

IS LOCAL CONSUMER PROTECTION LAW A BETTER REDISTRIBUTIVE MECHANISM THAN THE TAX SYSTEM?

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INTRODUCTION

As Judge Calabresi has argued, preemption decisions are, at their core, a choice about which tier of government should have policy-making authority.¹ In prior work, Mark Seidenfeld and I argued that the choice of whether or not to preempt state law decisions should be based explicitly on “fiscal federalism” considerations.² The economic discipline of fiscal federalism attempts to measure the welfare effects of situating a given policy either locally, nationally, or somewhere in between.³

In order to decide whether to preempt state-level tort law or other consumer safety regulation, policy makers must first determine the goals of the tort system and its alternatives. According to one highly influential welfarist⁴ account, while tort law may serve

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1. See Hon. Guido Calabresi, Remarks at the *New York University Annual Survey of American Law* Symposium: Tort Law in the Shadow of Agency Preemption, 65 ANN. SURV. AM. L. 435, at 435 (2010).

2. Brian Galle & Mark Seidenfeld, *Administrative Law's Federalism: Preemption, Delegation, and Agencies at the Edge of Federal Power*, 57 DUKE L.J. 1933, 1997, 2003–04 (2008).

3. Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120, 1121 (1999). Thus, our argument is that when courts attempt to decide whether a federal enactment preempts other government actors, one of the central considerations should be whether restricting power to the federal government would in that instance increase national welfare. Galle & Seidenfeld, *supra* note 2, at 1997. We also argue that applying this standard to agency efforts to preempt would likely lead to increased agency consideration of the fiscal federalism question, as well. *Id.* at 2003–04. Although courts have long been thought to struggle with these kinds of fact-intensive questions, we suggest that administrative involvement can go a long way towards remedying that problem. *Id.* at 2004–05.

4. A welfarist is someone who believes that society should maximize overall social utility, but that part of the relevant calculus should include consideration of the public's preferences for the fair distribution of wealth or utility across the population. See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 977–93 (2001).

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legitimate policy goals, such as promoting optimal deterrence, insuring accident victims, or even achieving corrective justice, it should not be a tool for redistributing wealth.⁵ Commentators holding this view argue redistribution should occur *solely* through the tax system because using tort law or any other set of legal rules and regulations is inefficient.⁶ However, there has never been any sustained consideration of whether redistribution through the tort system could be carried out more efficiently at the local level.

My central argument is that redistributive tort rules can be more efficient at the local level than the national level, and may be more efficient than local or national redistributive taxation. As a result, theory does not clearly predict whether society should prefer local tort law over national or local taxation. Federal preemption of local tort law therefore might well prevent society from using its most efficient tool for redistributing wealth. Thus my argument implies a need for further empirical work to determine whether federal preemption of local tort rules would reduce national welfare.

Tort law may be the superior alternative because, although it is less efficient than tax at the national level, it may be the lesser of evils at the local level. That is, while we would not choose local tort regulation in a world with no economic distortions, tort law may be the best available choice—the “second best”—in a world where the market has other flaws. While redistributive tort laws have costs that taxes do not, government cannot effectively satisfy a heterogeneous society’s preferences for redistribution with a single national set of tax rules. Local tort rules can better capture a wide variety of preferences. It is unclear whether this gain is large enough to overcome the additional losses accompanying the use of a tort system.

Of course, government can impose taxes locally as well. The trouble is, at least under existing legal arrangements, local redistributive taxes create distortions and deadweight losses that local tort laws do not. For example, firms cannot easily sell products in a market without being exposed to its tort law, while current constitutional restrictions on state taxing power make it easier for a firm to gain the economic benefits of a market without being subject to its taxes. As a result, sellers can easily avoid redistributive taxation, but

5. Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 669 (1994) [hereinafter Kaplow & Shavell, *Less Efficient*].

6. See, e.g., *id.*; David A. Weisbach, *Should Legal Rules Be Used to Redistribute Income?*, 70 U. CHI. L. REV. 439, 446–53 (2003); see also ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 8–10, 111–13 (4th ed. 2003); Lior Jacob Strahilevitz, *Wealth Without Markets?*, 116 YALE L.J. 1472, 1509–11 (2007).

cannot escape redistributive tort law without surrendering the market entirely. In jurisdictions where escaping redistribution is easy, redistribution is difficult, and the accompanying economic costs are correspondingly high.

This Article proceeds in four Parts. Part I details the welfarist argument against redistributive legal rules. Part II argues that both national and local taxes are inefficient redistributive tools. Part III explains that local consumer protection rules share some of these inefficiencies while avoiding others, so it is ambiguous which method is most efficient. Part IV considers the objection that tort systems give rise to externalities, which may cause over-production of redistribution.

I.

THE REDISTRIBUTION STORY SO FAR

Louis Kaplow and Steven Shavell have put forth a number of influential arguments against redistributive legal rules.⁷ Kaplow and Shavell are most interested in utility, but they concede that social preferences for how resources are distributed in society should be considered in calculations of which rule best maximizes social welfare.⁸ They argue, however, that achieving this distribution should be the exclusive domain of the tax system because “using legal rules to redistribute income distorts work incentives fully as much as the income tax system . . . and also creates inefficiencies in the activities regulated by the legal rules.”⁹

Consider the way in which taxation could affect work incentives. Suppose, for example, that in deciding how many hours to work Bruce will figure that for every hour he does not work, he can stay home, garden, and watch Oprah. Each hour of leisure time Bruce enjoys costs him the money he could have earned working.¹⁰ The net opportunity cost to Bruce of each hour of leisure is the salary he would have earned, less the costs of earning that salary, such as commuting expenses and taxes. As taxes increase, leisure becomes more attractive for Bruce, because the net opportunity cost of leisure has shrunk.¹¹

7. See Kaplow & Shavell, *Less Efficient*, *supra* note 5, at 669; Strahilevitz, *supra* note 6, at 1509–11; Weisbach, *supra* note 6, at 446–53.

8. Kaplow & Shavell, *supra* note 4, at 987–92.

9. Kaplow & Shavell, *Less Efficient*, *supra* note 5, at 668.

10. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 299–301 (5th ed. 1989).

11. For example, if Bruce could earn \$10 perhour, a 10% tax would mean that the opportunity cost of leisure is \$9. If taxes increase to 20%, the cost of an

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In essence, Kaplow and Shavell's first claim is that redistributive legal rules will affect Bruce's incentives in the same way as a tax.¹² Suppose Bruce must make his decision to work or stay home before he knows the liability costs he will incur as a result of working. Thus, he bases his decision on the ex ante expected cost of working. If a legal rule on average redistributes money from Bruce to others in the same amount as a 20% tax, then the ex ante expected cost to Bruce must be the same as under the tax. Some people similarly situated to Bruce may face 40% costs; others will face zero. But since the expected costs will be 20%, Bruce will assume that is the cost of going to work.

Unlike a tax, however, the redistributive legal rule also changes other kinds of behavior, producing the so-called "double distortion" problem. Kaplow and Shavell use the example of a tort rule aimed at reducing accidents.¹³ An optimal non-redistributive rule would maximize the tradeoff between accident prevention and the cost of prevention.¹⁴ However, once the rule is altered to also redistribute wealth, the behavior of actors changes, increasing or decreasing the number of accidents to a non-optimal level.¹⁵ Taxation would not have this additional distortive effect, assuming the rate did not vary depending on whether the taxpayer was involved in an accident.¹⁶ Thus, according to Kaplow and Shavell, taxes should always redistribute more efficiently.¹⁷

Using legal rules for redistribution may have other problems as well. Redistributive legal rules often reach only those parties affected by the legal rule, thereby making redistribution arbitrary and perhaps deterring wealthier parties from engaging in the regulated activity.¹⁸ Also, rules that operate on the assumption that one party—every plaintiff or every defendant—is usually richer or poorer than the other run some risk of distributing in the wrong

hour of leisure drops to \$8. A complete account of Bruce's incentives would also include the possibility that changes in his wealth would change his demand for leisure, but for the sake of parsimony I set aside that situation here. MUSGRAVE & MUSGRAVE, *supra* note 10, at 299 (distinguishing "income" from "substitution" effect of taxation).

12. Kaplow & Shavell, *Less Efficient*, *supra* note 5, at 670–71.

13. *Id.* at 669–72.

14. *Id.* at 669.

15. *Id.*

16. *Id.* at 671–74.

17. *Id.* at 677.

18. Richard A. Epstein, *The Social Consequences of Common Law Rules*, 95 HARV. L. REV. 1717, 1719–20 (1982); Kaplow & Shavell, *supra* note 4, at 994.

direction, while rules that are crafted to take account of each particular individual can be very costly.¹⁹

Critics have responded with a number of reasons to be skeptical of reliance solely on redistributive taxation. Some detractors, arguing from a welfarist perspective, claim that it is unlikely, or at least not always the case, that workers take into account legal rules to the same extent they do tax considerations.²⁰ Similarly, they argue that redistribution through taxation is politically more difficult than through legal rules.²¹ Another welfare critique, suggested by Chris Sanchirico and others, is based on a technical claim concerning the way behavioral distortions affect social welfare.²² Because the economic cost of a change in behavior—a “deadweight loss”—rises exponentially with the size of the distortion causing it,²³ it should be more efficient to redistribute through many small rule changes, rather than one large tax. Finally, non-welfarist arguments present another potential defense of redistributive legal rules. Daphna Lewinsohn-Zamir, for example, argues that the results Kaplow and Shavell reach assume that society should maximize a particular form of utility.²⁴

For my purposes here, I accept for the sake of argument that Kaplow and Shavell’s points are all well-taken. As I will explain, I think that even on their own terms their claims have serious potential holes.

19. Kaplow & Shavell, *Less Efficient*, *supra* note 5, at 675; Weisbach, *supra* note 6, at 449.

20. Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1657 (1998); Richard S. Markovits, *Why Kaplow and Shavell’s “Double-Distortion Argument” Articles Are Wrong*, 13 GEO. MASON L. REV. 511, 550–55 (2005); Edward J. McCaffery & Jonathan Baron, *The Political Psychology of Redistribution*, 52 UCLA L. REV. 1745, 1748–90 (2005). For a helpful survey of other welfarist exceptions to the Kaplow & Shavell position, see Nicholas L. Georgakopoulos, *Solutions to the Intractability of Distributional Concerns*, 33 RUTGERS L.J. 279, 304–17 (2002) (noting arguments for role of legal rules in deterring socially undesirable behavior that is connected to wealth of actor; in targeting behavior that reveals underlying characteristics of the actor; and in redistributing non-monetary wealth).

21. Brett McDonnell, *The Economists’ New Arguments*, 88 MINN. L. REV. 86, 111 (2003).

22. Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003, 1006–11 (2001). *But see* Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEG. STUD. 821 (2000) (discussing Sanchirico’s arguments).

23. Sanchirico, *supra* note 22, at 1006–11.

24. Daphna Lewinsohn-Zamir, *In Defense of Redistribution Through Private Law*, 91 MINN. L. REV. 326 (2006).

II. INADEQUACY OF LOCAL TAXATION AS A REDISTRIBUTIVE IMPLEMENT

Whatever the persuasiveness of the two sides in the redistribution debate, it should be noted that both have assumed a model with only one government. I argue in this Part that redistributive taxation in a federalist system with many competing governments is fundamentally different than in the one-government model. To some degree, this difference is because local taxes distort choices about where to live or do business. Location-specific rents can mitigate some of these distortions.²⁵ But current tax law makes those rents small, at least as to multistate firms. In contrast, Part III establishes that states may be able to extract large location-specific rents through tort and contract law. Thus at the local level, redistributive tort law may prove more efficient than redistributive taxation.

As Kaplow and Shavell acknowledge, one of their key assumptions is that there exists a tax system capable of providing the socially-preferred degree of redistribution.²⁶ They do not detail what would remain of their argument if that assumption were false. In all likelihood they would contend that, in the absence of full redistribution through taxation, their argument would not collapse completely. Instead, the policy planner would be faced with determining the second-best option.²⁷ Given two imperfect options, the planner must ask which would result in the smaller loss of social welfare: frustrating society's preference for optimal redistribution, or distorting the economy to achieve optimal redistribution through non-tax means?

It is a familiar point among federalism scholars that a single government probably cannot fully satisfy its citizens' preferences for redistribution or other public goods.²⁸ If the government sets one uniform national policy for redistribution, then some voters will be left who would prefer more redistribution and some who would

25. A locational rent is simply an opportunity for a taxing jurisdiction to capture some of the value it provides to private parties through tax. See Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563, 571-72, 601 (1983).

26. See Kaplow & Shavell, *Less Efficient*, *supra* note 5, at 675; see also Weisbach, *supra* note 6, at 452.

27. On the theory of the second-best, see R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956). For a summary, see Richard Markovits, *Second-Best Theory and Law & Economics: An Introduction*, 73 CHL-KENT L. REV. 3, 3-10 (1998).

28. MUSGRAVE & MUSGRAVE, *supra* note 10, at 451.

prefer less.²⁹ In contrast, if redistribution policy can be set in smaller governmental units, such as at the city or county level, then each unit can offer a different level of redistribution, and citizens can choose to live in the jurisdiction that matches their preferences, barring a number of other obstacles.³⁰ While the central government might conduct this arrangement itself, there would be informational challenges for the central coordinator as well as the problem that the coordinator may not be perfectly politically responsive to the information it receives from each locality.³¹

This analysis implies that in order to show that redistribution only through taxation is more efficient than the alternatives, Kaplow and Shavell must defend their theory not only in a single monolithic government, but also in a more complex federalist system. Redistribution only at the national level would not fully satisfy social preferences for distributive justice.³² Thus, they have two options. They can argue that local redistributive taxes are no more distortive than local non-tax redistribution. Or they might pursue the second-best argument, claiming that the welfare losses from local non-tax redistribution would exceed any gains from more fully satisfying the public's tastes. This latter line of argument will be awfully hard to get a handle on, so for now let me focus on the first.

It is well established in the fiscal federalism literature that redistributive taxation in a multi-jurisdictional world is more distortive than in a model with only one sovereign.³³ If a government extracts from residents or businesses more money than they are willing to spend on public goods (including redistribution), they may move to a rival jurisdiction with lower taxes.³⁴ This relocation

29. *Id.* at 455.

30. Gregory v. Ashcroft, 501 U.S. 452, 457–58 (1991); Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1498–99 (1987) (reviewing RAOUL BERGER, *FEDERALISM: THE FOUNDERS' DESIGN* (1987)).

31. Mariano Tommasi & Frederico Weinschelbaum, *Centralization vs. Decentralization: A Principal-Agent Analysis*, 9 J. PUB. ECON. THEORY 369, 378–80 (2007); Ernest A. Young, *The Rehnquist Court's Two Federalisms*, 83 TEX. L. REV. 1, 53–63 (2004).

32. I assume here that individuals have a taste for redistribution that is tied in part to their own personal participation in the act of giving, or to the benefit of those who are geographically near or personally known to them, so that the incentives of any one jurisdiction to free ride on the redistributive efforts of others should be small.

33. Charles C. Brown & Wallace E. Oates, *Assistance to the Poor in a Federal System*, 32 J. PUB. ECON. 307, 328 (1987); Helen F. Ladd & Fred C. Doolittle, *Which Level of Government Should Assist the Poor?*, 35 NAT'L TAX J. 323, 328–32 (1982).

34. Mark V. Pauly, *Income Redistribution as a Local Public Good*, 2 J. PUB. ECON. 35, 35 (1973).

results in deadweight loss: the firm has given up its most-preferred location for the second most preferred, lowering its profit, while this reduction in profit has not resulted in any additional tax revenues for the government.³⁵ This is simply a contraction in the economy, with no corresponding benefit for anyone.

Another familiar reason local redistribution is inefficient is because it can create a race to the bottom in the amount of redistribution.³⁶ When tax-paying firms or residents exit in response to redistribution, every remaining taxpayer must pay more for the same level of services. Moreover, redistribution may attract migrants who would like to benefit from the more generous services, also increasing costs for those who remain. Thus, localities may not be able to offer the level of redistribution they would prefer for fear of driving costs up while tax revenues plummet.³⁷

These two lines of thought suggest that in a federalist system it is more efficient to impose taxes on things that cannot move.³⁸ The more mobile the tax base, the more difficult the redistribution.³⁹ Additionally, the more firms respond to redistributive taxation in their decisions on where to locate themselves, the greater the deadweight loss.

This is not to say that the only efficient taxes are those imposed on land or things bolted to the ground. Firms and people may also

35. *Id.*

36. John Shannon, *Federalism's "Invisible Regulator"—Interjurisdictional Competition*, in *COMPETITION AMONG THE STATE AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM* 117, 118–19 (Daphne A. Kenyon & John Kincaid eds., 1991). *But see* Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 *N.Y.U. L. REV.* 1210, 1210, 1239–41 (1992) (challenging the accepted wisdom on the race to the bottom).

37. MUSGRAVE & MUSGRAVE, *supra* note 10, at 455; Michael I. Luger, *Federal Tax Reform and the Interjurisdictional Mobility Impulse*, 23 *J. URB. ECON.* 235, 236 (1988). Some commentators claim that this interjurisdictional competition is actually a race to the top, not the bottom. GEOFFREY BRENNAN & JAMES M. BUCHANAN, *THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION* 203–05 (1980); John Douglas Wilson, *Theories of Tax Competition*, 52 *NAT'L TAX J.* 269, 296–98 (1999) (reviewing claims by others); Jeffery S. Zax, *Is There a Leviathan in Your Neighborhood*, 79 *AM. ECON. REV.* 560, 560–67 (1989) (reviewing studies showing competition between governments can reduce the size of the local public sector). These commentators argue that because of the disproportionate lobbying power of interest groups, the limited time horizon of local officials, and similar factors, redistribution will usually be greater than socially optimal. Competition reduces redistribution back to (or below?) efficient levels. I take no position on that debate here.

38. MUSGRAVE & MUSGRAVE, *supra* note 10, at 470–71.

39. *Id.* at 455, 470–71.

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be relatively immobile because there is inherent value in being in their first-best location.⁴⁰ If so, the jurisdiction can likely extract a tax equal to the costs of exit, including the decline in value from the first-best to the second-best location.⁴¹ In these cases, the locality can impose a tax without causing deadweight loss from relocation and can mitigate the extent to which the preferences of its citizenry are frustrated.⁴²

A potential worry with location-specific rents is that they may themselves cause inefficiencies by distorting the jurisdiction's political processes.⁴³ If these rents are borne by outsiders, the proceeds from them may look like free money to the voters in the jurisdiction. Since the voters do not consider the burdens of the tax when they set tax levels, they may demand too much redistribution relative to the socially optimal point.⁴⁴ Tax-setting officials may be less politically responsive to the needs of non-voting outsiders.⁴⁵ While outsiders can lobby or make campaign contributions, there could be free rider and coordination problems among outside firms, and one doing business in many jurisdictions may have trouble acting effectively in all of them.⁴⁶

40. See David Schleicher, *The City as a Law and Economic Subject*, 2010 ILL. L. REV. (forthcoming).

41. See Levmore, *supra* note 25, at 571–72, 601–02; cf. Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1217–32 (2001) (arguing that Delaware's corporate tax system is designed to extract from firms the added value of Delaware's legal system).

42. See Charles E. McClure, Jr., *Legislative, Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income Taxes in the US and the EU*, 14 COLUM. J. EUR. L. 377, 389 (2008); cf. MUSGRAVE & MUSGRAVE, *supra* note 10, at 455 (noting that redistribution may still be effective at the local level where "mobility is checked by nonfiscal factors such as job location"); *id.* at 470 (arguing that sales taxes may be employed with lesser distortion when the taxing jurisdiction is large enough "to exclude avoidance by shopping abroad").

43. See Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 927–28 (1992).

44. *Id.* Some scholars are dubious that this form of "tax exporting" can work in practice. See Charles E. McLure, Jr., *Tax Exporting and the Commerce Clause, in FISCAL FEDERALISM AND THE TAXATION OF NATURAL RESOURCES* 169, 170 (Charles E. McLure, Jr. & Peter Mieszkowski eds., 1983). However, it may be that the perception that exporting works is itself sufficient to distort political outcomes, a point I will return to in Part V.

45. For a more detailed discussion, see Brian Galle, *Designing Interstate Institutions*, 40 U.C. DAVIS L. REV. 1381, 1398–1400 (2007).

46. See *id.* at 1400. Locational rents may have yet other costs, as well. For example, as Roberta Romano explains, the fact that firms are aware of locational rents may mean that, before a firm will commit to a start business in a state, the state will have to credibly commit not to siphon off all of the firm's profits. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L.

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Perhaps as a result of these kinds of concerns, the law of state and local taxation has evolved to minimize location-specific rents, especially for firms doing business in more than one jurisdiction. In other words, companies gain the financial rewards of doing business more easily without bearing much tax for doing so. Constitutional limits on states' power to tax, together with collective action problems among them, combine to provide a variety of tax-minimizing strategies.

The jurisprudence of the dormant Commerce Clause is responsible for one of the larger of these tax loopholes.⁴⁷ Sales taxes are an obvious way for jurisdictions to capture some of the value created by their efforts to establish a thriving economic community.⁴⁸ However, merchants can avoid sales taxes by selling from outside the jurisdiction. For example: northern New Jersey malls annually attract hordes of New York shoppers because of New Jersey's lower sales taxes.⁴⁹ To counter this problem, states have created the "use tax," which is essentially a sales tax imposed on goods bought outside the jurisdiction and then brought back to it.⁵⁰ In reality, though, the use tax is almost unenforceable unless merchants collect it directly.⁵¹ States, however, have been barred by the Supreme Court from compelling merchants to collect sales or use taxes on the states' behalf unless the merchant has some substantial "physical presence" in the jurisdiction other than the use of a common carrier.⁵² Thus, mail-order and internet sales,

ECON. & ORG. 225, 235–36 (1985). Since talk is cheap, this "bond" will have to be costly to the state. On the other hand, these bonding mechanisms oblige the state to internalize some of the cost of the tax, diminishing the danger of tax exporting.

47. For extended discussion, see Galle, *supra* note 45, at 1390–92.

48. See Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1, 15 (2003).

49. For a review of the literature on the effects of political borders on sales taxes and recent evidence at the international level, see Marcus Asplund et al., *Demand and Distance: Evidence on Cross-Border Shopping*, 91 J. PUB. ECON. 141 (2006). The classic articles in this area in the U.S. context are Ronald C. Fisher, *Local Sales Taxes: Tax Rate Differentials, Sales Loss, and Revenue Estimation*, 8 PUB. FIN. Q. 171, 173 (1980) (summarizing earlier studies of New York area) and John L. Mikesell, *Central Cities and Sales Tax Differential: The Border City Problem*, 23 NAT'L TAX J. 206 (1970).

50. See Hellerstein, *supra* note 48, at 19–21.

51. John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 428–29 (2002).

52. *Quill Corp. v. North Dakota*, 504 U.S. 298, 313–18 (1992); see Charles E. McClure, Jr., *Sales and Use Taxes on Electronic Commerce: Economic, Administrative, and Political Issues*, 34 URB. LAW. 487, 493 (2002) (stating that the ability of out-of-state sellers to escape sales tax is "more-or-less inevitable given the complexity of the system and the constitutional prohibition against barriers to interstate trade").

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and northern New Jersey malls, all allow merchants to benefit from a thriving market without charging any sales tax.⁵³ Consequentially, merchant behavior is highly sensitive to taxation: when a tax is present, the merchants can alter their business behavior without having to give up the opportunity to sell to customers in the taxing jurisdiction.⁵⁴

State-level corporate taxes have similar problems. Firms can shift taxable income from high-tax jurisdictions to low-tax jurisdictions easily.⁵⁵ For instance, a firm can license its intellectual property from a related entity in a low-tax jurisdiction, taking a deduction for the cost of licensing in the high-tax state.⁵⁶ The Due Process Clause limits states' power to tax transactions without any "nexus" to the state, preventing a high-tax state from exacting any revenue from the licensor.⁵⁷ However, state supreme courts are split over that issue, and other possible work-arounds exist.⁵⁸ Another common tax-reduction technique is to arbitrage the different state methods for "apportioning" corporate income.⁵⁹ Again, this

53. See Charles E. McClure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 TAX L. REV. 269, 377 (1997); cf. Mitchell A. Kane, *Risk and Redistribution in Open and Closed Economies*, 92 VA. L. REV. 867, 904–05 (2006) (explaining that one theory for imposing tax in jurisdiction where sales occur is that it permits that jurisdiction to capture some of the "rents," or value, it provided to seller).

54. See McClure, *supra* note 53, at 377.

55. See Mark J. Cowan & Clint Kakstys, *A Green Mountain Miracle and the Garden State Grab: Lessons from Vermont and New Jersey on State Corporate Tax Reform*, 60 TAX LAW. 351, 353–73 (2007); Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 212–13 (2008).

56. See *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13, 16 (1993). That is, suppose Firm A owns a toy store in South Hightax, which has a 10% corporate tax. Firm A has \$100 million in net profits for this year. To avoid paying \$10 million in tax, Firm A could enter into a licensing agreement with a sister corporation, A-Del, owned by a common parent, A'. A-Del is incorporated in Delaware and pays a flat \$500 annual incorporation fee to Delaware regardless of revenues. A' assigns the legal right to use the Firm A logo (say, a lovable giraffe) to A-Del. Firm A then must contract with A-Del for the rights to use the logo. Because costs are ordinarily deductible from taxable income, Firm A reduces its net profits by the entire amount of the license fee. It will be very difficult to identify a fair market value for the license, so that Firm A can likely claim virtually any number and stand a reasonable chance of prevailing against state challenge. Thus, Firm A pays A-Del \$100 million, reducing its tax to zero, while A-Del continues to pay only \$500 in tax. Shareholders of A' are indifferent to the location of the \$100 million, except to the extent that they want to minimize their tax.

57. *Quill Corp. v. North Dakota*, 504 U.S. 298, 305–09, 313–18 (1992).

58. Roin, *supra* note 55, at 213–15.

59. *Id.* at 212–13.

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tactic rests on a federal constitutional rule: states may not impose a tax on 100% of a multi-jurisdictional entity's income, but instead must "fairly apportion" the piece of the firm's value attributable to the contributions of the taxing state.⁶⁰ These formulae are highly complex and can easily be gamed so the firm is taxed on much less than 100% of its full value, or so most of the firm's income is apportioned to low-tax jurisdictions.⁶¹ States could probably solve both the sales-tax and corporate-tax problems by effective interstate coordination, but such efforts have routinely failed.⁶²

One could argue that these problems can be overcome by a system of federal subsidies. Indeed, several such subsidies are already in place. For example, federal taxpayers may take a deduction for many of the taxes they pay to their state and local governments.⁶³ Many commentators, however, claim that the deduction and similar subsidies are unsatisfying solutions to the local redistribution problem.⁶⁴ One difficulty they point to is that the availability of the deduction creates a common-pool problem, where each jurisdiction's taxes create a fiscal externality for the rest of the nation, inducing each to outspend what its preferences would have been absent the subsidy—in effect, an over-correction.⁶⁵ Further, federal support for local taxes may also weaken the incentives of unhappy citizens to leave an underperforming jurisdiction, which is an important accountability mechanism for local

60. Joseph Bankman, *State Tax Shelters and State Taxation of Capital*, 26 VA. TAX REV. 769, 779 (2007); see Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 319 (2001).

61. Roin, *supra* note 55, at 212–13. *But cf.* Kane, *supra* note 53, at 924–26 (noting the possibility that apportionment could solve other problems with taxation of multi-jurisdictional enterprises). R

62. See Galle, *supra* note 45, at 1394–1400, 1413–20. R

63. 26 U.S.C. § 164 (2006); Brian Galle, *Federal Grants, State Decisions*, 88 B.U. L. REV. 875, 931–32 (2008); see Sam Bucovetsky & Michael Smart, *The Efficiency Consequences of Local Revenue Equalization: Tax Competition and Tax Distortions*, 8 J. PUB. ECON. THEORY 119, 120–22 (2006) (discussing how a system of federal revenue-equalization grants can address the efficiency problems of decentralization).

64. Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 477–78, 484–90 (1996); Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1425–30 (2004).

65. U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 63, 78–81 (1984), available at <http://www.ustreas.gov/offices/tax-policy/library/tax-reform/>; Kaplow, *supra* note 64, at 489–90; Michael Smart, *Taxation and Deadweight Loss in a System of Intergovernmental Transfers*, 31 CAN. J. ECON. 189, 205 (1998). R

governments.⁶⁶ Economists have devoted considerable effort to designing fiscal tools to overcome these problems, but so far there seems to be no consensus that any of them succeed.⁶⁷

Thus, putting the local and federal systems together, American tax rules by and large free many firm owners from location-specific rents.⁶⁸ The implication is that redistribution through local taxes will be relatively inefficient. Jurisdictions will struggle to achieve their own citizens' preferences for redistribution, and, if they attempt to do so, may damage the economy in the process.

III. TORT AND CONTRACT AS LOCAL REDISTRIBUTION?

My claims in Part II pose a problem for those urging redistribution only through taxation. The tax system cannot efficiently satisfy society's preferences for redistribution because national redistribution cannot capture all preferences, and local redistribution is impractical and inefficient. The question then becomes one of the second-best. Which system is more costly, a tax system flawed in the way I have described, or redistribution through legal rules?

Kaplow and Shavell argue redistribution through legal rules may encounter many of the same costs as a tax.⁶⁹ Consider table one, below. Kaplow and Shavell's analysis captures the comparison between box one, national tax, and box three, national non-tax. Redistribution through nationwide legal rules will likely fail to fully capture public preferences for distributive fairness, just as national taxation would. The more difficult comparisons are those between box four, local non-tax, and boxes one and two, national and local

66. Brian Galle, *A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code*, 82 *IND. L.J.* 673, 696–700 (2007).

67. See Oates, *supra* note 3, at 1126–30.

68. It is true that redistributive taxes can also be exacted from other sources, such as wealthy individuals who are not business investors. However, one can tell a similar story about wealthy individuals, whose financial resources give them both the opportunity to relocate and also the wherewithal to lobby on their own behalf. Additionally, even if some redistributive taxes were collected from non-business-related sources, an ideally designed redistributive tax would fall at least in part on firm owners. Again, because deadweight losses grow exponentially in proportion to the size of the tax distortion, redistributive taxes should be levied very broadly, such that the marginal deadweight loss from each tax is equal. Sanchirico, *supra* note 22, at 1006–11. That implies that a jurisdiction that could not readily tax business-related sources would have to impose an inefficiently high tax on other sources.

69. Kaplow & Shavell, *Less Efficient*, *supra* note 5, at 667–68.

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tax, respectively. Does local non-tax redistribution create the same deadweight loss and impracticability problems as local taxation? If so, then at a minimum the choice between boxes two and four (accepting Kaplow and Shavell’s other arguments) is straightforward: box two is superior. However, I argue that the costs of shifting from box three to four are smaller than the cost of shifting from one to two: non-tax local redistribution has smaller deadweight losses than local taxation.

TABLE 1: POSSIBLE COMBINATIONS OF REDISTRIBUTIVE MECHANISMS

REDISTRIBUTION	NATIONAL	LOCAL
TAX	1. National Tax	2. Local Tax
NON-TAX	3. National Non-Tax	4. Local Non-Tax

Local non-tax redistribution is more efficient than local taxation because it affords greater opportunities for location-specific rents. That is, firms cannot easily reap the benefits of selling in a particular market without being subject to the liability rules of that jurisdiction.⁷⁰ As a constitutional matter, once a firm purposefully avails itself of the opportunity for local sales, the jurisdiction has the power to impose its rules on that firm.⁷¹ And most jurisdictions allow plaintiffs to exercise this power to the fullest extent the Constitution permits.⁷²

To be sure, in the case of defendants with a contractual relationship with prospective plaintiffs, defendants can attempt to specify a more favorable forum for disputes. Mandatory arbitration, waivers of jury trials, and choice-of-law clauses designating a more favorable jurisdiction’s rules are all common tactics for mitigating the costs of local consumer protection laws.⁷³ The difficulty for the firm, however, is that a given jurisdiction can simply refuse to give effect to such terms. Courts have found such terms to be unen-

70. See *supra* text accompanying notes 38–42; see also Stephen F. Williams, *Preemption: First Principles*, 103 Nw. U. L. REV. 323, 327–28 (2009) (making this claim about tort law).

71. 4 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1067.1 (3d ed. 1998) (citing *Hanson v. Denkla*, 357 U.S. 235, 253 (1958); *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980)).

72. *Id.* § 1068.

73. See Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, 1996 SUP. CT. REV. 331, 355–61, 374–78; see also Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 391–98 (2005).

forceable for technical contractual reasons, such as the absence of a genuine agreement, as well as on general public-policy grounds.⁷⁴ Aside from the Federal Arbitration Act and some recently developed rules capping punitive damages, it seems few federal laws limit non-discriminatory state or local rules mandating firms to be bound by the jurisdiction's legal rules.⁷⁵ Thus, a locality seeking to use its tort or contract rules for redistribution probably can do so.

It might also be argued that redistributive legal rules cannot actually work in practice, because the firm will simply include the expected cost of the legal rule in the price of the product. This is the classic "the landlord will raise the rent" problem much debated in the redistribution literature.⁷⁶ Notably, whether redistribution actually increases the welfare of beneficiaries depends in part on the seller's ability to price discriminate. In order to "raise the rent," the merchant must know that a particular customer belongs to the protected class and must be able to charge that customer a higher price. If, in contrast, the merchant can charge only one price to all of its customers, then there may still be redistribution.

It is true, however, that when the merchant "raises the rent" for all its customers at once the resulting redistribution is from unprotected to protected customers, rather than from the firm to poor customers. In other words, rich customers unprotected by the redistributive legal rule pay more to cover the firm's cost of paying out to protected poor customers.⁷⁷ But that is still a form of rich-to-poor redistribution. Similarly, some redistribution is still possible even if merchants can charge more from those protected by a legal rule. Even when the merchant can identify protected class members, the increased price typically represents an ex ante average expected cost. Thus, injured customers who win a judgment obtain a net gain, whereas uninjured customers pay more. In effect, the policy redistributes from lucky (uninjured) customers to the unlucky (injured) customers.⁷⁸ This is essentially the identical structure as

74. See Christopher R. Drahozal, "Unfair" Arbitration Clauses, 2001 U. ILL. L. REV. 695, 697-98 (noting reasons courts have refused to enforce arbitration agreements); Gilles, *supra* note 73, at 399-408.

75. See Williams, *supra* note 70, at 328.

76. E.g., Bruce Ackerman, *Regulating Slum Housing Markets on Behalf of the Poor: Of Housing Codes, Housing Subsidies and Income Redistribution Policy*, 80 YALE L.J. 1093, 1095 (1971); Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 604 (1982); see Weisbach, *supra* note 6, at 448-49.

77. See Weisbach, *supra* note 6, at 449.

78. See Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law*, 108 HARV. L. REV. 1785, 1793-97 (1995).

personal injury insurance: the customer transfers wealth from her current rich and healthy state to a potential future injured state.⁷⁹ Thus, the “landlord-will-raise-the-rent” problem does not preclude many forms of redistribution, including some that consumers routinely engage in every day.

As a result, whether redistributive taxes are superior to local non-tax redistribution is theoretically indeterminate. We cannot say confidently whether local taxation is superior to local non-tax redistribution. Local non-tax redistribution may well pose the double-distortion problem and other difficulties Kaplow and Shavell point to.⁸⁰ But local taxation creates deadweight losses and losses from incomplete redistribution that local non-tax redistribution does not. Similarly, theory does not clearly tell us whether the double-distortion costs are larger than the losses we would suffer from setting only a single uniform national redistributive tax rule.

IV. EXTERNALITIES AND THE INCIDENCE PROBLEM

One last set of potential arguments against redistribution through local legal rules is worth independent consideration. Professors Issacharoff and Sharkey have explained preemption as a response to over-regulation by states; over-regulation results from the fact that the costs of liability are putatively externalities for each state.⁸¹ The same point could be leveled against tort law as a tool of redistribution; rather than capturing local preferences for redistribution, it simply measures a jurisdiction’s willingness to appropriate the wealth of foreigners. In my view this danger is real, but somewhat overstated.

First, the costs of redistribution are not necessarily borne by out-of-staters. When a firm is liable for a judgment, the economic burden of that judgment is ultimately passed on to real people, whether they are the firm’s owners, its workers, its customers, or even investors in other businesses. Tax scholars call this question of which people bear the burden of an expense the “incidence” of the cost.⁸² Typically, incidence depends on the elasticities of supply and demand for the firm’s products and inputs.⁸³ For example, if demand is highly inelastic, consumers pay virtually any price for the

79. *Id.* at 1794–96.

80. *See supra* text accompanying notes 7–19.

81. Samuel Issacharoff & Catherine M. Sharkey, *Backdoor Federalization*, 53 *UCLA L. REV.* 1353, 1368–71 (2006).

82. MUSGRAVE & MUSGRAVE, *supra* note 10, at 236–39.

83. *Id.* at 250–62.

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firm's products. The incidence of a tax on such a firm is likely to be borne by its customers because it can easily pass along the costs to them without losing sales.⁸⁴ Given the complexity of these relationships, experts agree that measuring the true incidence of a tax on corporations is a very challenging task.⁸⁵

Thus, the true economic incidence of redistributive tort law might not fall on investors in the liable firms.⁸⁶ If demand is relatively inelastic the firm might charge a higher price for products it sells in the high-cost jurisdiction. In that case the jurisdiction largely internalizes the costs of any redistribution, since it is simply moving money from some of its citizens (unprotected customers) to others (the protected customers). Alternatively, the tax might fall on investors or employees who reside in the taxing jurisdiction, so that again costs are internalized.

In a recent essay, D.C. Circuit Judge Stephen Williams acknowledged a version of this argument, but suggested that firms would be unable to set prices to reflect the costs of a given jurisdiction.⁸⁷ Judge Williams argues:

[I]n our federal system, given (1) the Supreme Court's rather mild limits on in personam jurisdiction, (2) its almost complete laissez faire as to state choice-of-law decisions, (3) the way in which products and buyers wander among the states, and (4) modern courts' virtually complete indifference to contract provisions relating to liability, firms selling in interstate commerce cannot, as a practical matter, match selling prices to varying levels of litigation risk.⁸⁸

In other words, firms cannot price their products according to the legal rule of the consumer's jurisdiction because the consumer can take the product elsewhere, and the seller will still be liable under the rule of this third jurisdiction.

There is certainly some truth to these points, but it is rather overbroad to claim that they apply to all products and all industries. To take an extreme example, homebuilders and other construction contractors probably do not need to worry much that their customers will take their product to a different state. More generally,

84. *Id.* at 254.

85. *Id.* at 264–69.

86. See Charles E. McClure, Jr., *Incidence Analysis and the Supreme Court: An Examination of Four Cases from the 1980 Term*, 1 SUP. CT. ECON. REV. 69, 82 (1982) (arguing that incidence of state-level corporate taxes is unlikely to fall on investors, because they can easily shift their investment to a firm that is not taxed).

87. Williams, *supra* note 70, at 327–28 (2009).

88. *Id.* at 328.

prices should reflect average expected liability, and rational firms ought to be able to predict where their customers will take their products. Most claims will still be in the purchase jurisdiction and many others will be in neighboring locales. It is plausible that firms could price regionally, rather than state-by-state. Moreover, since policies often spread regionally,⁸⁹ a particular liability rule is reasonably likely to hold in any one of the several neighboring jurisdictions where consumers might take their products, further facilitating regional pricing. Yet other services, such as insurance, wireless, and satellite services, could simply add a surcharge (akin to a “roaming” fee) for use in a risky jurisdiction for the seller.

Another internalization mechanism, suggested in recent work by the corporate-law scholar Michal Barzuza, is through the corporate income tax.⁹⁰ If a state imposes taxes based on firms’ net profits and the costs of liability are deductible by firms, then state taxpayers in effect pay a portion of all judgments against the firm through the reduction in revenue resulting from those deductions.⁹¹ In fact, most states have just such a set of corporate tax rules.⁹² In those states, a portion of the costs of liability are spread across all taxpayers, leading to at least partial internalization of the jurisdiction’s liability rule.

On the other hand, whatever the reality of the extent to which the state internalizes the costs of liability, the state’s voters could still *believe* that those costs are externalities.⁹³ In that instance, we might predict that officials will tend to over-produce redistribution because they will not expect to be held accountable by voters for the resulting costs. These officials take the risk, though, that their political rivals will learn the truth and expose the hidden costs to the public.⁹⁴

Another complication raised by these kinds of political considerations is the possibility that outside firms may exert considerable political power despite lacking formal voting representation. This

89. Frances Stokes Berry & William D. Berry, *State Lottery Adoptions as Policy Innovations: An Event History Analysis*, 84 AM. POL. SCI. REV. 395, 399–400 (1990); see Frederick J. Boehmke & Richard Witmer, *Disentangling Diffusion: The Effects of Social Learning and Economic Competition on State Policy Innovation and Expansion*, 57 POL. RES. Q. 39, 40 (2004).

90. Michal Barzuza, *Delaware’s Compensation*, 94 VA. L. REV. 521 (2008).

91. *Cf. id.* at 535–37, 552, 556 (arguing that dependence of state revenues on firm performance gives states incentive to design efficient rules governing firms).

92. JOHN C. HEALY & MICHAEL S. SCHADEWALD, 2009 MULTISTATE CORPORATE TAX GUIDE I-170 to I-177 (2008).

93. See Shaviro, *supra* note 43, at 927–28, 957.

94. See Brian Galle, *Hidden Taxes*, 87 WASH. U. L. REV. 59, 91–93 (2009).

ground has already been thoroughly analyzed, not only in the preemption literature but also in the related field of the dormant Commerce Clause.⁹⁵ The only point to highlight here again is that thorough analysis of the political economy of discrimination against outsiders probably will be highly sensitive to the structure of the industry and the nature of the liability;⁹⁶ generalizations are hazardous.

Overall, the externality problem does not conclusively resolve the debate between taxation and non-tax redistribution. At times it will probably be true that externalities will predictably lead to overproduction of redistribution. At other times externalities may be negligible, or have little effect on the jurisdiction's political actors. Thus, whether taxation is always a superior redistributive mechanism is theoretically uncertain.

CONCLUSION

Current debates over preemption of local consumer protection regimes have over-simplified their analysis by failing to consider the possible use of legal rules as a tool for wealth redistribution. Possibly this omission rests on the strength of a well-established welfarist argument against redistributive legal rules. However, the argument that legal rules are a poor choice of redistributive instrument appears not to have taken federalism considerations into account. I have argued here that theory does not make strong predictions about whether society should prefer taxation, whether at the national or local level, over localized redistribution through legal rules. This finding, if it holds up, has implications not only for the preemption debate but also more generally for the design of our legal system.

95. See, e.g., Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 271–73 (1990).

96. Probably the most forceful version of this claim is Ed Zelinsky's argument that the political economy questions here are so difficult that the Court should just give up. Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation*, 29 OHIO N.U. L. REV. 29, 32–79 (2002).

