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COLLOQUIUM ON TAX POLICY  
AND PUBLIC FINANCE

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**“TAX JUSTICE AND THE EQUITABLE DISTRIBUTION  
OF BAILOUT COSTS”**

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## COLLOQUIUM ON TAX POLICY AND PUBLIC FINANCE

(All sessions meet on Thursdays 4:00-5:50 p.m., Vanderbilt 208, NYU Law School)

1. January 20 – Joseph Bankman, Stanford Law School. Reforming the Tax Preference for Employer Health Insurance.
2. January 27 – Yair Listokin, Yale Law School. Taxation and Liquidity.
3. February 3 – David Miller, Cadwalader, Wickersham & Taft LLP. Unintended Consequences: How U.S. Tax Law Encourages Investment in Offshore Tax Havens.
4. February 10 – Michael Keen, International Monetary Fund. The Taxation and Regulation of Financial Institutions
5. February 17 – Kenneth Scheve, Yale University Political Science Dep't. Envy and Altruism in Hard Times.
6. February 24 – Allison Christians, Wisconsin Law School. Hard Law, Soft Law, and No Law: The World of International Tax Dispute Resolution.
7. March 3 – Adam Rosenzweig, Washington University Law School. Thinking Outside the (Tax) Treaty.
8. March 10 – Eric Zolt, UCLA Law School. Tax Deductions for Charitable Contributions: Domestic Activities, Foreign Activities, or None of the Above.
9. March 24 – Kirk Stark, UCLA, Law School. Bribing the States to Tax Food (to be discussed with The Federal Role in State Tax Reform).
10. March 31 – Len Burman, Maxwell School of Syracuse University. Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform (with Marvin Phaup).
11. April 7 – Jennifer Blouin, Wharton School, University of Pennsylvania. Is U.S. Multinational Intra-Firm Dividend Policy Influenced by Reporting Incentives?
12. April 14 – Joshua Blank, NYU School of Law. In Defense of Tax Privacy.
13. April 21 – Leandra Lederman, Indiana University School of Law. Hold the Mayo: What Respect Should Courts Accord Tax Regulations and Rulings Issued During Litigation?
14. **April 28 – Cheryl Block, Washington University in St. Louis Law School. Tax Justice and the Equitable Distribution of Bailout Costs.**

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## **Tax Justice and the Equitable Distribution of Bailout Costs\***

Cheryl D. Block\*\*

### I. Introduction

#### A. History Repeats Itself

Federal government intervention to rescue private market participants or otherwise prevent private-sector economic failure is inconsistent with generally accepted free-market norms. Yet, centuries of economic history provide countless illustrations of government-supported “rescue” of private entities or industries in otherwise capitalist economies. Perhaps the earliest recorded public bailout was in 33 A.D. under circumstances eerily similar to the subprime mortgage crisis leading to U.S. government market interventions in 2008-2009. Centuries ago, Emperor Tiberius came to the rescue after a busted Roman real estate bubble by “distribut[ing] a hundred million sesterces among specially established banks, for interest-free three-year State loans, against security of double the value in landed property. Credit was thus restored; and gradually private lenders, too, reappeared.”<sup>1</sup>

Fast forwarding several centuries, the still infant United States suffered a major market crash in 1792. In addition to Treasury Department open-market purchases of U.S. debt, Treasury Secretary Alexander Hamilton previewed what would later be labeled “too-big-to-fail,” reportedly informing the private Bank of New York that “whatever support may be in my power shall be afforded. I consider the public interest as materially involved in aiding a valuable

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<sup>1</sup> TACITUS, *THE ANNALS OF IMPERIAL ROME*, trans. with introduction by Michael Grant 203 (1956) (historical account of early government bailout-type assistance). Looking back at these events from the fourteenth century, Tacitus blamed the economic crisis on greedy and unscrupulous lenders who’s “patriotism came second to private profits.” *Id.*

institution like yours to withstand the attacks of a confederated host of frantic and I fear, in too many instances, unprincipled gamblers.”<sup>2</sup>

By the time of President Roosevelt’s March 1933 inauguration in the midst of the Great Depression, the banking crisis had become so severe that he immediately declared a nationwide bank moratorium.<sup>3</sup> Within five days, Congress passed legislation allowing the Comptroller of the Currency to place banks into conservatorship,<sup>4</sup> and authorized the Reconstruction Finance Corporation (“RFC”)<sup>5</sup> to purchase preferred bank stock, thus infusing banks with much needed capital.<sup>6</sup> Through the years since the Great Depression, the federal government has continued to provide both individual<sup>7</sup> and industry-specific<sup>8</sup> assistance during periods of financial distress.

Government agencies, and ultimately Congress, scrambled through the 2008-2009 crisis to put out fires using numerous, sometimes unprecedented, devices including: 1) Federal Reserve brokering of the private acquisition of Bear Stearns, and agreeing to assume losses in order to facilitate the transaction;<sup>9</sup> 2) Federal Reserve lending to stave off imminent collapse of American International Group (AIG), the nation’s largest insurance company;<sup>10</sup> 3) Office of Thrift Supervision’s (OTS) closure of IndyMac Bank and naming the Federal Deposit Insurance Corporation (FDIC) as conservator;<sup>11</sup> 4) OTS closure of Washington Mutual, the largest bank failure in U.S. history, followed by an FDIC-facilitated sale of the bank to JPMorgan Chase;<sup>12</sup>

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<sup>2</sup> Richard Sylla, Robert Wright, David Cowen, *Alexander Hamilton, Central Banker: Crisis Management During the U.S. Financial Panic of 1792*, 83 BUS. HIST. REV. 61, 74-75 (2009) (quoting Hamilton letter). *See also* DAVID COWEN, THE ORIGINS AND ECONOMIC IMPACT OF THE FIRST BANK OF THE UNITED STATES, 1791-1797, 89-110, 154-55 (2000).

<sup>3</sup> Congress retroactively provided the emergency statutory authority for this remarkable presidential act five days later with the Emergency Banking Relief Act of 1933, Pub. L. No. 73-1, tit. 1 §4.

<sup>4</sup> Bank Conservation Act of 1933, Pub. L. No. 73-1, tit. II, §203, 48 Stat. 2.

<sup>5</sup> Reconstruction Finance Corporation Act of 1932, 7 Stat. 5, ch. 8 (creation of RFC).

<sup>6</sup> Pub. L. No. 73-1, tit. III, §304, 48 Stat. 6.

<sup>7</sup> *See, e.g.*, Chrysler Loan Guarantee Act, Pub. L. No. 96-185, 93 Stat. 1324 (1980). *See also* Emergency Loan Guarantee Act, Pub. L. No. 92-70, 85 Stat. 178 (1971). Although this Act was general in scope, its passage was motivated by the financial problems of the Lockheed Aircraft Corporation. H.R. Rep. No. 379, 92d Cong., 1st Sess. 1272 (1971).

<sup>8</sup> *See, e.g.*, United States Railway Association Amendments Act of 1978, Pub. L. No. 95-565, 92 Stat. 2397; Regional Rail Reorganization Act of 1973, Pub. L. No. 93-236, 87 Stat. 985 (1974) (railroad bailouts). Air Transportation Safety and System Stabilization Act, Pub. L. No. 107-42, 115 Stat. 230 (2001) (airline bailouts). Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989) (savings and loan bailout).

<sup>9</sup> *See* GARY SHORTER, CONG. RESEARCH SERV., RL34420, BEAR STEARNS: CRISIS AND “RESCUE” FOR A MAJOR PROVIDER OF MORTGAGE-RELATED PRODUCTS (2008). For Treasury Secretary Paulson’s personal perspective, *see* HENRY M. PAULSON, JR., ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM 90–121 (2010).

<sup>10</sup> *See* BAIRD WEBEL, CONG. RESEARCH SERV., R40438, ONGOING GOVERNMENT ASSISTANCE FOR AMERICAN INTERNATIONAL GROUP (AIG) (2009).

<sup>11</sup> FEDERAL DEPOSIT INSURANCE CORP., 2008 ANNUAL REPORT 46 (2009).

<sup>12</sup> *Id.*, at 47.

and 5) Treasury Department taking of Fannie Mae and Freddie Mac into conservatorship.<sup>13</sup> In addition, Congress responded to the Treasury Department's request for expanded "bailout" authority by including a new \$700 billion Troubled Asset Relief Program (TARP) as part of the Emergency Economic Stabilization Act of 2008 (EESA).<sup>14</sup> Instead of purchasing troubled assets as originally intended, the Treasury Department ultimately used TARP funds to infuse troubled banks with needed capital, and to assist General Motors and Chrysler.<sup>15</sup>

## B. Public Anger and the Grand Paradox of the Great Recession

The impact of the Great Recession was deep and widespread, affecting economies worldwide, businesses and investors large and small, and causing unemployment in market sectors and income brackets not accustomed to such suffering. An already angry public moved toward outright rage as word spread of the extraordinary bonuses paid to executives of failing companies that had so recently received government assistance.<sup>16</sup> Those suffering serious economic hardship not fortunate enough to receive direct government assistance understandably are bitter about the perceived inequities. To the extent that any government bailout-type assistance is funded with general revenues, businesses that are large or integrated enough to have a potentially systemic economic impact receive assistance at the expense of general taxpayers, including smaller businesses facing similar – or even more serious - economic threats. Those left to suffer from their own bad economic decisions wonder why others should be able to avoid similar suffering simply because they happened to be bigger.

Shortly after the officially declared end to the Great Recession,<sup>17</sup> two noted economists studying the macroeconomic effects of government responses, concluded that:

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13 See Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, §1117, 122 Stat. 2654, 2683-88 (providing Treasury Department authority to seize control of mortgage giants, Fannie Mae and Freddie Mac). See also ERIC WEISS, CONG. RESEARCH SERV., RL34661, FANNIE MAE'S AND FREDDIE MAC'S FINANCIAL PROBLEMS: FREQUENTLY ASKED QUESTIONS (2008).

14 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (to be codified at 12 U.S.C. §§5201–5261).

15 See CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY 6 (2009).

<sup>16</sup> Legislators from both parties shared the public's outrage upon hearing of extraordinary bonuses paid to AIG executives after it received assistance both from the Federal Reserve and through TARP. For hearings, see *AIG Bonuses: Audit Report of the SIGTARP: Hearing Before the H. Comm. on Oversight and Government Reform*, 111<sup>th</sup> Cong. (2009). House enacted legislation that would have imposed a 90% tax on "disqualified" TARP bonuses was not approved in the Senate. H.R. 1586, 11<sup>th</sup> Cong. (2009).

<sup>17</sup> The National Bureau of Economic Research (NBER), a private, nonprofit, nonpartisan research organization, officially declared that the U.S. domestic economic recession began in December 2007, NAT'L BUREAU OF ECON. RESEARCH, DETERMINATION OF THE DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY (2008), available at <http://www.nber.org/dec2008.pdf>, and ended in June 2009, noting that it was the longest of any U.S. recession since World War II. NAT'L BUREAU OF ECON. RESEARCH, BUSINESS CYCLE DATING COMMITTEE (2010), available at <http://www.nber.org/cycles/sept2010.html>.

when all is said and done, the financial and fiscal policies will have cost taxpayers a substantial sum, but not nearly as much as most had feared and not nearly as much as if policymakers had not acted at all. If the comprehensive policy responses saved the economy from another depression, as we estimate, they were well worth their cost.<sup>18</sup>

Conceding that one might legitimately critique the particulars of individual components of the government's response, the authors still took the position that "*laissez faire* was not an option; policymakers had to act. . . . Ben Bernanke was probably right when he said that 'We came very close in October [2008] to Depression 2.0.'"<sup>19</sup> Of course, such counterfactuals cannot be proved with certainty. We can never know how much worse the economy would have been in the absence of various government responses. Still, studies such as this suggest that the extraordinary fiscal policy adjustments, stimulus measures, and bailout actions taken in 2007-2009 may well have prevented an already serious economic crisis from becoming far more severe, and contributed to a more rapid recovery than would have occurred in the absence of government intervention. One can say with greater certainty that the government's overall TARP programs cost far less than the \$700 billion originally allocated, and that several individual programs have resulted in profits for the government. In March 2011, for example, the Congressional Budget Office estimated that TARP costs to the federal government would ultimately amount to only \$19 billion.<sup>20</sup>

Even so, public anger over the 2008 bipartisan bailout legislation has been so intense that "lawmakers from both parties who backed it remain haunted by the vote."<sup>21</sup> According to some reports, this "deep-seated resentment has factored into the anti-Washington, anti-incumbent sentiment so prominent in [the 2010] midterm elections, in which a yes vote on TARP has proven to be its own toxic asset."<sup>22</sup> Examination of the divide between economic findings and public perception reveals the grand paradox of the Great Recession: "Economists largely agree that the massive federal bailouts beginning in 2008 saved the country from a financial abyss. But rarely has a government program become so widely reviled, so stigmatized, that even lawmakers who voted for it avoid the subject."<sup>23</sup>

Perhaps the key reason that bailouts generate so much indignation is that they are not *fair* as most of us understand the concept. Government assistance in the bailout setting is *not* based upon greater need or hardship, or to reward good behavior. Some recipients of bailout assistance may even have substantially contributed to the crisis. At least theoretically, the sole reason for government assistance was to prevent systemic harm. Decisions to intervene were not based on

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<sup>18</sup> ALAN S. BLINDER & MARK ZANDI, *HOW THE GREAT RECESSION WAS BROUGHT TO AN END* 10 (2010). The study used Moody's Analytics' model of the U.S. economy to simulate the economic impact of fiscal stimulus and financial-market policies under four different scenarios. *Id.*, at 4.

<sup>19</sup> *Id.*, at 7.

<sup>20</sup> CONG. BUDGET OFFICE, *REPORT ON THE TROUBLED ASSET RELIEF PROGRAM—MARCH 2011*, at 1 (2011).

<sup>21</sup> Carl Hulse & David M. Herszenhorn, *Bank Bailout is Potent Issue for Fall Races*, N.Y. TIMES, July 11, 2010, at A1.

<sup>22</sup> *Id.*

<sup>23</sup> Brady Dennis, *Officials Assess Bailouts*, WASH. POST., Oct. 1, 2010, at A16.

the particular needs of the businesses receiving assistance, except to the extent that those needs revealed a threat of widespread contagion in the event of a firm failure; in other words, a determination that the rescue was necessary to avoid domestic – or even international – economic meltdown.

Not surprisingly, perhaps, Congress responded to the intense public anger by firmly declaring an end to “bailouts” and “too big to fail” policies in its statutory preamble to the Dodd-Frank Wall Street Reform Act.<sup>24</sup> As he signed the legislation, President Obama further asserted that “because of this law, the American people will never again be asked to foot the bill for Wall Street’s mistakes. *There will be no more tax-funded bailouts—period.*”<sup>25</sup> Such extreme “never again” positions and sentiments are sadly unrealistic and short-sighted. As I’ve argued before:

[po]litical “no more bailout” assertions—even those ultimately incorporated into statutory language—simply are not credible pre-commitment devices. Statutory declarations can always be amended. As much as Congress would like to eliminate any “too-big-to-fail” policy, the reality is that there may—and probably will—come a time when the failure of a particular firm or industry would be so economically devastating that Congress would step in to save it, despite earlier protestations to the contrary.<sup>26</sup>

In the end, public expenditures for bailout-type assistance are funded with coerced contributions from one group, which are then used to support another. In other words, publicly-supported bailouts involve redistribution through government use of its taxing authority.<sup>27</sup> Mindful that bailout-type assistance may someday again be necessary, and assuming that public anger is unlikely to dissipate, this paper uses tax policy approaches to explore alternative answers to the public’s question: “Why should we pay?” Part II begins with a brief discussion of general conceptions of tax justice, and suggests that different standards of tax fairness should be applicable to different tax circumstances. It closes by developing some background principles and assumptions about taxes, markets, and tax policy that will be useful for subsequent discussion. Part III explores the arguments that might be offered to justify the use of general taxpayer revenues for bailout-type expenditures, and Part IV considers some alternative approaches.

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<sup>24</sup> Pub. L. No. 111-203, 124 Stat. 1376 (preamble) [hereinafter Dodd-Frank Act].

<sup>25</sup> Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 DAILY COMP. PRES. DOC. 617 (July 21, 2010) (emphasis added).

<sup>26</sup> Cheryl D. Block, *Measuring the True Cost of Bailouts*, 88 WASH. U. L. REV. 149, 154 (2010) [hereinafter Block, *Measuring Bailout Costs*]. For similar observations, see Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 443 (2011) (“Bailouts are an inevitable feature of modern economies, . . . Any prefixed resolution regime will be abandoned whenever it cannot provide acceptable distributional outcome. In such cases, bailouts are inevitable.”)

<sup>27</sup> I use the term “tax” here in its broadest sense to mean any coerced contribution from the public, which the government may then put to any democratically-determined use, including a targeted subsidy payment for the benefit of a particular individual or group, assuming that the subsidy otherwise satisfies due process, equal protection, and other constitutional requirements.

I. Background Tax Justice Principles, Economic Assumptions, and Parameters

A. Tax Justice in General

The most important objective of a state-coerced taxation system, of course, is generating revenues necessary to fund government expenditures.<sup>28</sup> If this was the only consideration, the government might legitimately impose a head tax on all citizens above a certain age, or - at the other extreme - collect all necessary revenues only from the wealthiest citizens. Any thoughtful discussion of tax policy, however, must acknowledge additional considerations about the appropriate distribution, and the economic incidence, of tax burdens.<sup>29</sup> Hence, another primary tax policy objective is to impose tax burdens “equitably” or “fairly.” While notions of “fairness,” “equity,” and “justice” are emotionally compelling, they are notoriously vague and difficult to operationalize. Generations of philosophers, lawyers, economists, social scientists, and legislators have debated both first order questions of political legitimacy – referring to the fundamental principles used to justify government-coerced payments from citizens; and second order questions about the meaning of those principles. My purpose surely is not to expound upon or even to fully survey theories of tax fairness and justice through the ages. At the same time, one can hardly consider the concept of equitable distribution without some notion of underlying principles.

Although philosophical fashions have shifted over time, and despite disagreements at the margins (some wider than others), substantial numbers of tax policy analysts often surprisingly agree on certain foundational principles. Benefit theory, which posits that tax burdens should be allocated among citizens according to benefits they receive from government, was the earliest predominant first-order tax legitimacy principle.<sup>30</sup> The benefit approach has since largely been rejected in favor of the notion that tax burdens should be imposed in accordance with “ability to

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<sup>28</sup> This presupposes earlier determinations about the appropriate size of government, i.e. the *amount* of necessary revenue. My focus on equitable cost allocations for purposes of this paper is not intended to minimize the critical nature of such government spending determinations and the many challenges involved in making them. [connection between spending and tax design – the structure of tax system might differ under different government spending models].

<sup>29</sup>“Economic incidence” addresses the question of “who bears the final burden of a tax. Calculating tax incidence is complex because tax-induced changes in individual and firm behavior and the associated changes in commodity prices and factor returns often imply that the final burden or ‘economic incidence’ of a tax will be different from its ‘statutory incidence’ . . .” George R. Zodrow, *Incidence of Taxes*, in THE ENCYCLOPEDIA OF TAXATION & TAX POLICY 186 (Joseph J. Cordes, Robert D. Ebel, Jane G. Gravelle, eds (2005).

<sup>30</sup> HAROLD M. GROVES, TAX PHILOSOPHERS: TWO HUNDRED YEARS OF THOUGHT IN GREAT BRITAIN AND THE UNITED STATES 29 (1974) [hereinafter GROVES ] (reporting that benefit theory was predominant until the time of John Stuart Mill). See *infra* notes - , and accompanying text, for potential application of benefit theory in connection with bailout-type government intervention.

pay.”<sup>31</sup> In his thoughtful history of the modern American fiscal state, economic historian, Ajay Mehrotra, credits several “Progressive-Era economists with “guid[ing] a paradigm shift in the theories that undergirded American taxation – a paradigm shift away from benefits theory toward the principle of ability to pay.”<sup>32</sup> Even as early as 1918, economist Edwin R.A. Seligman put it bluntly: “nothing is more firmly established than the substitution of the ability theory for the old benefit theory in taxation.”<sup>33</sup>

Agreement quickly falls apart when one goes much beyond basic principles, however. Longstanding and seemingly intractable debates continue among academics, legislators, and other policy analysts about how to define ability-to-pay.<sup>34</sup> One major disagreement is over the extent to which “consumption” would be better than “income” as a surrogate measure of ability to pay.<sup>35</sup> And, debate continues over the extent to which treating taxpayers fairly in accordance with ability to pay justifies progressive marginal tax rates, i.e. rates that are *proportionately* higher for those at higher income levels.<sup>36</sup> Others maintain that tax policy cannot be evaluated in

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<sup>31</sup> See, e.g. Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 U.C.L.A. L. REV. 1793 (2005) (historical analysis of dramatic paradigm shift from benefit to ability to pay notions of tax equity). *But see* Louis Kaplow and Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961 (2001) (arguing that legal policies, presumably including tax policy, should be assessed exclusively based upon their impact on “individual welfare” rather than “fairness”); LOUIS EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 14-46 (2010) (challenging coherence of ability to pay ideology).

<sup>32</sup> Mehrotra, *supra* note , at 1864. This history focuses particularly on the influence of three American academic economists who began referring to themselves in the late 1800s as the “new school of American political economy”: Henry Carter Adams, Richard T. Ely, and Edwin R.A. Seligman. *Id.* at 1811-12. See also Herbert Hovenkamp, *The First Great Law & Economics Movement*, 42 STAN. L. REV. 993 (1990).

<sup>33</sup> E.M. Patterson, Arthur N. Young, Edwin R.A. Seligman, Harry H. Bond, Carl G. Barth, Roy G. Blakely, N.I. Stone, & R.R. Bowker, *Federal Taxes Upon Income and Excess Profits – Discussion* 8 AM. ECON. REV. 36, 43 (1918) (comments of Edwin R.A. Seligman).

<sup>34</sup> See, e.g. Mehrotra, *supra*, note , at 1863 (disagreements over the meaning of ability to pay). See also HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 5-7 (1938) [hereinafter SIMONS] (debate over whether ability to pay or “faculty” is best measured by “equal sacrifice,” “minimum sacrifice,” or “proportionate sacrifice” theory).

<sup>35</sup> See, e.g. William Andrews, *A Consumption-Type of Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) (proposing a consumption tax); Alvin C. Warren, Jr., *Fairness and A Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1974) (responding to Professor Andrews); Alvin Warren, *Would a Consumption Tax be Fairer Than an Income Tax?* 89 YALE L. J. 1081 (1980).

<sup>36</sup> For perhaps the most thoughtful and measured analysis of the progressivity debate, see WALTER J. BLUM AND HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1963) [hereinafter BLUM AND KALVEN].

isolation; rather, “[j]ustice or injustice in taxation can only mean justice or injustice in the system of property rights and entitlements that result from a particular tax regime.”<sup>37</sup>

Resolving these thorny issues fortunately will not be necessary for purposes of this Article. However they play out, debates about overall tax fairness generally revolve around the extent to which the tax system is actually based upon ability to pay, and on the extent to which the tax system treats similarly situated taxpayers equally, often referred to as horizontal equity.<sup>38</sup> My argument is that ability to pay – however one defines it - should not be the uniform “gold” standard for assessing cost allocation equities with respect to virtually all types of government-coerced payment. With respect to certain government-enforced collections from taxpayers - including some associated with bailout-type expenditures – assessing the equity of cost burden allocations requires application of different fairness standards.

#### B. Ability-to-Pay and General Revenue Expenditure as Default Principles

Most government programs are funded through general taxpayer revenues, and the fairness principle generally considered most appropriate for assessing the relative distribution of tax burdens among taxpayers is ability-to-pay.<sup>39</sup> As such, one might argue that assessing the cost distribution equities for any particular government program is no different than the same assessment for tax liabilities overall. However controversial and difficult it may be to assess tax equity generally, the allocation of costs for any one government program arguably is no more or less fair than the overall tax system itself; no separate fairness inquiry should be needed. To the extent that taxpayers are unhappy with government policy or the fair distribution of tax burdens, the usual political solution is to elect new representatives. As long as government officials acted within the scope of their authority, what makes any specific general revenue expenditure different from others with which we vehemently disagree – or which may prove in the end to have been unwarranted; for example - military expenses to save the nation from nonexistent weapons of mass destruction?

With regard to bailouts, voters may be angry enough to “vote the bums out,” but that does not resolve the deeper distributive justice question: Is there reason to apply a different fairness standard to determine the equitable allocation of bailout expenditure costs? Should the use of general revenues be especially troubling in the bailout context, and – if so – what are the alternatives? In general, perhaps one should start from a default presumption that no distinct fairness inquiry is necessary to assess relative taxpayer burdens to pay for specific government programs. In other words, government expenditures made from general revenues are presumptively fair to the extent that the tax system overall is fair. That said, I argue that there are circumstances – including certain bailout-type expenditures - that may call for a different fairness inquiry. Before turning to that argument, it will be useful first to develop some background principles and assumptions.

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<sup>37</sup> LIAM MURPHY AND THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 8 (2002) [hereinafter MURPHY AND NAGEL].

<sup>38</sup> Horizontal equity demands that similarly situated taxpayers pay the same tax. Thus, all items of income should be included in the tax base, regardless of their source, all personal consumption expenses should be treated similarly, regardless of their particular use, and all business expenses of a similar nature should receive similar tax treatment.

<sup>39</sup> *See supra* notes - , and accompanying text.

C. Disaggregating the “Whether to Act” from the “How to Pay” Issues

To begin, I think it important to acknowledge the distinction between political legitimacy and equitable distribution of cost burdens. A program implemented by legislators or government officials acting properly within the scope of their authority is politically legitimate in the sense that it complies with basic democratic procedure. Yet, the question of legitimacy - or even just the simple propriety – of the underlying government intervention itself is distinct from the question of how to pay for it. Any government decision requiring public expenditures can be funded in a variety of ways. In other words, policy makers presumably could design the same government program, motivated by the same policy objectives, resulting in essentially the same economic impact, yet fund it through a variety of different tax structures, each with very different allocations of cost burdens.<sup>40</sup> To the extent possible, policy makers should disaggregate the policy analysis of government decisions to *fund* particular activities or goods from the decision of *how* to fund them.

This is not to suggest that market impact and other policy features can be fully separated from the funding question. Quite the contrary. Although my focus is equitable cost distribution, a proper equitable cost distribution assessment cannot be made in a vacuum. Whether the distribution of costs is fair or equitable must be considered in light of the articulated purposes and motivating forces for the public expenditure. In general, an initial determination of whether government intervention is appropriate - and the particular type of intervention called for - should first be made by policy makers with the necessary expertise to consider substantive objectives and policy implications. Such decisions should be accompanied by careful and specifically articulated policy objectives, including a description of those intended to benefit from the intervention. These objectives, and the identity of intended beneficiaries, in turn, should be important factors in considering the standard by which to assess the fairness or equity of cost distribution.<sup>41</sup> For situations in which government intervention would be appropriate only in the event that cost burdens could be distributed in a particular way, those analyzing the substantive policy issues obviously would need to work closely alongside others addressing the distribution issues. Still, I think it important to think clearly about distinctions between the whether and the how questions.

D. Challenges to Assessment: Multiple and Conflicting Tax Policy Goals

Policy analysis of the modern U.S. tax system is complicated by one major personality flaw: a particular susceptibility to schizophrenia. In part, the problem is a tendency to expect too much – perhaps even the impossible - from the tax code. In the interest of fairness, we generally expect the tax code to treat similarly situated taxpayers alike – horizontal equity. We believe in free markets and generally want our tax system to interfere as little as possible with the natural operation of the marketplace – economic neutrality. At the same time – and in direct contradiction to horizontal equity and neutrality principles – legislators often succumb to almost

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<sup>40</sup> NOTE: I am still thinking about this. Would different tax structures almost invariably lead to different economic impacts/behavioral responses?

<sup>41</sup> See *infra*, notes - , and accompanying text, for discussion of alternative tax policy standards for assessing equity or fairness.

irresistible temptations to offer tax breaks for various worthy – or not so worthy - objectives. In certain instances, the tax system is considered a potential substitute for direct regulation that otherwise might be necessary to address market imperfections.<sup>42</sup>

In this world of varying tax and other programmatic objectives, tax justice may not be assessed properly by applying a one-size-fits-all fairness standard. Some taxes are market-based, whether to influence or correct private markets, while others are more purely redistributive. In a recent article about the assessment challenges presented by conflicting policy goals, David Elkins observed: “when considering tax policy, lumping together all different types of taxes and discussing them as if they were a unitary whole generally gets us nowhere.”<sup>43</sup> In the absence of a universally applicable conception of “tax justice,” Elkins proposes that distributive and market-based taxes should be considered separately.<sup>44</sup>

Oddly enough in the end, a distributive equity-focused approach might lead policymakers to enact similar tax rules to those they would have adopted based upon a more “market-driven” perspective. So, for example, one might impose a “systemic risk” tax on large, high-risk financial institutions on the theory that such a tax would force such institutions to internalize risks, thereby lowering the potential for future crises.<sup>45</sup> In the alternative, one might impose such a tax simply because it reflects the most equitable distribution of cost burdens in the event that government intervention is required. One danger with the first approach is that policy makers might feel less pressure to address future risk potential through direct regulation, counting on the tax to serve the regulatory function of reducing future risk. The equity-focused alternative would not purport to be a supplement or substitute for direct regulation. Nevertheless, a potential side-benefit might be that appropriate distribution of cost burdens in accordance with equitable considerations may indirectly produce desired behavioral changes in any event, thereby similarly reducing future risk. In contrast to market-driven approaches, however, such behavioral benefits would not be the primary focus driving tax design, but instead viewed as potential positive externalities derived from the proper allocation of costs. At the same time, the equity-focused approach would retain pressure on regulators to focus on their direct regulatory obligations rather than assume that the tax was effective in meeting regulatory risk-reduction objectives.

The following section develops some background principles and assumptions about taxes and markets that will be useful for the analysis that follows.

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<sup>42</sup> See *infra* notes - , and accompanying text for further discussion of corrective taxes.

<sup>43</sup> David Elkins, *Taxation and the Terms of Justice*, 41 U. TOL. L. REV. 73, 76 (2009) [hereinafter, Elkins].

<sup>44</sup> Elkins identifies two major “taxa”: 1) distributive; *id.* at 82-84; and, 2) commutative – those mimicking market exchanges, *id.*, at 76, 78-82. He also suggests two minor categories: 1) restitutive; and 2) and punitive. *Id.*, at 84-85.

<sup>45</sup> See., e.g., Viral V. Acharya, Lasse Pedersen, Thomas Phillippon, and Matthew Richardson, *Taxing Systemic Risk*, in REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 121 (Viral V. Acharya, Thomas F. Cooley, Matthew Richardson, Ingo Walter eds., 2011) [hereinafter, *Taxing Systemic Risks*]. For further brief discussion of such “corrective” or “Pigouvian tax” model approaches, see *infra* notes - , and accompanying text.

E. Background Principles and Assumptions: Taxes and Markets

1. Taxes Affect Economic Behavior

Whether by design or unintentional side-effect, a fact of economic life is that taxes inevitably alter market behavior. Still, adherents to economic neutrality as a tax policy ideal start from an assumption that free markets generally allocate resources to their optimal use. As such, “[a]n ideal tax system would . . . interfere with private decisions as little as possible.”<sup>46</sup> Even a purely neutral tax can influence private economic choices, however, by reducing available privately-held resources, thus altering market decisions that would be made in a world without the tax. That said, the private market’s response to any particular tax need not inevitably lead to market distortions. No distortion would occur, for example, if a tax caused taxpayers simply to spend less overall, but otherwise make *exactly* the same economic choices they would have made in the absence of the tax. Sometimes market distortions result as unintentional by-products of the tax system.<sup>47</sup> Tax-rules treating debt more favorably than equity, for instance, have led to excessive use of leveraging.<sup>48</sup> In fact, some argue that the tax-favored treatment of debt instruments substantially contributed to the recent economic crisis.<sup>49</sup>

2. Imperfect Markets

a) Public Goods

i) Market Failure to Produce Public Goods

Another economic reality is that free markets are not perfect; they suffer from at least two major imperfections.<sup>50</sup> First, without government intervention, private markets are unlikely to produce important public goods. A quick examination of the definition of a “public good”

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<sup>46</sup> OFFICE OF THE SEC’Y, DEP’T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 13 (Nov., 1984). “Distributional neutrality” is the more specific label for this particular use of the neutrality concept.

<sup>47</sup> Other distortions are deliberate incentives designed precisely to distort behavior in a legislatively desired direction. *See infra* notes - , and accompanying text.

<sup>48</sup> [cites]

<sup>49</sup> INT’L MONETARY FUND, DEBT BIAS AND OTHER DISTORTIONS: CRISIS-RELATED ISSUES IN TAX POLICY 4 (2009) (“tax distortions are likely to have contributed to the crisis by leading to levels of debt higher than would otherwise have been the case”). *See also* Daniel Shaviro, *The 2008 Financial Crisis: Implications for Income Tax Reform*, 3 N.Y.U. Law School Law & Economics Working Paper No. 09-35 (2009) available at <http://ssrn.com/abstract=1442089> (“the tax system’s ‘fingerprints’ are all over the ‘crime scene’ of the 2008 financial crisis”); Slemrod, *Lessons, supra* note , at 388 (“obvious link between tax policy and the crisis is the tax preference for corporate debt”).

<sup>50</sup> In fact, the standard legitimacy argument for much (most?) government regulation often is the necessity to address market imperfections.

exposes the reason for this particular market failure. Public goods generally are defined as those that are both: 1) non-exclusive; and 2) jointly supplied.<sup>51</sup> Non-exclusivity means that the good's use cannot feasibly be restricted; once provided to one individual, the good is equally available to all – imagine clean air, for example. A good is jointly supplied if making the good available to one individual effectively makes it also available to others without significantly increasing production costs.<sup>52</sup> The imperfect market issue resulting from these two public good characteristics is that “free riders” can benefit from the good with little or no incentive to contribute to the cost. Put slightly differently, “those who enjoy the public good without paying for it never signal their desire for it. Consequently not enough of the public good is provided. This is why public goods ought to be, in some way, publicly financed.”<sup>53</sup>

ii) Tax as a Tool to Overcome the “Public Good” Imperfection

Given the free market's failure to adequately produce “public goods,” government provides them publicly, using its constitutional taxing authority to collect revenues to fund production costs. The classic illustration of public good at the federal level is national defense.<sup>54</sup> The underlying assumption is that private markets left alone – and despite a widespread public demand for national defense - would not produce a national defense system. Most would agree that public defense is a “pure public good” that should be publicly provided.<sup>55</sup> Since one cannot calculate the amount of national defense that citizens would “buy” in a private market, it is difficult to estimate how much national defense expenditure is provided simply to overcome market imperfections and how much is simply the result of political preference. Moreover, beyond basic goods such as national defense, there is likely to be disagreement over which public programs produce genuinely “public goods,” as opposed simply to goods reflecting the political preferences of those in control of government at the time. Thus, it can be difficult to distinguish the portion of any public tax and spend program that is purely a response to market imperfection from the portion driven by other policy considerations.<sup>56</sup> [stronger tie in to later discussion] To the extent that economic stability is seen as a public good, a public goods

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<sup>51</sup> See, e.g., DENNIS C. MUELLER, PUBLIC CHOICE II 11 (1989) [hereinafter MUELLER, PUBLIC CHOICE] (“pure public good has two salient characteristics: jointness of supply, and the impossibility or inefficiency of excluding others from its consumption, once it has been supplied to some members of the community”). The “public good” concept is generally first attributed Paul Samuelson, writing in the 1950s. Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STATISTICS 387 (1954); Paul A. Samuelson, *Diagrammatic Exposition of a Theory of Public Expenditure*, 37 REV. ECON. & STATISTICS 350 (1950).

<sup>52</sup> See MUELLER, PUBLIC CHOICE, *supra* note , at 11.

<sup>53</sup> ALLAN FELDMAN, WELFARE ECONOMICS AND SOCIAL CHOICE THEORY 114 (1980).

<sup>54</sup> See, e.g. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 14 (1971).

<sup>55</sup> This generality, of course, does not account for pacifists who do not believe in such a system at all, or – at the other extreme – those who support private militias.

<sup>56</sup> I suspect, however, that the portion of public expenditures for goods that most would agree upon as public goods is small relative to the other portion. [At least some rough calculation of the extent of difference may be necessary in order to make the fullest equitable distribution assessment. See *infra* notes - , and accompanying text.]

analysis of bailout-relief measures might provide useful insights in assessing equitable cost allocation.<sup>57</sup>

b) Optimal Use of Resources

i) The Externality Problem

A second major imperfection is the market's failure in many instances to automatically allocate resources to their optimal use. A significant problem in this regard is the externality or spillover effect – positive or negative – potentially imposed by the market activities of some upon others not directly participating in the market activity. The standard illustration is the manufacturing plant whose smoke emissions impose harmful effects on neighboring homeowners.<sup>58</sup> Traditionally, governments respond to such negative externalities through command and control regulation; in the smoke stack case, for example, the government would simply regulate polluting emissions. By extension, the externality concept might be used to describe the negative economic impact that resulted from high-risk – in some cases, even fraudulent – actions taken by large financial institutions and insurance companies during the period leading up to the Great Recession.<sup>59</sup> Such externalities suggest tax implications, most of which are driven by market or behavioral rather than “equity-based” approaches to tax policy.<sup>60</sup>

ii) Harnessing Private Markets Through the Tax System to Achieve Optimal Resource Allocation

Another tax-based government tool advocated by some public finance economists addresses the externality or spillover effect problem. This idea is to rely on the market itself to self-correct by imposing a “corrective” tax on the externality-generating party.<sup>61</sup> The underlying principle of this tax is not to *alter* the otherwise natural operation of private markets; but instead to harness private market participants' rational self-interest in an effort to nudge the market back to its most efficient allocation of resources. Returning to the smoke stack example, the idea is that regulators theoretically could set a precise tax rate at which the burden from the additional cost of the corrective tax would cause a change in the polluting manufacturer's behavior; in other words, the plant owner would automatically reduce smoke emissions to the optimally desired

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<sup>57</sup> See *infra* notes - , and accompanying text for discussion of publicly-funded bailouts as public goods.

<sup>58</sup> R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) [hereinafter Coase, *Social Cost*].

<sup>59</sup> See, e.g. VIRAL V. ACHARYA AND MATTHEW RICHARDSON, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM (2009).

<sup>60</sup> For further discussion of the potential tax implications of externalities imposed by financial institutions, see *infra* notes - , and accompanying text.

<sup>61</sup> This “corrective tax” concept – sometimes referred to as a “Pigouvian tax” - generally is attributed to economist A.C. Pigou. ARTHUR CECIL PIGOU, *THE ECONOMICS OF WELFARE* (4<sup>th</sup> ed. 1932) [hereinafter PIGOU, *WELFARE*]. See also William J. Baumol, *On Taxation and the Control of Externalities*, 62 AMER. ECON. REV.307 (19972) (properly designed Pigouvian tax “automatically achieves an efficient allocation of the required reduction”). [Kaplow & Shavell]

level without any direct government regulation of smoke emissions. Put in economic terms, the tax would cause the polluter to internalize the externality costs previously borne by neighboring homeowners.<sup>62</sup> This corrective tax model perhaps has the most intuitive appeal as applied to environmental concerns. In fact, most of the literature focuses on the potential of “corrective” taxes as substitutes for or supplements to direct environmental regulation.<sup>63</sup>

In a recent contribution to the reform-focused literature in the aftermath of the Great Recession, Professors Shackelford, Shaviro, and Slemrod noted conceptual similarities between pollution externalities to which Pigouvian corrective tax models are most frequently applied, and financial externalities imposed on the general public by high-risk lending and investment activities of financial institutions.<sup>64</sup> They suggest further study of the potential promise of corrective tax models to address financial sector market externalities, and further suggest key design principles to consider in drafting a Pigouvian tax on financial firms.<sup>65</sup> The paper’s introduction briefly describes domestic and international consideration of alternative approaches to funding the substantial government intervention costs necessitated by economic crises, but then announces its intention to go “beyond the focus of . . . simply paying for the specific cost of past or potential future bailouts.”<sup>66</sup> While I support further exploration of corrective tax models as potentially fruitful solutions to externality problems in the financial sector, my purpose with this Article is to remain focused for the moment on simply paying for the costs of past or future bailouts. Thus, this Article is not directly about using the tax system – by “Pigouvian-type” tax, special tax incentive, or otherwise - as a possible supplement to or substitute for business regulation. It’s focus is also not directly on behavioral impact, including questions of moral hazard. And, except as necessary to the distributive question, the article does not address explicitly market-focused considerations related the use of taxation as a policy tool.

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<sup>62</sup> Use of the term “externality” apparently post-dates Pigou, who described what economists today refer to as externalities as “divergences between social and private net products.” PIGOU, WELFARE, *supra* note , at .

<sup>63</sup> *See, e.g.* James M. Buchanan and Gordon Tullock, *Polluters’ Profits and Political Response: Direct Controls vs. Taxes*, 65 AM. ECON. REV. 139 (1975); Nathaniel O. Keohane, Richard L. Revesz, and Robert N. Stavins, *The Choice of Regulatory Instruments in Environmental Policy*, 22 HARV. ENVTL. L. REV. 313 (1998); Henry E. Smith, *Ambiguous Quality Changes from Taxes and Legal Rules*, 67 U. CHI. L. REV. 647 (2000).

<sup>64</sup> Douglas A. Shackelford, Daniel N. Shaviro, and Joel Slemrod, *Taxation and the Financial Sector*, 63 NAT’L TAX J. 781, 781-82 (2010) [hereinafter *Taxation and Financial Sector*].

<sup>65</sup> *Taxation and the Financial Sector*, *supra* note , at 794-95. Others have recently explored Pigouvian approaches to financial regulation. *See, e.g., Taxing Systemic Risks*, *supra* note ; William Poole, *An Economy in Crisis: Law, Policy, and Morality During the Recession: Essay: Causes and Consequences of the Financial Crisis of 2007-2009*, 33 HARV. J. L. & PUB. POL’Y 421, 441 (2010) (suggesting the possibility of eliminating interest deductions for large banks as a corrective tax device to control negative externalities). *See also* Michael Keen, *Taxation and Regulation of Financial Institutions* <http://www.imf.org/external/np/fad/news/2010/docs/071910.pdf> [recent NYU Tax Policy Colloquium paper]

<sup>66</sup> *Id.*, at 782.

### 3. Deliberate Distortion: Tax as an Incentive-Based Tool

In dramatic contrast to government regulation designed simply to correct market failures or imperfections, Congress sometimes - in direct and explicit violation of economic neutrality and horizontal equity tax policy principles - turns to the tax system to deliberately *distort* markets in economically, socially, or politically favored directions. Put in slightly less politically-loaded terms, Congress sometimes offers “taxpayer incentives” to engage in certain desired behaviors. To encourage business innovation, for example, the tax code permits immediate business deductions for research and development (R&D) expenditures that otherwise could be deducted only over a period of years by way of amortization.<sup>67</sup> And, even though personal expenses typically are nondeductible, the tax code offers home mortgage interest deductions in order to promote homeownership.<sup>68</sup> The effect of special tax incentives or “tax expenditure” provisions might be to increase or decrease incentives for risk taking, and hence increase or decrease chances for economic crisis.<sup>69</sup> Nevertheless, such incentive provisions are primarily market-focused and thus generally fall outside the scope of a fairness-driven inquiry.

### III. Funding Through General Tax Revenue

#### A. Introduction: Why Should We Pay?

Based upon the default fairness presumption suggested earlier,<sup>70</sup> the easy answer to the public’s “why should we pay” question is simply that government decisions to use general revenues to provide targeted benefits to assist struggling businesses during the Great Recession were legitimate exercises of government authority in compliance with all constitutional and statutory requirements. As such, taxpayers’ relative cost burdens arguably are just as fairly (or unfairly) distributed as all other taxpayer burdens to cover the cost of government. As noted earlier, this argument may sufficiently answer the political legitimacy question; but does not necessarily offer an adequate answer to questions about fairness of the payment mechanism. To be clear, I am not suggesting that taxpayers have any legal recourse in the event that the relative cost burdens are considered unjust after application of an appropriate fairness standard. Government officials or legislators may well make redistributive decisions that are unfair or unjust. Individual taxpayers have no redress unless those decisions violate specific constitutional, statutory or common law rights. My purpose here is aspirational; that is, to raise questions that should be asked in the event that legislators should face similar issues in the future. To the extent that arguments developed here make a strong case that previous bailout-costs were fairly allocated, they might have some value in helping to subdue some of the pent up public anger over bailout costs. The sections that follow explore alternative “tax justice”

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<sup>67</sup> I.R.C. §174.

<sup>68</sup> I.R.C. §163(h)(2)(D), (h)(3)-(4) (permitting a deduction for qualified residence interest); I.R.C. §262 (non-deductibility of personal expenses).

<sup>69</sup> This is not to suggest that Congress would intentionally adopt tax incentives that would lead to dramatically increased risk-taking. Nevertheless, increases in risk-taking might be the unintentional by-product of tax incentives designed with other objectives in mind.

<sup>70</sup> See *supra* notes - , and accompanying text.

arguments that might be made to justify targeted bailout assistance payments out of general revenues.

[Question: Most of the TARP programs from 2007-2009 have actually generated profits for the government. CBO estimates that there will still be a “net cost,” but far lower than originally estimated. Most of the estimated loss is attributable to AIG and the auto industry. To what extent do *profitable* bailouts raise questions about the equitable distribution of gains?]

## B. Bailout as Public Good

One possible argument to justify general revenue expenditures for bailout-type rescues is that ensuring a stable economy is a public good. Absent government intervention, no private individual or group on its own is likely to contribute the emergency expenses necessary to provide continued economic stability, thereby allowing others to “free ride” on their private resources.<sup>71</sup> Everyone benefits from the public good produced when government intervention successfully averts system-wide economic collapse. Even though general taxpayers receive no direct rescue payments, they cannot be excluded from the public good of being spared systemic financial disaster.

To the extent that general taxpayer funds are spent on truly “public goods,” the mechanism for allocating costs arguably is just as equitable – or inequitable – as the overall tax collection and rate structure itself. In other words, the same ability to pay standard generally used to assess the overall fairness of the tax system should also be used to assess the allocation of burdens to pay for public goods.<sup>72</sup> However controversial and difficult it may be to assess tax equity generally, the allocation of public goods costs arguably is no more or less fair than the overall tax system itself; no separate fairness inquiry should be needed.

The problem with this analysis as applied to bailout-type expenditures is that the government rescue of private firms or industries – even those that are systemically important - is not a public good in quite the same sense as the general economic stability made possible by the infrastructure and regulatory regime maintained by the state. While everyone presumably benefits from continued or restored economic stability when crisis is averted, substantially disproportionate benefits go to particular owners or investors who were spared personal bankruptcy or whose investment losses were eliminated or reduced. Even more bothersome to many, these disproportionate benefits may be going to apparently “undeserving” private parties, rewarding those who took excessive risk, or even those who engaged in fraudulent or otherwise illegal activity.

One possible response to the disproportionate benefit problem would be to say that any additional benefit to those who received direct government assistance was merely the incidental

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<sup>71</sup> Notable exceptions include multiple occasions in the early twentieth century when J.P. Morgan, Sr. – and later his son – organized privately-funded rescues. During the 1907 panic, for example, Morgan, Sr. contributed personal funds, and also reportedly locked New York City’s major bank and trust presidents in his library until they agreed to assist in rescuing two ailing trusts. See RON CHERNOW, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE* 127(1990); JEAN STROUSE, *MORGAN: AMERICAN FINANCIER*, 586-87 (1999). It is difficult today to imagine anyone with comparable wealth, power, and force of personality to successfully coordinate privately-funded bailouts of such magnitude.

<sup>72</sup> See *supra* notes - , and accompanying text.

effect of providing the “economic stability” public good to all. As one Federal Reserve official conceded in connection with the mid-1970s bailout of Franklin National Bank, sometimes “intervention in the interests of the public and the economy as a whole can have the *incidental effect* of protecting large depositors from the proper consequences of their risk taking.”<sup>73</sup> Oddly enough in the end, this argument suggests that government intervention to address an imperfect private market problem has imperfections of its own. In this case, government actions necessary to produce the public good have their own externality effects. Coming full circle, the next question might be what the government should do – if anything – to address *this* imperfection. [Question: Does classifying something as a “public good” necessarily mean that equitable cost allocation questions overlap completely with the overall tax distribution equity question? I’m inclined to think so – as least as a “default” type rule. What if we decided that something was a “quasi public good” – somewhere on the continuum near the public good end, but not a “pure public good?”]

### C. Bailout as Redistribution

Even if publicly-funded financial assistance to forestall collapse of a struggling business or industry is viewed not as a public good, but instead as a “targeted” benefit to an identifiable group of owners or investors, perhaps general revenue bailout-type expenditures can be justified simply as appropriate exercises of government authority to implement programs that may have redistributive effects. The essence of democratic political systems is that people are free to express disagreement – sometimes vehement - about whether particular programs represent appropriate exercise of government authority. Political participants can – and should - legitimately debate underlying programmatic redistributive policy decisions. Once underlying policy choices are made through fair and open application of the political process, one might argue that the fairness standard for equitably distributing program costs is the same one used for equitably distributing tax burdens overall. If the general application of tax burdens is considered fair, then the tax burden of paying for the particular government program also should be considered fair. Once again, however, this argument merges the political legitimacy question for the underlying program with the issue of equitable cost distribution.

With respect to distributive justice, tax policy discussions generally focus on need or income-based redistributions. In fact, the progressive income tax rate structure is redistributive by its very nature; higher income taxpayers pay not only relatively more tax, but *proportionately* more based upon their taxable incomes. Even assuming that all taxpayers receive equal benefits from societal membership, higher income taxpayers subsidize a portion of the cost for those in lower income brackets. In addition, several government programs explicitly target benefits to certain taxpayers – at the expense of others - based on hardship or need. The tax system’s redistributive effect is stronger, of course, to the extent that lower income taxpayers receive such welfare or other government payments based upon need.

Bailout-type expenditures don’t seem to be need-based redistributions in the normal sense.<sup>74</sup> Bailout expenditures merely provide incidental benefits to those receiving assist in the

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<sup>73</sup> James H. Oltman, *Failing Banks – the Role of the Fed*, 27 ADMIN. L. REV. 317, 319 (1975) (emphasis added).

<sup>74</sup> NOTE: I’m still thinking this question through. Add discussion of how bailout “need” is different from “need” in the traditional welfare sense, arguing that the redistributive legitimacy

interest of serving a greater public interest. I do not mean to suggest here that general-revenue funded bailout redistributions *necessarily* fail to meet all possible fairness standards. My conclusion simply is that they do not easily satisfy distributive justice fairness standards. One point that I hope begins to emerge – and will develop throughout – is that standard ability to pay or redistributive tax justice models cannot capture the full essence of the fairness question.<sup>75</sup>

D. Bailout as “Public Duty”

Another potential justification for funding targeted “government-rescue” benefits out of general revenues is that “quite apart from any requirement of distributive justice - we have some form of collective obligation to contribute to the prevention or alleviation of major disasters . . . , and perhaps that we also have an obligation to support certain intrinsic goods . . . .”<sup>76</sup> Described more bluntly, “It’s just the right thing to do.” Sometimes basic empathy, humanity, morality, or simply membership in the world community demand that we step up to our duties as citizens. Under this notion, disproportionate benefits to bailout recipients through general revenues might be justified, not as “just” redistribution to those worthy of such benefits, but simply as part of our collective obligation to contribute to prevention or alleviation of economic disaster.

The “public duty” approach to tax justice bears some similarity to philosophical claims made by several “Progressive era economists.”<sup>77</sup> So, for example, in his effort to discredit the then prevailing view of taxes as payments in exchange for government-provided benefits, Seligman argued: “we pay taxes not because we get benefits from the state, but because it is as much our duty to support the state as to support ourselves or our family; because, in short, the state is an integral part of us.”<sup>78</sup> Along similar lines, Henry Carter Adams argued that citizens share a “solidarity of social interest,” or “organic unity,” which “implies that all the functions undertaken by the State are such as minister to common wants, and in large measure to wants which cannot be segregated or specialized to individuals or classes.”<sup>79</sup> Put more colloquially, the argument might sound something like this: “We’re in this together as a family. We can’t separate one person’s interest from another’s. If Mom and Dad decide that something is right,

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argument is weaker in the bailout context. I hesitate to go too far with the argument that we shouldn’t use general revenues for redistribution to bailout recipients because they created their own problems through excessively risky behavior. I don’t want to make claims that might be extended to support arguments that we shouldn’t provide welfare programs to individuals because they are personally to blame for their own poverty.

<sup>75</sup> For discussion of alternative possible fairness measures, see *infra* notes - , and accompanying text.

<sup>76</sup> MURPHY AND NAGEL, *supra* note , at 81 (referring to art and historic preservation as examples of such “intrinsic goods”).

<sup>77</sup> See *supra* notes - , and accompanying text.

<sup>78</sup> EDWIN R.A. SELIGMAN, *ESSAYS IN TAXATION* 72 (1895).

<sup>79</sup> HENRY CARTER ADAMS, *THE SCIENCE OF FINANCE: AN INVESTIGATION OF PUBLIC EXPENDITURES AND PUBLIC REVENUES* 301 (1898). The “solidarity” notion also bears some resemblance to Justice Oliver Wendell Holmes famous quote: “Taxes are what we pay for civilized society.” *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

then it's good for all of us." These approaches, of course, place substantial faith in the ability of our legislators and political leaders to fairly judge our public duties or collective interests. [Same question: Does classifying something as a "public duty" necessarily mean that equitable cost allocation questions overlap completely with the overall tax distribution equity question?]

#### E. Bailouts as Compensation

Most analysts studying the causes of the Great Recession would probably agree that there is plenty of blame to go around; the financial crisis undoubtedly resulted from a confluence of multiple factors, many of which will continue to be studied for decades to come. Some accuse mortgage lenders of enticing vast numbers of borrowers to take on debts that they could not possibly repay.<sup>80</sup> Others blame "greedy Wall Street" financial institutions for securitizing these debts – repackaging the mortgages into new, complex, and increasingly risky financial instruments, which the financial institutions then sold with little of their "own skin in the game."<sup>81</sup> These new "risk diversifying" products, such as credit default swaps, may have reduced the market risk faced by particular financial institutions, but left the ultimate location and extent of that risk difficult to determine, hence subjecting the financial system to considerable systemic risk.<sup>82</sup> Agencies responsible for rating these new financial instruments have been blamed for issuing high ratings to undeserving investments, succumbing to "capture" by the financial institutions paying them fees for the ratings.<sup>83</sup> Even the economics profession has been included on "the long list of those to blame for the crisis, . . . for it provided the special interests with arguments about efficient and self-regulating markets – even though advances in economics during the preceding two decades had shown the limited conditions under which that theory held true."<sup>84</sup>

One impediment to the government's crisis response was its out-dated, highly fragmented regulatory structure, and its lack of regulatory tools necessary to address some of the more troubling activities in newer markets. Financial regulations "formed according to business models that existed in the 1930s,"<sup>85</sup> divided regulatory authority according to functional classifications such as banks, insurance companies, securities firms, insurance companies. This outdated regulatory structure was unable to keep up with increasingly sophisticated and complex financial products and markets used by regulated entities "to outsource risk management to less-

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<sup>80</sup> ROBERT J. SHILLER, *THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED AND WHAT TO DO ABOUT IT* (2008).

<sup>81</sup> Viral V. Acharya and Matthew Richardson, *Causes of the Financial Crisis*, 21 *CRITICAL REV.* 195, 196 (2009).

<sup>82</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-61, *FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE* 6 (2004) [hereinafter GAO, *FINANCIAL REGULATION*].

<sup>83</sup> *Id.* (describing rating agencies as "rubber stamping" "opaquely structured securitized mortgages as 'AAA'"); Arthur E. Wilmarth, Jr., *Reforming Financial Regulation to Address the Too-Big-To-Fail Problem*, 35 *BROOKLYN J. INT'L L.* 707, 722 (2010) (financial institutions "paying large fees to credit rating agencies ('CRAs') in order to secure investment-grade rating")

<sup>84</sup> JOSEPH E. STIGLITZ, *FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY* xx (2010).

<sup>85</sup> Charles K. Whitehead, *Reframing Financial Regulation*, 90 *B.U. L. REV.* 1, 5 (2010).

regulated entities.”<sup>86</sup> Serious as they are, the financial regulatory system’s structural flaws and coverage gaps do not tell the full story. Even within the scope of an admittedly flawed regulatory regime, it seems clear that a variety of government official actions – or inactions - contributed significantly to the financial crisis. As described in the Financial Crisis Inquiry Commission’s final report, a financial regulatory culture of “pervasive permissiveness” led to the government’s failure - even when confronted with ample warning signs - to respond appropriately by using the regulatory tools that were available.<sup>87</sup>

This notion of government culpability suggests another possible argument for redistributing general revenue funds to extend targeted bailout-assistance to a particular group. A minority view held by some economic observers and analysts is that blame for the financial crisis belongs almost entirely to the government. For example, one commissioner dissenting from the Financial Crisis Inquiry Commission’s majority report argues that “the *sine qua non* of the financial crisis was U.S. government housing policy . . . . If the U.S. government had not chosen this path – fostering the growth of a bubble of unprecedented size . . . the great financial crisis of 2008 would never have occurred.”<sup>88</sup> Another view attributes the crisis to the Federal Reserve, whose exercise of monetary policy authority kept interest rates too low, allegedly causing the housing market bubble.<sup>89</sup>

Although common law sovereign immunity protects the government from claims based upon government officials’ negligent acts, Congress has statutorily waived this immunity for a wide range of actions.<sup>90</sup> Payments to the victims of government wrongdoing funded through federal revenue at the expense of general taxpayers clearly are redistributive. Justification for this type of redistribution might be grounded in notions similar to the “organic unity” principle discussed briefly above.<sup>91</sup> In effect, citizens share some collective responsibility for harms caused by state action. Here again, if the overall tax burden is equitably allocated, the burdens for the particular victim’s compensation costs would presumptively be considered equitable.

This compensation-based analysis is probably the weakest of the alternative theories that might be used to justify general taxpayer revenues to fund bailout-type distribution costs. First, empirically speaking, it seems doubtful that analysis of available data would provide sufficient evidence to identify government actions taken – or not taken – as the sole or even the principal cause for the crisis. Even assuming, *arguendo*, that the government was fully responsible, the

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<sup>86</sup> *Id.*, at 4. See also, GAO, FINANCIAL REGULATION, *supra* note , at 10 (noting that “financial firms may well engage in a form of regulatory arbitrage that involves the placement of particular financial services or products in that part of the financial conglomerate in which supervisory oversight is the least intrusive”).

<sup>87</sup> CRISIS INQUIRY COMMISSION REPORT, *supra* note , at xvii.

<sup>88</sup> CRISIS INQUIRY COMMISSION REPORT, *supra* note , at 444 (dissenting statement of Commissioner Peter J. Wallison)

<sup>89</sup> JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSED, PROLONGED, AND WORSENERED THE FINANCIAL CRISIS 1-3 (2009). In what has since come to be called the “Taylor Rule,” Stanford economist, John Taylor, plotted interest rates that would have resulted had the Federal Reserve applied the same monetary policy that it had applied during previous periods of good economic performance.

<sup>90</sup> Legislative Reorganization Act of 1946, Pub. L. 601, tit. IV (Federal Tort Claims Act), 60 Stat. 812, 842 (1946).

<sup>91</sup> See *supra* notes - , and accompanying text.

underlying “compensation” based argument would prove too much. Such an approach would seem to require compensation to a far larger class of beneficiaries, including homeowners caught in the middle of the home foreclosure crisis, taxpayers who lost substantial portions of their retirement funds due to market declines, and perhaps even those who lost jobs as a result of the crisis.

If “tax justice” principles cannot satisfactorily explain the use of general revenues for bailout-type payments as appropriate payment for public goods, redistribution, satisfaction of public duty, or compensation, perhaps the appropriate official response is to promise never to do it again, as Congress purported to do in its the recent Dodd-Frank legislation.<sup>92</sup> Congress understandably wanted to make it clear to angry voters that they would not be asked again to foot the bill for private financial rescues. Yet, congressional concern for the incidental – perhaps “improper” - benefits that might inure to some led Congress to limit its future policy options, or at a minimum, to construct barriers making it more difficult for the government to use certain intervention options in the event of future crises.<sup>93</sup> Rather than forever rule out the possibility of government-funded assistance, an alternative would be to think about funding sources other than general revenues.

#### IV. Alternative Equitable Cost Assessment Tools

##### A. Benefit Theory

###### 1. Definition and Application of Benefit Principles to Bailout-Type Transfers

Benefit theory evolved from eighteenth century political philosophy, taking the social contract notion and “translat[ing it] into the benefit basis for taxation, grounded on the idea that individuals interact with the state on a quid pro quo basis very much as they do for transactions in the marketplace.”<sup>94</sup> As described by Seligman, “taxes were looked upon as premiums of insurance which individuals paid to the collective insurance company – the state – in order to enjoy their possessions in peace and security.”<sup>95</sup> A more modern iteration of the benefit

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<sup>92</sup> See *supra* notes - , and accompanying text.

<sup>93</sup> To be fair, those opposed to creating an explicit public infrastructure or fund that might provide bailouts are understandably concerned with intensifying the considerable moral hazards already built upon the public perception of implicit government guarantees. These moral hazard concerns certainly must be taken very seriously. To that end, the design challenge for architects drafting any proposed infrastructure or funding mechanism is to equip government with sufficient tools and resources to respond quickly at times of economic crisis without simultaneously spawning perceptions of a broad government safety net, and thereby encouraging investors to take risks greater than those otherwise considered economically prudent.

<sup>94</sup> HERBERT KIESLING, *TAXATION AND PUBLIC GOODS: A WELFARE-ECONOMIC CRITIQUE OF TAX POLICY ANALYSIS* 32 (1992) [hereinafter KIESLING].

<sup>95</sup> EDWIN R.A. SELIGMAN, *PROGRESSIVE TAXATION IN THEORY AND PRACTICE* 79 (1894). For further discussion of insurance principles as applied to bailouts, see *infra* notes - , and accompanying text.

principle is that “an equitable tax system is one under which each taxpayer contributes in line with the benefits which he or she receives from public services.”<sup>96</sup>

Benefit theory has since been largely rejected as the predominant theory,<sup>97</sup> and replaced with the now generally-accepted, albeit ill-defined, principle that tax burdens should be distributed in accordance with ability to pay.<sup>98</sup> One reason for benefit theory’s fall from grace was the concern that benefits received from government can be diffuse and difficult to measure.<sup>99</sup> Another fundamental problem with benefit theory is its potential to impose higher tax burdens on lower-income taxpayers, who are more likely to receive public benefits. As such, many believe that benefit theory is incoherent and inconsistent with any theory of justice.<sup>100</sup> Applying benefit theory to tax those who received government benefits from redistributive programs based upon right, need, or merit, would simply appear illogical.<sup>101</sup> According to one account, John Stuart Mill penned the appropriate final epitaph, demolishing the benefit notion as a standard for allocating taxes: “to assert that individuals receive significantly different benefits from living in a particular society is in effect to assert that there is something seriously wrong with that society.”<sup>102</sup>

Despite its demise as a legitimizing principle for general taxation, or as an appropriate measure for overall fairness of the tax system, most acknowledge that benefit theory has

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96 RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 219 (5th ed. 1989) [hereinafter MUSGRAVE & MUSGRAVE] Some refer to this later version as the “quasi-exchange benefit” principle, in contrast to the earlier “contractarian” version. See Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399, 402-04 (2005) [hereinafter Dodge]

<sup>97</sup> See, e.g. BLUM & KALVEN, *supra* note , at 35, n. 92 (“Today almost every textbook on public finance pays its respects to benefit theory as a principle for allocating the overall tax burden but treats it as being only of historical or academic interest in this connection.”). See also KIESLING, *supra* note , at 34-35 (“Benefit as a general goodness principle for taxation has been out of favor among academic economists from Mill’s day until the present . . .”).

<sup>98</sup> See *infra* notes - , and accompanying text.

<sup>99</sup> See, e.g., BLUM & KALVEN, *supra*, note , at 36; MURPHY AND NAGEL, *supra* note , at 16.

<sup>100</sup> MURPHY AND NAGEL, *supra*, note , at 19. For further discussion of history and arguments for and against benefit theory, see David G. Duff, *Benefit Taxes and User Fees in Theory and Practice*, 54 U. TORONTO L. J. 393 (2004) [hereinafter Duff]; Sagit Leviner, *From Deontology to Practical Application: The Vision of a Good Society and the Tax System*, 26 VA. TAX REV. 405, 423-33 (2006).

<sup>101</sup> See, e.g. Duff, *supra* note , at 407.

<sup>102</sup> BLUM & KALVEN, *supra*, note , at 39 (quoting from JOHN STUART MILL, ON THE GENERAL PRINCIPLES OF TAXATION). See also GROVES, *supra* note , at 29 (describing Mills as effectively demolishing benefit theory); KIESLING, *supra* note , at 34 (describing Mill as delivering the “coup de grace to the benefit principle”). Deborah Geier has proposed reinvigorating the benefit principle, measuring “benefit” not based on services received from government, but based on an individual’s well-being, which is presumably made possible by government institutions. Deborah A. Geier, *Fundamental Tax Reform: Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 S.M. U. L. REV. 99 (2003); Deborah A. Geier, *Letter to the Editor, Time to Bring Back the “Benefit” Norm?* 102 TAX NOTES 1155 (2004). For a critique of this “new benefit” theory, see Dodge, *supra* note .

practical application in certain contexts. For example, imposing a tax or fee to national park visitors arguably allocates cost to those who most enjoy the park's benefits. Similarly, fuel excise taxes arguably allocate certain government transportation costs to those who make most use of the roadways.<sup>103</sup> One might not initially think of benefit theory as an especially effective or practical fairness standard in the bailout setting. After all, government bailout-type assistance presumably goes to businesses or industries that are already struggling. Imposing a tax on benefits under these circumstances would be counterproductive. Nevertheless, I contend that benefit theory can be a useful tool in analyzing equitable distribution issues as applied to a variety of different bailout-related tax issues.<sup>104</sup>

2. "Special Fund" Bailouts and "Bank Fees"

a) Ex Post Imposition of Tax to Recoup Government Bailout Costs

Between the extremes of a general revenue-funded bailout and a government hands-off policy, which leaves businesses to sink or swim alone, is something I have referred to as a "special fund" bailout, through which "those bearing cost burdens are more closely connected with those receiving benefits from the federal program."<sup>105</sup> For example, benefit theory provided the rationale for President Obama's 2010 proposed "financial crisis responsibility fee" to recoup TARP bailout costs through fees imposed on large banks and financial institutions.<sup>106</sup> The controversial proposed bank tax would have applied a .15% annual tax based upon the liabilities of financial institutions with assets of more than \$50 billion. The tax would have applied even to financial institutions that had not received any direct TARP assistance on the theory that the largest financial firms were those with the most at stake and, hence, the most to gain from avoidance of a financial meltdown. Based upon similar logic, the United Kingdom and France both imposed temporary payroll taxes in 2009-2010 on large bonus payments in order to recoup a portion of the massive government expense incurred through the economic crisis.<sup>107</sup>

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<sup>103</sup> MUSGRAVE & MUSGRAVE, *supra* note , at 221 (noting that "practical applications of benefit taxation may be found in specific instances where particular services are provided on a benefit basis")

<sup>104</sup> To be clear, I do not suggest that benefit – or any other – particular theory – be used in isolation.

<sup>105</sup> Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L. J. 951, 964 (1992). See also, Block, *Measuring Bailout Costs*, *supra* note , at 165-68.

<sup>106</sup> OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 2011, at 174 (2010). The proposed bank fee was meant to satisfy the President's statutory obligation to "submit a legislative proposal that *recoups from the financial industry* an amount equal to the shortfall in order to ensure that the Troubled Asset Relief Program does not add to the deficit or national debt." Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §134, 122 Stat. 3765, 3798 (to be codified at 12 U.S.C. §5239) (emphasis added).

<sup>107</sup> INT'L MONETARY FUND, A FAIR AND SUBSTANTIAL CONTRIBUTION BY THE FINANCIAL SECTOR: FINAL REPORT FOR THE G-20 8 (2010). [hereinafter IMF, FAIR CONTRIBUTION REPORT] Financial industry tax proposals are further discussed at *infra* notes - , and accompanying text.

Although the Dodd-Frank Act allegedly prohibits future bailouts, it does extend to the Federal Deposit Insurance Corporation (FDIC) “authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States.”<sup>108</sup> Consistent with its commitments to stop government-funded bailouts and not to impose costs on general taxpayers, the Act provides that funding for its implementation will be paid not out of general revenues, but from a new “orderly liquidation fund” maintained by the Treasury Department for the FDIC.<sup>109</sup> The legislation authorizes the FDIC to raise revenues needed for the fund by borrowing from the Treasury Department.<sup>110</sup> To make its commitment not to use general taxpayer funds absolutely clear, the legislation further proclaims:

ACT SEC. 214: PROHIBITION ON TAXPAYER FUNDING

- (a) LIQUIDATION REQUIRED.-All financial companies put into receivership under this title shall be liquidated. No taxpayer funds shall be used to prevent the liquidation of any financial company under this title.
- (b) RECOVERY OF FUNDS.-All funds expended in the liquidation of a financial company under this title shall be covered from the disposition of assets of such financial company, *or shall be the responsibility of the financial sector, through assessments.*
- (c) NO LOSSES TO TAXPAYERS.-Taxpayers shall bear no losses from the exercise of any authority under this title.<sup>111</sup>

In effect, the Dodd-Frank Act adopts benefit principles of tax justice to ensure the imposition of costs not on general taxpayers, but on a smaller sub-class based upon benefits received. In the event that the liquidation fund has insufficient resources to repay its obligations to the Treasury within 60 months of issue, the Act authorizes the FDIC to impose assessments first upon claimants of a financial company under FDIC receivership who received additional payments beyond amounts they would have received had all similarly situated creditors been treated equally.<sup>112</sup> In this case, the precise assessment is imposed upon an identifiable group of claimants who benefited from receiving favorable treatment relative to their similarly situated creditor counterparts in the process of liquidating the failed financial institution in FDIC receivership.<sup>113</sup> If the liquidation fund is still inadequate to meet its debt obligations after assessments against the favorably treated former claimants, the FDIC has authority to impose a risk-based assessment on financial companies with total consolidated assets of \$50 billion or more.

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<sup>108</sup> Dodd-Frank Act, *supra* note , at tit. II, §204(a).

<sup>109</sup> *Id.*, at §210(n) (establishing an “Orderly Liquidation Fund”).

<sup>110</sup> *Id.*, at §210(n)(5) (FDIC authority to issue obligations to the Treasury Secretary).

<sup>111</sup> *Id.*, at §214 (emphasis added).

<sup>112</sup> *Id.*, at §210(o)(1)(D)(i).

<sup>113</sup> Although the Act generally requires equal treatment of similarly situated creditors, the FDIC has authority to depart from this equality norm if it determines that unequal treatment is necessary for various statutorily specified reasons. *See id.*, at §210(b)(4), (d)(4), (h)(5)(E).

The Dodd-Frank large financial institution assessment bears similarities to the Obama administration's proposed "financial crisis responsibility fee" and the temporary payroll taxes in the U.K. and France.<sup>114</sup> Each is a limited *ex post* assessment to cover or recoup government expenses incurred in connection with government bailouts or orderly liquidations of failing financial institutions. Although the individual assessed entities themselves may not have received direct benefits, they constitute a group or sub-class of financial entities viewed as receiving disproportionately more "benefit" or value from the government rescue or resolution process.

One important distinguishing feature of the Dodd-Frank approach, however, is its use of a graduated risk-based assessment.<sup>115</sup> Other than requiring contributions *ex post* rather than *ex ante*, the Dodd-Frank risk-based assessment provision resembles a new or expanded FDIC government insurance program. In fact, government insurance programs in general are often justified based upon benefit conceptions of tax justice.

At least with respect to government insurance premiums or fees paid *ex ante*, varying the imposed charge based upon particular risk factors is one way to more closely align the burden to pay with the benefit or value received. This argument fares much less well, however, as applied to *ex post* assessments. Indeed, one of the fundamental problems with an *ex-post* approach to recouping bailout expenditures is that the struggling or failing entities that benefitted from the government program are not bearing any cost. In fact, healthy financial institutions are subsidizing weaker institutions that received direct benefits. If the financial institutions that received the direct assistance ultimately fail, they will not have contributed anything to the cost. It would far more sensible to have participating businesses contribute in advance. Then, at least, a firm subsequently requiring assistance would have paid into the rescue fund. Again, congressional stubbornness – refusal to admit in advance that there would ever be a need for such a thing – has tied its hands and led to an allocation mechanism that is less equitable in the end.<sup>116</sup>

## b) Ex Ante Tax Collections

### i) Financial Taxes

The 2007-2009 global recession led to many domestic and international proposals for international financial industry taxes, which varied in structure and objective.<sup>117</sup> In most countries, the objectives included one or more of the following: 1) raising revenue; 2) recouping

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<sup>114</sup> See *supra* notes - , and accompanying text.

<sup>115</sup> Dodd-Frank, *supra* note , at §210(o)(2),(4) (provision for graduated risk-based assessment, and specification of factors the FDIC shall take into account in developing risk matrix.)

<sup>116</sup> One argument in favor of a "backward-looking" tax is that it would have less distortive impact on markets. See, e.g. STIJN CLAESSENS, MICHAEL KEEN, CEYLA PAZARBASIOGLU, INT'L MONETARY FUND, FINANCIAL SECTOR TAXATION: THE IMF'S REPORT TO THE G-20 AND BACKGROUND MATERIAL 2 (2010). Since the focus of the Article is on equitable distribution principles, I have not considered those market arguments here.

<sup>117</sup> This section examines only the "forward looking" proposals. For discussion of *ex post* taxes to recoup government bailout or resolution expenses, see *supra* notes - , and accompanying text.

bailout-related costs already incurred (backward-looking); 3) providing a fund to cover future costs imposed by economic crisis (forward-looking); and 4) correcting perceived market imperfections, including the large size of financial institutions, and the excessive riskiness of investment activities<sup>118</sup> Some of the proposed taxes are transaction based - generally referred to as Financial Transactions Taxes (FTTs)<sup>119</sup> - and others are based on the value of profits and wages, often referred to as “Financial Activities Taxes” (FATs).<sup>120</sup>

[This section is incomplete. In the end, it is not likely to be long, given that most of the discussion about financial institutions taxes focuses on behavioral impact, which is not the focus of this paper]

### 3. Government Insurance Models

[In this section, I would like to look at government insurance from a benefit theory perspective. One of the issues I’m thinking about is whether this analysis would lead to a different programmatic structure than one based on more traditional public goods/market based analysis. I also want to look at the same questions about government insurance from a distributive justice perspective.]

#### 4. Issues With Respect to Benefit Theory as Applied to Bailout Related Expenditures

##### a) Identifying Beneficiaries

From the moment one decides to consider the possibility of distributing tax burdens among some subset of taxpayers or taxpaying entities, boundary questions immediately arise. The benefits-based idea that the financial sector based should pay the cost of bailouts because it benefits most from the overall stability of the financial infrastructure provided by the state is intuitively appealing. Alternatively, one might look to other fairness principles to justify imposing costs on the financial sector. One principle might be based on a sense of industry culpability; justice requires that we pay damages for the harms we cause to others.<sup>121</sup> Another alternative might be a variation of the ability to pay.<sup>122</sup> The title to a recent International

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<sup>118</sup> See *supra* note .

<sup>119</sup> A variety of different taxes fall within the FTT category: bank transaction taxes (BTTs), Securities Transactions Taxes (SSTs), and Currency Transaction Taxes (CITs), for example. Thorton Matheson, *Taxing Financial Transactions: Issues and Evidence* 5 (2011).

<sup>120</sup> *Id.*, at 4.

<sup>121</sup> This would require a very different factual determination regarding the government’s responsibility for the crisis than that considered in connection with the earlier discussion of bailout as compensation. See *supra* notes - , and accompanying text. For discussion of culpability as a fairness standard, see *infra* notes - , and accompanying text.

<sup>122</sup> If so, one would need to argue why ability-to-pay norms require that the entire cost be born by a particular industry as opposed to those with incomes above a particular level. Also, one would need to explain why the particular ability-to-pay judgments that we’ve already made in connection with the income tax are inapplicable.

Monetary Fund report in preparation for its 2010 G-20 meeting reflects the general sentiment and suggests the definitional problem: “A Fair and Substantial Contribution by the Financial Sector.”<sup>123</sup> Whatever the underlying principle, a decision to impose tax on a subgroup requires defining boundaries for group membership. With respect to President Obama’s proposed “fiscal responsibility fee,” for example, some complained that focusing the assessment on banks meant that many institutions not receiving any TARP assistance would be responsible for paying the tax, whereas General Motors and Chrysler, which did receive TARP benefits, would not.

In the modern economy, different types of business entities perform overlapping functions. Businesses no longer break down along functional lines as they did before. So, for example, a tax imposed upon a subgroup defined as banks would not apply to insurance companies, securities firms, and other entities engaged in the same types of activities.

Another boundary definition issue is size. One’s objective might generally be to impose a tax on “large” financial institutions. President Obama’s proposal chose \$50 billion as the financial boundary, which is also the figure that was ultimately included in the Dodd-Frank Act for purposes of the ex post risk-based assessment for contributions to the “orderly liquidation fund.” Still, the same magic size figure can result in very different boundary lines depending upon the “base” used for calculation, which might include assets, liabilities, volume of annual business, or some other factors. To answer these questions is to focus on the appropriate “tax base,” a question that has generated lively debate for decades, if not centuries. To be sure, the scale of the debate would be smaller, but one would still need to determine which assets or liabilities count or don’t count if we want to impose a tax that is horizontally equitable within the subgroup identified.

#### b) Incidence

Imposing a tax with the idea that the burden should be borne by a specifically identified subgroup not only requires accurately defining the group, but also confidence that this group, *in fact*, will bear the burden of the tax. If financial institutions are able to pass tax costs on to their day-to-day bank customers, the financial impact of the tax is not where it was meant to be. At the extreme, to the extent that financial institutions could pass on the entire burden, it is even conceivable that the economic burden would end up with general taxpayers after all.

[brief discussion of retributive, punitive, and other possible fairness standards as alternatives]

### III. Final Thoughts and a Proposal

#### A. Basic Debt and Discharge of Indebtedness Principles<sup>124</sup>

I’m thinking about a recoupment method that might be used with respect to entities that received government assistance and later recover their financial health. The proposal would use a mechanism similar to the current provisions in Internal Revenue Code §108. Discharge or

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<sup>123</sup> IMF, FAIR CONTRIBUTION REPORT, *supra* note .

<sup>124</sup> I include this brief section for non-tax readers who may not be familiar with these rules. Those who are familiar with them should skip Part A.

cancellation of indebtedness is considered income for tax purposes under the general definition of gross income provided in Internal Revenue Code §61.<sup>125</sup> Nevertheless, Congress provides exceptions to this general inclusion principle through a special exclusion rule in §108. One of the key §108 exclusions applies to taxpayers who are bankrupt or insolvent at the time of the debt discharge.<sup>126</sup> This provision is especially relevant in times of economic crisis as significant numbers of taxpayers experience personal or business bankruptcy or insolvency. But for special provision in §108, a borrower who is able to renegotiate any or all of principal amounts due, would have to report the reduction in principal owed as discharge of indebtedness income, taxed at ordinary income rates.

With respect to business taxpayers, §108 generally operates not as a permanent exclusion, but as a deferral. The device used to achieve this result is a requirement in §108(b) that the taxpayer reduce certain “tax attributes” by the amount of the excluded debt.<sup>127</sup> So, for example, imagine an insolvent business taxpayer who convinces its lender to shave \$10,000 off the principal amount due on business loans. Imagine as well that the taxpayer has \$10,000 in net operating losses (NOLs) from the prior year in which it experienced operating business losses. Special carryover provisions allow the taxpayer to carry these NOLs forward “to each of twenty years following the taxable year of the loss.”<sup>128</sup> In other words, the carryover provision allows taxpayers to use losses from the “bad” years as deductions against income in subsequent “good” years. Thus, if the business recovers its financial health at some time during the twenty year period following the loss year, it could use the NOLs as a deduction to offset otherwise taxable income in the later year.

When the lender agrees to the debt discharge, §108(a) permits the taxpayer to exclude \$10,000 of otherwise taxable ordinary income.<sup>129</sup> At the same time, however, §108(b) would require a \$10,000 reduction in the NOL account, thus reducing the account from \$10,000 to zero. The practical effect of the reduced NOL is additional taxable income in the subsequent good year; income that otherwise would have been offset by now unavailable NOL. In other words, the reduced “tax attribute” results in a deferral of income – in effect a “recapture” of the previously excluded debt discharge income for taxpayers who economically recover

## B. Extending the §108 Exclusion to the Bailout Context

If government assistance to forestall the imminent collapse of a struggling firm is successful, the firm will live on to experience profitable future tax years. If the firm received some type of direct bailout assistance, one potential for recouping the funds in subsequent years might be to use a device similar to §108(b). In other words, have taxpayers reduce NOLs or

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<sup>125</sup> I.R.C. §61(a)(12).

<sup>126</sup> In response to the home foreclosure crisis, Congress added an additional temporary category under §108, available even to solvent taxpayers, allowing them to exclude discharge of indebtedness income in the event that they were able to negotiate reductions in principal amounts owed to lenders on their mortgages.

<sup>127</sup> The statute provides a rank-ordered list of these attributes, which includes: 1) net operating losses; 2) general business credits; 3) minimum tax credits; 4) capital loss carryovers; and basis. I.R.C. §108(b)(2).

<sup>128</sup> I.R.C. §172(b)(1)(ii).

<sup>129</sup> I.R.C. §108(a)(1)(B).

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other tax attributes in the amount of any government assistance. This would be relevant only to certain kinds of bailout assistance, however. So, for example, it would not be applicable in the context of straight-forward government loans. Of course, nothing further needs to be recouped in the cases of loans subsequently repaid in full with interest and fees.