clarify the point. Consider whether a legislature, in an effort to raise revenues, could impose a discriminatory tax on residents according to the first letter of each resident's last name. If the "S" residents are taxed more heavily, then Smith loses while the other residents gain because they now can receive the same services while paying lower taxes.[24] But, before the letter is chosen, no one can predict whether he will be in the benefitted or burdened group. Even after the letter is chosen, there is likely nothing particularly stable about the legislature's choice to tax the "S" surnames. Smith might pay a higher tax this year, but next year he will lobby to have the letter changed to "J," and then Jones will spend resources changing it to "C," and Cohen will fight to change it to "M," and so on. Ex post, someone may receive a short-term benefit or burden from the tax, but in the end, citizens spend considerable resources trying to fix the details of the tax from year to year.[25]

If every person is as well situated as anyone else to be a member of the winning coalition, every person has an equal expectation of winning or losing from this policy. Over repeated legislative sessions, individuals will sometimes win and sometimes lose. What is certain is that total output (and income) in every period will be lower because of the surname taxes, so that every person has an identical expectation at the start of every legislative session that she will be a net loser on average. Despite this expectation, if such policies are allowed, it is individually rational for every voter to try to be a member of the winning coalition rather than the losing coalition. As a consequence, surname taxes may be pursued if they are not expressly prohibited. A social contract that prohibits symmetric, non-equalizing redistribution will be unanimously agreed upon, but the prohibition must be enforced by the courts. In fact, without court enforcement, rent-seeking costs could become large enough to threaten the benefits of even forming the government, in which case anarchy becomes the preferred political state. Thus, we predict that symmetric, non-equalizing forms of taxation will be treated by the courts as unconstitutional.

The expected outcomes of many discriminatory taxes are "asymmetric," however, because some non-equalizing taxes have fairly predictable winners and losers. Taxes that facilitate forming stable coalitions to take advantage of rent seeking opportunities can generate asymmetric expectations regarding the benefits of the taxes. As described in Part II.B, some citizens can form interest groups that can in turn unite into majority coalitions with significantly less cost than others. If the cheaper cost

[24] Alternatively, the "non-Smith" citizens can receive higher services while paying the same taxes. Either way, the non-Smiths benefit at the expense of the Smiths.

[25] We assume, here, that citizens cannot avoid the tax by changing their last names.

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groups can effectively minimize competition from outsiders for the rents obtained in legislative bargains, individuals in those groups expect to be better off with discriminatory taxes than without them. If, for example, a majority of the residents are named "Smith," then the Smiths might actually prefer that taxes be levied on the basis of surnames, because the Smiths can predict they will be insulated from the tax. Even if the Smiths make up only a minority of the population, if they are a cohesive group that anticipates consistently being part of the majority coalition, then they may nevertheless support the surname tax. In either of these latter situations, the Smiths would not agree to prohibit any non-equalizing transfers with asymmetric expectations, even though they reduce social welfare, for the simple reason that those in stable winning coalitions expect a benefit on balance from redistributive politics.

Let us summarize the relationship between democratic asymmetries and the constitutionality of discriminatory taxes. If the American social contract is as we have posited, then the courts, as constitutional checks on legislative bargains, should, at a minimum, serve one vital function: to prevent non-equalizing taxes that generate symmetric expected payoffs. This entails striking down two types of wealth transfers. First, courts should strike down taxes that are passed by "unstable coalitions," meaning those that came together momentarily in support of the tax but can easily break down by outsiders fighting to shift the tax burden. Second, they should prevent transfers to groups that can form coalitions relatively cheaply, but are likely to dissipate any gains through intra-group competition for the benefits. Here the coalition itself may appear stable, but the tax does not enable a stable distribution of the benefits within the favored group. If the favored individuals can be expected to fully dissipate the rents in an effort to obtain a larger share of those rents, no one can expect to benefit from the discriminatory tax on balance. The courts should strike down these benefit-dissipating taxes with existing general constitutional prohibitions rather than force the citizens to incur the costs of explicit constitutional amendments.

Do the courts serve this minimalist function? Anyone who has ever glanced at a U.S. tax code can see the effects of interest group politics. When the provisions are challenged, the courts very rarely step in to protect wealth-maximizing outcomes. Despite the dead-weight losses[26] associated with wealth transfers, courts generally permit discriminatory taxation so long as the legislature has not classified groups in an "arbi-

[26] "Dead weight losses" are those losses from redistribution that are not transferred to anyone. They represent forgone productive activities that decrease the wealth of society. *See* WALTER NICHOLSON, MICROECONOMIC THEORY 430 (3d ed. 1985); STEARNS, *supra* note 22, at 120-21.

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trary" or "unreasonable" fashion.[27] Unfortunately, however, the courts have never articulated a coherent distinction between arbitrary and non-arbitrary classifications. We argue in Part III that in practice the courts scrutinize discriminatory taxes according to the minimalist social contract we describe, but they go no further without an independent constitutional mandate.

Progressive taxation is a form of a wealth-equalizing transfer which is not prohibited under our predicted social contract and almost never struck down by U.S. courts. In contrast, the courts invalidate severely discriminatory property taxes when those taxes apparently create non-equalizing wealth redistribution with symmetric expectations. Other interest group transfers are occasionally invalidated but much more often survive scrutiny. While not a perfect explanatory theory, many of the Supreme Court's decisions turn on a rough guess of the symmetry of citizens' expectations. The taxes are impermissible only when the discriminatory classification will likely lead to excessive competition among individuals over time to avoid membership in the disfavored group or to reap a larger share of the wealth transferred. In most cases where taxes are invalidated, the group benefitted probably is no more efficient at forming coalitions than the group disfavored. Continuous efforts to change the classification will leave no individuals in a better net position, so the Court is confident the tax would have been unanimously condemned ex ante.

To be sure, there are some cases that do not match our expectations. The costs of enforcing the social contract may be prohibitively high in some contexts. And in other contexts, the courts might well be deciding cases based on pure normative preference. But, we offer the first positive theory that we know of designed to explain the courts' typical distinction between constitutional and unconstitutional discriminatory taxes.

We now turn to an exploration of redistribution under majority rule in an effort to shed more light on the constitutionality of discriminatory taxes in the United States. In Part III, we apply the model presented in Part II to the case law on tax disparities.

II. SYMMETRIC AND ASYMMETRIC EXPECTATIONS

When citizens are given the right to vote, creating some form of democratic decision making, then those citizens must determine whether to insulate some activities from majoritarian influences. Recall from Part I, that in a "pure democracy" all decisions regarding individual activities and resource allocation are determined by majority rule. Of course, pure

[27] *See infra* Part III.

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democracies are like perfectly competitive markets; both are useful theoretical constructs, but neither is likely to be found in the "real world." Instead, modern democratic societies all take the form of limited majority rule. Nevertheless, once some decisions are based on majority sentiment, redistributions of both wealth and utility are inevitable. The hard task is determining which forms of redistribution to prohibit.

In almost every democratic society, whether representative democracy or otherwise, some decisions are taken out of the political arena. Typically, a nation's constitution describes those areas that are not subject to popular determination. In the United States Constitution, for example, the right to speak and to choose one's religious affiliation cannot be abrogated even though a majority of the population might prefer to establish an official religion or ban speech that is critical of a dominant political party.[28] Some limitations on the power of majorities will be described in very general terms that reflect notions of fairness. Guarantees of "equal protection" and "due process," and guarantees against the uncompensated "taking" of private property are common examples.[29] Our courts are assigned the task of reducing these general terms to a set of concrete restraints on majority decision making.

Taxation can be a very tempting means for majorities to transfer wealth from minority groups to themselves because the dead weight losses to direct cash transfers are often smaller than those associated with indirect, or regulatory transfers. Where the Constitution specifically protects activities, the Supreme Court has consistently struck down taxes that burden those rights. When legislatures place special taxes on religious institutions or the press, for example, those taxes are held unconstitutional.[30] How do the courts treat taxes that redistribute wealth on other bases? Any nonuniform tax is a taking of private property and fails to guarantee equal treatment under the laws. In theory, then, courts could strike down all nonuniform taxes. In practice, however, the courts have carved out a much more limited role in checking tax legislation. A review of discriminatory tax cases indicates modern courts tend to strike down only those nonuniform taxes that, from an ex ante perspective, would be unanimously condemned by U.S. citizens. Otherwise, the taxes are upheld.

Which taxes would be unanimously condemned? The answer turns on the symmetry of expected payoffs from the particular transfer game at issue. And the symmetry of payoffs depends on the stability of the political coalition that formed to support the tax transfer. In section A below we

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[28] *See* U.S. CONST. amend. I.

[29] *See, e.g., id.* amend. V and XIV, § 1.

[30] *See, e.g.,* Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue, 460 U.S. 575, 583 (1983) (tax to limit circulation of information); Grosjean v. American Press Co., 297 U.S. 233, 250 (1936) (tax on press).

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consider "equalizing transfers," or wealth redistribution from unequal endowments toward equal consumption. In section B, we consider "non-equalizing" transfers, or transfers designed to redistribute wealth on bases other than achieving equality.

A. *Equalizing Transfers Under Pure Majority Rule*

In this section, we present a simple model of democracy when individual wealth endowments differ. The model is a parallel to the classic "divide-the-dollar" game used by economists.[31] We use this model to illustrate a very simple proposition: assuming sufficiently unequal wealth endowments and sufficiently modest coalition costs, democratic decision making inevitably results in wealth redistribution toward equality.[32]

1. Transferring Wealth

Although the results of our model hold for a democracy with any number of citizens, for simplicity we assume that the democracy has three rational, risk neutral citizens, or players, named Larry, Curly and Moe. Also for simplicity, assume the total wealth in the society is $100, but the initial endowments of the players are unequal. Specifically, assume:

Larry	=	$40
Curly	=	$40
Moe	=	$20

Assume these endowments have already incorporated the costs to each of enforcing property rights to these endowments. In other words, the endowments listed represent the dollar amounts each can consume without redistribution. Suppose further that all decisions, including the redistribution of society's wealth, are made according to majority rule unless an alternative decision making rule is specified in the constitution. Unless prohibited by the social contract, simple majority rule allows any coalition of two players to tax the third member and transfer those resources to its members. Assume also the tax and transfer can be achieved costlessly[33]

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[31] *See* MARTIN SHUBIK, GAME THEORY IN THE SOCIAL SCIENCES 2 (1982); Emerson Niou & Peter C. Ordeshook, *Universalism and Congress*, 29 AM. J. POL. SCI. 246 (1985); Barry R. Weingast, *A Rational Choice Perspective on Congressional Norms*, 23 AM. J. POL. SCI. 245 (1979).

[32] This proposition is more formally presented and proven in Dougan & Snyder, *Interest Group Politics*, *supra* note 21.

[33] Implicitly, we are also assuming that each player's supply of productive activities is perfectly inelastic. By this we mean that each player produces the same amount, regardless of his expectations

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and all players share the following three expectations:

1) only minimal winning coalitions (here, coalitions of two members) will form;
2) all minimal winning coalitions (MWC's) are equally likely to form; and
3) the MWC that forms will divide the total wealth equally among all the members of the coalition (here, two members will end up with $50 each).

Given these expectations, it is impossible for the players to tell which coalitions will form in any iteration of the voting game. Because the majority coalitions will likely shift over time if the odd man out can attract one member of a winning coalition away to form a new winning coalition in the next period, from an ex ante perspective, each of the players anticipates a 2/3 likelihood of receiving $50 and a 1/3 likelihood of receiving $0. Each player's expected payoff from any future voting is $33.33. Our rich citizens, Larry and Curly, prefer a prohibition on majority rule wealth transfers, but Moe, who was endowed with only $20, clearly prefers democratic transfers. And, without a prohibition on redistribution, even Larry and Curly are tempted to redistribute wealth, because each is better off in a majority coalition ($50) than either is outside it ($0) or with his initial endowment ($40).

If a majority of the population is "poor" in the sense that their expected payoffs from the transfer game are greater than their initial endowments, then the transfer game receives majority support. Suppose, for example, that our players' wealth endowments were instead:

Larry	=	$60
Curly	=	$20
Moe	=	$20

Now, Larry always prefers his initial endowment to redistribution, but Curly and Moe always prefer redistribution. In either event, if wealth transfers were costless, then a society with equal votes but unequal endowments would necessarily include some citizen support for redistribution of the wealth. In a democracy, then, the poorest members would not agree to a flat prohibition on wealth redistribution from rich to poor.

Of course, all redistribution entails costs, which we initially assumed away. These costs are key to any social contract and take several forms. First, individuals may be risk averse, which means they prefer to pay

regarding the transfer of the wealth that he and the others produce. We relax this assumption later.

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something to avoid the risk that the other members will reduce their wealth. Second, there are costs to negotiating over coalition formation. To form a winning coalition, each of the players must convince one of the other players to side with him rather than with the third member. Indeed, we assumed that only "minimal" winning coalitions would form because internal bargaining costs generally rise with the number of members in the coalition.[34] Third, in representative democracies, there are also opportunity costs of voting and influencing policymakers. Even if a majority coalition is stable, it must inform its delegate of preferred policies and monitor the actions of the delegate, whose interests may not fully coincide with her constituents' interests. Finally, and perhaps most importantly, the transfer of resources entails dead-weight costs. For example, if Larry knows there is some risk that Curly and Moe will take his wealth, then Larry has less incentive to work to produce income because he expects to consume only 2/3 of what he actually produces. Moreover, some individuals may choose to specialize in creating favorable redistribution rather than producing wealth for society. Once we take into account the costs of redistribution, then the preferences of the citizens regarding majority rule become somewhat ambiguous.

We incorporate the total costs of redistribution into our model by denoting them **g(c)**. Now the after tax wealth of the winning coalition cannot exceed **$100-g(c)**, because **g(c)** is lost in an effort to achieve the transfer. Assuming the same three expectations about minimal winning coalitions hold, with costly redistribution the expected after tax payoff to each player is **[100-g(c)]/3**. This is so because, if a player is a member of a winning coalition, he will consume **[100-g(c)]/2**, and he assesses a 2/3 probability of ending up in the winning coalition. Thus, each player's expected payoff is:

$$[(100-g(c))/2][2/3]\ [0][1/3] = [100-g(c)]/3.$$

Once we take the costs of redistribution into account, Moe's preference for majority rule turns on the magnitude of those costs.[35] But as long as those costs do not exceed 40% of the total wealth in our example, Moe will prefer redistribution. The greater the relative wealth of rich and poor players, the greater the costs must be before the players could achieve a

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[34] For a discussion of decision making costs as a function of the size of the group needed to agree to a policy change, see JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT 68-72 (1974).

[35] Recall that when Larry and Curly were "rich," they preferred a prohibition on redistribution, even when the redistribution proved costless. Presumably they prefer majority rule redistribution even less when it entails social costs, but to know for certain, the redistribution costs would have to be compared with any changes in the costs of property rights enforcement across the two regimes.

unanimous agreement prohibiting redistribution. Suppose, for example, that Moe was initially endowed with only $10 of the total $100 in wealth. Then, so long as coalition costs are less than 70% of the total wealth, he still prefers majority rule.

2. Reducing Transfer Costs

Implicit in these conclusions is an insight familiar to public choice theorists: the lower the costs of a wealth transfer, the more likely the transfer will succeed.[36] How might a winning coalition minimize the costs of equalizing redistribution? There are several possibilities, but we mention three here. First, if a majority coalition can credibly commit to limiting the maximum tax rate on the wealthy,[37] then the dead-weight costs and the costs associated with risk aversion will be reduced. If each wealthy member knows he will retain at least some of his wealth regardless of whether he ends up in the winning coalition, then the down-side risk of losing the transfer game is smaller. And, if he is guaranteed to keep at least some of his income, then he may have more incentive to produce. Moreover, confiscating all of an individual's wealth leaves him worse off than he would be in anarchy, which itself becomes an implicit violation of the social contract that adopted democratic decision making in the first place.[38] Of course, lower tax rates mean that members of the winning coalition consume a smaller percentage of total wealth, but Moe, our poor citizen, might ultimately prefer a smaller slice of a larger pie.

Second, the poorer members might reduce coalition costs with class identification.[39] Let us assume, for example, that members of a larger society choose a representative democracy in which politicians compete for office. Those politicians can ensure election by fusing together a stable winning coalition of voters. A politician may well find that he can garner a large number of votes by championing the interests of the poor and working classes. Class identification helps keep the group together for the

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[36] *See* Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983) [hereinafter Becker, *Theory of Competition*].

[37] This could be done by promise, by constitutional rule, or by electing a representative who is himself a member of the wealthiest class.

[38] Indeed, economists have used anarchic models to establish that a social contract typically entails at least some protection of private property. *See* Jack Hirshleifer, *Anarchy and Its Breakdown*, 103 J. POL. ECON. 26 (1995); John Umbeck, *Might Makes Rights: A Theory of the Formation and Initial Distribution of Property Rights*, 19 ECON. INQUIRY 38, 40 (1981). For a simple anarchic model where identical individuals choose a social contract incorporating property rights with positive enforcement costs, see Goran Skogh & Charles Stuart, *A Contractarian Theory of Property Rights and Crime*, 84 SCAND. J. ECON. 27 (1982).

[39] *Cf.* Lorenzo Kristov et al., *Pressure Groups and Redistribution*, 48 J. PUB. ECON. 135, 152 (1992) (social affinities make association and communication easier).

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purposes of redistribution. In effect, then, class identification might force a relaxation of the second expectation listed above; in this situation, some minimal winning coalitions are more likely to form than others.

Third, cash or direct wealth transfers typically entail lower deadweight costs than indirect forms of transfers.[40] Indeed, equalizing redistribution is more likely to take the form of direct transfers than is non-equalizing redistribution. For an explanation of the differences, we now turn to an analysis of non-equalizing redistribution.

B. *Non-equalizing Redistribution*

Equalizing redistribution is a likely result of unequal wealth endowments and equal votes because some individuals expect to be better off with the redistribution even when the coalitions formed to achieve the redistribution are unstable. In contrast, non-equalizing transfers, or those that do not tend toward equality of consumption, are unlikely to be enacted unless there are particular types of asymmetries among participants in the political process. For non-equalizing redistributions, the asymmetries depend upon stable coalitions that support the particular redistribution. In fact, whether some individuals expect to be made better off by a non-equalizing transfer game turns on the form of the transfer itself. As we explain below, asymmetries in expected outcomes are more likely when those transfers are indirect.

Some government policies are designed to transfer wealth regardless of initial endowments. Agricultural subsidies, tariffs and import restrictions, and occupational licensing requirements are just a few examples. These policies all have the effect of making the members of a domestic industry better off, while passing the costs of those redistribution programs to consumers of the goods or services. In addition, these transfers all appear to be indirect. Economists have established that direct cash transfers are generally more efficient than the more complex government programs[41] typically associated with non-equalizing wealth redistribution. Why, then, are these transfers typically indirect? Some economists have posited that indirect transfers fool the public by concealing the rent seeking nature of the legislaion.[42] This explanation is not entirely compelling, however, because often the public is not fooled. In a recent article, Dougan

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[40] *See* EDGAR K. BROWNING & JACQUELINE M. BROWNING, PUBLIC FINANCE AND THE PRICE SYSTEM 123 (4th ed. 1994).

[41] *See id.*

[42] *See, e.g.*, Gary Becker, Comment, 19 J.L. & ECON. 245, 246 (1976) [hereinafter Becker, Comment] (indirect transfers commonly explained by voter ignorance); Phillip Nelson, *Political Information*, 19 J.L. & ECON. 315, 323 (1976) (describing voter ignorance as "dominant view").

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and Snyder offer another rationale: indirect transfers enable "asymmetric expectations" that are necessary to make the transfers stable and therefore beneficial to the recipients.[43] To explain their rationale, we return to the model presented in section A above.

1. Symmetric Expectations

Assume that the same three players have formed a democracy. Because we are analyzing non-equalizing redistribution, assume that the three players are identically endowed with wealth. As a consequence, any wealth transfers will tend to be non-equalizing. Suppose therefore their total wealth is again $100, and each is endowed with $33.33. Assume also the three players play the same majority rule transfer game. Any two players can take the wealth of the third and split the proceeds equally.

Assume further that the same three expectations regarding coalition formation hold:

1) only minimal winning coalitions form (here, two players);
2) all MWC's are equally likely (in other words, the players share no natural affinities that make it easier for a particular majority to form); and
3) MWC's that form divide the proceeds equally among the coalition's members.

Expectations 2 and 3 taken together define the conditions under which individual expectations regarding the outcome of the transfer are "symmetric." That is, no player expects to be better off with redistribution than any of the other players. If the redistribution is costless, then after the transfer each player expects to have:

$50(2/3) $0(1/3) = $33.33

Larry, Curly and Moe are each indifferent between a rule permitting non-equalizing transfers and a rule prohibiting them. If instead, however, the transfers entail any costs, then the players' expected payoffs fall below their initial endowments, and everyone is made worse off under the transfer game. Because all transfers entail costs, individuals who have symmetric expectations regarding outcomes would unanimously agree to a constitutional prohibition on the transfers themselves.[44]

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[43] *See generally* Dougan & Snyder, *Rents*, *supra* note 21.

[44] We are assuming, of course, that the coalition costs avoided from imposing the restriction are greater than the costs of generating and enforcing the prohibition. Courts can use general constitutional

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This simple divide-the-dollar paradigm is useful for analyzing some types of discriminatory taxation. That is, there are situations when the assumptions of equal endowments and equally likely MWC's do not contradict reality in any critical sense. For example, if a society is composed of many small groups with divergent interests, it might be difficult to make predictions about who will be in the majority in any given period. If that majority shifts over time with bargaining, individuals can be expected to be in the majority sometimes but not others. Sometimes the individual or small group may be chosen in a democracy to bear a disproportionate burden of the aggregate tax bill, in effect redistributing wealth toward the majority. If unstable majority opportunism is a likely result of legislative bargaining, the individuals cannot predict who will likely be singled out to carry that burden. In these situations, individuals' expected outcomes from legislative bargains are symmetric.

Even though everyone is worse off in the end, the legislature might enact tax laws without realizing the long-term symmetric losses they entail. Alternatively, legislators might face relatively short time horizons which induce them to ignore long-term losses in order to provide their constituents with short-term benefits. To protect themselves from either possibility, the citizens would support a constitutional prohibition against these forms of non-equalizing discrimination.

2. Asymmetric Expectations

Of course, some legislative bargains do persist over time. And some political entrepreneurs and interest groups seem better able to form majority coalitions than others. How, then, do interest groups succeed in obtaining transfers with positive net benefits to the members of the group?[45] Our simple model identifies two requirements. First, the interest group must be a persistent component of the majority coalition. Second, allocation of the benefits among the individual members of the interest group also must be stable.

To explain, we return to our model. Within that model, net benefits can only be reduced by relaxing one or more of the three expectations listed above. Consider first the effect of relaxing the second expectation, that all minimal winning coalitions are equally likely to form. When the unrealistic Rawlsian "veil of ignorance" is lifted, we can take into account the fact that not all majority coalitions are equally likely to form. Some

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prescriptions of fairness to eliminate the costs of incorporating specific transfer prohibitions into the constitution.

[45] Dougan and Snyder describe the conditions under which groups can obtain positive rents from legislation. *See* Dougan & Snyder, *Rents*, *supra* note 21.

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political groups form more naturally than others as a result of shared affinities of the group's members. Those that can form more easily experience reduced coalition costs because natural affinities make it harder for non-members to attract group members away from their winning coalition.

To illustrate our point, suppose Larry and Moe are members of the same religion or cultural ancestry. Their similarities might make it easier for them to interact with each other than with Curly, for individuals typically prefer to associate with others who share similar backgrounds, beliefs, and talents.[46] As a result, they can form a winning coalition more cheaply than either can form a coalition with Curly. Members of a single profession might also form a successful political group.[47] Common examples today include the American Bar Association, the American Medical Association, and the Semiconductor Industry Association. Not only do they share common interests and endeavors, but it is also easier for them to generate policies that will likely benefit everyone within the group. If a given proposal will yield common benefits, then it will yield support from all the members.

Contrast these similarities with others that will not likely produce stable coalitions. Take eye color, for example. If Larry and Curly have brown eyes and Moe has blue eyes, then the brown-eyed people could form a coalition to impose a tax on the blue-eyed individual. Unfortunately for Larry and Curly, there is nothing inherently stable about a brown-eyed coalition. Moe could easily convince one of these two to form an alternative coalition with him organized along some other basis. If Moe can organize a coalition based on a more fundamental affinity such as religion, ethnicity, age, or occupation, then Moe's alternative coalition is much more likely to endure. If the affinity is strong enough, then it becomes too costly for the person outside the coalition to compete to bid away someone to form a new winning coalition. In fact, we do tend to see political organizers focusing on those affinities that reduce the costs of stable coalition formation.[48]

While forming stable coalitions is necessary to successfully obtain transfers, it is not alone sufficient. The coalition must find ways to allocate tax benefits at a cost sufficiently low to preserve those benefits for the coalition members. In other words, the third expectation listed above (i.e.,

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[46] *See, e.g.*, PHILIP A. MUNDO, INTEREST GROUPS 10 (1992) (table discussing U.S. interest group organizational focus on occupation, religion, veteran status, and union status); Ronald Hrebenar, *Change, Transition, and Growth in Southern Interest Group Politics*, *in* INTEREST GROUP POLITICS IN THE SOUTHERN STATES 321, 338-39 (Ronald Hrebenar & Clive S. Thomas eds., 1992) (listing 40 most effective national lobbying interests, including those representing occupational, gaming, abortion, senior citizen, religious, women's and minority groups).

[47] *See* MUNDO, *supra* note 46, at 10.

[48] *See, e.g.*, Kristov, *supra* note 39.

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MWC's that form divide the proceeds equally among its members) dodges an important problem for political groups: once the group manages to transfer wealth from others, how do the members of the successful coalition divide the proceeds among themselves? Unless the members precommit to a stable mechanism for distributing the benefits, considerable resources may be wasted when the members vie for the proceeds. Every parent knows, for example, that if an adult places a large piece of chocolate cake in front of two children to share, the children are likely to squabble over which child gets which portion of the cake. Potential solutions can increase the happiness of the children. The adult could cut the piece into two before presenting the cake to the children and decide which child will receive which piece. Or the children can adopt the classic "cut and choose rule" whereby one child divides the cake into two portions and the other child chooses which portion she prefers.

Similar squabbling raises potential problems for political coalitions. Suppose Christians form a coalition to tax non-Christians and transfer the cash to the Christians. Each Christian sect will vie for as large a portion of the cash as possible. With each sect attempting to persuade the coalition it deserves a larger portion, the costs associated with these attempts threaten to dissipate the net benefit of the transfer. Moreover, religious sects that were "non-Christian" before the tax will now attempt to appear "Christian" in order to share the benefits of the tax structure. Indeed, some political choice theorists have posited that potential recipients of "rents" will likely completely dissipate all the benefits from those rents in an effort to obtain them.[49] In other words, each is willing to spend a sum up to the expected benefits from the transfer in order to get the transfer, and, on net, no one can expect to be better off from rent seeking. To eliminate squabbling after the transfer, the Christians could propose legislation that describes the allocation of the cash to individual sects, but then the dissipating rent seeking occurs before the legislation is passed. Either way, the rents get dissipated.

Or do they? Certainly if the transfer takes the form of cash, rent dissipation is likely quite large. But, suppose instead the transfer takes a different form. Doctors, for example, could attempt to transfer cash to themselves from non-doctors, but then each doctor fights for a larger share. Even if the doctors could agree to divide the cash pro rata, the transfer attracts others into the medical profession to claim a share of the cash. The larger the number of claimants, the less each doctor receives. Doctors might be better off with a non-cash transfer, in the form of an occupational licensing requirement. In all states today, one who wishes to practice

[49] *See, e.g.*, Richard Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807, 809 (1975); Tullock, *Tariffs, Monopolies, and Theft*, *supra* note 22.

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medicine must attend medical school and be admitted to the medical bar. By limiting the number of people who are licensed to practice medicine, reduced competition enables doctors to charge higher fees for their services than they could with more people competing in the field. Those higher fees are as good as cash for doctors. In addition, the licensing requirement makes it more difficult for those outside the profession to enter the medical field in order to benefit from the transfer. Finally, the licensing requirement prevents costly bargaining by existing doctors over the distribution of the proceeds. The allocation mechanism is built into the requirement. Certainly, not all doctors will benefit equally from the licensing requirement because the supply curves for the individual competing doctors likely will differ. Nevertheless, each doctor can, if she wishes, increase the number of hours each year that she treats patients and consequently reap a greater benefit from the increased fees. The non-cash nature of the transfer prevents doctors from squabbling over the allocation of the benefits. To be sure, the licensing requirement entails more administrative costs than a pure cash transfer, but these costs are more than offset by the reduced intra-coalition costs of distributing the proceeds.[50]

In other words, doctors can expect to be made better off on net with the indirect transfer than they can with a direct cash transfer. If doctors expect to be part of a winning political coalition because their professional affinities lower the costs of forming a political coalition, then they expect to benefit from a constitutional rule that permits licensing requirements. In this sense, individual expectations regarding the transfer game are "asymmetric": some coalitions are more likely to form than others, and the individuals within the coalition can prevent rent dissipation that results from outside entry and intra-group lobbying.

Indirect transfers are common forms of rent seeking for other groups as well. Consider, for example, price supports on agriculture.[51] The farmers can lobby for government efforts to keep the price of farm products above some specified level by, for example, purchasing and then destroying excess produce. Because all farmers benefit from the price supports, political organizers find it easy to organize the group to support the measures. Some farmers benefit more than others from the supports, but the non-cash nature of the transfer prevents rent dissipation. And to a large extent, farmers can exclude others from joining the coalition to share in the rents because the supply of an essential farming input, here land, is relatively fixed.

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[50] *See* Dougan & Snyder, *Interest Group Politics*, *supra* note 21, at 63-64.

[51] *See, e.g.*, Ronald N. Johnson, *Retail Price Controls in the Dairy Industry: A Political Coalition Argument*, 28 J.L. & ECON. 55 (1985).

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C. *Minimalist Prohibitions*

We now return to the question we initially posed. Assume that a democratic society permits discriminatory taxation unless, viewed ex ante, the transfers are expected to make everyone worse off on net. Which transfers, if any, would be prohibited by the society? As described in Figure 1, redistributive policies can take the form of equalizing transfers or non-equalizing transfers. Because the poor expect to be made better off with equalizing transfers, they would not agree categorically to prohibit them. We would expect to see some progressive taxation in democracies, for example. Progressive taxation might well be capped, though, to contain the dead-weight costs of extreme redistribution.

For non-equalizing transfers, support for prohibition will turn on whether individuals' expected outcomes from the particular type of transfer are symmetric or asymmetric. If people cannot predict ex ante whether they are likely to be in the group benefitted or the group burdened, then they will agree to prohibit the transfer. Predictions are difficult, for example, if the coalitions that form to achieve a particular type of transfer are usually unstable. Sometimes the individual expects to benefit, and sometimes he expects to lose. In the end, playing the game becomes a losing proposition because everyone expects to lose on net once the costs of the wealth transfers are taken into account. If individuals have symmetric expectations regarding some wealth transfers, those transfers will be prohibited.

If individual expectations are asymmetric, however, some expect a net positive return from lobbying for tax deductions or for taxes imposed on others that inure to the benefit of a group within the winning coalition.[52] Those individuals may not agree to prohibit the transfers, even though the aggregate wealth of society is reduced as a consequence of the transfers, if their own expectations are sufficiently asymmetric. After all, politicians are rewarded for maximizing the well-being of their constituents, not the welfare of society as a whole. When affinities generate stable coalitions, and benefitted groups can minimize intra-group competition for the proceeds, then expectations are asymmetric. If instead, competition within a winning coalition will likely dissipate the benefits of a transfer, then otherwise asymmetric expectations become symmetric, where even the winning coalition expects to lose in the end. And, as we discussed above, asymmetries are more likely to occur with indirect wealth transfers than with direct ones. In the end, then, under a minimalist constitution, only one type of transfer is clearly prohibited: non-equalizing transfers with sym-

[52] *See* Dougan & Snyder, *Interest Group Politics*, *supra* note 21, at 57-61.

metric expectations.

A review of discriminatory tax cases indicates that the courts have adopted this very minimalist view in scrutinizing transfers under equal protection, due process, takings, and uniform taxation provisions of the state and federal constitutions. The modern courts only strike down taxes when the type of tax in question is likely to make everyone worse off in the end. In other words, the courts' line between arbitrary and nonarbitrary non-equalizing transfers often seems to correspond with Dougan and Snyder's distinction between symmetric and asymmetric expectations. We now review some of the discriminatory tax cases to illustrate the point. In Part IV, we proffer an explanation of why the courts have steered this very minimalist course in checking legislative bargains.

III. DISCRIMINATORY TAXES IN AMERICAN COURTS

In this Part, we apply our model to American case law on discriminatory taxation. Despite the categorical language of the Equal Protection Clause,[53] American courts have never categorically prohibited discriminatory taxes. Instead, the Supreme Court has taken the position that legislatures can break individuals into classes for separate tax treatment so long as the classification is "based upon some reasonable ground" and is "not a mere arbitrary selection."[54] As stated in *Magoun v. Illinois Trust & Savings Bank*:

> [T]he State may distinguish, select, and classify objects of legislation, and necessarily this power must have a wide range of discretion. It is not without limitation, of course. "[C]lear and hostile discriminations against particular persons and classes, especially such as are of [an] unusual character, unknown to the practice of our governments, might be obnoxious to the constitutional prohibition."[55]

But which discriminatory taxes are "arbitrary" or "clear and hostile," and what underlying theory have the courts used to decide the cases?

Section A describes the case law on progressive taxation and concludes

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[53] U.S. CONST. amend. XIV, § 1 ("nor shall any State . . . deny to any person within its jurisdiction the equal protection of the laws").

[54] Magoun v. Illinois Trust & Sav. Bank, 170 U.S. 283, 294 (1898); *see also* Allegheny Pittsburgh Coal Co. v. County Comm'n, 488 U.S. 336, 344 (1989) ("A State may divide different kinds of property into classes and assign to each class a different tax burden so long as those divisions and burdens are reasonable."); State Bd. of Tax Comm'rs v. Jackson, 283 U.S. 527, 537 (1931) ("The fact that a statute discriminates in favor of a certain class does not make it arbitrary, if the discrimination is founded upon a reasonable distinction, or if any state of facts reasonably can be conceived to sustain it.") (citations omitted).

[55] *Magoun*, 170 U.S. at 294 (quoting Bell's Gap R.R. Co. v. Pennsylvania, 134 U.S. 232, 237 (1889)).

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that the Supreme Court typically has interpreted the federal Constitution consistently with our contractarian model, which predicts no unanimous agreement prohibiting equalizing wealth transfers. In Section B, we discuss federal and state treatment of discriminatory property taxation, including general property taxes and special assessments. Here too, the courts' role as a safeguard against at least extreme discrimination comports with our model. In section C, we consider other classifications. Although the correlation with our model is less than perfect, the Supreme Court often appears to base distinctions on a rough guess about the symmetry of individual expectations.[56]

A. *Income and Wealth Based Progressive Taxation*

Our model of minimalist prohibitions predicts that while the social contract in the United States might well forbid some forms of discriminatory taxation, at least some redistribution toward equality would be permitted, indeed expected. One prominent example is progressive taxation, a mainstay of U.S. revenue-raising policies in the last century. Because progressive taxation is one of the least costly wealth-equalizing mechanisms, the minimalist contractarian theory predicts that the Constitution would either explicitly or implicitly allow some progressive taxation.

Not surprisingly, then, the Supreme Court has never interpreted the United States Constitution to forbid progressive income or wealth taxes. *Pollock v. Farmers' Loan and Trust Co.*[57] is often incorrectly cited to the contrary, however.[58] In *Pollock*, which preceded the adoption of the Sixteenth Amendment, the Supreme Court invalidated portions of a two percent federal tax on individual, business and corporate income above $4,000 on any gains, profits, or income from any property, rents, interest, dividends, salaries, or any other source.[59] While the tax technically incorporated mild progressivity, the equally divided Court expressed no opinion on the constitutionality of the general income tax scheme. The Court was considering, among other issues, whether all or part of the tax statute violated the Apportionment Clause of the Constitution, which provides: "Representatives and direct Taxes shall be apportioned among the

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[56] We leave for another paper a discussion of taxes that attempt to discriminate against interstate commerce. The coalition formation requires a slightly different model, and the incidence of the tax burdens becomes complicated and varies depending on whether we consider import or export taxes.

[57] 157 U.S. 429 (1895), *superseded by* U.S. CONST. amend. XVI, *overruled in part by* South Carolina v. Baker, 485 U.S. 505 (1988).

[58] *See, e.g.*, Ronald K.L. Collins & David M. Skover, *The Future of Liberal Legal Scholarship*, 87 MICH. L. REV. 189, 205 n.67 (1988); Morton J. Horwitz, *History and Theory*, 96 YALE L.J. 1825, 1828 (1987).

[59] *See Pollock*, 157 U.S. at 434-35 n.1, 583.

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several States which may be included within this Union, according to their respective Numbers . . . ."[60] With respect to the tax scheme, however, the Court struck down only the tax on the rents and income from real estate, reasoning that since a tax on real estate had historically been considered a "direct tax" under the Apportionment Clause, taxing the income flow from the real estate must also constitute a "direct tax."[61] Because the tax was not assessed in proportion to the population, as required for all direct taxes, it was unconstitutional.[62]

Of course, the concept of "direct tax" was nebulous at best, as evidenced by the Court's extensive discussion in *Pollock* of several possible definitions of the term.[63] The Court could easily have used this ambiguity to strike down taxes it found objectionable for other reasons. But both before and after *Pollock*, the Court upheld progressive tax schemes. For example, the Court in *Springer v. United States*, upheld the validity of an 1864 federal tax on incomes, gains, and profits by classifying it as an indirect tax not requiring apportionment.[64] Similarly, the Court had also upheld progressive federal inheritance and estate taxes as "indirect."[65] Nevertheless, the *Pollock* decision posed a problem for federal taxation. By holding that a tax on income from property was a "direct" tax, *Pollock* potentially signaled a widespread prohibition on Congress' ability to use progressive income taxes more generally.[66]

To restore fully the federal government's ability to tax income, from real estate as well as from other sources, the Sixteenth Amendment was added to the Constitution. It gives Congress the power to impose income taxes without requiring apportionment among the states.[67] The Sixteenth

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[60] U.S. CONST. art. I, § 2, cl. 3.

[61] *Pollock*, 157 U.S. at 580-83.

[62] *See id.* at 583.

[63] *See id.* at 558-83. The *Pollock* Court described the common understanding of direct taxes as follows:

> Ordinarily all taxes paid primarily by persons who can shift the burden upon some one else, or who are under no legal compulsion to pay them, are considered indirect taxes; but a tax upon property holders in respect of their estates, whether real or personal, or of the income yielded by such estates, and the payment of which cannot be avoided, are direct taxes.

Id. at 558. Yet, in *Springer v. United States*, 102 U.S. 586, 602 (1880), the Court concluded that direct taxes included only capitation and real estate taxes. At least some of the justices in *Pollock* were prepared to expand the *Springer* definition.

[64] *See Springer*, 102 U.S. at 602.

[65] Knowlton v. Moore, 178 U.S. 41, 78-83 (1900); *see also* New York Trust Co. v. Eisner, 256 U.S. 345, 349 (1921).

[66] *See, e.g.*, David P. Currie, *The Constitution in the Supreme Court: The Protection of Economic Interests, 1889-1910*, 52 U. CHI. L. REV. 324, 350-52 (1985) (*Pollock* signaled a shift in the Court's position on income taxes because twice in the preceding twenty-five years it had held that income taxes were indirect).

[67] The Amendment reads, "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to

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Amendment leaves many questions unanswered, however, for it is well known that a legislature's power to tax cannot be used to achieve unconstitutional ends.[68] More specifically, the Court still had to grapple with whether certain forms of state and federal income and wealth taxation, including progressive tax schemes, violate other provisions of the Constitution, such as the Due Process and Equal Protection Clauses.

The Supreme Court has rarely scrutinized progressive taxation under these clauses,[69] but a few cases indicate the Court's longstanding approval of progressive schemes. For example, in *Brushaber v. Union Pacific Railroad*,[70] the Court upheld a federal income tax scheme with progressively increasing rates and exemptions unavailable for individuals with incomes exceeding $20,000. The plaintiff asserted that the tax violated the Due Process Clause[71] because it was based solely on wealth, arguing that "the progressive feature of the tax cause[d] it to transcend the conception of all taxation and to be a mere arbitrary abuse of power."[72] The Court rejected the plaintiff's proposition, and noted that progressive taxes have existed in the United States since "the very early history of the Government."[73]

In another case, *Magoun v. Illinois Trust & Savings Bank*,[74] the Court reviewed Illinois' progressive state inheritance law, under which the tax rate increased with the value of the estate or property received by an heir. Since both the size of the estate and the amount transferred reflect the decedent's wealth, the progressive rate is consistent with our model. Not surprisingly, then, the Court held the law to be consistent with the Equal Protection Clause.[75]

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any census or enumeration." U.S. CONST. amend. XVI.

[68] *See, e.g.*, United States v. Butler, 297 U.S. 1, 68 (1936) ("It is an established principle that the attainment of a prohibited end may not be accomplished under the pretext of the exertion of powers which are granted."); *see also* Forsyth County, Ga. v. Nationalist Movement, 505 U.S. 123 (1992); Murdock v. Pennsylvania, 319 U.S. 105 (1943); Grosjean v. American Press Co., 297 U.S. 233 (1936).

[69] *See* Davidson v. New Orleans, 96 U.S. 97, 104-06 (1877) (in case predating application of Bill of Rights guarantees to state and local governments, Court declines to consider whether unequal taxation by state constitutes unconstitutional taking); BLUM & KALVEN, *supra* note 1, at 6-11.

[70] 240 U.S. 1 (1916).

[71] U.S. CONST. amend. V ("No person shall be . . . deprived of life, liberty, or property, without due process of law.").

[72] *Brushaber*, 240 U.S. at 25.

[73] *Id.*

[74] 170 U.S. 283 (1898).

[75] *See id.* at 299-301; *see also* U.S. CONST. amend XIV, § 1 ("nor shall any State . . . deny to any person within its jurisdiction the equal protection of the laws"). However, another aspect of the tax scheme upheld in *Magoun* puzzles us. The scheme also discriminated on the basis of the heir's relation to the decedent: that is, close relatives paid a lower tax rate on the size of the inheritance received than did more distant relatives, and all other heirs paid even higher tax rates, which were levied on the value of the entire estate. Although it may be that legacies to nonrelatives are primarily a luxury of the rich, the state could have effected wealth-based transfers much more cleanly with a single progressive rate structure. The scheme may serve a dual purpose, however. If the decedent is wealthy, then the higher tax seems to be a form of redistribution predicted by our model. If instead the decedent is poor, then

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The Supreme Court has not heard a case challenging the constitutionality of progressive taxation in recent years, probably because it so clearly signaled that progressive schemes are constitutional. However, we predicted that the United States Constitution likely includes a limitation on the amount of permissible redistribution toward equality. Are there any limitations built into the constitutional scheme?

Perhaps the Due Process Clause protects against the most extreme redistribution schemes. The Supreme Court has at times used this clause to provide a minimal guarantee that our legislative bargains be at least substantially fair.[76] The Court has indicated that it would invalidate taxes found to be "palpably arbitrary and unreasonable"[77] or "harsh and oppressive."[78] But in more recent years the Court has retreated away from using the Due Process Clause to ensure substantive fairness, as least with regard to economic liberties,[79] and the Court has yet to find a progressive tax scheme impermissibly redistributive. Indeed, as early as 1935, the Court signaled its refusal to strike down excessive taxes by stating, "[o]nce the lawfulness of the method of levying the tax is affirmed, the judicial function ceases. He deludes himself by a false hope who supposes that, if this court shall at some future time conclude the burden of the exaction has become inordinately oppressive, it can interdict the tax."[80]

This raises an interesting question: why has the Court not found it necessary to strike down a single redistributive scheme? One possible answer is that the limited redistribution contract is more accurate, but that the Court is manned with socialists who refuse to enforce the social contract properly. On the other hand, United States history has been characterized by a fair amount of wealth redistribution that has been growing markedly in recent decades,[81] but we hardly approach an "egalitarian society."[82] More

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the discriminatory tax helps ensure that his limited resources are used to support his family after his death. Otherwise, society might be forced to support that family by effecting yet another costly wealth transfer. While incentive-based taxes are largely beyond the scope of our paper, this one could ultimately be wealth-enhancing, and therefore not clearly excluded by the social contract.

[76] *See, e.g.*, JOHN HART ELY, DEMOCRACY AND DISTRUST 14-21 (1980).

[77] Milliken v. United States, 283 U.S. 15, 20 (1931).

[78] Welch v. Henry, 305 U.S. 134, 147 (1938).

[79] *See* GEOFFREY R. STONE ET AL., CONSTITUTIONAL LAW 744 (1986); Jerry L. Mashaw, *Constitutional Deregulation: Notes Toward A Public, Public Law*, 54 TUL. L. REV. 849 (1980).

[80] Stewart Dry Goods Co. v. Lewis, 294 U.S. 550, 563 (1935); *see also* City of Pittsburgh v. Alco Parking Corp., 417 U.S. 369, 373 (1974) ("The claim that a particular tax is so unreasonably high and unduly burdensome as to deny due process is both familiar and recurring, but the Court has consistently refused either to undertake the task of passing on the 'reasonableness' of a tax that otherwise is within the power of Congress or of state legislative authorities, or to hold that a tax is unconstitutional because it renders a business unprofitable."); Tanque Verde Enterprises v. City of Tucson, 691 P.2d 302, 305-06 (Ariz. 1984) (en banc) (taxing authorities have unlimited discretion to set the tax rate, despite its effect, and the judiciary will not invalidate the tax "even if the tax may or will result in restricting or destroying a particular business or occupation").

[81] *See* Alejandro Portes & D. Frances Ferguson, *Comparative Ideologies of Poverty and Equity:*

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likely, then, the Court has found no need to exercise a supervisory role regarding redistribution. Perhaps there are structural limitations, or procedural roadblocks, to legislative redistribution. Even without structural limitations, however, there is little reason to think the rich cannot enforce their own limitations in the political process. Indeed, the interests of the rich are well-represented; today most legislators are among the wealthiest individuals in the population.

It is not clear that the rich use these limitations to thwart the interests of the poor, either. In fact, redistribution creates significant negative effects. Because output is not supplied perfectly inelastically, at some point lowering the marginal tax rate might significantly increase aggregate wealth.[83] The poor might perceive that they are better off taking a smaller slice of a bigger pie, and might agree to limit tax rates accordingly. Note that in this case, the poor face no incentive incompatibility problems. No contrary action in the short run, with the exception of a one-time surprise tax, is likely to make the poor better off.

B. *Discriminatory Property Taxes*

Although American courts have been uniformly unsympathetic to progressive tax challenges, they have scrutinized discriminatory property taxes more carefully. In this section, we consider special assessments and general property taxes.

1. Special Assessments

The American courts have a long history of protecting citizens against the improper use of special assessments and disparate property taxes, and the courts review them carefully under state and federal due process and takings clauses. The Takings Clause, incorporated into the Fifth Amendment of the United States Constitution, provides that private property shall not be taken, except for public use, and with just compensation.[84] While the Takings Clause, by its terms, applies only to the federal government, the Due Process Clause of the Fourteenth Amendment has been interpreted to

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Latin America and the United States, *in* EQUITY, INCOME AND POLICY 70, 87-95 (Irving Louis Horowitz ed., 1977).

[82] Robert T. Lampman, *Concepts of Equity in the Design of Schemes for Income Redistribution*, *in* EQUITY, INCOME AND POLICY, *supra* note 81, at 19, 30-31.

[83] *Cf.* EPSTEIN, TAKINGS, *supra* note 1, at 299 ("By increasing the size of the pie, the flat tax tends to increase the size of each of its slices.").

[84] *See* U.S. CONST. amend. V ("nor shall private property be taken for public use, without just compensation").

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impose the same takings standard on state and local government action.[85] Moreover, several states have included similar takings provisions in their constitutions.[86]

American courts have used these constitutional provisions to hold that discriminatory property taxes can constitute an unconstitutional taking against the more heavily taxed property owner. For example, in *Bonnet v. State*,[87] the New Jersey Superior Court articulated the limits on the state's power to impose discriminatory taxes under a state constitutional provision identical to the Takings Clause in the U.S. Constitution: "the imposition of unfair tax burdens, to the point where they are discriminatory, with the power to sell the taxed property to collect payment, violates [the takings clause of the New Jersey Constitution]."[88] And while the U.S. Supreme Court's language seems less protective, the Court has indicated a willingness to use the clauses if discriminatory taxation exceeds permissible bounds:

> [The Due Process Clause] is applicable to a taxing statute only if the act be so arbitrary as to compel the conclusion that it does not involve an exertion of the taxing power, but constitutes, in substance and effect, the direct exertion of a different and forbidden power, as, for example, the confiscation of property.[89]

The most common type of taxation struck down under takings and due process provisions is the special assessment. Special assessments are levied against a small group of property owners when a public works project will inure mostly to the benefit of that small group. The legislature could force the entire community to bear the costs of the project by financing it with general revenues. Instead, those individuals who receive the benefit of the project, such as a new sewer main, might pay a separate tax, or special assessment, to finance the benefit. Courts strike down special assessments when it appears that (1) a majority of the community is actually forcing a minority to finance general programs, or (2) an individual taxpayer is being forced to pay for "improvements" he would never agree to because the cost assessed to him clearly outweighs the individual taxpayer's benefit. "[T]he exaction from the owner of private property of the cost of a public improvement in substantial excess of the special benefits accruing to him is, to the extent of such excess, a taking, under the guise of taxation, of private

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[85] *See, e.g.*, City of Pittsburgh v. Alco Parking Corp., 417 U.S. 369 (1974).

[86] *See* DENNIS J. COYLE, PROPERTY RIGHTS AND THE CONSTITUTION 280 n.50 (1993). *See, e.g.*, CAL. CONST. art. I, § 7(a); CONN. CONST. art. I, § 11; ME. CONST. art. I, § 21; PA. CONST. art. I, § 10; WIS. CONST. art. I, § 13.

[87] 357 A.2d 772 (N.J. Super. Ct. Law Div. 1976).

[88] *Id.* at 785.

[89] A. Magnano Co. v. Hamilton, 292 U.S. 40, 44 (1934) (citations omitted). *See also* Brushaber v. Union Pac. R.R., 240 U.S. 1, 24 (1916) (articulating same limitation on taxing power); Windham First Taxing Dist. v. Town of Windham, 546 A.2d 226, 234 (Conn. 1988) (same).

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property for public use without compensation."[90]

Consider, for example, the U.S. Supreme Court's decision in *Village of Norwood v. Baker*.[91] In *Norwood*, the village condemned a strip of land that ran north to south through the center of Ellen Baker's property to build a road connecting two existing roads that ran east to west.[92] A jury awarded her $2,000 as the value of the property condemned.[93] In the same ordinance that authorized the condemnation, the cost and expense of the condemnations were to be assessed against the bordering property, regardless of the extent to which the bordering property was benefitted by the new road.[94] Because Ms. Baker owned the land to the east and west of the strip condemned, she was assessed the $2,000 she was originally compensated, as well as $218, which represented the village's expenses in the previous condemnation proceedings.[95] In effect, the assessment made her worse off than she would have been had her land been confiscated with no compensation.[96] Since the latter option would have been an unconstitutional taking, the Court ruled that the village's taxation effected a disguised taking which was also unconstitutional under the Due Process Clause.[97] According to the Court, if a property owner can establish that he is forced to pay more than what he receives by reason of a public improvement, then the special assessment is unconstitutional.[98]

This outcome is consistent with our predicted social contract. Because everyone benefits from the development of an efficient road system, forcing a small subset of the community to pay for that road system is a form of discriminatory taxation. Ex ante, individuals cannot predict where roads are likely to be built and what property is likely to be condemned to build them. Consequently, individuals have symmetric expectations regarding the taking of their property to build the roads. Precisely because no one can predict who will bear the burden of a taking ex ante, all individuals can be expected to be worse off without a guarantee that those burdens will not be disproportionately assigned.

In other words, without the guarantee, each property owner faces a Prisoner's Dilemma.[99] All owners are better off if property cannot be taken

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[90] Village of Norwood v. Baker, 172 U.S. 269, 279 (1898). *See also* Gott v. Norberg, 417 A.2d 1352, 1358-59 (R.I. 1980) (under Rhode Island Constitution's takings clause, the legislature cannot levy a tax if it provides no benefit or protection in return).

[91] 172 U.S. 269 (1898).

[92] *See id.* at 275.

[93] *See id.*

[94] *See id.*

[95] *See id.* at 276.

[96] *See id.* at 281-82.

[97] *See id.* at 279, 289, 297.

[98] *See id.* at 279, 294.

[99] For a history of the invention of the Prisoner's Dilemma story, see Phillip D. Straffin, Jr., *The*

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through taxation. However, if an owner expects others to try to take property through taxation, then the owner has an incentive to be first in line to reap earlier benefits from a taking.[100] Individuals therefore can be expected to dissipate their net benefits from takings in a race to obtain the benefits and in an effort to avoid the disparate treatment themselves. The compensation guarantee prevents the expenditure of these wealth-reducing coalition costs by eliminating the incentive to use takings to redistribute wealth. From a contractarian perspective, then, Ms. Baker should be compensated for the loss of her property.[101]

In contexts short of outright condemnation, later courts have adopted the *Norwood* Court's general principle, that a special assessment is unconstitutional where it transfers wealth to those not taxed. For example, the Minnesota Supreme Court has articulated three requirements for the validity of a special assessment, which comport well with our contractarian predictions. First, the land must receive a special benefit from the improvement being constructed.[102] Second, the assessment must be uniform upon the same class of property.[103] Third, the assessment must not exceed the special benefit, measured by the increased market value of the land.[104] The first and third requirements together ensure that even those burdened receive a net benefit from the project. And the second requirement ensures that a subgroup of those individuals who benefit from the improvement do not single out other beneficiaries from which to reap redistributive benefits. Otherwise, the costs associated with competing to be in the tax favored group, whose membership is unpredictable over time, outweigh any tax savings to the group that benefits from the discrimination. In other words, from an ex ante perspective, discrimination among the beneficiaries of the improvement will not likely make anyone better off, and is therefore impermissible.

In *Ochs v. Town of Hot Sulphur Springs*, the town placed a frontage

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Prisoner's Dilemma, 1 U.M.A.P. J. 101 (1980). For a basic treatment of the Prisoner's Dilemma paradigm, see ROBERT M. AXELROD, THE EVOLUTION OF COOPERATION (1984); CHARLES J. GOETZ, CASES AND MATERIALS ON LAW AND ECONOMICS 8-35 (1984); ERIC RASMUSEN, GAMES AND INFORMATION 27-30 (1989).

[100] We are assuming here that the property owners each have a positive discount rate. That is, they prefer to reap benefits earlier and to defer losses until later.

[101] Our analysis is very close to Richard Epstein's position regarding all takings. *See* EPSTEIN, TAKINGS, *supra* note 1, at 3-104. However, we believe that the bulk of Epstein's "takings," while inefficient, likely produce net positive benefits to some groups and will therefore be upheld by the "minimalist" courts.

[102] *See* Southview Country Club v. City of Inver Grove Heights, 263 N.W.2d 385, 387 (Minn. 1978) (quoting Carlson-Lang Realty Co. v. City of Windom, 240 N.W.2d 517, 519 (Minn. 1976); Quality Homes, Inc. v. Village of New Brighton, 183 N.W.2d 555, 560 (Minn. 1971)).

[103] *See Southview*, 263 N.W.2d at 387.

[104] *See id.* at 387-88.

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tax on some of the residents to finance the road and sewer system.[105] The Colorado Supreme Court held that the tax was an unconstitutional taking because the taxed owners' land was not specially benefitted in any way not enjoyed by those exempt from the assessment.[106] The court condemned the tax as "nothing more than a devise or a scheme, unsupported by any permissive revenue producing authority, to provide funds for the general community benefit, and hence violative of the due process of law guarantees of the federal and state constitutions."[107] Of course under our contractarian model, the property owners that benefit from the improvements can be taxed to help pay for them. But the owners cannot be discriminatorily taxed to pay for improvements that also inure to the benefit of those not taxed. Otherwise, over time, the political costs to each citizen likely outweigh any benefits she expects to receive from discriminatory special assessments.

Southview Country Club v. City of Inver Grove Heights[108] provides another example of impermissible assessments. The Minnesota Supreme Court held that a special assessment levied on a country club for a water main improvement and sewer main extension constituted an unconstitutional taking.[109] The country club owned two adjacent parcels on which the tax was assessed.[110] One parcel was undeveloped, and even if it were developed to the maximum extent permitted by the zoning laws, the present water and sewer main would serve all its needs.[111] The other parcel was an integral part of the club's golf course, and placing lines where the city planned would destroy thirteen of the eighteen holes on the course.[112] The court concluded that the lines would confer no special benefits on the club, and, as a consequence, the assessment was unconstitutional.[113]

Here, too, our contractarian model predicts that even a minimally activist court would strike down this assessment. Other property owners might receive great benefits from sewer and water mains, but they are not entitled to single out property that receives no benefit to help pay for those improvements, especially when only a few property owners are required to

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[105] 407 P.2d 677, 678 (Colo. 1965) (en banc).

[106] *See id.* at 680. According to the *Ochs* court, "Special benefits which will sustain a special assessment must be immediate, and of such a character that they can be seen and traced. Remote or contingent benefits enjoyed by the general public will not sustain a special assessment." *Id.* (quoting Pomroy v. Board of Pub. Waterworks, 136 P. 78, 81 (Colo. 1913)).

[107] *Id.*

[108] 263 N.W.2d 385.

[109] *See id.* at 387-89.

[110] *See id.* at 386-87.

[111] *See id.* at 388.

[112] *See id.*

[113] *See id.* at 388-89. *See also* Anderson v. Town of Litchfield, 492 A.2d 210, 213 (Conn. App. Ct. 1985) (striking down sewer assessment that exceeded benefit to landowner as unconstitutional taking).

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bear the entire costs of the project. Again, it is not the discrimination itself but rather the instability of the coalitions creating the discrimination that makes the assessment impermissible. This year neighbor A is burdened, next year neighbor B, then C, and so on. In the end, no one expects to be made better off by the discrimination, but everyone spends resources competing to avoid the discriminatory tax each year. The restriction ensures that at least some coalition benefits from special assessments over time.

It may appear, however, that this tax is really a wealth tax—if only the rich can afford to join country clubs and the club passes its costs on to the members, why is this tax not permissibly redistributive under our predicted social contract? The key lies in the fact that a generally applied progressive tax can produce the same result with much lower social cost. Even assuming that all country club members are rich, the members may be primarily democrats, or republicans, or doctors, or lawyers. Once a small subset of the wealthy may be singled out for discriminatory taxation, the rich will incur coalition costs to avoid the subset that suffers the disparate treatment. Rich individuals cannot tell ex ante when they will be part of the benefitted or burdened groups. Presumably they would prefer uniform progressive taxation to random taxation that singles out members of the rich population who are not part of the existing majority coalition. At least then they will not compete to avoid the more heavily taxed group; after all, competition among rich groups will likely dissipate any gains to random discrimination among those wealthy groups. The poor will not likely object to prohibiting this seemingly random discrimination, for presumably they do not care which rich people pay for their transfers. Consequently, where the rich have symmetric expectations regarding the outcome of taxes that discriminate among them, a rule forbidding nonuniform redistribution from wealthy to poor might likely result.[114]

2. General Property Taxes

Courts scrutinize discrimination in general property taxes as well, although the costs of perfect enforcement are prohibitive. Here, discriminatory taxes are generally challenged under the Equal Protection Clause of the

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[114] As we note in Part III.C, some wealthy groups or industries might pay higher taxes because the supply or demand for their productive activities is relatively inelastic. We sharply distinguish those forms of taxation because majority coalitions typically prefer to raise revenues by taxing those goods and services that least distort production and consumption choices. In contrast, special assessments tend to discriminate against local individuals or groups, without regard to the stability of the coalitions that form to discriminate. Or, in other words, they may single out some, but not all, taxpayers with relatively inelastic supply functions, thereby creating incentives for those individuals to compete to avoid the taxes. In this sense, the discrimination is purely political, and more likely leads to the complete dissipation of any benefits than does more general discrimination based on persistent economic factors.

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U.S. Constitution or a uniform taxation provision in a state constitution.[115] The standard applied across jurisdictions is similar regardless of the provision used. When property is assessed for general tax purposes, the state may not assess two substantially identical properties at substantially different amounts. "Intentional and systematic undervaluation by assessors of other taxable property in the same class violates the constitutional right of a person taxed upon the full value of his property."[116]

For example, in *Penn Phillips Lands, Inc. v. State Tax Commission*,[117] the Supreme Court of Oregon struck down a county assessor's appraisal of a taxpayer's land at $60 per acre when neighboring properties "indistinguishable in soil, vegetation, topography, access to roads, and every other visible particular"[118] were assessed at $5 per acre.[119] Although the taxpayer admitted his property was worth at least as much as the value assessed,[120] the court found that the discriminatory tax burden violated both the Equal Protection Clause of the federal constitution and the uniform taxation provision of the state constitution.[121] To the court, "[t]he taxing authorities may not single out one taxpayer for discriminatory, or selective, enforcement of a tax law that should apply equally to all similarly situated taxpayers."[122] To us, "similarly situated" means individuals with symmetric expected outcomes. The assessor picked this particular property owner for discriminatory treatment that presumably benefits other property owners. Because ex ante almost all property owners are equally likely to be chosen for disparate treatment, we think the social contract would prohibit this

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[115] *See, e.g.*, Gilman v. City of Sheboygan, 67 U.S. (2 Black) 510, 514-17 (1862) (Wisconsin and Ohio Constitutions both provide that all property, real or personal, that is taxable, must be taxed uniformly); Idaho Tel. Co. v. Baird, 423 P.2d 337, 341-42 (Idaho 1967) (discussing Idaho, New Hampshire, California, Illinois, Missouri, Massachusetts, Pennsylvania and Delaware uniform taxation provisions); Prisk v. City of Poulsbo, 732 P.2d 1013, 1020 (Wash. Ct. App. 1987) (Washington Constitution provides that "[a]ll taxes shall be uniform upon the same class of property . . . and shall be levied and collected for public purposes only"); Bankers Pocahontas Coal Co. v. County Court, 62 S.E.2d 801, 805 (W. Va. 1950) (West Virginia Constitution provides that taxation must be equal and uniform throughout the state, and all property, both real and personal, shall be taxed in proportion to its value to be ascertained as directed by law), *overruled in part by In re* Kanawha Valley Bank, 109 S.E.2d 649 (W. Va. 1959).

[116] State Dep't of Assessments and Taxation v. Clark, 380 A.2d 28, 41 (Md. 1977); *see also* Sioux City Bridge Co. v. Dakota County, 260 U.S. 441, 445 (1923) ("[I]ntentional systematic undervaluation by state officials of other taxable property in the same class contravenes the constitutional right of one taxed upon the full value of his property.") (quoting Sunday Lake Iron Co. v. Wakefield Township, 247 U.S. 350, 352-53 (1918)); *In re* Kanawha Valley Bank, 109 S.E.2d 649 (W. Va. 1959) (systematic assessment of money and shares of bank stock at a higher percentage of their value than that at which other species of property are assessed violates West Virginia Constitution).

[117] 430 P.2d 349 (Or. 1967) (en banc).

[118] *Id.* at 351.

[119] *See id.* at 350-52.

[120] *See id.* at 350.

[121] *See id.* at 351-52.

[122] *Id.* at 352.

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discrimination.

However, the courts are careful not to take too active a role enforcing the social contract. Mere judgment errors by assessors will not support a claim of discrimination.[123] "There must be something which in effect amounts to an intentional violation of the essential principle of practical uniformity."[124] Because the courts have limited resources, they recognize that small, inadvertent, and short-term discrepancies in assessments must go unchecked. Indeed, the Supreme Court of Oregon has said that an underassessment of one or two properties in a taxing district cannot be challenged by those who pay more,[125] given the slight individual harm suffered by the large number of taxpayers more heavily burdened.

The U.S. Supreme Court recently has also distinguished between property tax discrimination against one or two individuals, and group discrimination which likely results from stable coalition formation. In *Nordlinger v. Hahn*,[126] the Court rejected an Equal Protection Clause challenge to California's well-known "Proposition 13." In response to rapidly rising real property values and taxes, the citizens of California, through a statewide ballot initiative, placed caps on both assessed values and tax rates.[127] Tax rates were prohibited from rising more than one percent each year, and assessed values of real property could increase no more than two percent each year, except in cases of improvements or changes in ownership.[128] The tax caused dramatic disparities in taxes paid by persons owning similar pieces of property.[129] Those who had purchased their property before Proposition 13 paid, in some cases, several times less per year than those who purchased comparable property after Proposition 13.[130]

The incidence of the discriminatory tax here is quite difficult to ascertain. Although there are several possibilities, we mention the two most obvious. First, it might transfer wealth generally from income earners to property owners. In the first year after Proposition 13 took effect, owners enjoyed a property tax cut of seven billion dollars.[131] Presumably, some of this cut was recouped by a tax on income or other sources of wealth.

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[123] Allegheny Pittsburgh Coal Co. v. County Comm'n, 488 U.S. 336, 343 (1989); Sunday Lake Iron Co. v. Wakefield Township, 247 U.S. 350, 353 (1918); Citizens' Comm. for Fair Property Taxation v. Warner, 254 P.2d 1005, 1010 (Colo. 1953); State Dep't of Assessments and Taxation v. Clark, 380 A.2d 28, 41 (Md. 1977).

[124] *Clark*, 380 A.2d at 41-42.

[125] Penn Phillips Lands, Inc. v. State Tax Comm'n, 430 P.2d 349, 351 (Or. 1967) (en banc).

[126] 505 U.S. 1 (1992).

[127] *See id.* at 4.

[128] *See id.* at 5.

[129] *See id.* at 6.

[130] *See id.* at 6-7.

[131] *See id.* at 5.

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Second, Proposition 13 may also transfer wealth from property sellers to property retainers. Those who retain their property receive a tax deferral, which might reduce their aggregate tax bills relative to what they would have been without Proposition 13. If so, the extra burden is borne at least in part by property sellers. Presumably, the sellers receive less for their property than they otherwise would if the purchasers must pay more in taxes than they would have without Proposition 13.

The point is that some groups, such as property owners and property retainers, can expect to benefit on net from assessed-value discrimination. Unlike discrimination against individuals, where expectations are symmetric and everyone loses on net because they spend resources trying to avoid the discrimination, Proposition 13 produces asymmetric expectations likely to lead to a stable majority coalition. Individual beneficiaries of Proposition 13 do not share equally in the transfers, but here the non-cash nature of the transfer prevents them from dissipating the proceeds. Thus, net beneficiaries of Proposition 13 would not agree to its prohibition ex ante. In this sense, the tax is "nonarbitrary."

Nordlinger provides evidence that the Court does, in fact, scrutinize discriminatory taxes based on the symmetry of expected outcomes. In upholding Proposition 13, the Court attempted to distinguish *Allegheny Pittsburgh Coal Co. v. County Commission*,[132] decided three years earlier. In *Allegheny*, the Court struck down a county assessor's policy effectively identical to Proposition 13.[133] The assessor increased property valuations minimally each year unless the property was sold, in which case the assessment increased to the sale price of the property.[134] As with Proposition 13, those who bought property after the assessor instituted her policy paid much higher taxes than those who purchased their property before the policy.[135] The assessor's policy, like Proposition 13, produced asymmetries in expected payoffs.

How can *Nordlinger* be distinguished from *Allegheny*?[136] The policy in *Allegheny* resulted from an administrative action whereas Proposition 13 was a state ballot initiative. True, the Court in *Nordlinger* expressly rejected lesser Equal Protection Clause protections against legislative mandates than against administrative actions.[137] But the critical distinction lies between ballot initiatives and other means of redistribution. Precisely because of the difficulty of determining who ultimately bears the burden of the tax scheme,

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[132] 488 U.S. 336 (1989).

[133] *See id.* at 338.

[134] *See id.* at 338-39.

[135] *See id.*

[136] Justice Thomas, in concurrence, *Nordlinger*, 505 U.S. at 18, and Justice Stevens, in dissent, *id.* at 31-32, found the two cases indistinguishable.

[137] *See id.* at 16 n.8.

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the Court is unable to determine what is motivating administrative (or legislative) action. The county assessor may have adopted his policy in order to benefit his grandmother at the expense of others. The next administrator might adopt a new policy designed to benefit his friends, and so on. In other words, there is much less evidence that the policy is supported by a stable coalition when it is promulgated by an administrator. At the same time, the voters presumably are better situated to determine whether they stand to benefit on net from Proposition 13 over time. If they nevertheless support the Proposition, the Court defers to the citizens' determination that the policy produces asymmetric benefits. Legislation presumably stands somewhere between administrative policy and ballot initiatives. Legislation typically receives stronger deference than administrative policy and is upheld unless the Court is convinced that it produces symmetric expectations. Absent strong evidence to the contrary, a coalition that produces legislation is likely to be stable over time. On the other hand, individual administrators come and go. At the other extreme lies the voters themselves, a population whose sentiments are likely to remain stable for much longer than the individuals in government who represent the competing groups.[138]

C. *Other Discriminatory Taxation*

1. Inter Versus Intra-group Discrimination

Tax classifications are made in other contexts as well. One common classification is to place a tax on all businesses in a particular industry but exempt businesses in other industries. The Supreme Court has fairly consistently upheld these industry taxes.[139]

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[138] *See* BENJAMIN I. PAGE & ROBERT Y. SHAPIRO, THE RATIONAL PUBLIC 383-90 (1992) (concluding, through extensive survey data, that citizens' policy preferences are stable, rational, and sophisticated).

[139] *See, e.g.*, Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 526-27 (1959) ("The State may impose different specific taxes upon different trades and professions and may vary the rate of excise upon various products. It is not required to resort to close distinctions or to maintain a precise, scientific uniformity with reference to composition, use or value."); Quong Wing v. Kirkendall, 223 U.S. 59, 62 (1912) ("A state does not deny the equal protection of the laws merely by adjusting its revenue laws and taxing system in such a way as to favor certain industries or forms of industry."); *see also* Carmichael v. Southern Coal & Coke Co., 301 U.S. 495 (1937) (upholding Alabama Unemployment Compensation Act, which exempted various categories of employers); A. Magnano Co. v. Hamilton, 292 U.S. 40 (1934) (Washington state tax on oleomargarine but not on butter); Gundling v. City of Chicago, 177 U.S. 183 (1900) (license fee for sale of cigarettes); Royall v. Virginia, 116 U.S. 572 (1886) (license fees for attorneys); Kentucky R.R. Tax Cases, 115 U.S. 321 (1885) (real estate tax on railroads, but not on other forms of real estate and business); McMillen v. Anderson, 95 U.S. 37 (1877) (mem.) (license fee on retail merchants with higher amounts charged to those selling liquor and to certain types of merchants); Lake Lanier Theatres v. Hall County, 189 S.E.2d 439 (Ga. 1972) (business license tax imposed on places of amusement charging an admission fee, but not on those not charging

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Here is a classic example of interest group politics with asymmetric expectations. Individuals know what professions they are likely to pursue, and those who can organize effectively to gain transfers without dissipating rents would not agree to a constitutional prohibition against their efforts. Let us suppose, for simplicity, that everyone in America belonged to one of three professions: bankers, grocers or farmers. If grocers and farmers can organize more easily to transfer wealth from bankers, then an occupational tax on bankers results from a stable coalition. Perhaps grocers and farmers share natural affinities not found with bankers. Or, the differing elasticities of supply and demand in the three industries might establish that the deadweight costs associated with burdening the bankers are lower than they would be if grocers or farmers were taxed instead. If so, grocers and farmers could receive greater net benefits from taxing the bankers than any group could obtain from taxing the grocers or farmers. Occupational taxes thus clearly enable asymmetric expectations, and those who expect to benefit from them would not agree to prohibit them. As with our earlier examples, the Court declines to strike down discriminatory taxes unless they would be unanimously condemned ex ante.

Discriminatory taxes placed on only a subset of those in a particular industry or interest group become more problematic. Sometimes the Supreme Court upholds the discriminatory taxes, while at other times the taxes are struck down. The disparate treatment often can be explained by "rough-guessing" the symmetry of expected outcomes. In *Bradley v. City of Richmond*,[140] for example, a city ordinance prohibited persons from pursuing certain businesses and occupations without paying a special license tax.[141] Those businesses and occupations were divided into thirteen classes, and each class was required to pay a different license tax ranging from $10 to $800.[142] The Court rejected an Equal Protection Clause challenge to the tax as applied to private bankers.[143] The bankers had been divided into two different classes.[144] Those who lent money at high rates upon sales and household furniture were required to pay a higher license fee

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an admission fee).

We focus our attention on discriminatory taxation, and confine our analysis to taxation primarily intended to raise revenues, excluding taxation motivated by regulatory concerns. However, regulatory taxes on particular industries clearly can be viewed as taxes for which expectations are asymmetric. *See, e.g.*, United States v. Kahriger, 345 U.S. 22 (1953) (tax on wagers), *overruled in part by* Marchetti v. United States, 390 U.S. 39 (1968); United States v. Sanchez, 340 U.S. 42 (1950) (tax on marijuana); Sonzinsky v. United States, 300 U.S. 506 (1937) (tax on firearms); United States v. Doremus, 249 U.S. 86 (1919) (tax on narcotics); McCray v. United States, 195 U.S. 27 (1904) (tax on colored oleomargarine).

[140] 227 U.S. 477 (1913).

[141] *See id.* at 480.

[142] *See id.*

[143] *See id.* at 482-84.

[144] *See id.* at 484.

than those who made commercial loans.[145] While both groups were engaged in the same industry—private banking—the two groups likely provided very different services to two very different markets. If so, the relative natural affinities within each subset were likely large enough so that the higher-taxed bankers would have difficulty luring some of the lower-taxed bankers into a coalition to readjust the tax burden to fall more heavily on some other group of private bankers. In this sense the expectations of the two groups of bankers are asymmetric, and ex ante the bankers would not agree unanimously to prohibit the discrimination between the banks. The Court upheld the tax.[146]

Similarly, in *Metropolis Theatre Co. v. City of Chicago*,[147] the Supreme Court upheld a city ordinance requiring the payment of license fees by "places of amusement."[148] The license fee for transfers was graded according to the price of admission, exclusive of box seats.[149] The fee ranged from $200 to $1,000, and rose with the price of admission.[150] As in *Bradley*, it seems reasonable that a theatre charging fifteen cents is providing a very different product and serving a distinctly different market than a theatre charging one dollar or more. If so, coalitions within the theatre industry may well be stable, and the tax not prohibited.[151]

Contrast these two cases with a third, *Louisville Gas & Electric Co. v. Coleman*.[152] The state of Kentucky imposed a tax on the recording of mortgages equal to twenty cents for each $100 of value secured, but exempted mortgages that matured within five years.[153] Here, the Court struck down the discrimination.[154] While states could charge a fee for the recording service, charging disparate fees in the manner chosen by Kentucky was arbitrary.[155] The expectations here seem symmetric. Recorders with three-year mortgages are not likely to be meaningfully different from recorders with eight-year mortgages, or at least the Court discovered no significant differences. The discrimination might as well have been on the basis of the recorder's eye color. In both cases, the group whose fees are

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[145] *See id.*

[146] *See id.* at 482-86.

[147] 228 U.S. 61 (1913).

[148] *Id.* at 61, 69-70.

[149] *See id.* at 61.

[150] *See id.* at 61-62.

[151] For other examples of intra-industry taxes for which the expectations are asymmetric, see Ohio Oil Co. v. Conway, 281 U.S. 146 (1930) (tax on oils classified by Baume gravity upheld; classification merely distinguished lubrication oils from gasoline); American Sugar Ref. Co. v. Louisiana, 179 U.S. 89 (1900) (upholding licensing tax imposed on manufacturers engaged in business of refining sugar, but exempting those who refine products of their own plantations).

[152] 277 U.S. 32 (1928).

[153] *See id.* at 35.

[154] *See id.* at 40-41.

[155] *See id.* at 38-39.

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subsidized share no affinities that make the coalition stable. Those who pay a higher tax are likely to compete for some of the members of the benefitted group by proposing a redrafting of the recording tax. And those who pay the lower tax will incur costs trying to retain a favorable classification. On net, none of the recorders can expect to be better off, and permitted discrimination induces coalition costs that likely leave everyone worse off. The recorders would therefore agree to prohibit this discrimination, and the Court stepped in to enforce the social contract.

Often the presence of asymmetries within a particular industry are not so clear. Here the Court seems reluctant to interfere, apparently preferring to risk large-scale dead-weight costs over interfering with interest-group politics. In this sense, then, the courts can be said to take a "super-minimalist" approach to discriminatory taxes. An example of the super-minimalist approach is *Quaker City Cab Co. v. Pennsylvania*[156] and its aftermath. In *Quaker City*, the Court initially struck down a tax imposed on corporate-owned cab companies, reasoning that the discrimination between these companies and unincorporated cab owners was "not justified by any difference in the source of the receipts or in the situation or character of the property employed."[157] After *Quaker City* was questionably distinguished in several subsequent opinions,[158] however, the Court finally overturned it forty-five years later in *Lehnhausen v. Lake Shore Auto Parts Co.*, stating:

> We could strike down this tax as discriminatory only if we substituted our judgment on the facts of which we can be only dimly aware for a legislative judgment that reflects a vivid reaction to pressing fiscal problems. *Quaker City Cab Co. v. Pennsylvania* is only a relic of a bygone era. We cannot follow it and stay within the narrow confines of judicial review, which is an important part of our constitutional tradition.[159]

Are cab owner expectations symmetric or asymmetric in this context? It is hard to say without more information about the differences in business volumes, services, practices and methods. Notice the Court's implicit change in burden of proof between *Quaker City* and *Lehnhausen*. Prior to President Roosevelt's famous Court-packing plan, the Supreme Court overturned non-equalizing taxes only when individuals' expectations were symmetric, but the Court sometimes assumed symmetric expectations in the absence of contrary evidence. More recently, the Court has apparently reversed its presumption, as illustrated in the block quote above, and now assumes expectations are asymmetric without contrary proof.

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[156] 277 U.S. 389 (1928), *overruled by* Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356 (1973).

[157] *Id.* at 402.

[158] *See Lehnhausen*, 410 U.S. at 360-65 (discussing gradual demise of *Quaker City* holding).

[159] *Id.* at 365.

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2. The Problem of Locating Discrimination

Occasionally a tax that looks discriminatory on its face is actually intended to remove a disparity that exists someplace else. An example is *In re Champion International Corp.*,[160] where the Court of Appeals of North Carolina upheld a county ad valorem tax placed on Champion's use of Hofmann Forest, which was owned by the state as a commercial timber farm. The North Carolina Constitution required "that taxation be done in a just and equitable manner and that no class of property be taxed except by uniform rule and that every classification be made by general law."[161] The state legislature had authorized the taxation of Champion's use of the forest by passing a statute which provided:

> When any cropland or forestland owned by the United States, the State, a county or a municipal corporation is leased, loaned or otherwise made available to and used by a person . . . in connection with a business conducted for profit, the lessee or user of the property is subject to taxation to the same extent as if the lessee or user owned the property.[162]

The court upheld the statute despite Champion's claim that it was the sole taxpayer singled out for discrimination because the statute's stated purpose was "to eliminate the competitive advantage accruing to profit-making enterprises from the use of the tax-exempt property."[163] Before the statute, Champion's tax burden was lower than other similarly situated companies because the state constitution forbade taxing state, county or municipally owned property.[164] While other companies paid property taxes to the county, Champion was exempted because it leased the forest from the state rather than owning it. The classification in the challenged statute in effect removed this exemption so that the county could achieve parity.[165] Without discrimination in the total tax treatment of these competitors, the question of symmetries becomes irrelevant.

In another case, *Walters v. City of St. Louis*,[166] the Supreme Court upheld a city ordinance that taxed gross salaries and wages of employed

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[160] 329 S.E.2d 691, 694-95 (N.C. Ct. App. 1985).

[161] *Id.* at 694.

[162] *Id.* at 692.

[163] *Id.* at 693.

[164] *See id.*

[165] *See also* W. W. Cargill Co. v. Minnesota *ex rel.* R.R. & Warehouse Comm'n, 180 U.S. 452 (1901). In *Cargill*, the Court upheld a tax on warehouses situated on the right-of-way of a railroad while exempting warehouses not so situated but doing exactly the same business. *See id.* at 468-69. By subsidizing the building of the railroad, the government had conferred a benefit on the warehouses located along the right-of-way. The state in this case taxes those warehouses in an effort to offset the competitive advantage it gave to those warehouses.

[166] 347 U.S. 231 (1954).

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persons but only the net profits of self-employed persons.[167] Because no taxes had yet been collected, the Court considered only whether the disparate treatment was unconstitutional on its face.[168] The Court's conclusion is not surprising, given that any disparate treatment between the two groups would likely be small, since wage earners would probably incur few expenses that could be deducted by self-employed persons but not themselves. Indeed, deductions to self-employed persons for the necessary costs of doing business seemed primarily motivated to achieve parity, not disparity, between the two groups. And, as mentioned earlier, perfectly monitoring small-scale discrimination is impossible for the courts. Thus, regardless of whether symmetric expectations exist, the Court upholds the tax.[169]

The argument that a tax effects parity or is a special assessment for the use of government-provided goods is dangerous, however. The same argument was used by the Supreme Court in *Lehnhausen v. Lake Shore Auto Parts Co.*[170] to uphold a state ad valorem tax on personal property of corporations. Individuals and noncorporate businesses were exempt from the tax.[171] The Court treated the distinction as one of paying for corporate benefits:

> [T]he tax is laid upon the privileges which exist in conducting business with the advantages which inhere in the corporate capacity of those taxed, and which are not enjoyed by private firms or individuals. These advantages are obvious, and have led to the formation of such companies in nearly all branches of trade. The continuity of the business, . . . the transfer of property interests by the disposition of shares of stock, the advantages of business controlled and managed by corporate directors, the general absence of individual liability, these and other things inhere in the advantages of business thus conducted, which do not exist when the same business is conducted by private individuals or partnerships.[172]

First, the tax on corporations does not seem to remove any concrete disparity, as was the case for Champion. Once Champion had leased the government lands, others were excluded from doing the same. In contrast, no business entity is excluded from using the corporate form just because others have done so. Because other businesses can adopt the corporate form to gain the same benefits as corporations, it seems only reasonable to assume the costs outweigh the benefits for unincorporated entities. Second, while the state could place a special assessment on benefits it provides to

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[167] *See id.* at 236-37.
[168] *See id.* at 232-33.
[169] *See id.* at 236-37.
[170] 410 U.S. 356 (1973).
[171] *See id.* at 357.
[172] *Id.* at 362 (quoting Flint v. Stone Tracy Co., 220 U.S. 107, 161-62 (1911)).

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corporations, those corporations are already subject to other forms of taxation which may adequately cover the "costs" to society, assuming there are any, to allowing them to choose the corporate form. Because corporations are generally taxed more heavily even without the ad valorem tax imposed in *Lehnhausen*, it seems unlikely the tax is justified on special assessment grounds.

That does not necessarily mean that the Supreme Court has failed to enforce a minimalist social contract, however. Shareholders are the primary losers in this discriminatory tax. If there are asymmetric expectations between shareholders and nonshareholders, then nonshareholders would not agree to prohibit the tax.

IV. THE MINIMALIST ROLE OF THE COURTS

Why have courts refused to take a more active role in scrutinizing discriminatory taxes? After all, rent seeking through taxation entails significant dead-weight costs. And, from a fairness perspective, why should some groups be permitted to systematically reap benefits at the expense of others? If anything, fairness norms should lead the courts to take the position converse to the one we observe. That is, using governmental powers to systematically discriminate seems much more oppressive and unjust than adopting tax treatments that shift the benefits and burdens across varying groups over time. Whatever our normative views of rent seeking, ultimately the American courts are institutionally incapable of checking legislative coalitions.

The critical point here is that where expectations are asymmetric, the coalition that generated the discriminatory tax is stable. Recall from our earlier discussion that stable coalitions entail cost advantages that make wealth transfers welfare-enhancing to their members over time. Usually natural affinities make it difficult for other groups to break down membership in the individual groups that tend to be included in the majority coalition. If the group can successfully prevent exit and limit those who share the benefits of the transfers, then the group will likely prove to be a powerful political force in the future as well. When judges are not insulated from majority whim, as is the case in many states, then the same political forces that create discriminatory taxes pressure the judges to uphold them.[173] Even in the federal system, where judges are insulated from Congress by guaranteed salaries and life tenure, judicial confirmations and congressional control of the courts' budgets may themselves constrain wide-

[173] *See* THE FEDERALIST NO. 78 (Alexander Hamilton) (noting importance of independent judiciary for confining legislative branch).

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spread rejection of interest group legislation. Indeed, the very fact that the Supreme Court can decide only a few cases each year may ensure a non-activist judiciary because once the Court engages in activism to control the legislature, it loses control over the lower courts. Extremely limited review prevents an activist Court from doing any more than generating broad guidelines for the lower courts. And once the lower courts are unleashed, the Supreme Court is incapable of closely monitoring their activism. In the end, the Supreme Court justices may prefer a somewhat unfettered legislature, which is at least limited by popular opinion, to an uncontrolled federal judiciary.

Moreover, while perfect judicial independence might enable the courts to scrutinize discriminatory taxes more carefully, the stable nature of the coalitions that produce wealth transfers renders efforts to check them futile. If the courts strike down a discriminatory tax generated by a stable coalition, then that stable coalition will likely respond by generating the same transfer in another more complicated and less efficient form. For example, the coalition might enact a complicated regulatory scheme to achieve the transfer.[174] As the transfer becomes more complicated, the courts become less able to identify the redistributive nature of the regulation. And the more complicated the regulatory scheme, the greater the dead weight costs associated with the transfer. To be sure, the greater the costs imposed on special interest groups seeking legislative benefits, the less rent seeking we will observe on the margin. But those that succeed may well entail much higher dead-weight costs on the margin than those the courts prevent. Moreover, active courts would be required to invest significant effort reviewing wealth transfers, and it is not clear they possess the resources to mount a fight, especially when they lack the information necessary to ensure success. The Court itself has expressed concern over locating the parties that end up bearing the burdens of taxation: "courts as institutions are poorly equipped to evaluate with precision the relative burdens of various methods of taxation. The complexities of factual economic proof always present a certain potential for error, and courts have little familiarity with the process of evaluating the relative economic burden of taxes."[175] Given their limited capacities to effectively check stable coalitions, the courts permit the tax transfers to minimize social losses.

Indeed, it should come as no surprise that courts lack either the

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[174] Regulators tend to choose the most efficient forms of redistribution available. *See* Becker, Comment, *supra* note 42, at 247. If these efficient redistributions are "detected" and struck down by the courts, then the legislators might naturally choose more elaborate and hence less efficient means to achieve the transfers, while simultaneously masking their special interest nature. *Cf.* Nelson, *supra* note 42, at 326 (obvious explanation for non-cash transfers is to hide transfers from majority).

[175] Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue, 460 U.S. 575, 589 (1983) (footnote omitted).

independence, or the resources, or both, to fight stable coalitions. Law and economics scholars often make normative arguments to the effect that courts should strike down inefficient legislative bargains.[176] But it is a logical fallacy to view the courts as an external, or exogenous, solution to an inferior contractarian equilibrium. After all, the very coalitions that succeed in generating wealth transfers have a large stake in ensuring that the courts preserve their benefits. Properly viewed, then, the courts are institutions endogenous to our rent seeking structure and cannot realistically be expected to succeed in thwarting political agendas in any wide-scale sense. Instead, without a specific constitutional prohibition, courts apparently are functionally confined to resolving only the Prisoner's Dilemma-type problem, where everyone agrees ex ante that he would be better off with a prohibition against a transfer.

We do not mean to suggest that the courts have eschewed all efforts to minimize the costs of rent seeking. In fact, the courts sometimes help minimize the dead-weight costs that stable coalitions generate by discriminating between the forms of tax transfers used by political groups. One example is the Supreme Court's Equal Protection Clause scrutiny of chain store taxes in the 1930s.[177] Several states had enacted tax schemes under which retail businesses were taxed progressively according to the number of stores under common ownership, management, or supervision.[178] The tax presumably was a response by local individual retailers threatened by the growth of higher volume, more cost-effective chain stores. In effect, the tax transferred wealth from the chain stores to the local retailers by raising costs to the chain stores and thereby making it easier for the local retailers to compete with the chains. In a series of cases, the Court upheld the schemes.[179] During the same period, however, the Court struck down, without discussion, Iowa's efforts to achieve the same transfer with a gross sales tax on the chain stores.[180]

[176] *See, e.g.*, EPSTEIN, TAKINGS, *supra* note 1, at 3-31; BERNARD H. SIEGAN, ECONOMIC LIBERTIES AND THE CONSTITUTION 265-303 (1980). *But see* Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31 (1991) (arguing that law and economics focus on defects of legislative processes ignores defects in judicial decision making).

[177] *See* Great Atl. & Pac. Tea Co. v. Grosjean, 301 U.S. 412 (1937); Valentine v. Great Atl. & Pac. Tea Co., 299 U.S. 32 (1936) (per curiam); Fox v. Standard Oil Co., 294 U.S. 87 (1935); Louis K. Liggett Co. v. Lee, 288 U.S. 517 (1933); State Bd. of Tax Comm'rs v. Jackson, 283 U.S. 527 (1931).

[178] *See, e.g.*, *Grosjean*, 301 U.S. 412; *Fox*, 294 U.S. 87; *Lee*, 288 U.S. 517; *Jackson*, 283 U.S. 527.

[179] *See Grosjean*, 301 U.S. at 419; *Fox*, 294 U.S. at 87; *Lee*, 288 U.S. at 517; *Jackson*, 283 U.S. at 542.

[180] *See Valentine*, 299 U.S. at 33.

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Why the distinction? Presumably, the chains generate scale efficiencies that enable them to earn profits that the local retailers do not earn. If a tax on the number of stores is not so large that it induces actual store closings,[181] then the tax affects neither supply nor price. As long as the stores remain open, the retailers have an incentive to provide the same services and goods they would provide without the tax. While creating the tax entailed some dead-weight costs, the tax itself merely redistributes wealth from the chains. In contrast, a tax on gross sales creates dead-weight losses in addition to the costs of generating the legislation. As is well known in public finance, an excise-type tax reduces the output of the taxed activity, which in turn reduces both consumer and producer surplus.[182] The Court may not have been able to effectively prevent the transfers, but it ensured that the transfers took the relatively efficient form.[183]

By definition, enhancing the efficiency of transfers eliminates costs associated with the transfers themselves. However, to the extent that only a minority benefits from a wealth transfer, the more efficient the transfer, the more durable it becomes. Costly transfers may generate opposition to them; indeed, the Dougan and Snyder theory of coalition formation incorporates the Chicago School public choice insight that less efficient rent seeking is more likely to be defeated in the political arena.[184] When the Court ensures more efficient forms of rent seeking, it may end up expanding the life of the transfer itself. One might wonder, then, whether this "second order" efficiency does not make us all worse off in the end.

The timing of the chain store tax cases is critical to our conclusion that individuals are better off when the Court strikes down the gross sales tax. The Court had already decided several chain store tax cases, so it knew that stable coalitions within the states tended to include local retailers striving for protection. The Court had no reason to believe that the political landscape in Iowa was any different. Even if the gross sales tax proved to be sufficiently costly that Iowa eventually abandoned it, local retailers would likely substitute the tax for the more efficient per store tax. In the end, one tax or the other would likely persist. And by striking down the gross sales

[181] The taxes were relatively small, generally in the range of $10 to $250 per store. *See Grosjean*, 301 U.S. at 418 ($15-$200 per store); *Fox*, 294 U.S. at 88 ($2-$250 per store); *Lee*, 288 U.S. at 529 ($5-$50 per store); *Jackson*, 283 U.S. at 531-32 ($3-$25 per store).

[182] *See generally* BROWNING & BROWNING, *supra* note 40.

[183] The courts have adopted the role of preserving "second best" efficiency in a myriad of other contexts as well. *See, e.g.*, Richard S. Murphy & Erin A. O'Hara, *Mistake of Federal Criminal Law: A Study of Coalitions and Costly Information*, 5 SUP. CT. ECON. REV. 217 (1997) (concluding that federal courts use criminal mistake of law doctrine to enhance the strength and efficiency of legislative bargains); Erin A. O'Hara, Contractual Choice of Law: A Libertarian Puzzle (unpublished manuscript on file with authors) (concluding that contractual choice of law enhances the likelihood of legislative bargains by diminishing their dead-weight costs).

[184] *See* Becker, *Theory of Competition*, *supra* note 36, at 20.

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tax, the Court helped eliminate the interim costs associated with the less efficient gross sales tax.

CONCLUSION

What role should courts serve regarding wealth redistribution through tax provisions? Perhaps they should base decisions on efficiency grounds, protecting society from the transactions costs and other wealth reductions associated with rent seeking. Perhaps they should protect those chosen to bear the burden of discriminatory treatment regardless of social costs, out of fairness concerns for equal treatment. At a minimum, however, the courts should prohibit taxes that would be unanimously condemned ex ante. In this Article, we show, primarily with cases treating progressive taxation, discriminatory property taxes, and taxes on businesses, that the courts have chosen only this third minimalist function.

In a society where wealth is unequally endowed, the proportion of rich to poor individuals sufficiently large, and the coalition costs of wealth transfers relatively modest, a unanimous social contract can be formed that permits wealth redistribution toward equality, although that redistribution may be limited by social norm or formal constitution. American courts, in accordance with our predicted social contract, have rather consistently rejected constitutional challenges to progressive taxation.

What about other taxes? Our model, building on Dougan and Snyder, predicts that unanimous agreement favoring prohibition is likely only for non-equalizing wealth distribution with symmetric expectations regarding the proceeds. Under these conditions, no one expects to be better off over time from rent seeking, and the transactions and other costs associated with attempting the transfers will make everyone worse off in expected value terms. If everyone is made worse off with a particular transfer game, then the benefits of the social contract are eroded. Without the prohibition, the society risks being thrown back into anarchy, an inferior state to that under a social contract that prohibits transfers with symmetric expectations. In those contexts where we find expectations are symmetric, as with discriminatory property taxation against individuals and small groups, for example, the courts have served a vital role as guardians of the social contract. While the courts are limited by enforcement costs, they help prevent anarchic unraveling by supervising the most egregious cases of non-equalizing wealth transfers.

However, where expectations are sufficiently asymmetric because some individuals expect that they are more likely to be members of coalitions reaping positive net benefits from discriminatory taxes, those individuals who expect to benefit from the transfers will not agree to a prohibition. The transfers may be both inefficient and unfair, but the courts apparently are

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reluctant to trump legislative bargains without a strong sense of unanimous agreement to prohibit them ex ante. We think the key lies in the courts' recognized inability to check stable coalitions.

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