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CHAPTER 8

CARBON TAX, HEALTH CARE TAX, BANK TAX, AND OTHER REGULATORY TAXES

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""[A] tax is a pecuniary burden laid upon individuals or property for the purpose of supporting the Government"[1]"

""[A] tax is not any less a tax because it has a regulatory effect"[2]"

The momentous decision of the U.S. Supreme Court to uphold the constitutionality of the Patient Protection and Affordable Health Care Act (PPACA) took sides in a long-running dispute about whether taxation can legitimately be used for purposes other than raising revenue for the government. The context was the imposition by Congress of a monetary penalty on individuals who refuse to buy health insurance. Opponents of the Act argued that calling this levy a tax added nothing to its constitutional validity since "the noncompliance penalty . . . does not meet the historical criteria for a tax" because "the clear purpose of the assessment is to regulate conduct, not generate revenue for the government."[3] On the other hand, the Federal Government argued that taxation has frequently been used for regulatory purposes, and that "[i]t is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed."[4] In his controlling opinion for the U.S. Supreme Court, Chief Justice Roberts took the latter view, writing that while "the essential feature of any tax [is that] it produces at least some revenue for the Government," "taxes that seek to influence conduct are nothing new," citing Justice Story for the proposition that "the taxing power is often, very often, applied for other purposes, than revenue."[5] Indeed, Roberts went further and stated that "[e]very tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed."[6] Is this view correct?

1. *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996).
2. *Sonzinsky v. United States*, 300 U.S. 506, 513 (1937).
3. *Virginia v. Sebelius*, Civil Action No. 3:10CV188-HEH, mem. op. at 26–27 (E.D. Va. Aug. 2, 2010).
4. *Id.* at 29 (citing *United States v. Sanchez*, 340 U.S. 42, 44 (1950)).
5. *National Federation of Independent Businesses v. Sebelius*, 132 S.Ct. 2566, 2594, 2596 (2012).
6. *Id.* at 37 (citing *Sonzinsky, supra*).

Taxation has two well-known goals.[7] Undoubtedly, as suggested by the first quotation at the beginning of this chapter, the first and most widely accepted one is to raise revenue for necessary government functions. Although there is a broad debate about which governmental functions are truly indispensable, most commentators would agree that raising revenue is an indispensable feature of governments and that a government that is unable to collect taxes, as the Russian government almost was in 1998, is unlikely to survive.

A second and more controversial goal of taxation is redistribution. Most developed countries see the tax system as a way to redistribute income from the rich to the poor. The desirability of redistribution has been controversial, but most commentators agree that if redistribution is a legitimate government goal, then taxation may be the most effective way to achieve that goal.

But taxation has a third goal that has not been noticed as widely: a regulatory goal. In most developed countries, governments use the tax system to change the behavior of actors in the private sector, by incentivizing (subsidizing) activities they wish to promote and by disincentivizing (penalizing) activities they wish to discourage. This is the point of the second quotation at the beginning of this chapter.

This regulatory function of the tax system is quite well established. Indeed, it can be argued that some types of taxes, such as Pigouvian taxes (designed to deter certain activities by forcing private actors to internalize their social costs), are entirely regulatory in nature. In other cases, such as the corporate income tax, much of the complexity of the current tax structure stems from the government's attempting to use it to achieve regulatory aims. If the U.S. income tax were purely a revenue-raising and redistributive tax, most of the complexity of the current tax code could be eliminated.

Precisely for this reason, most commentators have decried the use of taxation for regulatory purposes. Either, they argue, regulation should be done directly, or, if it is desirable that it be done via subsidies or penalties, those should be delivered directly as well by other government agencies. The Internal Revenue Service (IRS) should be left to its proper role of collecting revenues, with a possible side role in achieving redistribution.

This argument underlies the long debate over the U.S. tax expenditure budget. As originally conceived by Stanley Surrey in the 1960s, the tax expenditure budget (which has been a feature of U.S. budgets since 1974) was intended to single out all the instances in which the tax code is used for regulatory purposes. However, the tax expenditure budget has been controversial from the beginning, with critics charging that it is impossible to define an objective, nonpolitical baseline against which to measure tax expenditures. Recently, this has led the Joint Committee on Taxation to redefine tax expenditures as any deviation not from an objective baseline but from the language of other provisions of the code.[8] The committee eventually reversed course and returned to the original definition of tax expenditures, but the debate will continue.

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7. For a longer discussion, *see* Avi-Yonah, *The Three Goals of Taxation*, 60 Tax L. Rev. 1 (2007).

8. Edward Kleinbard, *Tax Expenditure Framework Legislation*, 63 National Tax J. 353 (2010); *see also* Edward Kleinbard, *The Congress Within a Congress: How Tax Expenditures Distort Our Budget and*

This chapter will discuss the regulatory role of taxation. First, it will argue that regulation is a legitimate role of taxation and that in some cases taxes are a superior vehicle compared to other regulatory techniques. Second, it will ask which of the current taxes in developed countries are best suited for achieving regulatory goals. Finally, it will argue that in general, using only one form of tax for each goal should permit us to simplify the others. In conclusion, we will examine two current proposals for regulatory taxation in the context of financial and health care reform, and argue that while one is a proper use of taxation as regulation, the other is not.

IS REGULATION A LEGITIMATE GOAL FOR TAXATION?

This essay will argue that in some cases regulation is a legitimate goal of taxation. In general, the choice between taxation and other forms of regulation, such as command and control regulation or direct subsidies, depends on the particular policy context. In some instances, taxation is the most effective way to achieve a specific regulatory goal.

A good example of this is combating global climate change. There are three broad methods that have been advanced for government to reduce greenhouse gas emissions: command and control regulation, cap and trade, and carbon taxes. Of these, there is a broad consensus among commentators that carbon taxes are the most effective.[9]

Command and control regulation of greenhouse gas emissions has generally been rejected because of a wide consensus that the government does not have the necessary information to ensure that the emissions targets are distributed most effectively among private market actors. The solution to the climate change problem depends on technological innovation in the private sector, and governments are ill suited to picking winners to develop such technologies. In addition, existing command and control regimes are sector-specific, while the climate change problem applies to the entire economy.

This leaves cap and trade and carbon taxes as the two leading market-based solutions. However, a carbon tax is much simpler than cap and trade. A tax is imposed at $x per ton of carbon content on the main sources of carbon dioxide emissions in the economy—namely, coal, oil, and natural gas. The tax is imposed "upstream"—that is, at the point of extraction or importation—which means that it can be imposed on only 2,000 taxpayers (500 coal miners and importers, 750 oil producers and importers, and 750 natural gas producers and importers). Credits can be given to carbon sequestration projects and to other projects that reduce greenhouse gas emissions, and exports are exempted.

Our Political Process, 36 Ohio Northern Univ. L. Rev. 1 (2010). *But see* Robert Peroni and J. Clifford Fleming Jr., *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base? A Critique of the 'New Paradigm' and Its Denouement*, 30 Va, Tax Rev. 135 (2010).

9. *See* Reuven S. Avi-Yonah and David M. Uhlmann, *Combating Global Climate Change: Why a Carbon Tax Is a Better Response to Global Warming Than Cap and Trade*, 28 Stan. Envir. L. J. 3 (2009).

Cap and trade, on the other hand, is inherently more complicated. While the cap can also be imposed "upstream," it has several features that require complexity. First, the proposal needs to determine how allowances will be created and distributed, either for free or by auction. Free distribution requires deciding which industries receive allowances, while an auction requires a complex monitoring system to prevent cheating. Second, the trading in allowances needs to be set up and monitored: a system needs to be devised to prevent the same allowance from being used twice, and penalties need to be established for polluters who exceed their allowances. Third, if allowances are to be traded with other countries, the international trading of allowances would need to be monitored as well. Fourth, to prevent cost uncertainty, cap and trade proposals typically have complex provisions for banking and borrowing allowances, and some of them provide for safety valves. Fifth, offsets are needed for carbon sequestration and similar projects, and those are more complicated than credits against a carbon tax liability. Finally, most cap and trade proposals involve provisions for coordinating with the cap and trade policies of other countries and for punishing countries that do not have a greenhouse gas emission reduction policy.

In addition to its inherent complexity, cap and trade is also more difficult to enforce. An elaborate mechanism needs to be set up to distribute and collect allowances and to ensure that allowances are real (a difficult task, especially if allowances from non-U.S. programs are permitted) and that polluters are penalized if they emit greenhouses gases without an allowance. A new administrative body needs to be set up for this purpose, or at least a new office within EPA, and new employees with the relevant expertise need to be hired. A carbon tax, on the other hand, can be enforced by the IRS with its existing staff or a small number of additional staff, which has the relevant expertise in enforcing other excise taxes.

Cap and trade also raises collateral issues that are not present in a carbon tax, such as the need for the SEC to enforce rules regarding futures trading in allowances. A good example is the tax implications of both policies. A carbon tax, as a federal tax, has no tax implications: it is simply collected and is not deductible. Allowances under cap and trade, on the other hand, raise a multitude of tax issues: What are the tax implications of distributing allowances for free? What are the tax implications of trading in allowances? Should allowance exchanges be permitted to avoid the tax on selling allowances? What amount of the purchase price of a business should be allocated to its allowances? If borrowing and banking occur, what are the tax consequences? Can allowances be amortized? None of these issues arises under a carbon tax.

It can in fact be argued that tax complexity is inconsistent with the basic premise of the cap and trade system. The theory behind cap and trade posits that permits to emit CO_2 will be traded freely among private market participants, so that they end up distributed in the most efficient way (i.e., in the hands of companies whose costs of abating emissions are the highest). This is consistent with the Coase theorem, because, in the absence of transaction costs, the initial allocation of permits does not matter. However, there are likely to be significant transaction costs, including the application of the corporate tax. Under current tax rules, companies are likely to face a tax burden

when they (a) receive permits, (b) sell permits, (c) borrow permits, and (d) bank permits and (e) when a business that has permits is bought or sold. These barriers mean that the Coase theorem does not apply and the initial allocation matters.[10] This problem can be mitigated by changing the Internal Revenue Code (IRC, the Code) to provide for tax-free trading in permits, but other tax-related transaction costs are likely to persist in any cap and trade regime. Therefore, a carbon tax emerges as the superior price mechanism to restrict carbon emissions.

This example illustrates that at least in one important policy context, taxation is not just an acceptable vehicle for regulation, but also the regulatory technique that is preferred by most commentators (even though it may be less realistic politically). Another example of a preference for taxation is Pigouvian taxes on items like tobacco and alcohol, which are designed to reduce behavior that has important negative externalities. The experience with Prohibition in the early part of the twentieth century has clearly demonstrated that taxation is superior to direct regulation in reducing alcohol consumption, and taxation of cigarettes has been the most effective technique in reducing smoking.

These taxes are relatively marginal in the tax systems of developed economies. But it is also clear that developed countries also use their main taxes, which are the individual and corporate income taxes and the value-added tax (VAT), to achieve regulatory goals. Given that regulation via taxation is legitimate in some cases, the next section will address which of these taxes is best suited to achieve regulatory goals.

WHICH TAX IS BEST SUITED FOR REGULATION?

One of the remarkable examples of convergence in comparative taxation is that most countries rely primarily on three types of tax—the individual income tax, the corporate income tax, and the VAT. While the weight of each tax in total revenue varies (in general, developing countries rely more on the VAT and the corporate tax than on the individual income tax), the vast majority of countries have all three taxes.

The reason for this phenomenon is that each tax is best suited to one of the three aforementioned goals of taxation and that most countries adopt all three goals. If your main goal is raising revenue to fund the government, the best instrument is the VAT. Because an invoice-credit, destination-based VAT relies heavily on the private sector to monitor its collection, even developing countries with weak tax administrations can collect significant revenues from the VAT. Much of it is collected at the border on imports, and the rest is collected on business-to-business transactions in which the buyer has an interest in making sure that the seller paid tax to obtain input credits.

10. Ethan Yale has argued that the tax on selling permits can be offset by deducting the costs of avoiding pollution when permits are sold. *See* Ethan Yale, *Taxing Cap and Trade Environmental Regulation*, 37 J. of Legal Studies 535 (2008). However, this only applies when the practice of borrowing and banking permits is not permitted, which seems unlikely, and it assumes that all pollution avoidance costs are currently deductible, which would also require changes in current law.

By contrast, the corporate income tax and the individual income tax are less effective at raising revenue. Corporate income taxation requires a sophisticated tax administration and is open to avoidance by techniques such as thin capitalization and transfer pricing. In addition, most corporate income tax is collected from multinational enterprises, and countries that wish to attract multinational enterprises (MNEs) use tax incentives, a form of tax competition that reduces revenues. As for the individual income tax, most developing countries are unable to enforce it on anyone except wage earners, and even developed countries have a hard time preventing tax evasion by taxpayers with mobile income.

For redistributive purposes, however, the individual income tax is best, and redistribution is the main reason this tax is used by developed countries and nominally even by developing countries (although they may not be able to enforce it, the tax has an important symbolic value). The VAT is inherently regressive and cannot reach wealth that is not consumed, while the corporate tax is a poor vehicle for redistribution because of the uncertainty about its incidence. This leaves the individual income tax as the main vehicle for redistribution in developed countries, and U.S. data indicate that the tax is in fact quite progressive and able to achieve significant redistribution.

This leaves the regulatory function of taxation, and here it is the corporate tax that is best suited to fulfill this function. The main reason is that corporations are major players in the economy of every country, and that there are relatively few of them, so that it is possible to achieve regulatory goals with minimal administrative efforts by focusing on the corporate sector. The carbon tax, for example, is to be levied only on about 2000 oil, gas, and coal producers and importers, all of whom are corporations. These 2000 corporations will pass the tax burden downstream, where it will ultimately influence consumer behavior, but the regulatory structure that is needed to police the tax is much simpler than it would be if the government attempted to monitor consumers directly.

Thus, because each tax is best suited to fulfill one of the three goals of taxation, most countries use all three. As the United States is now finding out, it is very difficult to collect sufficient revenue from taxation without using a VAT, which is why the VAT has now been adopted by every other member of the Organisation for Economic Co-operation and Development (OECD). Redistribution is very difficult without an effective personal income tax, and that is a major reason for the greater income inequality in developing than in developed countries. And the persistence of the corporate tax despite widespread calls to abolish it stems from its effectiveness as a regulatory vehicle. We could easily replace the revenue of our corporate tax by a small VAT, and it is not effective for redistribution because its incidence is unknown and probably shifting. But we are very unlikely to be able to achieve the regulatory goals of taxation without a corporate tax.

ALLOCATING ONE GOAL PER TAX?

Would it be possible to go further and simplify each tax if we were clear about its main goal? I believe the answer is yes, at least to a significant extent.

The clearest example of goal confusion is the individual income tax in the United States. Because we do not have a VAT, we must rely on the individual tax for most of our revenue. In addition, Congress in recent years has added a multitude of special credits to the individual tax to incentivize a myriad of desirable activities such as education, energy saving, saving for retirement, and the like.

We could achieve significant simplification of the individual tax if we gave up on its revenue and regulatory potential. For revenue, as Michael Graetz has suggested, we could substitute a VAT and exempt from tax anyone but the rich.[11] Anyone earning below $100,000 consumes most of his or her income and would benefit from elimination of the income tax.

In addition, most of the criticism of tax expenditures is focused on the individual tax provisions. They are very complex, difficult for ordinary taxpayers to use, and cumbersome for the IRS to administer. In most cases, we would save transaction costs by converting the tax expenditure to a direct subsidy—e.g., for tuition or for energy-saving equipment. These subsidies could be delivered to colleges and producers, rather than funneled via the individual tax system.

Similarly, the VAT in many countries is made needlessly complex by an attempt to mitigate its regressivity by exempting certain products such as food, clothing, or medicine or by having multiple rates. Once the VAT is conceived as a pure revenue raiser, it can be made as broad as possible with a single rate. Regressivity should be addressed via the income tax system or by sending low-income taxpayers rebate checks, as well as through the expenditure side of the budget.

Finally, a lot of the trouble people have with the corporate tax system stems from a misunderstanding of its primarily regulatory nature. Once we understand that the main purpose of the corporate tax is to regulate corporate behavior, the key issue becomes not how much revenue is raised, or what the incidence of the tax may be, but rather whether the tax is effective in achieving its regulatory goals. It may be, for example, perfectly acceptable for a large corporation to pay no tax, as long as the reason for this is consistent with Congress's intent in allowing it certain exemptions or deductions. The newly codified economic substance doctrine, for example, is misguided because it focuses on the business purpose of the corporate taxpayer, rather than on congressional intent.

CONCLUSION: THE BANK TAX AND THE HEALTH CARE TAX

Two current examples illustrate the distinction between effective and less effective uses of taxation as a regulatory instrument: the proposed bank tax and the enacted health care tax.

11. Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (Yale University, 2007).

The bank tax falls squarely within the realm of effective uses of taxation to regulate. It would be imposed on financial institutions' capital at risk, excluding federally insured deposits, and it is designed to deter banks from taking excessive risks. The bank tax is imposed on a relatively small number of sophisticated taxpayers and is not particularly complicated. It can serve as an offset to the numerous ways in which banks are currently subsidized by the tax system, including the ability to deduct bad loan reserves, to defer tax on interest earned overseas, and to acquire other banks to use their losses to offset future income. If enacted, the bank tax would represent a small repayment of the funds expended by taxpayers to rescue the major banks during the crisis of 2008, and it is well designed to target only those institutions that are deemed "too big to fail."

The health care tax, on the other hand, stems primarily from the desire to ensure the constitutionality of the individual health insurance mandate. It is really a penalty for individuals who do not purchase health insurance. It is relatively complex, with difficult definitions that govern the level of the penalty. It applies to many taxpayers but exempts those who are covered through their employers, so that it falls disproportionately on the poor. For the same reason, it is likely to be as difficult to enforce as the earned income tax credit.

Moreover, the two taxes have different signaling effects. Calling the bank tax a tax rather than a fee or premium is reasonable, because it does not represent payment for insurance. Calling the health insurance penalty a tax, however, may dilute its effect, because people tend to have a different reaction to not paying taxes than to avoiding penalties. One of the main concerns regarding the health care tax is that people would prefer to pay it rather than obtain insurance, and calling it a tax does nothing to mitigate this concern.

In general, taxation as regulation makes sense when (1) it is applied to small numbers of taxpayers, (2) the taxpayers are sophisticated and able to deal with complex tax incentives, and (3) the regulatory goal is clear and related to the level of the tax. The bank tax, the carbon tax, and other forms of corporate taxation meet these criteria, but the health care tax and many tax expenditures of the individual income tax do not. In general, Congress should limit its regulatory activities to the corporate tax, apply the individual income tax to the rich as a vehicle for redistribution, and enact a VAT to raise revenue.