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The Taxation of Nonshareholder Contributions to Capital: An Economic Analysis

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I. INTRODUCTION

Every year, billions of dollars are contributed to corporations by persons who are neither owners nor shareholders of those corporations.[1] These contributions, categorized under the income tax laws as "nonshareholder contributions to capital,"[2] play an important economic role

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1. One knowledgeable source has estimated that $30 billion a year is contributed by state and local governments alone as incentive for firms to locate in an area. See the comments of Donald Haider, Professor at Northwestern University's business school, contained in Donald Haider, *Controls Are Needed For State Battles Over Businesses*, Chi. Trib. at C25 (Aug. 18, 1989). For further discussion of the magnitude of these transactions, see notes 59-62 and accompanying text.

2. These contributions are "nonshareholder" in nature because the contributing parties do not become shareholders or owners of the corporations as a result of making the contributions. For an introduction to the taxation of nonshareholder contributions to capital, see William D. Andrews, *Basic Fundamental Income Taxation* 396-401 (Little, Brown, 4th ed. 1991) ("*Andrews Taxation*"); Michael J. Graetz, *Federal Income Taxation* 256-59 (Foundation Press, 2d ed. 1988) ("*Graetz Taxation*"). For more extensive analyses of this area, see William B. Landis, *Contributions to Capital of Corporations*, 24 Tax L. Rev. 241 (1969); Note, *Taxation of Nonshareholder*

in subsidizing the construction of new factories and other improvements to the nation's infrastructure.

This Article concerns the federal income tax treatment of the two principal categories of nonshareholder contributions to capital, which together encompass the great majority of these transactions.[3] The first category consists of contributions made for the purpose of obtaining economic development. Typically, this occurs when governments and business groups contribute property to corporations in order to persuade those corporations to construct factories and other facilities in their local areas. These contributions are made to the firms so that the local area will benefit from the jobs and economic stimulation provided, as positive externalities,[4] by the operation of the factories in the vicinity.

Under present law, corporations are not taxed on contributions they receive for economic development.[5] When, for example, a corpora-

Contributions to Corporate Capital, 82 Harv. L. Rev. 619 (1969); Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 Stan. L. Rev. 567, 604-13 (1965). See also Mark E. Larson, Jr. and Julius A. Jove, *Customer Contributions to Utilities Continue to Create Income Problems*, 45 J. Tax. 194 (1976); Brooke Pearson, United States v. Chicago, Burlington & Quincy Railroad: *A New Test For Nonshareholder Contributions to Capital*, 27 Tax Law. 503 (1974); J. Malcolm Harris, *Federal Income Tax Exclusion of Non-Shareholder Contributions to Capital*, 39 Tex. L. Rev. 623 (1961); Note, *Tax Consequences of Non-Shareholder Contributions to Corporate Capital*, 66 Yale L. J. 1085 (1957).

3. The importance of these two specific categories to the general subject of nonshareholder contributions to capital is evidenced by the dominant role the two categories play in discussions of the area. See, for example, Boris I. Bittker and Lawrence Lokken, 3 *Federal Taxation of Income, Estates and Gifts* ¶ 9.1 (Warren, Gorham & Lamont, 2d ed. 1991); *Andrews Taxation* at 396-401 (cited in note 2); *Graetz Taxation* at 256-59 (cited in note 2).

4. An externality may be defined as a side effect of a process that affects, negatively or positively, other parties through nonmarket processes. Thus, because the externalities function outside of market processes, normal market functions such as price determinations do not respond to these externalities in a corrective manner. Paul A. Samuelson, *Economics* 449-50 (McGraw-Hill, 11th ed. 1980) (describing externalities having a positive effect on others as "external economies"); Harry S. Rosen, *Public Finance* 143-47 (Richard D. Irwin, 1985) (describing externalities having a positive effect on others as "positive externalities"); Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* 56-58 (McGraw-Hill, 2d ed. 1976). A factory may have positive externalities on a merchant in the local area, for example, in that the factory might employ additional people who would purchase goods from the merchant. This is not to say that all of the externalities created by economic development (the new factory) will be positive. See note 77 and accompanying text for a discussion of the negative externalities that may accompany this development. My only point is tbat communities purchasing economic development by making contributions to firms clearly are doing so for purposes of obtaining the positive externalities that are generated by the development.

5. Corporations are allowed to exclude contributions to capital from income. I.R.C. § 118(a) (West 1992). In turn, Treas. Reg. ¶ 1.118-1 (1960) defines a contribution to capital as including nonshareholder contributions, such as "the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities." See *Brown Shoe Co. v. Commissioner*, 339 U.S. 583 (1950) (holding that buildings contributed to a corporation by a community group as inducement for location of a factory are contributions to the corporation's capital). Subsequent to the *Brown Shoe* decision, the

tion receives "free" land from a state government as an inducement to construct a factory, the law generally allows the corporation to exclude the value of the land from its taxable income.[6] Present law thus implicitly assumes that the corporation does not have income, defined as an accretion to wealth,[7] from the receipt of the land.

Supreme Court purportedly refined the definition of contributions to capital in *United States v. Chicago, Burlington & Quincy Railroad Co.*, 412 U.S. 401 (1973). For the Court's analysis of contributions to capital that, without reversing *Brown Shoe*, adds other criteria to the legal definition of these transactions, see *Chicago, Burlington & Quincy Railroad Co.*, 412 U.S. at 413. However, the *Brown Shoe* decision continues to be the controlling precedent in this particular area, having been recently embraced by the Internal Revenue Service as the conceptual framework for determining the tax treatment of these transactions after the 1986 Tax Reform Act. See IRS Notice 87-82, 1987-2 C.B. 389, 390 (1987) (citing *Brown Shoe* while pointedly ignoring *Chicago, Burlington & Quincy Railroad*). For a more thorough discussion of the case law in this area, see Landis, 24 Tax L. Rev. at 242-46 (cited in note 2); Pearson, 27 Tax. Law. at 504-10 (cited in note 2). For additional discussion regarding the basis of property contributed by nonshareholders to a corporation, see note 6.

6. The tax treatment of this particular type of contribution originated in an early Supreme Court decision holding that contributions made by the Cuban government to a railroad operating on the island were not included in the corporation's income. *Edwards v. Cuba Railroad*, 268 U.S. 628 (1925). This decision was effectively codified by Congress when it enacted the 1954 Internal Revenue Code, which, in turn, was followed in the 1986 Internal Revenue Code. See § 118(a) of the Internal Revenue Codes of 1954 and 1986; Landis, 24 Tax L. Rev. at 243 (cited in note 2). This favorable tax treatment, however, is not available to the corporation without a cost. A corporation excluding these contributions from its taxable income is not allowed to receive any tax basis for the property received. I.R.C. § 362(c) (West 1992). Thus, although a corporation may exclude these assets from income, the corporation is not allowed to enjoy the additional tax benefit of recovering (i.e., deducting) the costs of the assets when those assets are later sold or depreciated. For a history of this particular provision, see *Andrews Taxation* at 398-400 (cited in note 2). Present law, however, is still quite favorable to these types of transactions, even though the recipient corporation is not allowed any tax basis for the contributed asset. The corporation is still better off under present law's treatment of excluding the asset from income and receiving no basis in the asset, in comparison to the alternative of including the asset in income and receiving a corresponding basis. The reason for this is simple—although the total amount of taxes paid under the two alternatives will be equal under certain conditions, the former alternative delays or defers the payment of tax, and thus is the more desirable alternative because of the time value of money. Thus, the tax advantage granted under present law to these types of contributions consists of deferral, that is, delaying the payment of taxes. For a general discussion of the substantial value of deferral to taxpayers, see William A. Klein, et al., *Federal Income Taxation* 62-66 (Little, Brown & Co., 8th ed. 1990); Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 Mich. L. Rev. 722, 723-30 (1990); Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. Ill. L. Rev. 1019, 1021; Mark P. Gergen, *Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital*, 44 Tax L. Rev. 519, 524 (1989); Noel B. Cunningham and Deborah H. Schenk, *How To Tax The House That Jack Built*, 43 Tax L. Rev. 447, 451-56 (1988) (discussing the problems of deferring recognition of imputed income).

7. Modern tax scholarship generally utilizes the "Haig-Simons" definition of economic income as the consumption of the taxpayer plus the change in the value of the taxpayer's property rights for the particular taxable period. Thus, accretions to the taxpayer's wealth are included in economic income under this definition. See, for example, Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 Yale L. J. 1817, 1819 (1990); Daniel N. Shaviro, *Selective Limitations on Tax Benefits*, 56 U. Chi. L. Rev. 1189, 1190 (1989); Fellows, 88 Mich. L. Rev. at 723 (cited in note 6); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 Yale L. J. 506, 508-09 (1986).

The second category consists of contributions by customers of specialized assets to corporations who will use these assets in providing future services to the customers. For example, assume an individual homeowner moves to a house in a rural area that lacks water service (i.e., no facilities exist that connect the house with lines maintained by a utility water company). Typically, if the homeowner desires to obtain water service the homeowner will be required to make a contribution, termed a "contribution in aid of construction," to a utility company of the costs of extending a water line to the residence.[8] Under present law, the utility company would be required to recognize taxable income from the receipt of the water line equal to the line's fair market value.[9]

I believe that present law's treatment of these two categories of contributions is perversely flawed. In this Article I propose to reverse the taxation of these two categories of contributions. I would fully tax corporations receiving contributions for economic development, while allowing corporations receiving contributions of specialized assets from customers to exclude such items in their entirety from income.

Briefly, the rationale for my proposals is as follows. Corporations receiving contributions from governments for economic development recognize economic income (*i.e.*, an accretion to wealth) because they are able to auction off the positive externalities of economic development generated by their new factories, while at the same time retaining for themselves all of the factories' private returns. In contrast, corporations receiving contributions of specialized assets from customers gener-

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8. Although the discussion of these contributions is not confined to transactions involving regulated utilities (see, for example, notes 156-58 and accompanying text), they are referred to in the text hecause of their importance and illustrative value. For a brief introduction to the historical treatment of contributions in aid of construction under the Internal Revenue Code, see *Graetz Taxation* at 258 (cited in note 2); *Andrews Taxation* at 400-01 (cited in note 2). Prior to the Tax Reform Act of 1986 (the "1986 Act"), contributions in aid of construction had been treated as nonshareholder contributions to capital, and accordingly were excluded from the recipient corporation's income. See Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986* at 544 (U.S. G.P.O., 1987) ("*Blue Book-1986 Act*"). In the 1986 Act, Congress changed the treatment of contributions in aid of construction to require the inclusion of these amounts in the taxable income of the recipient corporation. I.R.C. § 118(b) (1986); *Blue Book-1986 Act* at 544-47 (stating that contributions in aid of construction are no longer considered to be contributions to capital, and are, accordingly, included in the corporation's income).

9. Present law regards the utility company as receiving payment from the homeowner, in advance, for water services the utility will be providing to the homeowner in future periods. *Tax Reform Act of 1985, Report of the Committee on Ways and Means House of Representatives on H.R. 3838*, H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 643-44 (1985) (stating that the provision taxing these contributions, ultimately adopted in 1986, is intended to tax utilities receiving prepaid income from customers); *Blue Book-1986 Act* at 544 (cited in note 8). For a general discussion of the federal income taxation of prepaid income, see Boris I. Bittker, 4 *Federal Taxation of Income, Estate and Gifts* § 105.3.4. (Warren, Gorham & Lamont, 1981); Stanley S. Surrey, et al., *Federal Income Taxation* 621-31 (Foundation Press, 1986). For a criticism of these rules generally applicable to prepaid income, see note 241.

ally experience no significant accretion to wealth. Rather, the economic benefit of the contributed assets continues to inure to the customers initially making the contributions, not the corporations receiving them. Thus, the corporations should not be taxed upon the receipt of assets from which they will receive no future benefits.

Part II of the Article discusses the problems created by the treatment of these contributions under present law. In addition to various doctrinal difficulties, present law creates unattractive results in both categories of nonshareholder contributions to capital. The undertaxation of corporations receiving contributions for economic development raises troubling issues of equity. Corporations are receiving huge payments, frequently in the hundreds of millions of dollars, from state and local governments, without paying any federal income tax on these benefits. I believe that such a situation is unfair and inappropriate. In contrast, the overtaxation of contributions involving specialized assets raises concerns regarding the allocation of resources. Essentially, present law is seriously overtaxing an important area of economic activity, thus discouraging investments of capital in this area and potentially diverting economic resources into other sectors of the economy.

Part III of the Article discusses contributions for economic development and develops an argument that corporations should be taxed on these contributions. Corporations receiving these contributions have income—i.e., an accretion to wealth—upon their receipt, largely because of market failures in the market for economic development. I acknowledge that in a perfectly competitive market, corporations would not have income from receiving these contributions. However, due to serious imperfections and failures in the market for economic development, corporations are able to extract income from selling the externalities associated with their new factories and other facilities. Hence, they should be taxed on that income.

Part IV of the Article discusses contributions by customers of specialized assets to corporations who will use those assets in providing future services to the customers. The economics literature dealing with transactions costs and their impact on economic organization have referred to such specialized assets as "transaction-specific assets."[10] Al-

10. Oliver Williamson, *Antitrust Economics: Mergers, Contracting, and Strategic Behavior* 64-66 (Basil Blackwell, 1987) (providing a definition and examples of transaction-specific assets). The term "transaction-specific assets" was apparently coined by Professor Williamson, who has written extensively on the impact of sucb assets on economic organization and structure. See, for example, Oliver E. Williamson, *Economic Organization* 177-81 (New York Univ., 1986); Oliver E. Williamson, *The Economic Institutions of Capitalism* 30-32 (Free Press, 1985); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & Econ. 233, 239-42 (1979). In addition, other economists have written widely on the impact of such assets on economic activity, although the federal income tax implications of transactions involving these

though this literature is not concerned with tax policy, this Part examines its implications for my argument that corporations receiving contributions of these transaction-specific assets do not experience accretions to wealth from their receipt. Rather, the economic returns from the contributed assets continue to inure to the benefit of the customer, not the corporation. The literature on transaction-specific assets supports this conclusion and its resulting implication that the receipt of these properties by corporations should not trigger payment of tax.

II. Problems with Present Law

A. *Conceptual Difficulties*

As a policy matter, the determination whether a corporation has realized economic income from receiving a contribution should provide the underlying basis for taxation. In contrast, the current tax treatment of nonshareholder contributions to capital is extremely confused and based on factors that have no legitimate policy rationale.

For example, current law places enormous importance on whether the person making the contribution to the corporation does so as a condition of receiving future services from the corporation.[11] If a party makes a contribution in order to receive subsequent services from the corporation, the law generally requires the corporation to recognize taxable income on the grounds that the contribution represents payment in advance for services to be provided later.[12] This rule effectively governs the taxation of contributions of specialized assets, *i.e.*, transaction-specific assets, from customers to corporations. The fact that these con-

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assets has not been previously discussed. See, for example, Paul L. Joskow, *Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence*, 4 J. L. Econ. & Org. 95, 103-11 (1988); Paul L. Joskow, *Vertical Integration and Long-term Contracts: the Case of Coal-burning Electric Generating Plants*, 1 J. L. Econ. & Org. 33, 36-39 (1985); Thomas M. Palay, *Comparative Institutional Economics: The Governance of Rail Freight Contracting*, 13 J. Legal Stud., 265, 268-69 (1984); Benjamin Klein, Robert G. Crawford, and Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & Econ. 297, 298-302 (1978); Victor P. Goldberg, *Regulation and Administered Contracts*, 7 Bell J. Econ. 426, 432-36 (1976).

11. The determination as to whether the person making the contribution to the corporation is doing so for the purpose of receiving future services from the corporation is the principal criterion for determining whether the corporation is taxed upon the receipt of the contributions. See *Blue Book-1986 Act* at 545-46 (cited in note 8) for an extensive discussion of the procedures for determining whether the fatal nexus to services exists in various situations. See also IRS Notice 87-82 at 389 (cited in note 5) (stating that contributions made to receive future services are taxable to the corporation, while contributions made for the "benefit of the public as a whole" are not taxable). Thus, the motive of the person making the contribution becomes the point of focus in determining the taxation of these amounts. For a general criticism of tax provisions that are based on the motive of the payor, see Joseph M. Dodge, Zarin v. Commissioner: *Musings About Debt Cancellations and "Consumption" in an Income Tax Base*, 45 Tax L. Rev. 677, 694 n.88 (stating that "[g]ifts aside, it is hard to see why the [payor's] motive should exempt the [payee] from tax").

12. See note 9 for a discussion of the rules regarding taxation of prepaid income.

tributions precede the provision of services by the corporations to the customers results in these contributions being taxable to the recipient corporations.[13]

This rule fails to reflect the economic realities underlying transactions involving these assets. If a prospective customer contributes a specialized asset to a corporation that is dedicated for specific use by the corporation in providing future services to the customer, it is fallacious to view the customer as prepaying the corporation for services. Instead, the more accurate view, subject to certain exceptions discussed later in the Article,[14] is that business exigencies require the customer to invest capital in the specialized asset in order that the two parties might consummate future transactions. Here, the customer is the party that is investing its capital in the specialized asset[15] that will be used in the future when the customer purchases services from the corporation. In such a situation, the economic benefit or rate of return from the capital investment in the asset will inure to the benefit of the customer, not the corporation.[16] Thus, it is simply incorrect, as a general matter, to view the corporation as receiving income of any kind from the receipt of the contribution.[17]

In contrast, if the contribution to the corporation does not precede such a service-providing relationship, as is the case with contributions for economic development, present law typically allows the corporation to exclude the contribution from income.[18] This rule is similarly misplaced, apparently relying on the primitive and outmoded notion that taxable income only includes amounts that a corporation has "earned" by providing services to customers.[19] This unduly narrow notion of in-

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13. See notes 8 and 9.

14. See notes 190-96 and accompanying text.

15. For a discussion of the business reasons why the customer, as opposed to the corporation, is making the investment in the asset, see note 161 and accompanying text.

16. See note 170 and accompanying text for further discussion of this point.

17. Thus, to view the corporation as receiving income, whether prepaid or not, is incorrect. For exceptions to this general rule, see notes 189-201 and accompanying text.

18. See note 11. This is the basic theory allowing corporations receiving contributions for economic development to exclude such amounts from their income. Since these corporations are not receiving the contributions in order to provide future services to the contributors, the contributions are viewed as made to the corporations for the benefit of the public at large.

19. The notion that income was required to be "earned" as a precedent to inclusion in the tax base was articulated by the Supreme Court in *Edwards v. Cuba Railroad*, which held that contributions made by the Cuban government to a railroad were excluded from income, because, in part, those contributions were not earned by providing services to the government. See *Edwards*, 268 U.S. at 633 (stating that "subsidy payments taxed were not made for services rendered or to be rendered"). For a closely analogous decision, see also *Eisner v. Macomber*, 252 U.S. 189 (1920) (holding that stock dividends are not income because they fail to qualify as gain derived from capital or labor). These limiting notions of income have been rejected by subsequent Supreme Court decisions, and are generally regarded as obsolete. See, for example, *Commissioner v. Glen-*

come has managed to persist in this area of the law, although courts have recognized for some time that taxable income is a much broader concept, embracing all accretions to wealth that the taxpayer has "realized," irrespective of whether those accretions were "earned."[20]

Finally, the tax laws, while employing these inappropriate criteria, have ignored more relevant inquiries that actually would be helpful in determining whether the corporation receiving these various types of contributions has realized economic income. I discuss these inquiries in more detail later in the Article.[21]

This haphazard system has resulted in a regime that, as previously discussed, seems to reach results that are generally opposite to those that would occur if the law were imposing tax only on economic income. I should note here that I do not claim that my proposals would achieve a perfect measure of economic income.[22] My simple approach of either including or excluding these contributions in toto for purposes of determining a corporation's income is far too crude to capture the complex transactions discussed in this Article. However, administrative concerns[23] and the critical need for less complexity in the tax laws[24] pre-

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shaw Glass, 348 U.S. 426 (1955) (holding that gross income includes all realized accretions to wealth, including windfalls and other amounts that are not earned); *Graetz Taxation* at 201 (cited in note 2) (stating that "although the court has not overruled *Macomber*, it has confined the decision to its facts"); Harris, 39 Tex. L. Rev. at 623-24 (cited in note 2) (recognizing the narrow and now outmoded theory of income adopted in *Cuba Railroad v. Edwards*, and noting the close conceptual relationship between that case and *Eisner v. Macomber*). Nevertheless, this antiquated notion that a taxpayer must "earn" amounts from performing services in order for those amounts to be included in the taxpayer's income persists in this area of the law dealing with nonshareholder contributions to capital.

20. *Glenshaw Glass*, 348 U.S. at 429-31.

21. For a discussion of some of these more relevant inquiries, see, for example, notes 86-135 and accompanying text (noting the degree of market failure and taxation of payments for economic development), and notes 197-206 and accompanying text (noting the degree of asset appropriation and taxation of transaction-specific assets).

22. See notes 136-47 and accompanying text for a discussion of problems and inaccuracies present in my proposals for taxation of payments for economic development. For a discussion of similar problems in my proposals regarding transaction-specific assets, see notes 189-206 and accompanying text.

23. See notes 139-40, 210-12, and accompanying text for recognition of specific administrative problems in dealing with these transactions.

24. Economists, tax professionals, government officials, and others generally agree that the present federal income tax system is far too complex. These complexities create dead-weight social loss, in the form of requiring the expenditure of substantial economic resources in order to comply with overly complex rules, while also aggravating the federal deficit by reducing the level of compliance with the law. For a sample of the criticisms leveled at the complexity of present tax law, and discussions of the resulting problems, see Thomas L. Evans, *The Taxation of Multi-Period Projects: An Analysis of Competing Models*, 69 Tex. L. Rev. 1109, 1137-42 (1991); Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 Wis. L. Rev. 1267, 1289-91; Internal Revenue Service, *Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates* 8-11 (Apr. 1990) (IRS Publication 1415, Supp. to Publication 7285); Charles E. McClure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 Tax L. Rev. 25, 26-27 (1989); James S.

vent me from proposing a system that would be more closely tailored to the subtleties and idiosyncrasies of every transaction in order to measure economic income with greater accuracy. Nevertheless, I believe that, in the aggregate, my proposals represent a significant improvement over present law in accurately measuring income, although imperfections would undoubtedly remain due to the difficulties of imposing administrable rules on very complex economic phenomena.

B. *Harmful Effects of Present Law*

1. Contributions for Economic Development

The erroneous tax treatment of nonshareholder contributions to capital raises questions concerning the fairness and economic effects of current law. First, consider the consequences of what I believe to be the undertaxation of contributions made for economic development, such as contributions of property by state governments to corporations locating factories in an area. Under present law, corporations are not taxed on these huge contributions, which I view as creating undesirable and unfair distributive consequences. Under the critical, but defensible, assumption that the "incidence" or economic burden of the corporate tax[25] ultimately resides with the owners or shareholders of the corporation,[26] the shareholders are able to retain the additional wealth pro-

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Eustice, *Tax Complexity and the Tax Practitioner*, reprinted in 45 Tax L. Rev. 7, 18-20 (1989); Pamela Brooks Gann, *What Has Happened to the Tax Legislative Process?*, 86 Mich. L. Rev. 1196, 1206-08 (1988). It is extremely important, therefore, that any proposals to alter the existing tax system consist of clear, administrable rules in order to avoid aggravating an already overburdened regime. As a result, the proposals in this Article generally recommend an "all or nothing" approach, under which contributions are completely included or excluded from taxable income, as opposed to a more complex (and accurate) system that would he closely tailored to the characteristics of particular transactions. For further discussion of this "all or nothing" approach, see notes 139-40 210-12 and accompanying text.

25. The incidence of a tax is defined as the ultimate burden of the tax. Rosen, *Public Finance* at 243-66 (cited in note 4); Klein, et al., *Federal Income Taxation* at 27-29 (cited in note 6); Douglas A. Kahn and Pamela B. Gann, *Corporate Taxation* 21-41 (West, 3d ed. 1989). Determining the incidence of a tax necessitates locating the party who ultimately suffers the burden of the tax. Conversely, determining the effects of undertaxing these contributions requires locating the party who ultimately enjoys the benefit of the tax's absence. For a general discussion of the difficulties in determining the party who ultimately benefits from favorable tax provisions, see Bittker and Lokken, *Taxation of Income* at ¶ 3.3.3 (cited in note 3).

26. In general, the corporate income tax is viewed as a progressive tax, notwithstanding the difficulties of determining its incidence. See note 25. The tax is regarded as burdening the shareholders of corporations who, in the aggregate, are more affluent than the population in general. Rosen, *Public Finance* at 262-65 (cited in note 4) (suggesting that the incidence of corporate tax is on the owners of the corporation or capital, which is a "progressive outcome"); Stanley S. Surrey, *Value-Added Tax: The Case Against*, 48 Harv. Bus. Rev. 86, 90 (1970). But see Musgrave and Musgrave, *Public Finance* at 419, 424-25 (cited in note 4) (asserting that the corporate income tax is progressive under certain assumptions, but not necessarily under others). Therefore, since the corporate income tax likely is progressive, a reduction of the income tax liabilities of these corpora-

vided by the lenient taxation of these contributions. This raises serious concerns regarding the distribution of the nation's wealth, in that the owners of corporations receive favorable tax benefits (arguably "windfalls")[27] at the expense of the federal fisc and the nation's taxpayers in general.[28] Such a result likely is regressive; wealth is transferred from a less affluent group, the nation's taxpayers, to the more affluent corporate sector. I will assume here that most readers share my concerns regarding the ethical problems of regressive taxes, without dealing with all of the complexities of such a position.[29]

Moreover, the conclusion that corporations should be taxed on these contributions is still defensible, even if one rejects the assumption that the incidence of the corporate tax lies with the corporation's shareholders. Corporations receiving contributions for economic development may compete these contributions away in the marketplace[30] by lowering

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tions receiving contributions for economic development likely would be viewed as regressive in nature. Such a conclusion assumes, however, that if additional taxes were enacted to replace those taxes lost tbrough this favorable treatment, those new taxes would be less progressive than the corporate taxes that they would be intended to replace. If, in contrast, the replacement taxes were more progressive than the corporate income tax, then the aggregate effect of this reduction in corporate income tax would be progressive. For recognition of this point, see Rosen, *Public Finance* at 448.

27. Note that this equity argument only applies to shareholders of corporations who managed to acquire corporate shares at lower prices tbat did not reflect this advantageous tax treatment. If this advantageous tax treatment were fully capitalized or reflected in the price of the corporation's shares (by increasing the price), then new shareholders purchasing those shares would not have a windfall by virtue of this favorable tax treatment because they already would bave purchased this tax treatment when they bought the shares. Rosen, *Public Finance* at 266 (cited in note 4); Bittker and Lokken *Taxation of Income* at ¶ 3.3.3 (cited in note 3) (noting what windfalls are obtained by investors who purchase tax advantaged assets before favorable tax treatment is granted.)

28. Similar equity arguments are made by persons who generally oppose the payments by state and local governments of contributions to corporations for economic development. (These persons are criticizing economic development programs in general and not the federal income tax treatment of sucb programs, which is generally overlooked.) Tbese writers criticize the market for economic development as shifting income to the corporate sector in an inequitable manner. See, for example, Bennett Harrison and Sandra Kanter, *The Political Economy of States' Job-Creation Business Incentives*, 44 AIP J. 424, 425 (Oct. 1978) (criticizing economic development programs as causing regressive transfers of wealth to the corporate sector); Jerry Jacobs, *Bidding For Business: Corporate Auctions And The 50 Disunited States* 36-37 (Public Interest Research Group, 1979) (criticizing state and local tax abatements as "the prerogative of the wealthy and the powerful"); Bryan D. Jones and Lynn W. Bachelor, *Local Policy Discretion and the Corporate Surplus*, in Richard D. Bingham and John P. Blair, eds., *Urban Economic Development* 245, 246-47 (Sage, 1984) (discussing the extraction by corporations of unnecessary concessions from state and local governments for economic development).

29. For the classical work dealing with this general tax policy issue, see Walter J. Blum and Harry Kalven, *The Uneasy Case for Progressive Taxation* (Chicago, 1953). For a poignant expression of the issues at stake here, see Klein, et al., *Federal Income Taxation* at 20-22 (cited in note 6).

30. See notes 136-37 and accompanying text for a discussion of this point.

the prices they charge for goods and services provided to customers.[31] In such a situation, the likely effect of an income tax imposed on these contributions would be to reduce the amount of the discount in prices that the corporations provide their customers. Here, the incidence of the corporate tax would be on the corporations' customers,[32] not their shareholders.[33]

In such a situation, the corporations would not have economic income upon receipt of these contributions. The value of the contributions would be competed away in the marketplace as opposed to inuring to the benefit of the corporations and their shareholders. Thus, one could argue that corporations should receive the contributions tax-free. Nevertheless, I would still maintain that the contributions should be taxed. In this situation, however, allocative efficiency would make taxation desirable, as opposed to considerations of fairness.[34]

The argument is as follows: as a result of receiving these contributions, corporations will be able to sell their goods and services to customers at lower prices, leading to their increased consumption and a corresponding increase in the resources allocated to that segment of the economy. This is a nonneutral development.[35] Corporations that can

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31. For a recognition of the fact that these benefits (categorized as "rents" in the economics literature) can be competed away by the firms receiving them, see James M. Buchanan, *Rent Seeking and Profit Seeking*, in James Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent Seeking Society* 6-7 (Texas A & M, 1980). For the related phenomenon of corporations competing away such rents through providing higher quality, more costly services to customers, see George W. Douglas and James C. Miller, III, *Economic Regulation of Domestic Air Transport: Theory and Policy* 91-92, 103, 163 (Brookings Institution, 1974) (discussing airlines, under jurisdication of Civil Aeronautics Board, competing away benefits of controlled prices by offering higher quality services, such as noncrowded planes, to passengers).

32. See, for example, Musgrave and Musgrave, *Public Finance Theory* at 423-24 (cited in note 4) for general analysis of such a result.

33. It is also possible tbat corporations would compete away these contributions by paying higher wages to employees, or by making larger payments to their suppliers. If this were to occur, then the effects of a tax on these contributions would be to reduce the wages or payments in question. Thus, the incidence of the tax here would rest on the employees or suppliers of tbe firm. See, for example, Musgrave and Musgrave, *Public Finance Theory* at 424 (cited in note 4) for a discussion of the possibility that the incidence of the tax would fall on employees of the firm. Such a scenario likely would result in a distortion of the labor or supplier market, and would present allocative problems similar to those discussed in the text regarding customers.

34. See note 53 for a discussion of second-best problems related to arguments for allocative efficiency. For the argument tbat inefficiency and unfairness in the tax system may be mutually exclusive problems, with each problem present to the extent that the other problem is absent, see Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, in Henry J. Aaron and Michael J. Boskin, eds., *The Economics of Taxation* 19 (Brookings Inst., 1980); Shaviro, 56 U. Chi. L. Rev. at 1224-25 (cited in note 7).

35. Admittedly, these contributions might be justified as a deliberate subsidy to capital tbat would help increase the rate of savings in the nation and otherwise facilitate capital formation. However, it would be difficult to justify these ad hoc and inadvertent subsidies to capital, especially in comparison with available alternative arrangments that would provide subsidies to capital

move (or threaten to move) their facilities from one locale to another can extract concessions from state and local governments that provide them with a competitive advantage over corporations that are unable to extract these concessions.[36] These concessions, in turn, distort the allocation of resources through price and market mechanisms.[37] I am not claiming here that all market advantages obtained by firms as a result of competition between local governments for economic development (including competition involving local taxes) create economic inefficiencies.[38] However, these special "deals," obtained by only certain corpora-

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on an ordered and principled basis. As an example of thoughtful and careful proposals to provide subsidies to capital in a more defensible manner, see David F. Bradford, *Tax Neutrality and the Investment Tax Credit,* in Henry J. Aaron and Michael J. Boskin, eds., *The Economics of Taxation* 281 (Brookings Inst., 1980); Arnold C. Harberger, *Tax Neutrality in Investment Incentives,* in *The Economics of Taxation* 299. For a general discussion of such tax subsidies to capital, see the assortment of views contained in William A. Klein, *Policy Analysis of the Federal Income Tax* 457-528 (Foundation, 1976).

36. Admittedly, allowing these contributions to be exempt from federal tax might be defensible if exemptions were used to attract foreign investment that would not otherwise be invested in this country. However, present law is not restricted to such a narrow application, and, therefore, cannot be defended by such an argument. Moreover, there are considerable doubts regarding the effectiveness of such incentives in luring foreign corporations to invest in the United States. See, for example, the comments of Professor Susan Tolchin, a co-author of a leading hook in this area, who criticizes state and local governments for wasting resources on recruiting these firms by noting that "[i]t's clear to me that after several years of study that the foreign multi-nationals locating here would do so with or without the incentives," quoted in Pamela Gaynor, *Incentive Race Among States is Cooling Off,* Pittsburgh Post-Gazette § 1 at 29 (March 4, 1991). For more discussion of this issue, see Martin Tolchin and Susan Tolchin, *Buying into America* 64-67 (Times Books, 1988).

37. The effect of these concessions on resource allocation is undesirable because it does not reflect differences in operating efficiencies or other natural cost advantages possessed by mobile capital. Instead, the concessions are more likely to reflect the ability of certain corporations to exploit strategic advantages available to them in the market for economic development. See notes 92-135 and accompanying text. Thus, the increased allocation of resources towards economic sectors represented by these corporations is not an efficient adaption of the market. On the other hand, this argument may be undercut to the extent that people living in areas that actually obtain economic development place more value on that development than those living in different areas. In such a situation, the firm settling in the area would produce a net efficiency gain. This gain would offset the efficiency loss resulting from the interference with market mechanisms. See notes 141-42 and accompanying text for a discussion of this point.

38. For example, to the extent that a particular state or local government is able to provide services in a low-cost, efficient manner to its citizens, local taxes in that jurisdiction will be low in relation to government services received. Firms operating in this area might have competitive advantages over firms located in other areas. This competitive advantage would be allocatively desirable, in that it would result in more pressure on other jurisdications to adopt similarly efficient government programs. For support of such an argument, see Charles E. McClure, *Tax Competition: Is What's Good For the Private Goose Also Good for the Public Gander?* 39 Nat'l. Tax J. 341 (1986). Contrast Andrew Reschovsky, *How Closely Does State and Local Government Behavior Conform to a Perfectly Competitive Model?,* in Daphne Kenyon and John Kincaid, eds., *Competition Among States and Local Governments* 147, 148-49 (Urban Inst., 1991) (criticizing certain factual assumptions made by McClure and the resulting conclusions drawn from those assumptions). For a criticism of certain types of competition between states that result in firms settling in

tions in the market for economic development, undoubtedly distort market mechanisms in peculiar ways that cannot be defended by appealing to the salutary benefits of competition.[39] My proposals to tax firms upon receipt of these contributions would reduce the net benefit of these contributions, which in turn would limit the ability of these firms to reduce their prices and alter the allocation of resources. Thus, the negative allocative effects of these special concessions would be reduced.

Finally, irrespective of one's views regarding the incidence of the corporate income tax, I would argue that taxing these contributions reduces the dead-weight social loss incurred by "rent seeking"[40] in the market for economic development.[41] Corporations incur substantial administrative costs in the process of attracting, receiving, and evaluating bids ("rents") from state and local governments to locate in particular areas.[42] Similarly, state and local governments also incur substantial costs participating in this process.[43] Taxing corporations upon their receipt of these contributions would reduce the amount of net rents available for private parties in this market and would therefore reduce the incentives parties would have to seek out these rents. As a result, the

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high-cost, inefficient areas, see Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 Mich. L. Rev. 895, 900-03 (1992). For a similar criticism on the grounds that such competition results in drastic underfunding of badly needed social programs, see Harold A. Hovey, *Interstate Tax Competition and Economic Development*, in Steven D. Gould, ed., *Reforming State Tax Systems* 89, 97 (Nat'l Conf. of State Legis., 1986). For an assortment of various views on the benefits of tax competition among states, see generally *Competition Among State and Local Governments* (Nat'l. Conf. State Legis., 1991).

39. See notes 37-38.

40. I use the term "rent seeking" here to describe "profit seeking" activities by persons in institutional settings in which exploitation of political structures presents opportunities for gain. See Buchanan, *Profit Seeking*, in *Toward a Theory of the Rent Seeking Society* at 3-4 (cited in note 31). In the specific context of this Article, the term "rent seeking" refers to efforts of persons to obtain grants and other benefits from government for economic development. See, for example, Dennis C. Mueller, *Public Choice II* 229-46 (Cambridge, 1989) (describing the entire federal budget as constituting "rent" since the entire budget is "up for grabs" to rent seeking groups and individuals). For a more technical definition of the term "rents," used in a different context, see note 197.

41. For recognition of the dead-weight social loss and waste created by the efforts of people to obtain rents, see Gordon Tullock, *Rent Seeking As A Negative Sum Game*, in James Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent Seeking Society* 16-36 (Texas A & M, 1980). For accounts of the considerable time and resources devoted by companies in dealing with these various state development associations, see, Robert W. Schmenner, *Making Business Location Decisions* 68, 70, 79 (Prentice-Hall, 1982).

42. For accounts of the considerable time and resources devoted by companies with these various state development associations, see id.

43. For a discussion of the substantial resources spent by state and local governments in this process, see Tolchin and Tolchin, *Buying Into America* at 52-54 (cited in note 36). See also Daphne A. Kenyon, *Interjurisdictional Tax and Policy Competition: Good or Bad for the Federal System?* 52 (Advisory Committee on Intergovernmental Relations, 1991).

amount of administrative costs incurred by corporations and governments in this market would be reduced, which would be a desirable development.[44]

2. Contributions of Transaction-Specific Assets

Next, consider the consequences of overtaxing (*i.e.*, imposing a tax in the absence of economic income) contributions of specialized assets (transaction-specific assets) received by corporations from customers. Many (but certainly not all)[45] of these particular contributions are received by regulated public utilities[46] whose prices charged to customers for services are determined by various regulatory authorities pursuant to specific formulas.[47] Consider again the individual homeowner who moves to a house in a rural area and contributes to a water utility the costs of extending a water line to the homeowner's residence. Present law requires the utility to include the value of this transaction-specific asset in its taxable income, thus immediately increasing its tax liability. Practices adopted by most regulatory authorities allow the utility to respond to this taxation by simply requiring the customer to make a larger initial contribution, which covers not only the costs of installing the water line, but also includes amounts for the taxes that the utility itself will pay to the federal government.[48] Thus, as a result of tax law,

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44. Note that this argument for taxation applies in situations in which corporations might not have economic income from receiving the contributions. For example, corporations might incur such substantial administrative costs in the rent seeking activities that the costs incurred would effectively offset the rents received, leaving the corporations no better off than before the rent seeking activity took place. Mueller, *Public Choice II* at 231 (cited in note 40). Nevertheless, although the rents received would not represent economic income to the corporation, they should be taxed simply to reduce the incentives for such rent seeking activities.

45. For a discussion of these types of contributions occurring in nonregulated market environments outside of the public utility area, see notes 156-58 and 222-23. To the extent that the overtaxation of these contributions occurs in a nonregulated environment, then all of the difficulties of determining the incidence of this tax, and hence its ultimate effect, are fully applicable. For a discussion of these problems, see note 25.

46. This problem of overtaxation occurs in contributions in aid of construction, which involve the contribution of transaction-specific assets to regulated public utilities by their customers. See note 8. This Article's proposals, however, apply to all contributions of transaction-specific assets, regardless of whether the recipient corporation is regulated. See notes 222-23 and accompanying text. Thus, the discussion in the text would not apply to all types of transactions that are covered under this Article's proposals.

47. For a discussion of how public utilities determine the prices they charge to customers, see notes 217-20 and accompanying text.

48. This treatment which, in effect, requires the contributor to indemnify the utility for the taxes the utility is required to pay on the contribution, has been adopted by most regulatory authorities. See, for example, California Public Utilities Commission, *Re: Tax Reform Act of 1986*, 86 Pub. Util. Rep. 4th 519 (1987) (authorizing the utilities to charge contributors for taxes imposed on the transactions); Missouri Public Service Commission, *Re: St. Louis County Water Company*, 79 Pub. Util. Rep. 4th 581 (1987); Vermont Public Service Board, *Glidden v. Central Vermont Public Service Corporation*, 116 Pub. Util. Rep. 4th 142 (1990); Price Waterhouse, *The Tax As-*

the costs of installing the water line have significantly increased[49] to the homeowner.[50]

These increased costs resulting from the overtaxation of transaction-specific assets may create a number of problems. Evidence indicates, for example, that these tax rules are interfering with attempts to construct new water and sewage treatment facilities, including facilities constructed in order to reduce pollution and alleviate other environmental problems.[51] Similarly, these tax rules may be placing excessive

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pects of Contributions In Aid of Construction 9 (Price Waterhouse, 1991) (stating that the public utility commissions have generally followed the principle that the contributor should be responsible for paying the tax on the contribution received by the utility). A minority of regulatory commissions may instead charge all of the utility's customers for the additional taxes paid by the utility, as opposed to charging only the persons actually making the contribution that results in the tax. See, for example, *Idaho PUC Adopts New Tax Policy on Contribution in Aid of Construction*, Electric Utility Week 16 (June 27, 1988) (discussing proposals adopted by Idaho Public Utilities Commission that, in effect, charge all of the utility's customers for the taxes created by these contributions, as opposed to charging only the person making the contribution).

49. For a discussion of this point, with an estimate that this tax treatment has increased the average cost of a home by $1500 to $2000, see *New Federal Tax Regulations Add to the Cost of a House*, Chicago Tribune at N18 (July 23, 1988); Bruce Keppel, *Paying Your Taxes; Developers Shoulder New Tax on Utilities—For Now*, L.A. Times at 67 (Mar. 15, 1987) (Home edition). As a caveat, these estimates of increases in home prices are being supplied by groups that are opposed to the taxation of these transactions, and thus have every incentive to portray these taxes as very burdensome. Notwithstanding the bias of these sources, this tax treatment is clearly increasing the prices of homes, although the amount of the increase is less certain.

50. For a general discussion of the problem of determining the gross amount of a payment in order to leave a certain net amount remaining after taxes, see *Graetz Taxation* at 114-15 (cited in note 2). To illustrate how this process occurs using the example in the text, assume that the cost of the water line (excluding the taxes paid by the utility), is $1000, and assume that the utility is subject to a marginal tax rate of 34%. See I.R.C. § 11(b) (West 1992). Under one methodology that sometimes is used by utilities, the contributor will be required to pay $1515 to the utility ($1000 for the water line and $515 for taxes), thus increasing the amount of the contribution by over 50%. For an example of a regulatory commission adopting this methodology, see California Public Utilities Commission, 86 Pub. Util. Rep. at 524, 553 (cited in note 48) (adopting this methodology, termed "method 2," to small water companies and small telephone companies in California). However, continuing with this same example, regulatory commissions may require other utilities to reduce the amount of the contribution to a figure below $1515, to reflect the federal income tax benefits that the utility will obtain over time from depreciation deductions the utility is allowed to take with respect to the $1000 invested in the water line. I.R.C. § 168. (The utility is deemed to be the owner of this water line for federal income tax purposes, and thus is allowed to depreciate the water line.) In such a situation, the contribution being required of the homeowner will still be substantial, although the contribution will be less than $1515. For an example of this methodology producing a total contribution of $1273, as opposed to a contribution of $1515, see California Public Utilities Commission, 86 Pub. Util. Rep. at 553, 556-59 (cited in note 48) (adopting and explaining the use of this methodology, termed "method 5," to all California utilities excluding small water companies and small telephone companies).

51. For example, private letter rulings issued by the IRS confirm that these tax provisions are burdening projects of this nature. See, for example, Priv. Ltr. Rul. 8910025 (Dec. 8, 1988), in which a town contributed water mains to a utility in an effort to deal with problems created by groundwater pollution contaminating private wells in the area. The IRS ruled that the utility was taxable on the receipt of the water main. The utility, in turn, required additional payment from the town to indemnify the utility for this tax liability. See also Priv. Ltr. Rul. 9040021 (July 5,

burdens on efforts to construct or relocate roads, water and electric distribution systems, traffic lights, and other safety-oriented improvements.[52] Thus, the overtaxation of these transactions raises concerns that economic resources are being diverted from particular sectors of the economy, resulting in allocations of resources that may be inefficient.[53] Whether allocatively inefficient results are definitely occurring is uncertain.[54] However, the risk that such outcomes are developing is sufficiently serious to warrant further consideration of this problem.

1990) (ruling that a utility was taxable on the receipt of new water and sewage facilities constructed to accommodate the needs of a subdivision in the area); Priv. Ltr. Rul. 8909019 (Dec. 2, 1988) (ruling that a utility was taxable on the receipt of water mains constructed by a town in order to extend water service to areas previously without service). For a discussion of the negative impact of these tax rules on the ability of companies to comply with various environmental safeguards, see James B. Groff, *The Water Supply Industry Faces the Impact of New Federal Rules*, 123 Pub. Util. Fortnightly 18 (Jan. 19, 1989). See also statement of Senator H. Reid (D. Nev.), a sponsor of legislation to amend these tax rules, regarding the negative effects of this tax treatment on efforts to improve the quality of drinking water by upgrading water treatment facilities, printed in 137 Cong. Rec. S. 8811, 102d Cong., 1st Sess. (June 26, 1991); Statement of Representative Peter Visclosky (D. Ind.), on the detrimental effect these tax rules have had on an environmental contamination problem occurring in Indiana, reprinted in *Tax Notes Today* (Mar. 9, 1990); Statement of Malcolm H. McLetchie on behalf of the Edison Electric Institute for the House Committee on Ways & Means, U.S. 101st Cong., 2d Sess., at 490-94 (Mar. 5, 1990). The nongovernmental sources cited here are opposed to the tax treatment of these contributions, and therefore should not be viewed necessarily as providing unbiased or completely objective evidence. Nevertheless, the IRS rulings discussed here corroborate these claims, and suggest that this tax treatment is indeed having an undesirable effect in many areas.

52. See Priv. Ltr. Rul. 9035023 (May 31, 1990), (ruling that a utility was taxable on amounts received from a local government to construct a traffic signal system); Priv. Ltr. Rul. 8723023 (March 6, 1987) (holding that a utility was taxable on electrical facilities constructed in order to provide alternative electricity services to a medical center in the event of failure of the primary system). cee also Statement of Malcolm H. McLetchie on behalf of the Edison Electric Institute (cited in note 51).

53. Admittedly, although the allocation of resources may be affected by this tax treatment, one cannot necessarily claim that the resulting consequences are economically inefficient. Due to other underlying inefficiencies in the economy, the overtaxation of contributions involving transaction-specific assets may actually improve overall resource allocation in the nation. Phrased more broadly, because we live in a "second best world," the allocative effects of overtaxing these types of transactions cannot be evaluated in isolation, because of their interaction with other phenomena that themselves produce allocative effects. See generally R. G. Lipsey and Kelvin Lancaster, *The General Theory of Second Best*, 24 Rev. Econ. Stud. 11 (1956). For recent recognition of second best complications in formulating tax policy, see Shaviro, 56 U. Chi. L. Rev. at 1218-20 (cited in note 7); George Mundstock, *Taxation of Business Intangible Capital*, 135 U. Pa. L. Rev. 1179, 1183 n.14 (1987). For specific proposals to recognize and deal with second best effects when setting policy, see Richard S. Markovits, *A Basic Structure for Microeconomic Policy Analysis in Our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics*, 1975 Wis. L. Rev. 950.

54. As previously mentioned, second best problems prevent one from confidently asserting tbat a particular tax creates economic inefficiencies, unless the matter has been studied carefully. See note 53. For example, although the overtaxation of transaction-specific assets may increase the price of housing, see note 49 and accompanying text, it may be that we already have an overinvestment in housing occurring in the United States, due, in part, to the favorable income tax treatment of home mortgage interest. For support for the proposition that the United States may have an

III. Contributions Involving Economic Development

A. Background and Description

State and local governments have developed extensive programs to promote economic development by providing contributions to firms locating in their areas.[55] Under these programs, firms receive a variety of benefits,[56] such as free property (e.g., land, buildings), employee job training, low-interest rate loans, and relief from local taxes,[57] such as exemption of a firm from property taxes for a number of years.[58] More-

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overinvestment in housing, see Lawrence H. Goulder and Philippe Thaimann, *Approaches to Efficient Capital Taxation: Leveling the Playing Field v. Living by the Golden Rule* (National Bureau of Economic Research Working Paper No. 3559, 1991). As a result, an increase in the price of housing caused by the overtaxation of these types of contributions might, in actuality, improve the allocation of resources by serving to dampen investment in this sector. A similar second best analysis might be applied to the effect of this tax treatment on the consumption of utility services. The increase in the price of utility services resulting from the overtaxation of transaction-specific assets might actually improve the allocation of resources if the utilities in question are creating environmental problems by burning fossil fuels and the full cost of these problems is not otherwise reflected in the prices they charge for their services. Harold M. Hubbard, *The Real Cost of Energy*, Scientific Am. 36 (Apr. 1991). These points are not intended to analyze fully the second best problems connected with this Article's proposals. Rather, the reader should acknowledge that complexities exist, beyond the scope of this Article, inherent in any discussion of the economic effects caused by particular tax provisions.

55. Although the majority of these transactions involve payments by governments and community groups, payments by private parties to induce economic development in an area are also excluded from the recipient's income. See, for example, *May Dep't Stores Co. v. Commissioner*, 33 T.C.M. 1128 (1974); *Federated Dep't Stores v. Commissioner*, 426 F.2d 417 (6th Cir. 1970). In these cases, developers contributed land to corporations operating retail stores, in the hopes that development of the land by the corporations would increase the value of neighboring properties owned by the retailers. For reasons similar to those underlying the treatment of contributions by governments, the corporations were held not to have recognized gross income from these contributions. My proposals to tax corporations on payments for economic development would apply fully to these cases involving private parties.

56. For an extensive list of the various types of incentives offered to firms, see John C. Gray and Dean A. Spina, *State and Local Industrial Location Incentives—A Well-Stocked Candy Store*, 5 J. Corp. L. 517 (1980). For specific examples of incentive packages offered to particular firms, see Cynthia Crossley, et al., *Daviess Selected for $500 Million Scott Paper Mill*, Courier-Journal A1 (Nov. 20, 1990) (reporting that incentives offered by Kentucky governments for paper mill included road and infrastructure improvements, low-interest rate loans, job training, relocation assistance for firm's employees, and extension of utility water line); Robert Guskind, *The Giveaway Game Continues*, 56 Planning 4 (Feb. 1990) (stating that incentives offered to Sears & Roebuck by Illinois included highway improvement, utility infrastructure development, tax abatements, job training, interest-free loans, and a large quantity of free land donated by a private firm).

57. Frequently, these tax abatements are provided through the state creating an enterprise zone in which the firm locates. For a typical example, see Nancy S. Lind and Ann. H. Elder, *Who Pays? Who Benefits? The Case of the Incentive Package Offered to the Diamond-Star Automotive Plant*, 3 Gov't Fin. Rev. 19, 21 (1986) (discussing tax benefits and other incentives to be delivered through firm locating in enterprise zone).

58. Under my proposals, the federal government would tax all of these benefits including, for example, state and local tax benefits provided to a firm. The federal income tax treatment of a firm receiving an exemption from state or local taxes (such as property taxes or state income taxes)

over, the amounts of these contributions are quite substantial, both in the aggregate[59] and at the level of the individual firm. Toyota's receipt of $325 million from Kentucky[60] as an inducement for locating a manufacturing plant, and Sears & Roebuck Co.'s receipt of $170 million from Illinois in return for the company retaining its corporate headquarters in the state,[61] illustrate the magnitude of the amounts that are frequently involved. Other examples of large contributions abound, including some that are quite recent.[62] In fact, it is now considered to be

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presents certain technical difficulties. Assume, for example, that a firm receives a ten-year exemption from property taxes. (After the 10-year period in which the firm pays no property taxes, the firm will begin paying property taxes at full rates applicable to all taxpayers.) I believe that such a firm has an immediate accretion to wealth that should be currently included in the firm's income for federal income tax purposes. The firm's wealth has been increased by the discounted present value of the 10-year stream of payments which the firm has been forgiven. (For a discussion of present value concepts, and how this amount would be determined, see Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance* 10-15 (McGraw-Hill, 2d ed. 1988)). This treatment is appropriate because the firm's value has increased by this discounted present value figure, in comparison with the firm's value in a situation in which a tax exemption had not been granted. (For analogous treatment, see I.R.C. § 7872(b) (West 1992), and its treatment of term loans bearing interest at a below-market rate.) This amount initially included in the firm's income would be viewed as an asset of the firm, which would decline in value as the 10-year period passed and the firm approached the point at which it will begin to pay taxes. (At this latter point, this asset of the firm would have no value.) The annual decline in the value of the asset over the 10-year period would result, for each year, in an expense for that year that would be deductible for federal income tax purposes. For a discussion of how this annual decline in value would be computed using concepts of economic depreciation, see Bittker and Lokken, Taxation of Income at ¶ 23.1.4 (cited in note 3); Johnson, 1989 U. Ill. L. Rev. at 1039-53 (cited in note 6) ("Samuelson" depreciation).

59. For an estimate that $30 billion a year is provided to firms as contributions for economic development, see Haider, Chi. Trib. at C25 (cited in note 1). Admittedly, the amount of these contributions made each year to corporations is uncertain, largely because of problems in accumulating this information from state budgets and other available sources. For a discussion of the lack of aggregate information on the size of these programs, see Tolchin and Tolchin, *Buying into America* at 66 (cited in note 36). See also notes 123-26. For another, very rough estimate that the amount of these benefits in 1986 was equal to $11.6 billion, see Dick Netzer, *An Evaluation of Interjurisdictional Competition Through Economic Development Incentives*, in Daphne Kenyon and John Kincaid, eds., *Competition Among States and Local Governments* 242 & n.1 (Urban Inst., 1991).

60. Norman J. Glickman and Douglas P. Woodward, *The New Competitors* 230 (Basic Books, 1989). Other sources have estimated that the contributions offered to Toyota may exceed this figure. See, for example, Roland Klose, *Incentives Offered by States to Attract Businesses Draw Challenges*, 8 Memphis Bus. J. § 1 at 16 (May 18, 1987) (citing sources that state the contributions made to Toyota may exceed $394 million).

61. Guskind, 56 Planning at 4 (cited in note 56); Long Hwa-Shu, *What it Took to Convince Sears to Stay in Illinois*, N.Y. Times § 8 at 1 (July 23, 1989) (quoting "experts" as stating that the total value of contributions made to Sears exceeded $170 million).

62. For a sample of local stories regarding contributions offered to particular firms regarding specific locations, see, for example, Richard W. Stevenson, *9 Towns Spare No Effort to Snare New Plant*, N.Y. Times A1 (Dec. 18, 1991) (discussing the heated competition for a McDonnell Douglas Plant involving hundreds of millions of dollars in incentives); Bob Merrifield and Martin Zabell, *Will County Hopes to Lure Bears with Romeoville Stadium Plan*, Chi. Trib. C3 (June 14, 1991) (discussing the incentives offered to the Chicago Bears professional football team considering a new stadium location); Barbara Deters, *BofA Could Get Millions as Lure to Utilize Center in*

standard procedure for state and local governments[63] to offer "incentive" packages featuring these contributions to firms that are considering the establishment of a facility in their area.[64]

B. Rationale for Taxation

The simple rationale for taxation of these contributions is that corporations have received free property or other privileges[65] of significant value, thus immediately experiencing an increase in their wealth that should be subject to tax. Through these subsidies provided by state and local governments, corporations are able to acquire factories, corporate headquarters, and other facilities at a cost that is substantially below their value. Under a Haig-Simons income tax, such accretions to wealth would be immediately taxed as they occur.[66]

To illustrate this point in a different manner, assume a corporation has decided to construct a factory to produce consumer products that the corporation will sell in the marketplace. Also, assume that the corporation would normally earn a ten percent annual return on investments of this kind.

Now, assume that the factory is able to obtain $1 million from a state government as an inducement to locate its factory in a particular area. This $1 million effectively reduces the amount of capital the cor-

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State, The Arizona Republic F4 (Mar. 17, 1991) (reporting that $16.3 million in incentives was accepted by BankAmerica Corporation from Phoenix and the State of Arizona to lure company to Phoenix); Gaynor, *Incentive Race Among States Is Cooling Off*, Pittsburgh Post-Gazette § 1 at 29 (cited in note 36) (reporting that a $40 million incentive package was offered to Sony Corp. to locate plants in Pennsylvania); Brian R. Ball, *Fisher Guide Plans $54 Million Upgrade*, Business First-Columbus § 1 at 1 (Jan. 22, 1990) (reporting that local tax abatements were planned as incentives for installations of new equipment at an existing plant). For discussion of the general significance and extent of these incentive programs, see Gray and Spina, 5 J. Corp. L. at 517 (cited in note 56); Heather A. Hatfield, Steven W. Setzer, and F. Housley Carr, *Politics Triumph in State Bid Wars For Plum Projects: Push is on for More Rational Approach*, Engineering News-Record 18 (Sept. 18, 1987); Robert Guskind, *Games Cities Play*, 21 Nat'l J. 634 (Mar. 18, 1989); *The States; Taking Care of Business*, The Economist 28 (Feb. 18, 1989). For information regarding the huge incentives offered, to foreign firms in particular, as inducements to locate plants in the United States, see Glickman and Woodward, *The New Competitors* at 225-54 (cited in note 60); Tolchin and Tolchin, *Buying Into America* at 49-67, 308-14 (cited in note 36).

63. Moreover, local community groups (such as business federations) also play a significant role in arranging and financing these incentive packages to entice firms to locate in the area. See, for example, Stephen Franklin, *Japan Finds Niche in Midwest; Job-hungry Towns Work Hard to Lure New Employers*, Chi. Trib. at C1 (Sept. 17, 1990) (discussing the efforts of the Illinois Valley Area Chamber of Commerce to entice Japanese firms to the state).

64. *The States: Taking Care of Business*, The Economist at 28 (stating that "today, there is hardly a state that does not practise some form of business seduction"); Hatfield, Setzer, and Carr, Engineering News-Record at 18 (stating that "[n]ow, every state has some form of incentive package for economic development"); Gray and Spina, 5 J. Corp. L. at 521 (cited in note 55) (discussing the " 'explosion' in the number of industrial incentives created in the past few years").

65. Such privileges would include, for example, exemption from local taxes. See note 58.

66. See note 7 for discussion of such a tax.

poration is required to invest in the factory. Since, however, the positive cash flows from future sales of the factory's products remain the same, the rate of return the corporation will earn on its investment of capital has increased. As a result of the $1 million contribution, let us say that the rate of return has increased two percent, i.e., the corporation is now anticipating earning a twelve percent annual rate of return on its investment. The corporation has now obtained an asset that provides an extraordinary rate of return, in excess of other rates of return available in the marketplace (adjusting for differences in risk). This results in the corporation having an immediate accretion to its wealth equal to the discounted present value of the premium return, *i.e.*, two percent (twelve percent less ten percent) that will be provided by the factory over its life.[67] The firm will achieve the normal ten percent return over the life of the plant and properly will be taxed in later years as the ten percent return is received.

Normally, intractable administrative difficulties prevent the tax system from immediately taxing firms which obtain projects that provide extraordinary rates of return.[68] Instead, the tax laws allow firms to defer recognizing such returns until they are actually received in later years. In this situation, however, there is an administrable and simple manner of determining the present value of that portion of the return that is extraordinary and that immediately should be included in income. It is $1 million, the amount of the contribution received by the corporation. Under my proposals, the corporation would be immediately taxed on this amount.

C. *Contributions in a Competitive Market*

1. The Lack of Economic Income

My thesis that corporations have income from these contributions largely depends on the argument that significant market failure exists[69] in the market for economic development. In contrast, in a perfectly competitive market,[70] these firms would not recognize economic income

67. See Strnad, 99 Yale L. J. at 1825-26 (cited in note 7).

68. See id. at 1901-02 (cited in note 7) (noting the administrative difficulties of making frequent assessments of market values of assets that are not publicly traded). See also Evans, 69 Tex. L. Rev. at 1151-52 (cited in note 24), for a discussion of problems connected with such extraordinary rates of return. For recognition of the general phenomenon of extraordinary rates resulting in immediate economic income, see Brealey and Meyers, *Principles of Corporate Finance* at 64 (cited in note 58).

69. By market failure, I mean the failure of an economic system to produce outcomes that represent an efficient allocation of resources. See Rosen, *Public Finance* at 61 (cited in note 4); Martin Bronfenbrenner, Werner Sichel, and Wayland Gardner, *Economics* 653 (Houghton Mifflin, 2d ed. 1987).

70. Perfect competition exists in situations in which there are exchanges of standardized

from participating in these transactions. To illustrate this point, consider a firm that has decided to construct a factory and is deciding where to locate the factory. Generally, firms evaluate locations based on an assessment of an area's "natural" characteristics, such as access to customers and suppliers, costs of labor, transportation, and energy, and "quality of life."[71]

Furthermore, assume that the search for a location by the firm takes place in a perfectly competitive market. Such a competitive marketplace would be characterized by large numbers of buyers (local governments and community groups) and sellers (firms), with all parties having perfect information, and with the goods being sold (economic development) of a standardized nature.[72] Thus, firms would know precisely which areas possessed natural advantages in terms of proximity to customers and suppliers, and inexpensive operating costs. Moreover, all buyers, such as local governments, would also have this information regarding the natural attractions provided to each firm by various locations.

In such perfect competition, a firm would settle in the area possessing the most natural advantages, unless governments of other less desirable areas offered additional incentives that at least offset the advantages possessed by the more desirable area. For example, assume that a firm finds that Location I possesses the most natural advantages for a planned factory. Location II, a less desirable area in that it imposes higher costs or provides a lower return, is the firm's second choice. Assume that the firm, possessing perfect information, determines that Location I's advantages over Location II's are equivalent, in monetary terms, to a lump sum payment of $1 million. Since all parties possess perfect information, local governments in both locations would also be aware of this fact. Assume, furthermore, that Location II, the less desirable alternative, provides a contribution of $1 million to the firm as an inducement to locate the factory in that area.

If the firm accepts this offer from Location II, then the firm's actual accretion to wealth from receiving the contribution and moving to Location II is zero.[73] The $1 million received by the firm is not an ac-

goods among numerous buyers and sellers, with those buyers and sellers having complete information and knowledge regarding the nature of the goods, their accessibility, and all other relevant data. Samuelson, *Economics* at 61-62 (cited in note 4).

71. Gray and Spina, 5 J. Corp. L. at 522-24 (cited in note 56); Barry M. Rubin and C. Kurt Zorn, *Sensible State and Local Economic Development*, 45 Pub. Admin. Rev. 333, 334 (1985); Schmenner, *Making Business Location Decisions* at 37-38 (cited in note 41).

72. See note 70.

73. Under a state of perfect competition, a firm could not plausibly have an accretion to wealth merely by moving into an area possessing tremendous natural advantages. If such an area existed, firms would compete with each other and would make payments to local governments in

cretion to the firm's wealth, and should not be included in the firm's taxable income. (Similarly, since the $1 million is not included in the firm's income, the firm should not receive any tax "basis" from this amount.)[74] Rather, the $1 million payment serves to compensate the firm for accepting a location that is naturally inferior to Location I. Thus, the $1 million serves as an offset to the real decrease in wealth that the firm experiences by moving to Location II, rather than Location I.[75]

This result also can be illustrated by reference to the previous example in which the market annual rate of return was equal to ten percent. By establishing its factory in Location II, the firm has invested its capital in a location that will provide a subnormal rate of return of, for example, eight percent. The $1 million payment reduces the amount of the firm's capital investment and raises the rate of return to ten percent, which allows it to earn the normal market rate of return from the factory. This normal market rate of return will be taxed, over time, as the factory generates income for the firm. No tax should be immediately imposed, however, because no immediate accretion to the firm's wealth has occurred. The contribution received by the firm simply results in the firm earning a normal rate of return from its net capital investment, not an extraordinary return. In other words, the $1 million payment prevents the firm from having a net investment in the factory that exceeds the factory's fair market value.

Some readers may object to this conclusion and argue that even in this situation, the firm should be taxed currently on the $1 million it receives as an inducement to settle in Location II, the inferior location. These readers may argue for taxation on the grounds that the $1 million payment serves as a substitute for future income that would be taxed to the firm.[76] I believe that this argument is fundamentally flawed because it fails to view the situation in the correct manner.

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order to be allowed to locate in the area. (Governments could control entry into the area by zoning and permit regulations.) Such payments would offset the natural advantages of the area, and result in the firms having no accretion to wealth from moving into the area. In fact, such a system exists in many areas where local authorities impose "impact fees" on real estate developers as a price for allowing the developers to build in an area. For a discussion of these impact fees and various legal challenges to their imposition, see John M. Payne, *Development Fee Developments*, 17 Real Est. L. J. 71 (1988).

74. For support of this zero-basis rule, see Calvin H. Johnson, *The Legitimacy of Basis From A Corporation's Own Stock*, 9 Am. J. Tax Pol. 155, 179-81, 185-87 (1991).

75. For recognition of this problem generally, see Note, 82 Harv. L. Rev. at 631 (cited in note 2); Sneed, 17 Stan. L. Rev. at 608 (cited in note 2).

76. This rationale is generally used to defend the taxation of "carved out" or temporal interests in property, by which one party sells future income streams from property to another person, and receives an immediate cash payment in the sale. Since the amounts immediately received by the seller of the carved-out interest serve as a substitute for future income the seller would other-

The firm that accepts $1 million from Location II as a reduction in the cost of its factory is in a similar position as an investor who purchases a bond, and immediately afterwards sells the right to receive future interest income on the bond to another party for a lump-sum cash payment. The investor does not have economic income from the receipt of the cash because the amount of the cash received is equal to the fair market value of what the investor has sold, i.e., the net present value of the future cash flows that the bond will generate. The tax laws recognize the validity of this point by treating the investor as recognizing no net taxable income from selling the bond interest for the cash payment.[77]

The firm receiving $1 million from Location II to locate in a less desirable place is essentially giving up its right to receive future cash flows, which have a net present value of $1 million, from a more desirable location.[78] In return for the loss of future cash flow, the firm receives a lump-sum cash payment that equals the present value of what the firm has lost. Thus, the firm does not have economic income from the receipt of the $1 million cash. The $1 million cash simply reduces the amount of the firm's investment in the factory, so that the firm's remaining investment in the factory equals the factory's fair market value. Without the $1 million cash payment, constructing a factory would cost the firm $1 million more than the factory's fair market value. The $1 million payment simply serves to equalize these two factors. Such a result, taken in the overall context of the firm deciding to locate the factory in the less desirable area, does not result in economic income.

2. The Consistency of this Model with Perfect Competition

This scenario is consistent with the conditions present in a perfectly competitive market. Location II would not necessarily contribute

wise receive, the amounts are included in the seller's income. See, for example, *Hort v. Commissioner*, 313 U.S. 28 (1941), and the discussion of *Hort* in Joseph M. Dodge, *The Logic of Tax* 254-56 (West, 1989).

77. The rules for "stripped bonds" in I.R.C. § 1286 (West 1992), allow a person selling hond interest to allocate basis to the sold interest based on the proportion of the fair market value being sold. (That is, if the interest being sold represents 40% of the total value of the bond, then 40% of the bond's basis will be allocated to the sold interest). Since the aggregate fair market value and basis of a newly purchased bond will be equal, an investor immediately selling the bond interest will recognize no gain from the sale (i.e., the amount received from the sale will be offset exactly by the basis allocated to the sold interest, resulting in a gain of zero). For recognition of the theoretical superiority of this stripped bond approach to the alternative approach adopted by the Supreme Court in *Hort v. Commissioner*, see Dodge, *The Logic of Tax* at 262-63 (cited in note 76).

78. Future cash flows may be reduced through higher operating costs imposed on the firm in future years, or, alternatively, through lower prices received by the firm because of its disadvantageous market location.

any more than the $1 million to the firm, since it has perfect information regarding the relative attractions of the two areas, and knows exactly how much it must offer to compensate the firm for its natural disadvantages vis-à-vis Location I. Similarly, Location I would have no incentive to offer contributions that would offset the effects of Location II's offer, since an abundance of firms are in the market.[79] For Location I to offer a premium to entice sufficient firms to its area would therefore be unnecessary.

Moreover, such a result is consistent with theories regarding perfectly competitive markets in equilibrium, which provide that sellers of goods do not earn any economic "profits" from sales.[80] Instead, sellers compete such profits away as they are forced to sell goods at prices equal to marginal cost in order to compete with other sellers.[81] The conclusion that firms receive no economic profits from selling positive externalities generated by their factories is consistent with these theoretical results. The marginal cost to the firm of its externalities is zero;[82] thus, in competitive equilibrium and perfect competition, the firm would receive nothing from selling these externalities.[83] Consequently, in a perfectly competitive situation, taxing these types of nonshareholder contributions would be inappropriate since the contributions would not represent accretions to the firm's wealth.

D. Contributions in an Imperfect Market

In contrast to the hypothetical market discussed above, the actual market for these types of transactions is highly imperfect. As discussed below, at least four important characteristics of this market are responsible for this imperfection: (i) the auction-like market for economic developments, which deviates from perfect competition in certain respects and thus presents systematic opportunities for governments to overpay for the development; (ii) the asymmetrical nature of information since it is available to one side of the exchange (the corporation) and not the other (the government), providing the informed party with a definite strategic advantage; (iii) the susceptibility of state and local govern-

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79. As previously mentioned, in a state of perfect competition numerous buyers and sellers are in the market. See note 70 and accompanying text.

80. Samuelson, *Economics* at 580-81 (cited in note 4); A. Mitchell Polinsky, *An Introduction to Law and Economics* at 88-89 (Little, Brown, 2d ed. 1989).

81. Samuelson, *Economics* at 468-470.

82. The proposition that the externalities generated by firms have a marginal cost to the firms of zero is, of course, tautological. Externalities are defined, in the first place, as phenomena that have no cost to the firm generating them. See note 4.

83. The firm that receives $1 million to locate in Location II, the less desirable location, is, in effect, receiving zero for its externalities because the $1 million merely offsets the inherently negative characteristics of settling in the area.

ments to political pressure, causing them to overbid in the market for new factory locations; and (iv) the oligopolistic market structure present in this market with many buyers (governments) but few sellers (firms), which allows firms to receive higher prices for the economic development that they auction off to various bidders.

In my view, these market imperfections result in a situation in which firms do experience significant accretions to wealth from receiving these contributions. Such a conclusion is supported by a significant amount of evidence accumulated through our historical experience with these types of arrangements.

The analysis as to whether a corporation has economic income from receiving contributions for economic development is, as a matter of logic, independent of the analysis as to whether state and local governments overbid for economic development. The analysis as to whether a corporation receiving a contribution has economic income is based on whether the amount of the contribution exceeds the relative disadvantages to the corporation of settling in that particular area.[84] Thus, if a corporation receives one hundred dollars as a contribution to locate in an area, and the relative disadvantages of that area in comparison to other locations is seventy-five dollars, the corporation recognizes twenty-five dollars of economic income. In contrast, the analysis applicable to a local community potentially overbidding for economic development focuses on whether the marginal cost of making the contribution (including, when appropriate, lost taxes), exceeds the marginal benefits to the community from more jobs and more spending in the area. These two analyses are logically independent. Thus, some of the discussion below (e.g., the discussion of auctions), which suggests that governments may overpay for economic development, does not prove that corporations receive economic income when they sell the same commodity.

This analysis, however, lends some support to my arguments for taxing corporations. First, the mechanisms that lead to overbidding by governments for economic development consist of market defects that generally exert upward pressure on amounts paid by governments in this market. The existence of these institutional structures, which present a systematic bias towards overpayment, would generally increase the chances, holding other factors constant, that corporations receiving these payments have income. Moreover, other factors discussed in the text below (e.g., the presence of asymmetric information and an oligopolistic market structure that allows the selling firms to extract benefits for themselves as opposed to competing them away), are not confined to

84. See notes 73-75 and accompanying text.

overbidding by governments, but also support the possibility of corporations extracting income from the economic development market.[85] Thus, although overbidding by governments and income recognition by corporations are analytically distinct, the following analysis nevertheless supports my general thesis that corporations should be taxed on contributions received in this market.

1. Auctions and Imperfect Competition

The market for economic development largely consists of an auction-type arrangement in which a particular firm sells its economic development to various state and local governments bidding for that commodity. The existence of this auction mechanism does not necessarily mean that market failure has occured. Tbis type of auction, however, has two characteristics that differ significantly from a situation of perfect competition. First, in perfect competition, so many buyers and sellers are present in the market that one party, acting alone, is unable to influence the price at which a particular commodity is bought or sold.[86] Instead, the party is confronted with what the market has determined to be the price of an item and has no discretion or power over the determination of that price. In contrast, the market for economic development involves the auctioning of development to various bidders that each have the power to infiuence the price by placing a winning bid or by pressuring others to raise their bids.[87] Second, in perfect competition, all parties have complete information regarding the characteristics of the commodity being sold.[88] In the auction for economic development, however, the various bidders lack such perfect information regarding the economic impact of the particular corporate facility being sought and may differ in estimating the number of jobs and similar benefits that the facility will provide to the area.

These two departures from perfect competition provide the conditions for the occurrence of the "winner's curse," documented in the economics literature on auctions.[89] The winner's curse may be described as follows: in an auction involving the sale of an item with uncertain value,

85. The presence of asymmetric information, utilized by corporations to the disadvantage of local governments, is just as probative of the argument that corporations receive income in this market as it is of the argument that governments overbid.

86. See note 70.

87. For recognition that this general structure of auctions deviates from perfect competition, see William Vickrey, *Counterspeculation, Auctions, And Competitive Sealed Tenders*, 16 J. Fin. 8, 9 (1961).

88. See note 70.

89. See, for example, Paul Milgrom, *Auctions and Bidding: A Primer*, 3 J. Econ. Persp. 3-6 (1989); John H. Kagel and Dan Levin, *The Winner's Curse and Public Information in Common Value Auctions*, 76 Am. Econ. Rev. 894 (1986).

the various parties bidding on the item will have differing views as to the item's value. Moreover, the person with the most optimistic view of the item's value will generally be the high bidder in the auction, thus obtaining the good. Frequently, the high bidder will find that its bid reflected an erroneously optimistic view of the item's value that ultimately proves to be inflated. Hence, the winner's curse—the fact that a person submitted the winning bid in an auction may mean that the person has suffered a financial loss by purchasing something for more than its value.

The winner's curse has been empirically documented to occur in situations involving, for example, bidding by oil companies for mineral leases.[90] Some evidence suggests that oil companies systematically overbid. State and local government may also feel the winner's curse. All the ingredients are present: the value of a factory to a community is more uncertain than the value of a mineral lease to an oil company and many unsophisticated bidders are present, who are unlikely to know how to discount their bids properly. Many experts believe that state and local governments do, in fact, systematically pay too much for economic development.[91] The existence of the winner's curse may explain why.

2. Imperfect Information and Market Failure

As previously noted, in contrast to a perfectly competitive market, the real market for economic development involves participants with highly imperfect information. In particular, the communities that are purchasing this economic development through their local governments are not aware of the degree to which their natural attractions (proximity to markets, low costs, etc.) entice a particular firm. As a consequence, these communities do not know how their natural attractions compare to the natural attractions of other competing areas from the perspective of a particular firm considering the location of a factory. The firms, however, are aware of how they have evaluated areas in terms of their natural advantages for business location and are similarly aware of how the competing locations compare to each other in terms of these advantages. Firms also possess advantages in that they are likely to know more about the particular product they are selling (i.e., the economic development provided by their particular facility) than the state and local governments interested in buying that development.[92]

90. Kenneth Hendricks, Robert H. Porter and Bryan Boudreau, *Information, Returns, and Bidding Behavior in OCS Auctions: 1954-1969*, 35 J. Indust. Econ. 517, 518-19 (1987).

91. See note 106 and accompanying text.

92. Here, the product heing sold (economic development) varies from firm to firm, in con-

Economists have referred to this type of situation, characterized by one-sided information, as involving "impacted information" or "information impactedness."[93] Impacted information may lead to instances of market failure;[94] here, market failure occurs because the firm opportunistically[95] exploits its informational advantage over the local governments wishing to purchase its collective goods.[96]

This model, involving impacted information and market failure, is consistent with the observations of many who have studied this market in operation. Numerous accounts and studies have portrayed local gov-

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trast to a perfectly competitive market involving standardized products. Economic development provided by one firm may differ, both quantitatively and qualitatively, from the economic development provided by another firm. Again, firms are typically in a better position to evaluate the particular product of economic development that they are selling. Firms know more regarding their business plans, their commitment to stay in a particular area, the possibilities of any expansion in their local business activities, and other factors that would affect the desirability of a particular firm. This creates a situation in which firms are able to overprice the economic development provided by a certain factory by misrepresenting the quality of the product they are selling. See, for example, Thomas J. Lueck, *Business Incentives: A High-Priced Letdown*, N.Y. Times § 4 at 16 (March 8, 1992); Guskind, 21 Nat'l J. at 635 (cited in note 62) (quoting a city council member as stating that only one-third of jobs promised by corporations moving into an area have materialized). State and local governments would be able, however, to respond in a partial manner to this problem if they were to adopt "clawback arrangements." Clawback arrangements typically provide that a firm initially receiving a contribution from a government for settling in an area may later forfeit this contribution if the firm eventually abandons the area or fails to achieve certain levels of economic development while there. However, most state and local governments do not impose clawback arrangements, and hence remain vulnerable to overpaying for economic development. For a discussion of such arrangements, see Kenyon, *Interjurisdictional Tax and Policy Competition* at 54 (cited in note 43).

93. Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* 14, 31-37 (Free Press, 1975). For other work on market problems created by asymmetrical information, see Kenneth J. Arrow, *The Organization of Economic Activity* 47, 54-56, in Joint Economic Committee, *The Analysis and Evaluation of Public Expenditures: the PPB System*, 91st Cong., 1st Sess. (U.S.G.P.O. 1969).

94. Rosen, *Public Finance* at 63 (cited in note 4) (discussing "costly" information as a cause of market failure). For a discussion of market failure in the insurance industry caused by nonsymmetrical information and the resulting process of "adverse selection" see Williamson, *Markets and Hierarchies* at 23 (cited in note 93); Arrow, *Organization of Economic Activity* at 35 (cited in note 93). For similar adverse selection problems caused by impacted information in the used car business, see George A. Akerlof, *The Market for "Lemons:" Quality Uncertainty and the Market Mechanism*, 84 Q. J. Econ. 488 (1970).

95. Opportunism may be defined as the tendency for persons to engage in Machiavellian self-interest, or "self-interest seeking with guile." Williamson, *The Economic Institutions of Capitalism* at 30 (cited in note 10).

96. In a situation involving large numbers of firms attempting to auction off their externalities to governments, competition between the firms might dissipate this informational advantage. See Williamson, *Markets and Heirarchies* at 31-32 (cited in note 93) (stating that impacted information is especially problematic in "small numbers" exchanges). However, our historical experience indicates that impacted information, in actuality, provides a significant advantage to the firms possessing it in the market for economic development. See notes 97-98 and accompanying text. This suggests, therefore, that there is an absence of competition among firms in this market. This point is discussed more thoroughly at notes 131-32 and accompanying text.

ernments and community groups as being unaware of the extent to which the natural features of an area were attractive to firms considering the location of a new factory.[97] Thus, the buyers of economic development were unaware of important information possessed by the sellers of that good. Moreover, these same historical accounts have also portrayed the firms as keeping this information from the governments, and in fact, exploiting the ignorance of the governments in an attempt to create "bidding wars" by playing off competing localities against each other.[98] Firms have extracted contributions from local governments by threatening to choose other competing sites, even though such threats may have been largely idle. In summary, the evidence strongly suggests that firms recognize an accretion to wealth from these contributions through their exploitation of impacted information among the various governments and community groups vying for their favor.

3. The Political Process

a. Government Involvement: The Need for Collective Action

State and local governments have become heavily involved in the market for purchasing economic development. This section explains the origin of this involvement, which lies in collective-action problems regarding the acquisition of economic development. It also develops the theory that this involvement acts to increase the amounts contributed by corporations for economic development, thus increasing the likelihood that the corporations recognize economic income from their receipt.

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97. For a typical example, consider the following description of the efforts by Illinois and other governments to attract a Chrysler/Mitsubishi plant to the state in 1986: "At this period and throughout the negotiations the automobile industry, not the state, was in the driver's seat. . . . [C]orporate officials knew what constituted an acceptable package of incentives to attract the facility. Government officials were not privy to this information." Lind and Elder, 3 Gov't Fin. Rev. at 20 (cited in note 57). For similar accounts of firms using such informational advantages, see Tolchin and Tolchin, *Buying Into America* at 64 (cited in note 36); Jones and Bachelor, *Urban Economic Development* at 247 (cited in note 28); Gaynor, Pittsburgh Post-Gazette § 1 at 29 (cited in note 36); Guskind, 21 Nat'l J. 634 (cited in note 62); Richard Brandt, *Wherever GM Puts Saturn, It's Going to Get a Sweet Deal*, Business Week 36 (Apr. 1, 1985); Jacobs, *Bidding for Business: Corporate Auctions and the Disunited States* at 54-55 (cited in note 28).

98. See note 97. See also Larry C. Ledebur and William W. Hamilton, *The Failure of Tax Concessions as Economic Development Incentives*, in Steven D. Gold, ed., *Reforming State Tax Systems* 101, 109-10 (Nat'l Conf. of State Legis., 1986); Paul Glastris, *Holdup in the Windy City*, 107 U.S. News & World Rep. 40 (July 17, 1989) (asserting that corporations have the "leverage to place bidders against each other"); Carole Davies and Jon Lowell, *Incentives Survive But Live Quiet Lives; State and Local Aid Given In Quest for Auto Plants*, 26 Ward's Auto World 39 (Apr., 1990); Georgiana Fiordalisi, *Did Kentucky Overpay For Toyota: State and Outsiders Have Different Views of Incentive Package*, Automotive News 18 (July 31, 1989).

In many respects, the jobs and economic stimulation sought by the local governments making contributions for economic development are collective goods, defined as goods that are difficult to exclude others from enjoying, or, phrased differently, goods that are nonexclusive in nature.[99] These goods are nonexclusive in nature in that merchants and businesses located in the area will experience the benefit of the economic stimulation provided by the factory,[100] regardless of whether those people played any role (or shared any costs) in initially persuading the firm to locate the factory in that area.

Because of this nonexclusive nature of economic development, the efforts of local communities to obtain economic development involves collective action problems,[101] or "free rider problems." Rational and self-interested persons living in these communities will frequently have an incentive, acting in their individual capacity, not to contribute to the

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99. For a similar use of the term "collective goods," see Russell Hardin, *Collective Action* 17-20 (Johns Hopkins, 1982). The critical characteristic of a collective good, as the term is used in this Article, is that it is difficult or costly to exclude others from enjoying the good. As a result, the production of the good involves "collective action" problems (or "free rider" problems), discussed later in the Article. See note 102 and accompanying text. On occasion, the term "public goods" has been applied to goods having this nonexclusive nature. See Mancur Olson, *The Logic of Collective Action* 14-15 & n.21 (Harvard, 1971). However, the types of goods discussed in this Article (jobs and economic stimulation provided to a community by a factory locating in the area) are not public goods in the technical sense of the word. A job, for example, is not a public good because the taking of that job by one person will necessarily eliminate another person from having that same job as well. Thus, the job lacks "jointness," an essential characteristic of public goods. "Jointness" is defined to mean that the consumption of the good by one person will not diminish the quantity of the good available for another person. See Hardin, *Collective Action* at 17; Paul A. Samuelson, *The Pure Theory of Public Expenditure* (North-Holland, 1954) (stating that "each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good"), reprinted in Brian Barry and Russell Hardin, eds., *Rational Man and Irrational Society* 175 (Sage, 1982). See also Duncan Snidal, *Public Goods, Property Rights and Political Organizations*, 23 Int'l Stud. Q. 532, 539-44 (1979), for the proposition that many private, nonpublic goods present both difficulties in excluding others from their enjoyment, as well as collective action problems. For a critique of Snidal's definitions of public goods as being too narrow, see Charles Silver, *Utilitarian Participation*, 23 Soc. Sci. Info. 701, 712-13 (1984).

100. Admittedly, some people might object to the location of a new factory in the area on the grounds that the factory would result in increased pollution, traffic, and demand for local services in the area. See, for example, Crossley, et al., Courier-Journal at A1 (cited in note 56) (discussing the opposition of environmental groups to a new paper plant in Kentucky); Rubin and Zorn, 45 Pub. Admin. Rev. at 334 (cited in note 71) (stating concerns regarding "unmanageable population density, congested transportation networks, and strained public services"); Harrison and Kanter, *The Political Economy of States' Job-Creation Business Incentives*, 44 AIP J. at 429 (cited in note 28) (discussing increased burdens on housing and social services). In addition to these concerns, some groups representing organized labor have opposed the granting of incentives to attract new factories on the grounds that the factories were to he staffed by non-union workers. See, for example, Jay Kraker, *Toyota Plant Plows Ahead With No Sign Of Union Pact*, Engineering News-Record 65 (Nov. 27, 1986).

101. Olson, *Logic of Collective Action* at 11-12 (cited in note 99); Hardin, *Collective Action* at 6-9 (cited in note 99).

recruitment efforts.[102] These persons will have a strong incentive to "free-ride" off the efforts of others, reasoning that the benefits to them individually from not making any contributions to the recruiting efforts will exceed the marginal benefits individually obtained from making any contributions.[103]

Governments that recruit firms to come to an area have solved this collective action problem at the municipal, county, and state level by taxing the inhabitants of the area to pay for the costs of the contributions made in the recruiting effort.[104] The use of governments, with their powers of compulsory taxation, to solve this collective action problem would be expected.[105] What is important, for purposes of this Article, is to note that this governmental involvement brings other factors into play that likely increase the amounts that are paid to firms for economic development.

b. *Politics, Special Interests, and Public Choice Theory*

A consensus exists among scholars that corporations, in practice, generally receive excessive amounts for the economic development they bring to an area.[106] This result occurs in ways consistent with predic-

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102. Such incentives are based on the assumption that individuals are motivated largely by self-interest. See Olson, *Logic of Collective Action* at 9 (cited in note 99). Some individuals may have particularly strong moral or ethical beliefs that may cause them to act out of consideration for others as opposed to pure self-interest. For an examination of the circumstances in which an individual, adopting utilitarian principles, would have a moral obligation to contribute towards producing collective goods, see Silver, 23 Soc. Sci. Info. at 701 (cited in note 99).

103. Every rational and self-interested individual in the community will hope that other people contribute to the recruiting effort so that the new factory may be brought to the area, although each individual will have a similar incentive not to personally make any contributions to this recruiting effort, but rather rely on the efforts of others. See Olson, *Logic of Collective Action* at 13-14, in which he notes that the nonexclusive nature of public goods creates this problem of collective action.

104. In addition, to a lesser extent, community groups, such as chambers of commerce and other local business federations, have been involved in these recruiting efforts. Again, it would be expected that such groups would be used to overcome the collective action problems in this area. These organized groups (especially smaller groups) can overcome many of the difficulties of collective action. Other things being equal, smaller groups are able to overcome collective action problems more effectively than larger groups. Olson, *Logic of Collective Action* at 53-57; Hardin, *Collection Action* at 38-42 (cited in note 99). These groups overcome collective action problems by adopting internally coercive measures to insure the cooperation of their members, and by policing their members to ensure that potential free-riders are discouraged from relying on the efforts of others to acquire collective goods. Hardin, *Collective Action* at 174-87.

105. For some time, it has been widely recognized that governments, with their powers of compulsory taxation, are well-suited to provide collective goods. See Olson, *Logic of Collective Action* at 13-14, for discussion of the importance of state taxation in providing public goods.

106. Kenyon, *Interjurisdictional Tax and Policy Competition* at 53 (cited in note 43) (stating that the "preponderance of the evidence . . . regarding state and local competition for economic development is that such activity is generally not cost effective from the point of view of the offering government or the nation as a whole"); Jones and Bachelor, *Urban Econ. Development* at

tions of political behavior made by public choice theory[107] and other theories of political action.

Economic development and growth in an area frequently provides substantial benefits to various members of the community, such as real estate developers, general business interests, and other influential groups.[108] Interestingly, such groups include the local press, which benefits from the increased circulation provided by growth.[109] This may explain the relatively favorable treatment provided by the press to the efforts of communities to attract economic development. In contrast, the costs of this economic growth, which include the direct expenditures made by the local government to recruit the firm and more subtle costs resulting from the development itself (i.e., increased congestion, pollution, and strains on local services),[110] are more likely to be dissipated over a broader number of people, and, correspondingly, to be experienced by each person only to a moderate extent.[111]

246-47 (cited in note 28); Ledebur and Hamilton, *Reforming State Tax Systems* at 110-112 (cited in note 98) (defining cost effectiveness as a comparison of the costs incurred by the government to the benefits obtained by the firm, but arguing that the same results would occur if the benefits to the local area were to be taken into account as well). Accord David W. Rasmussen, Marc Bendick, Jr., and Larry C. Ledebur, *A Methodology for Selecting Economic Development Incentives*, 15 Growth and Change 18 (Jan., 1984); Compare Netzer, *Competition Among States and Local Governments* at 231-236 (cited in note 59) (discussing the methodological difficulties of determining the effectiveness of such programs and the resulting uncertainty in this area).

107. Public choice theory would be defined as the application of economic theories to explain political behavior, or, more briefly, as the application of economics to political science. Dennis C. Mueller, *Public Choice* (Cambridge, 1979).

108. See Harold A. Hovey, *Interstate Tax Competition*, in *Reforming State Tax Systems* at 89-90 (cited in note 38). For a general argument that such special interests are the influential force behind "boosterism" and other growth oriented programs, see Harvey Molotch, *The City as a Growth Machine: Toward a Political Economy of Place*, 82 Am. J. Soc. 309 (1976); John L. Logan and Moshe Semyonov, *Growth and Succession in Suburban Communities*, 21 Soc. Q. 93, 95-96 (1980); John R. Logan, *Growth, Politics, and the Stratification of Places*, 84 Am. J. Soc. 404, 408-10 (1978) (noting the importance of various groups in promoting economic growth for a particular locality).

109. See Hovey, *Interstate Tax Competition*, in *Reforming State Tax Systems* at 90 (noting that the "media" is at the "top of the list" in groups which gain from economic development. The media henefits substantially from increased circulation which in turn results in higher advertising revenue without accompanying increases in production costs).

110. For a discussion of strains on services created by new growth, see Stephen Phillips, *The Town That Toyota Took From 0 to 60*, Business Week 20B (July 11, 1988). See also note 100.

111. See Hovey, *Interstate Tax Competition*, in *Reforming State Tax Systems* at 90 (noting that the "drawbacks" of growth "tend not to be mentioned much"); Richard C. Maurer and James A. Christenson, *Growth and Nongrowth Orientations of Urban, Suburban, and Rural Mayors: Reflections on the City as a Growth Machine*, 63 Soc. Sci. Q. 350, 352 (1982). I do not mean to imply that all political pressures originate from forces in support of economic growth in an area. The existence of special interest groups favoring nongrowth, preservationist tendencies is well known. However, sufficient numbers of motivated people favoring growth do exist in positions of power to provide adequate demand for such growth, and to fuel the market for economic development which allows firms to receive contributions for settling in a particular area.

Under certain branches of public choice theory, this is the perfect scenario[112] for politicians to appeal to special interests that have substantial stakes in continuing economic development, while safely ignoring the relatively minor (and perhaps unexpressed)[113] interests of others who are inconvenienced by this growth. Indeed, various accounts of the market for economic development have characterized the behavior of the parties in a manner consistent with this theory.[114] Public choice theory's explanation of political behavior would predict this phenomenon of politicians engaging in activities that are not cost-effective. Politicians will readily subsidize a certain area in which special interests have strong and identifiable stakes, although the benefits of the subsidies to the community at large may be less than their costs.[115]

Moreover, the argument that the political process places upward pressure on amounts firms receive for economic development remains credible even if one rejects the explanation of political behavior offered

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112. These particular versions of public choice theory emphasize the power of special interest groups to influence the political process to their own advantage, while the relatively minor and diluted interests of the general populace are typically ignored. See, for example, Anthony Downs, *An Economic Theory of Democracy* 94-95 (Harper, 1957); Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q. J. Econ. 371, 385-86 (1983); William M. Landes and Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J. L. & Econ. 875, 877 (1975). For this literature's treatment of the legislative process regarding federal income tax benefits, a subject analogous to the market for economic development and state tax abatements, see Richard L. Doernberg and Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 Minn. L. Rev. 913 (1987); Richard L. Doernberg and Fred S. McChesney, *Doing Good or Doing Well: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. Rev. 891 (1987). For general discussions of these particular versions of public choice theory, see Daniel A. Farber and Philip P. Frickey, *Law and Public Choice* 12-23 (Chicago, 1991); Mueller, *Public Choice* at 148-70 (cited in note 107).

113. Indeed, collective-action problems may prevent people with relatively minor preferences on an issue from developing effective political coalitions to express their preferences. See note 104.

114. See Harrison and Kanter, 44 AIP J. at 433 (cited in note 28); Molotch, 82 Am. J. Soc. at 310, 314 (cited in note 108) (describing individuals who influence local pro-growth efforts as individuals having the most at stake with respect to land-use decisions); John C. Logan, *Industrialization and the Stratification of Cities in Suburban Regions*, 82 Am. J. Soc. 333, 339 (1976) (noting that groups representing the interests of real estate developers and general business interests are heavily involved in promoting growth activity that may be adverse to other residents of the community); Jacobs, *Bidding For Business* at 52-54 (cited in note 28).

115. In many respects, this pattern of activity is simply an example of the exploitation of the political process in order to finance special interest projects. Such activity takes place by utilizing traditional logrolling practices in which a group of legislators engage in reciprocal voting patterns in which each legislator supports the other's proposals, in return for a promise of similar support. Through this vote trading process, the group may adopt projects that it would have rejected under a system of simple majority rule. These logrolling practices may result in government overspending on projects that benefit a few interest groups in the community, while the cost of such projects are financed by the general populace. See Gordon Tullock, *Problems of Majority Voting*, 67 J. Pol. Econ. 571, 575, 578 (1959); William H. Riker and Steven F. Brams, *The Paradox of Vote Trading*, 67 Amer. Pol. Sci. Rev. 1235, 1247 (1973). Contrast Mueller, *Public Choice* at 50-51 (cited in note 107) (noting that, in some situations, logrolling may produce positive results in which the aggregate utility of the entire group is increased).

by these branches of public choice theory. Recent attacks on this version of public choice theory have criticized the theory as being unduly narrow in portraying politicians as venal captives of special interests whose main interest is selling political favors to the highest bidder.[116] Studies of political behavior have indicated that, in addition to appeasing special interests, other factors may significantly affect the behavior of politicians. For example, the desire for reelection, power, and prestige, as well as the desire to further one's personal ideology by promoting "good policy," may play significant roles in motivating politicians to act in various ways.[117]

Even if these more complex models are correct, however, they still are consistent with the argument that politicians are motivated to recruit firms to settle in an area, even at the cost of paying excessive amounts to those firms. Our experience indicates that politicians who succeed in recruiting firms to an area generally receive substantial publicity and prestige as a result of their recruiting efforts; conversely, politicians who fail in recruiting efforts may suffer significant political damage from being perceived as paying inadequate attention to economic development.[118] Thus, politicians can claim credit for the visible

116. See, for example, Kay Kehman Schlozman and John T. Tierney, *Organized Interests and American Democracy* 401-03 (Harper & Row, 1986) who conducted a study of political behavior and concluded that models that view politics as an exclusively marketplace activity, with political favors for sale to the highest bidder, are deficient. Instead, more complex models that acknowledge the importance of nonmarketplace values, such as the personal views of elected officials, are more consistent with the realities of the American political experience. See also Farber and Frickey, *Law and Public Choice* at 27-33 (cited in note 112), who criticize public choice theory as underestimating the influence of ideology on political behavior.

117. For an insightful argument that such factors played a critical role in recent federal tax legislation, see Daniel N. Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980's*, 139 U. Pa. L. Rev. 1, 64-100 (1990). Professor Shaviro rejects the branches of public choice theory that portray politicians as exclusively motivated by the desire to appease special interests, noting that other empirical studies indicate that a far richer and more complex set of factors is actually at work. See, for example, Richard F. Fenno, Jr., *Congressmen in Committees* 1-3 (Little Brown, 1973) (noting that members of the U.S. House of Representatives act to achieve the goals of reelection, influence, and good public policy, and noting that members of the House Ways & Means Committee, in particular, place importance on prestige and power); John F. Manley, *The Politics of Finance, The House Committee on Ways and Means* 60, 68-72 (Little Brown, 1970) (noting that members of the House Ways & Means Committee are strongly motivated by the desire for dignity, power, and prestige). This literature is important because its conclusions regarding political behavior of congressional tax writers may he closely analogous to the behavior of state and local politicians who provide tax incentives to firms in the economic development market. Contrast Shaviro, 139 U. Pa. L. Rev. at 86-87, who argues that his conclusions regarding congressional behavior also apply to other non-elected individuals in the Washington, D.C. political community.

118. See Paul G. Glastris, 107 U.S. News & World Rep. at 40 (cited in note 98) (noting that "[o]fficials who balk at sweetening the [incentive] pot put their necks on the line, while politicians who go along get the glory"); Nonna A. Noto, *Trying To Understand The Economic Development Official's Dilemma*, in Daphne Kenyon and John Kincaid, eds., *Competition Among States and*

benefits of growth and new development, while conveniently ignoring many subtle and obscure costs incurred in obtaining that development.[119] Moreover, many politicians undoubtedly believe that promoting growth in an area is "good policy;" one can make a strong argument that people who seek and achieve positions of political power are frequently ideologically disposed toward pro-growth beliefs.[120] Thus, supporting government incentive programs for economic development would be consistent with the ideological background of many people elected to positions of power. Consequently, a number of factors other than the desire to appease special interest groups may explain the vigorous promotion of economic growth, even at the cost of paying what may be excessive amounts for economic development.

c. *Lack of Accountability*

An additional factor aggravating the tendencies of the political process to overspend in purchasing economic development is that the costs of acquiring economic development are frequently hidden and not accounted for in a clear manner. A large part of the problem is simply that these costs may be quite subtle and, as a result, frequently may be ignored. I have already mentioned some of these costs such as increased congestion, pollution, and strains on local services, which are difficult to trace to a particular source and are often times overlooked.[121] Moreover, other types of costs incurred to acquire economic development lend themselves to this lack of accountability. For example, politicians are

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Local Governments at 251, 254 (Urban Inst., 1991) (noting the importance of the downside risk of being blamed for failing to recruit firms); Gaynor, Pittsburgh Post-Gazette § 1 at 29 (cited in note 36) (quoting a state official as mentioning the political importance of successfully recruiting firms to an area); *North Carolina Vies For Semiconducter Project*, UPI-Regional News (June 17, 1987) (discussing political battles between Republicans and Democrats concerning charges of inadequate attention to economic development). But see Guskind, 56 Planning at 5 (cited in note 56) (noting voter anger at the mayor of a Michigan town for giving excessive benefits to a firm locating in the area, resulting in the mayor eventually being voted out of office).

119. See note 110. See also the comments of Professor Kenyon regarding the market for economic development that "[t]he way it is now, all that gets counted in the political calculus is the benefits, not the costs," quoted in Glastris, 107 U.S. News & World Rep. at 41 (July 17, 1989).

120. See Molotch, 82 Am. J. Soc. at 317-18 (cited in note 108), who argues that people elected to positions of office are, typically speaking, more likely to be in favor of growth than members of the population in general. See also Hovey, *Interstate Tax Competition*, in *Reforming State Tax Systems* at 90 (cited in note 38) who notes that "[s]tate officials, almost without exception, have a strong commitment to economic development," while also stating that "there isn't a race for governor in which the candidates did not try to outpromise each other on economic development issues." Compare Harold Dwight Laswell, *Power and Personality* 39-58 (W. W. Norton, 1948) (discussing the traits associated with the "political personality").

121. See notes 100 and 110. See Rubin and Zorn, 45 Pub. Admin. Rev. at 334 (cited in note 71), who support the notion that policymakers do not sufficiently appreciate the costs resulting from economic development, including lost taxes and increased congestion and pollution.

frequently able to portray tax abatements offered to a firm as costs that are not "real" and that should not be "counted," on the grounds that if the firm had not located in the area, the community would have collected no taxes whatsoever from the firm. Thus, based on such arguments, tax abatements provided to the firm should not be viewed with the same seriousness as "out of pocket" costs.[122]

An additional factor aggravating this problem is that the budgetary processes of state and local governments are notoriously ineffective in accurately portraying the costs of tax abatements and other incentive programs,[123] although proposals for reform have repeatedly been made.[124] Part of this problem may result from the fact that states, development agencies, and other involved parties have an incentive to understate the costs of such programs, and overstate their benefits.[125] In addition to this problem of bias, many state and local governments lack the financial sophistication to account for these programs in an accurate manner, although there are signs that the level of sophistication may be

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122. For a recognition of this problem, see Kenyon, *Interjurisdictional Tax and Policy Competition* at 54 (cited in note 43). There are two problems with this argument. First, tax abatements in many situations may function as a proxy for the costs of services (police, fire and other community services) used by a firm locating in an area. Thus, ignoring tax abatements results in the community overlooking the real costs of attracting a firm to locate in an area. Moreover, as discussed later, in some situations a firm would have settled in the particular area anyway, irrespective of whether tax abatements and other contributions would have been offered. To the extent this is true, then providing tax ahatements to that firm represents real out-of-pocket costs. Harrison and Kanter, 44 AIP J. at 429-30 (cited in note 28) (pointing out the real costs of incentive programs that do not result in increases in new jobs, and criticizing cost-benefit studies of incentive programs as only comparing economic conditions before and after the incentive programs, while not attempting to make the more relevant comparison of economic conditions with and without the program.)

123. See, for example, Tolchin and Tolchin, *Buying Into America* at 66 (cited in note 36) (stating that "[n]o one really knows how much is spent in the aggregate on these incentive packages and how much they cost the taxpayer. What is clear is that the cost is substantial and that some inequities are inevitable"); Paul Glastris, 107 U.S. News & World Report at 40 (cited in note 98); Rubin and Zorn, 45 Pub. Admin. Rev. at 333 (cited in note 71) (discussing the "sizable hidden costs associated" with economic development activities). But see Netzer, in *Competition Among States and Local Governments* at 234 (cited in note 59) (stating that "many" states regnlarly publish reports of the costs of economic incentive programs).

124. For an example of such proposals, see Rasmussen, Bendick and Ledebur, 15 *Growth and Change* 18 (cited in note 106); *Researcher: States Should Car-pool When Seeking Japanese Car Plant*, UPI (Oct. 29, 1990) (quoting a University of Illinois professor as recommending that states and local authorities adopt a number of analytical and accounting procedures to help avoid overpaying for economic development); Davies and Lowell, 26 *Ward's Auto World* at 39 (cited in note 98) (quoting Larry Ledebur, a prominent researcher in the field, as emphasizing the need for more sophistication among state and local officials in dealing in this area).

125. These groups have an incentive to portray these activities in a favorable manner in order to justify their actions and assure that these programs will be continued in the future. See, for example, Kenyon, *Interjurisdictional Tax and Policy Competition* at 52 (cited in note 43) (noting the incentives to create biased data). See also Netzer, *Competition Among States and Local Governments* at 231.

improving.[126] Still, the lack of coherent treatment of the costs of economic development reduces the accountability of the political process, and likely increases the size of contributions made to corporations locating in an area.

4. Oligopolistic Market Structures

Another reason why firms likely earn economic income from receiving these contributions is that the structural pattern of sellers (firms) and buyers (governments) participating in the economic development market differs sharply from the theoretical model of perfect competition characterized by virtually unlimited numbers of buyers and sellers.[127] In a situation of perfect competition, large numbers of buyers and sellers prevent sellers from lowering the quantity of items produced and extracting economic profits from the increase in prices that would occur from such a reduced supply.[128] Instead, in a competitive market, any attempt by one party to raise the price of an item by reducing its supply will be offset immediately by other sellers providing more of the item, thus frustrating the initial party's attempt to extract an economic profit through the activity.

In contrast, the market for economic development exhibits the traits of an oligopolistic market in which there are few sellers (firms) of an item, and literally thousands of buyers (local and state governments) competing against each other in their attempts to attract firms.[129] Such a theory is supported, in part, by the extremely heated competition among governments that immediately takes place when firms announce plans to open a new facility.[130] Moreover, the conclusion that this mar-

126. See, for example, Netzer, *Competition Among States and Local Governments* at 234.

127. For recognition of the possibility that reduced competition could result in firms receiving income from these contributions, see Note, 66 Yale L. J. at 631 (cited in note 2).

128. Technically, in a state of perfect competition, a firm has no control over the price it is able to obtain by selling a product. Instead, the firm may sell as much as it wishes of a particular good at the market price, without the firm's activity affecting such price for the good in any manner. Samuelson, *Economics* at 457-58 (cited in note 4). Thus, in such a situation, the firm will continue to produce the good until its marginal cost of production equals the good's market price. It would be completely ineffectual for the firm to attempt to manipulate the market price for the good by reducing the quantity of goods it produces.

129. For a discussion of oligopoly, see Samuelson, *Economics* at 462. For recognition that the market for economic development does, in fact, consist of this competitive imbalance of few sellers and many buyers, see Jones and Bachelor, *Urban Economic Development* at 246-47, 264-66 (cited in note 28); Compare Rubin and Zorn, 45 Pub. Admin. Rev. at 334 (cited in note 71) (noting the intensity of competition among increasingly large numbers of governmental units for economic development).

130. See, for example, Stevenson, N.Y. Times at A1 (cited in note 62) (discussing the heated competition for a McDonnell Douglas Plant); Deters, Arizona Republic at F4 (cited in note 62); Janice Castro, *Come on Down! Fast!*, Time 38 (May 27, 1991); Bob Lowry, *Austin Finalist For U.S. Memories*, UPI Release (Oct. 24, 1989). Periodically, one reads accounts claiming that the

ket is oligopolistic in nature is also supported, inferentially, by the strong consensus (previously discussed)[131] that asymmetrical or "impacted" information creates bargaining advantages for corporations in dealing with state and local governments. In a highly competitive marketplace, such informational advantages would not be significant. Competitive pressures would force corporations to either disclose the information to the other side, or completely bargain away the benefits of such information.[132] Thus, the continuing existence of such asymmetrical information as a powerful force in this market strongly supports the conclusion that the market is oligopolistic in nature.

Admittedly, this market structure of many buyers and few sellers may result from technological reasons as opposed to undue industrial concentration.[133] Firms engage in constructing new plants and factories on only an occasional basis. Moreover, any one firm is likely, for economies of scale and reasons of manufacturing technology, to construct one new factory to build an item as opposed to constructing several new factories.[134] Thus, technological reasons may account for the relative scarcity of new plants being constructed at any one time, while large numbers of state and local governments eagerly await the possibilities of recruiting such plants.[135] Such a market, however, results in prices

level of competition among state and local governments for economic development is declining. See, for example, Gaynor, Pittsburgh Post-Gazette § 1 at 29 (cited in note 36). However, such claims may simply reflect wishful thinking on the part of state and local governments, and should be viewed with skepticism. In contrast, other recent articles portray the competition for economic development as intensifying, due, in part, to economic problems currently facing many areas of the country. See, for example, Castro, Time at 38. See also Kenyon, *Interjurisdictional Tax and Policy Competition* at 50 (cited in note 43) (concluding that the number of incentives offered continues to grow, based on personnel budgets for state development agencies).

131. See notes 97-98 and accompanying text.

132. See note 96.

133. The reader should note that I am only arguing that the market for economic development among firms is oligopolistic in nature. In contrast, the markets for the output of these firms which they produce and sell to customers may be highly competitive. For the recognition that a firm may operate in two markets, with the two markets differing in the degree of competition present in each, see Markovits, *Tie-ins, Reciprocity, and the Leverage Theory*, 80 Yale L. J. 195, 228-29 (1970) (discussing differences in the markets for two products sold by the firm, and the potential for tie-ins created by these differences).

134. Samuelson, *Economics* at 539 (cited in note 4) (observing that economies of scale for modern technologies "increasingly require larger and larger plants") Other factors in addition to economies of scale influence plant size and location, including transportation costs to distant markets, freight costs of raw materials, labor rates, and taxes. Schmenner, *Making Business Location Decisions* at 126-28 (cited in note 42).

135. Periodically, state and local governments attempt to enter into various types of agreements and "understandings" among themselves in order to reduce the level of competition for economic development. For a proposal to reduce competition by such arrangements, see, for example, Kenyon, *Interjurisdictional Tax and Policy Competition* (cited in note 43). Apparently, such proposals have not worked; see notes 130-31 and accompanying text for discussions of the continuing intensity of competition among state and local governments.

being bid up to reflect the relative scarcity of supply. In turn, increased prices for economic development mean that firms are more likely to experience an increase in economic wealth from receiving the contributions.

E. Problems with the Foregoing Proposals Regarding Payments for Economic Development

Based on the foregoing analysis, corporations receiving contributions made for the purposes of generating economic development should recognize taxable income from the contributions equal to the fair market value of the property or benefits received.[136] Although such a proposal would represent an improvement over present law, in some situations it would, admittedly, overtax firms. First, as previously noted, firms receiving these contributions may compete them away in the marketplace by reducing the prices charged for goods and services they provide to customers. Some anecdotal evidence suggests that this phenomenon may not occur, i.e., that firms treat these contributions as essentially windfalls that do not enter into any calculus regarding the firm's future prices charged to customers.[137] Notwithstanding this evidence, the possibility remains that firms compete these contributions away by lowering future prices charged to customers. As previously set forth, however, these contributions can be defended on the grounds that taxation will reduce the amount of price discounts offered to the firms' customers. Reducing the extent of the price discounts is desirable in that it reduces the misallocation of resources resulting from the existence of these nonneutral locational incentives that only certain types of firms are able to obtain. Therefore, the possibility of overtaxation caused by these competitive pressures is not a concern. The discussion below addresses a more serious issue regarding the foregoing proposals to tax these firms.

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136. All legal precedent that has allowed firms to exclude these contributions from income should be expressly overturned. This would include the *Brown Shoe* decision (cited in note 5), Treas. Reg. § 1.118-1 (1956) (cited in note 5), IRS Notice 87-82 (cited in note 5), and all other precedent allowing firms to receive contributions for economic development without recognizing taxable income. If these proposals were adopted, and firms were required to recognize taxable income upon receipt of these contributions, the firms would be allowed to receive a tax basis representing their costs in the property. For a discussion of this point, see note 8.

137. See, for example, the discussion of how companies view incentives in Tolchin and Tolchin, *Buying into America* at 62-67 (cited in note 36). See also Jones and Bachelor, *Local Policy Discretion*, in *Urban Economic Development* at 262-65 (cited in note 28); Michael J. Wolkoff, *Is Economic Development Decision Making Rational?*, 27 Urban Affairs Quarterly 340 (1992) (noting that many subsidies are provided to corporations after they have already begun the project).

1. Overtaxation from Locating in Suboptimal Areas

Consider the previous example involving a firm wishing to locate a factory that is approached by communities from two locations. Location I is the most naturally advantageous to the firm, in terms of providing good transportation, inexpensive labor costs, and other natural advantages. Location II, in contrast, is the less attractive site. As in the previous example, assume that Location I's advantages over Location II's are equivalent, in monetary terms, to a lump-sum payment of $1 million. That is, the firm would require a payment of $1 million to locate in Location II as opposed to choosing the naturally attractive site of Location I. Now, assume that the firm eventually settles in Location II, and receives benefits with a fair market value of $1.5 million as an inducement to locate in that area.[138] Under the foregoing proposal, the firm would include the $1.5 million in taxable income. However, such a result would be incorrect and would overtax the firm—the firm's accretion in wealth was actually only $.5 million, which is the amount that should be included in income. The additional $1 million received by the firm over this amount merely serves to offset the disadvantages inherent in Location II, and should not be included in the firm's income because it is not an accretion to wealth.

Admittedly, some actual situations falling into this pattern would be overtaxed under the foregoing proposal. Although the perfect remedy would be to bifurcate somehow the payment received by the firm, and only include the $.5 million in income, such an approach would be inadministrable and unacceptably complex.[139] The only administrable way for the tax laws to deal with this phenomenon is an "all or nothing" approach.[140] Present law allows firms to completely exclude these contributions from income, while the law should instead require the entire amount to be included in income.

The first response to this problem of overtaxing the firm settling in Location II is to argue that overtaxation might actually be a desirable outcome. Overtaxation would promote economic efficiency by discouraging the firm from choosing Location II instead of Location I. The second response is that it is unlikely that many firms will choose Location II because of their ability to extract favorable concessions from Location I. Thus, the problem of overtaxation is a hypothetical one, and not especially likely to occur on a frequent basis in the real world.

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138. As previously discussed, in a perfectly competitive marketplace, Location II would only offer $1 million to the firm as an inducement for the firm to locate its factory. I have altered the example in the text immediately above, to illustrate the premiums that are likely to be received by the firm due to the presence of market failure in this area.

139. See note 24 regarding the need for less complexity in the tax law.

140. For previous discussion of this point, see notes 22-24 and accompanying text.

2. A Defense of Taxing Firms Locating in Suboptimal Areas

It is arguably desirable to overtax the firm by including the entire $1.5 million payment in the firm's income, even though $1 million of the payment represents compensation to the firm for the deficiencies of Location II and not economic income. Some scholars have noted that it might be inefficient for the firm to settle in Location II,[141] because that region possesses disadvantages (such as high manufacturing costs) that reduce the productivity of capital employed in the area. In other words, the economically desirable outcome is for the firm to build its factory in Location I, because that location offers an environment with lower costs and other increased efficiencies. Arguably, the nation's wealth decreases when Location II entices the firm to build its factory in tbat area, as opposed to the naturally preferable area of Location I.

Based on this argument, overtaxing the firm by including the entire $1.5 million in income is not necessarily a bad result. Such treatment will discourage the firm from settling in Location II, and will generally make it more difficult for high-cost jurisdictions to attract firms by offering them nonneutral incentives. Overtaxation of the firm will thereby reduce the pernicious effects of interstate rivalry, which manifest in nonneutral and inefficient locational incentives.

The problem with applying this argument in this particular situation is that the individuals living in Location II may value the positive externalities of economic development more than the individuals living in Location I. This discrepancy in the value placed on economic development may very well explain the difference in the bids offered by the two jurisdictions. Thus, it is not necessarily inefficient for a firm to settle in Location II, even though that location presents a higher-cost environment to the firm, if those higher economic costs are offset by additional utility obtained by the residents of that location. Consequently, the argument that nonneutral incentives offered by states are undesirable may fail to take into account the varying subjective preferences of the residents of those areas. Admittedly, the additional incentives offered by Location II to the corporation settling in its area are not necessarily reflective of the general population's preference for economic growth. Instead, the extent of preferences offered by Location II may reflect the degree to which special, pro-development interests control government activities and influence government appropriations. To the extent that the difference in bids reflects different degrees of special interest control over a locality's political apparatus, then the initial point remains and taxing the firm is acceptable. I am not aware of any

141. Shaviro, 90 Mich. L. Rev. at 900-03 (cited in note 38).

empirical evidence that would help determine which of these situations is more common in the real world, although observers of the market for economic development have repeatedly noted the importance of special interests in supporting local government efforts to obtain that development.[142] Thus, while this argument supporting overtaxtion is credible, I prefer the second argument, stated below, which relies on the thesis that these incidents of overtaxation will occur on a relatively infrequent basis.

3. The Relative Infrequency of Overtaxation

Consider again the previous example involving Locations I and II, and alter the example to reflect the more realistic assumption that many different locations are competing for firms in this market. For reasons discussed below, firms apparently are able to settle in areas having the natural advantages of Location I, while at the same time managing to extract incentive packages from those areas that they ultimately choose. Thus, in practice, firms obtain the best of both worlds—a business location with natural advantages and contributions from state and local governments to settle in the location that the firms likely would have adopted anyway. As a result, the hypothetical problem discussed above in which a firm would choose a less desirable site (Location II) in return for contributions from that area's governments, may occur on a relatively infrequent basis.

The conclusion that firms settle in areas that already possess natural business advantages is supported by evidence suggesting that firms determine the particular region in which to locate based on natural factors (access to customers and suppliers, costs of labor, availability of transportation, etc.) present in that region, without incentives offered by communities playing any significant role in this initial determination.[143] After having made this regional decision based on natural business advantages, a firm then decides on the particular site within the region. This latter decision may be influenced by competing offers the firm receives from various communities within the region.[144] In effect,

142. See notes 108-15 and accompanying text.

143. Rubin and Zorn, 45 Pub. Admin. Rev. at 335 (cited in note 71); Harrison and Kanter, 44 AIP J. at 430 (cited in note 28). See also note 144. The implication of such an argument is that the differences between regions of the country in transportation, raw materials, and other important variables are simply too large to be offset effectively by incentives offered to firms.

144. Jacobs, *Bidding for Business: Corporate Auctions and the 50 Disunited States* at 31 (cited in note 28) (stating that "[i]n general, the evidence indicates that investment subsidies are somewhat effective in moving industry to different areas within a state, rarely adequate to induce a firm to locate in a neighboring state, and almost never sufficient to lure a firm to another region of the country"). See Harrison and Kanter, 44 AIP J. at 428 (cited in note 28) (stating that "[o]nce a region (e.g., a state) has been selected, the choice of a particular location *within* that region may

after having narrowed the search to communities all roughly sharing the advantages of Location I, a firm then settles on a particular community based, in part, on the amount of contributions that the community offers to the firm.

Moreover, even if only one particular location (as opposed to several) is optimal for a firm, the firm can easily create a bidding war between that location and other less desirable locations, and thereby extract a concession from the jurisdiction that it would have chosen anyway.[145] The firm likely will succeed in such an endeavor for reasons already discussed. Because of asymmetrical or impacted information[146] the firm will be able to keep representatives of the optimal location from knowing how desirable their area is to the firm. Combining this informational advantage with the political pressure on officials to avoid losing business to other areas[147] creates a situation in which the firm readily extracts a concession from an area that is already optimal to the firm.

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turn on interjurisdictional variations in costs and site amenities. However, tax differentials appear, from recent research, not to be particularly important at this level either"). See, for example, Rubin and Zorn, 45 Pub. Admin. Rev. at 333, 335 (cited in note 71) (concluding that incentive packages play little or no role in a firm's choices among regions); Tolchin and Tolchin, *Buying Into America* at 62-64 (cited in note 36) (concluding that for a Japanese firm locating in Georgia, "incentives played an important part but a very minor one, and only at the very last stage of the process;" later, the author describes the incentives as "icing on the cake" and "easily duplicated almost anywhere else").

145. As an example, see the following:

> Shervin Freed, vice president of . . . the Chicago-based consulting firm [which assists corporations in choosing plant sites] said that he recently examined one deal where rival states had engaged in a bidding war for a small manufacturing plant. The highest bidder was ultimately the winner. But it would have been anyway, because of looser environmental regulations and transportation cost advantages that amounted to several hundred thousand dollars a year. "Of course they didn't know that," he said. He said that his firm typically advised clients who have pretty much decided on a location in one state to choose a backup in another, just because it may pry loose some extra incentives for the first choice to feel some competition.

Gaynor, Pittsburgh Post-Gazette § 1 at 29 (cited in note 36). See also Brandt, Business Week at 36 (cited in note 97) (suggesting that General Motors adopted this strategy with respect to its Saturn automobile plant); Glastris, 107 U.S. News & World Rep. at 40 (cited in note 98) (suggesting that Sears & Roebuck employed such a strategy when it chose the community of Hoffman Estates to relocate its corporate headquarters, by putting pressure on Hoffman Estates officials to sweeten their incentive package through indicating, falsely, that Sears was seriously considering the city of Chicago as an alternative cite); Hatfield, Setzer and Carr, Engineering News-Record at 20 (cited in note 62) (quoting Larry Ledebur, an expert on the economic development market, as saying that "[g]overnors throw money at firms that would locate there anyway without the tax abatements"); Fiordalisi, Automotive News at 18 (cited in note 98) (suggesting that a similar phenomenon occurred in forcing Kentucky to pay more than necessary to attract an automobile plant to the state).

146. See notes 118-19 and accompanying text.

147. See notes 97-98 and accompanying text.

Concededly, firms may occasionally locate in suboptimal areas. Nevertheless, such settlement activities occur on a relatively infrequent basis compared to the number of firms settling in optimal areas. Thus, the foregoing proposals would not create a significant risk of overtaxation, although admittedly some firms would be overtaxed.

Based on this analysis, I believe that the amounts received by firms for economic development are more likely to represent accretions to the firm's wealth, as opposed to offsets that serve to make up for natural deficiencies occurring in the particular community. Although such an approach has its inaccuracies, in the aggregate it appears to measure more properly a firm's income than the present law approach, which allows a complete exclusion of these amounts.

IV. Transaction-Specific Assets

A. Background and Description

In this section of the Article, I discuss the second category of nonshareholder contributions to capital, which involve contributions by customers to corporations of specialized assets, or "transaction-specific assets," that are used in future transactions occurring between the two parties.[148] Transaction-specific assets are defined by their one central trait: once these assets are committed to a particular project, their economic values become greater when used for specific types of functions, than when used for other general purposes.[149] The federal income tax laws generally require that a corporation receiving contributions of these transaction-specific assets include the fair market value of the assets in its taxable income.[150] Similarly, current law would tax a corporation receiving a contribution of cash that was earmarked to be used in the construction of such an asset.[151] The stated rationale is that such contributions represent compensation being paid to the corporation for services the corporation will provide in the future.[152] Under this ration-

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148. See note 10 and accompanying text.

149. Williamson, *Antitrust Economics* at 64 n.39 (cited in note 10).

150. See note 8.

151. Generally, corporations receiving these contrihutions are in the same economic position, regardless of whether the contributions are received "in-kind" in the form of the transaction-specific assets themselves, or, alternatively, in earmarked cash. Under my proposals, both types of contributions would generally be excluded from the recipients' income. Similarly, the corporate receipient would not have any tax basis in assets so excluded from its income. However, in-kind contributions should be treated differently from cash contributions in one situation. When a corporation receives cash contributions in excess of those amounts necessary to construct transaction-specific assets dedicated to the customer, the corporation should be taxed on those excess amounts received. In such a situation, the corporation is earning revenue from serving as a constructor of the transaction-specific asset, and therefore should be currently taxed on such construction income. Monies that were spent on constructing the transaction-specific asset, however, still would be excluded from the corporation's income under my proposals.

152. *Blue-Book-1986 Act* at 544-45 (cited in note 8).

ale, the person making the contributions is prepaying for future services to be received from the corporation; such prepaid income is generally taxable to the corporation upon receipt.[153] I believe this rationale is incorrect and that the corporation has not received income in any form (whether prepaid or not) from receiving the contribution. In my view, the corporation does not experience an accretion to wealth that would justify the taxation of the contribution.[154]

These contributions in aid of construction are generally made for the purpose of engaging in specific, future transactions with the recipient corporation. I already have referred to the example involving a home-owner contributing a water line to a utility as a condition of receiving water services from the utility.[155] Other transactions also share this common feature of specialized assets being contributed to another party who will use those assets in providing future services to the contributors. For example, an automobile manufacturer may contribute specialized dies to a subcontractor, in order that the subcontractor might produce automobile bodies for the manufacturer under the manufacturer's specifications.[156] As another example, a group of individuals living in a remote area might collectively contribute a large antenna (or cash necessary to construct the antenna) to a corporation that would use the antenna in broadcasting television programs to their homes.[157]

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153. For a general discussion of the law taxing prepaid income upon its receipt, see note 9. For an insightful analysis of these various rules and their economic impact, see Robert H. Scarborough, *Payments in Advance of Performance*, 69 Taxes 798 (1991).

154. Of course, since contributions of transaction-specific assets would be excluded from the recipient corporations' income, they would receive no tax basis in such assets. For a discussion of the significance of this point, see note 6.

155. See note 8. Under the tax laws, a technical distinction exists between contributions in aid of construction and "customer connection fees." Briefly, the former term includes contributions made to a utility on behalf of two or more customers desiring utility services, while customer connection fees involve only contributions made on behalf of one customer. IRS Priv. Ltr. Rul. 8723023 (Mar. 6, 1987). (But see Nov. 5, 1987 Letter from Edison Electric Institute to Mr. Geoffrey Taylor, Associate Director-Corporation Tax 2 of the Internal Revenue Service expressing the argument that transmission lines servicing only one customer are nevertheless contributions in aid of construction, and not customer connection fees.) Although the bistorical tax treatment of these two different contributions differs, for the purposes of this Article such distinctions are completely unimportant. All of the analysis and proposals made in this Article with respect to contributions in aid of construction also apply to customer connection fees, and hereinafter the former term will encompass both concepts.

156. For a study of these general practices involving General Motors, Ford, and their suppliers, see Kirk Monteverde and David J. Teece, *Supplier Switching Costs and Vertical Integration In The Automobile Industry*, 13 Bell J. Econ. 206, 207 (1982).

157. See *Teleservice Co. of Wyoming Valley v. Commissioner*, 27 T.C. 722 (1957), aff'd 254 F.2d 105 (3d Cir. 1958), in which a corporation that collected cash contributions to construct such an antenna was held to be taxable on the contributions. Under this Article's proposal, a corporation receiving cash to construct transaction-specific assets would not be taxed to the extent that such cash was spent in the construction activities. To the extent, however, that firms received cash in excess of costs they incurred to construct these assets, such excess amounts would be included

Similarly, a corporation manufacturing a particular product might contribute a sales building to a person selling its product, with the building to be used to facilitate the sales efforts.[158] The difference between this type of contribution involving transaction-specific assets and contributions for economic development is that contributions for economic development are typically not made by the governments in order to engage in future transactions with the corporations, such as purchasing goods or services.[159] Rather, the contributions are made simply for the purpose of benefitting from the economic development provided by the corporate presence in the area.

B. *Illustrative Example: Transaction-Specific Asset*

To illustrate these problems involving transaction-specific assets, assume a manufacturing firm is determining how to ship its manufactured goods to customers. Assume that the firm has two alternatives in shipping its goods. The firm can use a trucking service and ship the goods over the public highways at a cost of $200,000 a year. This alternative involving the use of trucks to ship the goods does not require the firm to make any initial capital investments; the annual payments of $200,000 are the only expenditures required under this arrangement.

Under a second alternative, the firm could ship the goods using the services of a railroad that owns and operates a rail line close to the

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in their income and currently taxed.

158. See *John B. White, Inc. v. Commissioner*, 55 T.C. 729 (1971), aff'd, 458 F.2d 989 (3d Cir. 1972), in which a corporation receiving such a contribution was held to have recognized gross income, thus increasing the corporation's federal income tax payments. See also note 54 for a discussion of cases involving contributions of land by developers to corporations, which are more akin to payments for economic development, and hence are excluded from income.

159. Occasionally, state and local governments do provide bids to corporations as locational incentives that include arrangements under which the government would be obligated to purchase goods from the corporation at a later date. For example, the state of Texas made a recent bid to retain a General Motors ("GM") plant in Arlington, Texas, by offering to purchase GM's automobiles for the state fleet at a later date. Hornbeck, *"Michigan to Match Texas in Bid to Keep GM Plant,"* Gannett News Serv. (Jan. 15, 1992). The implications of these arrangements are unclear. If Texas, for example, were to obtain automobiles at a discount price from GM at a future date, then the initial contribution made by Texas to GM would constitute prepaid income to GM. Prepaid income is generally outside the scope of this Article, although I believe that present law generally overtaxes GM by requiring the prepaid income to be recognized immediately when received. See note 240. If, in contrast, Texas obligated itself to purchase automobiles from GM in the future at an inflated price, then the amount of the excess price would be an additional contribution made by Texas to GM as a inducement to settle. The discounted present value of the contribution would be viewed as immediately received by GM, and would be excluded from its income. Normally, the growth in value of the contribution until it was actually received upon the purchase of the automobiles would be taxable interest to GM. However, such interest might be excluded from GM's income under I.R.C. § 103 (West 1992). In any event, these types of governmental bids involving future purchase obligations appear to occur quite infrequently, and thus do not represent an important exception to the general practice described in the text.

factory. The annual payments required if the firm chooses this rail alternative are only $100,000 a year. However, to ship the goods using the railroad requires the firm to construct a one-mile "spur" track from the factory to the main rail line.[160] The railroad refuses to extend rail service to the factory unless the firm pays for the construction of this one-mile rail spur.[161] This spur track can be constructed by the firm for a cost of $1 million. This spur track is useful to the firm only if it chooses to ship its equipment over the rail line. The track is worthless for any other function; thus the track's "salvage value" is zero.[162]

The spur track is an example of a transaction-specific asset.[163] Here, the entire value of the track, once constructed, pertains to the specific purpose of shipping equipment from the factory to the main rail line. In this situation, the specificity of the asset is determined by its location or site, i.e., "site specificity".[164] Because of the immobility of the track, once the asset is constructed its value becomes highly specific to the particular site where it is located. The asset has no value for use in other sites, largely because of the cost of moving the asset.[165]

Notice that by investing $1 million, the firm initially expects to re-

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160. For a study of such arrangements, see Russell Pittman, *Specific Investments, Contracts, and Opportunism: The Evolution of Railroad Sidetrack Agreements*, 34 J. Law & Econ. 565 (Oct. 1991). Although Pittman describes these structures as "sidetracks," id. at 567, I prefer the alternate designation of "spur track" or "spur," Id. at 582.

161. Alternatively, the railroad could construct the spur track itself, and recover the costs of its investment by increasing the charges made to the manufacturing firm for transportation services. Several reasons exist why the railroad might not pursue this approach. The railroad, for example, might have difficulties raising the necessary capital to finance the construction of the track; the manufacturing firm might be able to raise the capital more readily, at lower costs to the firm. For a suggestion that this rationale plays a role in structuring these types of transactions for utilities in general, see Letter and accompanying position paper from Public Service Commission State of Florida, to Assistant Secretary of the Treasury, J. Roger Mentz (Apr. 18, 1986) (on file with author). Similarly, the railroad might not be willing to take the risk of investing in the track and failing to receive an adequate return on its investment in the event the manufacturing firm were to go out of business or were unable, for other reasons, to provide the railroad with sufficient revenues to justify the railroad's investment. See Pittman, 34 J. Law & Econ. at 586, who suggests that the ability of manufacturing firms to resort to other forms of transportation creates significant risks for the railroad, thus resulting in the firms being required to construct these spur tracks themselves. Moreover, in situations in which the corporation occupying the position of the railroad was a regulated public utility, the regulatory rate structure governing the utility likely would prevent the utility from selectively increasing rates to one customer to help pay for the cost of this investment. Instead, the utility would be required to charge the same price per unit of service to all customers, thus effectively preventing it from making specific investments tailored to the needs of a particular customer.

162. For purposes of simplification, my example states the track's salvage value at zero. Although certain costs of constructing the spur track may be irretrievable, metals and other materials used in the construction may be salvageable for other purposes. Pittman, 34 J. Law & Econ. at 567.

163. See notes 148-49 and accompanying text.

164. Williamson, *Antitrust Economics* at 64 (cited in note 10).

165. Id. Compare note 162.

duce its annual shipping costs from $200,000 to $100,000. Thus, the $1 million investment is earning a ten percent rate of return to the firm, i.e., $100,000 a year.[166] The firm will make this investment if alternative uses of the $1 million would yield a rate of return inferior to the ten percent rate available from the investment. Assume, for example, that the next best alternative available to the firm, adjusting for the risk of the particular investments,[167] would provide an eight percent annual rate of return to the firm, or $80,000 a year. The firm would then prefer to construct the spur track, since the ten percent anticipated return on the track exceeds the rate of return available from all competing investments. Notice also, assuming social rates of return equal private rates of return,[168] that the construction of the track is an economically efficient investment, since the resources deployed in the track are earning a higher rate of return in that form than in any other competing investment. Thus, economic wealth is generally increased if this investment is made by the firm.[169]

Assume that the firm proceeds with the construction of the spur track and ships its equipment using the railroad, paying the railroad $100,000 for the service. In this example, the economic return from the spur track is inuring to the benefit of the firm, not the railroad, in that the firm is receiving the advantages of the lower rail rates in comparison to the higher rates charged for trucking. On first impression, the railroad itself has no accretion to wealth from the construction of the track, since the railroad simply continues to charge the market rate for its services of $100,000 a year.[170] This is the critical point regarding

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166. For purposes of simplicity, I am assuming that the rail track has a permanent life, and thus does not depreciate, nor require annual maintenance. The introduction of additional complexities such as depreciation would not substantively alter the conceptual analysis in the text, but rather would complicate the model and interfere with its clear presentation.

167. Since rates of return increase with the riskiness of a particular asset, adjustments for differences in risk in order to assess the desirability of two different investments are necessary. Henry T. C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 U.C.L.A. L. Rev. 277, 286-87 (1990).

168. The assumption that social rates of return equal private rates of return is simply another way of saying that the assets in question do not produce externalities (either positive or negative) that would cause their social values to deviate from their private values. Rosen, *Public Finance* at 62 (cited in note 4); Samuelson, *Economics* at 450 n.10 (cited in note 4) (discussing private costs versus social costs); Henry T. C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. Pa. L. Rev. 333, 367 (1989). For a discussion of externalities, see note 4.

169. See Williamson, *The Economic Institutions of Capitalism* at 32 (cited in note 10), who explains this gain in wealth by noting that "[a]ssets here are specialized to the particular needs of the parties. Productive values would therefore be sacrificed if transactions of this kind were to be prematurely terminated." See also Pittman, 34 J. Law & Econ. at 565 (cited in note 160), who notes that the "[m]aximization of joint long-term profits in a purchaser-supplier relationship often requires investment in assets that are in some way dedicated to the specific relationship".

170. Admittedly, the railroad may realize an accretion to wealth occurring from the acquisi-

these types of transactions—the railroad does not have income from the construction of the spur track by the manufacturing firm, because the railroad will not be raising its prices (or lowering the quality of its services and retaining the same prices) in response to the construction of the track. Later, this Article discusses whether this assumption regarding the railroad's behavior is generally reasonable. For now, the reader should assume that this is the case and consider the resulting consequence: The railroad does not experience an accretion to wealth by virtue of the manufacturing firm constructing the track.

C. *Treatment Under Present Law*

The current federal income tax treatment of these transaction-specific assets depends on legal niceties surrounding the form in which the parties arrange their affairs, rather than upon the substance of the arrangement. If, in the example involving the manufacturing firm constructing the spur track, the firm retains legal ownership of the track and does not convey the track to the railroad, the tax laws reach what is generally the correct result—the firm is regarded as the owner of the track and the railroad does not recognize taxable income from the firm's investment in the track.[171] Thus, no taxable income is generated in such a situation; the firm capitalizes[172] its costs of constructing the track and treats the track as any other asset used in its business.[173]

Unfortunately, for primarily technological reasons,[174] many transactions involving these types of assets follow a different pattern in

tion of a new customer committed to doing business with the railroad. For discussion of this point, see notes 190-96 and accompanying text.

171. Since the manufacturing firm has not transferred property to the railroad, the railroad will not recognize any income from the former party by constructing the spur track. For the importance of legal title in determining the taxation of these transactions, see IRS Notice 87-82 at 390 (cited in note 5).

172. The term "capitalize" is used to mean that the firm is not allowed to immediately deduct the costs of the expenditure in computing its taxable income, but rather is required to treat these costs as creating a capital asset that has future value to the firm. Bittker and Lokken, 1 *Taxation of Income* at ¶ 20.4.1. (cited in note 3).

173. Thus, the manufacturing firm would be allowed to depreciate the costs of the rail track. I.R.C. § 168 (West 1992).

174. For example, when these arrangements involve a utility and a prospective customer, the customer may be required to transfer the asset to the utility in order that the utility may control and monitor the integration of the asset into its utility "grid" or system. Thus, in order to protect the integrity of the utility infrastructure, and to avoid the possibility of legal liabilities resulting from a failure in the utility system, the utility receives the asset from the customer. See Letter from Edison Electric Institute to Treasury Tax Legislative Counsel Dale S. Collinson 2 (Nov. 21, 1975) (on file with author) (stating that the "utility acquires ownership of the facility in name only. The utility has a duty to retain this ownership for the benefit of the public in connection with possible tort liability, continuity of title, and maintenance, repair, and replacement, in accordance with regulatory standards."). For similar explanations involving closely analogous situations involving transfers of properties to utilities, see Letter from Covington & Burling to Treasury Tax

which title to the transaction-specific asset is transferred from one party to the other. When such a transfer of the asset occurs, the tax laws require the corporation receiving the asset to recognize income, which I believe to be incorrect.[175] Assume, for example, that the firm constructs the spur track and then transfers legal title to the track to the railroad. In addition, assume that the arrangement between the parties is otherwise unchanged; the firm continues to pay $100,000 to the railroad for the annual services. Under current law, the railroad will recognize $1 million in taxable income upon receipt of legal title to the spur track.[176] Moreover, the firm will still be required to capitalize the costs of constructing the track as an asset,[177] with no deduction allowed to the firm by virtue of the transfer.[178] As previously discussed, this result is clearly incorrect; the railroad does not have an accretion to wealth equal to $1 million. Indeed, subject to caveats discussed later,[179] the railroad's accretion to wealth is equal to zero.[180] The railroad does not experience an accretion to wealth from receipt of the legal title to the spur because the economic rate of return generated by the spur is inuring to the manufacturing firm, not to the railroad. Accordingly,

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Legislative Counsel Dennis Ross 1 (Feb. 19, 1988) (on file with author) (asserting that the transfer of legal title occurs so that the utility prevents damage to its transmission system); Letter and accompanying memorandum from Covington & Burling to Treasury Attorney Advisor Robert Scarborough 8 (Apr. 8, 1988) (on file with author) (stating that the "utility demands access to, or supervision and titular ownership" of asset to protect the integrity of the rest of the utility's system). In other situations, transfer of title may be important in consolidating ownership of the asset, so that licensing requirements and other transaction costs are minimized. One would infer, for example, that such considerations were dominant in *Teleservice Co. of Wyoming Valley v. Commissioner*, 27 T. C. at 723-24, in which a group of subscribers contributed the costs of constructing an antenna to a company, with the antenna to be used by the company in broadcasting television to the subscribers. One can imagine that licensing requirements and other practical problems would have been unmanageable if the individual subscribers had retained legal title to the antenna and not transferred it to the company.

175. See IRS Notice 87-82 at 389-90 (cited in note 5). See also IRS Rev. Rul. 75-557, 1975-2 C.B. 33, which strongly implies that such a result would occur in the specific situation involving a railroad. For the history surrounding Rev. Rul. 75-557, see *Andrews Taxation* at 333-36 (cited in note 2).

176. IRS Notice 87-82 at 390 (cited in note 5) provides that the amount included in the corporation's income in such a situation typically will be the "replacement cost" of the property received. In the example discussed in the text, the replacement cost of the rail track would be approximately $1 million, since the firm had recently constructed the track for that amount and then immediately transferred it to the railroad.

177. See note 172 for the meaning of the term "capitalize."

178. See, for example, IRS Notice 87-82 at 392, which requires the firm to capitalize the cost of the asset, with the firm then being allowed to depreciate (or amortize) the cost of the asset over time, assuming certain conditions are met.

179. See notes 162-79 and accompanying text.

180. For more specific defenses of this position, see notes 194-96 and accompanying text (discussing situations in which the railroad is a monopolist), and notes 214-15 and accompanying text (discussing situations in which the railroad might appropriate the asset for its own benefit).

under this Article's proposals, taxpayers receiving contributions of transaction-specific assets to be used in future transactions between themselves and the contributor would exclude these contributions from their income in their entirety.[181]

This incorrect treatment of the railroad under present law is based on the notion that the firm has prepaid the railroad in advance for services the railroad will perform in the future.[182] Thus, this "prepaid income" is immediately taxable to the railroad, upon receipt, even though the income might not be "earned" until a later date. Here, again, the law incorrectly characterizes this transaction. Although the railroad has insisted, for various business reasons,[183] that the manufacturing firm contribute the rail spur as a condition of the railroad providing services to the firm, it is quite strained to insist that the value of the spur represents a prepayment by the firm to the railroad for services, and that the railroad should be taxed on the fair market value of the spur. Rather, the railroad has simply insisted that the customer bear the cost of constructing this spur, which is highly specific and specialized to a particular function, before the railroad will provide services to the firm at its standard price. The fact that the firm is bearing the economic cost of the spur does not mean that the railroad has an accretion to wealth equal in amount to the fair market value of the spur.[184] In short, the firm has not prepaid the railroad for services; the firm has simply incurred capital expenditures necessary for the railroad to provide future services to the firm at its standard rates.

D. *Effects of Overtaxation Under Present Law*

This example illustrates the pernicious effects created by present law's overtaxation of these transactions. Assuming that both the railroad and the firm are aware of the taxation of this transaction before it occurs, the railroad will demand that the firm indemnify it for the taxes

181. Of course, if my proposals were adopted, firms excluding contributions of transaction-specific assets from their income would have no tax basis in the assets. That is, having excluded the receipt of such assets from their income, firms would not be allowed to depreciate or otherwise recover any costs of those assets. See note 6 for a discussion of a similar rule that presently applies to contributions received for economic development. For more specific defenses of this position, see notes 194-96 and accompanying text (situations in which the railroad is a monopolist), and notes 214-15 and accompanying text (situations in which the railroad might appropriate the asset for its own benefit).

182. See note 9.

183. Such reasons might include, for example, the relative abilities of the two parties to obtain capital for the transaction, or the preference of the parties for bearing the risk of this investment. See note 161.

184. For a similar analysis, see the dissenting opinion of Tax Court Judge Kern in *Teleservice Co. of Wyoming Valley*, 27 T.C. at 732-33.

it pays upon receipt of the rail spur.[185] This indemnification amount demanded by the railroad could be as high as $515,000.[186] Thus, if this were to occur, the firm would have to pay a total of $1,515,000 in order to construct the spur and complete this transaction; $1 million in the costs of constructing the track, and a $515,000 indemnification payment made by the firm to the railroad.

Moreover, because of the overtaxation of this transaction, the firm will now find it unattractive to construct the rail spur even though the investment of capital in the rail spur was an economically efficient transaction that resulted in an increase in wealth.[187] The firm will not construct the rail spur because the firm now will be required to invest $1,515,000 in order to earn $100,000 a year, for an annual rate of return equal to 6.6 percent. Now, comparing the 6.6 percent rate of return offered by the rail spur with the eight percent rate of return available from alternative projects results in the firm choosing the alternative projects over the rail spur. Thus, the tax laws, by overtaxing these types of transactions, may be creating a misallocation of resources by inappropriately lowering the rate of return from certain investments and driving capital away from those particular areas of the economy.[188]

E. Problems with My Proposals Regarding Transaction-Specific Assets

Based on the foregoing analysis, I propose that corporations receiving contributions of transaction-specific assets should not recognize taxable income from the transactions. Instead, the tax laws should regard the transaction as if the person contributing the asset to the corporation is still the economic owner of the asset.[189] Although, as discussed below, this proposal is not perfect, it would substantially improve the taxation of these contributions in comparison to the treatment under present law.

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185. See note 48. Admittedly, this assumes that the incidence of this tax is on the customer, as opposed, for example, to the railroad's shareholders. See note 25 for a discussion of the incidence of a tax.

186. For a discussion of how this amount is derived, see note 50.

187. Again, this assumes that social rates of return equal private rates of return, or, phrased differently, that the railroad track would not have generated negative externalities that would cause the social value of the track to be less than its private value. See note 168.

188. As previously discussed, any strong claims that this result was allocatively inefficient would first have to resolve second best problems associated with such an argument. See note 53.

189. Thus, the person making the contribution would still continue depreciating the asset as if it were still directly owned by that person. The corporation receiving the contributed asset would treat the asset as if it were not owned by the corporation. For example, the tax basis to the corporation of the contributed property would be zero. See note 6.

Admittedly, situations would exist in which the railroad would realize economic income from the construction of the track by the manufacturing firm. First, the railroad might experience economic income simply from acquiring another customer to purchase its services, with the manufacturing firm's construction of the track indicating the firm's intention to become such a customer. Second, the railroad might be able to "appropriate" the economic benefit of the track for the railroad's own use, as opposed to allowing the benefits of the track to inure to the manufacturing firm. The following sections discuss both of these possibilities, while explaining why neither presents fatal problems to the general thesis that the railroad should not be taxed on this transaction.

1. Acquisition of a New Customer

The conclusion that the railroad has no economic income from the receipt of the spur track may be erroneous if the railroad is operating in a market of imperfect competition and has an accretion to wealth by obtaining the manufacturing firm as another customer. The important point here is that the manufacturing firm, by constructing the spur track, is signaling an intention and commitment to purchase future services from the railroad at its standard prices.[190] If the railroad was operating in a perfectly competitive market within a state of equilibrium, the railroad would have no immediate accretion to wealth upon receipt of the asset. In such a market, the prices charged by the railroad to customers for its services would exactly cover the railroad's costs of generating those services, with costs being expansively defined to include a competitive rate of return to the shareholders of the railroad.[191] Consequently, the railroad would not experience an immediate accretion to wealth merely from a firm "signing-up" to purchase future services from the railroad. This is because the prices charged to the firm would not provide the railroad with an economic profit, but rather would only cover the railroad's costs.[192]

Assume, in contrast, that the railroad is not operating in a perfectly competitive marketplace, but rather, that the railroad is a monopolist or an oligopolist[193] and is able consistently to earn economic profits by

190. The fact that the asset is transferred to the railroad is largely irrelevant here. The initial construction of the asset by the manufacturing firm, irrespective of whether the asset is transferred, is the critical point that signifies the intention of the firm to do future business with the railroad.

191. Samuelson, *Economics* at 445-46 (cited in note 4).

192. Of course, in future years, as the railroad earns its normal competitive rate of return from the new customer, it would recognize taxable income and be taxed accordingly. My point here is that the railroad does experience an immediate accretion to wealth from the new customer when the spur track is constructed.

193. See note 129. Such assumptions of monopoly or oligopoly power would have been war-

charging higher prices for its services that reflect its market power. Now, in such a situation, the railroad would experience economic income from having a new customer commit to purchase future services from the railroad, since the standard prices charged by the railroad result in the railroad earning oligopolist profits. That is, every new customer acquired by the railroad at the railroad's standard prices for services would increase the railroad's wealth, since each customer would provide more revenues and profits to the railroad.[194] Therefore, my earlier conclusion that the railroad has no economic income from the transaction would be incorrect.

This result does not, however, justify taxing the railroad upon the receipt of the asset from the firm. In such a market, the railroad would have economic income from any new customer that it acquired, irrespective of whether that new customer contributed a transaction-specific asset to the railroad. For example, assume a second manufacturing firm opens a manufacturing plant that is located immediately adjacent to the main rail line. Also assume that the second firm does not require the construction of a spur track in order to use the railroad to ship its manufactured product. In such a situation, the railroad would have economic income merely from the addition of the second manufacturing firm as a new customer. Thus, the construction of the transaction-specific asset is irrelevant to whether the railroad has income.[195] The railroad has income from both manufacturing firms intending to use its future services, although only one firm contributed an asset to the rail-

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ranted especially earlier in the nation's history when railroads occupied a unique position in the transportation industry. In fact, railroads were regulated during those years in recognition of such power. However, in modern times, this market power has been widely dissipated, with the trucking industry and other nonrail competitors becoming increasingly important alternatives to rail transportation.

194. An examination of the actual arrangements regarding spur tracks provides support for the theory that the railroad benefits from the addition of a new customer. Based on Russell Pittman's study of these arrangements, the customer typically is required to pay for the costs of constructing the track. However, the railroad will then refund or rebate to the customer the construction costs so incurred, based on the amount of subsequent business provided the customer by the railroad. See Pittman, 34 J. Law & Econ. at 573, 586-87 (cited in note 160). This suggests that the railroad is in a situation of imperfect competition. The railroad would not be willing to pay the firm for additional business in the form of these refunds if the railroad's charges for that business were set in a perfectly competitive market only covering the railroad's costs. However, in this situation the contractual arrangement made by the parties reduces the amount of income realized by the railroad upon its acquisition of a new customer. Although the new customer may represent an asset to the railroad, the railroad has also incurred an offsetting liability in the form of its obligation to refund the costs of the track to the customer over future periods. Thus, it remains unclear as to whether the railroad experiences an accretion to wealth from its acquisition of the customer, and if so, how the accretion should be measured.

195. The construction of the transaction-specific asset is not, however, irrelevant to the separate issue of whether the railroad may have income by appropriating the quasi-rents generated by the asset. For further discussion of this point, see notes 197-201 and accompanying text.

road. Moreover, the amount of the economic income actually realized by the oligopolist railroad would generally bear little, if any, relation to the value of the transaction-specific asset contributed to the railroad. For example, two manufacturing firms might become customers of the railroad, with each firm representing the same amount of potential future business to the railroad. Thus, the railroad would experience an equal accretion to wealth from each firm. However, under present law, if one firm contributed a track of one mile in length to the railroad, with the second firm contributing a track two miles long, the railroad would recognize twice the taxable income from the first contribution as from the second contribution. In short, there is no administrable manner in which present law could accurately tax the oligopolist railroad from the income realized from acquiring another customer. The tax laws reflect a recognition of this problem, in that they generally treat all oligopolists in the same manner by allowing deferral of income recognition from the acquisition of new customers until subsequent periods when those customers actually receive services from the oligopolist.[196] Such an approach should be followed in this case as well, since the same problems that have stymied present law's attempt to deal with the general problem fully apply to this situation.

2. Appropriation of the Asset by the Railroad

The literature dealing with transaction-specific assets has recognized that such assets have peculiar characteristics that create unusual risks for their owners. These risks exist because these assets generate "quasi-rents"[197] that are vulnerable to appropriation by other parties. A

196. This point is so deeply imbedded in the tax law that finding specific authority for its validity is difficult. Inferentially, this result is implied by the tax law's treatment of firms incurring advertising costs, which undoubtedly attracts new customers. Firms engaging in advertising are allowed to deduct immediately the costs of such advertising, while deferring recognition of the increase in wealth generated by the advertising until the wealth is actually "realized" by a subsequent increase in the firm's business. *Graetz Taxation* at 202-03, 359 (cited in note 2).

197. The term "pure economic rent" generally refers to the values (or returns) attached to assets whose quantities are fixed (inelastic), and that can be used for only one purpose. Land that is only useful for raising one type of crop is an asset having pure economic rent. Because their owners have only one use for these assets, the assets will be employed in the economy regardless of the returns paid to their owners for the assets. Samuelson, *Economics* at 526-27 (cited in note 4). The term "quasi-rent" generally refers to values (or returns) attached to assets whose supply is temporarily fixed (or temporarily inelastic). Id. at 527 n.3. Such assets generate rent-like returns, because, during the phase when their quantity is fixed, their owners again are forced to take whatever the market will pay for the assets. Due to the fact that transaction-specific assets, once employed, are "locked-in" and are useful for a specific purpose (and to a lesser extent, for any other purpose), the values of those assets takes on a character of rent (quasi-rent). With respect to transaction-specific assets, the "quasi-rent" is defined as the value of the asset attributable to its specialized fixed use. This amount is the difference between the value of the asset used for its most productive purpose, and the value of the asset used for its second best purposes. If the asset is

quasi-rent is simply an economic return or benefit provided by a particular asset that is attributable to its use in a specific, specialized function once the asset is committed to that function. If, for example, a transaction-specific asset generates an economic benefit[198] of $100 a year when the asset is committed to and subsequently used in a specialized function, and if that asset would yield only $30 a year when employed for any other use, then the $70 difference is a quasi-rent. Another party could appropriate, for itself, a portion (or all) of the $70 quasi-rent, without causing the asset's owner to abandon the present project and to use the asset for other purposes. Thus, if another party were to appropriate $20 of the annual return from the asset, then $80 annually still would be available to the asset's owner. If this were to occur, the owner would continue to use the asset for the same specialized function, because the $80 return actually available to the owner would still exceed the $30 benefit available by employing the asset for other purposes.

My assumption that the railroad, in the previous example, does not have economic income from the construction of the spur track by the manufacturing firm is based on the assumption that the railroad is not able to appropriate any of the quasi-rents generated by the track. This assumption is consistent with the underlying premise of the economics literature regarding transaction-specific assets, that the quasi-rents generated from these transaction-specific assets will inure to the benefit of the firm that makes the investment in the assets (the first party), unless the other party to the transaction manages to "appropriate" some of these quasi-rents for itself.[199] Appropriation of the asset's quasi-rents

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useful for no other purpose, then the quasi-rent will be the difference between the value of the asset used for its most productive purpose and the salvage value of the asset. Klein, Crawford, and Alchian, 21 J. L. & Econ. at 298-99 (cited in note 10).

198. Such benefits might consist, for example, of additional revenue from a project, or a reduction of expenses incurred in the project.

199. See Klein, Crawford, and Alchian, 21 J. L. & Econ. at 298-99, for a numerical example of this premise. For a sample of this premise reflected in the literature, see Joskow, 1 J. L. Econ. & Org. at 37-39 (cited in note 10). For a discussion of the appropriation by other parties of quasi-rents generated by transaction-specific assets, see Monteverde and Teece, 13 Bell J. Econ. at 206-07 (cited in note 156) (discussing the organizational structure adopted by the automobile industry to protect against the appropriation by other parties of quasi-rents resulting from specific investments); Palay, 13 J. Legal Stud. at 265-66 (cited in note 10) (stating that idiosyncratic investments generating quasi-rents in the rail freight industry result in contractual relationships designed to prevent other parties from appropriating these rents); Scott E. Masten, *The Organization of Production: Evidence From the Aerospace Industry*, 27 J. Law & Econ. 403, 405 (1984) (stating that as specialization of assets increases in the aerospace industry, a similar increase occurs in organizational costs incurred to prevent appropriation of quasi-rents generated from these assets); Williamson, *The Economic Institutions of Capitalism* at 30-32 (cited in note 10) (discussing a tabular presentation of organizational structures adopted to reduce the risk of quasi-rent appropriation by opportunistic behavior).

will occur if the other party is able to raise the prices (or lower the quality) of the services it provides to the first party, knowing that the first party will be forced into accepting the new arrangement because it is "locked into" the transaction by virtue of investing in the asset. If, in contrast, the other party does not succeed in appropriating the quasi-rents generated by the asset, then the investment in the transaction-specific asset by the first party will not result in economic gain to the other party. Economic gain does not inure to the other party because the value of the asset, which consists of all future streams of the returns generated by the asset,[200] is economically enjoyed in total by the first party.

If, in contrast, the railroad were able to appropriate some of the quasi-rents generated from the asset, then, admittedly, taxing the railroad on its resulting accretion to wealth would be entirely proper.[201] In such a situation, the economic benefits of the asset would accrue to the railroad, and hence the railroad would have increased its wealth by essentially confiscating the asset without incurring an obligation to pay for the property. This section of the Article discusses how an appropriation might occur and illustrates the consequences of such an event.

Again, the economics literature provides substantial assistance in analyzing this problem.[202] Continuing with the previous example, the railroad could appropriate the quasi-rents generated by the rail spur by engaging in opportunistic behavior after the manufacturing firm had already constructed the spur. Risks of opportunism arise because the relationship between the manufacturing firm and the railroad consists of a bilateral monopoly, defined to mean a situation in which the parties to a transaction view each other as the only available person with which to conduct the transaction.[203] Bilateral monopolies arise from transaction-specific assets, because the nature of these assets ensures that a continuing, ongoing relationship exists between the two parties, and that the parties cannot sever this relationship without incurring a significant economic cost. In the case involving the firm and the railroad, the abandonment of the relationship between the two parties would necessitate the abandonment of the spur rail line, since the line has no value for any other purpose.

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200. The value of any asset is nothing more than the discounted present value of its future cash flows. Since the quasi-rents make up all of the cash flow of this asset, all of the asset's value consists of the present value of the quasi-rents.

201. If the railroad were not currently taxed on its accretions to wealth, then it would be able to defer the payment of tax, which would provide substantial benefits to the railroad. See note 6.

202. See note 10.

203. Williamson, *The Economic Institutions of Capitalism* at 32, 61-63 (cited in note 10). For a general example of a bilateral monopoly with one buyer and one seller, see Bronfenbrenner, Sichel, and Gardner, *Economics* at 621 (cited in note 69).

This characteristic of transaction-specific assets renders the firm vulnerable to opportunistic behavior by the railroad, in that the railroad might raise the price charged to the firm for rail service (or lower the quality of the service) and thereby "hold-up" the firm. Assume, for example, that the railroad waits until the firm constructs the rail spur line, and then raises the rates for rail service from $100,000 a year to $160,000 a year. Having incurred a sizable investment in the transaction-specific asset and having entered into a bilateral relationship with the railroad, the firm will choose to pay the railroad $160,000 a year, rather than pay trucking firms $200,000 a year. Note, however, that if the firm had anticipated this opportunistic behavior ex ante, it would not have constructed the rail spur. After the railroad's opportunistic behavior, the $1 million investment in the rail spur resulted in a savings of only $40,000 a year to the firm (not $100,000, as anticipated), yielding a four percent annual rate of return. This four percent rate of return is inferior to the eight percent rate of return that was available to the firm from other investments. Thus, if the firm had contemplated, ex ante, that the railroad would raise its prices for services to $160,000, the firm would have chosen to ship its equipment by truck for $200,000 a year. Because, however, the firm lacked perfect information regarding the future,[204] it failed to anticipate that the railroad would engage in this opportunistic behavior. Ex post, the firm will continue to use the railroad, since the marginal costs it will incur shipping over the rails is still less than the cost of using the highway.

In this example, by raising its rates to $160,000, the railroad essentially has appropriated, for its own economic benefit, some of the quasi-rents generated by the rail spur, the transaction-specific asset.[205] The $1 million asset is generating, in its entirety, a ten percent rate of return every year, or $100,000. The railroad, however, has appropriated $60,000 of this return for its own benefit, by raising its rates by $60,000 each year. The firm retains the remaining $40,000 rate of return by using the asset to ship its equipment on the railroad at a cost of $40,000

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204. That is, the firm possessed "bounded rationality" regarding future events. See Williamson, *The Economic Institutions of Capitalism* at 30-32.

205. Moreover, the amount of increase in the railroad's wealth hy virtue of the customer's construction of the rail spur would vary, depending on what percentage of the quasi-rents thrown off by the rail spur were appropriated by the railroad. The railroad could, for example, raise its annual rates from $100,000 to $199,999.99 (an amount short of the price charged by the trucking industry). Under such a scenario, the railroad would have appropriated all of the quasi-rents from the rail spur to its own benefit. In such a situation, it would be appropriate for the railroad to recognize taxable income equal to the present value of the quasi-rents appropriated by the railroad, or, roughly speaking, $1 million. Present law requires this treatment of the railroad, assuming that ownership of the rail spur is transferred to the railroad upon its completion. This treatment under present law, however, is only correct if the railroad is successful in appropriating all of the quasi-rents attributable to the asset.

less than the cost it would incur by trucking the equipment. By appropriating some of the quasi-rents from the transaction-specific asset, the railroad has experienced an accretion to wealth by virtue of the firm constructing the rail spur. In effect, the railroad now is experiencing the benefits of owning part of the asset, and thus, should be viewed as the economic owner of that portion of the asset for all purposes of the tax law.[206] The railroad should be taxed on its increase in wealth from participating in the transaction. This tax would equal the present value of the $60,000 annual stream of quasi-rents which the railroad has managed to appropriate from the firm, or $600,000. Consequently, as a policy matter, the proper treatment of the railroad would be for it to include $600,000 in income upon the construction of the rail spur by the customer.

a. Recognition of Loss from Appropriation and Substitute Taxation

Moreover, in the event that the railroad recognizes taxable income by virtue of such an appropriation, the manufacturing firm should be allowed to recognize a corresponding loss, which the firm would deduct from its gross income. Since the manufacturing firm has invested $1 million, and since $600,000 of that investment has been siphoned off by the railroad through opportunistic behavior, the firm should be allowed to recognize a loss of $600,000. If the firm is not allowed a loss of $600,000, then the tax system is, in the aggregate, overtaxing this transaction. Only $1 million of value is present in the asset—if the railroad appropriates $600,000 of that value, then the manufacturing firm's share of the value cannot be more than $400,000. Requiring the railroad to recognize income of $600,000, while disallowing any loss recognition by the firm, improperly treats the asset as if it had a value of $1,600,000, not $1 million, and thus, overtaxes the parties. The reader should note that present law requires the railroad to include the full $1 million in income, while disallowing any deduction at all to the manufacturing firm, thus, overtaxing the transaction in an especially egregious fashion.[207]

The argument that the manufacturing firm should be allowed to recognize a loss equal in amount to the income recognized by the railroad has important implications for tax policy. In the unusual case in

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206. Thus, the railroad would be allowed to depreciate the amount of the asset it has appropriated, after including that same amount in its taxable income.

207. See note 178 for a discussion of present law's requirement that the manufacturing firm capitalize, and not deduct, the cost of the track. In effect, present law treats the asset as if its value were $2,000,000, not $1,000,000.

which the railroad manages to appropriate a portion of the rents generated by the transaction-specific asset, the railroad should be required to include in income the value of the asset that it has appropriated. However, not requiring the railroad to include this amount in income could be justified, roughly speaking, if the manufacturing firm were not allowed to deduct a loss from the transaction. That is, undertaxing the railroad might be justified, as a policy matter, by overtaxing the manufacturing firm ("substitute taxation").[208] Under certain assumptions,[209] no adverse policy results will occur if the manufacturing firm's taxation serves as a substitute for the taxation that would otherwise apply to the railroad.

Indeed, I believe that administrative concerns force one to adopt substitute taxation as the governing rationale in this area. Due to problems of complexity,[210] it would be virtually impossible for the government to operate a tax system that taxed each railroad (or other taxpayers in a comparable position) by requiring income inclusion of the particular fraction of the asset's value that had been appropriated, while allowing the manufacturing firm (or other comparable taxpayers) to deduct the same amount as a loss. Instead, for administrative purposes, an "all or nothing" approach needs to be adopted—either all of the asset's value is included in the railroad's income and deducted by the firm, or, alternatively, the railroad recognizes no income and the firm sustains no loss. The current system, which requires the railroad to

208. The overtaxation of the manufacturer is a substitute for the undertaxation of the railroad. Substitute taxation may be adopted as a second best approach when the more optimal solution of properly taxing each party is impracticable or otherwise unattainable. For a discussion of the substitute taxation rationale, see Halperin, 95 Yale L. J. at 517-18 (cited in note 7). Compare Scarborough, 69 Taxes at 803 (cited in note 153) (noting the deficiencies of such an approach). Basically, substitute taxation may be seen as a logical extension of the Coase theorem. R. H. Coase, *The Problem of Social Cost*, 3 J. Law & Econ. 1 (1960). In order to achieve proper taxation of the overall transaction, the proper amount of tax must be assessed on one of the parties. The particular identity of the party who is taxed is not particularly important, since presumably, the contractual terms between the two parties will be appropriately altered to reflect the particular allocation of the tax burden. For a discussion of some of the important limitations of the Coase theorem, as used to justify substitute taxation, see note 209.

209. The primary assumption necessary for substitute taxation to function properly as a mechanism of tax policy is that both parties will be subject to the same marginal rate of tax. For example, if both parties are subject to a 34% marginal tax rate, then overstating the manufacturing firm's income by $1,000 will overtax the firm by $340, thus serving as an appropriate substitute for understating the railroad's income by $1,000 which results in $340 of tax benefit for the railroad. However, if the manufacturing firm is subject to a marginal tax rate of zero (for example, the firm is tax-exempt), then overtaxing the firm as a way of substituting for the undertaxation of the railroad will not work. The government will lose an aggregate $340 of tax to the government, because the $340 of tax reduction obtained by the railroad is not offset by $340 of tax increase suffered by the manufacturing firm. For recognition of this point, see Halperin, 95 Yale L. J. at 518 (cited in note 7).

210. For a previous discussion of complexity concerns, see note 24.

include one-hundred percent of the asset's value, while prohibiting the firm from recognizing any loss whatsoever, is truly indefensible.

Because appropriation of quasi-rents by the railroad is relatively unusual,[211] I believe that of the two alternatives, the more accurate approach would have the railroad recognize no income and the firm sustain no loss upon the construction of the transaction-specific asset. This approach is not perfect, however, and in some situations the railroad will undoubtedly succeed in appropriating a portion of the asset's quasi-rents. If this occurs, my proposal would undertax the railroad. However, my proposal would similarly overtax the firm and therefore would achieve a measure of substitute taxation, which is all that can be hoped for in a necessarily imperfect world.[212]

b. The Economic Irrelevance of Legal Title

Another important point needs to be made here. The reader should note that the determination as to whether the railroad appropriates the quasi-rents from the asset is independent of whether legal title to the rail spur was transferred to the railroad. That is, the ability of the railroad to raise the prices of its service, knowing that the manufacturing firm is "locked-in" to future dealings with the railroad, is determined by factors other than the identity of the party owning the rail spur. The relevant point about the rail spur is simply that it represents an investment that has already been made, and that it has no value for use in other functions. These characteristics of the rail spur create the opportunity for the railroad to hold-up the manufacturing firm by raising prices—not the identity of the party having legal title to the rail. Thus, the requirement of present law that the transaction-specific asset be transferred to the corporate recipient in order to trigger income is economically irrelevant to the correct analysis of the situation. Moreover, present law's emphasis on the transfer of legal title puts immense pressure on this particular issue, in that some firms may be able to avoid transferring legal title and thus avoid tax liability, while other firms may not be able to avoid such a transfer and suffer harsh tax treatment as a result.[213] The fact that present law is operating in this capricious

211. For defense of this point, see notes 216-30 and accompanying text.

212. Substitute taxation will be especially ineffective in dealing with situations in which governments transfer transaction-specific assets to firms, and those firms appropriate the quasi-rents generated by the assets. Substitute taxation will not work in such a situation because of the tax-exempt status of the governments. See note 209.

213. The IRS is fully aware of the importance of title in this area of the law, and has done everything in its power to prevent firms from deliberately refraining from transferring title in an attempt to lower their tax liabilities. For example, the IRS has publicly stated that parties who refrain from transferring title to transaction-specific assets, but who engage in certain economic arrangements involving these assets, will be treated as if legal ownership of the assets was effec-

and arbitrary manner is another reason to reform the taxation of these transactions.

c. *The Likelihood of Appropriation*

Before the manufacturing firm decides to construct the rail spur, it likely will be aware of the possibility that the railroad might engage in opportunistic behavior and appropriate quasi-rents from the rail spur. The firm will therefore avoid entering into this transaction unless it feels that it is protected from the opportunistic behavior. If the firm believes it is vulnerable to the railroad appropriating the rents, then the firm would not construct the spur, and instead would rely on the trucking industry to ship the goods from the factory to the firm's customer.[214]

Thus, the firm will only engage in this transaction and construct the rail spur if it believes that the quasi-rents from the spur will inure to its benefit and not to the railroads.[215] To the extent that the firm's belief proves to be an accurate prediction of the future, the railroad will be prevented from appropriating the quasi-rents and it would be incorrect to tax the railroad for participating in this transaction. The firm might construct the rail spur by different mechanisms and be protected against appropriation by the railroad.

i. Protection Against Appropriation by Utility Regulation

The economics literature dealing with transaction-specific assets has recognized that regulation of rates, occurring in the public utility industry, is one way that firms making investments in transaction-specific assets are protected from other parties appropriating the economic benefit of those assets.[216] This is an especially important point because,

tively transferred, thus triggering tax consequences to the recipient. IRS Notice 87-82 at 390 (cited in note 5). Although this position of the IRS may be subject to challenge, it certainly indicates the tensions and problems inherent in the legal title issue, an issue that is irrelevant to a proper economic analysis of the issue, but upon which a tremendous amount is based.

214. Technically, the firm would truck its goods, as opposed to sbip its goods over rail, if the railroad were able to appropriate enough of the spur track's quasi-rents to reduce the firm's rate of return from its investment in the track to a level below what would be available to the firm from alternative investments.

215. See notes 239-45 and accompanying text for discussion of a scenario in which both parties deliberately plan a transaction intended to transfer the asset to the corporate recipient (the railroad).

216. See, for example, Victor P. Goldberg, *Regulation and Administered Contracts*, 7 Bell J. Econ. 426, 439-41 (1976) (discussing the role of rate regulation in protecting parties from being "held up" by others after those parties make investments in specialized ass:ts); Williamson, 22 J. L. & Econ. at 257-58 (cited in note 10) (noting the importance of regulation in preserving expectations in natural monopolies involving significant investments in transaction-specific assets). Thus, this literature represents a new perspective on regulation that recognizes the positive role that

as previously mentioned, many of these transactions occurring in our economy involve contributions by private parties of transaction-specific assets to regulated public utilities. Typically, customers (or prospective customers) contribute transaction-specific assets (such as lines or mains for water, natural gas, or electricity) that the utility will use to provide utility services to the customers in the future.

The regulatory treatment of these contributions by public utilities helps ensure that the quasi-rents generated by the transaction-specific assets inure to the benefit of the customer, and not the utility. In short, as explained below, the regulatory environment applicable to public utilities is designed to prevent the utility from raising its prices (or lowering the quality of its services) in response to the investment in the transaction-specific asset by the customer. Thus, this treatment ensures that the utility does not experience an accretion to wealth by virtue of receiving the asset. Therefore, taxing the utility for participating in this transaction would be inappropriate.

A utility receiving a contribution of a transaction-specific asset is required by regulatory authorities to account for this asset as if it were not owned by the utility.[217] The prices charged by utilities to customers for utility services consist of two different elements: (i) a reimbursement of the expenses the utility incurs in providing services to customers (e.g., salaries, depreciation, taxes) and (ii) a rate of return on the capital invested in the utility.[218] Nothing else typically enters into the determination of prices utilities are allowed to charge customers for services provided. Utilities are unable to appropriate the quasi-rents generated by transaction-specific assets, because under general regulatory principles, transaction-specific assets are excluded from both of the items mentioned above that determine the prices charged for services,

regulation plays in the nation's economy. In the past, regulation was heavily criticized for various reasons, such as providing undue henefits to the regulated industry at the expense of consumers in general. See, for example, Richard A. Posner, *Natural Monopoly And Its Regulation*, 21 Stan. L. Rev. 548, 635 (1969) (criticizing regulation on the dual grounds that the prohlems of monopoly are exaggerated and that regulation is largely ineffectual in dealing with those problems).

217. This reflects the proper economic understanding of the transaction in which the utility is not able to appropriate the quasi-rents generated hy the asset. The real economic owner of the asset is the utility's customer, regardless of where legal title to the asset rests. If the utility were treated as the owner of the asset, then the economic investment in the asset would be included in the utility's rate base. The utility would earn a rate of return on the economic investment and the prices charged to the utility's customers would increase. See note 218. Similarly, the depreciation of the asset would be viewed as an expense incurred by the utility with respect to which the utility would be reimbursed by its customers. See notes 218-20 and accompanying text. Since neither of tbese two conventions are adopted for this asset, the utility is treated as if it does not own the asset.

218. See Posner, 21 Stan. L. Rev. at 592 (cited in note 216).

i.e., the utility's reimbursable expenses and rate of return.[219] Thus, by excluding the transaction-specific assets from these two factors, the regulatory authorities prevent the utilities from raising their rates in response to the receipt of transaction-specific assets, or earning any profits from the assets.[220]

Phrased differently, utilities are prevented by regulatory authorities from engaging in opportunism with respect to transaction-specific assets, because utilities are not allowed selectively to increase rates to a particular customer to appropriate the quasi-rents being generated by the assets. The regulatory requirement that the utility charge to all customers the same price for each unit of utility services has the effect of protecting the customer from opportunistic behavior and insuring that the economic benefit resulting from the contributed asset inures to the benefit of the customer.[221]

Thus, in the case of regulated utilities, a strong argument exists that contributions of transaction-specific assets should not be taxed to the utility receiving those contributions, because the utility does not experience an accretion to wealth from such transactions.

ii. Protection Against Appropriation by Nonregulated Market Arrangements

My proposal, however, would go beyond the regulated sector to exclude all contributions of transaction-specific assets from the recipient's taxable income, even if the transaction was consummated in a nonregulated environment.[222] For example, railroads generally have been "de-

219. See Price Waterhouse, *The Tax Aspects of Contributions in Aid of Construction* 7 (Price Waterhouse 1991); Letter from Edison Electric Institute to Tax Legislative Counsel Dale Collinson 2 (Nov. 21, 1975) (on file with author). Congress implicitly recognized the importance of this regulatory treatment of transaction-specific assets, prior to the 1986 Act, by requiring such treatment in the Internal Revenue Code as a condition to the utilities being allowed to exclude these contributions from their income. See Section 118(b)(1)(C) of the 1954 Internal Revenue Code (defining contrihutions in aid of construction as, inter alia, amounts excluded from the utility's rate base).

220. Moreover, regulatory controls and monitoring of the utility prevent the utility from reducing the quality of service provided to customers while maintaining the same price. Compare Posner, 21 Stan. L. Rev. at 593-94 (cited in note 216) (acknowledging the existence of controls over the quality of such services, but expressing doubts as to the practical ability of regulators to police these controls).

221. See Goldberg, 7 Bell. J. Econ. at 440 (cited in note 210) (discussing regulatory policies that are based on the overall operations of the firm and not individual services); Posner, 21 Stan. L. Rev. (cited in note 216) (noting this phenomenon of charging customers the same price per unit of service, but criticizing it as failing to reflect the differing cost of serving customers in various areas of the country).

222. See notes 156-58 and accompanying text for a discussion of contributions of transaction-specific assets in a nonregulated environment.

regulated" and are no longer subject to strict rate regulation.[223] Thus, in the previous example involving the manufacturing firm constructing a rail spur in order to ship its goods over rail, rate regulations would not prevent the railroad from appropriating the quasi-rents generated by the spur track. Nevertheless, the railroad should not be taxed on the receipt of the spur track from the manufacturing firm.

My position is based on the considerable amount of evidence suggesting that parties in the nonregulated sector will take steps to prevent the appropriation of quasi-rents, in a manner similar to the mechanisms existing in the regulated sector.[224] Specifically, several studies of particular industries suggest that parties in those industries have adopted various arrangements to prevent the appropriation of quasi-rents generated from transaction-specific assets.[225] For example, parties making investments in transaction-specific assets will enter into elaborate long-term contracts that will govern the future prices set by the railroad (or comparable firms) to the manufacturing firm (or comparable firms) to protect against the possibility of appropriation of the quasi-rents.[226] Other phenomena, such as a firm's concern over its reputation,[227]and the desire of a firm to continue a business relationship with a particular customer,[228] also may significantly discourage firms from

223. Such deregulation was accomplished in the Railroad Revitalization and Regulatory Reform Act, 90 Stat. 31 (1976), and the Staggers Rail Act of 1980, 94 Stat. 1895 (1980). For a discussion of the effects of these acts, see James M. MacDonald, *Railroad Deregulation, Innovation, and Competition: Effects of the Staggers Act on Grain Transportation*, 32 J. L. & Econ. 63, 64-65 (1989).

224. In fact, this is the basic theme of transaction cost economics and its treatment of transaction-specific assets. The presence of potentially appropriable quasi-rents from transaction-specific assets leads to increased transaction costs, as parties create particular economic structures and relationships for the purpose of decreasing the risk of appropriation. See, for example, Klein, Crawford, and Alchian, 21 J. L. & Econ. at 325-26 (cited in note 10); Williamson, 22 J. L. & Econ. at 234 (cited in note 10).

225. See, for example, Klein, Crawford, and Alchian, 21 J. L. & Econ. at 308-13 (automobile and petroleum industries); Monteverde and Teece, 13 Bell J. Econ. 206 (cited in note 156) (automobile industry); Masten, 27 J. L. & Econ. 403 (1984) (cited in note 199) (aerospace industry); Palay, 13 J. Legal Stud. at 265 (cited in note 10) (rail industry); Joskow, 1 J. L. Econ. & Org. 33 (cited in note 10).

226. See Williamson, *The Economic Institutions of Capitalism* at 75-77 (cited in note 10); Douglas G. Baird, *Self Interest and Cooperation in Long-Term Contracts*, 19 J. Legal Stud. 583, 585 (1990); Klein, Crawford, and Alchian, 21 J. L. & Econ. at 302-07 (cited in note 10).

227. See Palay, 13 J. Legal Stud. at 276 (cited in note 10) (discussing the attempt by the railroad companies to preserve their reputations for honesty and trustworthiness in order to induce others to invest in transaction-specific assets); Williamson, 22 J. L. & Econ. at 240-41 (cited in note 10) (discussing the importance of personal and institutional trust between parties participating in specialized, idiosyncratic exchanges).

228. See Palay, 13 J. Legal Stud. at 274-75 (cited in note 10); Klein, Crawford,cnd Alchian, 21 J. L. & Econ. at 303 (cited in note 10) (asserting that the withdrawal of future business, or the loss of goodwill, provides a significant deterrent to opportunistic behavior); R. H. Coase, *The Nature of the Firm: Influence*, 4 J. L. Econ. & Org. 33, 44 (1988)

attempting to appropriate these quasi-rents, even when such behavior might be legally defensible because of loopholes and ambiguities in contracts.[229] Thus, to the extent that these contractual arrangements and other phenomena function as described above, taxing the corporations upon receipt of these transaction-specific assets is inappropriate, because those corporations have not been successful in appropriating the assets' quasi-rents.

Finally, strong evidence suggests that a firm will deal with situations that present extremely serious risks of appropriation by "vertically integrating" or "internalizing" the particular economic functions. This eliminates the risk of appropriation of transaction-specific assets.[230] Thus, the firm will perform the particular economic activity itself, with its own personnel and facilities, instead of accomplishing the activity by contracting with other parties. This protects the firm from the risk that other parties will appropriate its assets. Moreover, vertically integrating or internalizing a particular economic function also eliminates the tax problems relating to these transaction-specific assets. After integration, there is no longer any risk that one party will be taxed inappropriately on investments made by another party in transaction-specific assets, since the economic functions involving these assets are now conducted by only one firm. This is another factor in favor of the argument that appropriation of transaction-specific assets occurs on an infrequent basis. The situations that do, in fact, pose the most likely risks of appropriation are removed from the market altogether, thus not presenting any issue for the tax laws to resolve.

3. Inevitable Inaccuracies of this Article's Proposals

In some situations, these various protective devices may fail, and firms may succeed in increasing their wealth by engaging in opportunistic behavior. The response to this problem is two-fold. First, this result can be defended by noting the presence of substitute taxation, previously mentioned.[231] That is, although the firms that successfully appro-

229. See Palay, 13 J. Legal Stud. at 276 (discussing arrangements designed to protect transaction-specific assets from appropriation, which were honored by the participating parties, although not legally enforceable); Klein, Crawford, and Alchian, 21 J. L. & Econ. at 303-04 (discussing reliance on legally nonenforceable practices).

230. This point is one of the paradigms of the economics literature on transaction costs, and has been both proposed as a theoretical construct of economic behavior and empirically tested by observing actual industries. See, for example, Williamson, *The Economic Institutions of Capitalism* at 78, 105-06 (cited in note 10); Klein, Crawford, and Alchian, 21 J. L. & Econ. at 298-302 (cited in note 10); Masten, 27 J. L. & Econ. at 416-17 (cited in note 199); Monteverde and Teece, 13 Bell J. Econ. at 212 (cited in note 156); Palay, 13 J. Legal Stud. at 278; Joskow, 4 J. L. Econ. & Org. at 104-11 (cited in note 10).

231. See notes 208-10 and accompanying text.

priated these quasi-rents would be undertaxed under this Article's taxation proposals, the party on the other side of the transaction would be overtaxed by the same amount. Clearly, substitute taxation is not a perfect solution to this problem: it is especially ineffective in situations involving transfers of transaction-specific assets from governments (which are tax-exempt) to corporations (which are fully subject to tax).[232] However, substitute taxation is a more attractive mechanism in achieving the right policy result than available alternatives in this particular situation.[233] Second, I would note that administrative problems generally result in our tax system not imposing immediate tax on accretions to wealth experienced by persons who make "bargain purchases"[234] or who otherwise enter into advantageous contracts with others.[235] Instead, taxation is deferred until some later event, such as a subsequent sale of the property by the initial purchaser.[236] Immediately taxing a firm that manages to increase its wealth by appropriating quasi-rents that will be received by the firm in the future[237] is analogous to taxing persons on bargain purchases when those purchases initially occur—in both situations, parties are immediately taxed on advantageous contractual provisions that may result from their hard bargaining or shrewd negotiating. Although foregoing current taxation

232. For a discussion of this problem, see note 209. Unfortunately, there are transactions that fit this pattern and which would not be remedied by substitute taxation.

233. Such alternatives consist of (i) impossibly complex schemes to tax corporations based on the exact degree of asset appropriation that has occurred in that particular situation; and (ii) taxing all corporations on the entire value of transaction-specific assets that they receive from others (as in present law). The second alternative is substantially more inaccurate than the proposals made in this text.

234. For a general discussion of the exclusion of bargain purchases from income, see Dodge, 45 Tax L. Rev. at 680-81 (cited in note 11). See also note 235.

235. If a person, through either skill or good luck, manages to purchase property from another at a price below its fair market value, the purchaser is not required to immediately include the bargain element in income. Bittker and Lokken, *Taxation of Income* at 5-78 (cited in note 3); Sanford M. Guerin and Philip F. Postlewaite, *Problems and Materials in Federal Income Taxation* (Little Brown & Co., 2d ed. 1988) (discussing the contrast between nontaxable bargain purchases obtained by negotiating with strangers, and taxable bargain purchases intended to be compensatory). Generally, taxing persons on economic advantages they obtain in bargain purchases would be inadministrable; difficulties of valuation, liquidity, and enforcement would make this an impossible task. See Bittker and Lokken, *Federal Income Taxation* at 5-24 through 5-26 (discussing reasons for not taxing imputed income), 5-16 through 5-17 (discussing reasons for not taxing unrealized gains) (cited in note 3).

236. If the value of the property remains higher than its initial cost to the purchaser, then a subsequent sale of the property by the purchaser will result in taxable gain, because the amount realized in the sale will exceed its tax basis. I.R.C. § 1001(a) (West 1992).

237. A firm that, through opportunistic behavior, manages to raise prices charged to a customer by appropriating the customer's transaction-specific asset has an immediate accretion to wealth equal to the discounted present value of all future price increases that it will collect because of the appropriation. However, under this Article's proposals, this immediate accretion in income would not be recognized until later years as those higher prices were actually collected by the firm.

of this income is not optimal, it is virtually required in light of the administrative complexities that would result if our tax system attempted to tax these accretions to wealth as they currently accrue.[238]

4. Possibilities of Abuse

The possibility that this Article's taxation proposals would lead to wide-scale abuse in the nonregulated sector of the economy needs to be addressed. If the law were changed to allow contributions of transaction-specific assets to be made tax-free to the recipient corporation, parties might collaborate and deliberately engage in such transactions for purposes of obtaining tax benefits. That is, firms and their customers might deliberately structure transactions in which customers paid the firms for services in the form of transaction-specific assets. The response to this problem is that the nature of these particular assets largely eliminates the possibility of abuse in this area.

First, it should be noted that this scenario is radically different from the situation portrayed in the economics literature regarding appropriation of transaction-specific assets. In that literature, appropriation occurs if a firm manages to raise the prices it charges another party in response to that other party investing in a transaction-specific asset. The investment in the asset allows the firm to "hold-up" the other party by raising prices and thereby siphoning off some of the returns generated by the asset.[239] In contrast, when a customer and firm deliberately plan for the customer to pay the firm in the form of a transaction-specific asset that will be used in future transactions between the two parties, the customer's investment in the asset leads to a decrease in the prices the firm charges the customer, not an increase.[240]

Thus, in the previous example involving the manufacturing firm constructing a rail spur, the firm will not willingly invest in the rail spur and contribute that asset to the railroad knowing that the prices charged to the firm will increase as a result of the contribution. Instead, such a contribution would be made only if the firm and railroad had agreed that the prices charged to the firm by the railroad would de-

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238. See note 235 for discussions of the reasons for not taxing bargain purchases, including administrative concerns over complexity.

239. See notes 204-06 and accompanying text.

240. For recognition of this point, see Halperin, 95 Yale L. J. at 515-19 (cited in note 7) (discussing prepayments for goods and services, and noting that one would prepay $100 for a service worth more than $100 that would be received later), and Scarborough, 69 *Taxes* at 800-02 (cited in note 153). The reason for this phenomenon is simple. A customer will not knowingly prepay a corporation for goods or services the corporation is to provide in the future, unless the customer obtains some advantage from the prepayment (for example, lower prices for the goods or services provided). Absent any such advantage, the customer would wait and pay the corporation at a later date, when those goods or services were actually provided.

crease as a result of the contribution. This suggests that the railroad does not have economic income from receiving the spur track. Instead, the value of the track is immediately offset by the railroad's agreement that it will provide services to the firm at a lower price than what would otherwise apply.[241] Moreover, in such a situation, the firm and the railroad are akin to persons participating in a joint endeavor involving co-ownership of property.[242] The firm has invested in the rail spur, and the railroad has invested in the remaining assets of the railroad.[243] The firm's return from its investment in the rail spur is in the form of lower

241. Admittedly, this same point applies to firms receiving payment from customers in advance of providing services to those customers ("prepaid income"). See note 9. Although differences exist between prepaid income and the situation described in the text involving contributions of transaction-specific assets, see note 244, they do share at least one common element—the recipient party is generally overtaxed under present law. That is, firms receiving prepaid income are generally required to include the amounts in income when received, even though such treatment results in overtaxation of the recipient party. For recognition of this point, see Halperin, 95 Yale L. J. at 517 n.38 (cited in note 7); Scarborough, 68 Taxes at 801, 808-09 (cited in note 153) (noting that the correct system would not tax the seller on receipt of income, and contrasting that with present law that typically does apply such a tax); Evans, 69 Tex. L. Rev. at 1192-93 (cited in note 24); Sneed, 17 Stan. L. Rev. at 590 (cited in note 2) (criticizing rules requiring immediate inclusion of prepaid income as overstating the recipient's income). But see Surrey, et al., *Federal Income Taxation* at 630-31 (cited in note 9) (defending this rule on the basis of administrative concerns such as taxpayer liquidity and valuation). A corporation receiving prepaid income for services the corporation will later provide to a customer is essentially borrowing money from the customer. The corporation repays the loan when it provides the services, at a later date, to the customer. At this later point, the corporation actually realizes the economic income from the transaction, not before. Halperin, 95 Yale L. J. at 516; Scarborough, 69 Taxes at 801. Thus, taxing a corporation initially upon prepaid income is tantamount to taxing a person upon receiving the proceeds of a loan. This is overtaxation, because receiving the proceeds of a loan does not result in economic income to the borrower; the proceeds are offset by the obligation to repay the loan, resulting in no accretion to wealth. Klein, et al., *Federal Income Taxation* at 238-39 (cited in note 6). Such overtaxation of prepaid income can only be justified (as substitute taxation) if the party on the other side of the transaction, the customer, is being undertaxed by being allowed to deduct, immediately, the proceeds of the loan. Halperin, 95 Yale L. J. at 517. As an aside, it also should be noted that, economically speaking, these loans are interest-bearing. The corporation pays interest on the loan, implicitly, in the sense that the customer receives the services for a lower price by paying early, in comparison to the higher price the customer would have been charged had it paid later. This reduction in price is, in economic substance, interest that is paid by the corporation to the customer. The economic nature of this payment, however, is disguised and not explicitly stated. Id. at 516.

242. Although this arrangement is quite similar to a partnership, it differs technically from such an arrangement because the returns from the rail spur inure completely to the manufacturing firm, while the returns from the remaining assets inure completely to the railroad. Thus, the arrangement lacks one of the true characteristics of a partnership—the sharing of entrepreneurial profit and risk with respect to the same properties. As a result, it likely would fail to qualify as a partnership for federal income tax purposes. William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 3.02[4]-[5] (Warren, Gorham, & Lamont, 2d ed., 1990); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 Tax L. Rev. 1, 31-32 nn.120-21 (1991).

243. Other commentators have noted this characteristic of these transactions. See Note, 82 Harv. L. Rev. at 639 (cited in note 2).

prices it pays for rail transportation, while the railroad continues to earn a return from the assets in which it has an economic investment.[244] The tax laws would not ordinarily tax a co-owner of property with respect to the investment in the property by another co-owner.[245] Correspondingly, the laws should extend similar treatment to the railroad here, and not tax it on the receipt of an asset whose economic returns will inure to another party. In such a situation, the railroad's wealth does not increase by the receipt of such an asset, and, therefore, taxation is inappropriate.

V. Conclusion

Nonshareholder contributions to corporations represent an important array of transactions occurring in our economy. For too long, the federal income tax treatment of these contributions has been muddled by archaic and irrelevant concepts that fail to focus on the questions that are necessary to fashion an intelligible tax policy. Present law is badly in need of reform to insure that firms are taxed on their economic income, and that the undesirable effects of mistaxation are eliminated.

I propose taxing firms on amounts received for economic development because I believe that systematic market failure occurs in this area, which results in firms receiving economic income when they sell development to state and local governments. In contrast, firms should not be taxed on the receipt of transaction-specific assets, largely because no evidence indicates that market failure has occureed in this area. Instead, it appears that the expectations of the various parties involved are generally preserved, and that a customer investing in a specialized asset continues to receive the future returns from that asset, as opposed to those returns reverting to the firm.

Finally, it should be noted that the changes proposed in this Article are administratively feasible. The proposals could be implemented without increasing either the complexity of the tax system or the costs

244. This helps explain the difference between prepaid income and contributions of transaction-specific assets. When firms receive prepaid income they eventually realize economic income from that receipt of property. The proper timing, however, of such realization is deferred until such time as the firms provide services to the customers. See note 241. When a firm receives a transaction-specific asset from another, the firm never realizes economic income from that transaction (assuming, for example, that the firm does not appropriate the quasi-rents from the asset). Instead, the returns from the transaction-specific asset inure to the benefit of the customer throughout the asset's life. Although a contribution of transaction-specific assets is therefore distinct from a transaction involving prepaid income, modification of the tax laws regarding prepaid income to eliminate the overtaxation that presently occurs would not be objectionable. For proposals to make such modifications, see Scarborough, 69 Taxes 798 (cited in note 153).

245. See, for example, I.R.C. § 721 (West 1992), which provides that no gain shall be recognized by a partnership or any of its partners, by virtue of a contribution to the partnership of property in exchange for a partnership interest.

imposed on persons attempting to comply with the law. Moreover, the proposals are reasonably balanced in a fiscal sense. Tax monies raised from taxing economic development could be used, in part, to pay for the costs of exempting contributions of specialized assets from tax. Thus, the proposals could be adopted without aggravating the fiscal problems involving the federal deficit. In short, these proposals would improve the law in a way that is administratively and fiscally viable. They deserve serious consideration by policymakers when enacting future legislative changes to the tax laws.