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The Great and Mighty Tax Law: How the Roberts Court Has Reduced Constitutional Scrutiny of Taxes and Tax Expenditures

Linda Sugin

Fordham University, lsugin@law.fordham.edu

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ARTICLES

The Great and Mighty Tax Law

HOW THE ROBERTS COURT HAS REDUCED CONSTITUTIONAL SCRUTINY OF TAXES AND TAX EXPENDITURES

Linda Sugin[†]

INTRODUCTION

The Roberts Court has written two important tax opinions. Both endow the tax law with legal superpowers, giving it the astonishing ability to elude constitutional limits. The justices have sent Congress and state legislatures a strong and clear message: they may use their tax laws as a means to aggressively enact public objectives unrelated to the traditional revenue-raising function of taxation. The justices have also made clear that the Court will uphold policies administered through the tax law even where those same policies would be unconstitutional if administered as either direct regulation or appropriated spending.

In *National Federation of Independent Business v. Sebelius (NFIB)*,¹ the tax law saved the Affordable Care Act (Obamacare or ACA) from death at the hands of the Commerce Clause. The case confirmed the broad reach of the taxing power under the Constitution, and showed the current high Court's willingness to treat regulatory legislation as taxation, even where Congress declined to call the legislation a "tax." The

[†] Professor of Law, Fordham Law School. Many thanks to Yariv Brauner, Brian Galle, Abner Greene, Dan Halperin, Louis Kaplow, Charlene Luke, Diane Ring, Stephen Shay, David Walker, and the students at Harvard Law School and the University of Florida Law School Tax Policy Colloquia for helpful discussion and comments on prior drafts.

¹ Nat'l Fed'n of Indep. Bus. v. Sebelius (*NFIB*), No. 11-393, slip op. at 1 (U.S. June 28, 2012).

cliffhanger ending to the Obamacare challenge may have been made possible by a much-less publicized—but more legally radical—case from the previous term, *Arizona Christian Schools v. Winn* (ACS).² In the ACS case, the Court adopted a novel judicial approach to targeted tax benefits for religious schools. It rejected the widely accepted treatment of tax expenditures as government spending administered through the tax law, and instead treated them as simple tax cuts. It thereby allowed tax benefits that are functional equivalents to direct government spending to bypass the constitutional scrutiny to which both taxes and direct spending are usually subject. Tax benefits are now beyond even the reach of the Bill of Rights, which prohibits government from treading on individual rights.

This is bad news for the tax law, and maybe for the Constitution as well. Both of these cases aggravate a growing tension between the economic and legal analyses of taxation, widening the gap between these two central approaches to tax law. The Court transformed tax expenditures from state action, ordinarily subject to constitutional limits, into nonreviewable private spending by individuals. This development reduces the protection that the Constitution provides to individuals, undermines tax reform efforts and fiscal responsibility, jeopardizes established legal doctrine, and discourages transparent and equitable governance.

NFIB confirms established law that Congress's power under the Constitution's taxing power is vast. In that case, the Court concluded that Obamacare's so-called "shared responsibility payment"³ constituted a tax, and was therefore within Congress's enumerated powers. The payment must be made by individuals who fail to procure health insurance⁴ despite the ACA's instruction that they do.⁵ The Court treated the payment as a tax, rather than as a penalty for failure to comply with the statutory requirement, even though Congress did not label it a tax. The Court's holding pursuant to the taxing power in *NFIB* is important because a majority of the Court agreed that the individual mandate—if understood as a requirement for people to procure health insurance—was

² *Ariz. Christian Sch. Tuition Org. v. Winn* (ACS), 131 S. Ct. 1436 (2011).

³ I.R.C. § 5000A(b) (2010).

⁴ Internal Revenue Code § 5000A(b) imposes the payment requirement, calling it a "penalty."

⁵ Internal Revenue Code § 5000A(a) imposes the "[r]equirement to maintain minimum essential coverage."

beyond Congress's power under the Commerce Clause.⁶ Congress cannot *make* people buy health insurance, but it can nudge them to do so by increasing the price of going without it. People who refuse to buy health insurance are not law-breakers, but taxpayers. The Supreme Court has long accepted Congress's vast authority under the tax power,⁷ including the power to regulate through taxation, so the decision is not legally surprising on this point.⁸ There was more than ample precedent for the Court to follow in treating the shared responsibility payment as a tax.⁹ Nevertheless, the decision highlights the potential for the tax law to swallow all government policy; a shrinking Commerce Clause invites Congress to consider a more aggressive use of the tax power. Congress can regulate through taxation as long as it limits its regulatory mechanism to affecting prices, which is all that taxation can do. Taxation rises in importance in the overall legislative scheme, even though *NFIB* breaks no new legal ground, because of the contraction of Congress's other available tools.¹⁰ The decision invites Congress to tax anything that it cannot otherwise regulate. While that invitation may go largely unheeded because of the political opposition to raising taxes,¹¹ it implies a broader scope for the Internal Revenue Code.

⁶ *NFIB*, slip op. at 16-27.

⁷ See, e.g., *The License Tax Cases*, 72 U.S. (5 Wall.) 462, 471 (1866) ("It is true that the power of Congress to tax is a very extensive power. It is given in the Constitution, with only one exception and only two qualifications.").

⁸ See *United States v. Kahriger*, 345 U.S. 22, 28 (1953) ("It is conceded that a federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed. Nor is the tax invalid because the revenue obtained is negligible."); *Sonzinsky v. United States*, 300 U.S. 506, 513 (1937) ("Every tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed. But a tax is not any the less a tax because it has a regulatory effect.").

⁹ See Robert D. Cooter & Neil S. Siegel, *Not the Power to Destroy: An Effects Theory of the Tax Power*, 98 VA. L. REV. 1195, 1239-40 (2012) (foreshadowing Justice Roberts' approach); Gillian E. Metzger, *To Tax, To Spend, To Regulate*, 126 HARV. L. REV. 83, 86 (2012); Linda Sugin & Benjamin Zipursky, *Regulation, Taxation, and Coercion: Understanding Chief Justice Roberts' Defense of the Mandate* (Oct. 2, 2012) (unpublished manuscript) (on file with the Brooklyn Law Review); Brian Galle, *Conditional Taxation and the Constitutionality of Health Care Reform*, 120 YALE L.J. ONLINE 27, 28-30 (2010), <http://yalelawjournal.org/2010/5/31/galle.html>; Andrew Koppelman, *Bad News for Mail Robbers: The Obvious Constitutionality of Health Care Reform*, 121 YALE L.J. ONLINE 1, 10-11 (2011), <http://yalelawjournal.org/2011/04/26/koppelman.html>.

¹⁰ The Commerce Clause has been under stress in the Court for some time. See generally *United States v. Morrison*, 529 U.S. 598 (2000) (regulation of violence against women not authorized by Commerce Clause); *United States v. Lopez*, 514 U.S. 549 (1995) (regulation of guns near schools not authorized by Commerce Clause).

¹¹ "Taxes dominate domestic politics." Jill Lepore, *Tax Time: Why We Pay*, NEW YORKER, Nov. 26, 2012, at 25; see also Galle, *supra* note 9, at 35.

The Court's 2011 decision in *ACS* is a more significant expansion of the tax law's power than *NFIB* because that decision broke new legal ground by placing tax expenditures beyond review under the Establishment Clause. That case concerned a provision in the Arizona state income tax that granted a dollar-for-dollar tax credit for transfers to state tuition organizations (STOs), organizations that subsidize private school tuition of Arizona children. The Court held that the tax credit was not constitutionally reviewable state action,¹² characterizing it instead as an abstention from legislative action.¹³ The tax credit was treated as a legislative decision to *not* tax, turning STO contributions into private action instead of state action, even though the tax credit financed the entire outlay dollar for dollar.¹⁴ Because the actions were private, they were beyond the Court's concerns about constitutionality. The plaintiffs were dismissed for lack of standing because the Court determined that they failed to adequately prove that the tax credit was government taxing and spending.¹⁵ The tax-credit mechanism pulled all the constitutional weight in foreclosing review because an economically equivalent program allocating state treasury funds to the STOs would have been reviewable as a possible unconstitutional establishment of religion. The *ACS* case gives Congress and state legislatures an incentive to adopt tax credits for anything that might be constitutionally suspect under the Bill of Rights. As long as the legislature designs a preference for religion as a tax benefit, it is now effectively beyond judicial review.

This article considers the implications of these decisions for the law and policy of taxation. It argues that these cases undercut the tax law's revenue-raising role and give it tremendous potential to overcome constitutional obstacles that legislatures face.¹⁶ The holdings also introduce confusion into the law of taxation by incentivizing the adoption of more non-revenue policy in the tax law¹⁷ and blurring the conceptual structure of taxation.¹⁸ This article claims that these decisions

¹² The Court held that the taxpayers lacked standing. *ACS*, 131 S. Ct. 1436, 1499 (2011).

¹³ *Id.* at 1447 (“[T]he government declines to impose a tax” when it awards a credit.).

¹⁴ *Id.* (“When Arizona taxpayers choose to contribute to STOs, they spend their own money, not money the State has collected from respondents or from other taxpayers.”).

¹⁵ *Id.* at 1447-49.

¹⁶ See *infra* Parts II and III.

¹⁷ See *infra* Parts II.F and III.

¹⁸ See *infra* Part III.B-C.

undermine the important work on tax reform and fiscal responsibility that other branches of government are doing.¹⁹ They additionally create new doctrine that threatens established law on constitutional conditions attached to tax benefits.²⁰ Finally, these cases encourage legislatures to favor high-income taxpayers, giving them unwarranted financial and political advantages.²¹ While *NFIB* has received more attention than *ACS*, the earlier case was more important for the developments discussed here; it established the tax law's power, which *NFIB* seized upon when upholding the ACA.

Many tax articles are highly economic and not particularly legal, ignoring the tension between the economic effect and legal logic that is ubiquitous in the tax law. This article is an exception. It focuses on how the economics and the law of taxation conflict, and why legal consequences do not always track economic effects. This conflict reared its head in the stark divergence of the holdings of the two cases this article analyzes; most of the justices voting with the majority in one case voted in dissent in the other. In *NFIB*, economic equivalence prevailed and the majority upheld the mandate under the taxing power, even though the provision had many legal characteristics that distinguish it from the economically equivalent taxing scheme that it might have been.²² In *ACS*, economic equivalence did not matter, and the Court refused to treat the tax credit as legally equivalent to the direct government-spending program that would have achieved the same economic results, even though the credit refunded the entire amount of an individual outlay, making it economically indistinguishable from a simple government transfer.²³ These decisions are a turning point for the legal analysis of taxation.

The next Part examines the two cases by fleshing out the Supreme Court's interpretation of what constitutes a tax, as compared to government regulation, and how we can

¹⁹ Congress and the President have been looking for ways to raise revenue, not reduce it. In the American Taxpayer Relief Act of 2012, adopted at the precipice of the fiscal cliff, they agreed to allow rates to rise on high income taxpayers, estates, and capital gains. H.R. Res. 8, 112th Cong. (2013) (enacted Jan. 2, 2013). Long-term tax reform efforts are expected to focus more on reducing tax expenditures. *See infra* Part III.A.

²⁰ *See infra* Part II.E.

²¹ *See infra* Part III.D.

²² *See infra* Part I.C.

²³ It is well accepted to treat such credits as their direct spending equivalents. In fact, the federal government is required to treat such items as their direct spending equivalents by including them in the federal budget. *See* OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT (2013), at 248-64 [hereinafter ANALYTICAL PERSPECTIVES 2013], available at http://www.whitehouse.gov/omb/budget/analytical_perspectives.

recognize a diminution in taxation, as compared to government spending. Part II further parses the reasoning in the *ACS* opinion to illuminate the conceptual shift in judicial thinking about tax benefits that the case embodies, and explains the legal ramifications of the Court's approach. Part III places these two decisions in the broader context of tax policy, analyzing the institutional and distributional implications of the Court's reasoning. Parts II and III suggest that there is much to worry about. Part IV briefly concludes.

I. WHAT IS A TAX? WHAT IS A TAX CUT?

In *NFIB*, a majority of the Court concluded that the shared responsibility payment is a tax, allowing the Court to uphold Obamacare's mandate under the taxing power, even though a different majority believed that it was beyond Congress's power under the Commerce Clause if understood as a penalty for unlawful behavior. In *ACS*, the Court refused to treat a tax credit that reimbursed taxpayers for payments made to STOs as either "taxing" or "spending," the two possible categories in which a tax credit might be included, and instead turned it into a tax cut, which placed it beyond constitutional review. Thus, the Supreme Court adopted broad definitions of taxes and tax cuts, expanding legislative power in the face of constitutional challenge. Alternative interpretations, such as treating the respective laws as regulation with a penalty in *NFIB*, and as government spending in *ACS*, would have allowed greater judicial oversight.

A. *Obamacare's Individual Mandate Is a Tax, Not a Regulatory Penalty*

In *NFIB*, the Court's conclusion that the mandate is actually a tax, and not a penalty, stemmed from its observations that the shared responsibility payment is not very high, the requirement is codified in the Internal Revenue Code, and the payments are made to the Internal Revenue Service.²⁴ The distinction between a tax and a penalty ultimately turned on whether the exaction is so heavy a levy that people will refrain from the taxed activity altogether.²⁵ Under this standard, as long as a statute includes these formal aspects and does not

²⁴ *NFIB*, No. 11-393, slip op. at 33-36 (U.S. June 28, 2012).

²⁵ *Id.* at 36-38.

function as a prohibition of conduct, it should constitute a tax.²⁶ If Congress had simply called the shared responsibility payment a “tax,” justifying its constitutionality would likely have been easier. In *NFIB*, all the justices agreed that Congress could have constitutionally imposed a tax that achieved precisely what the Affordable Care Act legislation achieved; the dispute centered on whether it had, in fact, done so.²⁷ Congress called the charge a “shared responsibility payment” and a “penalty,” not a “tax.” But the Court determined that Congress’s label does not control whether something is, in fact, a tax—and not a regulatory penalty—for purposes of the Constitution.²⁸ Justice Roberts was persuaded that the payment should be treated as a tax based on a confluence of factors, rather than on some essential element that epitomizes taxation. Those factors were that Congress placed the shared responsibility payment in the Internal Revenue Code, that it was collected by the Internal Revenue Service, and that it “yields the essential feature of any tax: it produces at least some revenue for the Government.”²⁹

Article I, Section 8 of the Constitution grants Congress the power to tax, but it does not define what a tax is. There are many individual statutory provisions in the federal tax scheme. Some of them form the structure of the tax by defining taxable income, some of them are necessary for administration, and others carve out exceptions from the tax’s coverage. Some provisions in the Internal Revenue Code are only marginally related to the general purpose of taxing income, as is the shared responsibility payment, which is primarily concerned with whether an individual has health insurance and not with accurate income measurement. The Constitution does not provide any guidance about which of these arguably extraneous elements are included under Congress’s taxing power, thus its silence lends discretion to the Court to conclude that every one constitutes a “tax.”

In very rare cases, the Supreme Court has rejected a provision of the tax law as not constituting a “tax,” but only where the tax was disguising something else that was legally significant, such as a criminal penalty subject to the double jeopardy clause³⁰

²⁶ See Sugin & Zipursky, *supra* note 9, at 16-17; see also Cooter & Siegel, *supra* note 9, at 1229-36.

²⁷ See *NFIB*, slip op. at 17 (Scalia, Kennedy, Thomas, & Alito, JJ., dissenting).

²⁸ *Id.* at 34; see also Metzger, *supra* note 9 (discussing institutionalism).

²⁹ *NFIB*, slip op. at 33.

³⁰ *Dep’t of Revenue of Mont. v. Kurth Ranch*, 511 U.S. 767, 778-83 (1994).

or a taking.³¹ The alternative to characterization as a tax in *NFIB* was to treat the payment as a regulatory penalty designed to enforce Obamacare's requirement to acquire health insurance.³² The joint dissent favored the latter characterization, which would have invalidated the provision as beyond Congress's power.³³ The majority conceded that the distinction between taxes and penalties continues to be important, but decided that the shared responsibility payment did not cross the line from tax to penalty.³⁴

There is no bright line distinguishing taxation from regulation accompanied by a penalty, and the tax law is important in regulating all manner of activities. The tax law imposes levies and administers subsidies for all sorts of activities, just as regulation might do.³⁵ While there is a great deal of overlap between the legal regimes, the Supreme Court has treated some regulation as beyond Congress's taxing power. The leading case on the distinction between taxes and penalties, cited extensively by Justice Roberts in his *NFIB* opinion, concerned taxes imposed on businesses that engaged in child labor.³⁶ The purpose of the child labor tax was clearly to prevent employers from hiring children, and was an explicit end run around Congress's inability to directly regulate child labor at the time.³⁷ The child labor tax was ten percent of income³⁸—substantial enough that no reasonable business would choose to pay it as a cost of business. The Supreme Court characterized the ostensible tax provision as a form of regulation and punishment, rather than a tax, and struck the statute down because it was not authorized by Congress's taxing power.³⁹ The Court refused to allow Congress to call

³¹ *Cheaney v. Hooser*, 48 Ky. (9 B. Mon.) 330, 345 (1848).

³² The *NFIB* court relied heavily on *Bailey v. Drexel Furniture Co. (The Child Labor Tax Case)*, 259 U.S. 20, 38 (1922), which treated a so-called tax as a penalty. See *infra* notes 36-40 and accompanying text.

³³ *NFIB*, slip op. at 16-24 (Scalia, Kennedy, Thomas, & Alito, JJ., dissenting).

³⁴ *Id.* at 43 (“we need not here decide the precise point at which an exaction becomes so punitive that the taxing power does not authorize it”).

³⁵ The Treasury Department's budget includes a comparison of tax expenditures and regulation that shows various similarities and differences in their operation and administration. See OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES (2006), at 332.

³⁶ *Bailey v. Drexel Furniture Co.*, 259 U.S. 20, 38 (1922). The *NFIB* opinion may have revived that opinion from obsolescence. See Galle, *supra* note 9, at 29 (questioning whether case had been effectively overruled).

³⁷ See generally *Hammer v. Dagenhart*, 247 U.S. 251 (1918).

³⁸ *Bailey*, 259 U.S. at 34.

³⁹ “[A] court must be blind not to see that the so-called tax is imposed to stop the employment of children within the age limits prescribed. Its prohibitory and regulatory effect and purpose are palpable. All others can see and understand this.” *Id.* at 37.

something a tax as an end run around a constitutional impediment.⁴⁰ Later cases followed this lead. In *Department of Revenue of Montana v. Kurth Ranch*, the Supreme Court invalidated the imposition of a tax under the double jeopardy clause.⁴¹ In that case, the Court held that the levy was not really a tax, but was instead an invalid criminal sanction because the “taxpayer” had already been punished once. The Court has also treated ostensible taxes as takings.⁴² Such cases, however, are the exception; in most instances, the Court has upheld the legislature’s characterization of a tax and treated it as such.⁴³

As a legal matter, it would be possible to treat each individual provision included in a taxing statute as a tax since it is part of the whole that constitutes the tax, essentially allowing the legislature to determine the constitutionality of a tax by designating it as one.⁴⁴ It would also be possible for courts to focus solely on revenue, which would narrow the constitutional definition of a tax. Unfortunately, none of these characteristics are definitive. Placement in the tax law and collection by the Service is a pure formality. Revenue is more functional, but not definitive because fines and monetary penalties also yield revenue. So, revenue may be necessary, but cannot be sufficient to define a tax if the law is to maintain a distinction between taxes and penalties.⁴⁵ The inquiry is more aggregative of multiple factors of comparison, and the shared responsibility payment has some other income tax-like elements

⁴⁰ “To give such magic to the word ‘tax’ would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states.” *Id.* at 38.

⁴¹ *Dep’t of Revenue of Mont. v. Kurth Ranch*, 511 U.S. 767, 784 (1994).

⁴² The Court held that a tax levy crossed the line from a tax to an unauthorized taking where there is

a palpable and flagrant departure from equality in the burthen as imposed upon the persons or property bound to contribute, or it must be palpable that persons or their property are subjected to a local burthen for the benefit of others, or for purposes in which they have no interest, and to which they are, therefore, not justly bound to contribute.

Cheaney v. Hooser, 48 Ky. (9 B. Mon.) 330, 345 (1848); *see also Henderson Bridge Co. v. Henderson City*, 173 U.S. 592, 616 (1899).

⁴³ Except in rare and special instances, the due process of law clause contained in the Fifth Amendment is not a limitation upon the taxing power conferred upon Congress by the Constitution. *See Brushaber v. Union Pac. R.R.*, 240 U.S. 1, 24 (1916); *see also A. Magnano Co. v. Hamilton*, 292 U.S. 40, 44-45 (1934) (collecting cases supporting this position).

⁴⁴ That would allow the legislature to make the ultimate constitutional determination, which has been the Court’s role. *See Brushaber*, 240 U.S. at 12.

⁴⁵ In an ideal world, taxes would raise revenue while fines and penalties would not because everyone would be law-abiding, so they would never incur penalties.

that suggest it could be part of the larger scheme of income taxation in place. The most important provision is section 5000A(c)(2), which determines the amount of the penalty by reference to an individual's income and the size of his family. An income tax is levied based on an individual's ability to pay, and both income and family size are relevant to that determination, so these factors argue for including the payment as an element of the income tax. At the same time, however, the shared responsibility payment does not quite fit in the model of an income tax. It is not a structural component of the existing tax system because it does not refine the definition of income nor does having health insurance relate directly to measuring an individual's ability to pay taxes. The thing that is taxed under Obamacare is an individual's decision to forego insurance, which is unique compared to the items of "income" taxed under the Code.⁴⁶ The income tax does not generally tax decisions that individuals make or states of affairs; it rather looks to receipts and expenditures. Nevertheless, there are many provisions of the federal tax law that are not elements of the structural core that accurately measures income.

While not appearing precisely like a tax, the shared responsibility payment also does not look precisely like an average penalty. The toll, as Justice Ginsburg called it,⁴⁷ is unlike the penalty in the child labor cases because it is not very punitive. It is limited both by dollar amount and as a percentage of income, and will never exceed a modest sum.⁴⁸ The majority considered it important that individuals might choose to pay the toll instead of complying with the mandate to insure.⁴⁹ In addition, nonpayment does not lead to criminal sanctions,⁵⁰ so if it were a "penalty," the charge is unlikely to be perceived as a more substantial punishment beyond ordinary taxes.

The crux of the tax-penalty distinction for purposes of the law depends on whether there is a legal duty underlying the exaction. Penalties are imposed for failure to comply with legal obligations, but taxes are imposed even on fully law-abiding citizens. The distinction between a tax and a penalty—on these terms—is not obvious and the substantive disagreement between the majority and the joint dissent comes

⁴⁶ See I.R.C. § 61 (2006) (listing examples of income included in the tax base).

⁴⁷ *NFIB*, slip op. at 17 (Ginsburg, J., concurring in part and dissenting in part).

⁴⁸ I.R.C. § 5000A(c) (2010). The exact amount varies by individual, but is never onerous.

⁴⁹ *NFIB*, slip op. at 35-36.

⁵⁰ I.R.C. § 5000A(g).

down to the question of whether a legal duty exists.⁵¹ Reasonable people can disagree about whether the ACA imposes such a duty, and while elsewhere I have concluded that the best reading of the mandate is that it does not, I concede that the question is debatable.⁵²

The reason that the line between a tax and a penalty is not easy to draw is that taxes and penalties can be functional economic equivalents.⁵³ Taxes and regulation are effective economic substitutes for one another because the same objective can often be achieved by either taxation or regulation coupled with a penalty. It is in the discretion of the legislature to decide which mechanism to employ. Put simply, economic analysis cannot solve the tax-penalty dilemma. Similarly, government spending can be achieved directly via appropriations, or indirectly through the tax system. There is a legal distinction separating those categories, even though the economics overlap. Indirect spending is accomplished via the tax system by allowing taxpayers to reduce their tax liabilities if they engage in activities that the government wants to fund. Provisions in the tax system that operate as spending equivalents are called “tax expenditures,” because of their function as spending and their placement in the tax law. The next section discusses the Supreme Court’s recent attempt at defining tax expenditures.

B. *Tax Expenditures Are Now Constitutionally Irrelevant Tax Cuts*

Unlike Congress, state legislatures do not depend on enumerated powers in the Constitution; states can pass any law they like and regulate any conduct, subject only to the explicit constraints imposed by the Constitution. Because the Bill of Rights prohibits it, no state law may establish religion or

⁵¹ The dissent wrote, “[W]e have never held—never—that a penalty imposed for violation of the law was so trivial as to be in effect a tax.” *NFIB*, slip op. at 18 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting) (emphasis omitted).

⁵² See Sugin & Zipursky, *supra* note 9, at 17-19 (arguing that there is no duty); Metzger, *supra* note 9, at 85 (describing Justice Roberts’ opinion as reflecting “a libertarian resistance to compulsory measures in favor of choice and incentives”). Professors Cooter and Siegel conclude that the statute is a tax, even though its “normative language appears to reflect a congressional judgment that failing to insure is wrong.” Cooter & Siegel, *supra* note 9, at 1240.

⁵³ The theory proposed by Professors Cooter and Siegel suggests that there is a distinction based on effects. See Cooter & Siegel, *supra* note 9, at 1198. I am less sure that it is always possible to draw that line, because the existence of an underlying duty may not always be determinable. See Sugin & Zipursky, *supra* note 9, at 17-19.

abridge speech or deny equal protection. Similarly, Congress is subject to these rights-based limitations on its legislation. Through its analysis in the *ACS* decision, the Supreme Court has created an irresistible incentive for both Congress and state legislatures to use their tax statutes to avoid the constitutional constraints on direct spending that apply to their non-tax powers.

The *ACS* opinion makes tax benefits constitutionally unreviewable under the Establishment Clause by characterizing them as the legislature declining to impose a tax;⁵⁴ the resulting subsidy to religious institutions is consequently private spending⁵⁵ beyond constitutional concern. The tax credit at issue in the case produces a targeted reduction in tax for individuals who follow a narrow set of statutory parameters, effectively subsidizing the targeted activities. Nevertheless, the *ACS* decision treats the credit as though it is a tax cut similar to a reduction in rates, which reduces overall burdens rather than targeting specific expenditures. Characterizing such a targeted tax reduction as equivalent to a general cut in taxes—such as a rate reduction—is a truly radical development in the law. It effectively immunizes tax expenditures from constitutional review and gives them a unique constitutional status more privileged than other legislation.

Tax expenditures⁵⁶ function the same way as spending provisions but are located in the tax law. They include subsidies administered through the tax law that could have been delivered in another way. Tax credits reduce tax liability, and are an effective substitute for direct government transfers to taxpayers. Instead of the government allocating funds for particular programs, tax expenditures allow taxpayers to reduce their tax liabilities by participating in various activities enumerated in the statute,⁵⁷ creating entitlements for taxpayers who can fit the statutory definition. For example, the government can provide matching grants out of federal funds to charities that individuals support,⁵⁸ or it can achieve the same effect by

⁵⁴ *ACS*, 131 S. Ct. 1436, 1499 (2011).

⁵⁵ *Id.* at 1448.

⁵⁶ Tax expenditures were defined by Congress as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” See Congressional Budget Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 297, 299 (1974).

⁵⁷ Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX L. 1, 3 (2012).

⁵⁸ This is what the U.K. does. See *infra* discussion at note 152.

allowing individual donors to take deductions for their gifts to those charities.⁵⁹ The subsidy in the deduction is equal to the tax savings enjoyed by the individual.⁶⁰

The tax administration mechanism distinguishes tax expenditures from direct expenditures, even though their function and effect are equivalent. The government's reporting of tax expenditures reflects their economic substance as spending programs. Every year, the Treasury Department and the Joint Committee on Taxation prepare lists that enumerate the cost of tax expenditures, as they would for appropriations. The Treasury's tax expenditure budget is incorporated as one element in the Office of Management and Budget's comprehensive budget for the federal government that includes all federal spending, both direct and indirect.⁶¹ Tax expenditure *analysis* was developed to provide an appropriate method to evaluate these provisions, identifying sections in the tax law based on statutory function, and demanding that tax provisions that resemble spending be evaluated on the same terms as spending provisions.⁶² Tax expenditure analysis was designed to be a budgetary tool, not a legal tool, so tax expenditure analysis does not mandate a particular legal methodology.⁶³

The state tax credit at issue in *ACS* precisely fits the established definition of a tax expenditure. It is "analogous to [a] direct outlay program[]" and "similar to [a] direct spending program[] . . . available as entitlements to those who meet the statutory criteria."⁶⁴ It operates to reduce the tax of individuals who participate in the narrow program described in the legislation, and it has the effect of fully subsidizing the contributions that individuals make to the organizations specified in the statute. Because the statute allows a credit for the full amount transferred to STOs, every dollar that a taxpayer contributes to an STO, up to the maximum allowed by the statute, reduces the taxpayer's tax liability by a full dollar. As an economic matter, there is no after-tax cost to individuals for their contributions as long as they have sufficient tax liability to

⁵⁹ I.R.C. § 170 (2006).

⁶⁰ For example, a taxpayer with a 35 percent marginal rate of tax saves \$35 for each \$100 donated to charity because the \$100 deduction produces \$35 in tax savings.

⁶¹ See Analytical Perspectives 2013, *supra* note 23; JOINT COMM. TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009–2013 (JCS-1-10), Jan. 11, 2010 [hereinafter ESTIMATES OF FEDERAL TAX EXPENDITURES].

⁶² See STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 25-26 (1985).

⁶³ See Sugin, *supra* note 57, at 7.

⁶⁴ ESTIMATES OF FEDERAL TAX EXPENDITURES, *supra* note 61, at 3.

enjoy the benefit of the credit. The state refunds, through the tax system, the entire amount paid to the STO. Despite this clear economic equivalence to government funding, the ACS Court flatly rejected the notion that the tax credit be “understood as a governmental expenditure.”⁶⁵ In its legal reasoning, it refused to acknowledge the economic equivalence of tax expenditures and direct spending. Instead, the Court treated the tax credit as a simple tax cut.

The disposition in the ACS case turned on standing—the Supreme Court denied standing to plaintiffs who were challenging an Arizona state tax credit⁶⁶ on Establishment Clause grounds. The plaintiffs had alleged that the tax credit, which was allowed to individuals who made payments to STOs, provided an unconstitutional benefit to religious schools and their students.⁶⁷

⁶⁵ ACS, 131 S. Ct. 1436, 1447 (2011).

⁶⁶ The tax credit allowed is for 100 percent of payments to a qualified organization, up to a maximum of \$1000 (for married tax filers). ARIZ. REV. STAT. ANN. § 43-1089 (2010). The credit is not refundable for filers with insufficient tax liability to absorb the credit.

⁶⁷ The statute governing STOs, Arizona Code § 43-1603 provides:

A. A certified school tuition organization must be established to receive contributions from taxpayers for the purposes of income tax credits under § 43-1089 and to pay educational scholarships or tuition grants to allow students to attend any qualified school of their parents’ choice.

B. To be eligible for certification and retain certification, the school tuition organization:

1. Must allocate at least ninety per cent of its annual revenue for educational scholarships or tuition grants.
2. Shall not limit the availability of educational scholarships or tuition grants to only students of one school.
3. May allow donors to recommend student beneficiaries, but shall not award, designate or reserve scholarships solely on the basis of donor recommendations.
4. Shall not allow donors to designate student beneficiaries as a condition of any contribution to the organization, or facilitate, encourage or knowingly permit the exchange of beneficiary student designations in violation of § 43-1089, subsection F.

C. A school tuition organization shall include the following notice in any printed materials soliciting donations, in applications for scholarships and on its website:

Notice

A school tuition organization cannot award, restrict or reserve scholarships solely on the basis of a donor’s recommendation.

A taxpayer may not claim a tax credit if the taxpayer agrees to swap donations with another taxpayer to benefit either taxpayer’s own dependent.

D. In evaluating applications and awarding, designating or reserving scholarships, a school tuition organization:

This article does not focus on the standing issue. Instead, it argues that the *ACS* decision is important because its novel treatment of tax expenditures will have significant repercussions for tax policy and law. Even though tax expenditures have the same economic effect as direct government spending, and may have been adopted as functional substitutes for direct spending, the Supreme Court has now characterized them as “the government declin[ing] to impose a tax.”⁶⁸ This characterization turns tax expenditures into legislative forbearance, rather than affirmative policy choices contained in tax provisions. It transforms tax expenditures into decisions by the legislature *not* to tax. This is a critical conceptual shift: tax expenditures have become tax cuts. The Court’s rejection of economic analysis into legal analysis is not too surprising,⁶⁹ but its decision to treat tax expenditures as tax cuts is new and important.

The effect of the *ACS* decision could be substantial because the Court’s reasoning threatens to make federal tax expenditures disappear from legal analysis altogether. This new characterization of tax expenditures as tax cuts logically extends beyond state tax credits such as the one at issue, to the judicial treatment of all tax expenditures, state and federal. While the credit in *ACS* concerned only \$43 million in Arizona revenue,⁷⁰ at the federal level, the judicial conceptualization of tax expenditures applies to the equivalent of a trillion dollars of

1. Shall not award, designate or reserve a scholarship solely on the recommendation of any person contributing money to the organization, but may consider the recommendation among other factors.

2. Shall consider the financial need of applicants.

E. A qualified school shall not accept an educational scholarship or tuition grant from a school tuition organization in an amount that exceeds the school’s total cost of educating the student in whose name the scholarship or grant is received.

ARIZ. REV. STAT. ANN. § 43-1603 (2010).

⁶⁸ *ACS*, 131 S. Ct. at 1447.

⁶⁹ The Court never fully adopted tax expenditure analysis as a legal framework, which is why tax-based assistance to churches is constitutional, even though direct aid is not. See *Walz v. Tax Comm’n of New York*, 397 U.S. 664, 680 (1970) (tax exemption to churches was not a violation of the Religion Clauses of the First Amendment). I have previously argued against constitutionalizing tax expenditure analysis. See Linda Sugin, *Tax Expenditures Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 412-13 (1999).

⁷⁰ STATE OF ARIZONA, DEPT OF REVENUE, INDIVIDUAL INCOME TAX CREDIT FOR DONATIONS TO PRIVATE SCHOOL TUITION ORGANIZATIONS: REPORTING FOR 2010, EXECUTIVE SUMMARY 1 (2010), available at <http://www.azdor.gov/Portals/0/Reports/private-school-tax-credit-report-2010.pdf>.

federal spending annually.⁷¹ The Court's approach places an enormous number of statutory provisions on a protected legal pedestal by shielding them from constitutional review for violations of individual rights.

Without the economic framework of tax expenditure analysis, tax credits produce an opaque reduction in the tax liability of some individuals. The problem with the ACS majority's approach is that an opaque reduction eludes legal analysis; it ignores the existence of the public policy that a targeted tax reduction reflects. Such a nebulous "tax cut" cannot be reviewed, whether it is structured as state aid to religion or anything else. It was only possible for the ACS Court to dismiss the case because it treated the credit as the absence of tax—a big legal nothing.

C. *Economic vs. Legal Analysis of Taxes and Tax Cuts*

The debate about the definition of taxes and tax cuts is confused, in part, because tax scholars commonly assume that economic equivalents must be legal equivalents. Tax scholars, both economists and lawyers, regularly engage in economic analysis, so perhaps they should be forgiven for thinking that economic effects should control legal results. The classic tax policy criteria of efficiency demands economic analysis, so tax lawyers have adopted economic criteria into legal discourse.⁷²

The debate between the *NFIB* majority and dissent fails to fit the framework usually applied by tax scholars because the distinction between taxes, on the one hand, and regulation accompanied by a penalty, on the other, is *legal*, not economic. The substance of the individual mandate to purchase health insurance could have been designed either as direct regulation or as a tax, with the same function and effect. A parallel issue arises in distinguishing tax benefits from government spending, so the ACS decision is also an example of the conflict between legal and economic analysis. In that case, the Arizona credit could have been designed as direct state funding for private school tuition with the same function and effect as the tax credit, but economic equivalence was not a meaningful part of the Court's legal analysis. The established jurisprudence on tax

⁷¹ See THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., RL34622, TAX EXPENDITURES AND THE FEDERAL BUDGET 13 (2011).

⁷² I have argued that efficiency receives too much deference in tax scholarship. See Sugin, *supra* note 57, at 35-36.

expenditures confirms that form often controls substance when the Court reviews tax-based benefits.⁷³ Prior to *ACS*, the constitutional treatment of tax expenditures had been nuanced: economic equivalence did not necessarily imply legal equivalence, but it was not irrelevant either. Rather, economic equivalence was considered evidence of government support, one element relevant in determining legal consequences.⁷⁴ After *ACS*, tax provisions that benefit religious institutions through a credit are now immune from legal attack, even where other provisions with the same effect would not only be subject to judicial review, but likely adjudicated to be unconstitutional on the merits.

For *NFIB*, Professor Edward Kleinbard urged the Court to uphold the mandate as a tax by basing his argument on the economic substance of the shared responsibility payment.⁷⁵ He reconceptualized the mandate as a tax on everyone, with an associated “notional tax credit” for those who acquire health insurance.⁷⁶ His characterization posits an increased tax for all, accompanied by an offsetting reduction for certain qualified individuals through a tax expenditure. As a result, the statute in *NFIB* was transformed into something that looked like the statute at issue in *ACS* where Arizona imposes a tax only on people who do not make payments to STOs.⁷⁷ In other words, the net effect of the increased tax with the notional credit is a liability only for those who are not entitled to the credit. Economically, Kleinbard’s description is accurate—the notional tax credit combined with a universal tax would be economically equivalent to what actually exists in the law—a tax payment to be made only by individuals who fail to acquire health insurance. The mistake that Kleinbard made is not economic; it is legal. He assumed that the Court would treat the imposition of additional tax—say, a general rate increase—along with a tax credit the same way that it would treat a targeted levy charged only to a few individuals. His economic characterization is undeniably correct, but he mistakenly believed that economic

⁷³ Part III.D, *infra*, develops this point.

⁷⁴ See *infra* notes 120-125 and accompanying text.

⁷⁵ See Edward D. Kleinbard, *Constitutional Kreplach*, 128 TAX NOTES 755, 755-56 (2010). He also contributed to one of the briefs submitted to the court: Brief for Constitutional Law Scholars as Amici Curiae in Support of Petitioners (Minimum Coverage Provision), *Dep’t of Health & Human Servs. v. Florida*, 132 S. Ct. 1133 (2012) (No. 11-398), 2012 WL 135050.

⁷⁶ Edward D. Kleinbard, *The Taxing Power and the ACA: Cravenness Is Not Unconstitutional*, HUFFINGTON POST (June 29, 2012, 4:29 PM), http://www.huffingtonpost.com/edward-d-kleinbard/the-taxing-power-and-the_b_1635361.html.

⁷⁷ *Id.*

equivalents are legal equivalents, which the Supreme Court has made amply clear is not the case.⁷⁸

Kleinbard compared *NFIB* to *ACS*, as this article does, but came out in a different place. He rationalized the two cases by arguing that they are both examples of avoiding taxes by spending one's own money. That financial characterization may apply to both cases, but the Court's legal conclusions cannot be made consistent on those grounds. Kleinbard described the *ACS* majority as treating the law in that case as "just another tax," putting it in the same category as the mandate. But that is not an accurate reading of what the Court actually did in *ACS*.⁷⁹ The Court there refused to treat the Arizona statute as a tax. It also declined to treat the credit as its economic equivalent, government spending. Instead, the Court's legal conclusion was that the spending was solely private individual action. The Court's refusal to treat the statute as a tax was crucial because the constitutional claim in *ACS* concerned religious freedom, not the commerce power. Adoption pursuant to the taxing power would not have been enough to uphold the statute because the Establishment Clause limits the government's power to tax.

NFIB recognizes that Congress may tax even where it may not constitutionally regulate under the Commerce Clause. The Supreme Court, however, has never declared that taxes are completely immune from constitutional limitations, and the *NFIB* opinion confirmed that they are not. The majority stated that the affirmative prohibitions on the government's power, "such as contained in the Bill of Rights[,] . . . come into play . . . where the Government possesses authority to act."⁸⁰ Thus, taxes authorized by Article I, Section 8 may not tread on individual rights. The prohibition on establishment of religion extends to establishment through taxation, even though an absence of power under the commerce clause has no effect on Congress's tax power. Similarly, the actions of state legislatures, which are not limited by constitutionally enumerated powers, are still subject to limitation by the Bill of Rights. Justice Roberts' *NFIB* opinion noted that states may not deny equal protection of the laws to any person.⁸¹ Consequently, a tax imposed only on individuals of a particular race or of certain

⁷⁸ See *infra* Part III.D.

⁷⁹ See *supra* note 68 and accompanying text.

⁸⁰ *NFIB*, No. 11-393, slip op. at 3 (U.S. June 28, 2012).

⁸¹ *Id.*

religious denominations, whether adopted by Congress or one of the states, would be unconstitutional. Even something clearly identified as a tax and clearly within the powers of the government, must still withstand scrutiny under the religion clauses of the First Amendment. Thus, the constitutional question in *NFIB* was fundamentally different from the constitutional question in *ACS*: *NFIB* concerned Congress's enumerated constitutional powers, whereas *ACS* concerned the limitations imposed on those enumerated powers by the Bill of Rights. If the *ACS* Court had characterized the provision as "just another tax," it would have needed to face the constitutional question. Instead, the *ACS* Court characterized the tax credit as an absence of taxation. Because the Court concluded that the legislature did nothing, it was not subject to any constitutional limitations. Economic analysis fails to provide clarity for these legal issues.

II. HOW THE COURT MADE TAXES AND TAX EXPENDITURES CONSTITUTIONALLY EXCEPTIONAL

This part argues that the Court's new rulings on the tax law are likely to have troubling legal repercussions. The most worrisome aspect of the Court's holdings is that tax expenditures disappear from the legal regime; they become essentially unreviewable as a constitutional matter because the Court's characterization denies the presence of any reviewable state action. If the *ACS* Court's approach is adopted broadly as the judicial treatment of tax expenditures, the ramifications will extend beyond the context of standing in Establishment Clause cases to the legal substance of tax expenditures more generally. The decision on tax expenditures also threatens to destabilize the accepted precedent on the constitutionality of restrictions attached to tax benefits.

Part III explores the policy ramifications of this legal development. From a policy perspective, the Court's expansive interpretation of the taxing power and hands-off approach to tax expenditures encourage increased policymaking of all sorts in the tax law. This is precisely the opposite of what tax reformers advocate because tax expenditures often create problems of inequity and inefficiency. In particular, dollar-for-dollar nonrefundable credits should not be encouraged because they constitute irresponsible budgeting by states, and allow economic and political advantages to flow inequitably to some individuals, while leaving others out. The Court's decisions undermine the

integrity of the tax law, making it harder to raise the revenue needed to address the country's fiscal challenges.

A. *Taxation Is More Powerful Than Regulation, but Tax Cuts Are More Popular*

The *NFIB* decision emphasizes Congress's power to tax where it cannot constitutionally regulate. This privileges taxation over direct regulation and encourages regulatory taxation even where direct regulation would be a more effective alternative. Post-*NFIB*, Congress might choose to tax and thereby allow deleterious activities to proceed, even where prohibition would be better social policy. Nevertheless, the Court's invitation in *NFIB* to regulate with taxation is not excessively alarming because Congress is unlikely to seize the opportunity. In the Affordable Care Act, Congress used the taxing power to regulate beyond the powers of the Commerce Clause. In order to do that, however, it had to increase taxes on individuals, which it generally avoids at all costs, and the continuing public disapproval of the individual mandate provision⁸² explains why. The political unpopularity of increased taxation is likely to constrain the regulation by taxation of "all private conduct" that the *NFIB* dissenters worried about.⁸³ The shared responsibility payment stands out as one of very few tax increases passed by Congress in recent years. As long as raising taxes remains politically unpopular, *NFIB*'s confirmation of the expansiveness of Congress's tax power is unlikely to produce many new and onerous taxes.

From a legal perspective, the *ACS* opinion's conflation of tax cuts with government spending is more significant than the *NFIB* opinion's definition of a tax. While the *NFIB* opinion followed precedent on the scope of the tax power, the *ACS* opinion broke new ground in treating tax expenditures as tax cuts. The practical effects of the *ACS* opinion are also likely to be more significant. The twenty-first century Congress is one of tax cutters, not tax raisers.⁸⁴ The Court's rejection of tax

⁸² In July 2012, after the Court upheld the ACA, sixty-three percent of people surveyed had an unfavorable view of the mandate. See HENRY J. KAISER FAMILY FOUND., KAISER HEALTH TRACKING POLL: PUBLIC OPINION ON HEALTH CARE ISSUES 6 (July 2012), available at <http://www.kff.org/kaiserpolls/upload/8339-F.pdf>.

⁸³ See *NFIB*, No. 11-393, slip op. at 2 (Scalia, Kennedy, Thomas, and Alito, JJ., dissenting).

⁸⁴ See, e.g., Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (2003).

expenditure analysis in its legal reasoning is likely to encourage legislatures to engage in irresponsible behavior. The *ACS* decision created a protected legal space for tax expenditures as compared to their direct spending equivalents, and effectively constitutionalized the definition of tax expenditures, immunizing them from judicial review. The *ACS* decision invites legislatures to tread upon the Bill of Rights with impunity, and they might be politically tempted to do so because they can claim to be cutting taxes. Now that tax expenditures share the legal status of tax cuts, legislatures will be tempted to multiply the programs they administer through the tax law, all the while proclaiming their generosity in passing politically popular tax cuts.

The Court's analysis in *ACS* was more complex than its analysis in *NFIB* on account of the distinction between the relevant constitutional issues. The central issue in *NFIB* was whether the mandate was a tax authorized by Article I, Section 8's power to tax. As soon as the majority determined that it was, the inquiry was largely finished.⁸⁵ If the *ACS* majority had concluded that the statute at issue in that case was a tax, the inquiry would have needed an additional step. A tax would have been legislative action subject to limitation by the Establishment Clause, so the legal analysis would have proceeded to evaluate the constitutional question. The same analysis would have been required if the Court had characterized the credit as its economically equivalent public spending program because federal spending is also subject to the constraints of the Establishment Clause. But the Court's legal reasoning in *ACS* rejected both the tax characterization and the spending characterization; the tax credit was neither taxing nor spending by the legislature, but rather legislative forbearance, so the state did nothing constitutionally important when it allowed taxpayers to reduce their tax bills. The Court's characterization allowed it to dispense with the First Amendment analysis, whereas both taxing and spending would have been subject to further review.

Portraying tax expenditures as an absence of taxation, as the *ACS* Court did for purposes of standing, spills over into the substantive law evaluation of tax expenditures. Because

⁸⁵ A secondary question relating to that authority was whether the Commerce Clause imposes any limitations on Congress's enumerated taxing power. The *NFIB* court concluded that it did not, which kept the constitutional analysis of the tax simple. *NFIB*, slip op. at 43-44.

the consequence of the legislature declining to tax is that the state does not do anything of legal significance when it adopts a tax expenditure, the Court's account of tax expenditures negates any allegation of state action in support of religion from tax credits. Accordingly, it is not surprising that the Court described the subsidy to religion in *ACS* as private, rather than public.⁸⁶ If the legislature has declined to act, there can be no allocation of public funds, so there is no legal issue. The state is not the decision-maker in the Court's analysis, so any religion-supporting action is private action and not subject to constitutional limitation; individual taxpayers decide to contribute their own money to the scholarship organizations so they are the agents supporting religion. If this analysis is extended to all tax expenditures, then tax expenditures only implicate private action, which is not subject to constitutional constraints. This is why the *ACS* opinion shields tax expenditures from constitutional review, elevating tax expenditures to a constitutional status, even where taxes would remain subject to constitutional limits.

B. The Court Takes A Literal Approach to Taxing and Spending Under Flast v. Cohen

A more detailed parsing of the Court's 2011 decision in *ACS* is necessary to fully understand the implications of the holding. The plaintiffs in *ACS* claimed access to the courts as taxpayers under the Court's precedent in *Flast v. Cohen*,⁸⁷ which carved out an exception from the particularized injury requirement generally necessary for a plaintiff to gain access to judicial review. Under *Flast*, taxpayers—as taxpayers—have been allowed to challenge government support of religion as a violation of the Establishment Clause, even where they suffered no unique personal injury. The *ACS* decision was inconsistent with numerous prior cases in which the Court decided challenges to tax-based aid to religion on the merits,⁸⁸ often without any discussion of the standing question. Justice Scalia observed that the majority's opinion in *ACS* eviscerated

⁸⁶ *ACS*, 131 S. Ct. 1436, 1439 (2011).

⁸⁷ 392 U.S. 83 (1968).

⁸⁸ Justice Kagan's dissent cited many of those cases. *ACS*, 131 S. Ct. at 1453 & n.2 (Kagan, J., dissenting).

the taxpayer standing authorized in *Flast*, essentially ending the era of taxpayer standing in Establishment Clause cases.⁸⁹

The demise of *Flast*—whether complete or partial—is a significant development and will be important to the jurisprudence of the Establishment Clause.⁹⁰ Nevertheless, this article is not about the taxpayer standing rule in *Flast*. It's not about standing at all,⁹¹ and takes no position on whether the majority, concurrence, or dissent in *ACS* had the better interpretation on the standing question.⁹² The nuances of Article III are better left to scholars of constitutional law. Rather, the analysis of *Flast* in *ACS* led the Court to its decision that the tax credit is constitutionally meaningless, since it is not “taxing and spending.”

The Court reached the conclusion that the legislature declined to impose a tax by methodically working through the *Flast* standard. It demanded that plaintiffs show that taxpayer property is transferred through government to religion “by means of the taxing and spending power.”⁹³ The notion of taxing and spending, as a required unit, originated with *Flast* because *Flast* focused on the federal government's constitutional power to tax under Article I, Section 8—the same power considered by the Court in *NFIB*—but with a greater focus on the spending element. In *Flast*, the claim was that the Establishment Clause limited the government's constitutional authority to spend funds supporting religion, and the specific issue concerned the direct spending of federal funds for books used by religious schools.⁹⁴ The *Flast* rule was created to allow taxpayer standing because government funding of religion in violation of the

⁸⁹ See *id.* at 1450 (Scalia, J., concurring).

⁹⁰ The effect of narrowing the *Flast* rule in the law of standing could be small in practical effect. There are other plaintiffs with injuries that would be sufficient to support individual standing who can still challenge state tax credit programs on Establishment Clause grounds. See *id.* at 1457 n.7 (Kagan, J., dissenting). *ACS* closes the courthouse doors only to taxpayer plaintiffs complaining of Establishment Clause violations—claims that would have previously been heard, but would not have been the only claims to attack the type of program in Arizona. Thus, while the holding on standing was surprising and new, the practical importance of the Court's decision on the standing issue may be limited.

⁹¹ In a forthcoming project, I will make some observations about when taxpayer standing might be necessary to address Establishment Clause issues in the tax system. See Linda Sugin, When Taxpayer Standing Really Matters (Mar. 2013) (unpublished manuscript) (on file with the Brooklyn Law Review).

⁹² The majority narrowed the *Flast* rule to deny the plaintiffs' standing, the concurrence would have explicitly overruled *Flast*, and the dissent would have allowed the plaintiffs to proceed under *Flast*'s exception.

⁹³ *Id.* at 1438 (internal quotation marks omitted).

⁹⁴ *Flast v. Cohen*, 392 U.S. 83, 85-86 (1968).

Establishment Clause related to the plaintiff's status as a taxpayer and created a taxpayer-relevant injury. The *Flast* court did not dwell on the taxing aspect of the government's action because whenever there is direct spending for particular purposes, it assumed the tax step would precede it—the government has nothing to spend if it does not collect any revenue.⁹⁵ Even though state-law decisions to tax and spend are not governed by Article I, Section 8, the *Flast* standard for allowing taxpayer plaintiffs to challenge state decisions to tax and spend has been adopted into the jurisprudence of federal court review of state law, and the Establishment Clause has been understood to limit state decisions in the same manner as federal decisions.⁹⁶ Consequently, the Supreme Court's understanding of taxing and spending is relevant to determining what falls under the *Flast* standard for state law challenges like the one in *ACS*. It is also relevant to the issue of state action, which is necessary for constitutional limits to apply in any case.

In *ACS*, the Court adopted a highly literal interpretation of the *Flast* standard—requiring *both* taxing and spending for application of Establishment Clause standing. Under that approach, money must actually be collected and then disbursed, in separate steps. Neither of those steps occur for tax expenditures; there is no “extraction” separate from “spending” with tax expenditures. Thus, tax expenditures seem to fall through the cracks of the possible categories that might be subject to judicial review, even though they could reasonably be legally categorized as taxing, spending, or both. Tax expenditure analysis, the mode of thinking about tax provisions as spending equivalents, is necessary to find that both extraction and spending have taken place. It explains how tax expenditures accomplish the result of both taxing and spending simultaneously, by foregoing revenue that would have otherwise been collected under the law. Tax expenditure analysis would treat tax credits like the one in *ACS* as spending provisions by relying on the economic equivalence of the credit and direct spending on scholarship programs.

Since the Court was reticent to employ economic analysis to treat the STO credit as legally equivalent to direct spending, it could have instead subjected the statute to review

⁹⁵ Deficit financing refutes this, but the *Flast* court accepted the taxing element without discussion. *Id.* at 102-06.

⁹⁶ See Nancy C. Staudt, *Taxpayers in Court: A Systematic Study of a (Misunderstood) Standing Doctrine*, 52 EMORY L.J. 771, 794 (2003).

as a tax. An expansive notion of what constitutes a tax would be consistent with the Court's approach in *NFIB*. Like the individual mandate, the Arizona credit was in the state's tax statute, administered by the state's taxing authorities, and accounted for on taxpayer returns. Tax expenditure analysis, however, rejects the tax characterization because tax credits like the one in Arizona fit poorly into the definition of a tax for other purposes. For example, the Supreme Court has long defined a tax in terms of revenue collection—this was one of the reasons it found the shared responsibility payment to be a tax in *NFIB*⁹⁷—but tax credits reduce revenue. Revenue has been an important touchstone for defining a tax under the Tax Injunction Act,⁹⁸ which bars federal courts from interfering with the collection of tax by the states.⁹⁹ In fact, the *ACS* litigation itself had a prior visit to the Supreme Court in 2004, and the majority in that decision held that the Tax Injunction Act did not bar review by the federal court because the challenge to the credit would not “impede Arizona’s receipt of tax revenues.”¹⁰⁰ The Court there refused to treat the whole “state tax system” as a tax under the Tax Injunction Act,¹⁰¹ paving the way for treating the credit as spending. But the author of that earlier opinion dissented in the later *ACS* decision, which rejected the spending characterization in favor of treating the credit as declining to tax.

C. *The ACS Court Makes an Economic and a Legal Mistake*

The *ACS* Court's reasoning was based on two mistakes. The first mistake was economic: the Court treated individuals as spending their own money to support STOs even though there is no economic burden on taxpayers who “support” STOs. It is not necessary to adopt tax expenditure analysis into judicial reasoning to reject that conclusion. The second was legal: the Court treated the *taxpayers'* decision to send money to STOs as legally relevant, whereas the *legislature's* decision to adopt the tax credit should have been the central legal

⁹⁷ *NFIB*, No. 11-393, slip op. at 33 (U.S. June 28, 2012).

⁹⁸ 28 U.S.C. § 1341 (2006).

⁹⁹ *NFIB* also involved a tax injunction issue, under the federal Anti-Injunction Act. The Court concluded that the mandate was not a tax for purposes of that statute, allowing it to reach the merits of the case. That holding is consistent with the revenue focus because it effectively allows Congress to determine whether it will be subject to suits that interfere with revenue collection. *See NFIB*, slip op. at 11-15.

¹⁰⁰ *Hibbs v. Winn*, 542 U.S. 88, 92 (2004).

¹⁰¹ *Id.* at 94.

question. These mistakes together led the majority to the conclusion that the case involved private action of no constitutional concern. It was a short step from the Court's statement that the credit is a decision to decline to impose a tax, to its ultimate conclusion that taxpayers claiming the credit simply "spend their own money."¹⁰² Pursuant to the Court's approach, where the legislature has declined to impose a tax, it has no revenue to spend, so any transfer must come from private sources. Because the entire transaction is the private business of taxpayers, those claiming the tax credit are separate and apart from the rest of Arizona's taxpayers under this approach.¹⁰³

The conclusion that taxpayers who contribute to STOs and claim the attendant tax credit are "spend[ing] their own money" rests on a tortured understanding of what it means to "spend" one's own money. Spending one's own money generally implies that the spender has less of it after the expense. While Arizona taxpayers claiming the credit do physically send their checks to the STOs, they are no poorer for doing so because every dollar that a taxpayer spends on an STO—up to the maximum creditable amount—is reimbursed by the state. Individuals suffer no net outlay from personal resources. This 100 percent credit design is more generous to taxpayers than deductions, or even most credits. For all deductions, and most tax credits, the taxpayer bears an out-of-pocket cost for the underlying expense eligible for the tax benefit because the tax benefit is only part of the dollar expense necessary for claiming the tax benefit.¹⁰⁴ A deduction saves a taxpayer an amount equal to the deducted outlay multiplied by the taxpayer's marginal rate of tax. Because a deduction operates to reduce taxable income, rather than tax, there is always an after-tax cost of a deductible item.¹⁰⁵ The only example in the federal tax

¹⁰² ACS, 131 S. Ct. 1436, 1447 (2011).

¹⁰³ The Court says, "respondents [opposed to the credit] . . . remain free to pay their own tax bills, without contributing to an STO," *id.*, implying that the issues they raised about the credit have nothing to do with the respondents' tax bills, and that the tax bills of those claiming the credit have no effect on the taxpayers who do not claim the credit.

¹⁰⁴ Unlike deductions, credits reduce tax liability by the amount of the credit. So a credit for \$100 saves \$100 in tax. In the federal tax system, however, credits are generally designed to offset only a part of a taxpayer's outlay. For example, the child-care credit in the Internal Revenue Code has a maximum of only thirty-five percent of the child-care expenses incurred, leaving the taxpayer with an after-tax cost of sixty-five percent of the outlaid funds. I.R.C. § 21 (2006).

¹⁰⁵ To illustrate, a \$100 deduction to a taxpayer with a thirty percent marginal rate of tax saves that taxpayer \$30 in tax; the after-tax cost to the taxpayer of the expense is \$70 in that case.

law of a credit as generous as the one at issue in *ACS* is the credit for qualifying educational expenses up to \$2000.¹⁰⁶

Spending one's own money also usually implies substantial autonomy over the spending decision. The broader a statute's eligible class of recipients, the more autonomy taxpayers would have in any spending decision. For example, if the credit had been available for payments to any educational institution, it would have given taxpayers greater autonomy. With the Arizona credit, there is limited autonomy over what receives support because the state has defined the narrow circumstances in which it will reimburse the contribution amount.

In keeping with its assertion that the state is passive in this financing, the Court stated that awarding the credit to STO supporters "allows other citizens to retain control over their own funds in accordance with their . . . consciences."¹⁰⁷ Thus, the Court suggested that private individuals can choose not to spend on STOs, but on something else of their choice. Although this is true, those individuals are worse off than those who contribute to STOs because they have to actually spend their own money without state reimbursement. They need to pay more money to the state in taxes because they are ineligible for the credit. Only the contributors to STOs are allowed to spend the funds as they like. Since the amount of the credit fully reduces the amount of tax owed, it is clear how much additional cash the taxpayer has available for other purposes.¹⁰⁸

The *ACS* Court's legal mistake is more serious than its economic one. The opinion recognized that a government's decision to collect revenue and spend it is a government choice,¹⁰⁹ but it did not acknowledge that the decision to allow tax credits for contributions to STOs is also a government choice. That is why the majority treated the case as involving

¹⁰⁶ This is the American Opportunity Tax Credit. I.R.C. § 25A(i) (extended through 2017 by the American Taxpayer Relief Act of 2012 P.L. 112-240 §103(a) (2013)). Even so, since college expenses often exceed \$2000 per year, the \$2000 cap on the 100 percent credit often requires some taxpayer outlay in addition to the amount reimbursed through the tax system.

¹⁰⁷ *ACS*, 131 S. Ct. at 1447.

¹⁰⁸ To illustrate, Taxpayers *A* and *B* each earn \$10,000. If the tax rate applicable to them is five percent, then they each presumptively pay \$500 in tax, leaving them each \$9500 to spend after tax. If *A* gives \$500 to an STO, he is entitled to the credit and still has \$9500 after tax to spend as he likes. If *B* gives \$500 to a needy person, he is not entitled to the credit. Consequently, *B* has only \$9000 after tax to spend because his \$500 tax liability is not diminished on account of the gift. *B* is out of pocket both the \$500 tax and the \$500 gift to the needy person, while *A* is only out of pocket either the \$500 tax or the \$500 STO payment, but not both.

¹⁰⁹ *ACS*, 131 S. Ct. at 1438.

only private decisions, rather than state action.¹¹⁰ Government choice extends beyond the narrowest categories of taxing and spending to include the myriad ways that government influences private action. All legislation is the product of government choice; the Arizona legislature made the choice to adopt the enabling legislation authorizing STOs,¹¹¹ and it also made the choice to adopt the tax credit that is so important in funding them.¹¹² Arizona's data indicates that only a miniscule percentage of all funds received by STOs are in excess of tax-credited donations, so almost all STO funding, in fact, comes from foregone taxes.¹¹³

The state's role in administering and regulating STOs is also substantial. STOs are certified and listed on the Department of Revenue's website.¹¹⁴ The tax credit that helps to finance STOs is implemented by the state through the apparatus of the state taxing authorities. Like nonprofit organizations generally, STOs are privately controlled by trustees. The fact that there is "no state intervention"¹¹⁵ in the internal operations of individual STOs, however, is not particularly meaningful where the legislated requirements for eligibility largely dictate the business of such organizations.¹¹⁶ The state's role in inducing private parties to organize and support STOs should be included in any assessment of the private role of individuals compared to the public role with respect to these organizations. While it is true that the government does not force anyone to send money to STOs or to take the credit for such outlays, creating a powerful incentive to do so was a legislative choice.

¹¹⁰ The Court treats the STOs and their financing as private matters, undertaken by citizens rather than the state. *Id.* at 1439.

¹¹¹ See *supra* note 67.

¹¹² ARIZ. REV. STAT. ANN. § 43-1089 (2012).

¹¹³ See ARIZ. DEP'T OF REVENUE, PRIVATE SCHOOL TUITION ORGANIZATION INCOME TAX CREDITS IN ARIZONA: A SUMMARY OF ACTIVITY FY 2011, at 2, available at <http://www.azdor.gov/Portals/0/Reports/2011-Private-School-Tuition-Organization-Individual-and-Corporate-Income-Tax-Credit-Report.pdf> (last visited Jan. 30, 2013) ("[t]wenty-eight STOs reported that their revenue equaled their donations, meaning that they had no non-tax credit revenue"); *id.* at 23 (App. II) (showing revenues in excess of tax credit donations).

¹¹⁴ See OFFICE OF ECON. RESEARCH & ANALYSIS, ARIZ. DEP'T OF REVENUE, SCHOOL TUITION ORGANIZATIONS CERTIFIED TO RECEIVE DONATIONS FOR THE INDIVIDUAL INCOME TAX CREDITS (Feb. 1, 2013), available at <http://www.azdor.gov/LinkClick.aspx?fileticket=4LCbUS0EE4w%3d&tabid=114>. It also has a manual for participation. OFFICE OF ECON. RESEARCH & ANALYSIS, ARIZ. DEP'T OF REVENUE, MANUAL FOR SCHOOL TUITION ORGANIZATIONS (June 22, 2012), available at https://www.azscholarships.org/Media/School+Tuition+Organization+Manual_062212.pdf.

¹¹⁵ ACS, 131 S. Ct. at 1448.

¹¹⁶ See *supra* note 67 for the enabling statute.

D. *Tax Benefits Should Be Subject to Constitutional Scrutiny*

I have previously argued that “the government’s role in providing tax benefits should always be evaluated as state action,”¹¹⁷ even though that evaluation does not always result in a finding of unconstitutional state action. The key to the legal analysis of the state’s role depends on whether the statute reflects general principles. The price for government immunity on account of individual choice demands that the government may not too narrowly draw the contours of the beneficiaries.¹¹⁸ Constitutionality depends on a substantive review of the state’s program, along with an inquiry into any related independent decisions made by individuals. Individual agency can interrupt the effects of legislative actions so that private choices are more significant than public choices in determining outcomes, but only if that choice is meaningful. Where the statutory limits are wide, taxpayer action is more meaningful and it is much harder to argue that the government is supporting particular organizations. If a statute provides broad contours with numerous interpretations to be filled in by individuals, then the individual’s role is legally significant and holds more weight, thus the overall scheme would be less likely to reflect government control over funding. In other words, wide entitlements to government benefits that are available to all citizens are more likely to be constitutionally acceptable than narrower ones, even where some recipients of those benefits are religious.¹¹⁹

The law has long been clear that tax expenditures are not necessarily legally equivalent to direct spending, even where they are economic equivalents.¹²⁰ As a result, the Supreme Court is more accepting of tax-based aid to religion over its direct spending equivalent.¹²¹ Consequently, if the ACS Court had reviewed the substance of the Arizona statute, the plaintiffs may well have lost the case under established precedent on tax-based aid to religion.¹²² The judicial inquiry is nuanced, and courts

¹¹⁷ Sugin, *supra* note 69, at 433 (emphasis omitted).

¹¹⁸ *Id.* at 437-38.

¹¹⁹ *Id.* at 437.

¹²⁰ *Id.*

¹²¹ The leading case is *Walz v. Tax Commission of New York*, 397 U.S. 664 (1970) (upholding property tax exemption for churches); *see also* *Mueller v. Allen*, 463 U.S. 388 (1983) (upholding deduction for school costs for all taxpayers).

¹²² Another iteration of the challenge to the Arizona tax credit upheld it on substantive grounds. *Kotterman v. Killian*, 972 P.2d 606, 625 (1999). The Supreme Court denied certiorari in that case. *See* *Kotterman v. Killian*, 528 U.S. 921 (1999); *Rhodes v. Killian*, 528 U.S. 810 (1999).

exercise judgment about which economically equivalent cases are legally equivalent. A tax expenditure constitutes a government establishment of religion only if it fails to satisfy the substantive elements of constitutionality: secular purpose, no primary effect of advancing religion, and no excessive entanglement of government with religion.¹²³ If government action is superseded by meaningful individual choice, a tax expenditure can be constitutional where its equivalent direct appropriation subsidy would not.¹²⁴

In the substantive Establishment Clause analysis, the message of government support for religion can be more important than that of economic support,¹²⁵ so the purposes that are evident in the statute may outweigh the economic consequences of its implementation. Furthermore, tax-based aid generally has less entanglement with religion than direct aid, so it more easily avoids Establishment Clause problems.¹²⁶ Under this substantive criteria, the ACS facts favor the state. First, the statute is neutral with respect to religious and secular schools; there is no mention of religious organizations anywhere in the legislation. And second, the STOs stand between the state and the religious schools so that no money flows directly from state coffers to religious organizations. These distinctions are important to the substantive constitutional evaluation of Establishment Clause claims, so the ACS majority did not need to characterize tax expenditures as tax cuts or private spending to uphold the STO credit. For these reasons, the plaintiffs would likely have lost on the merits if the Supreme Court had reached them, despite the fact of economic equivalence.

The taxpayer's own out-of-pocket, after-tax cost elevates the role of individuals relative to the state because it tips the legal balance further towards individual purposefulness. For example, under the federal charitable contribution deduction¹²⁷ the financial commitment that the taxpayer must make to garner the state's contribution is substantial.¹²⁸ Thus, there might be enough individual agency to separate the state from

¹²³ These are described in *Lemon v. Kurtzman*, 403 U.S. 602, 612-13 (1971).

¹²⁴ See Sugin, *supra* note 69, at 437, 446, 461.

¹²⁵ See *Lee v. Weisman*, 505 U.S. 577, 584-85 (1992); *Lynch v. Donnelly*, 465 U.S. 668, 678 (1984); see also Sugin, *supra* note 69, at 465.

¹²⁶ See Sugin, *supra* note 69, at 466-67.

¹²⁷ I.R.C. § 170 (2006).

¹²⁸ The top marginal rate under current law is thirty-five percent, so any contribution deducted under § 170 leaves the taxpayer with a sixty-five percent after-tax cost. Appreciated property is an exception to this because gain is untaxed while fair market value is deducted. Treas. Reg. § 1.170A-1(c) (2012).

the charitable recipient.¹²⁹ For the Arizona tax credit, the individual plays a purely ministerial role in choosing the STO to which the government's reimbursement will be paid. The individual is merely a conduit for the government funds, so both individual agency and individual cost are very limited.

By describing the support of STOs as purely private decisions of individuals, the ACS majority appeared confused about the nature of the plaintiffs' complaints. The opinion states, "any injury suffered by respondents would not be remedied by an injunction limiting the tax credit's operation."¹³⁰ This statement indicates that the majority imposed a private action perspective onto the complaint. But the plaintiffs were not challenging private support for STOs; they were challenging the tax credit's public subsidy of that private support. Since the Court refused to recognize the tax credit as public support, however, the majority did not acknowledge their grievance. Enjoining application of the tax credit would certainly have addressed their concerns.

The Court's interpretation of government action and private action understated the significance of government actions in shaping policies, while simultaneously overstating the private nature of actions that would be unlikely to occur without the government's intervention. Should the Supreme Court insist that there be absolutely no discretion by citizens in order to be considered a statutory scheme reviewable as government action, it would ignore the most effective regulatory tool of taxation, which is precisely what it upheld in *NFIB*.

E. Treating Tax Expenditures as Tax Cuts Jeopardizes Settled Law Permitting Conditions Attached to Tax Benefits

If tax benefits are no longer to be understood as government spending for favored activities, the law's limits are not attached to government largesse, but to private actions. Congress has chosen to limit the benefits flowing from tax expenditures in various ways, and the Supreme Court has long allowed those limitations. The Court has held that government may condition its own generosity on recipients' surrender of constitutional rights, even where it would be unconstitutional

¹²⁹ The Supreme Court has specifically upheld charitable exemptions and deductions for religious organizations. See generally *Walz v. Tax Comm'n of New York*, 397 U.S. 664 (1970).

¹³⁰ ACS, 131 S. Ct. 1436, 1448 (2011).

to limit the actions of private persons. The jurisprudence of these limitations rests on the Court's characterization of tax expenditures as public subsidy and government privileges. The ACS Court's reasoning threatens to undermine the law of constitutional conditions on government benefits that are administered through the tax law because it disturbs the subsidy-privilege paradigm. If tax expenditures are no longer treated as government privileges, then the conditions the government imposes on them would no longer be constitutional.

In prior cases, the Supreme Court recognized that tax expenditures function as the equivalent of direct government spending. The leading authority on this issue is *Regan v. Taxation with Representation (TWR)*,¹³¹ though the ACS majority's reasoning destabilizes that precedent. In *TWR*, a nonprofit organization challenged the lobbying limitations in § 501(c)(3) of the Code.¹³² It claimed that the lobbying limitations on exempt charitable organizations were unconstitutional under the First Amendment,¹³³ an argument that the Court rejected. The organization was allowed to lobby through an affiliate not organized as a charity for tax purposes,¹³⁴ but not as a substantial part of its own charitable activities. The Court focused on the benefit of exemption under § 501(c)(3): only § 501(c)(3) organizations are eligible to receive tax-deductible contributions on the condition that the organization adheres to rigorous statutory limits on lobbying. The issue in the case was whether it was constitutional to condition the deductibility of donor contributions on how strictly the organization limited its lobbying. The Court determined that it passed constitutional muster, even though lobbying is constitutionally protected speech.

The characterization of the charitable exemption/deduction as a subsidy for § 501(c)(3) organizations was the linchpin in the decision. It allowed the Court to uphold the political limitations on charitable organizations by concluding, "Congress has merely refused to pay for the lobbying out of public moneys."¹³⁵ Although Justice Rehnquist did not use the term "tax expenditure" in the

¹³¹ *Regan v. Taxation with Representation of Wash. (TWR)*, 461 U.S. 540 (1983).

¹³² That section describes organizations exempt from tax (and eligible to receive deductible contributions) to require that "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . and which does not participate in, or intervene in . . . any political campaign . . ." I.R.C. § 501(c)(3) (2006).

¹³³ There was also an equal protection claim not relevant to the issue here.

¹³⁴ The affiliate was a social welfare organization, exempt from tax under § 501(c)(4), but not eligible to receive deductible contributions from donors. *TWR*, 461 U.S. at 543.

¹³⁵ *Id.* at 545.

majority opinion, he unmistakably adopted the lessons of tax expenditure analysis. He wrote:

Both tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income. Deductible contributions are similar to cash grants of the amount of a portion of the individual's contributions.¹³⁶

It was important in the case that Taxation with Representation could forego its § 501(c)(3) status and engage in lobbying, or have a non-charitable affiliate lobbying with non-deductible contributions. The price for lobbying was that no deduction would be allowed for its contributors.¹³⁷ The Court's holding that the restriction on substantial lobbying was not an unconstitutional condition on free speech depended on the Court's characterization of the restriction, and it did not treat the loss of the donor deduction as a penalty on exercising a constitutional right. Instead, it treated the grant of the exemption as a privilege that could have conditions attached.

Similarly, in *Branch Ministries v. Rossotti*, the D.C. Circuit decided that § 501(c)(3)'s restriction on political campaign activity of charities, including churches, was not an unconstitutional condition burdening the free exercise of religion.¹³⁸ In that case, a church had sponsored a Presidential campaign advertisement and solicited tax-deductible contributions on the face of the ad.¹³⁹ The government revoked the church's § 501(c)(3) status and its ability to receive deductible contributions from donors.¹⁴⁰ The court upheld the exemption revocation on tax expenditure analysis reasoning, treating the charitable deduction as a benefit that could be constitutionally conditioned on refraining from engaging in political campaigns.¹⁴¹ Judge Buckley explained that the church's free exercise right was not itself burdened by the loss of the exemption; the lost exemption reduced the money available to the church, but did not require that the church do anything contrary to its religious beliefs.¹⁴²

¹³⁶ *Id.* at 544.

¹³⁷ Section 501(c)(4) organizations are allowed to engage in substantial lobbying. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (2012).

¹³⁸ *Branch Ministries v. Rossotti*, 211 F.3d 137 (D.C. Cir. 2000).

¹³⁹ *Id.* at 140.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 142.

¹⁴² *Id.* (“[T]he Church does not maintain that a withdrawal from electoral politics would violate its beliefs. The sole effect of the loss of the tax exemption will be to decrease the amount of money available to the Church for its religious practices.”).

The church could still engage in political campaign activity if it felt compelled to do so. However, it could not both retain its § 501(c)(3) status and engage in politicking.¹⁴³ It was important to the holding that the statute did not require that the church or its members engage in any religiously proscribed activity, which would have been unconstitutional.¹⁴⁴ Instead, the statute withdrew a “conditional privilege for failure to meet the condition.”¹⁴⁵ *Branch Ministries* clarified the jurisprudence of unconstitutional conditions on tax benefits by distinguishing between (1) requiring that a person do something proscribed by his religious conviction—which is not legally permissible—and (2) limiting constitutionally protected activity as a condition on a tax-based benefit—which is legally permissible.

These two cases make clear that as long as there is a “privilege,” it can be conditioned on waiving constitutional rights.¹⁴⁶ But if tax expenditures are legislatures declining to act, as the *ACS* majority believed, then there is no way to distinguish among different species of tax reductions for purposes of determining which ones can be constitutionally conditioned. Without tax expenditure analysis and the judicial treatment of the tax benefit as a form of subsidy, there is no privilege on which to hang a restriction. Without a government subsidy, the *TWR* court’s description of the government paying for lobbying makes no sense, and *Branch Ministries*’ “conditional privilege” disappears. If a tax expenditure is not a subsidy, as the *ACS* decision insisted, then the lobbying and campaign limitations in § 501(c)(3) may become unconstitutional restrictions on speech or religion. This is a consequence that the Court failed to consider when it reconceptualized tax expenditures in *ACS*.

¹⁴³ *Id.* at 143-44.

¹⁴⁴ This was essentially the holding of *Speiser v. Randall*, 357 U.S. 513, 515, 532 (1958) (striking down property tax exemption required signing patriotic declaration).

¹⁴⁵ *Branch Ministries*, 211 F.3d at 142.

¹⁴⁶ It is not clear how much Congress would be allowed to condition the § 501(c)(3) exemption and whether there are any limits to the *TWR* doctrine. For example, there has been no test of whether Congress can regulate solicitation of charitable giving through the exemption, something that states and localities have been unable to do as a matter of direct regulation. See *Riley v. Nat’l Fed’n of the Blind*, 487 U.S. 781, 784-87 (1988). The non-political limitations in § 501(c)(3), such as the prohibition on private inurement, do not implicate free speech concerns and are more integral to the purpose of the exemption.

F. *The ACS Decision Could Have Unintended Consequences*

The definition of a tax expenditure is not strong enough to bear the weight of constitutional status,¹⁴⁷ as the Court now requires it to do. This is precisely why it is so troublesome for the Court to make tax expenditures nonreviewable simply because they are tax expenditures rather than actual spending from extracted taxes. Because the tax-cut characterization applies equally to all tax expenditures, *ACS* could resonate beyond the Establishment Clause and shield tax expenditures that are suspect under other constitutional provisions, such as the Equal Protection Clause.¹⁴⁸ Justice Kagan was certainly right when she stated in her dissent that the Court's *ACS* opinion offers a "one-step instruction[] to any government that wishes to insulate its financing of religious activity from legal challenge."¹⁴⁹ "[T]he government need follow just [the] simple rule—subsidize through the tax system—to preclude taxpayer challenges to state funding of religion."¹⁵⁰ But her concern, directed only to the standing question under *Flast*, was too narrow. The Court's *ACS* opinion implies that legislation that can be characterized as a tax cut will be completely immune from constitutional scrutiny for any purpose.

Arizona parents or children would have sufficient personal injury to challenge the tax credit under the rules for standing.¹⁵¹ But the *ACS* majority's reasoning guts the claims that would be made by those parents or children on the merits. Even beyond the standing context, the decision suggests that the children are not harmed by anything that the state has done. They are harmed instead only by the private decisions of the individuals who choose to organize STOs and contribute their own money to them. The key aspect of the majority's opinion is that there is no government support in the tax credit; legislative forbearance, from their perspective, lacks both the policy purpose and the financial baseline necessary to constitute

¹⁴⁷ I discussed this at length in Sugin, *supra* note 69, and argued that structural provisions of the tax should not be immune from constitutional review.

¹⁴⁸ For a discussion of equal protection and tax expenditures, see Sugin, *supra* note 69. In that article, I argued that it would be a bad idea to constitutionalize tax expenditure analysis. At that time, I did not imagine the Court would go significantly further and protect tax expenditures from constitutional review.

¹⁴⁹ *ACS*, 131 S. Ct. 1436, 1462 (2011) (Kagan, J., dissenting).

¹⁵⁰ *Id.* at 1450.

¹⁵¹ *Id.* at 1448-49 (majority opinion); *id.* at 1457 n.7 (Kagan, J., dissenting).

government support because declining to tax implies an absence of policy.

Characterizing the STO credit as a tax cut makes the distinction between tax cuts and government spending purely formal, with potentially bizarre legal consequences. For example, the Court's analysis would mean that a provision modeled after the U.K.'s system of charitable subsidies would be subject to a constitutional challenge because it comprises both extraction and spending by the government, while our current charitable deduction model would not be subject to review because it lacks those two elements. In the U.K., the government directs the tax subsidy for charitable contributions directly to the charities,¹⁵² rather than reducing the tax liability of the contributors by that amount, as is the case in the U.S. system.¹⁵³ An important recent proposal to reform the charitable contribution in the United States, proposed by the influential Bipartisan Policy Center,¹⁵⁴ would provide a matching grant system similar to the one in the U.K., which would distinguish it, as a legal matter, under the ACS court's approach, from the deduction under current law.

The legal analysis of tax expenditures becomes truncated on account of the ACS Court's characterization of the state's decision as one to *not* tax. Taken to its logical conclusion, the state would be free to decline to tax on any basis that it wants—a tax credit for payments to racially discriminatory schools, contrary to the clear precedent of *Bob Jones University v. United States*,¹⁵⁵ would be an acceptable decision not to tax. The Court's reasoning could apply to tax credits more specifically drafted to benefit religion. For that matter, a tax credit for Christians only would also be a decision not to tax, though it would clearly be precisely the kind of thing that the Establishment Clause should prohibit. In short, the Court's decision to characterize a tax credit as the state declining to impose a tax proves too much. Not only does it shelter Arizona's STO credit from review, but it potentially protects

¹⁵² See Income Tax (Earnings and Pensions) Act 2003, 2003, c. 1, § 713 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2003/1/section/713>. The British equivalent of the U.S. Internal Revenue Service explains the operation of its system on its website. *Giving to Charity Through Gift Aid*, HM REVENUE & CUSTOMS, <http://www.hmrc.gov.uk/individuals/giving/gift-aid.htm> (last visited Jan. 30, 2013).

¹⁵³ See I.R.C. § 170 (2006).

¹⁵⁴ BIPARTISAN POLICY CTR., RESTORING AMERICA'S FUTURE 27 (2010) (describing the credits for charitable contributions as going directly to the charitable institutions).

¹⁵⁵ 461 U.S. 574 (1983).

any other provision in a tax statute that reduces ultimate tax liability, regardless of the provision's design or effect. Since tax expenditures are characterized in the negative—as an absence of affirmative government action—it could now be impossible to get constitutional review of any tax expenditure. This is precisely the opposite of how courts should approach tax statutes; any provision of the tax law, whether it functions as integral to taxing or a substitute for spending, should have to withstand constitutional scrutiny on the merits.¹⁵⁶

It is also possible that the majority's approach will extend beyond tax expenditures. Justice Thomas has been trying to reduce the scrutiny of both tax expenditures and direct spending for some time. In *Rosenberger v. Virginia*, instead of arguing for scrutiny of tax expenditures on the same terms as direct expenditures, as do the advocates of tax expenditure analysis, Justice Thomas instead argued against scrutiny for direct spending on account of the existence of equivalent tax expenditures.¹⁵⁷ *ACS* may be the beginning of the slippery slope that leaves tax expenditures (now) and direct spending (later) largely unreviewable for constitutional violations. These are reasons to worry about the Roberts Court's tax precedents.

III. POLICY IMPLICATIONS OF THE ACS DECISION

A. *The Court Encourages More Non-Revenue Policy in the Tax Law, When There Is Too Much Already*

The Supreme Court's reasoning in *NFIB* and *ACS* is troubling from a policy perspective because it encourages legislatures to use the tax law to achieve non-revenue policy. When non-revenue policies make their way into the tax law, they are often revenue losers hidden from the political process—a significant problem given the current dire fiscal situation. Even revenue raisers are undesirable if they are hidden

¹⁵⁶ See Sugin, *supra* note 69, at 418-24 (arguing that income-defining provisions should be subject to the same constitutional scrutiny as tax expenditures). In that article, I focused on the problem of insulating normal structural provisions of the tax law from constitutional scrutiny. What the *ACS* Court has now done is far more radical than that; it has now insulated any provision of the tax law from challenge on Establishment Clause grounds simply because it is a provision of the tax law. Both structural provisions and tax expenditures would be unchallengeable under the majority's interpretation.

¹⁵⁷ See *Rosenberger v. Rector & Visitors of Univ. of Va.*, 515 U.S. 819, 845-55 (1995); see also discussion in Sugin, *supra* note 69, at 463.

in the tax law as a way to bypass legitimate restraints in the political process. Non-revenue policies in the tax law, whether they happen to gain or lose revenue, directly burden revenue collection by diverting administrative resources, thereby harming the effectiveness of governmental administration.

The practice of loading up the tax law with non-revenue policy is already at a critical point. The Internal Revenue Code is bloated with all sorts of policies that tax administrators are not specialized in interpreting or accustomed to carrying out. In addition to raising revenue, the Code is now burdened with health care policy,¹⁵⁸ housing policy,¹⁵⁹ family policy,¹⁶⁰ and education policy,¹⁶¹ among others. Only a few of these disparate policies have synergies with revenue collection. The proliferation of these policies in the tax law has distorted the political process, concentrating power in the tax-writing committees.¹⁶² It has allowed politicians to pretend that they are reducing the size of the government while actually increasing it. These policies burden the IRS with an obligation to enforce provisions that its expertise in revenue collection fails to prepare it for.¹⁶³ Some non-revenue provisions are justifiable because they are related to the functions carried out by the tax law and are more efficiently administered through the current tax law's existing apparatus,¹⁶⁴ but many provisions

¹⁵⁸ The exclusion for employer-provided health insurance is the single most expensive tax expenditure in the budget, estimated at over \$180 billion for fiscal 2013. See ANALYTICAL PERSPECTIVES 2013, *supra* note 23, at 261 tbl.17-3.

¹⁵⁹ The home mortgage interest deduction is the second largest item on Treasury's list, at approximately \$101 billion. See *id.* But the home mortgage interest deduction, I.R.C. § 163(h)(3) (2006), is only one of numerous provisions related to housing. Homeowners may also exclude the gain on their home sales, *id.* § 121, and deduct their property taxes, *id.* § 64. Developers can depreciate residential housing more quickly than other buildings. *Id.* § 168(c).

¹⁶⁰ In addition to the child credit and dependency deduction, *id.* §§ 24, 151, there are credits for the costs of adoption, *id.* § 23, and child care, *id.* § 21.

¹⁶¹ There are credits for education expenses, *id.* § 25A, a deduction for interest on education loans, *id.* § 221, an exclusion for employer financed education expenses, *id.* § 127, and tax-preferred savings vehicles for education expenses, *id.* §§ 529, 530.

¹⁶² See Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1, 3 (2010).

¹⁶³ The Affordable Care Act is a tremendous burden on the IRS, requiring additional funding. See *Written Testimony of Douglas H. Shulman Comm'r of Internal Revenue Before the H. Appropriations Comm. Subcomm. on Fin. Servs. & Gen. Gov't on FY 2013 Budget*, Mar. 21, 2012, at 9, 11, available at <http://appropriations.house.gov/uploadedfiles/hhrg-112-ap23-wstate-dhshulman-20120321.pdf>.

¹⁶⁴ The earned income tax credit is probably the best example. See David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 961 (2004).

do not. We need to worry whether tax policy swallows up too much of the rest of the government.

The ACS majority's approach to tax expenditures conflicts with the methodology used by the other branches of government and is in conflict with the prevailing understanding in public debate and scholarly analysis. The Joint Committee on Taxation and the Treasury Department, the government's taxation and budget experts, do not characterize tax expenditures as tax cuts, but treat them as functionally equivalent to spending.¹⁶⁵ The mantra of tax reformers has been to simplify the tax law and repeal tax expenditures, not promote them.¹⁶⁶ The most important recent proposal on reforming the whole tax system adopts as its basic framework a goal of broadening the base and lowering the rates.¹⁶⁷ That means repealing tax expenditures, not expanding them.

There are good reasons why reformers generally want to reduce the number and cost of tax expenditures. They increase the complexity of the tax law, and are often inefficient or inequitable.¹⁶⁸ Some provide benefits only to the highest-income taxpayers.¹⁶⁹ Some are shameless giveaways to special interests.¹⁷⁰ Some provide incentives to engage in activities that are not in the country's long-term interest.¹⁷¹ That said, I am critical of the wholesale attack on tax expenditures in the recent reform proposals and I have argued that distributional concerns

¹⁶⁵ The Office of Management and Budget states that tax expenditures are "alternatives to other policy instruments, such as spending." ANALYTICAL PERSPECTIVES 2013, *supra* note 23, at 247.

¹⁶⁶ In his recent proposal on corporate tax reform, President Obama recommended repealing targeted provisions available to corporations that reduce their taxable income. In connection with that base broadening, he proposed reducing the highest marginal corporate rate. See WHITE HOUSE & DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM (Feb. 2012), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf> [hereinafter JOINT REPORT].

¹⁶⁷ NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH 29 (2010) (often known as the Bowles-Simpson Report) [hereinafter MOMENT OF TRUTH]; see also BIPARTISAN POLICY CTR., RESTORING AMERICA'S FUTURE 30 (2010).

¹⁶⁸ This was the reason why Stanley Surrey believed it was important to identify tax expenditures and give them a name, as he did. See STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 136 (1973).

¹⁶⁹ See Leonard E. Burman, Christopher Geissler & Eric J. Toder, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?*, 98 AM. ECON. REV. 79, 82 (2008). In 2007, the preferential rates on capital gains and dividends were enjoyed by the "top 1 percent of taxpayers and provide[d] little income gain for anyone else." *Id.*

¹⁷⁰ See Sugin, *supra* note 57, at 41.

¹⁷¹ This is why President Obama has suggested eliminating the tax preference for fossil fuels. See JOINT REPORT, *supra* note 166, at 9.

demand a more nuanced approach to tax expenditure reform.¹⁷² Nevertheless, there is no question that tax expenditures need to be reviewed as part of comprehensive reform.

The debate about tax reform taking place in government, in the media, and in academia, reflects a uniform acceptance of tax expenditure analysis and its core principle that tax expenditures are equivalent to government spending and need to be evaluated on those terms. The Supreme Court's insistence that tax expenditures are not the same as spending is therefore at odds with the framework shared by virtually everyone else who has thought about the issue. The *ACS* decision sends the judiciary in a unique direction by equating tax expenditures with rate reductions.¹⁷³ Treating tax expenditures as tax cuts encourages irresponsible budgeting and disenfranchises low-income taxpayers who are unable to benefit from the tax credits. While the high Court is purposely insulated from the political process, its position on tax expenditures makes it appear that the justices are completely clueless about the necessary direction our fiscal policies need to take.

B. ACS Encourages Legislatures and Courts to Treat Tax Expenditures as Costless

The Court's *ACS* opinion also encourages increased policymaking in the tax law by offering the dubious economic argument that reducing taxes does not reduce revenue and by suggesting that nobody needs to bear the burden of taxation. It was not necessary for the Court to discuss this issue when reaching its holding, and it is troubling that it did, because the opinion encourages legislatures to treat tax expenditures as though they are free, even though they are not. Recognizing and identifying what parties bear the burden of taxes, even if they are in future generations, is important to responsible public budgeting. Similar to treating tax expenditures as tax cuts, this aspect of the *ACS* decision makes tax expenditures disappear from the legal regime, creating another conflict between legal and economic analyses.

¹⁷² See Sugin, *supra* note 57, at 6, 40-42.

¹⁷³ This aligns the Court with the tax expenditure fringe occupied by Grover Norquist, who is on a quest to starve the government of revenue by any means possible so that it can be "drowned in a bathtub." Paul Krugman, *The Tax-Cut Con*, N.Y. TIMES, Sept. 14, 2003 (Magazine), at 57.

A closer look at the *ACS* opinion is helpful to understand the analysis. The first part of the opinion explained why taxpayers, generally, lack standing to challenge government actions they do not like.¹⁷⁴ *Frothingham v. Mellon*,¹⁷⁵ which established the doctrine against taxpayer standing, described a taxpayer's injury—*qua* taxpayer—as too “remote, fluctuating and uncertain” and shared by everyone, so that no case or controversy was presented for judicial review. Instead, taxpayer complaints about government spending presented an issue to be resolved in the political process. *Frothingham* contained the reasonable observation that each government spending decision is financed by miniscule exactions from individuals, none of which—standing alone—is significant enough to support standing.

The *ACS* opinion took the *Frothingham* idea—that no taxpayer suffers when the state expends funds—a step further, by rejecting the notion that there is any cost at all to taxpayers when the state spends resources. The burden on taxpayers is not just miniscule—as it was under the *Frothingham* analysis—it totally disappears. The *ACS* Court came to this conclusion by explaining that the government's budget does not necessarily suffer when it “expends resources or declines to impose a tax”¹⁷⁶ because (1) reduced taxation raises revenue, and (2) increased government spending reduces government costs. While both these inferences are possible, neither is likely.¹⁷⁷ The Court's legal conclusion on the injury question was thus dependent on dubious economic assumptions.

Reducing taxation can only raise revenue if there is enough economic growth to produce sufficient additional revenue to cover the loss from the reduction. Unfortunately, there is little evidence that tax cuts will work that way, at least at the levels of taxation that have actually been in effect. As the 2001 and 2003 tax cuts have shown, cutting taxes reduces

¹⁷⁴ There was no dispute on this issue; it has been settled for decades that there is no all-purpose taxpayer standing because taxpayers generally have insufficient injury to challenge government actions. The Court could have proceeded straight to an analysis of *Flast's* exception, which grants taxpayers standing despite their lack of particularized injury. Instead, the Court used the opportunity to create a novel framework for analyzing public economics. *ACS*, 131 S. Ct. 1436, 1444 (2011).

¹⁷⁵ 262 U.S. 447 (1923).

¹⁷⁶ *ACS*, 131 S. Ct. at 1437.

¹⁷⁷ For a succinct review of the literature on reducing rates to maximize revenue, see Bruce Bartlett, *What is the Revenue-Maximizing Tax Rate?*, TAX NOTES, Feb. 20, 2012, at 1013.

revenue,¹⁷⁸ and raising taxes increases revenue.¹⁷⁹ The revenue-from-growth argument is one that can only apply to business credits, not to personal credits like the one in *ACS*, because the tax reduction must translate into economic growth that produces more taxable income for the math to work. The *ACS* majority cited an earlier ruling it had made on business tax credits to support that statement, even though the cited case does not clearly take that economic position adopted in the later decision.¹⁸⁰ It is surprising that the Supreme Court chose to take a contested position on the economic effects of tax credits at all since there was no argument in *ACS* that the STO credits produced revenue that paid for the cost of those credits.

Instead, the Court maintained that the plaintiffs could suffer no injury because STOs support private school education, and that private school education reduces public costs because it relieves the government of the burden of educating the children who could have attended public schools.¹⁸¹ Reducing the burdens of government is a common justification for tax benefits for nonprofit organizations, and may even be an argument for treating tax benefits for such institutions as part of a normative tax structure. And it is possible that the STO credit saves Arizona money.¹⁸² But that

¹⁷⁸ See CONG. BUDGET OFFICE, CHANGES IN CBO'S BASELINE PROJECTIONS SINCE JANUARY 2001 (June 7, 2012), available at <http://www.cbo.gov/sites/default/files/cbofiles/attachments/06-07-ChangesSince2001Baseline.pdf>.

¹⁷⁹ See CONG. BUDGET OFFICE, AN ECONOMIC ANALYSIS OF THE REVENUE PROVISIONS OF OBRA-93 (1994), available at <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/48xx/doc4832/doc03.pdf>; CONG. BUDGET OFFICE, THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE 32 (1997), available at <http://cbo.gov/sites/default/files/cbofiles/attachments/Eb09-97.pdf>.

¹⁸⁰ See *ACS*, 131 S. Ct. at 1443-44 (citing *DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332, 334 (2006) (denying standing in business context)).

¹⁸¹ *Id.* at 1444.

¹⁸² If the state legislature designed this credit as a way to reduce the state's burden in providing public school education, it would have had alternative programs, some of which could have been tax-based, that might have been more effective. Tax-based incentives are generally designed to encourage taxpayers to spend some of their own money on something, so the 100 percent credit seems unusually generous. Some of the alternative programs that the state could have adopted to support private school education would not have been eligible for the tax benefits allowed under the STO credit, so the credit may have been designed to avoid the problems inherent in other designs. For example, a credit to the parents of private school students has encountered constitutional difficulty where parents claimed tax benefits for religious education.

Special tax benefits, however, cannot be squared with the principle of neutrality established by the decisions of this Court. To the contrary, insofar as such benefits render assistance to parents who send their children to sectarian schools, their purpose and inevitable effect are to aid and advance those religious institutions.

conclusion can only be proven with empirical evidence that shows that the savings on education exceeds the cost of the credit, and that there is a causal connection between the tax credit and attendance at private schools.¹⁸³

The Court's economic conclusions—that reducing taxes raises revenue and that increasing spending reduces costs—are important beyond the taxpayer standing question. If we take these conclusions seriously, they should also apply to individuals challenging tax credits who would have personal injury standing. For example, parents whose children were unable to receive STO scholarships because they do not practice the specified religion might suffer no injury under this analysis because the state incurs greater cost for educating their children in public school. The Court's approach to such a tax benefit undermines the injury argument itself, further insulating these provisions from legal attack.

Another aspect of the Court's discussion that tax credits are free is worth considering. The Court suggested that the plaintiffs may have no injury because if there were no tax credits, the government might have collected the money and used it for something else.¹⁸⁴ If the government had spent the money on something not currently funded at all, the taxpayer would be in the same position as with the credit in place. While it is true that government can choose to spend on something

Comm. for Pub. Educ. & Religious Liberty v. Nyquist, 413 U.S. 756, 793 (1973). *But see* Mueller v. Allen, 463 U.S. 388, 390-91 (1983) (upholding tax benefit). It is not clear whether the STO credit was designed to benefit donors, student families, or taxpayers generally, or what its effect has been, so the Court's position on the burdens of government is pure speculation.

¹⁸³ The ACS Court assumed that the scholarship assistance provided through the STO program encouraged families to send their children to private schools when they otherwise would have relied on public education. But there is no evidence in the record that the scholarships actually incentivized families to send their children to private school. If those children would have attended private schools even if there had been no scholarships subsidized by the tax credit, then the scholarships are simply windfalls to the families of recipients. Similarly, if donors would have financed scholarships for needy families without any tax incentive, the credits are windfalls to the donors who receive them. In neither windfall case does the tax credit operate to reduce the burden of government because in both scenarios, the demand for private school would be unaffected by the credit. The ACS Court also assumed that the existence of private schools reduces government cost of public schools, another empirical question. Whether Arizona's private schools reduce the cost of public education depends on the concentration of private schools and the overhead costs compared to the marginal costs of public education. Holding all else constant, in order to determine whether total taxes would go up or down without the STO tax credit provision, it would be necessary to know how the credit affects the decisions of both donors and parents of scholarship students, and how the existence of private schools affects the funding of public schools.

¹⁸⁴ *Id.*

other than what it currently chooses to spend on, that choice is not irrelevant to individual taxpayers, and it is troubling that the Court's treatment made so little of it. Arizona's choice to direct funds to STOs means that tax revenues are not being collected that could be collected and used for something that would have benefited the taxpayer-plaintiffs more than the STO program. It is a mistake to assume that taxpayers should not care how revenues are used as long as their personal tax liability does not change. Debates about taxation too often ignore the spending side of the budget, and this argument reflects that myopia. The costs and benefits of government to any individual depend on both that individual's tax liability and that individual's share of government benefits, in whatever form they take. Equal tax liabilities do not imply equal overall packages of government burdens and benefits.

Targeted tax benefits, as a whole, represent a significant allocation of government resources. The Court's approach—treating each particular tax expenditure as costless—has produced a federal budget where spending on tax expenditures exceeds revenue collected.¹⁸⁵ Most tax expenditures are small, and therefore, insignificant as a budgetary matter taken alone, but they add up on the federal level to over a trillion dollars a year.¹⁸⁶ It is not conducive to good federal policy to treat tax expenditures as free, and there would certainly be increased revenue if we repealed all tax expenditures, which is precisely why tax reform today is about repealing tax expenditures.¹⁸⁷ Thinking that tax expenditures are tax reductions for particular individuals rather than government spending financed by all, disassociates taxes from the burdens on individuals. While no identifiable taxpayer is substantially injured by a single tax expenditure, the totality of tax expenditures threatens the country's fiscal viability. The Court's assertion of a no-cost perspective makes tax reform that much harder.

¹⁸⁵ See OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, FISCAL YEAR 2012, at 167 tbl.8.7, 346 tbl.15.4 (2011), available at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/hist.pdf>.

¹⁸⁶ HUNGERFORD, *supra* note 71, at 13.

¹⁸⁷ The Fiscal Commission's starting point is a repeal of all tax expenditures. It builds on that idea by adding back some provisions and raising rates to finance them. See MOMENT OF TRUTH, *supra* note 167, at 29.

C. *Muddling Tax Credits with Tax Cuts Undermines the Coherence of the Tax Law*

The tax expenditure budget was designed to provide conceptual clarity in the tax law.¹⁸⁸ It categorizes some statutory provisions as part of the structure of the tax, and others as extraneous to that structure.¹⁸⁹ Unlike elements in the tax law that are necessary to accurately measure income, like deductions for business expenses, if all tax expenditures were repealed, the tax law could still effectively carry out its revenue collection function. Without tax expenditures, however, tax law could no longer incentivize and subsidize particular activities, a concededly important function of the federal tax system. While the federal income tax is a far cry from an ideal income tax, there are general rules in the tax law that make the system operate in a moderately consistent way.¹⁹⁰ The ACS majority confuses the analysis of taxation by failing to recognize that there is a principled distinction between reducing taxes, on the one hand, and spending in the tax law, on the other. Tax cuts are about reducing burdens on individuals while spending is about targeting government resources for particular purposes.

Conflating tax expenditures with tax cuts threatens the logic of the tax system because it incorrectly equates provisions necessary for accurately measuring the tax base with provisions that depart from base measurement. While there is not complete agreement on which items constitute tax expenditures, there is broad acceptance that most of the items that are treated as tax expenditures do share a spending character.¹⁹¹ The reasonable disagreements about compiling the list of tax expenditures largely reflect differences about whether the underlying baseline should reflect income or consumption tax principles.¹⁹²

The hard issues in defining what constitutes a tax expenditure are not raised by the tax credit in the ACS case.¹⁹³

¹⁸⁸ See SURREY & MCDANIEL, *supra* note 62, at 26.

¹⁸⁹ See ESTIMATES OF FEDERAL TAX EXPENDITURES, *supra* note 61, at 5.

¹⁹⁰ STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 1, 10 (Joint Comm. Print 2008) [hereinafter RECONSIDERATION REPORT].

¹⁹¹ The Joint Committee and the Treasury have very few differences in their compilations.

¹⁹² See Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 189 (2004).

¹⁹³ The Joint Committee on Taxation, in its comprehensive review of tax expenditures, created a new category that it called "Tax-Induced Structural

Credits are applied against tax, not against gross income, so they do not contribute to the determination of the tax base. For this reason, there is greater resemblance between tax credits and direct expenditures than there is between deductions—which also reduce ultimate tax liability—and direct expenditures. Not all deductions are the equivalent of government spending because some deductions are necessary to accurately measure the income on which the tentative tax liability is based. The tax determination itself requires some addition and subtraction to determine the thing to be taxed.

Deductions cannot be as easily translated into direct spending as credits because their value is a function of the taxpayer's marginal rate—deductions operate to eliminate the tax on the deducted expenditure. This is why the costs of producing income should be deductions rather than credits. A credit operates to eliminate the cost of the credited amount, so a credit has an easily determined alternative program that spends government funds directly. A credit at 100 percent of the taxpayer's expense, such as the STO credit, is indistinguishable from a direct government payment of the full amount of the taxpayer's expense.¹⁹⁴ This does not mean that every credit is independent of the normative features of a tax, just that it is more likely to be a substitute for spending because it is a better mechanism for designing subsidies.¹⁹⁵

Even proponents of tax expenditure analysis would concede that some reductions in tax liability should be considered tax cuts, while others should be treated as the equivalent of direct spending and analyzed on those terms. Tax cuts reduce burdens on taxpayers and shift resources from

Distortions," consisting of rules of the Code that "materially affect economic decisions in a manner that imposes substantial economic efficiency costs" such as the distinction between debt and equity. RECONSIDERATION REPORT, *supra* note 190, at 10; *see also* Sugin, *supra* note 57, at 41 (categorizing some provisions as "modifications to the base that reflect reasonable differences about the ideal baseline, such as provisions that make the system more consumption-tax like and less income-tax like"); DONALD MARRON & ERIC TODER, URB. INST. & URB.-BROOKINGS TAX POL'Y CTR., MEASURING LEVIATHAN: HOW BIG IS THE FEDERAL GOVERNMENT? 7-8 (Mar. 26, 2012), *available at* <http://www.urban.org/UploadedPDF/412528-How-Big-Is-The-Federal-Government.pdf> (suggesting that tax expenditures could be treated as spending if they fit into the following categories: 1. Clear spending substitutes; 2. Targeted incentives to reallocate resources; 3. Substitutes for transfer programs; and 4. Departures from both consumption and income base).

¹⁹⁴ This is an unusual characteristic because most credits are for some percentage of outlay.

¹⁹⁵ Some credits may be an integral part of the rate structure rather than the definition of the tax base. *See* Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1186-88 (1988).

control of the public sector to control by the private sector. There are three factors that help to illuminate whether a reduction in tax liability is actually a tax cut. First, burdens are about adjusting the tax on people, not things. If reductions are connected to favored activities or investments, they are not about adjusting the tax burden; tax cuts need to resemble rate reductions in some way. Second, the more targeted a provision, the more it resembles spending and the less it relates to burdens. And third, tax cuts reduce the size of government, while spending in the tax law increases it. Even though the ACS provision fails to resemble a real tax cut under these factors, the Court treats it as a tax cut nonetheless.

The paradigm tax cut is a rate reduction; nobody would argue that reducing statutory rates should be treated as spending. That is because a reduction in rates reduces the burden of taxation without changing the definition of what is taxed.¹⁹⁶ Rate reductions do not change the relative advantage of different sources or uses of funds. They do not encourage particular activities, but instead distribute tax burdens across broad groups of people. Targeted tax benefits do the opposite. They alter the advantage of particular sources or uses of funds, encourage particular activities, and change the burdens within income groups. Like rate reductions, repeal of a whole tax system, such as a state sales tax or the federal estate tax, also constitutes a tax cut. In those cases, the burden of taxation is eliminated without altering any underlying measure on which the tax depends.

The ACS majority described the credit as declining to impose a tax.¹⁹⁷ Declining to impose a tax should mean that the government has imposed no part of a tax. A targeted tax break within a tax system in place is very different from the absence of a tax. For example, the federal government has declined to impose a value added tax. Declining to impose that tax means that there is no part of a value added tax in place. Once the general tax is chosen, excised elements of that tax do not operate in the same way as declining to impose the general tax in the first place. It is possible that some adjustments are tax cuts, but the more specific and targeted an adjustment, the less it looks like declining to impose a tax. Targeted tax provisions

¹⁹⁶ See *id.*

¹⁹⁷ ACS, 131 S. Ct. 1436, 1447 (2011).

affect the relative economic advantage of different decisions within the general scheme in place.

The Supreme Court's approach in *ACS* fails to recognize that the coherence of the tax law requires certain provisions to be treated as part of the general rules that constitute the tax structure and others as extraneous. Calling the credit a tax cut muddles the structural components of the law with the non-structural ones, undermining the integrity of coherent tax systems. The Joint Committee on Taxation's recent study on tax expenditures¹⁹⁸ is instructive on this point, and is an important affirmation of the tax law's internal coherence. After many years of wrangling about the baseline against which to measure tax expenditures, the Joint Committee suggested that tax expenditures be redefined as provisions that are inconsistent with general rules that are evident in the structure of the tax in place.¹⁹⁹ Under the revised approach, most tax expenditures defined under the old baseline rules continued to be included as tax expenditures.²⁰⁰

The existence of a coherent tax in place—with whatever elements the legislature has chosen—refutes the Court's contention that tax expenditure analysis treats all income as belonging to the government. The *ACS* majority stated: "Respondents' . . . position assumes that *income* should be treated as if it were government property even if it has not come into the tax collector's hands."²⁰¹ This is a variation on a well-worn mantra. In 1983, President Reagan's Treasury Department asked: "If revenues . . . not collected due to 'special' tax provisions represent Government 'expenditures,' why not consider all tax rates below 100% 'special,' in which case all resources are effectively Government-controlled?"²⁰² Both the Supreme Court's statement and the Treasury's question imply that there is no principled way to distinguish tax cuts from government spending. The Supreme Court, however, confused the government's entitlement to presumptive tax payments with its much weaker claim on income more generally.²⁰³ The

¹⁹⁸ See RECONSIDERATION REPORT, *supra* note 190.

¹⁹⁹ *Id.* at 1, 16.

²⁰⁰ See STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008–2012 (Joint Comm. Print 2008) (containing tax expenditure budget prepared under the Reconsideration Report approach).

²⁰¹ *ACS*, 131 S. Ct. at 1448 (emphasis added).

²⁰² See OFFICE OF MGMT. & BUDGET, SPECIAL ANALYSIS G, THE BUDGET OF THE UNITED STATES GOVERNMENT, 1983, at 3 (1982).

²⁰³ Where there is a tax in place, the presumptive tax under that system is the baseline against which tax expenditures are measured. If the base is all consumer

tax law delineates what is properly treated as presumptive government property even before it comes into the tax collector's hands, based on a combination of the base and the rates, and it is substantially less than what the law treats as the private property of individuals.

In treating tax expenditures as undifferentiated tax cuts, the ACS majority adopted Grover Norquist's incoherent approach to the tax system. Norquist has been one of the most controversial figures in tax policy for the last thirty years. His organization, Americans for Tax Reform, is responsible for the "Taxpayer Protection Pledge" that has been signed by 238 members of the House of Representatives and 41 members of the Senate.²⁰⁴ It reads as follows:

I, _____, pledge . . . to the American people that I will: ONE, oppose any and all efforts to increase the marginal income tax rates for individuals and/or businesses; and TWO, oppose any net reduction or elimination of deductions and credits, unless matched dollar for dollar by further reducing tax rates.²⁰⁵

The pledge's wording makes clear that the drafters equate tax deductions and credits with reductions in tax liability that result from reduced rates. That is why the pledge treats increases in marginal tax rates and repeal of deductions and credits as equivalent sins. The goal of the pledge is to prevent any overall increase in tax revenue for the government, which explains the dollar for dollar match in reducing rates that is required when repealing deductions and credits.

There is no tax equity norm underlying the pledge; it does not prevent an individual from suffering an increase in tax, as long as someone else enjoys a tax cut in the same amount. Thus, the pledge reflects only a desire to "starve the beast." Starve the beast is a dubious theory of political economy that posits that tax cuts will force the government to grow

purchases, it would be irrelevant that the tax excluded investment income. But if the base is all consumer purchases, with the exclusion of gasoline, that exclusion is relevant because it is a narrow exception carved out from a presumptive baseline that would include it. The possible universe of government spending through the tax law is limited by the definition of the tax base and the rates applicable in the system in place. So, if the base is consumer purchases, which total \$100,000 and the rate is three percent, the presumptive tax is \$3000, not \$100,000. The decision to exempt gasoline would represent a \$300 decision if gasoline purchases are \$10,000.

²⁰⁴ *Federal Taxpayer Protection Pledge Questions and Answers*, AM. FOR TAX REFORM, <http://www.atr.org/federal-taxpayer-protection-questions-answers-a6204> (last visited Jan. 22, 2013).

²⁰⁵ *Taxpayer Protection Pledge*, AM. FOR TAX REFORM, [http://www.atr.org/userfiles/Senate%20Pledge\(2\).pdf](http://www.atr.org/userfiles/Senate%20Pledge(2).pdf) (last visited Jan. 22, 2013).

smaller.²⁰⁶ Bruce Bartlett, a Treasury official in the Reagan administration, has claimed that “to a large extent our current budgetary problems stem from the widespread adoption” of the starve the beast theory.²⁰⁷ While an overwhelming number of Republican politicians have signed the pledge, including both Presidents Bush,²⁰⁸ the “beast” has continued to grow. Substantial reductions in tax revenue have been accompanied by deficit spending instead of spending reductions, creating enormous long-term fiscal imbalance. The Congressional Budget Office estimated that federal debt would soon “reach roughly 70 percent of gross domestic product (GDP)—the highest percentage since shortly after World War II.”²⁰⁹ Last year, the budget deficit was 8.7 percent of GDP, the highest level in decades.²¹⁰

Contrary to the implications of the pledge, there is widespread agreement among experts that marginal rate cuts are not equivalent to deductions and credits. The acceptance of tax expenditure analysis is widespread, even among conservative economists, who reject the equivalence of rate cuts with all deductions and credits. Martin Feldstein, one of the country’s most distinguished economists,²¹¹ has proposed “limiting each individual’s tax reduction from the use of tax expenditures to 5% of that individual’s adjusted gross income.”²¹² He defines tax expenditures for purposes of his proposal as “special tax rules that substitute for direct government spending as a way to subsidize health insurance, mortgage borrowing and other things.”²¹³ Similarly, Gregory Mankiw²¹⁴

²⁰⁶ See Editorial, *Budget Calculations Slay the “Starve the Beast” Mythology: View*, BLOOMBERG (July 19, 2011), <http://www.bloomberg.com/news/2011-07-20/budget-calculations-slay-the-starve-the-beast-mythology-view.html>.

²⁰⁷ Bruce Bartlett, *Tax Cuts and “Starving The Beast,”* FORBES (May 7, 2010, 6:00 AM), http://www.forbes.com/2010/05/06/tax-cuts-republicans-starve-the-beast-columnists-bruce-bartlett_print.html.

²⁰⁸ See *Federal Taxpayer Protection Pledge Questions and Answers*, *supra* note 204; AM. FOR TAX REFORM, FEDERAL TAXPAYER PROTECTION PLEDGE, 113TH CONGRESSIONAL LIST, available at <http://s3.amazonaws.com/atrfiles/files/files/121012-113thCongress.pdf>; *Taxpayer Protection Pledge*, *supra* note 205.

²⁰⁹ CONG. BUDGET OFFICE, CBO’S 2011 LONG-TERM BUDGET OUTLOOK (June 2011), available at <http://cbo.gov/doc.cfm?index=12212>.

²¹⁰ CONG. BUDGET OFFICE, TESTIMONY ON THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022 (Feb. 2, 2012), available at <http://cbo.gov/ftpdocs/127xx/doc12713/02-02-TestimonyOutlook-Senate.pdf>.

²¹¹ Chairman of the Council of Econ. Advisers under President Ronald Reagan, professor at Harvard, and a member of The Wall Street Journal’s board of contributors.

²¹² Martin Feldstein, *The Tax Reform Evidence From 1986*, WALL ST. J. (Oct. 24, 2011), <http://online.wsj.com/article/SB10001424052970204002304576629481571778262.html?KEYWORDS=feldstein>.

²¹³ *Id.*

has embraced the idea that targeted tax cuts increase the size of government.²¹⁵ He has argued that “tax expenditures are best viewed as a hidden form of spending.”²¹⁶ Even the conservative think tank Cato Institute has warmed to the notion that tax expenditures differ from tax cuts.²¹⁷

The final factor that helps to distinguish tax cuts and government spending through the tax law is their effects on the size of government. Spending increases the size of government, while tax cuts reduce it. Rate reductions diminish the total resources under government control, while many tax expenditures increase the reach of the government’s economic control. Targeted tax breaks reflect substantial government involvement in the economy, in the same way as direct spending. The economist David Bradford invented an often-cited hypothetical “weapons supply tax credit” that would replace all defense spending with transferrable tax credits for the manufacture of weapons.²¹⁸ Although the direct appropriations of the government would go down as the defense budget is transformed into a tax credit, the size of government would not shrink, since it would still control the manufacture of weapons. Public resources would still be committed by the government and would still be received by the weapons manufacturers. The credit would not free up any resources for private control the way a real tax cut would. The same is true for the tax credit in ACS; it represents an intrusion into the market for education, and reflects government control of resources directed to private school tuition.

This is not to suggest that it is easy or clear where lines should be drawn. Many reductions in tax liability are not easily categorized as either rate reductions or spending because they affect different taxpayers differently. A provision that reduces tax for some taxpayers, but not all, might be a tax cut or it

²¹⁴ Chairman of the Council of Economic Advisers under President George W. Bush and a professor at Harvard.

²¹⁵ N. Gregory Mankiw, *The Blur Between Spending and Taxes*, N.Y. TIMES, Nov. 20, 2010, at BU5, available at <http://www.nytimes.com/2010/11/21/business/economy/21view.html>.

²¹⁶ *Id.*

²¹⁷ It published an article by a former chief of staff of the Joint Committee on Taxation entitled *The Hidden Hand of Government Spending* that argued that tax expenditures distort the budget and political process. Edward D. Kleinbard, *The Hidden Hand of Government Spending*, REGULATION, Fall 2010, at 18, available at <http://www.cato.org/pubs/regulation/regv33n3/regv33n3-2.pdf>.

²¹⁸ See David F. Bradford, *Reforming Budgetary Language*, in PUBLIC FINANCE AND PUBLIC POLICY IN THE NEW CENTURY 98 (Sjibren Cnossen & Hans-Werner Sinn eds., 2003) (proposing the hypothetical credit); see also Shaviro, *supra* note 192, at 197 (explaining how such a credit increases the size of government).

might be the equivalent of spending, depending on the purpose and design of the provision. For example, the earned income tax credit,²¹⁹ which provides a refundable credit to low-income taxpayers who earn wages, can be understood either as a tax cut or spending. If it is understood to reduce the burden of payroll taxation on low-income workers, then it is like an adjustment to the rates, making it a tax cut. It creates a negative rate of tax for poor workers, which is integral to the rate system. On the other hand, it might be understood as a transfer payment to recipients, in place of a federal welfare program that sends out checks.²²⁰

The minimum lesson to draw from the instability of these categories is that constitutional consequences should not depend on them. All tax-law provisions, whether structural or not, should be subject to the limitations of the Bill of Rights. In a previous article, I warned against constitutionalizing the definition of a tax expenditure.²²¹ Unfortunately, *ACS* has done just that. Its key determination is on a constitutional question: whether there is a case or controversy for purposes of Article III.²²² The majority's holding turned on whether the challenged provision is designed as direct spending or a tax expenditure. The form of a tax expenditure has now been elevated to constitutional importance. Tax "cuts" and increased "spending" through the tax law can be the same thing, with different political spin.²²³ So it is hard to accept that one is subject to a different legal regime than the other. But that seems to be where the Supreme Court has taken tax expenditures. The highly formal requirements of extraction and spending that it read into the *Flast* standard means that equivalent policies carried out in slightly different ways but reaching precisely the same result have different constitutional consequences. The constitutional issues are equivalent, but they are now subject to different treatment in court. The Supreme Court seems to have mistaken political rhetoric for legal description.

²¹⁹ I.R.C. § 32 (2006).

²²⁰ The welfare characterization would be more compelling if the poorest individuals received the biggest credits. But they do not, so the Earned Income Tax Credit seems to be an adjustment to the tax system, more like a tax cut.

²²¹ See generally Sugin, *supra* note 69.

²²² *ACS*, 131 S. Ct. 1436, 1444 (2011).

²²³ I have previously argued this at length. See Sugin, *supra* note 69, at 424-26.

D. Privileging Tax Expenditures Favors High-Income Taxpayers, Encourages Irresponsible State Budgeting, and Creates a Bias for Reducing the Tax Base

In addition to the consequences already discussed, the protected legal status of tax expenditures pursuant to the *ACS* opinion could produce further undesirable results. This section mentions a few, but it is likely there will be additional unanticipated consequences of the Court's reconceptualization of tax expenditures because its approach fundamentally alters the legal approach to many tax law provisions.

One possible consequence is that legislatures may shun refundable tax credits, in favor of nonrefundable ones, to the detriment of low-income individuals. The distributional fairness of the federal tax system depends on refundable credits because they are the mechanism for providing equal benefits to high and low-income taxpayers. The *ACS* Court did not discuss the treatment of refundable credits, which were not before it because the Arizona credit is not refundable. Refundable credits are those that are paid to individuals regardless of their tax liability, such as the earned income tax credit, while nonrefundable credits depend on offsetting tax owed to the government. A taxpayer with \$100 tax liability and a \$300 refundable credit would receive a \$200 check from the government, while a taxpayer with a nonrefundable credit would reduce tax liability to zero but not below.

Refundable credits challenge the analytical structure that the *ACS* Court created because it is hard to characterize refundable credits as tax cuts when there is no tax liability to offset.²²⁴ Perhaps the \$100 reduction in the taxpayer's bill qualifies as a tax cut, but the additional \$200 check sent by the government is not. Under the *ACS* Court's framework, the refunded \$200 would have to be characterized as extracted from other taxpayers and spent as a transfer payment. In that analysis, refundable credits—at least the refundable portion of them—would be constitutionally distinguishable from nonrefundable credits. A constitutional distinction dependent upon refundability, or the extent refunded, seems highly unprincipled because the nonrefundable portion has the same subsidy character as the refundable part. Such a distinction

²²⁴ The Earned Income Tax Credit is refundable, but it may be a reduction in payroll taxes paid, so would not necessarily present the problem of excess refundability the text raises. I.R.C. § 32.

encourages states and localities to adopt only nonrefundable credits, which would deny them to individuals who are most in need of government financial subsidies for their expenditures, since, by definition, they have little income.

Because tax expenditures will be subject to less judicial review than government spending, legislatures may try to substitute tax credits for direct appropriations, reducing legislative accountability and budget control. Taxpayers are largely in control of the budgetary impact of tax expenditures because they operate as entitlements. Tax credits transfer government resources in an amount determined by taxpayers, without coordination among themselves or knowledge of the cumulative cost. The amount may be limited per taxpayer, but not overall as a budget item. Arizona's reports on the STO credit program indicate that the sum of money flowing to STOs, and the overall public cost of the credit, has increased over time.²²⁵ Proliferation of this type of tax credit would be unfortunate because it constitutes an abdication of legislative responsibility and control.

Budgeting is hard political work and legislatures need to make difficult trade-offs. Many states have constitutionally imposed requirements to balance their budgets.²²⁶ Individual taxpayers may not be aware of the complex interaction of different priorities or the costs that particular choices might impose on other public goals. A budgeting procedure that allows taxpayers to direct government funds, a few hundred dollars at a time, can undermine fiscal discipline overall, and skew the support available for a few programs. Credits can deplete the public treasury without legislators prioritizing funding choices, a core responsibility of representative government. The ACS decision encourages this kind of irresponsible legislative behavior by providing greater judicial cover for check-the-box budgeting.

A possible defense of tax credits as part of the budgeting process is that they can be considered a form of direct

²²⁵ See ARIZ. DEP'T OF REV., PRIVATE SCHOOL TUITION ORGANIZATION INCOME TAX CREDITS IN ARIZONA: A SUMMARY OF ACTIVITY FY2012, at 2, available at <http://www.azdor.gov/Portals/0/Reports/FY2012%20private%20schl%20tuition%20org%20crdt%20rept.pdf>.

²²⁶ See NAT'L CONF. OF STATE LEGISLATURES, STATE BALANCED BUDGET REQUIREMENTS: EXECUTIVE SUMMARY, available at <http://www.ncsl.org/issues-research/budget/state-balanced-budget-requirements.aspx> (last updated Apr. 12, 1999).

democracy.²²⁷ The state of Arizona could be using the STO credit to determine which STOs the people want to fund and how much. That argument suggests that tax expenditures can be effectively used to promote civic engagement generally, even for programs that are not questionable under the Establishment Clause. Unfortunately, the Arizona credit is poorly designed for the “taxes as ballots” model.²²⁸ In order to accurately gauge the public’s commitment to particular programs, there must be some after-tax cost to voting with your checkbook. Because there is no after-tax cost to individuals who direct government funds to STOs, the signal of support for particular organizations is too weak to be meaningful. The paradigm for taxes as ballots is the federal charitable deduction, under which taxpayers must spend some of their own money to get the functional equivalent of a matching grant from the government.²²⁹ They can increase government subsidies, but they also need to “vote” with their own money.

In addition, the taxes-as-ballot-model as applied to nonrefundable credits is troubling from a political perspective. Because the credit is nonrefundable, it effectively disenfranchises the poorest citizens from participating in the decision of what to fund. There is no compelling reason to exclude the poor from the political decision about which STOs deserve funding, but only taxpayers with sufficient resources are able to direct state resources to the STO of their choice. Individual matching costs might justify excluding the lowest income taxpayers, but in this case, there is no cost to individuals who have sufficient tax liability to absorb the credit. Consequently, low-income taxpayers may receive scholarships, but only if high-income taxpayers choose to direct state funding to STOs that will grant them scholarships.²³⁰ This illustrates a serious distributional concern because it involves the exercise of political power that is

²²⁷ See generally Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387 (1998) (suggesting that tax expenditures like the charitable deduction are a form of voting with your money because the taxpayer pays some amount and the government adds a subsidy to it).

²²⁸ This is Levmore’s term. I have been skeptical of taxes as ballots, generally. See Sugin, *supra* note 69, at 456 n.228.

²²⁹ See generally Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377 (1972) (analyzing a direct government matching grant program to remedy shortcomings of the charitable deduction).

²³⁰ Since STOs can discriminate on the basis of a child’s religion, some low-income individuals are ineligible for the bulk of STO money. See *ACS*, 131 S.Ct. 1436, 1440-41 (2011).

allocated only to those who have sufficient income to owe tax. The preferences of the taxpayers, who make use of the credit, will determine the choices of the scholarship seekers, while low-income taxpayers are excluded from exercising that choice. A credit with this design fails to provide advantages for the political system.

The *ACS* decision also presents a potential meta-problem for revenue collection since the effect of the precedent may ultimately be contraction of the tax base. Shielding tax benefits from review by treating them as declining to tax would exacerbate a bias that already exists in the review of tax statutes, to the detriment of the government treasury. There is already an imbalance in the reviewability of tax statutes created by the standing rules applicable to most taxpayer suits.²³¹ Government imposes tax through a system that includes revenue-raising and revenue-reducing provisions. The revenue-raising provisions are subject to perennial challenge.²³² The revenue-reducing provisions in the form of tax expenditures are targeted reductions that produce identifiable winners, but not identifiable losers. The general public, and the fisc that it funds, is always the loser from targeted tax benefits. Taxpayers complaining that they have been overtaxed are entitled to sue to reduce their assessed tax liability, and taxpayers attempting to reduce their liability will sometimes win and sometimes lose on the merits. The set of cases, as a whole, has a revenue-reducing effect because the government losses will reduce collections compared to the government's initial position, and the government wins will leave the original assessment intact. But nobody complains that they are being taxed too little. This disparity means that government decisions *to tax* are always reviewed, but decisions *not to tax* are not, creating a one-way ratchet of less taxation. The *ACS* Court's approach exacerbates this problem by reducing the provisions benefiting taxpayers that will be subject to review. Disputes involving tax expenditures are now even less likely to be litigated than tax deficiency cases since the *ACS* precedent treats them as cases involving individual, not state, action. Because it minimizes injuries, it also reduces the scrutiny that reviewed provisions will receive.

²³¹ Without the *Flast* exception, plaintiffs need personal injury that is actual and concrete, caused by the defendant, and which could be remedied by a court decision in their favor. See *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992).

²³² The government can be forced to litigate the same issue against numerous taxpayers. Although there is *stare decisis* for the judicial interpretation of tax statutes, there is no *res judicata* across taxpayers.

CONCLUSION

The Roberts Court's two recent tax opinions fundamentally change the way the law treats taxes and tax expenditures under the Constitution. The justices placed taxes and tax expenditures on a legal pedestal, favoring tax statutes compared to government regulation and direct spending. Whether raising government revenue or losing it, the tax law has proved powerful enough to fend off the Constitution.

This article has demonstrated how the economic approach to tax law and policy is in tension with legal analysis of taxation, particularly where the tax law intersects constitutional law. It has also shown how the Supreme Court's new favoritism of tax law might create problems, for both law and policy. Observers of the tax law should worry about the fallout from the Court's decisions, as legislators turn to their tax laws to direct resources where they may not constitutionally spend money. These cases undercut the efforts of tax reformers, and make the goal of achieving a fair and simple tax system even more elusive than it might otherwise have been.