

Federalism and the Taxing Power

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Scholars and courts recognize that the federal government uses its broad spending power to enlist states in achieving federal goals, thereby expanding the federal government's reach beyond the areas enumerated for it in the Constitution. Previously underappreciated, however, is that the federal government can achieve similar ends—it can regulate the states and private parties—through its potentially equally broad taxing power. This Article draws on the spending power literature to illuminate the analogous federalism concerns raised by expansive use of the taxing power. For example, by crowding out state regulation of similar policy areas, federal tax regulation may limit policy diversity and hinder regulatory competition both among the states and between the states and the federal government. But this Article also identifies important differences between taxation and grants that suggest that federal tax regulation represents less of a federalism threat than do conditional grants to the states. For example, because federal tax incentives neither contractually bind states to follow federal policy nor expend state legislative and administrative resources in enacting and enforcing federal policy, states may remain freer under tax incentives than grants to enact concurrent or contrary policies.

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Introduction.....	976
I. Federal Regulation Through Taxing and Spending.....	981
A. Some Modes of Federal Regulation	982
1. Conditional Grants.....	982
2. Tax Expenditures	984
3. Tax Penalties.....	989
B. Effects of Federal Tax Regulation on the States.....	992
II. Constitutional Limits on Taxing and Spending.....	994
A. Express Limits	995
1. Uniformity and Apportionment	995
2. Other Requirements	997
B. The Taxing and Spending Clause	997
C. Other Constitutional Provisions.....	1003
1. Personal Rights	1003
2. Dormant Commerce Clause.....	1004
D. Taxing and Spending Outside Congress’s Enumerated Powers ...	1006
III. Distinguishing Taxing from Spending.....	1008
A. Regulation of Private Taxpayers, Not States.....	1008
B. State Right of Refusal and “Repeal”	1010
C. Complex Benefits	1014
D. Completeness.....	1015
E. Political Safeguards.....	1016
F. State Conformity with the Federal Tax Base	1019
G. Federal Tax Aid to the States: The SALT Deduction.....	1021
H. Institutional Limitations	1025
I. Distinguishing Tax Expenditures from Tax Penalties.....	1026
1. Federal Tax Expenditures	1027
2. Federal Tax Penalties.....	1029
Conclusion	1035

INTRODUCTION

Ranging from the picayune to the potent, Congress’s constitutionally enumerated powers help describe the limits of the federal government.¹ Commentators have criticized the Supreme Court for eroding the limitations imposed by enumeration by expansively interpreting the congressional spending power. For example, a well-established principle of constitutional interpretation provides that Congress may condition grants to the states upon the requirement that the states adopt particular regulatory policies, even if those regulatory

1. Compare U.S. CONST. art. I, § 8, cl. 5 (Congress shall have the power to “fix the Standard of Weights and Measures”), with U.S. CONST. art. I, § 8, cl. 3 (Congress shall have the power “to regulate Commerce . . . among the several States”).

policies fall outside Congress's enumerated powers.² Critics argue that this broad interpretation of the spending power threatens federalism values.³

As has long been recognized, Congress uses the taxing power, like the spending power, to regulate.⁴ Tax scholars have analyzed the federalism impact of particular tax provisions, including the federal deduction for state and local taxes.⁵ But both tax and constitutional scholars have ignored the larger federalism concerns that taxes raise.⁶ This Article fills that gap. It argues that, to the extent Congress uses taxes to regulate areas traditionally or constitutionally reserved to the states, taxes raise federalism concerns similar to those raised by conditional spending. For example, by crowding out state regulation, federal tax incentives may reduce opportunities for regulatory competition both among the states and between the states and the federal government.

Congress uses two kinds of tax incentives to regulate private actors. Tax subsidies or "tax expenditures" are tax laws that offer special tax deductions, credits, and other tax benefits designed to accomplish public policy goals. The

2. See *South Dakota v. Dole*, 483 U.S. 203, 206–07 (1987) (holding that Congress could condition federal highway grants to the states upon states' enactment of a minimum drinking age).

3. Justice Kennedy observed that "the Spending Clause power . . . has the potential to obliterate distinctions between national and local spheres of interest." *Davis v. Monroe Cnty. Bd. of Educ.*, 526 U.S. 629, 654 (1999) (Kennedy, J., dissenting). Extensive scholarly literature addresses the spending power's relation to federalism; a small portion of it, further referenced *infra*, includes Lynn A. Baker, *Conditional Federal Spending After Lopez*, 95 COLUM. L. REV. 1911 (1995) [hereinafter Baker, *After Lopez*]; Lynn A. Baker, *The Spending Power and the Federalist Revival*, 4 CHAP. L. REV. 195, 198 (2001) [hereinafter Baker, *Federalist Revival*]; Erwin Chemerinsky, *Protecting the Spending Power*, 4 CHAP. L. REV. 89 (2001); David E. Engdahl, *The Spending Power*, 44 DUKE L.J. 1, 56 (1994); Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and "Dual Sovereignty" Doesn't*, 96 MICH. L. REV. 813 (1998); Lewis B. Kaden, *Politics, Money, and State Sovereignty: The Judicial Role*, 79 COLUM. L. REV. 847 (1979); Thomas R. McCoy & Barry Friedman, *Conditional Spending: Federalism's Trojan Horse*, 1988 SUP. CT. REV. 85; Ilya Somin, *Closing the Pandora's Box of Federalism: The Case for Judicial Restriction of Federal Subsidies to State Governments*, 90 GEO. L.J. 461 (2002).

4. Tax scholars have analyzed the regulatory effect of taxation mostly under the term "tax expenditures." See, e.g., STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) [hereinafter Surrey, *Tax Incentives*]. For criticism of the concept of tax expenditures for vagueness, see Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967) [hereinafter Bittker, *Comprehensive*]; Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969) [hereinafter Bittker, *Subsidies*].

5. See Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction*, 106 MICH. L. REV. 805 (2008) [hereinafter Galle, *The "SALT" Deduction*]; Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax*, 82 VA. L. REV. 413 (1996); Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389 (2004).

6. An exception is Professor Peter Engdahl, who addresses the federal taxing power, even though his principal topic is spending. See Engdahl, *supra* note 3, at 16. Professor David Super also discusses the federalism impact of taxes, but he does not focus on tax expenditures or tax penalties. See David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544 (2005).

archetypal examples of tax expenditures are the deduction for home mortgage interest payments and the exclusion of employer-provided health insurance benefits. While such tax expenditures do not constitute direct outlays, the federal government nevertheless carefully tracks tax spending by measuring the amount that otherwise would have been collected had the special tax provision not been in place.⁷ The General Accounting Office (GAO) estimates that in 2005 tax expenditures were equivalent to 7.5 percent of GDP.⁸ In fact, Congress spends about as much through the tax system as it does through discretionary outlays.⁹ Moreover, since Congress spends significantly more through the tax law than it does through conditional grants, tax spending initially appears to be a more serious federalism problem than are grants.¹⁰

To a lesser extent than tax expenditures, Congress also employs what I refer to as “tax penalties.”¹¹ Tax penalties are special tax code provisions that increase the normal tax burden.¹² Like tax expenditures, Congress designs tax penalties to influence taxpayer behavior. For example, by disallowing deductions for “excessive” employee remuneration, Congress hopes to influence salaries without directly regulating companies.¹³ Likewise, by taxing

7. See Congressional Budget Act of 1974, 2 U.S.C. § 622(3) (2006) (requiring annual publication of a tax expenditure budget that measures the impact of tax expenditures in terms of forgone revenue).

8. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-690, TAX EXPENDITURES REPRESENT A SUBSTANTIAL FEDERAL COMMITMENT AND NEED TO BE REEXAMINED 35–37 (2005) [hereinafter GAO, TAX EXPENDITURES], available at <http://www.gao.gov/new.items/d05690.pdf> (citing the Treasury Department's outlay equivalent estimates of tax expenditures).

9. *Id.*, at 35–37. Whether a federal expenditure is “discretionary” or “mandatory” depends on the congressional committee that controls it. Appropriations committees control discretionary spending, including annual appropriations, such as those for defense, transportation, national parks, and foreign aid. Discretionary expenses usually have dollar caps and expiration dates. In contrast, authorizing committees control mandatory spending, which is generally uncapped. With mandatory spending, rather than setting forth a precise dollar amount to be spent, Congress describes eligibility criteria for certain government benefits and anyone meeting the eligibility criteria may claim the benefit. Entitlement programs—such as Social Security, Medicare, Medicaid, and unemployment—represent mandatory spending, as does interest on federal debt obligations. For more on budget concepts and tax expenditures, see ALLEN SCHICK, THE FEDERAL BUDGET: POLITICS, POLICY, PROCESS 57–81, 171–73 (3d ed. 2007).

10. See *infra* notes 53–56 and accompanying graph.

11. Compare Eric Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989) (likewise terming such provisions “tax penalties”), with J. COMM. ON TAXATION, JCX-37-08, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 45 (2008) [hereinafter JCT, TAX EXPENDITURES] (referring to “Negative Tax Subsidies”).

12. Cf. JCT, TAX EXPENDITURES, *supra* note 11, at 45 (defining “Negative Tax Subsidies” as tax provisions “that increase the normal tax burden” as compared to “what the general rules would impose”). In contrast with the Joint Committee's “negative tax subsidy” concept, the “tax penalty” concept used in this Article defines tax penalties as deviations from the Schanz-Haig-Simons definition of income, rather than as deviations from a current tax law baseline. For more on the baseline problem, see discussion *infra* notes 35–40, 69–73 and accompanying text.

13. See I.R.C. § 162(m) (2006) (denying deduction for payments to certain employees of public companies of non-performance-based compensation that exceeds \$1 million).

the profits of illegal drug sales, but denying related expenses, Congress seeks to discourage drug trafficking, or perhaps to punish dealers.¹⁴

More controversially, as part of the Patient Protection and Affordable Care Act (PPACA), Congress recently inserted into the tax law a provision that has come to be known as the “individual mandate.” This provision imposes a penalty on certain people who fail to buy private medical insurance.¹⁵ Over twenty states have sued the federal government arguing that the PPACA is unconstitutional.¹⁶ The complaining states assert that the health care reform act invades regulatory areas reserved to the states, thereby violating the Tenth Amendment. Among the states’ arguments is that Congress exceeded its constitutionally enumerated powers by imposing the individual mandate. The states argue that the Commerce Clause does not give Congress the power to penalize Americans for refusing to engage in private commercial transactions. The federal government has responded that the individual mandate represents a valid use of the commerce power, and even if it does not, that it is nevertheless constitutional as an exercise of the taxing power.¹⁷

While this Article does not focus on the constitutionality of the individual mandate, the enforcement of major health care reform primarily through the tax law dramatically highlights how Congress uses the tax law to pursue objectives other than raising revenue. Drawing on the individual mandate and other examples, Part I of this Article shows how Congress uses the tax law to influence taxpayer behavior. Analogizing taxing to spending, Part I argues that, by enabling Congress to regulate areas falling beyond its other enumerated powers, the taxing power likewise may jeopardize the values served by federalism, such as regulatory competition, diffusion of power, promotion of local values, political accountability, and policy experimentation.¹⁸

14. See I.R.C. § 280E (2006) (denying expenses related to illegal drug trade profits).

15. See Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1501(a)(1), 124 Stat. 119 (2010). The Act adds Section 5000A to the Internal Revenue Code. Section 5000A sets forth the “Requirement to Maintain Minimum Essential Coverage,” effective beginning in 2014, and it taxes those who fail to maintain such coverage. See I.R.C. § 5000A (effective 2014).

16. The individual mandate has been challenged in over a dozen separate legal actions. For example, *Virginia ex rel. Cuccinelli v. Sebelius* is currently on appeal to the Fourth Circuit. See 728 F. Supp. 2d 768 (E.D. Va. 2010) (holding that the individual mandate exceeded Congress’s commerce power and that it did not constitute an exercise of the taxing power because, inter alia, Congress’s intention with the mandate was to regulate, not raise revenue; Congress labeled the mandate a “penalty” rather than a “tax,” and, in passing the legislation, Congress purported to be exercising the commerce, not the taxing power). *But see, e.g.,* Thomas More Law Center v. Obama, 720 F. Supp. 2d 882 (E.D. Mich. 2010) (upholding the individual mandate under the Commerce Clause). The official documents for the cases challenging the PPACA, including complaints, motions, briefs, and amici curiae can be found at the ACA LITIGATION BLOG, <http://acalitigationblog.blogspot.com>.

17. *But see Virginia v. Sebelius*, 728 F. Supp. 2d 768 (holding that Congress did not intend to—and did not as a matter of law—exercise its taxing power in imposing the individual mandate, but not ruling on whether Congress could impose the individual mandate under the taxing power).

18. See *infra* Part I.B.

Because Congress uses taxes to regulate, understanding the scope of the taxing power is important for understanding the scope of federal power. Part II therefore explores the Supreme Court's interpretations of the taxing power. Because the taxing power and the spending power derive from the same clause of the Constitution, Part II asks whether, just as Congress may spend to achieve regulatory goals that it could not achieve directly, it may also tax to achieve such goals. Part II concludes that Supreme Court doctrine on this question is unclear.

Part III considers how the Supreme Court might resolve the question of whether the taxing power is as broad as the spending power by comparing the federalism concerns raised by each. Several factors suggest that tax incentives are no worse for federalism than are conditional grants. For example, federal tax incentives hold out their enticements to private taxpayers; they do not bind states as conditional grants do. As a result, federal tax incentives may leave states freer than do conditional grants to pursue policies that differ from or conflict with federal policy. Second, Part III explains how states may be able to effectively "repeal" federal tax incentives through their own tax or regulatory systems. Third, compared to grants, the regulatory objects of federal tax incentives are limited as a practical matter. Tax incentives are most effective for federal goals that can be achieved through the actions of private taxpayers, rather than states. Thus, through taxes, Congress can promote charitable giving, but it probably cannot implement a complex program like Medicare without the help of the states. Fourth, the regulatory reach of federal tax incentives is narrower than that of conditional grants because up to one-third of American households have no federal income tax liability. Since most federal tax incentives take the form of non-refundable deductions and exemptions, they fail to influence many Americans. Fifth, while federally funded grant programs may raise accountability concerns if voters have trouble identifying which level of government to hold responsible for particular policies, the locus of federal tax spending in the federal tax code and on federal tax forms makes it easier for taxpayers to hold Congress accountable for federal tax policy. Sixth, certain federal tax expenditures, particularly the federal deduction for state and local taxation, may enhance rather than restrict state policymaking by providing a federal subsidy for state tax collections. Finally, Part III observes that interpreting the taxing power to be limited by Congress's other enumerated powers would draw federal courts into intractable debates over whether Congress had regulatory (or only revenue-raising) intent in enacting particular tax statutes. Part III concludes that these factors support interpreting the taxing power, like the spending power, to be unconstrained by Congress's other enumerated powers. As a result, politics, rather than judicial review, would remain the primary mechanism for safeguarding federalism values from federal overreaching through taxation.

I.

FEDERAL REGULATION THROUGH TAXING AND SPENDING

This Part reviews certain modes of federal regulation—including direct spending, tax spending, and tax penalties—and the federalism concerns they raise. Direct spending includes paying federal expenses, such as salaries of federal employees and the costs of equipping the military. Direct spending also includes all other cash outlays, such as payments for conditional grants and Social Security benefits.

Congress also spends through the tax law. By offering tax breaks to taxpayers who engage in favored activities, Congress “spends” by forgoing collection of taxes that otherwise would be due. As this Part explains, the social policies supported by such tax incentives run a wide gamut. For example, Congress provides special tax breaks to people who make donations to charity¹⁹ and companies that engage in research and development.²⁰

To a lesser extent, Congress also regulates through what this Article labels “tax penalties,” which are provisions of the tax law that deliberately overtax with the aim of penalizing undesirable activities. For example, a business cannot deduct fines from its federally taxable income.²¹ More controversially, the PPACA inserts into the tax law a penalty for certain individuals who fail to buy private health insurance.²²

This Part illuminates the extent to which Congress uses tax expenditures and tax penalties to regulate. Furthermore, it argues that Congress’s use of taxes to regulate raises federalism concerns. In this Part, I do not mean to unequivocally endorse federalism values or the notion that active judicial intervention is needed to secure states from federal infringement of their regulatory competences.²³ My goal instead is to draw an analogy between

19. I.R.C. § 170(e) (2006).

20. *Id.* § 41.

21. *Id.* § 162(f).

22. *See id.* § 5000A(a) (providing penalty); *id.* § 5000A(e) (excluding from the penalty individuals who cannot afford insurance coverage, those whose income falls below the PPACA’s filing threshold, members of Indian tribes, those experiencing short gaps in coverage, and hardship cases); *id.* § 5000A(d)(2) (providing religious exemptions).

23. *See, e.g.,* Herbert Wechsler, *The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government*, 54 COLUM. L. REV. 543 (1954) (arguing that aggressive judicial review of federalism was contrary to the Founders’ original intentions); Larry D. Kramer, *Putting the Politics Back into the Political Safeguards of Federalism*, 100 COLUM. L. REV. 215 (2000) (providing historical evidence that the Founders expected the boundaries of federalism to be policed by popular political action, not judicial review); Larry D. Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485 (1994) (arguing that the modern political safeguards of federalism include political parties and a shared administrative bureaucracy and that these institutions create co-dependency among state and federal officials that has the byproduct of maintaining federalism). *See also* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528 (1985) (rejecting Court’s prior attempt, in *National League of Cities v. Usery*, 426 U.S. 833 (1976), to define state regulatory immunity in terms of “traditional governmental functions”); *id.* at 554 (“The fundamental limitation that the constitutional scheme

taxing and spending to show that Congress may use both powers to regulate areas traditionally or constitutionally reserved to the states. For example, by crowding out state regulation, federal tax regulation may limit policy diversity and hinder regulatory competition both among the states and between the states and the federal government. Thus, to the extent that we are concerned about the federalism impact of conditional grants, arguably we also should be concerned about the federalism impact of tax expenditures and penalties.

A. *Some Modes of Federal Regulation*

1. *Conditional Grants*

The Constitution provides the federal government with certain enumerated powers, such as the ability to regulate naturalization, the postal service, and interstate commerce.²⁴ In addition to directly regulating in these enumerated areas of competence, the Supreme Court has held that Congress may indirectly regulate other areas through its power of the purse. Specifically, in *South Dakota v. Dole*, the Supreme Court held that Congress may condition federal funding to the states upon the requirement of state compliance with federal regulatory goals, even if those goals fall outside Congress's enumerated powers.²⁵ The Supreme Court held that

the power of Congress to authorize expenditure of public moneys for public purposes is not limited by the direct grants of legislative power found in the Constitution. Thus, objectives not thought to be within Article I's enumerated legislative fields . . . may nevertheless be attained through the use of the spending power and the conditional grant of federal funds.²⁶

In dicta, the *Dole* Court suggested some limits on conditional spending. For example, the Court stated that conditions attached to federal grants must be related to the federal purpose for the expenditure, not prohibited under other provisions of the Constitution (such as the Bill of Rights), and not coercive.²⁷ In other decisions, the Court has emphasized that to bind the states, federal spending conditions must be unambiguous.²⁸ Moreover, conditional spending,

imposes on the Commerce Clause to protect the 'States as States' is one of process rather than one of result."). *But see* Kaden, *supra* note 3, at 857–68 (reviewing erosion of states' influence on the federal government).

For arguments that the values of federalism are overrated, see, e.g., Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. REV. 903 (1994).

24. U.S. CONST. art. I, § 8, cl. 4 (naturalization); U.S. CONST. art. I, § 8, cl. 7 (post); U.S. CONST. art. I, § 8, cl. 3 (commerce).

25. *South Dakota v. Dole*, 483 U.S. 203, 206–07 (1987).

26. *Id.* at 207 (internal quotation marks omitted).

27. *Id.* at 210–11.

28. *See* *United States v. New York*, 505 U.S. 144, 171–72 (1992) (affirming the limits on conditional spending announced by *Dole* and *Pennhurst*); *Pennhurst State Sch. & Hosp. v. Halderman*, 451 U.S. 1 (1981) (holding that the challenged federal grant did not clearly create

like all taxing and spending, must be for defense, to repay federal debts, or it must otherwise advance the “general welfare.” But there exist few other formal limits on congressional spending.²⁹

Congress often uses its spending power to make conditional grants to the states, even when it could regulate directly using the Commerce Clause or another enumerated power.³⁰ Congress may employ grants even when it possesses direct regulatory authority because it believes the states will be more effective regulators than the federal government would, or because the federal government lacks the administrative expertise or apparatus to effectuate federal policy cheaply. But in areas that Congress otherwise could not reach with direct regulation, grant-making allows Congress to enlarge its policy sphere by enticing the states into adopting federally prescribed policies in exchange for federal funds. For example, in *Dole* the Supreme Court held that it was not unconstitutional for Congress to condition a portion of federal highway grants to the states upon the requirement that the states enact a minimum drinking age of twenty-one.³¹ Using highway funds, the federal government achieved through state cooperation a regulatory goal that it lacked constitutional authority to achieve directly, namely, imposition of a minimum drinking age.³²

That Congress enlarges its powers through use of conditional grants has been much discussed and will not be described more fully here.³³ Rather, the forgoing discussion of conditional grants provides the foundation for the following analogy to tax spending.

private rights of action against states for failure to implement the grant’s terms).

29. U.S. CONST. art. I, § 8, cl. 1 (taxing and spending must be “to pay the Debts and provide for the common Defence and general Welfare of the United States”). *See, e.g.*, *Helvering v. Davis*, 301 U.S. 619, 640 (1937) (holding that Congress, not the courts, determines what advances general welfare). The spending power also is not constitutionally limited by balanced budget or deficit-control measures. Engdahl, *supra* note 5, at 49–50. Nor must Congress limit its spending to those measures necessary and proper for carrying out its enumerated powers. *Dole*, 483 U.S. at 216 (O’Connor, J., dissenting) (“Congress has the power to spend for the general welfare”) (quoting Brief for the National Conference of State Legislatures et al. as Amici Curiae, in Support of Petitioner, 1987 WL 880310 at *19).

30. Although Congress also spends by making payments directly to private parties, this Article hereafter uses the term “grants” to refer exclusively to conditional grants to states.

31. *South Dakota v. Dole*, 483 U.S. 203, 206–07 (1987).

32. *Id.* at 207–08; *see also* *Oklahoma v. U.S. Civil Serv. Comm’n*, 330 U.S. 127 (1947) (upholding a federal grant conditioned on the requirement that states end partisan political activities by certain state officials, even though Congress could not regulate officials’ local political participation directly); *cf.* *New York v. United States*, 505 U.S. 144, 188 (1992) (holding that although Congress may use conditional grants to encourage states to adopt regulatory regimes that lie beyond Congress’s enumerated powers, Congress may not simply conscript the states into enacting regulatory regimes).

33. For more on the Supreme Court’s broad interpretation of the spending power, and the impact of conditional grants on federalism, see references in *supra* note 3.

2. Tax Expenditures

The principal method of federal tax regulation is through tax expenditures, defined by the Congressional Budget Act of 1974 as “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.”³⁴ Tax expenditures differ from income-defining tax provisions, such as the deduction for business expenses, because tax expenditures are intended to serve public policy goals, instead of (or in addition to) measuring net income.

Critics of tax expenditure analysis argue that the concept is hopelessly vague because it requires a common normative definition of net income against which deviations (i.e., tax expenditures) can be measured.³⁵ For example, should we consider a deduction for business attire to be part of the normative net income baseline for taxpayers required to wear business suits to work because in such cases buying suits represents a cost of earning income? Or should a deduction for business attire be labeled a tax expenditure, since taxpayers may receive personal enjoyment from wearing suits, and a taxpayer’s choice about how much to spend on her work wardrobe represents personal consumption, much like her decision about how much to spend on food or housing?³⁶

This baseline problem is well understood, and so far, no satisfying solution has been advanced to solve it.³⁷ Nor do I offer one here. Instead, like many other commentators, I simply report that for purposes of identifying tax expenditures (and later, tax penalties), I use the Schanz-Haig-Simons definition of income.³⁸ But I would further observe that although not all tax scholars and policymakers agree on the net income baseline, all concede that the government uses the tax law not only to raise revenue, but also to influence taxpayer behavior.³⁹ And while commentators disagree at the margins about whether

34. Congressional Budget Act of 1974, 2 U.S.C. § 622(3) (2006).

35. Professor Boris Bittker argued that the concept of tax expenditures was fundamentally and unavoidably arbitrary because it depends on unattainable agreement about the baseline against which tax expenditures should be measured. Bittker, *Subsidies*, *supra* note 4, at 247, 260. To eliminate reliance on a normative net income baseline, the Joint Committee on Taxation recently proposed measuring tax expenditures as deviations from an “identifiable general rule of the present tax law.” JCT, TAX EXPENDITURES, *supra* note 11, at 39.

36. See Daniel I. Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859 (1974).

37. *But see* Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 207–13 (2004) (attempting to surmount the baseline problem by proposing a more flexible approach that would identify tax expenditures as primarily allocative provisions contained in an otherwise primarily distributional tax system).

38. The Schanz-Haig-Simons definition of income is “consumption plus (or minus) the net increase (or decrease) in value of an individual’s assets during the taxable period.” See Bittker, *Comprehensive*, *supra* note 4, at 929.

39. Of course, even without tax expenditures, income tax regimes influence behavior of taxpayers, such as their decisions whether to save or consume and whether to work or spend time at leisure.

certain provisions constitute tax expenditures, there is substantial agreement on the core content of tax expenditures.⁴⁰

Estimated to cost the federal government over \$100 billion in 2009,⁴¹ one of the largest tax expenditures is the deduction for home mortgage interest.⁴² Since home ownership does not produce currently taxable income, allowing taxpayers to deduct home mortgage interest is not necessary to properly calculate their normative net income.⁴³ Instead, the mortgage deduction is a special tax benefit, usually characterized as an incentive for home ownership. Other large tax expenditures include the exemption for employer-provided health insurance, the deduction for charitable contributions, and deductions and exemptions for retirement savings.⁴⁴

The federal government uses tax expenditures to regulate, including in areas traditionally reserved to the states. For example, in a move he describes as “stealth preemption,” Professor James Fishman argues that the federal government has begun to regulate nonprofit entities—entities that the states traditionally regulated—via its power to confer federally tax-exempt status.⁴⁵ Fishman criticizes this federal regulation from an efficiency perspective; he argues that federal intrusion into entity governance unnecessarily increases administrative costs and distracts nonprofits from their charitable missions.⁴⁶

While regulating nonprofits may fall under Congress’s enumerated power to regulate interstate commerce, certain other federal tax measures would be considerably harder to shoehorn into an enumerated power. For example, many federal tax measures concern the family, a domain traditionally regulated by the states.⁴⁷ The federal tax code provides special deductions and credits for adoption,⁴⁸ child care,⁴⁹ birth control pills, vasectomies, abortions, and fertility

40. Although even the Treasury Department and the Joint Committee on Taxation calculate their tax expenditure budgets using slightly different baselines, there is general agreement that the government uses the tax law for regulatory purposes in addition to revenue-raising purposes. JCT, TAX EXPENDITURES, *supra* note 11, at 4.

41. OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE U.S. GOVERNMENT, FISCAL YEAR 2009, at 298 tbl.19-3 (listing the mortgage deduction as the second costliest tax expenditure in 2009, and estimating its revenue loss at \$100.8 billion).

42. I.R.C. § 163(h)(3) (2006).

43. Again, by normative net income, I mean Schanz-Haig-Simons income.

44. See OMB, ANALYTICAL PERSPECTIVES, *supra* note 41, at 298 tbl.19-3 (estimating the revenue loss from employer-provided health insurance at \$168 billion, from the charitable contribution deduction at \$58 billion, and from retirement plans, such as IRAs, Keoghs, and 401(k) plans, at \$76 billion for 2009).

45. James J. Fishman, *Stealth Preemption: The IRS’s Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545 (2010).

46. See *id.* at 589–91.

47. Anne C. Dailey, *Federalism and Families*, 143 U. PA. L. REV. 1787, 1821–26 (1995) (arguing that the assignment of the sphere of family law to the states can be seen as more a product of congressional self-restraint than judicial assignment to the states of exclusive legislative competence over family law).

48. I.R.C. § 23 (2006).

49. *Id.* § 21.

treatments.⁵⁰ And married heterosexual couples may file joint tax returns, while married gay couples may not.⁵¹

The tax expenditure budget divides tax expenditures into categories that demonstrate their wide regulatory range and reveal federal activity in areas of local concern.⁵² Traditional areas of federal interest—such as national defense, veterans' benefits, and international affairs—find expression in the tax expenditure budget, but so do areas of traditional state and local concern, such as housing, community development, education, social services, and health.⁵³

In addition to providing a sense of the broad range of federal goals pursued through the tax law, the tax expenditure budget also can be used to approximate the importance of federal tax expenditures to the overall fiscal system. Figure 1 compares federal tax expenditures to other kinds of government spending.

Although estimating aggregate tax expenditures is an inexact endeavor,⁵⁴ the chart shows that, as measured by forgone revenue, total annual federal tax

50. *Id.* § 231 (qualified medical expenses include birth control pills, vasectomies, abortions, fertility treatments). *See also* IRS PUB. 502, MEDICAL AND DENTAL EXPENSES 5–14 (2009). That tax deductions for family planning expenses can be understood to regulate both family choices and healthcare choices highlights another aspect of the tax expenditure definition problem. Not only may it be difficult to identify which tax provisions have regulatory (as opposed to income-defining) effects, but the same tax expenditure may pursue multiple policy goals, some of which, like healthcare, fall within the competence of both the states and federal governments, and others of which, like the family, represent traditional state competences. Because the motives for tax expenditures may be mixed, it would be difficult for courts to review them without entangling themselves in essentially legislative questions. For more on this issue, see *infra* Part III.H.

51. *See* Treas. Reg. § 1.6013-1 (as amended in 1980) (providing guidelines on who may file joint returns). Rather than staking out a position on whether same-sex couples can file joint returns, the federal government could defer to state law for determinations of marital status.

Most commentators would regard filing statuses (single, married, etc.) as so-called structural provisions of the tax code, rather than as “tax expenditures.” For more on the difference between structural provisions and tax expenditures, see Linda Sugin, *Tax Expenditure Analysis and Constitutional Decisions*, 50 HASTINGS L.J. 407, 409–10 (1999). From a federalism perspective, however, what matters is the tax law’s regulatory effect on marriage, not whether a particular tax provision constitutes a “tax expenditure” or not.

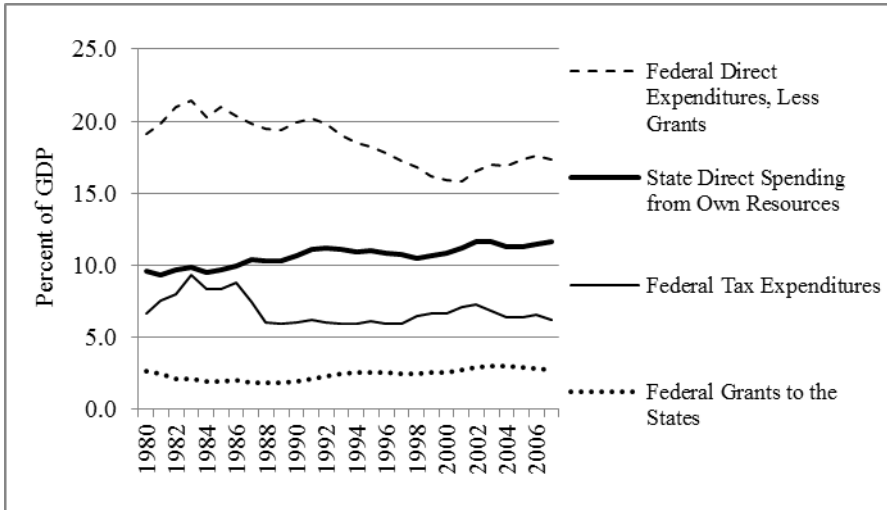
52. *See, e.g.*, OMB, ANALYTICAL PERSPECTIVES, *supra* note 41, at 288–91 tbl.19-1.

53. *Id.* at 288–91.

54. For a discussion of the challenges inherent in the tax expenditure estimation process, see GAO, TAX EXPENDITURES, *supra* note 8, at 92–98. The most serious challenge facing tax expenditure estimation is lack of a universally accepted baseline against which to measure “deviations” or tax expenditures. *See* references in *supra* note 35. Additionally, because these estimates do not take into account how taxpayer behavior would change were the provisions repealed, they tend to overestimate the revenue that would be raised via repeal. JCT, TAX EXPENDITURES, *supra* note 11, at 81. Finally, although the GAO sums estimates for particular tax expenditures in order to approximate aggregate annual tax expenditures, potential interactions between individual tax expenditures render such aggregate figures inexact. *See* GAO, TAX EXPENDITURES, *supra*, at 35–37. Without attempting to remedy any of these flaws, Figure 1 simply aggregates and reproduces tax expenditure data published in the appendix to the annual federal budget for individual fiscal years 1980 to 2007. *See, e.g.*, OMB, ANALYTICAL PERSPECTIVES, *supra* note 41 at 288–91 tbl.19-1 (providing, inter alia, data on Fiscal Year 2007 tax expenditures).

expenditures represent a significant federal fiscal commitment. Tax expenditures greatly exceed grant expenditures, and for several years in the last decade they even exceeded federal discretionary spending.⁵⁵

Figure 1: Direct and Tax Spending as a Percentage of GDP, 1980–2007



Source: U.S. Budget⁵⁶

Viewed from the perspective of the recipient, tax expenditures are economically equivalent to direct government spending.⁵⁷ Indeed, the

55. GAO, TAX EXPENDITURES, *supra* note 8, at 4–5 (measuring tax expenditures on an outlay equivalent basis).

56. Federal and state outlay data is from the 2010 U.S. budget. See OFFICE OF MGMT. & BUDGET, HISTORICAL TABLES, BUDGET OF THE U.S. GOVERNMENT, FISCAL YEAR 2010, at tbls.15.3, 15.5. Tax expenditure data is from the Analytical Perspectives appendix to the U.S. budget for individual fiscal years 1980–2007.

57. Whether tax expenditures constitute spending as a constitutional matter, however, is less clear. *Regan v. Taxation with Representation*, 461 U.S. 540, 544, 549 (1983) (stating that “[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” and that “appropriations are comparable to tax exemptions and deductions” in that both are legislative choices that warrant judicial deference). *But see id.* at 544 n.5 (noting that “[i]n stating that exemptions and deductions . . . are like cash subsidies . . . we of course do not mean to assert that they are in all respects identical”) (citing *Walz v. Tax Comm’n*, 397 U.S. 664 (1970)). In *Walz*, the Court held that New York’s exemption of religious organizations from property taxes did not violate the Establishment Clause because “[t]he grant of a tax exemption is not sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state.” *Walz*, 397 U.S. at 675.

For scholarly discussion of the equivalence of tax expenditures and direct expenditures for constitutional law purposes, see Donna D. Adler, *The Internal Revenue Code, the Constitution, and the Courts: The Use of Tax Expenditure Analysis in Judicial Decision Making*, 28 WAKE FOREST L. REV. 855 (1993); Sugin, *supra* note 51; Edward A. Zelinsky, *Are Tax “Benefits” Constitutionally Equivalent to Direct Expenditures?*, 112 HARV. L. REV. 379 (1998).

In the recent debate over the constitutionality of the individual mandate in the PPACA, most

foundation of tax expenditure analysis is the insight that the government spends money when it forgoes collecting taxes by offering special tax benefits. Consider the example of the home mortgage interest deduction, which Stanley Surrey used when introducing the tax expenditure concept to the United States.⁵⁸ Surrey argued that Congress could achieve ends economically equivalent to the home mortgage deduction by repealing the deduction (thereby allowing the federal government to collect more revenue) and replacing it with checks issued to all of the taxpayers who formerly benefited from the deduction for the amount of the tax savings they would have been entitled to had the deduction not been repealed.⁵⁹ Rather than regarding this alternative programmatic implementation as politically feasible, Surrey used it to emphasize the economic equivalence of tax spending and direct spending. He reasoned that, since “[a] dollar is a dollar,”⁶⁰ tax spending programs should receive the same careful scrutiny accorded to direct spending.⁶¹

Of course, federal tax expenditures differ from direct spending in a variety of ways.⁶² For example, conditional grants directly raise federalism concerns because Congress offers them to the states themselves, whereas tax spending influences private parties.⁶³ This difference could explain why conditional grant spending has received more attention from federalism scholars than has taxation. But, like grant spending, much tax spending represents a mode of congressional regulation.⁶⁴ Moreover, as shown in Figure 1, since the federal government spends more through tax expenditures than through federal grants to the states, arguably we should be even more concerned about the federalism impact of tax expenditures than grants.

commentators seem to discuss tax expenditures as if they are taxes, rather than spending. *See, e.g.*, Ryan Lirette, *The Health Insurance Mandate: If It Must Be, Let It Be a Tax*, 128 TAX NOTES 415, 423 (2010) (discussing tax expenditure provisions as taxes).

58. Surrey, *Tax Incentives*, *supra* note 4, at 722.

59. Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 395–408 (1970).

60. Surrey, *Tax Incentives*, *supra* note 4, at 717.

61. *Id.* at 726–27.

62. For a comparison of tax spending and conditional grants, see discussion *infra* Part III. For scholarship reviewing Supreme Court precedent on the differences between direct spending and tax spending, see, e.g., Adler, *supra* note 57, Sugin, *supra* note 51, and Zelinsky, *supra* note 57.

63. In addition to influencing private taxpayer behavior, federal tax expenditures may also influence state behavior. For example, by limiting the federal deduction for state and local taxes to only certain kinds of state and local taxes, Congress puts pressure on lower levels of government to structure their taxes to qualify for the federal deduction. *See* discussion *infra* Part III.G. Furthermore, this Article argues that federal tax expenditures may crowd out state regulation of the same policy area. *See* discussion *infra* Part I.B.

64. Not all tax expenditures operate as tax incentives. Some tax expenditures, such as tax benefits for the blind or disabled, simply seek to relieve taxpayer hardship. *See, e.g.*, I.R.C. § 22 (2006) (tax credit for the elderly or disabled).

3. Tax Penalties

Although tax scholars have widely acknowledged the regulatory effects of tax expenditures, the regulatory impact of tax penalties has received much less attention, probably because Congress employs tax penalties far less than it employs tax expenditures.⁶⁵ Nevertheless, Congress undeniably uses taxation to raise the costs of activities it deems undesirable.

This Article uses the term “tax penalties” to describe laws that deliberately overtax compared to the normal tax burden.⁶⁶ These provisions may impose new taxes⁶⁷ or accelerate the liability to pay the normal tax,⁶⁸ but the majority of tax penalties deny exemptions, deductions, and credits that otherwise would be available under the normal tax.⁶⁹

Like the tax expenditure concept, the tax penalty concept faces an inescapable definitional problem. Defining tax penalties as deviations from the “normal” tax or deviations from the “normal” net income baseline will generate controversy as to what constitutes the normal tax baseline. Without agreement on the baseline, there can be no more agreement about which provisions increase the normal tax (and thus constitute tax penalties) than there can be about which provisions decrease the normal tax (and thus constitute tax expenditures). As noted above, this Article follows general scholarly practice by adopting the Schanz-Haig-Simons definition of income as the baseline for identifying both tax expenditures and tax penalties. But others would choose other baselines, which would lead to disputes over the proper characterization of particular tax provisions as tax penalties.⁷⁰ In the absence of universal agreement on a normative net income baseline, such disputes are inevitable.⁷¹ I predict, however, that, as with tax expenditures, there would be substantial agreement that certain provisions constitute tax penalties.⁷² Moreover, for the

65. An exception is Zolt, *supra* note 11 (discussing the effectiveness of penalties enacted through the tax law).

66. For our purposes, the “normal” baseline is the Schanz-Haig-Simons definition of income. See *infra* notes 35–40 and accompanying text.

67. See, e.g., I.R.C. § 884 (2006) (branch profits tax). Outside the income tax there also exist a variety of federal excise or “sin” taxes, such as those on cigarettes. See *id.* §§ 5701–5703.

68. See, e.g., *id.* §§ 951–64 (accelerating the tax liability on certain profits of foreign subsidiaries of U.S. shareholders).

69. See, e.g., *id.* § 280E (denying deduction for business expenses related to earning taxable income from the illegal drug trade).

70. Cf. Bittker, *Subsidies*, *supra* note 4, at 260 (“[E]very man can create his own set of ‘tax expenditures,’ but it will be no more than his collection of disparities between the income tax law as it is, and as he thinks it ought to be.”).

71. Indeed, even if there were universal agreement on the Schanz-Haig-Simons baseline, disputes might still arise about the extent to which progressive tax rates constitute tax penalties. For more on the intractable problem of identifying tax expenditures and penalties and the ramifications of that problem for judicial review of tax expenditures and penalties, see *infra* Part III.H.

72. For example, I expect that most people would regard as a penalty the denial of deductions for expenses incurred for the production of taxable income from illegal drug trafficking. This conclusion derives from the premise that deductions must be allowed for all

argument made in this Article, what is important is not the proper characterization of tax provisions as tax expenditures or penalties, but rather the more general recognition that because Congress uses tax laws to regulate, understanding the limits of the taxing power is important for understanding the limits of federal power.

Congress uses tax penalties in a wide range of policy areas. Many of these penalties increase the progressivity of the tax system,⁷³ help to enforce the tax law,⁷⁴ or prevent taxpayer abuse.⁷⁵ Some tax penalties reinforce U.S. foreign policy positions. For example, although the tax law ordinarily allows U.S. taxpayers to credit taxes paid to foreign governments against their U.S. tax liability, that credit is unavailable both for taxes paid to foreign governments not recognized by the United States and for taxes paid to foreign governments that support terrorism.⁷⁶ Similarly, some commentators have described the high withholding tax rates imposed by the United States as tax penalties designed to encourage foreign countries to enter with the United States into tax treaties that reciprocally reduce withholding taxes.⁷⁷ Thus, Congress also may use tax penalties to enhance its tax treaty bargaining position.⁷⁸

business expenses under a normative net income tax. In contrast, although some might regard progressive individual tax rates as a penalty on high income earners, there would not be substantial agreement on such a categorization.

73. See I.R.C. § 56(b)(1)(E) (2006) (denial of personal exemption for alternative minimum taxpayers); *id.* § 63(c)(1) (denial of standard deduction for alternative minimum taxpayers). Denial of standard deductions and personal exemptions represents a tax penalty because the standard deduction and personal exemption generally are considered to be part of the “normal” tax baseline. See OMB, ANALYTICAL PERSPECTIVES, *supra* note 41, at 298. In contrast, phase-outs of tax expenditures, such as credits for payments of college tuition (and the like), while also increasing the progressivity of the tax system, would be regarded as reductions in tax expenditures, rather than tax penalties. This characterization reminds us that tax penalty and expenditure analysis raises thorny baseline questions. See *supra* notes 35–40 and accompanying text.

74. See, e.g., I.R.C. § 6621(a) (2006) (interest on underpayments of tax); *id.* § 6651(a) (failure to file); *id.* § 6654(a) (underpayment of estimated tax); *id.* § 6662 (fraud and substantial understatement); *id.* § 6663 (inaccuracies); *id.* § 6702 (frivolous returns); *id.* § 6721 (failure to file information return); *id.* § 6676 (erroneous tax refund claims); *id.* §§ 7701–7212 (criminal penalties).

75. The tax law contains many other penalties aimed at preventing taxpayer abuse. See, e.g., *id.* § 382 (disallowing use of net operating losses after certain ownership changes); *id.* § 1091 (wash sale rules); *id.* § 531 (accumulated earnings tax).

Many tax penalty provisions apply to cross-border economic activity. See *id.* § 884 (imposing the branch profits tax on U.S. branches of certain foreign corporations with effectively connected U.S. income); *id.* §§ 951–64 (currently taxing certain income earned by foreign corporations controlled by U.S. shareholders even when such controlled foreign corporations do not repatriate the income).

76. *Id.* § 901(j); see also *id.* § 891 (authorizing the President to double taxes of residents of foreign countries if their home country assesses discriminatory taxes against U.S. taxpayers).

77. See *id.* §§ 871(a), 881, 1441 (providing 30 percent gross withholding tax regime applicable to, among other payments, direct dividends paid from a U.S. corporation to a nonresident shareholder). Tax treaties typically reduce this withholding rate to zero or five percent. See United States Model Income Tax Convention of November 15, 2006, art. 10, available at <http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf>.

78. AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF

Many tax penalties regulate business. For example, Congress uses the tax law to influence employee compensation in a variety of ways, including by limiting public companies' deductions to one million dollars for non-performance-based salaries paid to certain key employees.⁷⁹ The tax law also disallows deductions for certain golden parachute payments,⁸⁰ and it delays employer deductions for the payment of certain compensatory stock options.⁸¹ Although it ultimately was not enacted, last year members of Congress proposed a "bonus tax" on employees of financial institutions that received TARP funds.⁸² Other tax penalties seek to reduce business influence over politics by denying deductions for lobbying expenses and political contributions.⁸³

In addition to regulating business, Congress also uses tax penalties to influence the behavior of individual taxpayers. For example, while a number of federal tax expenditures subsidize retirement savings,⁸⁴ federal tax law also penalizes those who prematurely withdraw funds from tax-advantaged savings accounts.⁸⁵ Still more federal taxes seek to raise the cost of unhealthy or unproductive activities—such as gambling, smoking, or driving a gas-guzzling car—that impose costs on society.⁸⁶

More generally, Congress uses the tax law to support various federal and state non-tax regulatory efforts. For example, although taxpayers generally may

UNITED STATES INCOME TAXATION II 13 (1992) (“[B]y imposing withholding tax rates higher than deemed appropriate,” the United States secures “a ‘bargaining chip’ to bring potential treaty parties to the negotiating table.”).

79. I.R.C. § 162(m) (2006).

80. *Id.* § 280G.

81. Treas. Reg. § 1.83-7(a) (as amended in 2004) (deferral of employer deduction for compensation paid in the form of nonqualified stock options without a readily ascertainable value until either the year that employee exercises the option or the year that it substantially vests). *See also* I.R.C. § 162(k) (2006) (denying deduction for greenmail payments to corporate acquirers).

82. Greg Hitt & Aaron Lucchetti, *House Passes Bonus Tax Bill: 90% Hit Would Affect Major Banks; Senate Mulls Similar Action Amid AIG Furor*, WALL ST. J., Mar. 20, 2009, at A1.

83. I.R.C. § 162(e) (2006). Tax-exempt section 501(c)(3) organizations, contributions to which generate charitable deductions for the contributor, cannot participate in lobbying activities, although tax-exempt organizations willing to forgo the benefit of deductible contributions can engage in lobbying. *See id.* § 501(c)(4).

84. *Id.* § 401 (retirement plans); *id.* §§ 408–408A (IRAs); *id.* §§ 409, 4975 (employee stock ownership plans).

85. *Id.* §§ 72(m)(5)(B), (q), (t), and (v) (taxes on early withdrawal from retirement plans and IRAs); *id.* §§ 402(g) and 4979 (penalty on excess contributions to a 401(k) plan); *cf. id.* § 530(d)(3) (additional tax on certain distributions from Coverdell educational savings accounts); *id.* § 220(f)(4) (additional tax on medical savings account distributions not used for qualified medical expenses); *id.* § 138(c)(2) (penalty for Medicare Advantage savings accounts distributions not used for qualified medical expenses).

86. *See, e.g., id.* § 165(d) (denying losses from gambling to the extent that they exceed the taxpayer's gains from gambling); *id.* § 280F (limiting depreciation deductions for trucks, SUVs, and vans), *id.* § 4064 (imposing a graduated tax on manufacturers' sale of cars based on fuel economy). Federal “sin” taxes discourage certain activities by raising their cost. *See, e.g., id.* §§ 5701–5703 (cigar, cigarette, and tobacco taxes). Sin taxes, as well as other federal tax penalties, may also aim to force the taxpayer to internalize some of the social costs imposed by her behavior. *See, e.g., id.* § 4081 (gas tax).

deduct business expenses, federal tax law specifically denies deductions for fines and penalties paid to any government for the violation of law.⁸⁷ Federal tax law also disallows deductions for the payment of illegal bribes and kickbacks,⁸⁸ anti-trust treble damage awards,⁸⁹ and penalties for failure to pay federal taxes.⁹⁰ Federal tax penalties also support certain state and federal crime prevention efforts. For example, taxpayers may not deduct any business expenses associated with carrying on an illegal drug business, even though the income from such business is taxable.⁹¹ The purpose behind these kinds of tax penalties is to help enforce the law by making violations more costly.⁹²

Although Congress undoubtedly has the authority to pursue some of the policies just described through direct regulation under its commerce, foreign policy, or other enumerated powers, some tax penalties—including the newly adopted penalty for failing to comply with the PPACA's individual mandate—regulate areas that Congress arguably could not reach with its other enumerated powers.⁹³ As a result, tax penalties, like tax expenditures, raise federalism concerns.

B. Effects of Federal Tax Regulation on the States

If Congress uses tax expenditures and penalties to regulate areas traditionally or constitutionally reserved to the states, then such tax regulation raises federalism concerns similar to those raised when Congress makes conditional grants to the states.⁹⁴ Thus, to the extent that we are concerned about the federalism impact of conditional grants, arguably we should also be concerned about the federalism impact of tax expenditures and penalties.

Among the values that federalism promotes is horizontal competition among the states for residents who are free to move to any state in the Union. Competition forces state governments to respond to the political preferences of their residents.⁹⁵ The states' smaller size compared to that of the nation also

87. *Id.* § 162(f).

88. *Id.* § 162(c) (denying deduction for payments that are illegal under federal or state law).

89. *Id.* § 162(g) (limitations on deduction of anti-trust damage payments).

90. See references in *supra* note 74.

91. *Id.* § 280E (disallowing deductions for businesses consisting of “trafficking in controlled substances . . . prohibited by Federal law or the law of any State in which such trade or business is conducted”).

92. *But see* Zolt, *supra* note 11 (arguing that linking tax penalties to taxpayers' marginal tax rates is arbitrary and will not optimally deter unwanted behavior).

93. For the argument that the individual mandate exceeds Congress's enumerated powers and unconstitutionally invades the reserved powers of the states, see Randy E. Barnett, *Commandeering the People: Why the Individual Health Insurance Mandate Is Unconstitutional*, 5 N.Y.U. J.L. & LIBERTY 581 (2010).

94. This effect is different from the usual federalism effect attributable to federal taxation, namely, that federal taxation crowds out state taxation of the same base. For critical discussion of that question, see, e.g., Galle, *The “SALT” Deduction*, *supra* note 5.

95. *Cf.* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956) (presenting model predicting that perfect local mobility would reveal voters' hidden political and fiscal preferences).

may facilitate political participation,⁹⁶ at least when a single voter's voice carries more weight in state than federal elections.⁹⁷ Similarly, the smaller size of states, coupled with uneven distribution of voter preferences across the country, facilitates policy diversity: each state can adopt policies that reflect the preferences of its residents, which may differ from national preferences or from preferences of residents of other states.⁹⁸ Closely related to this is the idea that states may devise different ways to pursue similar policy goals, thus serving, in Justice Brandeis' famous words, as "laborator[ies]" for "social and economic experiments."⁹⁹

Federalism also promotes vertical competition between the federal and state governments. Although the federal and state governments do not compete for residents, James Madison predicted that they would compete for the affections of the governed.¹⁰⁰ For any regulatory area not exclusively assigned to the federal or state governments by the Constitution, Madison envisioned that the people would choose their regulator.¹⁰¹ If they trusted the federal government more, the people would invest more power with the federal government, or vice versa.¹⁰² In this way, Madison believed that the federal and state governments would check each other, so that neither would become oppressive.¹⁰³

It is not necessary to repeat at length here the well-known claim that conditional federal spending jeopardizes federalism values.¹⁰⁴ Instead, it should suffice to draw the analogy between federal grant spending and federal tax spending. When it conditions grants upon states' implementation of particular policies, the federal government thereby reduces the scope for state policy experimentation and competition. Similarly, when the federal government uses federal tax law to reach past the states to regulate private taxpayer behavior through tax expenditures and penalties, it may leave less room for states to implement different or contrary policies. Where federal tax incentives reward taxpayers for engaging in particular activities, such as education,¹⁰⁵ home

96. *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991).

97. Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1509 (1987).

98. *Id.* at 1493–1500.

99. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

100. THE FEDERALIST NO. 51, at 320 (James Madison) (Clinton Rossiter, ed., 1961); Todd E. Pettys, *Competing for the People's Affection: Federalism's Forgotten Marketplace*, 56 VAND. L. REV. 329 (2003) (quoting THE FEDERALIST NO. 17 (Madison)) (describing Madison's view of vertical federalism and how the federalism decisions of the Rehnquist Court can be seen as supporting that vision).

101. Pettys, *supra* note 100, at 332–33.

102. *Id.* at 333.

103. *Gregory*, 501 U.S. at 459.

104. For criticism of the Supreme Court's expansive interpretation of the spending power, see Baker, *After Lopez*, *supra* note 3; McCoy & Friedman, *supra* note 3; Somin, *supra* note 3;. For arguments that the spending power should be interpreted broadly, see Chemerinsky, *supra* note 3; Engdahl, *supra* note 3.

105. *See, e.g.*, I.R.C. § 25A (2006) (tax credit for higher education).

ownership,¹⁰⁶ and the purchase of private health insurance,¹⁰⁷ those tax incentives may displace the expression of local values and local political preferences. Similarly, to at least some extent the federal government may override local political decisions when it uses tax penalties to discourage certain activities, such as smoking, gambling, and driving. If, in order to secure federal subsidies or avoid federal penalties, taxpayers strive to meet federal (rather than local) standards, then the taxing power raises concerns similar to those raised by the spending power.¹⁰⁸ Specifically, if the federal government uses its taxing power to enlarge the scope of its regulatory influence beyond its constitutionally enumerated powers, it reduces the areas in which the states can compete with the federal government and with each other. Thus, just as commentators have accused Congress of using conditional federal grants to crowd out state regulation,¹⁰⁹ so too may Congress use federal taxes to crowd out state regulation. Ultimately, the extent of this problem depends on unanswered empirical questions regarding the extent to which federal taxing and spending displaces state and local regulation in similar substantive areas. The impact of federal taxes on state legislative choices also depends on legal questions, such as whether the federal government may use taxes to achieve ends that lie beyond its other constitutionally enumerated powers, and whether such regulation can preempt state taxes and regulations. These issues are considered in Parts II and III.

II.

CONSTITUTIONAL LIMITS ON TAXING AND SPENDING

This Part considers the Supreme Court's interpretations of the taxing power, especially as they relate to the question of whether the Constitution constrains Congress to use the taxing power to achieve ends only within its other enumerated powers. Section A reviews the express constitutional limits on the taxing power, and Sections B through D analyze Supreme Court decisions considering additional limits on the taxing power.

The congressional powers to tax and spend derive from the same clause of the Constitution, alternatively called the General Welfare Clause or the Taxing and Spending Clause. The Clause provides:

[The Congress shall have Power] To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties,

106. *Id.* § 163(h)(3) (deduction for home mortgage interest).

107. *Id.* § 106 (exclusion from income of employer contributions to accident and health plans).

108. For example, with non-profit organizations, the requirements to secure federally tax-exempt status effectively serve as the regulatory floor for nonprofits in every state, and states may impose additional requirements. *Cf.* Fishman, *supra* note 45, at 586–88 (criticizing the federal government for effectively preempting state regulation of charitable organizations through its ability to confer federal tax-exempt status).

109. *See, e.g.,* Baker, *Federalist Revival*, *supra* note 3, at 212–13.

Imposts and Excises shall be uniform throughout the United States.¹¹⁰

Although it is not clear from this text whether Congress may use the tax power to achieve goals lying beyond its other enumerated powers, the Supreme Court has shown considerable deference to federal tax measures. It generally has not invalidated federal taxes as exceeding federal competence, even when those taxes have the effect or purpose of destroying the activity taxed.¹¹¹ This deference has motivated commentators to describe the taxing power as “plenary,”¹¹² but although the Supreme Court has interpreted the taxing power expansively, its decisions do not unequivocally state that the power to tax is as broad as the power to spend. Thus, the regulatory reach of the taxing power is unclear. The Court’s modern decisions seem to support an interpretation of the Taxing and Spending Clause that would allow Congress to use its taxing power, like its spending power, to regulate areas that it may not regulate directly. This conclusion is tentative, however, because several *Lochner*-era precedents held otherwise and have not been overruled.

A. Express Limits

1. Uniformity and Apportionment

Although the congressional taxing power is “very extensive,”¹¹³ the Constitution expressly limits it in several ways. According to the Taxing and

110. U.S. CONST. art. I, § 8, cl. 1; see *United States v. Butler*, 297 U.S. 1, 65 (1936) (interpreting the clause to confer upon Congress the power to tax and spend). *But see* Engdahl, *supra* note 3, at 49–54 (arguing that the Property Clause would provide a firmer foundation for the congressional spending power).

111. See references *infra* note 113.

112. See, e.g., Erik M. Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2339 (1997) (rejecting this “pervasive” view). The taxing power, although broad, is unlike exclusive federal powers such as the power to regulate immigration. For example, although Congress has preempted certain state taxes, such as airline taxes and certain taxes on out-of-state companies selling into a state via the Internet, Congress could not, for example, preempt all state income taxation, even though as an empirical matter federal taxation of income may diminish states’ abilities to tax the same base. Thus, even on a very broad interpretation of the federal taxing power that allows Congress to use taxes to regulate areas it could not regulate directly, the federal taxing power would not properly be labeled plenary.

113. See, e.g., *License Tax Cases*, 72 U.S. (5 Wall.) 462, 471 (1867) (“[T]he power of Congress to tax is a very extensive power . . . [I]t reaches every subject, and may be exercised at discretion.”); *United States v. Kahriger*, 345 U.S. 22, 28 (1953) (“It is axiomatic that the power of Congress to tax is extensive and sometimes falls with crushing effect . . . As is well known, the constitutional restraints on taxing are few.”); *Steward Machine Co. v. Davis*, 301 U.S. 548, 581 (1937) (“The subject matter of taxation open to the power of the Congress is as comprehensive as that open to the power of the states.”); *McCray v. United States*, 195 U.S. 27, 59 (1904) (“Since . . . the taxing power conferred by the Constitution knows no limits except those expressly stated in that instrument, it must follow, if a tax be within the lawful power, the exertion of that power may not be judicially restrained because of the results to arise from its exercise”); *Austin v. Alderman*, 74 U.S. (7 Wall.) 694, 699 (1868) (“The right of taxation, where it exists, is necessarily unlimited in its nature. It carries with it inherently the power to embarrass and destroy.”).

Spending Clause, duties, imposts, and excises—collectively *indirect* federal taxes—must be “uniform throughout the United States,” meaning that they must apply in the same way to, for example, residents of Connecticut and residents of California.¹¹⁴

By its terms, the uniformity requirement does not apply to direct taxes. Elsewhere, however, the Constitution requires apportionment of direct taxes, which means that the aggregate tax liability of taxpayers in each state must be proportional to that state’s population.¹¹⁵ So, for example, if the population of California is ten times that of Connecticut, then Californians’ collective direct tax liability must be ten times that of Connecticut residents. Although the Supreme Court has never made the distinction between direct and indirect taxes clear, Professor Erik Jensen argues that the Court’s jurisprudence supports a distinction that looks to whether the tax can be shifted or avoided.¹¹⁶ If the taxpayer cannot shift the tax to someone else (for example, to consumers in the case of a sales tax) or avoid the tax (for example, by refusing to buy the good subject to a sales tax), then it constitutes a direct tax that must be apportioned.¹¹⁷ In 1895, the Supreme Court held the individual income tax unconstitutional because it was a direct tax that was not apportioned.¹¹⁸ This holding led to the adoption of the Sixteenth Amendment, which excludes income taxes from the apportionment requirement.¹¹⁹

114. U.S. Const. art. I, § 8, cl. 1 (“[A]ll Duties, Imposts and Excises shall be uniform throughout the United States . . .”). A “tax is uniform when it operates with the same force and effect in every place where the subject of it is found.” *United States v. Ptasynski*, 462 U.S. 74, 82 (1983) (internal quotation marks omitted).

115. U.S. CONST. art. I, § 9, cl. 4 (“No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.”).

116. See Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of “Incomes,”* 33 ARIZ. ST. L.J. 1057, 1067–80 (2001). But see *Murphy v. I.R.S.*, 493 F.3d 170, 184 (D.C. Cir. 2007) (expressing doubt that certain taxes that have been held to be (indirect) excise taxes, such as estate taxes, can be shifted).

117. See Erik M. Jensen, *The Individual Mandate and the Taxing Power* 24–38 (Case Research Paper Series in Legal Studies, Working Paper No. 2010-33, 2010), available at <http://ssrn.com/abstract=1683462> (analyzing the constitutionality of the individual mandate under the taxing power) [hereinafter Jensen, *Individual Mandate*]. See generally Jensen, *supra* note 116.

118. *Pollock v. Farmers’ Loan & Trust Co.*, 158 U.S. 601 (1895) (holding that a tax on income from real or personal property was a direct tax that must be apportioned). See also *Murphy v. I.R.S.*, 493 F.3d 170, 181 (D.C. Cir. 2007) (“Only three taxes are definitely known to be direct: (1) a capitation, (2) a tax upon real property, and (3) a tax upon personal property.”) (internal citations omitted). In contrast, (indirect) excise taxes include, but are not limited to, “taxes on consumable items, . . . the sale of corporate stock, doing business in corporate form, gross receipts from the ‘business of refining sugar,’ the transfer of property at death, gifts, and income from employment.” *Id.* (internal citations omitted). In *Murphy*, the D.C. Circuit held that federal taxes on compensatory damages for emotional distress and loss of reputation were excise taxes that need not be apportioned.

119. U.S. CONST. amend. XVI (“Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”).

2. Other Requirements

In addition to the uniformity and apportionment requirements, the Constitution expressly forbids Congress from imposing taxes or duties on state exports.¹²⁰ It also requires general revenue-raising legislation to originate in the House of Representatives.¹²¹ Finally, taxes must not constitute takings without just compensation.¹²² Whereas the apportionment and uniformity requirements do not apply to spending, both taxing and spending must be for federal debts, defense, or “general welfare.”¹²³ The Supreme Court defers to Congress and voters on whether taxing and spending provisions advance general welfare.¹²⁴

B. The Taxing and Spending Clause

At least since *Dole*, it has been clear that Congress may use “the spending power and the conditional grant of federal funds” to achieve regulatory goals that fall outside its other enumerated powers.¹²⁵ The *Dole* Court treated conditional grants as merely a subset of all federal spending.¹²⁶ If tax expenditures likewise constitute a subset of federal spending, then under *Dole*, Congress presumably may use tax expenditures to regulate areas it could not regulate directly.

120. U.S. CONST. art. I, § 9, cl. 5. Although this Article concerns federal taxation, the Constitution also provides some express limitations on states’ taxing powers. For example, it prevents the states from enacting imposts or duties on imports and exports and tonnage duties. U.S. CONST. art. I, § 10, cl. 2 (limiting states’ ability to assess “Imposts or Duties on Imports or Exports”); U.S. CONST. art. I § 10, cl. 3 (limiting ability to assess “any Duty of Tonnage”).

121. U.S. CONST. art. I, § 7.

122. U.S. CONST. amend. V (“[N]or shall private property be taken for public use, without just compensation.”). For how to distinguish taxes from takings, see, e.g., Eric Kades, *Drawing the Line Between Taxes and Takings: The Continuous Burdens Principle, and Its Broader Application*, 97 NW. U. L. REV. 189 (2002).

123. U.S. CONST. art. I, § 8, cl. 1.

124. See, e.g., *Helvering v. Davis*, 301 U.S. 619, 640 (1937) (“The line must still be drawn between one welfare and another, between particular and general The discretion, however, is not confided to the courts. The discretion belongs to Congress.”).

125. *South Dakota v. Dole*, 483 U.S. 203, 207 (1987). This reasoning can be traced to *Butler*, in which the Court first explicitly endorsed Hamilton’s view that the spending power constitutes an independent congressional power not limited by its other enumerated powers. See *United States v. Butler*, 297 U.S. 1, 66 (1936) (“[T]he power of Congress to authorize expenditure of public moneys for public purposes is not limited by the direct grants of legislative power found in the Constitution.”); see also *Oklahoma v. United States Civil Serv. Comm’n*, 330 U.S. 127 (1947) (upholding conditioning of federal funds on state’s prohibition of certain state officials’ participation in partisan political activities); Engdahl, *supra* note 3, at 3, 47 (noting that although the Supreme Court gave lip service to Hamilton’s view in *Butler*, it did not properly apply it until *Oklahoma* in 1947).

126. See *Dole*, 483 U.S. at 206–07 (“[T]he power of Congress to authorize expenditure of public moneys for public purposes is not limited by the direct grants of legislative power found in the Constitution.” Thus, objectives not thought to be within Article I’s ‘enumerated legislative fields’ may nevertheless be attained through the use of the spending power *and* the conditional grant of federal funds.”) (emphasis added) (internal citations omitted).

Tax expenditures may, however, represent an exercise of the taxing power, rather than the spending power. And even if tax expenditures are spending for constitutional law purposes, tax penalties surely are not. Thus, to fully understand the constitutional limits on Congress's ability to regulate through the tax law, we must look to the taxing power.

Since the taxing and spending powers derive from the same constitutional clause, it would make sense to construe Congress's power to tax as broadly as its power to spend.¹²⁷ Dicta from recent federal court decisions support the notion that federal taxing, like federal spending, is unconstrained by enumeration.¹²⁸ And the Supreme Court has repeatedly concluded that, as long as a tax raises general revenue,¹²⁹ the Court will not closely examine regulatory goals Congress may have had in imposing it. Thus, the Supreme Court has upheld federal taxes on state bank notes, dyed oleomargarine, corporate profits, and sales of narcotics, even though those taxes had clear regulatory effects.¹³⁰

127. Commentators have relied on the placement of the taxing and spending powers in the same clause of the Constitution to argue that the powers should be interpreted coextensively. *See, e.g.*, Brief of Constitutional Law Professors in Support of Motion to Dismiss as Amicus Curiae at 7, *Virginia ex rel. Cuccinelli v. Sebelius*, 728 F. Supp. 2d 768 (E.D. Va. 2010) (No. 3-10CV188-HEH) [hereinafter *Con Law Professors' Brief*] ("Given [the taxing and spending powers'] grounding in the same portion of the Constitution's text, it would be anomalous to say the least if the taxing power did not similarly extend beyond Congress's enumerated areas of regulatory authority."); Brian Galle, *Conditional Taxation and the Constitutionality of Health Care Reform*, 120 *YALE L.J. ONLINE* 27, 30 (2010), <http://www.yalelawjournal.org/images/pdfs/889.pdf> [hereinafter *Galle, Health Care Reform*] ("[B]ecause [taxing and spending] derive textually from the same words, it would be odd for those words to be limited in one setting and not in another.").

128. *See, e.g.*, *Pace v. Bogalusa City Sch. Bd.*, 403 F.3d 272, 278 n.22 (5th Cir. 2005) (stating that "Congress's spending power, like its power to tax, is 'to provide for the general welfare,' and is therefore untrammelled by the specific grants of legislative power found elsewhere in Article I, Section 8" (citation omitted) (citing *United States v. Lipscomb*, 299 F.3d 303, 319 (5th Cir. 2002)). The Fifth Circuit in *Lipscomb* cited *Butler* for the proposition that Congress's taxing and spending powers are co-extensive. *Lipscomb*, 299 F.3d at 319. But in *Butler*, although the Supreme Court stated that Congress's taxing power was not limited by its other enumerated powers, it nevertheless struck down the tax at issue in the case essentially because it was a disguised regulation of activities falling outside Congress's other enumerated powers. *United States v. Butler*, 297 U.S. 1, 65 (1936).

129. The term "general revenue" is meant to evoke what the *Butler* Court termed "an exaction for the support of the Government," rather than a user fee or other exaction that raises revenue earmarked for a particular purpose. For more on the requirement that taxes raise revenue, see references *infra* note 270.

130. *See, e.g.*, *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533, 548 (1869) (upholding tax on state bank notes); *McCray v. United States*, 195 U.S. 27, 59 (1904) (upholding high tax on oleomargarine dyed to look like butter, even if Congress's intention in imposing tax was to destroy or restrict oleomargarine industry, because "the motive or purpose of Congress in adopting the acts in question may not be inquired into"); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 167 (1911) (upholding federal corporate tax, even if consequence may be to destroy corporations, because "right to select the measure and objects of taxation devolves upon the Congress and not upon the courts"); *United States v. Doremus*, 249 U.S. 86, 93 (1919) (upholding challenge to federal tax on unregistered sale of narcotics against a challenge that it invaded state police power because "fact that other motives may impel the exercise of federal taxing power does not authorize the courts to inquire into that subject").

In certain *Lochner*-era cases, however, the Supreme Court read the Constitution to prohibit Congress from using tax penalties to regulate areas outside its other enumerated powers. For example, in 1918 in *Hammer v. Dagenhart*, the Supreme Court held that the Commerce Clause did not give Congress the power to regulate child labor.¹³¹ Undeterred, Congress imposed a tax of 10 percent of the net profits of any business that knowingly¹³² employed child labor. In 1922, in *Bailey v. Drexel Furniture Company* (commonly called the *Child Labor Tax Case*), the Supreme Court unanimously struck down the tax on the grounds that it exceeded Congress's enumerated powers.¹³³ In so doing, the Court stated:

[G]rant the validity of this law, and all that Congress would need to do, hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the States have never parted with, and which are reserved to them by the Tenth Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. 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.¹³⁴

In striking down the tax on goods produced with child labor, the Supreme Court distinguished the taxes it had previously upheld on state bank notes, dyed oleomargarine, corporate profits, and sales of narcotics because Congress could reach each of these activities with other enumerated powers, such as the power to coin money and the commerce power.¹³⁵

The Court decided *Hill v. Wallace* the same Term as the *Child Labor Tax Case*.¹³⁶ In *Hill*, the Supreme Court struck down federal taxes that applied to the sale of commodities futures unless they were sold on boards of trade meeting specific conditions as enforced by the Secretary of Agriculture.¹³⁷ Again, the Supreme Court found unconstitutional Congress's attempt to use taxes to regulate areas reserved to the states.

In *United States v. Constantine*, decided in 1935, a divided Court struck down a federal excise tax of \$1,000 on dealers who sold liquor in contravention of state law.¹³⁸ The majority concluded that the purpose of the tax was to

131. *Hammer v. Dagenhart*, 247 U.S. 251 (1918).

132. The Court made much of the scienter requirement in the tax provision. *See Bailey v. Drexel Furniture Co. (Child Labor Tax Case)*, 259 U.S. 20, 37 (1922) ("Scienter is associated with penalties not with taxes.").

133. *Id.* at 38.

134. *Id.*; *see also id.* at 39 ("[T]he so-called tax is a penalty to coerce people of a State to act as Congress wishes them to act in respect of a matter completely the business of the state government under the Federal Constitution.").

135. *See Child Labor Tax Case*, 259 U.S. at 41–44.

136. *Hill v. Wallace*, 259 U.S. 44 (1922).

137. *Id.* at 67 (citing *Child Labor Tax Case*, 259 U.S. at 20).

138. *United States v. Constantine*, 296 U.S. 287 (1935).

penalize liquor dealers for violating the law, and it held that such regulation was reserved to the police powers of the state.¹³⁹ The Court identified the characteristics that distinguished a “penalty” designed “to punish rather than to tax”¹⁴⁰ from a “true tax”¹⁴¹ or “[an exaction] laid to raise revenue.”¹⁴² First, the Court found the \$1,000 excise to be “highly exorbitant” and “grossly disproportionate to the amount of the normal tax” applicable to liquor dealers, which was only twenty-five dollars.¹⁴³ Second, the “condition of the imposition is the commission of a crime.”¹⁴⁴ Allowing the federal government to impose penalties for violations of state laws would, in the majority’s view, “obliterate the distinction between the delegated powers of the federal government and those reserved to the states.”¹⁴⁵

United States v. Butler, decided in 1936, is the most recent case in which the Supreme Court struck down a federal tax on the grounds that it invaded reserved state powers.¹⁴⁶ The case involved the Agricultural Adjustment Act of 1933, which attempted to control agricultural commodity prices by subsidizing certain crops (including by paying farmers to produce less). Congress raised the funds for the subsidies from a special purpose tax on agricultural producers. In the Court’s analysis, this earmarked tax was an “expropriation of money from one group for the benefit of another,” rather than “an exaction for the support of the Government.”¹⁴⁷ Furthermore, the “avow[ed]” aim of the statute was to regulate, rather than to raise revenue.¹⁴⁸ The Court ultimately struck down the earmarked-tax-and-subsidy scheme on the grounds that its purpose was to control agricultural production, which was a “purely local activity”¹⁴⁹ whose regulation was reserved exclusively to the states.¹⁵⁰

Since the *Child Labor Tax Case* and *Butler*, however, the Supreme Court has upheld a variety of regulatory taxes.¹⁵¹ For example, in *Steward Machine*, the Supreme Court upheld provisions of the Social Security Act of 1935 against

139. *Id.* at 296.

140. *Id.* at 294.

141. *Id.*

142. *Id.* at 293.

143. *Id.* at 295.

144. *Id.*

145. *Id.* at 296.

146. *U.S. v. Butler*, 297 U.S. 1 (1936).

147. *Id.* at 61.

148. *Id.* at 59.

149. *Id.* at 64.

150. *Id.* at 68.

151. For example, the Court upheld a regulatory tax on liquor after it decided the *Child Labor Tax Case*, but before it decided *Butler*. See *United States v. One Ford Coupe Auto.*, 272 U.S. 321, 328 (1926) (upholding continued validity of federal tax on sale of liquor, even after liquor sales were prohibited because “[a] tax on intoxicating liquor does not cease to be such because the sovereign has declared that none shall be manufactured, and because the main purpose in retaining the tax is to make law-breaking less profitable”).

a Tenth Amendment challenge.¹⁵² The Act imposed a federal wage tax on certain employers. Although the proceeds of the tax were not earmarked, employers liable for the federal tax received a federal tax credit for 90 percent of the tax if they also made contributions to a state unemployment fund possessing certain federally-prescribed features.¹⁵³ The Act also contained federal appropriations to aid the states in administering their unemployment compensation regimes that satisfied the federal requirements. An employer subject to the federal excise (and entitled to the 90 percent credit) challenged the Act on the grounds that it invaded the states' reserved powers by coercing them into adopting unemployment compensation regimes.

In his majority opinion, Justice Cardozo reasoned that although denying tax credits to employers resident in states that did not enact unemployment compensation regimes constituted an inducement, it did not unlawfully coerce the states.¹⁵⁴ Justice Cardozo concluded:

[the complaining taxpayer] confuses motive with coercion. Every tax is in some measure regulatory. . . . In like manner every rebate from a tax when conditioned upon conduct is in some measure a temptation. But to hold that motive or temptation is equivalent to coercion is to plunge the law in endless difficulties. The outcome of such a doctrine is the acceptance of a philosophical determinism by which choice becomes impossible. Till now the law has been guided by a robust common sense which assumes the freedom of the will as a working hypothesis in the solution of its problems.¹⁵⁵

In upholding the challenged statute in *Steward Machine*, the Court emphasized that unemployment was a problem “national in area and dimensions,”¹⁵⁶ one that Congress had the power to regulate directly.¹⁵⁷ As a result, the case does not directly confirm that Congress may use taxes to regulate areas it could not regulate directly, and it does not overrule *Butler*.¹⁵⁸

The 1937 case *Sonzinsky v. United States* involved a federal license tax on dealers, importers, and manufacturers of certain firearms, including sawed-off shotguns. The challenging taxpayer argued that the tax represented “a penalty

152. *Steward Machine Co. v. Davis* 301 U.S. 548 (1937).

153. *Id.* at 574. These features included, among others, requirements related to circumstances under which states could make unemployment compensation payments and the requirement that contributions to state unemployment insurance funds had to be transferred to the federal Unemployment Trust Fund. *Id.* at 576–77.

154. *Id.* at 589.

155. *Id.* at 589–90 (internal quotation marks omitted).

156. *Id.* at 586.

157. *Id.* at 593 (“The condition is not directed to the attainment of an unlawful end, but to an end, the relief of unemployment, for which nation and state may lawfully cooperate.”).

158. Similarly, in 1937 in *Helvering v. Davis* the Supreme Court upheld as valid exercises of Congress’s power to spend for the “general welfare” other portions of the Social Security Act of 1935 that provided old age pensions. 301 U.S. 619, 640 (1937). As in *Steward Machine*, in *Davis* the Court emphasized that the problems of unemployment and poverty among the aged were “plainly national in area.” *Id.* at 644.

imposed for the purpose of suppressing traffic in a certain noxious type of firearms, the local regulation of which is reserved to the states.”¹⁵⁹ In upholding that tax, the Supreme Court stated:

[e]very tax is in some measure regulatory. To some extent it interposes an economic impediment to the activity taxed as compared with others not taxed. But a tax is not any the less a tax because it has a regulatory effect; and it has long been established that an Act of Congress which on its face purports to be an exercise of the taxing power is not any the less so because the tax is burdensome or tends to restrict or suppress the thing taxed.

Inquiry into the hidden motives which may move Congress to exercise a power constitutionally conferred upon it is beyond the competency of courts. They will not undertake, by collateral inquiry as to the measure of the regulatory effect of a tax, to ascribe to Congress an attempt, under the guise of taxation, to exercise another power denied by the Federal Constitution.¹⁶⁰

Thus, without specifically ruling on whether Congress possessed the authority (under the Commerce Clause or some other enumerated power) to regulate firearms directly, the Court unanimously upheld the tax. Likewise, in the 1950 case *United States v. Sanchez*, the Court stated that “[i]t is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed.”¹⁶¹ This language contrasts with that in the *Child Labor Tax Case* decided twenty-eight years earlier, in which the Court stated that “there comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such and becomes a mere penalty with the characteristics of regulation and punishment.”¹⁶² Notably, the Court in *Sanchez* stated that a tax statute is not necessarily unconstitutional “because it touches on activities which Congress might not otherwise regulate.”¹⁶³

159. *Sonzinsky v. United States*, 300 U.S. 506, 512 (1937).

160. *Id.* at 513–14.

161. *United States v. Sanchez*, 340 U.S. 42, 44 (1950) (upholding federal Marijuana Tax Act that taxed unregistered transfers of marijuana even though the tax served a federal regulatory purpose in addition to a revenue-raising purpose).

162. *Bailey v. Drexel Furniture Co. (Child Labor Tax Case)*, 259 U.S. 20, 38 (1922). The Supreme Court in the *Child Labor Tax Case* held that the 10 percent tax on the net profits of businesses knowingly employing child labor was not an exercise of the taxing power at all because exactions for departures from “a detailed and specified course of conduct in business” were penalties rather than taxes. *Id.* at 36. Many provisions of the modern tax law require a “detailed and specified course of conduct” to avoid additional tax. *See, e.g.*, I.R.C. § 4980B (2006) (tax penalty for failure of group health plan to comply with continuation of coverage requirements); *id.* §§ 9801–34 (tax penalty for failure of group health plan to comply with portability requirements).

163. *Sanchez*, 340 U.S. at 44 (upholding a federal transfer tax on marijuana against a challenge that it invaded the police powers of the states and stating “[n]or does a tax statute necessarily fail because it touches on activities which Congress might not otherwise regulate”).

The Court's broad interpretations of the taxing power in cases like *Steward Machine*, *Sonzinsky*, and *Sanchez* call into question the continued relevance of the Court's *Lochner*-era jurisprudence that construed the power to be constrained by Congress's other enumerated powers.¹⁶⁴ But the Court has not clearly delineated the scope of the taxing power in its modern jurisprudence.

C. Other Constitutional Provisions

This Section explains that Supreme Court cases considering whether taxing and spending are constitutionally equivalent for purposes of interpreting the Bill of Rights and the Commerce Clause shed little light on the question of whether Congress may use its taxing power to regulate areas that fall outside its other enumerated powers.

1. Personal Rights

The Supreme Court has considered whether tax expenditures are equivalent to direct expenditures for purposes of limiting government abridgement of *personal* rights.¹⁶⁵ The cases in this area treat tax subsidies and direct subsidies inconsistently, sometimes equating them for constitutional law purposes, and other times distinguishing them.¹⁶⁶ As a result of this doctrinal inconsistency, these cases do not provide clear guidance on whether taxes and spending are equivalent for analyzing personal rights questions, let alone for analyzing federalism questions. Specifically, these cases do not reveal whether Congress may use taxes to achieve regulatory ends that lie beyond its other enumerated powers.

164. *Id.* (noting that taxes are not necessarily invalid because they “touch on” activities that Congress cannot regulate directly); *see also* *United States v. Kahriger*, 345 U.S. 22, 31 (1953) (upholding a federal tax on wagering against a challenge that Congress did not have the authority to regulate wagers and stating that “[u]nless there are provisions extraneous to any tax need, courts are without authority to limit the exercise of the taxing power”). The Court also gave the taxing power a broad reading in cases decided before the *Lochner* era. *See, e.g.*, *License Tax Cases*, 72 U.S. (5 Wall.) 462, 470–71 (1867) (upholding federal license taxes on (intrastate and interstate) sales of lottery tickets and liquor even though at that time the Supreme Court's view was that Congress had no power to authorize or regulate intrastate sales).

165. *See, e.g.*, *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1 (1989) (holding that an exemption from state sales and use tax for religious periodicals was a content-based distinction that violated the Establishment Clause); *McGlotten v. Connally*, 338 F. Supp. 448 (D.D.C. 1972) (holding that granting tax-exempt status to nonprofit and fraternal organizations that excluded nonwhites from membership was sufficient government action to invoke both the Fifth Amendment's Due Process Clause and the 1964 Civil Rights Act).

166. At times, courts equate tax spending with direct spending, and at other times, courts distinguish them. *See, e.g.*, discussion in *supra* note 57. *See also* Adler, *supra* note 57, at 869 (concluding that federal courts' “varied approaches have created a quagmire” and recommending that courts consider tax and direct spending to be equivalent for all constitutional cases); Zelinsky, *supra* note 57, at 381 (criticizing the Supreme Court for failing to “indicat[e] a rationale for such a seemingly inconsistent approach” but arguing against a universal assumption of equivalence of taxing and spending in favor of a case-by-case inquiry).

2. *Dormant Commerce Clause*

In dicta under the dormant Commerce Clause, the Supreme Court has stated that spending can be used to accomplish goals that the Constitution would forbid if achieved through taxes. If taxes and direct spending are distinguishable for Commerce Clause purposes, it is possible that they are also distinguishable for Taxing and Spending Clause purposes.

Among other requirements, the Supreme Court has interpreted the dormant Commerce Clause to prohibit states from using taxes to discriminate against interstate commerce or nonresident taxpayers.¹⁶⁷ For example, a state may not condition property tax exemptions for charitable institutions upon the requirement that their charitable activities principally benefit the state's own residents.¹⁶⁸ Nor may a state provide special tax exemptions for locally-produced products.¹⁶⁹

In interpreting the dormant Commerce Clause in *West Lynn Creamery v. Healy*, the Supreme Court distinguished discriminatory subsidies from discriminatory taxes.¹⁷⁰ The Court held that a state could not use a nondiscriminatory tax assessed on both in-state and out-of-state interests to fund a discriminatory subsidy granted only to in-state interests.¹⁷¹ The Court stated in dicta, however, that a discriminatory subsidy funded by general taxes ordinarily would raise no dormant Commerce Clause problem, even if the state used the subsidy to favor in-state over out-of-state producers.¹⁷² Although the

167. See generally JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶¶ 4.01–26 (3d ed. 1999 & Supp. 2009) (discussing in detail the Supreme Court's decisions under the dormant Commerce Clause in cases involving state taxation). The Supreme Court has interpreted the dormant Commerce Clause to restrain state taxation in other important ways, including by requiring that state taxes be fairly apportioned. See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (setting forth requirements of nondiscrimination, nexus, fair apportionment, and reasonable relation to the government services provided); HELLERSTEIN & HELLERSTEIN, *supra*, ¶¶ 8.01–15 (requirements related to division of the tax base).

168. *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997).

169. *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984).

170. *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (striking down a tax on both in-state and out-of-state milk dealers when the proceeds of the tax were distributed only to in-state dairy farmers).

171. The Court stated:

Nondiscriminatory measures, like the evenhanded tax at issue here, are generally upheld, in spite of any adverse effects on interstate commerce, in part because "[t]he existence of major in-state interests adversely affected . . . is a powerful safeguard against legislative abuse" However, when a nondiscriminatory tax is coupled with a subsidy to one of the groups hurt by the tax, a State's political processes can no longer be relied upon to prevent legislative abuse, because one of the in-state interests which would otherwise lobby against the tax has been mollified by the subsidy.

Id. at 200 (citations omitted) (quoting *Minnesota v. Clover Leaf Creamery Co.*, 449 U.S. 456, 473 n.17 (1981)). See generally Dan T. Coenen, *Business Subsidies and the Dormant Commerce Clause*, 107 YALE L. J. 965 (1998); Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 MICH. L. REV. 2167 (1997) (offering guidelines for when the Supreme Court should strike down state subsidies).

172. *West Lynn*, 512 U.S. at 199 n.15 ("We have never squarely confronted the

Court did not explain why discriminatory spending measures, such as subsidies, would be acceptable even though it has consistently held that discriminatory taxes violate the dormant Commerce Clause, the Court's distinction raises questions concerning whether taxing and spending measures are constitutionally equivalent. Commentators have criticized the dicta in *West Lynn*, arguing that since discriminatory subsidies can have economic effects identical to discriminatory taxes, they should be treated the same way for constitutional law purposes.¹⁷³ For these commentators, there is no rational basis for distinguishing regulation by spending from regulation by taxation.¹⁷⁴ Unfortunately, however, because the *West Lynn* Court failed to articulate why it thought taxing and spending could be distinguished, it is difficult to predict what, if any, implications for the scope of the federal taxing power can be drawn from the distinction the Court drew in *West Lynn*.

constitutionality of subsidies, and we need not do so now. We have, however, noted that 'direct subsidization of domestic industry does not ordinarily run afoul' of the negative Commerce Clause.") (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 278 (1988)).

173. Compare Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Dormant Commerce Clause Prohibition on Discriminatory Taxation*, 29 OHIO N.U. L. REV. 29 (2002) (arguing that because the Court cannot meaningfully distinguish subsidies from discriminatory taxes, it should abandon its dormant Commerce Clause review of state taxes altogether) with Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996) (arguing that the Supreme Court should strike down as inconsistent with the dormant Commerce Clause certain business tax subsidies offered by states because such subsidies have economic effects indistinguishable from prohibited discriminatory taxes).

174. Modern behavioral economics, however, may provide a basis for distinguishing the two. Empirical studies of loss aversion show that people prefer avoiding losses to making gains. See, e.g., Daniel Kahneman, et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990) (providing experimental evidence of the endowment effect, under which people ascribe more value to assets they own than assets of equivalent objective value that they do not own); see also *id.* at 1326–28 (defining loss aversion as "the generalization that losses are weighted substantially more than objectively commensurate gains in the evaluation of prospects and trades"). As a result of loss aversion, a taxpayer may value avoiding a \$10 tax more than securing a \$10 refundable tax credit. Thus, loss aversion may make the incentive effect of tax penalties more powerful than the incentive effect of tax subsidies. This difference could be significant for purposes of interpreting the Taxing and Spending Clause if we take seriously Justice Rehnquist's dictum in *Dole* that the Constitution precludes Congress from using its spending powers coercively. *South Dakota v. Dole*, 483 U.S. 203, 211 (1987) ("[I]n some circumstances the financial inducement offered by Congress might be so coercive as to pass the point at which 'pressure turns into compulsion.'") (quoting *Steward Machine Co. v. Davis* 301 U.S. 548, 590 (1937)). If Congress may not use the spending power to coerce the states in areas outside its enumerated powers, perhaps Congress also may not use the taxing power to coerce private taxpayers in areas outside its enumerated powers. Due to loss aversion, taxes may become coercive sooner than an equivalent dollar amount of direct spending. See *United States v. Butler*, 297 U.S. 1, 81 (1936) (Stone, J., dissenting) ("Threat of loss, not hope of gain, is the essence of economic coercion."). As a result of these factors, there may be a basis for distinguishing taxes from spending for constitutional law purposes. It bears emphasizing, however, that both the distinction between taxes and subsidies the Court made in *West Lynn* and the coercion limitation the Court expressed in *Dole* were dicta.

D. Taxing and Spending Outside Congress's Enumerated Powers

Based on the Supreme Court precedents just discussed, what can we conclude about the limits on Congress's ability to regulate using tax incentives? The Supreme Court has interpreted the taxing power broadly, showing federal taxes significant deference. But because the Court has not overruled certain *Lochner*-era precedents that held that Congress could not use taxes to accomplish regulatory aims that it lacked the authority to accomplish directly, the scope of the taxing power is uncertain. Specifically, the Court's decisions do not unequivocally state that the power to tax has the same broad scope as the power to spend, even though those powers derive from the same clause of the Constitution.

In the absence of a clear indication from the Supreme Court of the limits of the taxing power, scholars have attempted to predict how the Supreme Court might rule on the question. Although scholars disagree on the point, the dominant view seems to be that Congress may use taxes to achieve regulatory goals that fall outside its other enumerated powers.¹⁷⁵ Commentators supporting this expansive view of the taxing power have argued that the Supreme Court's pronouncements on the scope of the taxing power in the *Lochner*-era cases should be limited to their particular historical context.¹⁷⁶

The Supreme Court itself has limited the applicability of those cases. First, the regulatory schemes struck down in the *Child Labor Tax Case*, *Hill*, and *Butler* as exceeding congressional power would be upheld today under the Court's modern view of the commerce power.¹⁷⁷ Second, the Supreme Court

175. See, e.g., Con Law Professors' Brief, *supra* note 127, at 2 (The Supreme Court has "specifically and repeatedly affirmed that the taxing power is not limited to subjects within Congress's other enumerated powers"); Engdahl, *supra* note 3, at 16 (Congress can "create tax incentives or disincentives [for activities] that Congress could not require"); Galle, *Health Care Reform*, *supra* note 127, at 28 (The "best reading [of existing doctrine] is that courts will not impose any substantive limits on the uses to which Congress may put its taxing authority."). *But see* Barnett, *supra* note 93, at 23 (arguing that limits expressed by the Supreme Court in the *Child Labor Tax Case* are "moribund," not obsolete); Jensen, *Individual Mandate*, *supra* note 117, at 23 (concluding that "[d]espite the deferential post-*Child Labor Tax Case* authority, the distinction between a tax and a penalty has not disappeared").

176. See, e.g., Con Law Professors' Brief, *supra* note 175, at 11 (arguing that the cases' "continued validity is doubtful. To begin with, they are the products of the *Lochner* era, the heyday of the Supreme Court's hostility to economic regulation, including a highly restrictive view of Congress's commerce and spending powers. Those doctrines have been repudiated."). *But see* Barnett, *supra* note 93, at 608–09 (arguing that under the modern expansive view of the Commerce Clause, Congress "no longer needed to obviate the limits on its regulatory powers by taxing rather than regulating activity . . . For this reason, the principle for which [the *Child Labor Tax Case*] still stands became moribund. Yet precisely because a mandate to engage in economic activity has never been upheld by the Court, the tax power is once again being used to escape constitutional limits on Congress's regulatory power.").

177. See *United States v. Darby*, 312 U.S. 100, 115 (1941) (overruling *Hammer v. Dagenhart* and holding that Congress could regulate workplace conditions under the Commerce Clause); see also John Buchovecky, Comment, *The Future of Leverage Contract Trading Under the Futures Trading Act of 1986*, 37 AM. U. L. REV. 157, 167 (1987) (noting that only one year

and lower federal courts have declined to extend the reasoning of the *Lochner*-era cases.¹⁷⁸ The Supreme Court even stated in dicta in a recent case interpreting the Anti-Injunction Act that it has “abandoned” “distinctions between regulatory and revenue-raising taxes,”¹⁷⁹ although in another recent case, the Court distinguished between revenue-raising taxes and penalties assessed through the tax code for purposes of determining bankruptcy priorities.¹⁸⁰ The existence of these contradictory precedents makes it difficult to draw clear conclusions on the scope of the taxing power, although it is perhaps telling that the Court has not invalidated a federal tax as exceeding the scope of Congress’s enumerated powers since *Butler* in 1936.¹⁸¹ The next Part considers

after *Hill* “Congress enacted substantially similar legislation in the Grain Futures Act and the Supreme Court upheld the law under the commerce clause” in *Board of Trade of Chicago v. Olsen*, 262 U.S. 1, 33–38 (1923)); *Wickard v. Filburn*, 317 U.S. 111 (1942) (upholding as valid exercise of the commerce power crop quotas imposed under the Agricultural Adjustment Act of 1938).

178. For example, while upholding the challenged tax, the Court in the following cases distinguished the *Child Labor Tax Case*: *Sonzinsky v. United States*, 300 U.S. 506, 513 (1937) (upholding federal tax on firearms dealers and distinguishing tax on goods produced with child labor on the grounds that the tax on firearms dealers was not a “penalty resorted to as a means of enforcing the regulations”); *United States v. Kahriger*, 345 U.S. 22, 34 (1953) (upholding federal gambler’s occupation tax as non-punitive), *overruled on other grounds by* *Marchetti v. U.S.*, 390 U.S. 39 (1968) (holding that compliance with federal gambler’s occupational tax violated taxpayer’s right against self-incrimination). For cases declining to extend the reasoning in *Butler*, see references *infra* note 181.

179. *Bob Jones Univ. v. Simon*, 416 U.S. 725, 741 n.12 (1974) (holding that revoking a private letter ruling that acknowledged a university’s tax-exempt status constituted a “tax” for purposes of the Anti-Injunction Act) (citing *Sonzinsky*, 300 U.S. at 513); *see also id.* at 741 n.12 (noting that the cases like *Hill* drew distinctions between “regulatory and revenue-raising taxes,” but that the Court had “abandoned” such distinctions); *id.* at 742 (observing that cases like *Hill* were “of narrow scope”).

180. In *CF & I Fabricators*, the Supreme Court was interpreting whether a particular liability constituted an “excise tax” entitled to higher priority than a “penalty” under the federal bankruptcy code. It stated that “[a] tax is an enforced contribution to provide for the support of the government; a penalty, as the word is here used, is an exaction imposed by statute as punishment for an unlawful act.” *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996) (quoting *United States v. La Franca*, 282 U.S. 568, 572 (1931)). Both *CF & I Fabricators* and *La Franca* were interpreting the difference between two categories—“tax” and “penalty”—that appeared in the federal bankruptcy statute and received different priorities in bankruptcy.

181. The Court has also declined to extend the reasoning in *Butler*. *See, e.g., Pace v. Bogalusa Sch. Bd.*, 403 F.3d 272, 286 (5th Cir. 2005) (quoting LAURENCE H. TRIBE, *AMERICAN CONSTITUTIONAL LAW* § 5-b, at 836 (3d ed. 2000), for the proposition that the Supreme Court has “effectively ignored *Butler* in judging the limits of congressional spending power”); *Horn Farms, Inc. v. Veneman*, 319 F. Supp. 2d 902, 917 n.13 (N.D. Ind. 2004) (“[T]he reasoning in *Butler* has not been followed in any subsequent Supreme Court case”); *Kansas v. United States*, 214 F.3d 1196, 1200 n.6 (10th Cir. 2000) (noting that *Butler* “relied on an overly narrow view of Congress’ enumerated powers to determine that Congress had overstepped its authority. The analysis in *Butler* has been discredited as flawed and unworkable, and has not been followed.”).

Judge Hudson of the Eastern District of Virginia recently held that the individual mandate of the health care reform act was not an exercise of Congress’s taxing power, in part because Congress expressly evoked the commerce, but not the taxing, power when implementing it and because Congress labeled it a “penalty” rather than a “tax.” Judge Hudson reasoned that since it

whether a narrower interpretation of the taxing power than the spending power can be justified by comparing the impacts of those powers on federalism.

III.

DISTINGUISHING TAXING FROM SPENDING

This Part compares how taxing and spending differently impact federalism by comparing conditional federal grants to the states to federal tax incentives. If federal tax incentives adversely affect federalism no more than do grants, the Supreme Court need not give the tax power a narrower reading than it gives the spending power. If federal tax incentives are worse for federalism, however, it would justify reading the taxing power more narrowly than the spending power, notwithstanding the derivation of both powers from the same clause of the Constitution.

While an Article of this length cannot hope to identify and discuss all of the relevant differences between tax incentives and grants, this Part uses eight criteria to compare the federalism impact of tax incentives and grants. In order to present a balanced assessment of federal taxes and conditional grants, Sections A through H reserve judgment on the question of how broadly the tax power should be interpreted. Thus, this Part principally aims to identify, rather than resolve, the factors the Supreme Court should consider when determining whether the taxing power is coextensive with the spending power. The final Section of this Part (Section I), concludes that tax expenditures represent no greater threat to federalism than do conditional grants. Although the case is weaker for interpreting Congress's ability to regulate through tax penalties as broadly as its ability to regulate through tax spending, I conclude that the political safeguards of federalism are adequate to protect states from excessive federal erosion of state autonomy through tax penalties.

A. Regulation of Private Taxpayers, Not States

Drawing inspiration from Supreme Court anti-commandeering jurisprudence, we could look to *New York v. United States*, in which the Court stated that “the Framers explicitly chose a Constitution that confers upon Congress the power to regulate individuals, not States.”¹⁸² From this, we might conclude that tax incentives directed to private taxpayers—whether subsidies or penalties—pose less of a threat to state autonomy than does federal grant regulation, which specifically targets states.¹⁸³

was a penalty, rather than a tax, it had to be supported by one of Congress's other enumerated powers. Judge Hudson did not rule on whether Congress would have possessed the power to enact the provision if it had evoked the taxing power and labeled the provision a tax. This decision is on appeal. See *Virginia ex rel. Cuccinelli v. Sebelius*, 728 F. Supp. 2d 768, 786 (E.D. Va. 2010).

182. *New York v. United States*, 505 U.S. 144, 166 (1992).

183. In *New York*, the Supreme Court distinguished “generally applicable” federal regulation that applies to both states and private parties from federal regulation that applies only to

Support for this line of reasoning can be found in *Horn Farms*. In that recent case, the District Court for Northern Indiana and the Seventh Circuit each expressly rejected the notion that there is a coercion limitation to the federal spending power when the federal government directs spending to individuals, rather than states. The district court granted summary judgment for the government in response to a farmer's claim that the federal "Swampbuster" program exceeded Congress's spending power because it coerced farmers by denying them federal agricultural subsidies if they cultivated protected wetlands. The district court cited *Dole* as part of its analysis:

The [plaintiff farmer] argues that . . . the standard to determine impermissible government coercion for an individual citizen must be more relaxed, because most cases analyzing conditional federal spending arguably interfere with a state's autonomy. But that is precisely the reason that coercion is even being discussed in those cases, because the Constitution limits the power of Congress to force the states to carry out Congressional policy. The Plaintiff has not explained how coercing farmers to protect wetland[s] or risk losing their federal farm program benefits violates the Constitution.¹⁸⁴

Although the Seventh Circuit reversed on other grounds, it confirmed the district court's reasoning that a private party could not complain that a spending condition was coercive; the Seventh Circuit reasoned that the private party was "not a governmental body and lacks any sovereignty that can be trampled upon."¹⁸⁵

But the district court and the Seventh Circuit in *Horn Farms* failed to heed the purpose of federalism, as described by the Supreme Court in *New York v. United States*. The *New York* Court scrutinized federal attempts to regulate the states, but it also made clear that maintenance of the structural protections of federalism ultimately furthered the goal of protecting individuals, not states *per se*, from federal overreaching. According to the Court:

The Constitution does not protect the sovereignty of States for the benefit of the States or state governments as abstract political entities, or even for the benefit of the public officials governing the States. To the contrary, the Constitution divides authority between federal and

states. The latter received heightened scrutiny under the Tenth Amendment. *See id.* at 160. *But see id.* at 201 (White, J., dissenting) ("The Court's distinction between a federal statute's regulation of States and private parties for general purposes, as opposed to a regulation solely of the activities of States, is unsupported by our recent Tenth Amendment cases . . . [and] not based on any defensible theory").

184. *Horn Farms, Inc. v. Veneman*, 319 F.Supp.2d 902, 916 (N.D. Ind. 2004) (internal citations omitted).

185. *See Horn Farms, Inc. v. Johanns*, 397 F.3d 472, 476–77 (7th Cir. 2005) (holding that the federal program was not coercive). The Seventh Circuit further reasoned that "[t]he sort of argument *Horn Farms* presses would demolish, not the Swampbuster legislation, but the whole system of agricultural subsidies, and indeed all federal legislation (including tax credits and deductions) linking financial rewards to the satisfaction of conditions." *Id.* at 477.

state governments for the protection of individuals. State sovereignty is not just an end in itself: “Rather, federalism secures to citizens the liberties that derive from the diffusion of sovereign power.”¹⁸⁶

Thus, the Supreme Court may not share the Seventh Circuit’s view, as expressed in *Horn Farms*, of the permissible scope and objects of federal spending.¹⁸⁷

The reasoning of the district court and the Seventh Circuit also can be criticized for examining only the *direct* target of federal regulatory spending—private farmers—while ignoring the *indirect* effects of such regulation on the states. In contrast with the views expressed in *Horn Farms*, this Article has argued that when Congress uses federal taxes to regulate, such regulation may crowd out competing state regulation of the same substantive areas. By constraining state autonomy, federal tax incentives may indeed threaten federalism values, even if they nominally apply only to private taxpayers.

B. State Right of Refusal and “Repeal”

To understand the effects on the states (and ultimately, the people) of federal tax regulation of private parties, we need to know to what extent federal tax incentives displace state regulation. Although this question is ultimately an empirical one, we can begin to answer it here by considering the options available to states *as a legal matter* to regulate concurrently with federal tax incentives and to resist federal policies enacted via tax incentives.

When comparing the federalism impact of various modes of federal regulation, it is important to note that conditional grants do not cut states out of the regulatory process entirely. Indeed, grants are federalism-preserving compared to preemptive federal regulation.¹⁸⁸ However, conditional grants generally require states to adopt legislation consistent with the federal policies proposed in the grant, and states generally agree under grants not to engage in activities that undermine those federal policies. Thus, conditional grants have the effect of both prescribing and circumscribing state government action. While states have some ability to negotiate the terms of federal grant conditions, the primary remedy available to states that do not wish to accede to federal grant conditions is to refuse the grant.

In contrast, states are not contractually bound to implement federal tax incentives. Thus, compared with grants, federal tax incentives do not expend

186. *New York*, 505 U.S. at 181 (quoting *Coleman v. Thompson*, 501 U.S. 722, 759 (1991) (Blackmun, J., dissenting)).

187. For example, in *Butler*, the Supreme Court struck down a tax-and-subsidy scheme applicable to private farmers precisely because the scheme constituted “coercion by economic pressure.” See *U.S. v. Butler*, 297 U.S. 1, 70–72 (1936).

188. Cf. Evan H. Caminker, *State Sovereignty and Subordinacy: May Congress Commandeer State Officers to Implement Federal Law?*, 95 COLUM. L. REV. 1001, 1002–03, 1012 (1995) (arguing that federal commandeering may preserve a greater role for states than preemptive direct federal regulation).

limited state legislative and regulatory resources. This could be particularly useful in areas where, although state residents generally approve of the goal behind a federal tax incentive, they do not regard it as a sufficiently high priority upon which to concentrate limited state resources. Congress's pursuit of federal policies through taxes, rather than conditional grants administered by the states, therefore may leave more room for the accomplishment of local goals. Thus, where state voters approve the goals behind federal tax incentives, but do not prioritize them as highly as do national voters, federal tax incentives may complement, rather than supplant, local policy objectives. In this way, federal tax incentives may be federalism-preserving compared to grants.

Unlike with grants, however, when state voters and their representatives disapprove of the federal aim embodied by a federal tax incentive, they have no right of refusal, because states cannot exempt their residents from federal tax provisions. The importance of this difference between conditional federal grants and federal tax incentives depends on whether states possess other effective means—short of a right of refusal—to resist unwanted federal policies implemented through federal tax incentives.

States could use their own tax systems to resist federal tax policy. One way for states to dampen the effect of federal tax policies would be to simply refuse to conform their own tax bases with that of the federal government.¹⁸⁹ For example, by refusing to allow its residents to exclude fringe benefits from taxable income, a state would raise the overall tax cost of such benefits for its residents.¹⁹⁰ Similarly, in the past several years, as the federal government has raised the exemption amount for the estate tax, many states failed to follow suit, which has meant that certain federally exempt estates of taxpayers residing in non-conforming states remained subject to state-level estate taxation.¹⁹¹ In this way, the estate tax policy of some states diverged from that of the federal government.

States could go further. For example, by characterizing federal tax expenditures as generating state-taxable income, states could use their own tax systems to “claw back” the benefit of federal tax expenditures from state residents. For example, states could define the federal tax savings due to the federal mortgage interest deduction as constituting income for state tax

189. Although most states conform their tax bases to that of the federal government, states have often “decoupled” or departed from the federal tax base on important issues. For example, many states declined to adopt a particular accelerated depreciation program when the federal government did. *See also* HELLERSTEIN & HELLERSTEIN, *supra* note 167, ¶ 7.02 (discussing decoupling). Rather than undermining federal policy, the better view of cases in which states decouple from the federal tax base is that they represent instances in which the states simply declined to bolster federal policy. *See* discussion of federal-state tax base conformity *infra* Part III.F.

190. *See, e.g.*, I.R.C. § 132(f) (2006) (providing federal income tax exclusion for certain employer-provided transportation fringe benefits, including transit passes, qualified parking, and bicycle commutation reimbursement).

191. *See* Laura Saunders, *State Death Taxes Are the Latest Worry*, WALL ST. J., Oct. 31, 2009, at B1 (noting that 23 states and the District of Columbia still have estate or inheritance taxes).

purposes. By setting the state tax rate on this item of income high enough, states theoretically could completely repeal the federal home mortgage interest deduction for their own residents.

States also could use their direct spending programs to claw back federal benefits. For example, a state could reduce its residents' entitlements to state-level direct spending benefits when those residents receive federal tax incentives. Thus, we could imagine a scenario in which, for example, a state would reduce a resident taxpayer's state-level direct subsidies for adopting certain green technologies by the amount of any tax credits the residents could claim from the federal government. In this way, states could effectuate a kind of soft repeal of federal policy. In contrast, it is harder for states to "repeal" conditional federal grants, since grants are contracts between the federal government and the states, and those contracts require states to meet express conditions. The kinds of soft repeal of federal tax policies described here would likely violate the terms of federal grants.¹⁹²

The Supremacy Clause may limit the ability of states to resist federal tax policy. Congress has expressly preempted state taxation in only a few areas.¹⁹³ And failure of the states to offer the exact same tax incentives as the federal government generally will not create a direct conflict with federal tax law.¹⁹⁴ Thus, state tax base nonconformity probably does not raise serious Supremacy Clause concerns.¹⁹⁵

192. For analysis of states' opportunities to enact policies inconsistent with those laid out in federal conditional grants, see Engdahl, *supra* note 3, at 69–71. Conditional grant terms may specify that states may not reduce direct aid to state residents eligible for aid under a jointly administered federal-state program. For example, states accepting grants under Food Stamps were not permitted to reduce welfare or similar aid to state residents who were eligible for the Food Stamp program. See Kaden, *supra* note 3, at 876.

193. Congress occasionally *expressly* preempts state taxation, as in the case of airline taxes. For discussion of federal legislation that expressly preempts state tax authority, see HELLERSTEIN & HELLERSTEIN, *supra* note 167, ¶ 4.25[1]; David E. Wildasin, *Pre-emption: Federal Statutory Intervention in State Taxation*, 60 NAT'L TAX J. 649 (2007).

194. The Supreme Court rarely has held federal regulation to *impliedly* preempt state taxation. Compare *Xerox Corp. v. Cnty. of Harris*, 459 U.S. 145, 153 (1982) (state tax on imported goods stored in customs-bonded warehouses and bound for further transshipment outside the United States was impliedly preempted by Congress's comprehensive regulation of customs duties that included a waiver of such duties; the federal customs waiver was designed to preference merchants' use of American ports for storage over the ports of other countries, and the state tax interfered with that goal because it "was large enough . . . to offset substantially the very benefits Congress intended to confer by remitting the duty"), with *R.J. Reynolds Tobacco Co. v. Durham Cnty.*, 479 U.S. 130 (1986) (finding no implied preemption of state tax on imported goods stored in customs-bonded warehouses where goods were to be sold domestically, rather than transshipped).

195. Suppose, for example, that the federal government allows individual taxpayers a deduction for installing certain green technologies in their homes. A state's failure to mirror the federal deduction does not necessarily undermine the federal policy, since the federal purpose arguably is to subsidize green technologies to the tune of the taxpayer's marginal *federal* tax rate. That leaves the states free to increase the subsidy by adopting the deduction, or not. See *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 448 (1980) ("Absent some explicit directive from

But the Supremacy Clause may preclude state claw backs of federal tax benefits. Suppose, for example, that the individual mandate of the PPACA represents a valid use of Congress's commerce power. Virginia presumably would be preempted from providing its residents a refundable tax credit for the amount of any federal tax penalty they pay for violating the individual mandate because such a tax credit would clearly frustrate the federal purpose behind the tax penalty.¹⁹⁶ But take a less extreme case: may Virginia simply allow its residents to deduct the federal penalty for purposes of calculating their income for state tax purposes? Even this less extreme tactic could raise implied preemption issues because it would interfere with federal health policy by lowering the cost of the federal tax penalty.¹⁹⁷

In the last example, we assumed that the individual mandate was a valid exercise of Congress's commerce power. Now suppose that Congress uses taxes to achieve a regulatory goal that it could not achieve directly. The preemption analysis may change. To understand why, we must first review the distinction the Supreme Court has drawn between conditional spending and commandeering. Unlike commandeering, conditional spending does not violate the Constitution, in part because states have the option to refuse conditional grants.¹⁹⁸ For the opportunity to refuse a grant to be meaningful from a

Congress, we cannot infer that treatment of . . . income at the federal level mandates identical treatment by the States."); see also HELLERSTEIN & HELLERSTEIN, *supra* note 167, ¶ 4.25[2][b] (noting that the "mere fact that Congress has adopted a particular policy towards taxation of income at the federal level . . . does not require the states to adopt similar policies for state income tax purposes").

196. Congress has not expressly preempted the hypothetical Virginia tax considered in the text, and the Court is unlikely to hold that the federal government has occupied the field of health regulation, such that states cannot regulate health concurrently with the federal government. Thus, the preemption inquiry would focus on the degree of conflict between the individual mandate and the hypothetical refundable tax credit issued by Virginia. It is not impossible for a taxpayer to satisfy both statutes. She would pay the federal tax penalty for violating the individual mandate and then receive a refundable state tax credit from Virginia for the same amount. But unlike the example discussed in *supra* note 195, where I argued that a state's refusal to conform its tax base with the federal base created no conflict because the federal goal was to subsidize the purchase of green technologies by the amount of the taxpayer's marginal *federal* tax rate, in the case of the PPACA, if Congress's goal is to impose a specific monetary penalty, a refund or reduction of the penalty by a state would frustrate federal goals. See *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 248 (1984) (state law "actually conflicts" with federal law "where the state law stands as an obstacle to the accomplishment of the full purposes and objectives of Congress").

197. Another interesting question is whether, in addition to frustrating federal health policy, such a state tax provision would also conflict with the clearly stated federal policy in Section 162 that denies federal tax deductions for fines and penalties. I.R.C. § 162(f) (2006). See also *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 33–36 (1958) (approving disallowance of federal deduction for fines assessed for violation of state truck weight limits because such deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct" by "reducing the 'sting' of the penalty prescribed by the state legislature").

198. *New York v. United States*, 505 U.S. 144, 166–77 (1992) (contrasting constitutionally permissible conditional grants, under which if "a State's citizens view federal policy as sufficiently contrary to local interests, they may elect to decline a federal grant" with unconstitutional commandeering, under which a "State may not decline to administer the federal

federalism perspective, however, states must be free not only to decline the grant, but to decline the grant and also enact *contrary* public policy.¹⁹⁹ To conclude otherwise would bestow on the federal government the ability to use conditional spending to preempt state regulation in areas beyond Congress's direct regulatory reach, even when the state has refused the grant. Likewise, perhaps states must remain free to countermand federal policies that Congress enacts under the authority of *only* its taxing power—that is, policies that Congress could not achieve via direct regulation. If this is the case, then at least where Congress uses taxes to regulate outside its enumerated areas of regulatory authority, states would retain a power analogous to the right of refusal seen in the grant context, and federal regulatory taxes would not pose a significantly greater threat to state autonomy than do grants. In other words, Virginia would retain autonomy to refund its residents the federal tax penalty that enforces the individual mandate. But if states are not free to resist federal policy enacted through tax incentives, the federal taxing power represents a potentially greater threat to federalism than do grants because Congress can enact tax incentives unilaterally, over the objection of states.

C. Complex Benefits

By conditioning grant funding upon state assistance in carrying out federal policy priorities, Congress harnesses the entire state regulatory apparatus, including legislatures, courts, and administrative agencies. Congress can even condition grants on states' consent to be sued by private citizens, which promotes enforcement and implementation of federal regulatory goals. Because the permissible subject matter of state regulation is not federally-constrained, conditional grants allow Congress to expand its regulatory reach.

In contrast, as a practical matter, tax incentives are narrow instruments; they encourage private taxpayers to engage in certain behaviors by raising or lowering their taxes. Accordingly, tax incentives are most appropriate for regulatory goals that can be accomplished by the actions of private taxpayers. Thus, it makes sense to use tax incentives to encourage private taxpayers to, for example, contribute to charities. But it would be difficult or impossible to structure a tax incentive program that would result in the federal highway system or

program. No matter which path the State chooses, it must follow the direction of Congress.”).

199. Professor David Engdahl argues that the Supremacy Clause does not cover congressional taxing and spending measures when the regulatory objective of such taxing or spending lies outside of Congress's other enumerated powers. As a result, he argues that states remain free to undermine federal goals that Congress seeks to achieve solely through taxing or spending. In his view, state non-interference with federal spending objectives in such cases would rest exclusively on an express federal-state contract. See Engdahl, *supra* note 3, at 20–24, 62–71. For criticism of this view as contrary to Supreme Court precedent, see Samuel R. Bagenstos, *Spending Clause Litigation in the Roberts Court*, 58 DUKE L. J. 345, 386–93 (2008) (arguing that the Court “has repeatedly held that conditional spending statutes preempt inconsistent state legislation pursuant to the Supremacy Clause”).

Medicare. Such benefits, which for purposes of this discussion I label “complex benefits,” require state cooperation. The need for state cooperation affords states protection from federal attempts to use taxes to deliver complex benefits.

As *Steward Machine* demonstrates, however, it is not impossible for the federal government to use tax incentives to provide complex benefits. Recall that in *Steward Machine*, Congress imposed a tax on certain employers equal to a percentage of wages paid. However, employers received a refund (in the form of a tax credit) of 90 percent of the federal tax if they also made contributions to a state unemployment compensation fund meeting federally-prescribed requirements. The Supreme Court acknowledged that this federal tax-and-credit scheme represented an inducement to states to adopt unemployment regimes consistent with federal guidelines, and the Court reviewed evidence that the federal law had the effect of encouraging states to enact such regimes.²⁰⁰ But in upholding the federal scheme against a Tenth Amendment challenge, the Court also emphasized both the states’ choice in cooperating with the federal program and their ability to terminate their cooperation at any time.²⁰¹ Thus, when the federal government uses taxes to implement complex benefits, the states effectively retain a right of refusal.

The inability of the federal government to use tax incentives to provide complex benefits over the objection of the states suggests that interpreting the taxing power coextensively with the spending power would not introduce significant new threats to federalism beyond those already inherent in the broad spending power. On the other hand, use of federal tax incentives to provide complex benefits may deprive the states of the opportunity to bargain with the federal government over the terms of the federal program. Additionally, states may not receive direct federal funding as part of a federal tax incentive scheme (though the unemployment insurance tax-and-subsidy regime upheld in *Steward Machine* included grants to the states).²⁰² If Congress does not pair its tax incentive scheme with grants to the states, then any inducement for state spending created by the federal tax incentive scheme may crowd out state legislative priorities.

D. Completeness

In addition to their inability to achieve complex benefits without state cooperation, federal tax incentives are limited in another important way: most federal tax incentives do not reach private parties who have no federal income tax liability. Since people with no tax liability receive no benefit from nonrefundable tax expenditures, the regulatory influence of such expenditures is incomplete. In a given year, as many as one-third of American households

200. *Steward Machine Co. v. Davis*, 301 U.S. 548, 587–88 (1937).

201. *Id.* at 589–95.

202. *Id.* at 577.

have no (or negative) federal income tax liability.²⁰³ Although tax penalties and refundable tax credits reach people without federal tax liability, the large majority of federal tax incentives take the form of nonrefundable tax expenditures.²⁰⁴ In contrast, because almost all U.S. residents are subject to the jurisdiction of one or more state governments, Congress can reach almost all U.S. residents when it uses grants to act through the states. Compared with grants, the relative incompleteness of federal regulation through tax incentives leaves more room for autonomous state regulation. This limitation on the personal reach of federal tax incentives represents a practical safeguard against federal aggrandizement through taxation.

E. Political Safeguards

If the political safeguards of federalism are as effective for tax incentives as they are for conditional grants, then the argument is stronger for giving the taxing power as broad a reading as the spending power. Certain factors suggest that government officials are less politically accountable for tax incentives than grants, whereas other factors suggest the opposite.

First, there are reasons to conclude that tax incentives present political accountability problems. For example, because they are not part of the outlay budget, tax expenditures are said to receive less scrutiny from voters and legislators than do direct spending measures, including conditional grants.²⁰⁵ Moreover, once enacted, tax expenditures are generally permanent; that is, they do not have to be renewed each year, but instead continue unless repealed.²⁰⁶ Like tax expenditures, tax penalties are generally permanent. In contrast, conditional grants generally take the form of appropriations; they appear on the budget, and they must periodically compete with each other and with other direct spending programs for limited federal funds. Thus, grants arguably receive more careful (and certainly more frequent) review from members of Congress, state legislators, and state and national voters than do tax provisions. Finally, because it can be hard to predict how many and to what extent taxpayers will take advantage of tax incentives, it also may be difficult to predict the degree to which proposed federal tax incentives will crowd out competing state legislation.²⁰⁷ As a result, voters and lawmakers may not have

203. See Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 53 (2006).

204. *Id.* at 24.

205. Surrey, *Tax Incentives*, *supra* note 4, at 730.

206. *Id.* at 730. Surrey implicitly compares tax expenditures with discretionary direct spending. In contrast, mandatory direct spending (for entitlement programs such as Social Security Insurance and other mandatory programs, such as federal debt service) is likewise immune from annual budget scrutiny.

207. Although governments estimate the cost of tax expenditures prior to passage, those estimates can be highly inaccurate. For example, in 2000, Arizona offered a tax credit for the purchase of alternative fuel cars. The state estimated that the credit would cost \$3 to \$10 million, but in its first year, it cost \$680 million. JASON LEVITIS ET AL., PROMOTING STATE BUDGET

the information they need to evaluate the federalism impact of tax incentives. Although the tax expenditure budget mandated by the Congressional Budget Act of 1974 has done much to cure this accountability problem by bringing tax expenditures to light and providing cost estimates and information about their content, accurately estimating tax expenditures is a notoriously difficult endeavor.²⁰⁸ Moreover, the Budget Act does not require identification of tax penalties or estimations of the revenue they raise.²⁰⁹ Without such information, voters and policymakers lack important information needed to evaluate tax penalties.

These procedural and substantive differences between tax incentives and grants tend to make tax incentives easier to enact, more difficult to monitor, and harder to repeal than conditional grants. As a result, it may be easier for Congress to use tax incentives than grants to invade state regulatory areas. This suggests that maintenance of federalism requires more protection against federal overreaching through taxation than through grants. One such protection could be a narrower interpretation of the taxing power than the spending power.

On the other hand, advocates of active judicial intervention to protect state autonomy against federal incursion argue that such intervention is especially needed in the case of conditional grants because the political safeguards of federalism break down when state officials, anxious to receive federal grant money, fail to check federal overreaching.²¹⁰ This confluence of state officials' interest in receiving grants and federal officials' desire to expand areas of federal policy lacks a clear analog in the tax context. Specifically, since federal tax incentives provide state officials no additional direct funding, state officials might more readily oppose federal tax provisions that encroach upon state autonomy than conditional grants that do so.²¹¹

Of course, even if state officials do not oppose Congress's use of conditional grants or tax incentives to regulate areas of traditional state concern, state residents may use their right to vote in national elections to curb such federal expansion. For votes in national elections to serve as an effective check, however, voters must understand which level of government is responsible for the offending policy. But critics have argued that conditional grants undermine political accountability by confusing voters as to which level

ACCOUNTABILITY THROUGH TAX EXPENDITURE REPORTING 8 (2009), available at <http://www.cbpp.org/files/4-9-09sfp.pdf>.

208. For problems with estimating tax expenditures, see *supra* notes 54 and 207.

209. Recently, the Joint Committee on Taxation took it upon itself to make tax penalty revenue estimates, but for reasons it did not explain, it excluded from its estimates provisions of the law the principal purpose for which is to enforce general tax rules, or to prevent the violation of other laws. See STAFF OF J. COMM. ON TAXATION, 111th CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009–2013, at 5 (Comm. Print 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3642>.

210. See, e.g., Baker, *After Lopez*, *supra* note 3, at 1933–39.

211. States may receive indirect funding through federal tax incentives, including the federal deduction for state and local taxes. For discussion of this deduction, see *infra* Part III.G.

of government to reward or punish for policy choices.²¹² The federal government exacerbates this problem by exercising differing degrees of control and supervision over different grants. Although a certain degree of voter confusion may be inherent in federal forms of government, grants arguably compound such confusion.²¹³

In contrast, federal tax incentives avoid such confusion. Since taxpayers must affirmatively claim most federal tax expenditures on their federal tax forms (and self-assess most penalties using federal forms), it is relatively easier for taxpayers to discern the federal origin of such tax provisions. This, in turn, allows taxpayers to properly target Congress for blame and praise. Moreover, since federal tax incentives affect taxpayers directly, and, unlike states, individual taxpayers have direct representation in the federal political system, taxes may be more politically responsive than grants.²¹⁴ The Supreme Court's taxing power jurisprudence reflects this notion. For example, the Court has repeatedly asserted that the ballot box, not the courts, represents the proper avenue for redressing oppressive federal taxation.²¹⁵

212. See, e.g., McCoy & Friedman, *supra* note 3, at 124–25; Somin, *supra* note 3, at 485 (arguing that Congress and state legislators will blame each other for unpopular grant policies, allowing both to escape political consequences). It is unclear why voters would not hold both federal and state legislators accountable for policies enacted pursuant to conditional federal grants, and if so, why that result would be unwarranted. See Chemerinsky, *supra* note 3, at 100; Hills, *supra* note 3, at 825–27.

The Supreme Court expressed concerns about the political accountability of unfunded mandates. It recognized that “where the Federal Government directs the States to regulate, it may be state officials who will bear the brunt of public disapproval, while federal officials who devised the regulatory program may remain insulated from the electoral ramifications of their decision.” *New York v. United States*, 505 U.S. 144, 169 (1992) (striking down the Low-Level Radioactive Waste Policy Amendments Act of 1985, which required states to dispose of or take title to radioactive waste created in their borders).

213. Pettys, *supra* note 100, at 381 (“[C]onfusion . . . is simply the price one pays for choosing federalism over alternative forms of government.”).

214. Cf. *Cook v. Gralike*, 531 U.S. 510, 528 (2001) (Kennedy, J., concurring) (“[F]reedom is most secure if the people themselves, not the States as intermediaries, hold their federal legislators to account . . .”).

215. This view finds expression in *Veazie Bank*, in which the Court upheld a federal excise tax on state bank notes with the following oft-quoted statement:

[t]he power to tax may be exercised oppressively upon persons, but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected.

So if a particular tax bears heavily upon a corporation, or a class of corporations, it cannot, for that reason only, be pronounced contrary to the Constitution.

Veazie Bank v. Fenno, 75 U.S. (8 Wall.) 533, 548 (1869). See also *United States v. Kahriger*, 345 U.S. 22, 28 (1953) (“The remedy for excessive taxation is in the hands of Congress, not the courts.”); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 169 (1911) (upholding the federal corporate tax and noting that the remedy for “disastrous” exercises of lawful legislative power “is in the ability of the people to choose their own representatives”); *McCray v. United States*, 195 U.S. 27, 55 (1904) (upholding high federal tax on artificially dyed margarine and stating that the remedy for exercises of the taxing power and other powers for “a wrong motive or purpose” lies “in the people, upon whom, after all, under our institutions, reliance must be placed for the correction of abuses committed in the exercise of a lawful power”); Edward D. Kleinbard, *Constitutional Kreplach*, TAX NOTES, Aug. 16, 2010, at 757 (“[T]he Constitution can best be understood as

Finally, certain political accountability problems are present in grants but not tax incentives. For example, once Congress disburses conditional grant funds, it can be difficult to track their use in fifty different states, even when Congress imposes reporting requirements.²¹⁶ Furthermore, state budgets may not clearly reflect the costs of implementing federal conditions.²¹⁷ Finally, by delegating responsibility for implementation of federal grant programs to state legislatures and state administrative agencies, Congress takes the risk that those agents' policy preferences will diverge from its own. In contrast, although it is not a perfect congressional agent, the IRS exercises relatively little discretion when administering tax incentives.²¹⁸

F. State Conformity with the Federal Tax Base

The last Section argued that federal tax incentives are less likely than grants to confuse voters about which level of government was responsible for particular policy decisions because federal taxes are administered through federal tax forms, which alert voters that Congress, not the states, should be held accountable for their content. Likewise, earlier I suggested that since tax expenditures and penalties hold out their enticements to private taxpayers, not states, they leave states freer to implement policies at odds with federal tax policy.

Federal-state tax base conformity may vitiate these safeguards. States that tax income generally use the federal income tax base as the basis for calculating their own income taxes, largely for administrative reasons.²¹⁹ Although nothing requires states to conform their tax bases with that of the federal government, states substantially do so because conformity secures significant administrative advantages. For example, by requiring state residents to report the same amount for state tax purposes as they report for federal tax purposes, states reduce tax compliance costs. Federal-state tax base conformity also allows states to piggyback on the elaborate federal administrative mechanisms for enforcing the federal tax code. These include third-party reporting requirements, withholding, and auditing. Moreover, tax base conformity eases administrative problems that would arise for taxpayers who earn income from more than one state. If each state used a tax base

contemplating that the principal remedy for harsh, oppressive, or stupid tax legislation is to vote the rascals out.”).

216. See Somin, *supra* note 3, at 465–66.

217. *Id.*

218. Cf. David A. Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823, 1837 (2006) (arguing that when Congress distrusts federal agencies, it is more likely to enact tax expenditures, since the IRS exercises less discretion than do other federal agencies).

219. See, e.g., JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* ¶ 7.02 (3d. ed. 1999 & Supp. 2007) (discussing corporate income tax conformity); *id.* ¶ 20.02 (discussing individual income tax conformity).

substantially different from all the others, taxpayers with income from more than one state might suffer unrelieved double taxation.

Although federalism scholars have paid little attention to this mirroring of federal fiscal policy in state fiscal policy, federal-state tax base conformity poses several federalism problems. First, when states adopt the federal tax base as their own tax base, they deliberately or inadvertently import into their own tax systems federal regulatory preferences embodied in federal tax expenditure and tax penalty provisions.²²⁰ States may be reluctant to deviate from the federal tax base because deviations generate compliance costs and reduce states' ability to free-ride on federal tax enforcement. Thus, compared with when it uses direct regulation or direct spending, when Congress uses taxation to achieve regulatory goals, the administrative advantages of tax base conformity exert pressure on states to adopt the same tax policy. Indeed, since most federal tax incentives take the form of tax expenditures, rather than penalties, it costs the states tax revenue to maintain conformity with the federal base. Thus, rather than receiving payment for implementing federal policy as they do in the conditional grant context, when they import federal tax expenditures, states both bolster federal policy and relinquish revenue they could otherwise employ in the pursuit of local policy preferences. Concomitantly, state conformity with federal tax penalties increases state tax revenue.

Second, state residents use state tax forms to claim state tax expenditures and remit tax penalties, and state tax authorities administer such tax incentives. Thus, conformity of the state and federal tax bases may raise a similar risk to that raised by grants: voters may be confused about which level of government to hold accountable for state tax expenditures.

Arguably, since conformity with the federal tax code is optional, states that mirror federal regulatory tax provisions in their own tax law should be seen as making an affirmative election to follow federal policy. Thus, the appearance of conforming provisions on state income tax forms appropriately allows state voters to hold state legislators politically accountable for them. But here again an argument analogous to one raised in the conditional grant context applies. Commentators argue that although conditional grants are formally optional, they are as a practical matter coercive because by refusing federal grants, states forego badly needed federal funds.²²¹ Similarly, although states are not legally compelled to conform their tax bases with that of the federal

220. The extent to which states import federal tax expenditures and penalties into their own tax systems varies from state to state. For example, since the federal "adjusted gross income" amount represents federally-taxable income before deduction or credit for many tax expenditures, by using adjusted gross income, states can avoid importing many federal tax expenditures. In contrast, if states used federal "taxable income," they would import more federal tax expenditures. Even when they use federal adjusted gross income, however, states import all federal tax expenditures structured as exemptions. For more on this issue, see Ruth Mason, *Delegating Up* (forthcoming 2012) (on file with the author).

221. See, e.g., Baker, *After Lopez*, *supra* note 3, at 199.

government (and states occasionally deviate from the federal tax base),²²² deviation increases compliance costs for taxpayers, and it is costly for states both in terms of tax administration and legislative resources.

G. Federal Tax Aid to the States: The SALT Deduction

This Section considers the extent to which grants and federal tax incentives bolster, rather than undermine, autonomous state policy. To the extent that the alternative to conditional grants or federal tax incentives is preemptive federal regulation, both grants and tax incentives preserve a regulatory role for the states. Likewise, when Congress provides grant or tax spending for a policy that a state would have enacted anyway, the federal funding helps the state achieve its own regulatory goals.

But in some cases, states accepting conditional funds oblige themselves to carry out federal policies that they otherwise would not pursue. Since states have limited legislative and other resources, such conditional grants crowd out state and local policy priorities. Although this Article so far has argued that federal tax incentives may work similarly to crowd out state regulation, certain federal tax incentives bolster both specific state policies and state autonomy more generally. For example, by denying federal deductions for fines and penalties assessed by state governments, federal tax law makes violating state law more expensive. Similarly, by denying deductions for the costs of drug trafficking that violates state law, the federal government increases the deterrent effect of state criminal law. Such federal tax penalties are not efficiently calibrated to maximize deterrence because they link the tax penalty to the taxpayer's marginal rate, rather than his or her propensity for committing the infraction.²²³ However, by increasing the penalty for state law violations, they support, rather than undermine, state policy.

More importantly, certain federal tax expenditures enlarge the scope of autonomous state power by enhancing the ability of states and localities to raise their own funds. For example, a taxpayer with a marginal federal tax rate of 35 percent who pays \$100 in qualified state and local taxes may deduct this amount from her federally taxable income, saving \$35 in federal taxes. This deduction lowers the burden of state and local taxes, allowing states and localities to charge higher taxes.²²⁴ Accordingly, the federal tax expenditure budget aptly characterizes the deduction as “[a]id to State and

222. See HELLERSTEIN & HELLERSTEIN, *supra* note 167, ¶ 20.02 n.16 (noting that “some states provide no deduction for charitable contributions [and] many deviate from the federal standard deduction”).

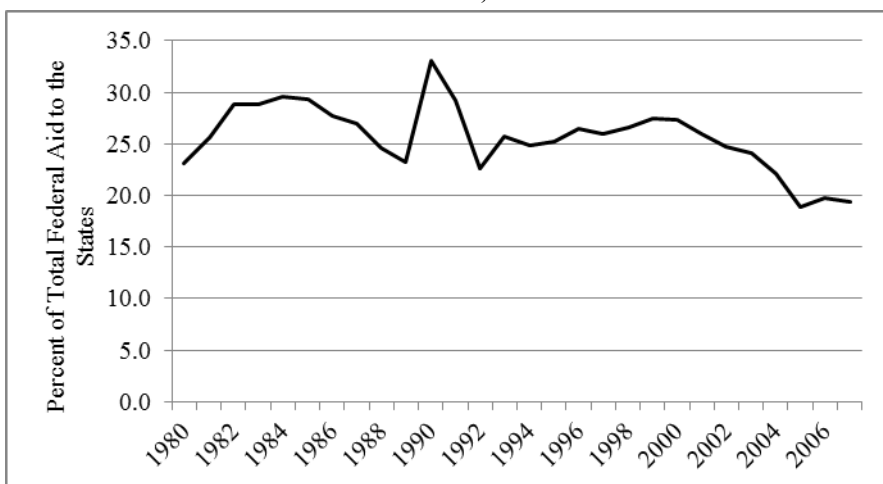
223. See Zolt, *supra* note 11, at 360–74.

224. See Kaplow, *supra* note 5, at 487 n.204 (citing various empirical studies estimating that federal deductibility increases state and local spending from two to twenty percent); *id.* at 486 (because of the state and local tax deduction, “taxpayers will favor higher taxes (or be less aggressive in demanding lower taxes”).

local governments.²²⁵

Likewise, allowing taxpayers to exclude state and local bond interest from their federally taxable income aims to lower borrowing costs for states and localities. In 2007 the aggregate cost in forgone revenue of federal tax expenditures providing aid to the states was \$88.6 billion.²²⁶ Because Congress does not require states to spend this aid in any particular way, these federal tax expenditures function like unconditional federal grants to the states. Figure 2 shows the cost of providing aid to the states via the federal tax code as a percentage of total federal aid to the states, including conditional grants. The figure shows that the federal tax law provides a significant source of unconditional aid to the states, amounting in some years to over a quarter of total federal aid to the states.

Figure 2: Federal Tax Aid to the States as a Percentage of Total Federal Aid to the States, 1980–2006



Source: *U.S. Budget*²²⁷

Several commentators have already analyzed the deduction for state and local taxes. These scholars have focused on whether the deduction is fair,²²⁸

225. See OMB, ANALYTICAL PERSPECTIVES, *supra* note 41, at 291 tbl.19-1 (estimating the cost of various such tax expenditures, the largest of which are the deduction for state and local taxes (\$37.5 billion), the deduction for state and local property taxes (\$19.1 billion), and the exclusion of interest on state and local bonds (\$23.5 billion)).

226. *Id.*

227. OMB, HISTORICAL TABLES, *supra* note 54, at 326–27 tbl.15.3 (providing data on state spending from their own resources and federal grants to the states). Tax expenditure estimates come from the relevant year's Analytical Perspectives appendix to the U.S. Budget.

228. See Stark, *supra* note 5, at 1425–26 (criticizing the SALT deduction because it is available only to itemizers and is worth more to higher income taxpayers); Galle, *The SALT Deduction*, *supra* note 5 (considering the fairness of the deduction and its partial repeal via the alternative minimum tax).

whether it causes states to spend more,²²⁹ whether it is needed to properly measure taxpayers' income,²³⁰ and whether it is needed to compensate states for interjurisdictional spillovers.²³¹ But several aspects of the state and local tax deduction remain unanalyzed. For instance, the deduction allows state legislators to indirectly induce federal tax spending. When states raise their taxes, the federal subsidy of state taxes also automatically grows. In this sense, the deduction for state and local taxes can be seen as an open-ended matching grant to the states with no substantive limits on how to spend it.

The view presented here contrasts with the more traditional federalism perspective on the state and local tax deduction, which criticizes the deduction for constraining state fiscal decisions by encouraging states to raise revenue via federally deductible income or property taxes, rather than other, federally nondeductible taxes.²³² Although limiting the federal deduction to only certain kinds of state and local taxes may influence state legislators to use those tax bases, the deduction for state and local taxes is less restrictive than almost any other form of federal aid to the states. Whereas grants usually impose significant restrictions on how states may spend federal money and require states to report to the federal government how funds were spent, the deduction for state and local taxes is closer to a general revenue sharing program. It places no substantive restrictions on how states should spend federally subsidized tax revenues and involves no state reporting requirements.²³³ Thus, while some federal tax incentives may occupy the regulatory field as a practical matter, thereby crowding out competing state policies, the federal deduction for state and local taxes subsidizes independent state policymaking. Indeed, if the deduction helps the states raise their own funds, it may enhance their financial independence from the federal government, thereby also enhancing their ability to refuse undesirable federal grant conditions.²³⁴ The extent to which the state and local tax deduction promotes federalism by offsetting some of the

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

230. See Kaplow, *supra* note 5, at 420–41.

231. *Id.* at 480–84.

232. See Martin S. Feldstein & Gilbert E. Metcalf, *The Effect of Federal Tax Deductibility on State and Local Taxes and Spending*, 95 J. POL. ECON. 710, 731 (1987) (arguing that the SALT deduction is a tax incentive for state governments to rely more heavily on personal taxes than on other sources of revenue); Kaplow, *supra* note 5, at 415 n.3 (reviewing conflicting empirical studies about whether states substitute deductible for nondeductible taxes); see also Stark, *supra* note 5, at 1425–26 (criticizing the deduction for encouraging states to rely on redistributive taxes such as property and income taxes, even though it is more efficient for only the federal government to engage in redistribution). *But see* Stark, *supra* note 5, at 1415 (noting that when Congress repealed the federal deduction for state and local sales taxes, states did not reduce their reliance on the kinds of taxes that had been federally deductible prior to the repeal).

233. *Cf.* Kaplow, *supra* note 5, at 485 (criticizing the state and local tax deduction as state spending stimulus because it subsidizes all state spending, not just state spending that produces positive national or interjurisdictional externalities).

234. See Galle, *The "SALT" Deduction*, *supra* note 5, at 841.

federalism-undermining effect of federal taxing and spending authority is an empirical question. However, when evaluating its impact on federalism, it is important to place the deduction in its proper context by comparing it to other, more restrictive, forms of federal aid to the states.

A remaining question is how the existence of federal tax incentives that preserve state autonomy should affect the interpretation of the constitutional limits on Congress's taxing power. So far, I have discussed two kinds of federalism-preserving tax incentives. The first was federal tax penalties that increase federal taxes for taxpayers that violate state law. Given the extremely broad modern interpretation of the commerce power, the federal tax penalties discussed in this Article that help enforce state laws probably would be permissible even on a narrow interpretation of the taxing power that limited Congress to assessing tax penalties in areas it could directly regulate.²³⁵ If they can be sustained independently under the Commerce Clause, the desirability of retaining state-autonomy-preserving federal tax penalties cannot be offered as support for a broad interpretation of the taxing power.

But consider the federal deduction for state and local taxes. On a narrow interpretation of the taxing power that limits Congress's use of tax incentives to regulatory goals falling within its other enumerated powers, would Congress be permitted to offer the deduction? It is difficult to know how we would even go about answering such a question. First, we would need to know what, exactly, Congress regulates when it implements the state and local tax deduction. Let's assume that Congress's purpose in enacting the deduction is to bolster state policy autonomy. That is, the underlying federal purpose for the deduction is to provide unconditional aid to the states for the pursuit of the states' own regulatory goals. Does such a federal goal itself fall within one of Congress's other enumerated powers? Or should we look to the uses to which the states put the additional state tax revenue facilitated by the federal deduction? Since money is fungible, and we cannot trace the additional state revenues attributable to the federal deduction, should we regard the state and local tax deduction as making the federal government a junior partner in all of the states' regulation? If so, Congress would be indirectly involved in policy areas that it could not regulate directly. Does this mean that a narrow interpretation of the taxing power paradoxically may preclude the federal deduction for state and local taxes, notwithstanding that it bolsters independent state policy choices?

This tortuous and unsteady line of analysis points to a practical reason for interpreting the taxing power, like the spending power, to be unbounded by Congress's other enumerated powers. Namely, it would avoid the need for

235. For example, denial of a federal deduction for payment of a state fine imposed on a private party for failure to obey state weight limits on trucks using state roads could be sustained under Congress's power to regulate the instrumentalities of interstate commerce. *Cf.* *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 33–36 (1958) (approving disallowance of federal deduction for fines assessed for violation of state truck weight limits).

courts to speculate as to which regulatory goals motivated Congress's adoption of particular federal tax laws. The next Section addresses this issue more fully.

H. Institutional Limitations

If the Supreme Court interpreted the taxing power to be limited by Congress's other enumerated powers, such that Congress would be forbidden from using taxes to regulate areas that it could not regulate directly, it would force courts to police the unworkable distinction between regulatory and income-defining tax provisions. An example from one of the cases discussed above will illuminate the problem.

Recall that *Constantine* dealt with a \$1,000 federal tax on dealers who sold liquor in violation of state law.²³⁶ A majority of the Court struck down the tax on the theory that it was an attempt to regulate the sale of liquor, a matter the Court regarded as lying within the exclusive police powers of the states.²³⁷ In concluding that the motive for the federal tax was punitive, the majority looked to the high dollar amount of the tax and to the fact that liability for the tax was triggered upon commission of a crime.²³⁸ To the majority, these features clearly pointed to Congress's "intent to prohibit and to punish violations of state law" and they "remove[d] all semblance of a revenue act."²³⁹

But in his dissent, Justice Cardozo offered an alternative interpretation. The high tax could be seen as policing, not state law, but rather the federal government's interest in collecting tax revenue.²⁴⁰ Justice Cardozo started from the unobjectionable proposition that, like legal enterprises, criminal enterprises produce taxable income.²⁴¹ Unlike taxes on legitimate profits, however, taxes on illegal profits were less likely to be collected due to the "furtive character" of criminal enterprises.²⁴² Thus, the higher tax on illegal profits could be seen, in Justice Cardozo's words, as "reimbursement" for the greater expense imposed on the federal government to collect taxes from illegal enterprise.²⁴³ Furthermore, Justice Cardozo noted that since illegal businesses yield larger profits than legal businesses, equity demands that they be taxed more.²⁴⁴ Thus, subjecting illegal gains to higher tax may be "not repression, but payment commensurate with the gains."²⁴⁵ Finally, rather than viewing Congress as attempting to punish liquor dealers for a crime, Justice Cardozo argued that the

236. United States v. Constantine, 296 U.S. 287, 288 (1935).

237. *Id.* at 295–97.

238. *Id.* at 294–96.

239. *Id.* at 295.

240. *Id.* at 297 (Cardozo, J., dissenting).

241. *Id.* at 298 (Cardozo, J., dissenting).

242. *Id.* at 297 (Cardozo, J., dissenting).

243. *Id.* (Cardozo, J., dissenting).

244. *Id.* (Cardozo, J., dissenting).

245. *Id.* (Cardozo, J., dissenting).

high taxes applicable to liquor dealers could be seen as a nuisance tax.²⁴⁶ He cited precedent in which the Court had previously upheld higher taxes on activities that created nuisances.²⁴⁷ Seen in this light, Justice Cardozo argued that the tax “is not punishing at all. It is laying an excise upon a business conducted in a particular way with notice to the taxpayer that if he embarks upon that business he will be subjected to a special burden.”²⁴⁸

Some readers may be convinced by the majority’s conclusion that Congress’s intent in enacting the \$1,000 tax on liquor dealers was punitive, while others may be convinced by Justice Cardozo’s conclusions. What is troubling is that any court in a position of reviewing tax measures in order to determine whether they regulate outside of particular circumscribed areas must engage in what Justice Cardozo in *Constantine* labeled “psychoanalysis” of Congress.²⁴⁹ Such psychoanalysis is needed because Congress may not state its motivation for particular tax provisions; it may have mixed regulatory-and-revenue motives for enacting a tax provision, or different members of Congress may have different motives for enacting the same tax statute. This difficulty is compounded if courts “imput[e] to the lawmakers . . . a purpose not professed,” as did the majority in *Constantine*.²⁵⁰

But in addition to the practical difficulties of discerning congressional motive, there are insurmountable theoretical problems with distinguishing regulatory tax provisions from non-regulatory (that is, income-defining) tax provisions because, as previously explained, drawing the distinction requires agreement on a net income baseline.²⁵¹ Tax professors and policymakers have not been able to agree on a baseline despite the benefit of more than four decades of study, and the members of the Supreme Court are unlikely to do better. The question “what is the net income baseline?” essentially asks how we, as a society, want to define income for purposes of distributing the burden of paying for public benefits. This question, which has no clear analog in the grant context, seems quintessentially legislative and best left untouched by courts. Requiring courts to determine precisely the regulatory intentions of Congress inevitably will lead to ad hoc, controversial rulings that produce little guidance to Congress or lower courts and that give the appearance of judicial lawmaking.

I. Distinguishing Tax Expenditures from Tax Penalties

This Section first concludes that because tax expenditures do not represent a greater threat to federalism than conditional grants, the Supreme

246. *Id.* at 298 (Cardozo, J., dissenting).

247. *Id.* (Cardozo, J., dissenting).

248. *Id.* (Cardozo, J., dissenting).

249. *Id.* at 299 (Cardozo, J., dissenting).

250. *Id.* (Cardozo, J., dissenting).

251. *Cf.* Sugin, *supra* note 51, at 418–24 (arguing against “constitutionalizing” the definition of income for personal rights purposes).

Court could interpret Congress's power to spend through the tax code as broadly as its power to spend directly without impairing federalism values. This Section next turns to the question of regulation via tax penalties, and it argues that, although the case is more equivocal, because political safeguards are adequate to preserve federalism values against the expansion of federal power through tax penalties, the Supreme Court could interpret the taxing power as broadly as the direct spending power without introducing significant new threats to federalism values.

1. Federal Tax Expenditures

Because tax expenditures are economically equivalent to direct expenditures, arguably they should be (or already are) covered by the broad interpretation of the spending power the Supreme Court announced in *Dole*. Notably, although the Supreme Court in *Dole* faced a question concerning the constitutionality of a conditional grant, in interpreting the limits of the federal spending power, the Court did not limit its discussion to conditional grants. Specifically, the Court held that Congress could use “the spending power *and* the conditional grant of federal funds” to achieve regulatory goals that fall outside Congress's other enumerated powers.²⁵² This language highlights that conditional federal spending is only one type of federal spending. If tax expenditures likewise represent an exercise of the spending power, rather than an exercise of the taxing power, for constitutional law purposes, then under the Court's reasoning in *Dole*, regulatory tax expenditures need not be supported by another enumerated federal power. Critics may argue that allowing Congress to use tax expenditures to regulate areas that lie beyond its other enumerated powers undermines the very concept of a federal government of enumerated powers.²⁵³ But so far, this argument has failed to persuade the Supreme Court. Thus, unless the Court overrules or significantly limits *Dole*, it is reasonable to conclude that the federal power to regulate through tax spending is as broad as the federal power to regulate through conditional spending.²⁵⁴ If this is so, then politics will remain the primary method for

252. *South Dakota v. Dole*, 483 U.S. 203, 207 (1987) (emphasis added).

253. *See, e.g., Virginia ex rel. Cuccinelli v. Sebelius*, 728 F. Supp. 2d 768, 788 (E.D. Va. 2010) (holding that Congress exceeded its commerce and taxing powers when it enacted the individual mandate and concluding that to hold otherwise “would invite unbridled exercise of federal police powers”).

254. Certain post-*Dole* cases limiting federal power may signal renewed interest in active judicial review of federalism questions. *See, e.g., United States v. Morrison*, 529 U.S. 598, 617 (2000) (striking down the Violence Against Women Act as beyond congressional commerce power); *Printz v. United States*, 521 U.S. 898, 914 (1997) (holding Congress could not commandeer state officials to conduct background checks on potential handgun purchasers); *United States v. Lopez*, 514 U.S. 549 (1995) (striking down the Gun-Free School Zones Act as beyond congressional commerce power); *New York v. United States*, 505 U.S. 144 (1992) (holding that Congress could not commandeer states by forcing them to take title to radioactive waste produced in their territory). These post-*Dole* cases represent a revival of what might be

ensuring that the federal government does not overreach with its (tax and direct) spending powers.

Although the matter is not free from doubt, the comparison of the federalism impact of conditional grants and federal tax expenditures in this Part supports this doctrinal conclusion. First, unlike grants, tax expenditures directly regulate private (not state) activity, although I suggested that this difference is not significant when we consider that federal tax spending may indirectly displace states just as effectively as conditional grants do. Second, since they are not contractually bound by federal tax spending, states remain freer than they do under grants to enact policies different from or even conflicting with federal tax policies. Third, unlike conditional grants, which the federal government can use to reach any subject that lies within the reach of state regulatory authority, tax expenditures have limited applicability. Congress can only use them effectively where its regulatory object is one that can be furthered by direct money transfers to private taxpayers. More ambitious regulatory goals that require significant oversight or complicated implementation require state cooperation and therefore implicitly provide states a right of refusal. Fourth, the personal reach of grants is potentially wider than that of tax expenditures, since many U.S. residents are not influenced by federal tax expenditures because they have no federal income tax liability. In contrast, since almost all U.S. residents are subject to regulation by one or more states, Congress can reach almost all U.S. residents when it uses conditional grants to regulate. Fifth, several types of federal tax expenditures—most notably the federal deduction for state and local taxes—actually enhance states' ability to enact local regulation by subsidizing its cost.

In other ways, federal tax expenditures appear to raise more serious federalism concerns than do grants. For example, because federal tax expenditures do not appear on federal or state outlay budgets, they raise more serious accountability concerns than do grants. Additionally, commentators have long argued that the special budgetary and legislative procedures that apply to tax expenditures make them easier to enact and harder to repeal than traditional appropriations.²⁵⁵ The ease of enacting tax expenditures also may make them more effective than grants at displacing state regulation. On the other hand, the accountability problems posed by federal taxation may be less serious than they appear at first impression. For example, although it may be hard to keep track of regulatory tax provisions because they are not an explicit part of the federal outlay budget, the appearance of tax expenditures on the

called the “judicial safeguards of federalism.” *But see* *Gonzales v. Raich* 545 U.S. 1 (2005) (holding that Congress has the power under the Commerce Clause to prohibit in-state possession of home-grown medical marijuana). Professor Bagenstos has argued that the Roberts Court will stake out a middle ground. *See* Bagenstos, *supra* note 199, at 384–409 (predicting that the Roberts Court will indirectly limit the spending power through doctrines, such as the clear statement requirement, that narrow the enforceability of conditions placed on grant funds).

255. *See supra* note 174 and accompanying text.

annual tax expenditure budget mitigates this accountability concern by exposing the expected cost of such provisions. Another factor tending to mitigate the political accountability problems posed by federal tax expenditures is that they appear on federal tax forms and are administered by the federal Treasury Department. As a result, they should not cause undue confusion as to which level of government is responsible for them.

Of course, these same tax provisions also may appear on state tax forms because many states import federal tax incentives into their own tax law by conforming their tax bases to the federal tax base. But such tax base conformity arguably represents a choice for which state legislators ought to be held accountable. At least, it seems reasonable that in interpreting the limits on the federal taxing power, the Supreme Court would regard any coercive effect of federal-state tax base conformity as analogous to the coercive effect of conditioning much-needed federal funds upon the express adoption by states of federal policy goals. Accordingly, just as the Supreme Court regards states' ability to refuse grants as a paramount federalism safeguard, it would presumably view as equally important states' ability to deviate from the federal tax base.²⁵⁶ Moreover, states' deviations from the federal tax base in some policy areas show that perfect federal-state tax base conformity is not a prerequisite to an administrable state tax system.²⁵⁷ Indeed, since deviating from federal tax expenditures increases state tax collections, as a fiscal matter, it is easier for states to deviate from federal tax expenditures than for states to deviate from federal tax penalties (or to refuse grants).

2. Federal Tax Penalties

Supreme Court doctrine is unclear on the limits of Congress's ability to use tax penalties to regulate. Although the Court unequivocally stated in several cases decided in the 1920s and 1930s that the Constitution forbids Congress from using tax penalties to accomplish what it could not accomplish via direct regulation, the precedential value of these cases is unclear.²⁵⁸ As Part II explained, these cases were never overruled, but, since the *Lochner* era, the Supreme Court's understanding of the limits of federal power has evolved, and this evolution calls into question the continued validity of the *Lochner*-era tax cases. Specifically, the modern Court has read both the commerce and spending powers very broadly. Moreover, as Part II also explained, both before and after its decisions in cases like the *Child Labor Tax Case* and *Butler* that interpreted the taxing power narrowly, the Supreme Court showed federal taxes significant deference, upholding them even when they evinced

256. The ability of states to refuse federal grants is what distinguishes them from impermissible acts of federal commandeering. *See* *New York v. United States*, 505 U.S. 144, 168, 176–77 (1992).

257. For examples of state deviation, see *supra* note 220.

258. *See supra* Part II.B.

Congress's goal to regulate or even destroy the activity taxed.²⁵⁹ This suggests that the narrow view of the taxing power that the Court took in the *Lochner*-era tax cases was a special product of that historical period and is therefore of limited precedential value today.

If the Court were to consider as a question of first impression whether Congress's ability to regulate through tax penalties is constrained by its other enumerated powers, it would consider the impact a broad interpretation of the ability to regulate through tax penalties would have on federalism. Certain factors suggest that failure to constrain federal power to regulate via tax penalties would undermine federalism. For example, federal tax penalties, like federal tax expenditures, may crowd out concurrent or conflicting state regulation of the same substantive area. Unlike with grants and tax expenditures, however, because Congress does not have to first raise tax revenue (as it must when regulating through conditional grants), or forego tax revenue (as it must when regulating through tax expenditures), its ability to regulate through tax penalties arguably is less constrained politically.²⁶⁰

Moreover, states' ability to oppose federal regulation enacted through tax penalties may be limited as compared to states' ability to oppose federal policies enacted through conditional grants or tax expenditures. The Supreme Court has held that states' ability to refuse conditional grants adequately protects them from unconstitutional federal invasion of their regulatory competence, notwithstanding commentators' arguments that states' urgent fiscal need renders their right to refuse grants meaningless. But states lack even a formal right to refuse federal regulation enacted through tax penalties. I argued above that states could theoretically repeal federal regulations enacted via federal tax penalties.²⁶¹ For example, Virginia could refund to its residents any penalties they pay for violating the individual mandate of the healthcare reform act. But there are at least two problems with this form of "repeal." First, it would be costly. As compared to refusing to import federal tax expenditures into the state tax base (which would *increase* state tax revenue), refunding federal tax penalties would be expensive for states and would leave less money for accomplishing state priorities. Second, as explained above, refunding federal tax penalties at the state level may violate the Supremacy Clause.

Additionally, whereas I argued that the regulatory reach of tax expenditures was incomplete because as many as one-third of American households have no positive income tax liability and therefore are not influenced by nonrefundable tax expenditures, tax penalties influence all Americans, whether they have tax liability before the imposition of the penalty or not. Likewise, although I argued that the tax expenditure budget increases the political transparency of tax expenditures, the Congressional Budget Act of

259. See *supra* Part II.B.

260. But see *infra* text accompanying notes 261–64.

261. See *supra* Part III.B.

1974 does not require estimations of revenue raised by tax penalties. As a result, voters and policymakers may lack the information they need to evaluate tax penalties. If voters and policymakers do not understand the impact of tax penalties, politics may be insufficient to safeguard federalism. This would be a special cause for concern if tax penalties' budgetary obscurity made them easier to pass than regulations. If tax penalties are both easier to enact than regulations and also unconstrained by Congress's other enumerated powers, they would represent a significant source of federal regulatory power that could threaten federalism values.

Despite their budgetary obscurity, however, there is reason to believe that tax penalties are nevertheless highly politically salient. As compared to regulations or tax expenditures, voters pay more attention to tax increases.²⁶² As a result, politics may be a particularly effective check on the ability of Congress to overreach using tax penalties. As Professor Deborah Schenk recently observed, "Congress and politicians go to extraordinary lengths to steer clear of taking any action that might be construed as raising taxes."²⁶³ For example, the desire to avoid the accusation that they "raised taxes" led politicians to change the label on the individual mandate of the healthcare reform act from "tax" to "penalty."²⁶⁴ Empirical evidence suggests that such labels make a difference for how people react to policies.²⁶⁵ If tax increases are

262. There are many explanations for this effect, including political rhetoric, interest group politics, and cognitive biases (such as loss aversion). For more on this topic, see Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes* Part IV.A–C, 28 YALE J. ON REG. (forthcoming 2011).

263. *Id.* at 47.

264. See *Virginia ex rel. Cuccinelli v. Sebelius*, 728 F. Supp. 2d 768, 786 (E.D. Va. 2010) (finding it probative of whether Congress exercised its taxing power that "[e]arlier versions of the bill . . . used the more politically toxic term 'tax'" but the final version of the bill substituted the term "penalty"); see also *Mead v. Holder*, No. 10-950, 2011 WL 611139, at *23 (D.D.C. Feb. 22, 2011) (holding that the penalty for violating the individual mandate is not a tax because, inter alia, "Congress specifically rejected the term 'tax' in favor of 'penalty'"); *Liberty Univ. v. Geithner*, 753 F.Supp.2d 611 (W.D. Va. 2010) (holding that the tax penalty for violating the individual mandate is a "penalty" rather than a "tax" for purposes of the Anti-Injunction Act, but upholding it under the Commerce Clause).

Whether the individual mandate constitutes a "tax" or a "penalty," and whether this difference carries constitutional significance, also has been a matter of debate among scholars. Professors Randy Barnett and Erik Jensen separately argue that the individual mandate is not a tax, in part because it was not labeled a tax and Congress did not invoke the tax power when enacting it. See Barnett, *supra* note 93, at 24–27; Jensen, *The Individual Mandate*, *supra* note 117, at 16–18. For arguments that the individual mandate is sustainable independently under the taxing power, see, e.g., Con Law Professors' Brief, *supra* note 127.

265. In her article, Professor Deborah Schenk briefly surveys the nascent empirical literature on labeling. See Schenk, *supra* note 262, at Part V.A (citing studies showing that experimental subjects reacted more negatively to payments labeled "taxes" than to payments that were not labeled or to payments labeled "fees").

The legal significance of this change in terminology has been a major point of contention between the government and the parties challenging the constitutionality of the individual mandate, but whether Congress labels a revenue-raising provision a "tax" may be less important than whether the public comes to understand the provision as a tax increase, regardless of its label.

more politically salient than tax expenditures or other kinds of regulation, then politics can serve as a meaningful check on tax penalties, vitiating the need for extensive judicial review of federal tax penalties. The relative scarcity of federal tax penalties compared to tax expenditures may reflect the greater political obstacles tax penalties face. As a result, the Supreme Court could interpret the power of Congress to regulate via tax penalties to be unconstrained by its other enumerated powers without introducing a significant new threat to federalism.

Finally, to determine whether a tax penalty falls within the scope of Congress's other enumerated powers, courts would need to be able to identify the regulatory motives behind tax penalties. But, for the reasons discussed in Section H above, that will not always be possible. A similar institutional competence argument counsels against adopting a different rule for tax expenditures than for tax penalties. If tax expenditures are not limited by enumeration (because, for example, they fall under the *Dole* rule), but tax penalties are limited by enumeration, then courts must be able to distinguish tax expenditures from tax penalties, which once again implicates the baseline problem. To be able to identify tax expenditures or tax penalties we need agreement on the normative net income baseline; but no such agreement exists. For example, is it proper to conceive of the limited deduction for investment in traditional individual retirement accounts as a benefit, and therefore, as a tax expenditure? Or is the deduction a tax penalty because it is subject to an overall dollar cap? The answer depends on the choice of a normative net income baseline. Under the Schanz-Haig-Simons definition of income, savings would be taxed, so deductions for savings would qualify as tax expenditures. But under a cash-flow consumption tax, savings would not be taxed, which would make limitations on savings deductions tax penalties. To distinguish tax expenditures from tax penalties, courts would have to adopt a normative income baseline, a task they lack institutional competence to achieve. This unresolved challenge suggests that the Supreme Court should not distinguish tax expenditures and tax penalties when interpreting the scope of the taxing power. As a result, if the Court will interpret tax expenditures to be unconstrained by enumeration, it should also interpret tax penalties to be similarly unconstrained.

* * *

Since Herbert Wechsler, commentators have debated whether the political safeguards of federalism dispense with the need for judicial intervention to prevent the federal government from encroaching on the competences of the states.²⁶⁶ In the pending context, the Supreme Court has answered this

Thus, for example, before the last congressional election, the Republicans successfully characterized the expiry of the Bush tax cuts as a "tax increase," even though that characterization is debatable.

266. See *supra* note 23.

question in the affirmative.²⁶⁷ By interpreting the spending power as an autonomous grant of federal power, unlimited by Congress's other enumerated powers, the Supreme Court has left policing the relative competences of the state and federal governments primarily to the political arena.²⁶⁸

If Congress's power to regulate through the tax law is as broad as its power to regulate through direct spending, the principal method of protecting the states from federal overreaching through both taxing and spending would be political. Of course, both the taxing and spending powers remain subject to the express constitutional limitations described in Part II, including that taxes must promote the general welfare and satisfy applicable apportionment or uniformity requirements.²⁶⁹ Additionally, the Supreme Court has held that taxes must raise general revenue, although the amount of revenue raised by a particular tax can be "negligible."²⁷⁰ Like direct spending, tax expenditures and tax penalties must not violate other constitutional provisions, such as taxpayers' civil liberties.²⁷¹ Finally, the possibility remains that the Supreme Court would

267. *South Dakota v. Dole*, 483 U.S. 203, 209–11 (1987).

268. *Id.* at 207.

269. See discussion *supra* Part II.A.

270. *United States v. Sanchez*, 340 U.S. 42, 44 (1950) (ruling that a tax does not cease to be valid because it also seeks to regulate, even if "the revenue obtained is obviously negligible" or "the revenue purpose of the tax [is] secondary"); *Sonzinsky v. United States*, 300 U.S. 506, 514 n.1 (1937) (upholding a tax with regulatory effects that produced "some" revenue and noting that only twenty-seven people were subject to the challenged tax in 1934); *J.W. Hampton, Jr., & Co. v. United States*, 276 U.S. 394, 412 (1928) (upholding federal tax on imported barium dioxide designed to equalize competition with domestic manufacturers because "[s]o long as the motive of Congress and the effect of its legislative action are to secure revenue for the benefit of the general government, the existence of other motives in the selection of the subjects of taxes cannot invalidate congressional action"). See also *United States v. Kahriger*, 345 U.S. 22, 28 n.4 (1953) (comparing favorably the \$4 million raised by the Gamblers' Occupational Tax Act, which the Court upheld as a valid tax, to other previously sustained federal tax penalties, including the total of \$3,500 in taxes collected on adulterated butter, the less than \$1 million collected on narcotics and other drugs, and the \$29,000 collected under the firearms transfer tax).

271. *Cf. Speiser v. Randall*, 357 U.S. 513 (1958) (striking down a requirement that veterans swear an oath not to advocate the overthrow of the government as condition of *state* property tax exemption because such oath violated veterans' freedom of speech); *Green v. Connally*, 330 F. Supp. 1150 (D.D.C.) *aff'd sub. nom. Coit v. Green*, 404 U.S. 997 (1971) (upholding the IRS's interpretation of the federal tax code to deny charitable tax benefits to racially discriminatory private schools because such schools are not charitable and because allowing such tax benefits would frustrate the federal policy against segregated education); *id.* at 1164–65 (avoiding deciding the case on constitutional grounds, but observing that "tax exemptions and deductions certainly constitute a Federal Government benefit and support . . . [And] it would be difficult indeed to establish that such support can be provided [in this case] consistently with the Constitution"); *id.* at 1165–68 (holding that denying tax-exempt status to racially discriminatory schools did not violate the free association rights of parents of children enrolled in such schools); *Walz v. Tax Commission of N.Y.C.*, 397 U.S. 664 (1970) (upholding against an Establishment Clause challenge state tax exemptions for real property owned by churches and used for religious worship because such exemptions avoided excessive government entanglement with religion); *McGlotten v. Connally*, 338 F. Supp. 448 (D.D.C. 1972) (holding that granting tax-exempt status to nonprofit and fraternal organizations that excluded nonwhites from membership was sufficient government action to invoke the strictures of both the Fifth Amendment's Due Process Clause and the 1964

subject tax incentives to the limits it announced in dicta in *Dole* for the spending power. Writing for the majority in *Dole*, Justice Rehnquist noted that conditions on grants to the states must be related to the federal purpose underlying the grant and not coercive (a standard left undefined by the *Dole* Court).²⁷² Likewise, perhaps tax incentives must be related to a legitimate federal purpose and not coercive.

As a practical matter, leaving the policing of the relative competences of the states and federal government to the political arena, rather than the courts, is especially desirable when it comes to regulatory tax policies because it dispenses with the need for courts to determine which portions of the tax law are regulatory and which are income-defining. If the Constitution limits Congress to using its taxing power only to achieve goals within the scope of its other enumerated powers, then courts must try to identify which federal tax provisions have regulatory effects and what those regulatory effects are. In contrast, interpreting the federal tax power to be unconstrained by Congress's other enumerated powers would avoid miring courts in legislative "psychoanalysis" and unresolved questions of tax theory.

Civil Rights Act).

For scholarly consideration of whether tax expenditures are equivalent to direct spending for constitutional law purposes and discussing several *state* taxes that the Supreme Court has struck down for violating federal constitutional rights such as free speech and free exercise, see Adler, *supra* note 57; Sugin, *supra* note 51; Zelinsky, *supra* note 57.

The Supreme Court has also found *federal* tax penalties to violate individual rights in some cases. See, e.g., *Marchetti v. United States*, 390 U.S. 39 (1968) (holding that the registration requirement under the federal occupational tax on wagering required the taxpayer to incriminate himself and therefore the privilege against self-incrimination constituted a complete defense to prosecution for failure to pay the tax). *But see id.* at 61 ("We emphasize that we do not hold that these wagering tax provisions are as such constitutionally impermissible; we hold only that those who properly assert the constitutional privilege as to these provisions may not be criminally punished for failure to comply with their requirements."). See also *Dep't of Revenue of Montana v. Kurth Ranch*, 511 U.S. 767, 778–79 (1994) (holding that a Montana drug possession tax that was equal to eight times the value of the confiscated drugs and was triggered by the taxpayer's arrest for drug possession constituted a punishment for double jeopardy purposes, despite state's argument that the tax could be imposed in addition to criminal sanctions because it was a mere civil penalty). *But see id.* at 778 ("Montana no doubt could collect its tax on the possession of marijuana, for example, if it had not previously punished the taxpayer for the same offense.").

272. *Dole*, 483 U.S. at 207–08, 211; see also *New York v. United States*, 505 U.S. 144, 171–72 (1992) (holding that the conditional spending provisions of the Low-Level Radioactive Waste Policy Act did not exceed congressional power and summarizing precedent as providing that conditional federal spending must be for the general welfare, and any attached conditions must be unambiguous, reasonably related to the federal purpose for the expenditure, and not violate any independent constitutional prohibition); *Pennhurst State Sch. and Hosp. v. Halderman*, 451 U.S. 1, 17 (1981) (holding that in order to bind states, spending conditions must be unambiguous, "enabl[ing] the States to exercise their choice knowingly, cognizant of the consequences of their participation"); Engdahl, *supra* note 3, at 81 (observing that "no spending program or condition since *Butler* has been held invalid on coercion grounds").

CONCLUSION

Even though it is Congress's first enumerated power, the taxing power does not attract much scholarly attention. But the taxing power is the Constitution's hidden giant. The Supreme Court has interpreted the taxing power broadly, despite its early acknowledgement of the risk, described by Alexander Hamilton in *The Federalist* No. 31, that "an indefinite power of taxation in the [federal government] might, and probably would, in time, deprive the [state governments] of the means of providing for their own necessities; and would subject them entirely to the mercy of the national legislature."²⁷³

Drawing an analogy to conditional federal grants, this Article argues that, like the spending power, the taxing power raises federalism concerns because federal tax policies may crowd out state regulation of the same regulatory area. Opponents of conditional federal grants argue that by essentially reassigning legislative competences through contract, conditional grants reduce the policy space available to the states and alter the structural division of government power contemplated in the Constitution. In this way, grants are said to redraw the lines of federalism, thereby jeopardizing the benefits conferred by federalism, including decentralization, policy diversity, and regulatory competition. This Article argues that, similarly to grants, Congress uses tax incentives to influence private taxpayer behavior in ways that may crowd out state regulation, including in areas that arguably lie outside Congress's enumerated areas of regulatory authority.

The impact of federal tax incentives on federalism depends on the constitutional scope of the taxing power. The broader the federal taxing power, the more it may displace state regulation. Despite the appearance of the taxing and spending powers in the same clause of the Constitution, the Supreme Court has not unequivocally endorsed a construction of the taxing power that confirms that Congress may use it, as it does the spending power, to achieve policy goals that Congress lacks constitutional authority to implement via direct regulation. Nevertheless, except for several cases decided in the *Lochner* era, the Court has taken a broad view of the taxing power. Moreover, this Article analyzes the potential impact on federalism of reading the taxing power as unconstrained by enumeration, and it concludes that such an interpretation would not pose a greater threat to federalism than that already posed by the Court's broad reading of the spending power. Thus, if the Court continues to adhere to the broad interpretation of the spending power that it announced in *Dole*, there is a persuasive case that it should interpret the taxing power equally broadly.

273. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 317, 433–34 (1819).

