2022

The Legal Envelope Theorem

David A. Weisbach

Daniel J. Hemel

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles

Part of the Law Commons
THE LEGAL ENVELOPE THEOREM

DAVID A. WEISBACH* & DANIEL J. HEMEL**

ABSTRACT

Nontax legal rules regulating the workplace, the financial sector, real property, and many other areas affect the ability of governments to collect revenues and provide public goods. Yet tax-collection considerations rarely enter into economic analyses of nontax legal rules. Usually, tax-collection concerns are shunted aside to separate studies (and separate law school courses) rather than integrated into debates in nontax spheres. This separation between nontax legal rules and tax-collection considerations bears significant negative consequences for the ability of law and economics to generate descriptively accurate and normatively attractive accounts of important nontax legal questions.

This Article takes a step toward remedying that oversight. We present an analytic framework for understanding the interaction between nontax legal rules and tax collection. This framework—which we call the Legal Envelope Theorem—demonstrates that legal rules should systematically deviate from simple notions of efficiency to take stock of tax effects. We then provide a series of examples applying the Legal Envelope Theorem, illustrating how the nontax legal system ought to be (and, on occasion, actually is) designed with tax effects in mind. These examples range from parental leave mandates to bank capital requirements to centuries-old property and contract rules regularly taught in introductory law school courses. We illustrate how a framework that is attentive to tax-collection considerations can enhance the government’s capacity to redistribute resources and address wealth inequality.

* Walter J. Blum Professor of Law, University of Chicago Law School. d-weisbach@uchicago.edu.
** Professor of Law, University of Chicago Law School. dhemel@uchicago.edu.

For helpful comments on earlier drafts, we thank William Hubbard, Louis Kaplow, Alex Raskolnikov, and participants at the University of Chicago Law School Faculty Works-in-Progress Workshop and the University of Virginia Tax Invitational. All errors are our own.
CONTENTS

INTRODUCTION .................................................................................................................. 451

I. ANALYTIC FRAMEWORK ................................................................................................. 455
   A. The Behavioral Elasticity of Tax Revenue ............................................................... 456
      1. Market vs. Nonmarket Production ................................................................. 456
      2. Reported vs. Unreported Income .................................................................. 458
   B. The Legal Envelope Theorem .............................................................................. 460
      1. The Legal Envelope Theorem in a Single-Person Setting ......................... 460
      2. The Legal Envelope Theorem in a Multi-Person Setting ....................... 463
   C. Comments and Qualifications .............................................................................. 465
      1. More than Marginal Changes ........................................................................ 465
      2. The Problem of the Second Best .................................................................. 467
      3. Redistribution and the Relationship to Kaplow & Shavell (1994) .............. 468
      4. Relationship to Public Finance Literature ...................................................... 472

II. APPLICATIONS ............................................................................................................. 475
   A. Legal Rules Related to Work .............................................................................. 475
      1. Mandatory Benefits ....................................................................................... 477
         a. Framework .................................................................................................. 477
         b. Parental Leave ......................................................................................... 480
         c. Job Protection and Wrongful Discharge .................................................. 484
      2. Laws Indirectly Affecting Work ...................................................................... 485
      3. Summary ......................................................................................................... 487
   B. Legal Rules Affecting Business Organizations ..................................................... 487
      1. Debt/Equity Rules .......................................................................................... 488
      2. Choice of Entity ............................................................................................. 491
   C. Rules Affecting the Informal Economy ................................................................. 495
      1. Raising the Cost of Cash ................................................................................. 496
      2. Reducing the Cost of Financial Services ..................................................... 500
   D. Property .................................................................................................................... 503
      1. The Statute of Frauds ..................................................................................... 503
      2. Modern-Day Analogues ............................................................................... 506

CONCLUSION ...................................................................................................................... 509
INTRODUCTION

As late as the second half of the nineteenth century, communities in many parts of Europe organized landholdings in ways that would look strange to modern eyes. For example, in parts of rural Russia, during the summer, a household might hold a dozen or so noncontiguous strips of land in different ecological zones surrounding a single village. In the winter, the cropland might revert to commonly owned property where anyone could graze their fowl and livestock. These arrangements, writes James C. Scott in his book, Seeing Like a State, were well understood by local inhabitants and “worked admirably for their purposes.” But property-rights regimes of this sort created problems for tax collectors, who faced tremendous difficulties in assigning liabilities to different households.

On Scott’s account, authorities in several countries responded to this challenge by modifying property regimes to make landholdings more “legible,” i.e., more susceptible to observation and taxation. In many places, authorities replaced well-functioning but illegible regimes with freehold tenure systems that facilitated revenue collection. Legal rules governing real property were devised with taxation in mind, and arrangements that might have been otherwise optimal were instead modified in light of tax considerations.

In Scott’s view, legibility is a double-edged sword. Efforts to facilitate observation and taxation are “vital to the maintenance of our welfare and freedom” because a state unable to collect revenue from its citizens is also unable to protect and advance their interests. But, Scott warns, “the legibility of a society provides the capacity for large-scale social engineering,” and it is thus a necessary (though not sufficient) ingredient in many of the greatest tragedies of the nineteenth and twentieth centuries. Scott’s account of the various efforts at legibility is thus not entirely—or primarily—valedictory. After all, the same features that allow a state to raise revenue likewise enable it to suppress minorities (and sometimes majorities).

——

2 See id. at 39.
3 See id.
4 Id. at 40.
5 See id. at 37-39.
6 Id. at 44.
7 See id. at 47-49.
8 See id. at 48-52. This claim may not be the best description of the reasons for the shift to freehold tenure, and there may have been other advantages to freehold tenure. Our focus is on modern examples, and our analysis does not depend on whether Scott’s account is accurate.
9 See id. at 4.
10 Id.
11 Id. at 5.
12 See id. at 4.
While Scott is focused on the relationship between legibility and tyranny, his account also suggests a close relationship between legibility—the ability of the government to observe and tax—and legal rules. For a state to revise its entire property law system to facilitate tax collection is exceptional, but the idea that property law might be designed with a view toward taxation is not. Legal rules seemingly unrelated to taxation—such as the Statute of Frauds—have historical origins in debates over tax-collection capacity. Legal rules engineered for nontax purposes—from parental leave laws to bank capital requirements—potentially serve important tax-facilitating functions. Understanding the idea of legibility and the relationship between nontax rules and tax collection is essential to understanding why our current legal system looks and works the way that it does.

In this Article, we examine the relationship between taxes and legal rules. We seek to understand whether—and under what circumstances—nontax legal rules have been or should be adjusted to take the tax system into account. We will argue that there are a small number of cases in which well-known nontax legal doctrines do reflect tax-collection considerations and a larger number of cases in which they ought to. In this latter bucket, we place (among others) many legal rules governing the workplace, the structure of business organizations, the financial sector, and the transfer of real property. In all of these cases, nontax legal rules affect tax collection, and the nontax legal regime ought to be adjusted in light of this phenomenon.

To advance our thesis, we develop a theoretical apparatus for understanding the interaction of legal rules and the tax system, resulting in what we call the Legal Envelope Theorem. The Legal Envelope Theorem builds on a narrower instrument that we introduced in prior work on tax policy. That tool—which we called the Behavioral Elasticity of Tax Revenue (“BETR”)—measures the efficiency effects of a small tax policy change. It allows us to estimate the effects on total resources available to society of almost any modification to tax policy, including changes in tax rates, the tax base, or tax enforcement.

Our fundamental insight is that nontax legal rules affect the total resources available to society through the same channels as tax policy. For example, changes to workplace rules may make labor in the formal (taxed) sector relatively more attractive than leisure or work in untaxed sectors of the economy, such as household production. As a result of a change in relative value, people will shift toward working more in the formal sector and paying more in taxes. Likewise, legal rules can make activities relatively easier for the government to

---

13 See infra Section II.D.1.
14 As the large literature on tax expenditures argues, the line between tax and nontax legal rules is to a great extent arbitrary. Nothing in our paper turns on this distinction. In fact, our thesis is that there should be less of a distinction between tax and other legal rules.
16 Id.
observe and thus easier to tax. For example, the Uniform Commercial Code’s Statute of Frauds—which requires contracts for the sale of goods totaling $500 or more to be indicated in writing—potentially makes it easier for tax authorities to find evidence of unreported income. Scott’s example of early-modern European property rules, which enhanced the legibility of land holdings, fits this latter logic.

To analyze how nontax legal rules affect total resources, we rely on the envelope theorem—familiar to many readers from basic microeconomics. The envelope theorem holds that a slight change in the value of one parameter has no first-order effect on the optimized value of a function. For example, if an individual allocates her time between labor and leisure in a way that is privately optimal, a small shift toward more labor or more leisure does not make her materially better or worse off. The reason for this is at the optimum, the marginal benefit to the individual from working a little more is equal to the marginal cost (in this example, the opportunity cost of losing a little bit of leisure time). If it were otherwise (i.e., if the marginal benefit were greater than the marginal cost or vice versa), the individual would reallocate her time between labor and leisure until she reached a point at which there were no additional incremental gains to be had.

Applying the envelope theorem to the interaction of legal rules and the tax system yields a powerful conclusion. If we start from the point at which the marginal nontax benefit of adjusting a legal rule in one direction or the other equals the marginal nontax cost, but the tax consequences of the change are more than marginal, then we can potentially achieve first-order (i.e., more than marginal) tax system benefits without material nontax costs. Better yet, the BETR—which measures the efficiency effects of small changes in the tax system—allows us to determine how far from the nontax optimum to deviate in light of tax-collection considerations. In other words, it tells us how far from “simple efficiency” we want our legal rules to be (where by “simple efficiency,” we refer to the maximization of nontax benefits net of nontax costs).

Having established the Legal Envelope Theorem as a conceptual manner, we then illustrate its practical applications. Across a wide array of doctrinal areas, we highlight important interactions between legal rules and the tax system. We show how the Legal Envelope Theorem can inform the design of core legal rules,

---

18 See Scott, supra note 1, at 33-36. These two pathways are not distinct. Activities that the government cannot observe are likely to be in the informal sector. Making activities more observable may often be the same thing as shifting activities to the formal sector. Nothing except nomenclature depends on the distinction. Instead, it is, we hope, a helpful way of organizing cases.
20 See Hemel & Weisbach, supra note 15, at 397-98.
including laws affecting work, the law of business organizations, laws affecting size of the informal sector, and property law.

The Legal Envelope Theorem also sheds light on long-running debates in law and economics regarding the relationship between efficiency and distribution. Louis Kaplow and Steven Shavell have argued that legal rules should not be adjusted to favor the poor, because “such use of legal rules to redistribute income is generally less effective than relying exclusively on the income tax system to achieve distributive objectives.”

Our analysis—though compatible with a careful reading of Kaplow and Shavell’s argument—adds an important qualification. The ability of the tax system to achieve redistributive objectives depends critically on the design of nontax legal rules. When nontax legal rules are structured so as to make the tax system function more effectively, the efficiency costs of redistributive taxes will be lower, and the optimal level of redistribution will be higher.

This last insight connects the Legal Envelope Theorem to conversations about widening wealth and income inequality, which former President Barack Obama has described as “the defining challenge of our time.” The failure of nontax legal rules to account for tax-collection consequences makes the challenge of wealth and income inequality even greater because it renders efforts to address that challenge through the tax-and-transfer system more costly. Although our statement of the Legal Envelope Theorem does not explicitly account for redistribution (and, indeed, we agree with Kaplow and Shavell that nontax legal rules generally are not the most efficient means of achieving purely redistributive objectives), the primary underlying motivation for the Legal Envelope Theorem is to facilitate redistributive taxation. If society did not care at all about redistribution, it would not need the Legal Envelope Theorem.

Because we do care about redistribution, the addition of the Legal Envelope Theorem to the toolkit of legal system design is imperative.


23 Absent any concern regarding redistribution, the most efficient mechanism for raising revenue is a lump-sum tax (i.e., a tax that does not depend upon income). See, e.g., Alan J. Auerbach & James R. Hines Jr., Taxation and Economic Efficiency, in 3 HANDBOOK OF PUBLIC ECONOMICS 1347, 1349 (Alan J. Auerbach & Martin Feldstein eds., 2002). The decision instead to use taxes that depend upon income, consumption, and wealth—which, in turn, gives rise to the distortions that the Legal Envelope Theorem addresses—is a decision that reflects society’s distributional concerns.
We proceed as follows. Part I provides the analytic underpinnings of the Legal Envelope Theorem. It begins with an explanation of our prior measure of the effects of changes to the tax system: the BETR. It then shows how the BETR can be extended to capture changes to legal rules. It also situates the Legal Envelope Theorem within the broader law and economics and public finance literatures. Part II shows how the Legal Envelope Theorem applies to four different areas of law: (1) laws that affect work, (2) the law of business organizations, (3) laws that affect the size of the informal sector, and (4) property law. In each case, we consider a number of different legal rules, showing how reforms should be evaluated in light of their interactions with the tax system. We conclude with reflections on the role of the Legal Envelope Theorem in scholarly and policy reform debates.

I. ANALYTIC FRAMEWORK

In prior work, we developed a measure of the efficiency effects of changes in tax policies, such as changes to tax rates, the tax base, or enforcement efforts.24 Here, we show that this measure—the BETR—also allows us to estimate the efficiency consequences of changes to legal rules that affect tax collection. Building on this foundation, we establish the Legal Envelope Theorem. The Legal Envelope Theorem holds that it is optimal to deviate from an otherwise efficient legal rule if the BETR from the change is positive. Although the strong form of the Legal Envelope Theorem applies only to marginal changes to legal rules, the same framework also sheds light on larger legal system reforms.

Our motivating example in the next two sections involves a straightforward tradeoff between two activities—raising cattle for sale in the taxable sector versus growing vegetables for consumption in the untaxed sector. Many readers will recognize this rancher-grower example from Ronald Coase’s canonical article The Problem of Social Cost,25 almost certainly the most influential article in the law and economics literature. The difference between Coase’s example and ours is that Coase considers the allocation of land between two people engaged in different activities—a rancher who raises cattle and a farmer who grows vegetables.26 We begin by considering cases in which the same individual engages in different activities (cattle raising and vegetable growing) and allocates land between those two activities. Later on, we will extend our analysis to multi-actor settings that are closer to Coase’s. While we take some liberties with Coase’s example, the correspondence to Coase is intentional. We seek to show how the Legal Envelope Theorem informs central problems in law and economics, as well as other areas.

24 For a more complete explanation of the BETR, see Hemel & Weisbach, supra note 15, at 382.
26 Id. at 2-3.
A. The Behavioral Elasticity of Tax Revenue

1. Market vs. Nonmarket Production

Consider, first, a very simple setting in which an individual chooses between two potential uses of the same plot of land. The individual can (a) use the land to raise cattle, which she will then sell at a cattle market in a transaction observable by the tax authority, or (b) use the land to grow vegetables, which she and her family will then consume. Her choice need not be all-or-nothing: she can split the land between the two uses.

The individual makes this choice against the backdrop of a tax system. For purposes of the example, we will assume a very simple tax system consisting only of a flat-rate 30% cash flow income tax. We will also assume, as is standard, that the cash flow income tax does not reach household production and consumption. Finally, we will assume that the government does not tax—because it has no way of observing—the value of goods and services that an individual produces for herself and her household members (e.g., vegetables from one’s own garden).

The individual will want to allocate her available land between cattle raising and vegetable growing such that the value she derives from an additional unit of land devoted to cattle raising equals the value she derives from an additional unit of land used for gardening. If one of those values were greater than the other, she would reallocate land to the higher-value use until there were no more incremental gains to be had.27

Let’s say that, at the private optimum, an additional unit of land devoted to cattle raising will allow the individual to earn an additional $10 at the cattle market. She then will have to pay a 30% tax on the $10—a $3 tax—leaving her $7 with which she can buy goods and services. Since the individual is optimizing, this implies that the value of the vegetables that she can grow by devoting the same unit of land to vegetable growing is also $7. If it were anything more than $7, she would want to reallocate land from cattle raising to vegetable growing (and vice versa if it were less than $7).

Now suppose that the tax rate falls from 30% to infinitesimally less than 30%, such that the after-tax amount that the individual can earn from devoting an additional unit of land to cattle raising is slightly more than $7. The individual will then reallocate a little bit of land from vegetable growing to cattle raising because cattle raising is now slightly more valuable to the individual than before.

What is the effect of this change on the individual’s well-being? If she devotes one more unit of land to cattle raising and one fewer to vegetable growing, she is not materially better or worse off than before, because she was previously

27 We will assume, for purposes of this Article, that the individual chooses the privately optimal allocation (i.e., what’s best for her and her family). The BETR and the Legal Envelope Theorem can be extended to individuals who make optimization errors following the approach outlined in Raj Chetty, Is the Taxable Income Elasticity Sufficient to Calculate Deadweight Loss? The Implications of Evasion and Avoidance, 1 AM. ECON. J. 31, 39-41 (2009).
indifferent between those two options. A small change in the tax rate causes her to shift her choices, but that shift itself has approximately zero effect on the individual’s utility. True, when she earns an additional $10 at the cattle market, she pays an additional tax of almost $3, but she is approximately as well off as if she had spared herself the $3 in taxes and grown vegetables worth $7 (indeed, slightly better off). This result follows from what is known in economics as the envelope theorem. Envelope effects are a key part of the arguments that follow.

While the individual is roughly indifferent as to whether she allocates an additional unit of land to cattle raising and pays $3 more in taxes, society is not. Society is $3 better off when the individual allocates the extra land to cattle raising because the individual’s income from cattle raising is taxed while the value of vegetables grown for home consumption is not. Thus, the government raises an additional $3 of revenue and can purchase an additional $3 of public goods. This $3 of revenue is the tax equivalent of manna from heaven—it’s $3 of extra wealth to be allocated across society. We will refer to it as the “behavioral” effect on tax revenue—“behavioral” because it resulted from a change in the behavior of a taxpayer (here, the individual allocating more of her land to cattle raising).

The $3 behavioral effect on tax revenue from the individual reallocating land to cattle raising is not the only consequence of a slight reduction in the tax rate. Recall that the individual already was raising cattle on some of her land, and she was selling that cattle at the market and paying tax on those sales. Now, she is paying a little less in taxes on all of those sales—sales that would have happened regardless of the tax change. With respect to those sales of cows raised on land that she would have allocated to cattle raising anyway, the individual is better off: she is doing exactly what she was doing before, but now her after-tax income is a little bit higher. Symmetrically, the government is worse off, since it is raising less revenue and has less to spend on public goods. Assuming that the value of $1 in the hands of the individual and the government is the same, the benefit to the individual and the cost to the government exactly offset.

The shift in wealth from the government to the individual is a “transfer” that does not affect the total resources available to society. In the language of economics,

---


29 We discuss the reasons why this assumption is appropriate in our prior work. See Hemel & Weisbach, supra note 15, at 423 (“[T]he benefits and costs of raising one more dollar are equal, which implies that money is worth the same to the government as it is to individuals.”).
this is the “mechanical” effect on tax revenue (as distinguished from the “behavioral” effect).\textsuperscript{30}

Summing up, the effect on the total resources available to society as a result of a small reduction in the tax rate is equal to the behavioral effect on tax revenue (here, $3), minus administrative and compliance costs (here, zero). We intentionally ignore mechanical effects in this calculation because those are transfers—one side (here, the individual) is better off, and the other side (here, the government) is symmetrically worse off. This is the key lesson from the BETR framework. The effect of a small change in tax policy on the total resources available to society (i.e., the efficiency effect of the tax policy change) is the \textit{behavioral effect} on tax revenue less any change in administrative and compliance costs.

2. Reported vs. Unreported Income

In the example above, the individual’s only possible uses of her land were (a) raising cattle to be sold at the market in a transaction observable by the tax authority, or (b) growing vegetables for household consumption. Now we will introduce a third option: the individual can grow vegetables that she sells to her neighbors for cash in transactions that—though legally subject to taxation—will not be reported by the individual to the tax authority.

As before, the individual will allocate her land across these three uses optimally, such that there are no additional gains to be had from reallocation. If her net after-tax income from allocating an additional unit of land to cattle raising is $7 (i.e., $10 in pretax income less $3 in taxes), then this means that she also derives $7 in value from an additional unit of land given over to growing vegetables for household consumption or for neighborhood sales. This could be because her neighbors are only willing to pay $7 for the vegetables, and the individual can hide that income from tax authorities without cost. Or it could be because her neighbors are willing to pay more than $7 for the vegetables, but the individual bears costs in hiding that income from tax authorities (e.g., the cost of opening a secret bank account).\textsuperscript{31}

Now imagine that instead of lowering the tax rate, the government slightly raises the rate at which it audits taxpayers. The very small increase in the frequency of audits makes it slightly more likely that the individual will get caught evading taxes on her neighborhood vegetable sales. If she is caught, she will have to pay past-due taxes and penalties. The increase in the audit rate therefore makes the neighborhood vegetable sales slightly less attractive than they were before, causing the taxpayer to reallocate a bit of her land from that


\textsuperscript{31} The cost of not reporting income might also be the moral disutility that the individual experiences from violating the tax laws. If the value she assigns to that moral disutility is less than the amount she pays in taxes, she will bear that moral-disutility cost.
purpose to either (a) raising cattle, or (b) growing vegetables for household consumption.32

What is the effect on the individual’s well-being from reallocating from neighborhood vegetable sales to (a) or (b)? Again, there is no material effect because the individual already was indifferent between these options. If the individual reallocates toward raising cattle that she sells for $10 at the market in a taxable transaction, then the government gains an additional $3 in tax revenue, and society is $3 better off. This is a behavioral effect on tax revenue. If the individual reallocates toward growing vegetables for household consumption, then the government does not collect any additional revenue, and society is no better off than before.

Once more, the change in tax policy generates mechanical effects on tax revenue in addition to behavioral effects. When the government audits more taxpayers, more people will be caught evading taxes and have to pay back taxes and penalties. Those payments are transfers from the private sector to the public sector. What the evader loses is precisely equal to what the government gains.

Changing the audit rate, however, will lead to an additional set of costs not seen in our first example: the additional administrative and compliance costs from the new audits. By “administrative costs,” we refer to costs borne by the government in collecting taxes. By “compliance costs,” we refer to costs borne by the private sector. Administrative and compliance costs of tax collection are real resource costs that reduce the total amount available to society. Therefore, the effect of the audits on the total resources available to society is the behavioral effect on tax revenue less the change in administrative and compliance costs.

We have illustrated the BETR using simple examples involving (1) a tradeoff between market and nonmarket production and (2) a tradeoff between reported and unreported income, but the framework applies much more broadly to any case where an individual is indifferent between two options, one of which will cause her to pay more in taxes (but bear less of some other cost). For example, it applies to the familiar labor-leisure tradeoff (where the taxpayer’s alternative to market production is not household production but no production at all).33 It also applies to circumstances in which an employee is choosing between taxable income and untaxed fringe benefits, such as health insurance.34 It applies, too, when the individual is choosing between two types of income subject to different

---

32 If the vegetables that she sells to her neighbors are the same vegetables that she grows for herself and her family, then she will not need to reallocate land; she can just reallocate the vegetables. For purposes of our example, it doesn’t matter which is the case.

33 See Hemel & Weisbach, supra note 15, at 428-29 (using tradeoff of leisure and labor to illustrate BETR).

34 See id. An optimizing employee will select the mix of compensation that leaves her indifferent between an extra $1 of taxable income and an extra $1 of untaxed fringe benefits. If her tax rate is 30%, that means she values the extra $1 of untaxed fringe benefits at $0.70. A policy change that causes her to reallocate $1 of compensation from untaxed fringe benefits to taxable income will leave her no worse off than before, but the behavioral effect on tax revenue makes society better off by $0.30 if the tax rate is 30%.
tax rates (e.g., income from wages versus income from self-employment).\textsuperscript{35} In all these cases, the effect of the change in tax policy on the total resources available to society is the behavioral effect on tax revenue less administrative and compliance costs.

There are a number of nuances that we have left out of this explanation—nuances that are important to the BETR but less essential to understanding the Legal Envelope Theorem. One such issue is the computation of “compliance costs” (and, more specifically, the limited circumstances in which tax-related compliance costs might not enter the BETR directly).\textsuperscript{36} Another issue, mentioned above, is whether $1 in the hands of a private individual should be valued the same as $1 in the hands of the government.\textsuperscript{37} We explored these subtleties at length in earlier work.\textsuperscript{38} We set them aside here to focus more intensively on the legal rules context.

\textbf{B. The Legal Envelope Theorem}

The BETR, as developed above, measures the change in the total resources available to society resulting from small changes in tax policy. We show here that the same framework also allows us to measure the change in the total resources available to society resulting from small changes in legal rules that affect tax collection. The core logic is the same. If society sets its legal rules to maximize net benefits irrespective of tax consequences, then small changes to otherwise optimal legal rules will not have first-order effects on the sum of nontax net benefits. They may, however, have tax consequences, thus changing total social resources. We call this the Legal Envelope Theorem because it arises from the same envelope effect outlined above.

1. The Legal Envelope Theorem in a Single-Person Setting

To illustrate the Legal Envelope Theorem, we begin with an example that directly parallels our exposition of the BETR in the previous Section. Imagine again that a single individual is allocating a fixed amount of land across two uses: cattle raising for sale in the taxable sector, and vegetable growing for untaxed household consumption. On the margin, the individual is indifferent

\textsuperscript{35} Starting in 2018, self-employment income is eligible for a 20\% deduction for single taxpayers with up to $157,500 in taxable income and married-filing-jointly taxpayers with up to $315,00 in taxable income. Those thresholds are adjusted each year for inflation. Taxpayers with income above those thresholds are eligible for a full or partial deduction under certain circumstances. The benefit is set to sunset at the end of 2025. I.R.C. § 199A.

\textsuperscript{36} See Hemel & Weisbach, \textit{supra} note 15, at 397-98 (explaining differences between mechanical and behavioral compliance costs and how they impact BETR).

\textsuperscript{37} See id. at 395.

between (a) allocating a unit of land to cattle raising, selling the cattle for $10 on the market, and paying a tax of $3; or (b) allocating a unit of land to vegetable growing, resulting in $7 worth of untaxed household consumption. The individual’s choice will be influenced not only by the tax rate—as illustrated above—but also by the constellation of legal rules that affect the costs and benefits of cattle raising and vegetable growing. These include laws addressing the treatment of animals, fencing, fertilizer use, the transportation of livestock to market, and much more.\(^\text{39}\)

Consider any one of these laws—for example, the maximum amount of water-soluble nitrogen that a grower may apply per square foot.\(^\text{40}\) Nitrogen enhances crop yields, so a lower limit on nitrogen means the individual and her household will grow fewer vegetables per unit of land.\(^\text{41}\) But excess nitrogen use can contaminate groundwater, potentially seeping into the household’s drinking well.\(^\text{42}\) For the sake of simplicity, we will assume that the direct effects of the change in the legal rule all fall on a single individual or household (i.e., this household’s drinking water and only this household’s drinking water will be affected by a rule change). In the next Section, we will consider the more complicated case in which changes in legal rules reallocate entitlements across individuals and households.

Ignoring tax-collection consequences, the efficient fertilizer rule would set the maximum amount of water-soluble nitrogen such that the marginal benefit from a small reduction in that amount (improved drinking water) equals the marginal cost (lower crop yields). We will say that this rule satisfies the standard of “simple efficiency.” A rule accords with simple efficiency if the nontax benefits from a slight change in the rule equal the nontax costs (i.e., if the rule maximizes total resources before accounting for taxes), holding the distribution of income fixed.\(^\text{43}\)

---

\(^\text{39}\) See, e.g., Animal Welfare Act, 7 U.S.C. § 2131 (regulating transportation, purchase, sale, housing, treatment, etc. of animals in interstate commerce).

\(^\text{40}\) See, e.g., N.J. STAT. ANN. § 58:10A-63 (West 2021) (establishing limits on use of water-soluble nitrogen).


\(^\text{42}\) See id.

\(^\text{43}\) As Louis Kaplow has argued in a related context, simple efficiency must be defined holding the distribution of income (or the distribution of utilities) fixed, see generally Louis Kaplow, A Unified Perspective on Efficiency, Redistribution, and Public Policy, 73 NAT’L TAX J. 429 (2020). The tax and transfer system imposes efficiency costs to redistribute income. For example, income-based taxes and transfers distort how much people work and save, what jobs they take, where and how they invest, and so forth. Society judges these efficiency costs as worth bearing in order to get the redistributive benefit of shifting resources from people with a low marginal utility of wealth (the rich) to people with a high marginal utility of wealth (the poor).

If simple efficiency were not defined holding distribution fixed, the category of “efficient”
Importantly for our purposes, a slight reduction in the nitrogen limit also slightly lowers the value of allocating land to vegetable growing. The yield on the marginal unit of land allocated to vegetable growing is now a bit less than $7. As a result, the individual reallocates one unit of land from vegetable growing to cattle raising.

The effect on the individual’s utility is, as in Section I.A, approximately zero. The reduction in her vegetable yields is balanced out by the improvement in the quality of her drinking water. Also, the envelope theorem tells us that if her allocation of land between cattle raising and vegetable growing was previously optimal, the reallocation of one unit of land from vegetable growing to cattle raising does not make her appreciably better off or worse off than before. But the reallocation of one unit of land from vegetable growing to cattle raising does—as before—have a first-order effect on the total resources available to society. Now, the individual’s taxable income rises by $10, and so the taxes she pays increase by $3.

This result should not be surprising since it is—for all intents and purposes—the same result as in Section I.A. The only modification is that the relevant policy change that caused the individual to reallocate one unit of land from vegetable growing to cattle raising (or, at a higher level of generality, from the untaxed sector to the taxed sector) was a change in a nontax legal rule rather than an element of the tax system. The change in total resources available to society is, as under BETR, the behavioral effect on tax revenue (here, $3) less any change in administrative and compliance costs. If, for example, the government had to spend money to implement the reduction in the nitrogen limit, that would be a real resource cost that enters the total-utility analysis, equivalent to the tax administrative costs considered in Section I.A. Similarly, if the individual has to spend money to comply with the reduction in the nitrogen limit, such as tracking and reporting her nitrogen use to a regulator, these costs are real resources that enter the analysis in the same way tax compliance costs do.

Our analysis shows that we should change the fertilizer rule so that it no longer satisfies simple efficiency but instead maximizes the total resources available to society, inclusive of taxes, or what we will call “full efficiency.” By moving away from simple efficiency, we do not make the individual rancher/grower appreciably worse off or better off, but we generate $3 of additional tax revenue that can be used to produce $3 worth of public goods or legal rules would include regressive legal rules that offset the efficiency costs of the tax system. For example, if the tax system takes a dollar from a rich person and gives it to a poor person at an efficiency cost of $0.25, an “efficient” legal rule might give the dollar back to the rich person, even if the efficiency benefit were less than $0.25. The same qualifier is needed in much of the literature discussing the relationship between the redistribution, tax system, and legal rules.

returned to the rancher to spend as she pleases. The move away from simple
efficiency thereby constitutes an increase in total resources.

A shorthand way of thinking about these effects is that the change in the legal
rule generates what might be called a fiscal externality. It causes the
rancher/grower to change her behavior in a way that is immaterial to her but
generates a benefit to others because of the additional resources available to the
government. The Legal Envelope Theorem can be reframed as stating that
efficiency needs to account for fiscal externalities.

2. The Legal Envelope Theorem in a Multi-Person Setting

In the immediately preceding example, we imagined that the nontax costs and
benefits of the change in the legal rule all fell on the same individual. This may
accurately describe some legal rules, which seek to maximize the well-being of
all individuals to whom they apply, rather than to assign rights, resources, and
responsibilities across different individuals. Often, however, legal rules affect
different individuals differently, potentially making some individuals better off
and others worse off. The Legal Envelope Theorem applies in this case as well:
simple-efficient legal rules do not maximize total resources because they ignore
tax effects. Fully efficient legal rules must take all of the effects into account.

---

45 Nathaniel Hendren uses this terminology in a similar sense. See Nathaniel Hendren, The
Policy Elasticity, 30 TAX POL’Y & ECON. 51, 53 (2016) (defining “fiscal externality” as “the
impact of the behavioral response to [a] policy on the government budget outlays per dollar
of government expenditure”). The term is sometimes used in a related but distinct sense in the
literature on fiscal federalism and interjurisdictional competition. See, e.g., Zvi Hercowitz &
David Pines, Migration with Fiscal Externalities, 46 J. PUB. ECON. 163, 163-64 (1991) (stating
that “[i]n its strict sense fiscal externality is defined as a situation where a pure public good is
financed by residence-based taxes,” such that migration, which affects per-capita cost but not
per-capita benefit of public goods, generates positive fiscal externalities for jurisdiction into
which migrants are moving and negative fiscal externalities for jurisdiction out of which
migrants are moving); Bev Dahlby, Fiscal Externalities and the Design of Intergovernmental
Grants, 3 INT’L TAX & PUB. FIN. 397, 398 (1996) (“Interjurisdictional fiscal externalities occur
when a government’s tax and expenditure decisions affect the well-being of taxpayers in other
jurisdictions . . . ”).

46 In the single-person case—which in public economics is typically called a Ramsey
model after the early twentieth-century British mathematician Frank Ramsey—there is no
reason to distinguish between wealth and utility. See F.P. Ramsey, A Mathematical Theory of
Saving, 38 ECON. J. 543, 543 (1928). Ramsey models, like the one we use, preclude
distributional considerations by assumption because they involve only one individual, and so
no redistribution across individuals. Id.

In the multiple-person case considered in this Section, the difference between wealth and
utility becomes relevant because different individuals will have different marginal utilities of
wealth. It matters which individuals have resources if we want to maximize a function of
individual utilities. Definitions of efficiency try to abstract away from these distributional
effects by focusing on total resources (or total wealth), rather than who has those resources.

To keep the multiple-person case as parallel as possible to the single-person case, we will
focus on the maximization of total resources, rather than total utility. We can do this by
To see how the analysis applies in the multi-person setting, continue with the immediately preceding example, except imagine now that the nitrogen from fertilizer contaminates not the rancher/grower’s own drinking well but her neighbors’ wells. Lowering the water-soluble nitrogen limit from the simple-efficient level will make the rancher/grower worse off, because she now reaps a smaller yield from the land that she continues to allocate to vegetable growing. It will, however, make her neighbors better off because they now benefit from safer drinking water. It generates a transfer between the rancher and her neighbor.

Since we were previously at the simple-efficient legal rule, we know that the transfer away from the rancher is of equal size as the transfer to her neighbors. (If not, we could have adjusted the prior legal rule and increased total resources leaving aside tax effects, which means that the prior rule would not have been simple-efficient.) The transfer does not affect the total resources available to society. As a result, we treat the transfer as a wash to measure the efficiency effects of the legal change.

Because the rancher/grower had previously chosen the privately optimal allocation of her land, her behavioral change—the reallocation of one unit of land from vegetable growing to cattle raising—also does not materially affect her well-being. This, too, is the envelope effect at work: if the rancher/grower was at the private optimum, then we know that the marginal benefit to her of a small change in either direction was equal to the marginal cost, and a small reallocation will not make her appreciably better or worse off. It does, however, affect the total resources available to society because when she reallocates land to cattle raising, she pays more in taxes. Again, the change in society’s total resources is measured by the BETR: the behavioral effect on tax revenue of $3 less any change in administrative and compliance costs.

The neighbors may also change their behavior in response to improved drinking water. Those changes also will not make them materially better or worse off. For example, improved drinking water from their well might cause the neighbors to drink a little bit less beer and a little bit more water; if they were previously allocating their liquid consumption between beer and water optimally, then they are effectively indifferent to a small change in the direction of more water consumption. The neighbors’ behavioral change would, however, have a first-order effect on the total resources available to society if it changed tax collections (for example, if beer is taxable and water is not). Under those circumstances, we would use the BETR to calculate the effect of the neighbors’ behavioral change on total resources. The BETR adds (or nets, depending on the sign) these effects to the effects of changes in the rancher/grower’s behavior to measure the total change in resources from the change in the legal rule. If the change is positive, the simple-efficient legal rule fails to maximize total resources, and we can do better by modifying it.

assuming that all individuals affected by the legal rule have the same marginal utility of wealth. We explicitly consider differences in the marginal utility of wealth infra Section I.C.3.
To summarize: Small changes in “simple-efficient” legal rules do not materially affect the sum of total resources available to society except through the tax channel. We know this because the simple-efficient legal rule is, by definition, set to maximize total resources before taking taxes into account. Therefore, a small change in either direction may generate transfers but has no first-order effects on total resources. Moreover, since individuals are choosing their own behavior to maximize their own well-being, a small change in their behavior in either direction does not leave them materially better or worse off. These behavioral changes may, however, have tax-collection consequences. When they do, the BETR allows us to see how those behavioral changes affect the total resources available to society.

So far, we have illustrated the Legal Envelope Theorem through what in the natural and social sciences is called a “toy model,” a deliberately simplistic model that strips away many details so that we can convey the central mechanism concisely.\footnote{See, e.g., Alexander Reutlinger, Dominik Hangleiter & Stephan Hartmann, \textit{Understanding (with) Toy Models}, 69 Brit. J. Phil. Sci. 1069, 1071 (2018) (explaining and examining goal of toy modeling).} In Part II, we will show how our toy model corresponds to a wide range of real-world scenarios in which nontax legal rules affect tax collection. Before doing so, we will consider several points left out of the toy model but important to the analysis that follows.

C. Comments and Qualifications

1. More than Marginal Changes

The Legal Envelope Theorem applies to small changes in legal rules away from simple efficiency. Because the marginal nontax benefit from a legal rule change in any direction away from the simple-efficient legal rule equals the marginal nontax cost (both at the individual level and the level of society), we can proceed as if the only effects of the change on total resources are those captured by the BETR. Once we make more than small changes, however, there will be first-order costs in the primary legal area, at which point the envelope theorem logic no longer applies.

Nonetheless, the Legal Envelope Theorem can help us analyze larger legal rule changes in two ways. First, and most straightforwardly, the Legal Envelope Theorem can be used not only to analyze marginal changes from simple-efficient legal rules but also to find fully efficient legal rules. A fully efficient legal rule maximizes total resources including those affected by the primary legal system and those in the tax system. At the optimum, the marginal loss in simple efficiency should equal the marginal fiscal externality, as measured by the BETR.

Because tax rates are substantial in developed countries, the fully efficient legal rule may deviate substantially from the simple-efficient rule. The fiscal externality is equal to the tax rate. We have been using 30% in our example, but

in the United States, the tax rate often exceeds 50% (taking both federal and state taxes into account), and in other developing countries may be well above 50%.48

Second, the Legal Envelope Theorem also offers insight into the effects of discrete changes to legal rules that are not marginal. For example, repealing the Statute of Frauds altogether would be a discrete legal rule change.49 Discrete changes present a challenge not present with marginal or small changes. With respect to small rule changes, anyone who alters her behavior in response to the rule change was previously indifferent between engaging in a little more or a little less of the relevant activity. This is not so for individuals who change their behavior in response to a discrete legal rule change. Some of these changes may be “inframarginal”—i.e., they leave individuals substantially better off or worse off than before. For example, if we eliminate the Statute of Frauds, making tax evasion easier, some of the behavioral changes will reflect inframarginal changes, and we cannot assume that anyone who changed her behavior was indifferent.

The BETR and the Legal Envelope Theorem still can aid our analysis of discrete changes, though the function of these tools will be nuanced. When a discrete change in a tax or nontax legal rule leads to a change in tax revenue due to behavioral effects, the BETR can allow us to estimate lower bounds and upper bounds of the effect on total resources from a given individual’s tax-related behavioral change (i.e., a behavioral change that affects taxes collected). In some circumstances, these lower-bound and upper-bound estimates may be all we need.

To illustrate, imagine that the wage rate is $10 per hour and the tax rate starts out at 30%. Then, the tax rate falls to 20%, and an individual works an hour more and pays $2 more in taxes. We know that the individual valued an additional hour of leisure at $7 or more; otherwise, she would have been working the additional hour in the first place. We also know that she did not value an additional hour of leisure at more than $8; otherwise, she still would not be working. The increase in total resources resulting from the behavioral change is at least $2, representing the behavioral effect on tax revenue. It is potentially as


2022] THE LEGAL ENVELOPE THEOREM 467

much as $3, representing the behavioral effect on tax revenue plus the benefit to

the individual of replacing $7 worth of leisure with $8 in after-tax income.\(^{50}\)

The same analysis applies to legal rules. Imagine that a new nitrogen limit for

fertilizer raises the cost of growing vegetables by $1 per unit of land. The

rancher/grower in the previous two Sections reallocates one unit of land from

vegetable growing to cattle raising, causing her to earn an additional $10 in
taxable income and pay an additional $3 in taxes. We know that the

rancher/grower assigned a value of at least $7 to the vegetables from that unit of

land; otherwise, she would have been raising cattle on that land in the first place.

We also know that the rancher/grower did not value the vegetables at more than

$8; otherwise, she would have continued to grow vegetables even after the new

nitrogen limit. The increase in total resources resulting from tax-related

behavioral changes is at least $2, representing the $3 behavioral effect on tax

revenue less the loss to the rancher of replacing $8 of vegetables with $7 of after-
tax income. The increase is potentially as much as $3, representing purely the

$3 behavioral effect on tax revenue, with the rancher/grower’s $7 of additional

after-tax income and $7 less of vegetables netting out.

Even where we can estimate only lower and upper bounds, the BETR and the

Legal Envelope Theorem can help us make decisions about discrete changes to

legal rules. Sometimes, a lower-bound estimate of the increase in total resources

resulting from a tax-related behavioral change will be sufficiently large that the

benefits will outweigh the nontax costs of deviating from simple efficiency, even

if the true effect is only the lower bound. In other cases, an upper-bound estimate

of the increase in total resources resulting from tax-related behavioral changes

will be sufficiently small that, even if the true effect is the upper bound, the

nontax costs of deviating from simple efficiency will swamp the benefits. There

still will be instances in which the nontax costs of deviating from simple

efficiency lie between the lower- and upper-bound estimates of the increase in

total resources from tax-related behavioral changes, in which case the BETR and

the Legal Envelope Theorem will not be determinative. Even in those

circumstances though, the BETR and Legal Envelope Theorem can give us a

rough sense of magnitudes that a focus on simple efficiency ignores.

2. The Problem of the Second Best

Our analysis above contemplates a change to what is already a simple-
efficient legal rule. If the starting point legal rule is not simple-efficient, then a

change in the direction suggested by the Legal Envelope Theorem will not

necessarily increase (and may even reduce) total resources. In the example

above, if the limit on nitrogen per square foot is already too low by the standards

of simple efficiency, then lowering it marginally may not add to total resources

\(^{50}\) Put differently, the benefit to the individual from the behavioral change cannot be less

than zero; otherwise she would not have made the change. And it cannot be greater than $1;

otherwise she would not have needed the tax cut in order to make the change. So we add the

$2 behavioral effect on tax revenue to an individual benefit ranging from zero to $1.
even if it induces a small shift from the untaxed activity (vegetable growing) to the taxed activity (cattle raising).

This conclusion—a corollary to the general theory of the second best—takes on special significance if real-world legal rules are often not simple-efficient. And given both the epistemic and political obstacles to the adoption of simple-efficient legal rules, it is not safe to assume that all existing legal rules satisfy simple efficiency. For present purposes, we will set this qualification aside and focus on characterizing the optimum. If the existing rule is not simple-efficient, the solution is not for policymakers to ignore the Legal Envelope Theorem—it is to adopt the simple-efficient rule plus the adjustment indicated by theorem. In any given circumstance, policymakers should consider whether the underlying rule satisfies simple efficiency and whether an adjustment in either direction will increase revenues via behavioral changes.

3. Redistribution and the Relationship to Kaplow & Shavell (1994)

In establishing the Legal Envelope Theorem, we focused on the efficiency effects of tax and legal rules. We set aside distributional aspects, such as the possibility that the rancher/grower might be wealthier than her neighbors, or vice versa.

There is a vibrant debate about whether, and the extent to which, legal rules should be used to redistribute income. To the extent they are used to

51 See R.G. Lipsey & Kelvin Lancaster, The General Theory of Second Best, 24 REV. ECON. STUD. 11, 11 (1956) ("The general theorem for the second best optimum states that if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are, in general, no longer desirable.").

52 See Alex Raskolnikov, Distributional Arguments, in Reverse, 105 MINN. L. REV. 1583, 1597 (2021).

53 See id.

redistribute income, legal rules should not be set to be efficient—whether simple or full. Here we address the relationship between that debate and our claims in two ways.

First, to a great extent, that debate is orthogonal to our claims. Our claims are about which legal rules are efficient. Regardless of whether one thinks legal rules should be used to redistribute, it is important to know which legal rules are efficient. For example, we want the most efficient legal rules for a given level of redistribution. And understanding which legal rules are efficient is central to understanding the costs of redistribution through legal rules.

Moreover, regardless of one’s views about whether rules should be used to redistribute directly, distributional concerns strengthen the importance of adjusting legal rules to take the tax system into account. Taxation is society’s most powerful tool for addressing income and wealth inequality. Taxes allow society to shift resources away from high-income individuals and households to the rest of society, and negative taxes—like the earned income tax credit and the child tax credit—allow us to transfer resources to low-income individuals and households. From a welfarist perspective, the primary reason why we do not tax at a 100% rate and redistribute wealth equally across individuals is that taxation (whether based on income, consumption, or wealth) introduces inefficiencies. Making the tax system more efficient allows us to redistribute more wealth, so using legal rules that make it easier to tax becomes more important the more that we care about redistribution. That is, our analysis is orthogonal to the arguments over whether legal rules should be used to redistribute income, but it is central to the project of reducing income inequality.

Second, the Legal Envelope Theorem is consistent with prior work establishing that nontax legal rules themselves are generally not the most effective tools for redistributing resources from high-income to low-income individuals (or high-wealth to low-wealth individuals). As noted, the canonical analysis of the relationship between distributional issues and legal rules is a 1994

*Legal Rule Design Should Incorporate Equity as Well as Efficiency*, 123 Yale L.J. 2478 (2014).

Chris Sanchirico uses envelope-theorem reasoning to argue that legal rules should be adjusted away from efficiency to shift resources from the rich to the poor (in contrast to our argument that legal rules should be adjusted away from simple efficiency in order to facilitate redistributive taxation that then shifts resources from the rich to the poor). See Sanchirico, * supra*, at 813-20. Sanchirico’s argument is valid if individuals with the same taxable income differ in their marginal utility of wealth in ways that the legal system can observe but the tax system cannot. See Kaplow & Shavell, *Should Legal Rules Favor the Poor?*, supra note 21, at 828. Under those circumstances, changes to otherwise efficient legal rules might be used to redistribute from individuals with lower marginal utility of wealth to individuals with higher marginal utility of wealth. *Id.* The practical difficulty in implementing this insight, as Kaplow and Shavell note, is that the marginal utility of wealth cannot be observed directly—and thus, the insight does not tell policymakers in which direction to adjust otherwise efficient legal rules. See *id.* at 832. By contrast, our version of the Legal Envelope Theorem recommends modifications based on observable changes in tax revenue (and does not depend upon unobservable marginal utilities).
article by Louis Kaplow and Steven Shavell.55 Kaplow and Shavell argue that the tax system can achieve distributional goals more efficiently than legal rules.56 They conclude, therefore, that legal rules generally should not seek to redistribute income and, instead, should pursue efficiency.57

Kaplow and Shavell consider a redistributive legal rule and a tax on labor income.58 The legal rule, by construction, deviates from simple efficiency in an attempt to redistribute income. For example, an efficient, strict liability system sets damages equal to harm. To make the rule redistributive, damages could be a function of the income of the injurer, with damages set lower than harm for low-income defendants, and increasing relative to harm as the injurer’s income goes up, so that damages are higher than harm for high-income defendants.59

Kaplow and Shavell suggest the following thought experiment. Replace the inefficient redistributive legal rule with the efficient one, and simultaneously adjust the tax rate schedule so that at each income level, individuals are equally well-off.60 For example, in our hypothetical inefficient strict-liability regime described above, high-income individuals were worse off relative to an efficient regime. When we replace the inefficient regime with the efficient one, we would simultaneously increase the tax rate on high-income individuals so that they are no better off than under the inefficient rule. Imagine that we do the same at each income level—for example, lowering the tax rate on low-income individuals and replacing a tort system favorable to them with an efficient one.61

Kaplow and Shavell then examine the effects of this swap.62 By construction, individuals at each income level are no better or worse off than before. Moreover, the effective tax schedule (the actual tax schedule plus any implicit tax due to the tort system) is the same before and after the swap, and Kaplow and Shavell assume that individual labor-supply choices will respond to changes in the effective tax schedule in the same way that they respond to changes in the actual tax schedule.63 But we have replaced the inefficient tort rule with an efficient tort rule, which means that total resources have increased. Since the tax changes leave every individual as well-off as under the inefficient rule but total resources increase, the increase in resources shows up as an increase in tax revenue.64 This revenue can then be used to lower taxes on the rich and increase transfers to the poor or, equivalently, to provide public goods that everyone

55 See Kaplow & Shavell, Why the Legal System Is Less Efficient, supra note 21.
56 Id. at 667-68.
57 Id. at 667-69.
58 Id. at 669.
59 See id. at 669-70.
60 Id. at 669.
61 See id. at 671-74.
62 Id.
63 See id. at 671 n.5.
64 Id. at 674.
values. Therefore, we should prefer to swap the inefficient legal rule and the original tax schedule for the efficient legal rule and the modified tax schedule. The swap generates a Pareto improvement: everyone is at least as well off as before and some people or all people are better off. As a result, Kaplow and Shavell conclude that legal rules should not seek to redistribute wealth. Instead, we should use legal rules to pursue efficiency and the tax system to redistribute wealth.

This conclusion is consistent with our claims about which legal rules are efficient. Although Kaplow and Shavell appear, in their main text, to support the idea that we should pursue what we have called simple efficiency, this is driven by two limiting assumptions in their model. First, they assume a relatively simple tax system. Although they do not specify the details of their tax system, we take it to be a tax on labor income with no enforcement problems. Second, Kaplow and Shavell make a technical assumption about the individual utility function, known as weak separability. This assumption guarantees that the content of legal rules has no effect on the tax system’s ability to operate.

When we relax these assumptions, our arguments and Kaplow and Shavell’s are consistent. Kaplow and Shavell explicitly consider the effects of relaxing their weak separability assumption. In this case, they conclude that legal rules should deviate from simple efficiency but only in a limited way. The key idea is that a tax on labor income distorts the choice of how much to work. Individuals reduce their work and increase their leisure. When we relax the weak separability assumption, legal rules can increase the relative price of leisure, offsetting this distortion. The legal system can help the tax system function, but it still does not seek to directly redistribute.

This is precisely the same effect we consider with the Legal Envelope Theorem, but we do so in the context of a more complex tax system, one that may tax different activities at different rates, that has enforcement problems, that requires administrative and compliance costs, and so forth. The legal system in this case plays the same conceptual role of helping the tax system. It acts to penalize choices that reduce tax collections and to subsidize choices that increase tax collections—but the role for legal rules is much larger.

---

65 See id.
66 Id. at 669.
67 See id. at 680.
68 See id. at 678-79.
69 In particular, Kaplow and Shavell assume that utility takes the form

\[ U = U(l, u(c_1, c_2, \ldots, c_n)), \]

where \( l \) is labor effort, and \( c_i \) is consumption of good \( i \). This assumption is not strictly necessary for their core conclusions but greatly simplifies the analysis. For further discussion, see Kaplow, supra note 43, at 444.
70 Kaplow & Shavell, Why the Legal System Is Less Efficient, supra note 21, at 679.
71 See id.
Even in this more general context, the legal system still lacks any general advantage over the tax system in redistributing income directly. Instead, the legal system is helping the tax system function better. In that sense, the legal system is important for redistribution because it makes the central tool for redistribution—the tax and transfer system—more effective. As a result, our arguments are compatible with, and are an extension of, Kaplow and Shavell’s arguments.

4. Relationship to Public Finance Literature

The literature on the economics of taxation, for the most part, considers the design of the tax system taking the legal system as given. For example, the economics literature often takes labor supply elasticity as a primitive rather than a choice. The literature assumes there is such a thing called a corporation whose structure and operations are determined exogenously. In addition, for the most part, the economics literature assumes that there are a set of activities—colloquially, leisure—that cannot be taxed for external reasons.

We instead treat these and similar items as choices. Within some range, we can change the elasticity of labor supply by changing the legal rules surrounding work. Corporations are legal inventions and can have the characteristics that we choose. And the activities we do not tax depend in large part on our ability to observe. We can choose legal rules that make it easier or harder to observe various activities, and we can choose to spend resources observing.

---

72 We say that the legal system lacks any “general advantage” because, like Kaplow and Shavell, we acknowledge the possibility of cases in which behavior may respond less to redistribution via the legal system than via the tax system. See id. at 671.

73 See, e.g., FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 117 (1921) (describing trade-off between leisure and labor as defined by set, rational behavior).

74 The economist Frank Knight defined leisure as “all non-pecuniary, alternative uses of time.” Id. at 117. For other attempts to define leisure, see generally Justin Voss, The Definition of Leisure, 1 J. ECON. ISSUES 91 (1967); and Stephen Enke, On the Economics of Leisure, 2 J. ECON. ISSUES 437 (1968). As noted above, the BETR and the Legal Envelope Theorem do not require the analyst to distinguish between nonpecuniary uses of time and other pecuniary, but untaxed, uses of time (e.g., labor in the informal economy).

Some papers make the nontaxed sector endogenous. See, e.g., Shlomo Yitzhaki, A Note on Optimal Taxation and Administrative Costs, 69 AM. ECON. REV. 475, 475 (1979) (proposing solution to simple model of optimal taxation); John Douglas Wilson, On the Optimal Tax Base for Commodity Taxation, 79 AM. ECON. REV. 1196, 1196 (1989) (arguing existence of general rise in efficiency loss when there is less spending on taxed commodities); Joel Slemrod & Wojciech Kopczuk, The Optimal Elasticity of Taxable Income, 84 J. PUB. ECON. 91, 93-94 (2002) (examining effect of optimal income tax problem); Dhammika Dharmapala, Joel Slemrod & John Douglas Wilson, Tax Policy and the Missing Middle: Optimal Tax Remittance with Firm-Level Administrative Costs, 95 J. PUB. ECON. 1036, 1036 (2011) (analyzing optimal taxation of firms with fixed government tax-collections costs). Our analysis builds on this literature by showing how the legal system can shape the nontaxed sector’s scope.
To illustrate how we differ from the standard approach in economics, consider a recent paper by three of the most prominent economists currently working on tax issues, Thomas Piketty, Emmanuel Saez, and Stefanie Stantcheva. They consider how the optimal top tax rate is affected by three different behavioral margins: the labor supply elasticity, the ability of taxpayers to evade taxes, and what they call the bargaining elasticity. The bargaining elasticity reflects the ability of top income earners to extract rents from their employers, such as CEOs getting paid excessive salaries. The authors suggest a top tax rate that reflects a combination of all three elasticities.

All three of these elasticities are in part determined by law. As we demonstrate below, legal rules affect the costs and benefits of work and, therefore, the labor supply elasticity. They affect the ability of taxpayers to engage in evasion, such as using anonymous offshore bank accounts, and, therefore, the evasion elasticity. And they determine the ability of CEOs to bargain with their employers, and, therefore affect the bargaining elasticity. Under the approach we advocate here, we should not simply design the tax system taking the legal system as fixed. We should instead design the two in tandem, recognizing that optimal tax rules depend on the content of legal rules and that optimal legal rules depend on the structure of the tax system. Our approach, we believe, will provide more socially beneficial outcomes because it allows us to use the full toolkit to design the tax and legal system rather than only half of it.

A second issue is how our arguments relate to one of the canonical results in the economics of taxation, the Corlett-Hague rule. The Corlett-Hague rule has played an influential role in the public finance literature since it was introduced by two British economists in 1953. It holds that goods that are complements to leisure or substitutes for labor should be taxed at a higher rate than other goods, and goods that are substitutes for leisure or complements to labor should be taxed at a lower rate than other goods (or equivalently, subsidized). The intuition behind this result is the same as we discussed above with respect to Kaplow and Shavell’s arguments. A tax on labor income distorts labor effort: people will work less and spend more time on leisure. Taxing, say, a complement

---

76 Id. at 231-32.
77 See id. at 239.
78 Id. at 231.
79 Piketty, Saez, and Stantcheva note that this last elasticity, the bargaining elasticity, can be affected by legal choices. See id. at 243. We show that all three elasticities—labor supply elasticity, tax avoidance, and bargaining—are shaped by legal-design choices.
81 Id.
82 Id.
to leisure reduces this distortion because leisure becomes relatively less attractive.

Boiled down to its core, the Legal Envelope Theorem proposes that legal rules should be adjusted away from simple efficiency to subsidize complements to taxpaying and penalize substitutes for taxpaying. That is, our core claim is that the Corlett-Hague logic applies to margins other than labor/leisure that affect tax collection, such as the choice between taxable and untaxed production and the choice between reporting and evasion. Complements to taxpaying should be subsidized. Substitutes for taxpaying should be penalized. The legal and tax systems are alternative mechanisms for implementing Corlett and Hague’s intuitions. The Legal Envelope Theorem is the legal rule generalization of the Corlett-Hague tax rule.

Corlett and Hague suggest using excise taxes while we suggest using legal rules. Kaplow and Shavell make a suggestion similar to Corlett and Hague and note that excise taxes will often be a better tool than legal rules. A natural question is when we should use one approach or the other.

Existing literature, extending as far back as the debate between Coase and Pigou, addresses this question in analyzing whether (and when) we should rely on public or private enforcement of law. The use of excise taxes corresponds to public enforcement: excise taxes are comparable to fines imposed by a government agency. Legal rules entail a mix of public and private enforcement but often involve private enforcement. The choice between excise taxes and legal rules in any given case will likely depend on the particulars in each case, such as which parties have the relevant information, the incentives for various parties to enforce, administrative and compliance costs, and whether bringing in a third party (the government) can improve incentives for private actors.

In many of our applications below, we consider cases in which legal rules already regulate behavior, and the sorts of adjustments recommended by the

---

83 See id. at 30.
84 Kaplow & Shavell, Why the Legal System Is Less Efficient, supra note 21, at 681.

Legal Envelope Theorem can be implemented at low marginal administrative cost. It may be that some of these legal regimes should be replaced with a different enforcement system that relies on fines or excise taxes. We leave the complex choice between legal rule adjustments and excise taxes for future work.

II. APPLICATIONS

In this Part, we show that there are a large number of legal rules that affect the tax system and, as a result, need to be set taking the tax effects into account. We do not attempt a detailed analysis of each legal rule, and we do not claim that the existing rule satisfies simple efficiency. Instead, we seek to show in each case that it would be desirable to deviate from the simple-efficient legal rule and possibly to deviate substantially.

We cover four categories of legal rules: laws that affect work, laws concerning business organizations, laws that affect the size of the informal economy, and the law of property. Our claim is not that each of these cases is original; it is that there are a large number of such cases. The effect of legal rules on the tax system is pervasive, and, therefore, tax effects are likely to be important in determining the optimal content of the legal rules.

A. Legal Rules Related to Work

Labor income is the most important part of the tax base in all tax systems in developed countries. This is inevitable because returns to labor make up a majority of gross domestic product in developed economies. Thus, broad-based tax systems must rely primarily on taxing labor income. Because of the centrality of labor income to the tax base, the elasticity of labor supply is one of the most important parameters determining the ability of the tax system to operate and, importantly, to redistribute.


As noted, the elasticity of labor supply is taken by many economists to be a primitive.\textsuperscript{88} We illustrate here that it is not a primitive but is instead affected by the legal rules surrounding work (in addition to preferences about work versus leisure).\textsuperscript{89} In a basic sense, this observation is obvious. Legal academics who work on employment and labor law do so on the belief that those legal choices affect the work environment and, presumably, individual choices regarding work. The same is true of labor economists. They study the effect of the institutions surrounding work—such as unionization, the minimum wage, or wrongful discharge laws—and regularly recommend reforms to those institutions on the theory that reforms will lead to better outcomes (e.g., encouraging work or—equivalently in our model—increasing pay).\textsuperscript{90} Only those studying the tax system—particularly public finance economists—take the elasticity of labor supply as a primitive rather than as a choice. That is, a simple glance at the massive literature in labor economics, employment law, and labor law should be sufficient to show that the elasticity of labor supply is not a deep primitive.\textsuperscript{91} And once we recognize that the elasticity of labor supply is partly a

\textsuperscript{88} To give another example, in their review of the economics of labor income taxation, Thomas Piketty and Emmanuel Saez characterize the difference between labor supply elasticity and the elasticity of tax evasion as follows: “The key distinction between real [labor supply] and tax avoidance responses is that real responses reflect underlying, deep individual preferences for work and consumption while tax avoidance responses depend critically on the design of the tax system and the avoidance opportunities it offers.” Thomas Piketty & Emmanuel Saez, \textit{Optimal Labor Income Taxation}, in \textit{5 Handbook of Public Economics} \textit{391, 417} (Alan J. Auerbach, Raj Chetty, Martin Feldstein & Emmanuel Saez eds., 2013).

\textsuperscript{89} We are not the first to make this point. See Michael Keane & Richard Rogerson, \textit{Micro and Macro Labor Supply Elasticities: A Reassessment of Conventional Wisdom}, \textit{50 J. Econ. Literature} \textit{464, 465} (2012) (noting that “one important source of confusion in the literature is the idea that one can estimate a labor supply elasticity in one context and import this elasticity into other contexts,” and stating that “in general, labor supply elasticities are neither a single number nor a primitive feature of preferences”).

\textsuperscript{90} In the BETR, a behavioral change that yields an $x$ increase in taxable wages taxed at rate $t$ has the same effect on total resources ($tx$) whether or not the change is an increase in labor supply (working an additional hour at a wage of $x$) or an increase in pay of $x$ holding hours fixed.

\textsuperscript{91} See, e.g., Henrik Jacobsen Kleven, \textit{How Can Scandinavians Tax So Much?}, \textit{28 J. Econ. Persp.} \textit{77, 78} (2014). The experiences of Scandinavian countries shed some light on the extent to which legal rules can affect labor supply and, as a result, increase the ability to tax. Scandinavian tax systems raise substantially more revenue as a percent of GDP than most other Western tax systems and yet report some of the highest labor force participation rates in the developed world, as well as low levels of tax evasion. \textit{Id.} at 77. While it might be the case that Scandinavians are just hardworking, Henrik Kleven argues that this is a result of design choices. \textit{Id.} at 78. Their tax systems have broader bases that discourage avoidance and their governments have adopted policies that reduce the cost of work. For example, Scandinavian countries have substantial childcare and elder care subsidies, good public transportation, and good education systems. \textit{Id.} These sorts of services reduce the cost of work, and, as a result, reduce the efficiency costs of taxing work. \textit{Id.} While the United States may not desire to adopt Scandinavian-style social welfare policies, the Scandinavian example shows how much the institutional environment surrounding work can influence work effort.
choice, it follows straightforwardly from the Legal Envelope Theorem that we
can, and should, choose that elasticity based in part on the tax effects.

There are a vast number of laws that directly regulate or that indirectly affect
work.92 Moreover, laws affecting leisure choices thereby affect labor supply
elasticity, which means that those laws can be thought of as work-related rules
for our purposes. We cannot cover even a modest fraction of these laws—taken
together there are hundreds. Instead, we consider a selection of examples
illustrative of the broader universe.

1. Mandatory Benefits

Mandates that require employers to provide a particular bundle of benefits
constitute a core element of the regulation of work. Many, if not most,
employment laws take this form. For example, laws require many employers to
provide health insurance,93 family leave,94 a safe workplace environment,95
protection against termination except under certain circumstances,96 protection
against unjust discrimination on the basis of a host of characteristics,97 and many
other benefits. We explore mandated parental leave and wrongful discharge laws
as examples. We start with a general framework before turning to the particular
applications.

a. Framework

To understand how the Legal Envelope Theorem sheds light on mandated
benefits, begin with a standard labor-economics model of mandatory work-
related benefits in which a mandate is instituted to correct a market failure. To

---

92 Christine Jolls, in her insightful survey of employment law, lists nine categories of legal
rules regulating work (each category made up of multiple legal rules): safety mandates,
workers compensation, privacy mandates, fringe benefit mandates, targeted mandates such as
family and medical leave, wrongful discharge laws, unemployment insurance, minimum
wage rules, and overtime rules. Christine Jolls, Employment Law, in 2 HANDBOOK OF LAW
AND ECONOMICS 1349, 1349 (A. Mitchell Polinsky & Steven Shavell eds., 2007). She
explicitly leaves off discrimination law and labor law, both of which are central to work
choices. See id. at 1371. Jolls also does not consider antitrust laws, which may allow, or
disallow, monopsony by employers. And Jolls also does not list legal rules that may have
important but indirect effects on work, such as rules that affect the costs of commuting, rules
that affect the physical work environment such as zoning or building codes, or laws that affect
the costs of obtaining skills needed to work.

93 The Affordable Care Act requires employers with fifty or more full-time employees (or
equivalents) to provide health insurance to at least 95% of their full-timers. I.R.C. § 4980H.

94 The Family and Medical Leave Act of 1993 requires most employers with fifty or more
employees to provide twelve weeks of unpaid leave each year so that employees can recover
from a serious illness or care for a new child or seriously ill family member. See Pub. L. No.


97 See, e.g., 2000e-2(a).
simplify the analysis, we will assume that employers pass the cost of the mandate along to employees through lower wages. Employees are willing to sacrifice extra wages in order to receive a benefit that they value. To arrive at simple efficiency, the government should mandate additional benefits until any further increase in the required benefit and corresponding reduction in the wage would leave the employee no better off. In addition to changing how they are compensated, a mandate may also change how much people are willing to work: it may have long-run employment effects. In the Corlett and Hague sense, the mandate may be a complement to, or substitute for, taxable, market work.

One might wonder why a mandate is even necessary under these circumstances—specifically, why employers won’t offer the benefit absent a requirement that they do so. One possible explanation is adverse selection. For example, employers operating in the absence of a mandate may decide not to offer maternity leave—even though employees value such leave—because employers do not want to attract job-seekers likely to become pregnant.

A second possibility is transaction costs. Employees would bargain with their employers for the benefit if bargaining were costless, but it is not, and therefore employers and employees might be willing to stick with the default terms of employment provided by law unless those terms differ dramatically from the outcome for which the employers and employees would bargain. The government has some (though not infinite) leeway to set the terms of employment arrangements before employers and workers begin looking for legal alternatives (e.g., switching from an employer-employee arrangement to an independent-contractor arrangement). A third possibility is imperfect information. For example, employees might be misinformed about their rights under the status quo and would bargain for more benefits if they were better informed.


99 See supra note 80 and accompanying text.

100 See Philippe Aghion & Benjamin Hermalin, Legal Restrictions on Private Contracts Can Enhance Efficiency, 6 J.L. ECON. & ORG. 381, 402 (1990) (“[T]he weeks of maternity leave provided by the employer could be inefficiently low; for example, the good-type employee seeks to signal that she is unlikely to become pregnant by asking for no maternity leave privileges, and the bad-type employee does better to mimic than to reveal herself.”).


informed. Mandates might also be intended to address entrenched discrimination. For our purposes, what is important is not why simple efficiency might call for a mandatory benefit but instead how the prescription of simple efficiency diverges from full efficiency after accounting for taxes.

Consider the following scenario: An employee faces a 30% tax rate, and an employer will reduce taxable wages by $1 for every $1 that the employer spends on providing the mandated benefit. The employer’s expenses on wages and the benefit are deductible, so the employer is indifferent as to which it provides.

Now imagine that the government requires the employer to provide the employee with an untaxed benefit (e.g., health insurance or unpaid leave). Moreover, the mandate is set at a level that satisfies simple efficiency. The employee is indifferent between $1 of taxable wages ($0.70 in after-tax wages) and an extra bit of benefit to which the employee assigns a value of $0.70.

These two effects imply that the simple-efficient legal rule will not be the same as the fully efficient legal rule. First, holding total compensation fixed, adding a mandate often means cash wages go down and a fraction of the compensation is now paid in the form of the mandate. Because many mandated benefits, such as health insurance and unpaid leave, are not taxed, the fraction of taxable compensation goes down. While employers and employees may be indifferent, at the margin, between taxable and nontaxed compensation, society prefers that the employee receive taxable wages. Every extra $1 of taxable wages yields $0.30 more of tax revenue, which can be used to purchase public goods. In these circumstances, society will want to reduce the level of mandated benefits from the level that satisfies simple efficiency because a lower mandate leads to more tax revenue.

Second, the mandate might affect how much people work (or whether to work at all) in the taxable sector. For example, as we will discuss, parental leave may have important effects on women’s workforce participation. To continue with our example, if, as a result of the mandated benefit, the worker increases her workforce participation by an additional hour, she is indifferent—she gives up leisure time worth $0.70 and gets after-tax compensation of $0.70—but society has $0.30 more. Accounting for both effects, the fully efficient legal rule should deviate from the simple-efficient rule (except by sheer coincidence when the two effects perfectly offset each other). Moreover, at the optimum, this deviation might be significant. With our assumed 30% tax rate, the benefits of shifting

103 See id.
104 See id. at 107 n.9 (“Because of these difficulties of proof, some commentators argue that the background presumption of employment at will undermines the effectiveness of antidiscrimination legislation and other wrongful discharge protections.”).
105 See I.R.C. § 162(a)(1) (allowing business deductions for “a reasonable allowance for salaries or other compensation for personal services actually rendered”).
106 The cost of health insurance to the employer is, straightforwardly, the premium that the employer pays on the employee’s behalf. The direct cost of unpaid leave to the employer is, of course, zero (because it is unpaid), but the employer will likely bear indirect costs (e.g., the cost of training other employees to fill in for the worker on leave).
from untaxed activities to taxed activities are almost a third of the total value. As noted above, actual marginal tax rates are often much higher. 107 Although we expressed the Legal Envelope Theorem in terms of marginal deviations from simple efficiency, the difference between the simple-efficient and the fully efficient mandates will often be anything but marginal.

b. Parental Leave

We can analyze mandated parental leave using this framework. Notwithstanding large changes in women’s social and economic roles over the last fifty years in the United States, women still experience pay gaps relative to men. 108 Much of the gap between women’s and men’s pay appears to arise soon after childbirth. 109 As a result, one of the core methods of addressing the gender pay gap is to require parental leave. The idea behind paid parental leave is to allow parents (most often women) to take short-term leave, retain firm-specific capital, and hopefully be able to return to the workforce.

Federal law already requires unpaid parental leave. 110 Paid parental leave is common in European countries but not in the United States, although there has been a shift toward paid parental leave in the United States in recent years. Nine states and the District of Columbia have enacted laws that either already mandate or soon will mandate paid parental leave. 111 As of 2021, the federal government is enacting paid parental leave for federal employees. 112

To understand the effects of parental leave, consider first the case of unpaid leave. Unpaid leave is an untaxed benefit. Thus, an employee facing a 30% tax rate will be indifferent between $100x of wages and unpaid leave benefits to which she or he assigns a value of $70x. Starting from a simple-efficient unpaid

107 See Altig et al., supra note 48, at 19.


109 Blau & Kahn, supra note 108, at 819; see also Claudia Goldin & Joshua Mitchell, The New Life Cycle of Women’s Employment: Disappearing Humps, Sagsging Middles, Expanding Tops, 31 J. ECON. PERSPS. 161, 163 (2017) (“Our bottom line is that the US female labor force has greatly expanded and evolved, but that birth events that had always produced a temporary retreat from employment are now occurring later with the delay in marriage and childbirth.”).

110 5 C.F.R. § 630.1203(a) (2021) (entitling employees to twelve “administrative workweeks of unpaid leave” following a child’s birth or adoption).


parental leave policy, the Legal Envelope Theorem might counsel for a slight move in the direction of less generous leave benefits (e.g., moving from twelve workweeks to eleven workweeks and four workdays). Such a change would shift the compensation mix toward more taxable wages, thus generating more tax revenue.

Weighing in the opposite direction, there is some evidence that unpaid parental leave encourages women to increase their participation in the workforce, as proponents hope. For example, Sankar Mukhopadhyay examines the labor-output effects of the Pregnancy Discrimination Act of 1978, which required employers to provide the same leave benefits for pregnant and post-partum mothers as they would for an employee experiencing a temporary disability. Mukhopadhyay estimates that unpaid maternity leave reduces labor force participation among mothers immediately after childbirth but raises labor force participation among mothers with children between one and six years old by nearly four percentage points. These findings suggest that preserving a mother’s attachment to the labor force immediately after childbirth increases the likelihood that she will return to work in the long term, even though it reduces her labor output in the short term. The additional tax revenue from her extra years of working is a benefit of parental leave that a simple efficiency calculus would leave out. The net effect left out of a simple efficiency analysis combines the social cost of reduced taxable compensation (for any given level of employment) and increased long-term employment.

---


114 See id. at 1136.

115 See id. at 1135.

116 See id. (implying mothers remaining attached to workforce due to policy are more productive because of more work experience and less skill depreciation). Mukhopadhyay’s finding that unpaid leave increases long-term labor force participation for new mothers is debated. For example, Natalie Goodpaster studies the Family and Medical Leave Act of 1993 and reaches a contrasting conclusion. Natalie K. Goodpaster, Leaves and Leaving: The Family and Medical Leave Act and the Decline in Maternal Labor Force Participation, 10 B.E. J. ECON. ANALYSIS & POL’Y, no. 1, art. 6, 2010, at 3. Focusing specifically on married mothers, she finds evidence that unpaid maternity leave led more married mothers to leave the workforce in the long term. Id. She suggests that mothers who take leave may learn that they derive greater value from staying home with their children than they expected, and that “[t]his effect can be compounded over time as more expecting married mothers have social interaction with mothers who have already made the choice to stay out of the labor force.” Id. For our purposes, it does not matter whether Mukhopadhyay or Goodpaster is correct (and they could both be correct—the 1978 and 1993 laws may have had different consequences due to different statutory features and different social and economic conditions). What matters is that leave laws may have important effects—positive or negative—on future taxpaying behavior that a comprehensive efficiency analysis should take into account.
While Mukhopadhyay focuses on unpaid leave for mothers, much of the debate over parental leave now focuses on paid leave, including for nonbirthing parents. Several studies find that paid parental leave increases mothers’ labor-force participation in the months after the birth of a child\(^{117}\) and in the medium to long term,\(^{118}\) though evidence on the medium- and long-term effects is not uniform.\(^{119}\)

Analysis of paid parental leave differs from unpaid parental leave in that paid leave is taxable (or more precisely, payments by employers to employees on leave is included in gross income for federal income tax purposes).\(^{120}\) Paid leave mandates, though, provide for less than 100% wage replacement,\(^{121}\) so we can think of paid parental leave as a partly taxed, partly untaxed benefit. Thus, we can apply the same general framework as for unpaid leave. That is, paid parental leave with a wage replacement rate of less than 100% changes the compensation mix so that less of an employee’s compensation is taxed (a negative effect on tax revenue) but likely increases future labor force participation (a positive effect on tax revenue). As with unpaid leave, the Legal Envelope Theorem suggests taking the resulting fiscal externalities into account when setting the rule.

Some analyses of paid leave—including one recent analysis by congressional committee staff—suggest that the latter effect predominates and that the entire increase in economic output, or GDP, as a result of paid leave should be counted as a benefit.\(^{122}\) However, as the Legal Envelope Theorem shows, an analysis that includes the economic output of parents who remain in the workforce as a benefit while ignoring the value of the time stay-at-home parents spend with their children does not provide an accurate picture of the effect of paid leave on total resources. Public policy should support the choice of parents to remain in the workforce—indeed, our argument here is that the case for pro-work laws and

\(^{117}\) See Tanya S. Byker, Paid Parental Leave Laws in the United States: Does Short-Duration Leave Affect Women’s Labor-Force Attachment?, 106 AM. ECON. REV. 242, 242 (2016) (“I find that short-duration paid leave increases labor force attachment of women who otherwise would have exited the labor force temporarily in the months around a birth.”).


\(^{120}\) See I.R.C. § 61(a)(1).


policies is even stronger than a simple-efficiency analysis would suggest. But we should not proceed in our analysis as if the time that parents spend at home with children is worthless to society.

The Legal Envelope Theorem provides a fuller picture of the resource effects of changes in labor force participation resulting from changes in paid-leave mandates. Consider again a new parent whose earnings would be $100x and whose tax rate is 30%. Imagine that the parent is on the fence between remaining in the workforce and leaving (i.e., the value that the parent assigns to the care she can provide by staying at home is $70x). Assume that a small change in the paid parental leave law (e.g., extending the leave that employers must provide from twelve workweeks to twelve workweeks plus one workday) would push the parent over the fence and cause her or him to remain in the workforce. What is the effect on total resources?

The entire effect on economic output, or GDP ($100x), supplies the wrong answer. Although the value of the parent’s output in the taxable sector has increased by $100x, the value of her or his output in the untaxed sector has declined by $70x. On the other hand, ignoring the effect on economic output entirely will supply the wrong answer too. When the parent shifts from staying at home to participating in the workforce, the government collects additional tax revenue that can be used to provide valuable public goods. If the parent fully internalizes the benefits and costs of the choice to her or his child, then the increase in total resources is the behavioral effect on tax revenue: here, $30x. If current leave laws fail to account for this tax-revenue effect, and if a longer paid-leave period would lead to greater long-term labor force attachment, then the Legal Envelope Theorem favors a change in the law toward longer paid leave.

To be clear, workforce participation effects are far from the only factor to consider in a policy analysis of paid parental leave. A full analysis should account for possible positive effects on children’s health and educational outcomes (to the extent parents do not internalize those outcomes in their own behavioral choices).123 And insofar as paid parental leave results in higher rates of female labor participation and career advancement, the positive externalities from having more women in the workplace (and, particularly, more women in leadership roles) must be factored in, too.124 There is a strong gender-equity case—apart from the tax-revenue case—for policies that facilitate and encourage labor force participation and career advancement among mothers.

123 See, e.g., Sakiko Tanaka, Parental Leave and Child Health Across OECD Countries, 115 ECON. J. F7, F26 (2005) (concluding job-protected paid leave has “significant effects on decreasing infant mortality rates”). But cf. Qian Liu & Oskar Nordstrom Skans, The Duration of Paid Parental Leave and Children’s Scholastic Performance, 10 B.E. J. ECON. ANALYSIS & POL’Y, no. 1, art. 3, 2010, at 27 (“[O]ur results suggest that expanding parental leave entitlements does not improve schooling results on average, nor does it appear to have any beneficial distributional effects or any beneficial effects on child health.”).

124 On the positive externalities provided by female managers to younger and less senior female workers, see Geoffrey Tate & Liu Yang, Female Leadership and Gender Equity: Evidence from Plant Closure, 117 J. FIN. ECON. 77, 79 (2015).
Said another way, whatever we would do to achieve gender egalitarian goals, we should do more because of the tax effects.

c. **Job Protection and Wrongful Discharge**

A central, and contested, area of workplace regulation is the set of laws that regulate termination. There are numerous laws that regulate employment termination, including civil service laws for federal and state employees, laws that affect the power of public- and private-sector unions, employment discrimination laws, state-level wrongful discharge laws, and judicial doctrines that deviate from the common law rule of employment at will.\(^{125}\)

The most straightforward argument for these rules is that employees may value limits on when they can be fired more than their cost. Being fired is extremely disruptive to one’s life. While limitations on firing are costly to firms and, therefore, may force firms to reduce pay, individuals may be willing to take this trade-off.

We may need to enact laws imposing wrongful discharge rules, rather than relying on firms and employees to enter into agreements via employment contracts, because any single firm that offers wrongful discharge protections may attract less desirable employees, a form of adverse selection.\(^{126}\) In addition, there is evidence that employees have imperfect information about when they can be fired.\(^{127}\) Employees often believe that they cannot be fired at will and instead can only be fired for some sort of misconduct.\(^{128}\) If this is true, employees may not believe that they need to make a wrongful discharge limitation explicit in their employment contracts.

Laws that provide employment security can be thought of as mandating a term of employment, and the analysis above applies in a straightforward fashion. Suppose that a particular level of wrongful discharge protection is simple-efficient. Relative to slightly weaker protection, this rule will reduce taxable compensation: what was previously taxable compensation now comes in the form of the nontaxable utility benefit from additional job security. If we were to lower the discharge protection a little bit, the individual and her employer would be no worse off. The relative portion of compensation paid in taxable form would increase, thus generating a social benefit. As a result, we should want somewhat less employment security.

---

\(^{125}\) Wrongful discharge laws come in a number of different forms, including (1) an implied contract of no wrongful discharge, (2) public policy against wrongful discharge in particular circumstances, and (3) an implied duty of good faith. For a brief description of these doctrines and a history of their development, see David H. Autor, John J. Donohue III & Stewart J. Schwab, *The Costs of Wrongful-Discharge Laws*, 88 REV. ECON. & STAT. 211, 211 (2006).


\(^{127}\) See, e.g., Kim, supra note 102, at 110-11.

\(^{128}\) See id.
While the evidence is mixed, it appears that wrongful discharge laws—one form of employment protection—reduce workplace participation because employers are reluctant to hire workers that they cannot fire. To the extent this is true, wrongful discharge laws further reduce taxable compensation. A small decrease in their strength would increase tax revenues while not making workers or employers worse off.

In the parental leave case, the two effects—the mix of taxable versus nontaxable compensation holding market work constant, and the change in taxable, market work—act in opposite directions. Taxable compensation as a fraction of the total goes down but total work appears to go up. The Legal Envelope Theorem suggests moving away from simple efficiency based on the net effect. In the wrongful discharge case, the two effects appear to work in the same direction. The Legal Envelope Theorem in this case is clearer, suggesting weaker protection from termination than the simple-efficient rule.

2. Laws Indirectly Affecting Work

The examples above involved laws whose nominal subject was work or employment. Other laws whose subject matter is not nominally work or employment, however, may also have substantial effects on work. Indeed, nonwork-related legal rules may have a greater effect on work levels than many rules that directly regulate the work environment. In all of these cases, we should deviate from the simple-efficient rule in the direction that increases taxable compensation. Consider the following:

Zoning and land use: Zoning and other rules regulating land use affect where businesses and homes are located relative to one another. Their relative location determines, in part, the length of commutes, which in turn affects the cost of working. Zoning and land use rules also in part determine the type of

129 For example, one study finds that employment (as a percent of population) goes down by an average of 0.8% to 1.6% for states adopting the implied contract exception, with the effects most pronounced for females and younger, less-educated workers. See David Autor, John J. Donohue III & Stewart J. Schwab, The Employment Consequences of Wrongful-Discharge Laws: Large, Small, or None at All?, 94 AM. ECON. REV. 440, 441 (2004) [hereinafter Autor et al., Employment Consequences]; Autor et al., supra note 125, at 212. On the other hand, Tom Miles finds no effects on employment levels but does find that employers increase their use of temporary-help agency workers. See Thomas J. Miles, Common Law Exceptions to Employment at Will and U.S. Labor Markets, 16 J.L. ECON. & Org. 74, 76 (2000). Autor, Donohue, and Schwab argue that the difference in results is due to Miles’s reliance on a system of classifying case law developments that often records a later date for state-level changes than the date at which those changes first emerged. See Autor et al., Employment Consequences, supra, at 444-45.

130 See, e.g., Nicole Stelle Garnett, On Castles and Commerce: Zoning Law and the Home-Business Dilemma, 42 WM. & MARY L. REV. 1191, 1196-98 (2001) (“[A]ll indications suggest that local officials increasingly will find it difficult to avoid confronting the continued viability of zoning proscriptions against working at home.”).

131 See id. at 1244.

132 See id. at 1225.
building or other amenities of the workplace and the amenities surrounding the workplace. For example, working in an office park is different than working in a dense urban environment, and that is different from working in an area zoned for heavy industry. Zoning and land use rules involve a host of complex considerations, one of which is the effect on work. To the extent zoning and land use rules affect work, they generate fiscal externalities which should be taken into account when setting those rules.

Transportation: Legal rules also directly govern how people commute. For example, driving laws affect the length of a commute and its safety. Driving laws also affect the types of vehicles that people use for commuting and can influence people’s decisions whether to carpool. Laws regulating the vehicles themselves affect the cost of commuting and the commuting experience. To the extent these legal rules change the amount of work individuals do, they have a fiscal externality that should be taken into account.

Leisure: The regulation of leisure activities is extensive. For example, laws regulate the safety of various leisure activities (e.g., bicycle helmet laws). They determine what sorts of leisure activities one may engage in (e.g., alcohol laws). They determine the costs of many leisure activities (e.g., laws regulating the movie industry). Making leisure activities more attractive unfortunately generates a negative fiscal externality, which means we should be slightly less willing to make leisure attractive than otherwise.

Spending: So far we have focused on nontax legal rules that affect the workplace, but—as suggested by Corlett and Hague—nontax subsidies for complements to labor affect work decisions too, and should be adjusted in light of tax considerations. For example, government subsidies for childcare and early childhood education have potentially significant consequences not only for children’s outcomes but also for the labor supply choices of their parents (particularly mothers). As with paid parental leave, the tax effects reinforce

---

133 Id. at 1223.
134 Id. at 1198.
135 Id. at 1225.
136 The distinction between law and spending is especially confusing in this context. Speed limits and HOV lanes are “laws” while an additional lane of road surface is “spending.” Both affect commutes.
137 Corlett & Hague, supra note 80, at 21.
138 For a recent analysis of the costs and benefits of universal subsidized child care, see generally Tarjei Havnes & Magne Mogstad, Is Universal Child Care Leveling the Playing Field?, 127 J. PUB. ECON. 100 (2015).
139 For example, Jonah Gelbach finds significant positive effects on women’s employment from the introduction of schooling for five-year-olds (kindergarten). Jonah B. Gelbach, Public Schooling for Young Children and Maternal Labor Supply, 92 AM. ECON. REV. 307, 321 (2002). Other studies, however, find more mixed results. Compare Stefan Bauernschuster & Martin Schlotter, Public Child Care and Mothers’ Labor Supply—Evidence from Two Quasi-experiments, 123 J. PUB. ECON. 1, 15-16 (2015) (finding positive effect in Germany), with
egalitarian goals of increasing women’s labor force participation and earnings. Public transit subsidies also appear to have positive employment effects, and, therefore, we should spend more on public transit than simple efficiency would suggest.140

3. Summary

The workplace is a legally constructed environment. The regulation of work is pervasive. As such, legal rules affect the costs and benefits of work. The regulation of nonwork activities is also pervasive, and these regulations affect the costs of work as well. As a result, the elasticity of labor supply should be thought of as, in part, a choice, rather than an exogenously given variable. Legal rules surrounding work and leisure should be designed with a view to the tax revenue consequences. They should deviate from simple efficiency, possibly significantly, because of these considerations.

B. Legal Rules Affecting Business Organizations

Even more so than for work, the law shapes business entities. Their very existence is created by law—they are legal fictions. Their governance, their capital structure, the relationship between owners and the firm, the relationships between suppliers and the firm, the size of firm, the information they must collect and disclose, and numerous other aspects of their operations are shaped by the law. Many of these legal choices have important effects on the tax system.

The analysis of how business law affects the tax system is, in a basic sense, the same as the analysis of legal rules affecting work: we want legal rules to deviate from simple efficiency in order to favor higher-tax activities. For example, debt is generally taxed at a lower rate than equity, so we want legal rules to favor equity more than simple efficiency would suggest.

A key problem with analyzing the interaction of business law and taxes is that the tax rules governing business organizations are likely far from their optimum and can themselves be reformed.141 For example, rather than shifting the nontax legal rules to reduce the use of debt, we could fix the tax rules to eliminate the distinction between debt and equity. This would eliminate the distortion without


140 See, e.g., Paul M. Ong & Douglas Houston, Transit, Employment and Women on Welfare, 23 URB. GEOGRAPHY 344, 361 (2002) (“Every ten additional nearby transit stops increases the odds of using transit by 2% to 3%, and the odds of being employed by 3% to 4%, ceteris paribus.”).

changing nontax legal rules. To keep the analysis simple, we assume that the tax rules are, in the short term, largely fixed and discuss how legal rules interact with them with the understanding that the optimal policy likely involves changes to both tax rules and legal rules.

We consider two areas where legal rules intersect the tax rules governing business organizations: (1) debt versus equity, and (2) the choice of legal entity. These are two of the major distortions caused by the corporate tax, as identified by the Treasury Department’s study of major corporate tax reform.

1. Debt/Equity Rules

Leverage—the use of debt rather than equity—reduces the tax on corporations because corporations can deduct interest payments made to lenders but not dividend payments made to shareholders. As a result, the Treasury Department study concluded that the tax law creates an incentive to capitalize corporations with debt rather than equity.

The economic difference between debt and equity is that debt (borrowing) is typically characterized by a mandatory requirement to repay a fixed amount at a fixed time, while equity is typically characterized by a return contingent on the performance of the business. Businesses have some optimal mix of these two instruments in their capital structure.

Legal rules affect this choice. The bankruptcy law and the law of secured transactions affects the ability of a corporation to use debt. In addition, securities laws affect the cost of issuing debt and of issuing equity in public or private markets. Banking laws affect the ability of businesses to get bank loans. That is,

---

142 See, for example, the proposal by the Treasury Department to eliminate the distinction. Id.


144 The net tax benefit of leverage to the corporation also depends on the tax treatment of the lenders as compared to shareholders. Large pools of capital, particularly foreign capital and capital owned by pension funds, are not taxed under U.S. law, which means that interest payments are not taxed at all while earnings distributed as dividends are taxed at the corporate level. See id. at 8-9.

The American Law Institute study of corporate integration emphasizes that the preference for debt, if any, depends on the relative tax rates of lenders and shareholders as well as the corporate-level treatment. Id. at 3. With low enough tax rates on dividends and on corporate income, the preference may be reversed—the tax law may generate a preference for equity. See id.


146 In reality, the line between debt and equity is almost impossible to draw. See WARREN, supra note 143, at 3 (providing debt and equity as example of “unadministrable legal distinction”). Debt can be contingent and depend in part on the performance of the business, and equity can have required fixed payments. But in the prototypical cases, the difference between the two is relatively unclear.
the “debt” and “equity” relationship is determined by legal rules (as well as by the terms of the instruments themselves). Therefore, the ability of a corporation to use debt depends on legal choices.

The analysis of how legal rules and the tax system interact is roughly the same as above, which is that we want to shift away from the simple-efficient set of legal rules governing debt and equity to favor equity. Rather than repeat this analysis, we illustrate the interaction with an actual case where a legal rule was changed in response to tax issues.

Banks are required to meet what are known as capital requirements. These are requirements that a certain portion of their capital structure be made up of financial instruments that do not require immediate repayment—they are long-term claims rather than claims with rigid, fixed payment schedules. Common stock is the paradigmatic form of bank capital because it never needs to be repaid.

The reason for the capital requirement, as laid out in work by Douglas Diamond and Raghuram Rajan, is to reduce the probability of financial distress. A secure cushion of capital means that banks are more likely to be able to make mandatory payments on the debt that they issue. The cost of bank capital requirements is that they reduce one of the core functions of banks, which is issuing short-term, liquid notes that can act as money in a modern financial system. The higher the capital requirement, the less a bank can provide liquidity to the market. Simple-efficient capital rules balance these costs against the benefits.

A capital requirement needs a definition of “capital.” Most countries follow the Basel Committee on Banking Supervision guidelines, classifying capital into Tier 1 and Tier 2, with Tier 1 being preferred. The Basel Committee provides a complex set of rules that determine how much of any given financial instrument counts toward each tier.

As noted, common stock is the paradigm of Tier 1 capital. If a bank uses common stock as its Tier 1 capital, however, it loses the benefit of the interest deduction. Therefore, a central tax planning goal for banks is to structure a

---

148 Id. at 2454-55.
149 See id.
150 Id. at 2431.
151 See id. at 2455.
153 Id. at 47-84.
154 Id. at 47.
155 See U.S. Dep’t of the Treasury, supra note 141, at vii.
financial instrument that qualifies as Tier 1 capital for bank regulatory purposes yet is treated as debt for tax purposes. It is the Holy Grail of bank tax planning.

In the mid-1990s, tax planners almost reached the Holy Grail through an exotic tax structure known as “Reverse MIPS.”\footnote{MIPS, or Monthly Income Preferred Stock, was a financial instrument designed to generate most of the features of equity while allowing an interest deduction for tax purposes. Mark P. Gergen & Paula Schmitz, The Influence of Tax Law on Securities Innovation in the United States: 1981-1997, 52 TAX L. REV. 119, 153 (1997). MIPS was widely used by nonfinancial corporations but did not satisfy the capital requirements for banks. Id. at 153-54. Reverse MIPS is a variant on MIPS which effectively reversed or flipped upside down the basic structure. Id. at 154 n.130.} The basic idea was to issue preferred stock (which counted as Tier 1 capital) to a partnership and have the partnership issue debt secured by the preferred stock. For tax purposes, the partnership is a pass-through entity, which means that the interest deductions on the debt flowed through to the bank. (The dividends on the preferred stock used to pay the interest on the debt were treated as a nothing for tax purposes because the bank was treated as just paying itself.) For bank regulatory and accounting purposes, however, the partnership was treated as an independent entity, which means that the debt was not treated as bank debt. Instead, the bank was treated as having merely issued preferred stock to the independent partnership. Therefore, the bank was treated as having issued Tier 1 capital for bank regulatory purposes but debt for tax purposes.\footnote{For further background on the Reverse MIPS saga, see Tom Pratt, IRS Notices on MIPS Leave Basic Structure Unscathed; but Some Variations Clearly Won’t Work, INV. DEALERS’ DIGEST, Apr. 25, 1994, at 12.}

Before any Reverse MIPS were issued, however, the Treasury found out about them. Immediately upon hearing of these instruments, the Treasury issued a public notice, Notice 94-48, stating that the government would challenge the intended tax treatment of these instruments, should any of them be issued.\footnote{The government described the core problem as follows: The Internal Revenue Service is aware of proposed transactions designed to provide corporations with significant tax advantages in satisfying their equity capital requirements. Although the details may vary, these transactions are intended to give the issuing corporations the tax benefits of issuing debt even though the corporations actually issue stock. In addition, the instruments are intended to be treated as equity for regulatory, rating agency, or financial accounting purposes. I.R.S. Notice 94-48, 1994-1 C.B. 357.} The Notice laid out a number of theories of why the instruments did not generate an interest deduction for tax purposes.\footnote{Id. at 358.} The banks’ tax advisors disagreed, and the banks were prepared to issue the instruments.\footnote{See Pratt, supra note 157, at 12. The Notice, however, effectively acted to inform the bank regulators of the tax problem that the instruments generated. In response, the bank regulators determined that they

\[\text{\footnotesize 156 MIPS, or Monthly Income Preferred Stock, was a financial instrument designed to generate most of the features of equity while allowing an interest deduction for tax purposes. Mark P. Gergen & Paula Schmitz, The Influence of Tax Law on Securities Innovation in the United States: 1981-1997, 52 TAX L. REV. 119, 153 (1997). MIPS was widely used by nonfinancial corporations but did not satisfy the capital requirements for banks. Id. at 153-54. Reverse MIPS is a variant on MIPS which effectively reversed or flipped upside down the basic structure. Id. at 154 n.130.}\]

\[\text{\footnotesize 157 For further background on the Reverse MIPS saga, see Tom Pratt, IRS Notices on MIPS Leave Basic Structure Unscathed; but Some Variations Clearly Won’t Work, INV. DEALERS’ DIGEST, Apr. 25, 1994, at 12.}\]

\[\text{\footnotesize 158 The government described the core problem as follows: The Internal Revenue Service is aware of proposed transactions designed to provide corporations with significant tax advantages in satisfying their equity capital requirements. Although the details may vary, these transactions are intended to give the issuing corporations the tax benefits of issuing debt even though the corporations actually issue stock. In addition, the instruments are intended to be treated as equity for regulatory, rating agency, or financial accounting purposes. I.R.S. Notice 94-48, 1994-1 C.B. 357.}\]

\[\text{\footnotesize 159 Id. at 358.}\]

\[\text{\footnotesize 160 See Pratt, supra note 157, at 12.}\]
would not allow the instruments to be classified as Tier 1 capital, effectively preventing banks from issuing them.\textsuperscript{161}

We can think about how the bank regulators acted in terms of the Legal Envelope Theorem. Before they focused on the tax effects and risks, the bank regulators thought that the proper legal rule was to classify Reverse MIPS as Tier 1 capital. That is, regulators classified the instrument based on Basel Committee’s rules that determined the trade-off between liquidity creation and safety. The determination that Reverse MIPS was Tier 1 capital was simple-efficient.\textsuperscript{162} Declining to classify them as Tier 1 was a small move away from simple efficiency that generated positive tax benefits. Indeed, the tax benefits were likely significant because Reverse MIPS and similar structures could have eliminated a substantial portion of the tax base for financial institutions. The regulators chose the fully efficient rule rather than the simple-efficient rule, consistent with the recommendation of the Legal Envelope Theorem.

2. Choice of Entity

The corporate tax also may distort the choice of business entities. In particular, businesses may avoid using the corporate form to avoid the double-level corporate tax. The 1992 Treasury Department study of the corporate tax argued that distortions in the choice of organizational form generated significant social losses, as businesses used otherwise suboptimal structures.\textsuperscript{163} For example, a business that would have operated efficiently as a corporation might choose to be a partnership because of the tax cost of incorporation.

The ability of businesses to choose their form, and how that choice affects the operation of the business, depend almost entirely on the legal rules that govern business entities. Corporations, general and limited partnerships, and limited liability companies are all creatures of law. We can choose their attributes. Whether businesses choose to operate through the higher-taxed or lower-taxed form will depend, in part, on the nontax attributes that the law assigns to each form. We cannot understand whether, and the extent to which, the tax incentives to choose particular forms of business organizations generate social losses without understanding the underlying law.

As with debt versus equity, we illustrate the interaction with a historical incident, the 1977 invention of the limited liability corporation and the tax

\begin{footnotesize}
\textsuperscript{161} An interesting contrast to this story is the regulatory actions behind \textit{Cottage Savings Ass’n v. Commissioner}, 499 U.S. 554 (1991). There, bank regulators—the Federal Home Loan Bank Board—actively helped banks generate tax deductions for losses while avoiding the regulatory and accounting implications of those losses. \textit{Id.} at 557.

\textsuperscript{162} The Basel Committee’s rules may have been flawed, in which case, the bank regulator’s decision would also have been flawed. To keep reality from getting in the way of a good yarn, we ignore this possibility. More seriously, all the legal and tax choices in this sort of complex environment are difficult ones. We are using this history as an example of the types of interactions between the laws governing business organizations and taxes, rather than attempting to make definitive statements about the optimal content of particular rules.

\textsuperscript{163} See \textit{U.S. Dep’t of the Treasury, supra} note 141, at 3-4, 112-15.
\end{footnotesize}
response known as check-the-box.\textsuperscript{164} The LLC was at least arguably created as a response to the corporate tax.\textsuperscript{165} It is an example of the nontax legal rules taking taxation into account. As we will discuss, states probably made the wrong choice because of free-rider incentives. That is, the invention of the LLC probably had a negative BETR. Regardless of the merits of the states’ actions, the story shows how legal choices regarding what entities should exist and their attributes affect the tax system.

To understand the invention of the LLC, we must review how the tax law classified business entities at the time of their invention. The tax rules were (and remain) asymmetric. If a business was organized under state law as a corporation, the entity was treated as a corporation for tax purposes.\textsuperscript{166} But if a business was organized under state law as some other legal form, such as a partnership, the entity might be characterized for tax purposes as either a partnership or a corporation.\textsuperscript{167}

To draw the distinction between partnerships and corporations (for entities that did not use a state law corporate form), the tax law used a “looks like” test, known colloquially as the four-factor test. Under this test, if the entity had enough features of a platonic corporation, it was taxed as a corporation.\textsuperscript{168} In particular, platonic corporations were said to have four factors: (1) continuity of life (i.e., death of a shareholder does not cause the corporation to cease to exist), (2) centralization of management, (3) limited liability, and (4) free transferability of interests.\textsuperscript{169} Partnerships were said to lack these attributes.\textsuperscript{170} Recognizing that there was flexibility in structuring entities—for example, a partnership could hire a centralized manager rather than being run by the partners themselves—the regulations treated an entity as a corporation if it had at least three of the four factors.\textsuperscript{171}

The four-factor test meant that the corporate tax was in part a tax on the use of these factors in addition to a tax on the choice of entity. That is, the corporate tax fell on (1) the choice to use the corporate form and (2) the use of a sufficient

\textsuperscript{165} Id. at 395 (“By combining the best of both worlds, partnership taxation and limited liability, the LLC revolution can be characterized as tax driven.”).
\textsuperscript{166} See id. at 400-02.
\textsuperscript{167} Technically, corporations are defined in I.R.C. § 7701(a)(3) to include “associations, joint stock companies, and insurance companies.” This provision has been read to mean that any entity that is actually a state-law corporation is a corporation for tax purposes. In addition, entities that are “associations” are also tax corporations. The question is what it means to be an association.
\textsuperscript{169} See Kintner, 216 F.2d at 422.
\textsuperscript{170} See id.
\textsuperscript{171} See id.
number of the four factors. To the extent that the tax fell on the use of the corporate form, it fell on a legal fiction. To the extent it fell on the four factors and to the extent they represented underlying economic arrangements, it fell on economic choices (though to some extent, the four factors were formalistic legal arrangements rather than true economic arrangements).

Sufficiently clever lawyers were able to manipulate the four factors to achieve most of what their clients wanted for nontax legal purposes while getting their clients’ preferred tax law treatment. For example, lawyers were able to create publicly traded entities that were treated as partnerships for tax purposes, allowing businesses to access public capital markets without having to pay the corporate tax. In response, Congress changed the tax law to treat most publicly traded entities as corporations regardless of their other attributes. Lawyers could also give partnerships limited liability for the most part, by making a modestly capitalized corporation the general partner in a limited partnership.

The final push to take advantage of the four-factor test involved a change to state law rather than structuring within existing law: Wyoming enacted the first limited liability company statute in 1977. An LLC, unlike a limited partnership, does not require any partner to have unlimited liability. Nevertheless, Wyoming LLCs were able to be treated as partnerships under the four-factor test. In effect, LLCs had the most important state law attributes of a corporation but qualified as partnerships for tax purposes.

The IRS was initially unsure how to treat LLCs and considered forcing them to be treated as corporations. After a number of years of deliberation, however, the IRS basically just gave up. It made the choice whether to be a corporation or a partnership elective (unless the entity is a state law corporation

---


173 I.R.C. § 7704(a).


175 See Rev. Rul. 88-76, 1988-2 C.B. 360 (analyzing Wyoming LLCs under four-factor test). The Service held that a Wyoming LLC only had two of the attributes of a corporation: centralized management and limited liability. Id. at 360-61. Because a Wyoming LLC would dissolve upon the death or exit of any member, it did not have the corporate characteristic of continuity of life. Id. And because a full transfer of a membership interest—along with all the attributes of membership—required the remaining members’ approval, a Wyoming LLC did not have the corporate characteristic of free transferability of interests. Id. A Wyoming LLC satisfied only two prongs of the four-factor test, thus the IRS ruled that it was partnership and not a corporation. See id. Following the advent of the Wyoming LLC, all states would ultimately adopt their own LLC statutes. See Howard M. Friedman, The Silent LLC Revolution—The Social Cost of Academic Neglect, 38 CREIGHTON L. REV. 35 app. at 92-96 (2004).

176 Hamill, supra note 164, at 400-01.
or is publicly traded).¹⁷⁷ Entities simply “check the box” to determine how they are treated for tax purposes.¹⁷⁸ That is, the state law change so drastically altered the relevant elasticity that it made the tax rule impossible to enforce. And while we cannot tie it directly to the invention of the LLC (there could be a number of contributing factors), the fraction of business income in corporate form has fallen dramatically in the last several decades.¹⁷⁹

Like the saga of Reverse MIPs, the LLC story illustrates the tax revenue effects of nontax legal rules regarding business organizations. But unlike Reverse MIPs, the advent of the LLC was a move in precisely the wrong direction.¹⁸⁰ Making the choice of entity easier most likely created a negative fiscal externality. The Legal Envelope Theorem, by contrast, counsels for adjusting legal rules to make it more costly to avoid taxation rather than making it easier.¹⁸¹

Stepping back from the specifics of the LLC case study, the discussion here illustrates a more general point about the interaction between the tax system and nontax legal rules regarding choice of organizational form. Nontax law provides business enterprises with a menu of organizational forms from which they can choose.¹⁸² The tax system must decide how to treat each of these organizational forms. The tax system can strive for rough equivalence across forms, but in a complex tax system, it is likely (if not inevitable) that the use of some forms will be tax-advantageous relative to other forms for particular enterprises under certain circumstances. Setting tax considerations aside, there is likely to be some efficient number of forms and some efficient set of rules regarding the ease with which enterprises can change their form.¹⁸³ The more options there are, and the easier it is to move across them, the more likely it is that any particular enterprise will be able to shift to a form that reduces its or its owners’ taxes. If we would otherwise have a menu that satisfies simple efficiency, we should adjust it to

¹⁷⁷ Id. at 403.
¹⁷⁸ Treas. Reg. § 1.7701-3 (as amended in 2020).
¹⁷⁹ Matthew Smith, Danny Yagan, Owen Zidar & Eric Zwick, Capitalists in the Twenty-First Century, 134 Q.J. ECON. 1675, 1733 (2019) (“We find that top pass-through income has grown dramatically over time, even after adjusting for tax-induced organizational form switching.”).
¹⁸⁰ The likely reason for this move in the wrong direction was that states were trying to externalize costs to other states, in effect creating a fifty-player prisoner’s dilemma game.
¹⁸¹ For an argument along these lines, see David M. Schizer, Frictions as a Constraint on Tax Planning, 101 COLUM. L. REV. 1312, 1319 (2001). The BETR provides a precise characterization of the social benefits of tax-planning frictions.
¹⁸² The menu could be provided by private-sector sources, though the state is the sole supplier in virtually every modern market economy. See Gillian Hadfield & Eric Talley, On Public Versus Private Provision of Corporate Law, 22 J.L. ECON. & ORG. 414, 417 (2006).
reduce the number of options and/or make it somewhat harder to switch among them. Doing so will not lead to any first-order loss in efficiency but will increase tax revenues. The LLC revolution illustrates one way that state law regarding business organizations can be adjusted to affect tax revenues. Unfortunately, it appears that states made precisely the wrong adjustment.

C. Rules Affecting the Informal Economy

A central problem affecting tax collection in many nations is that a substantial portion of their economy is in the informal sector.\textsuperscript{184} Estimating the size of the informal economy is difficult because informal activity is, by its nature, hidden. By almost any measure, however, it is large.\textsuperscript{185} According to the International Labour Organization, more than 60\% of the world’s employed population works in the informal economy.\textsuperscript{186} In some countries, such as Haiti, Nigeria, and Zimbabwe, the informal economy accounts for more than half of GDP.\textsuperscript{187} Even in the United States, which has proportionately one of the smallest shadow sectors in the world, the informal economy still accounted for 7\% of GDP in 2015.\textsuperscript{188}

There is a tight correlation between the share of taxes (as a percent of GDP) and economic development: highly developed economies collect a large share of GDP in taxes, while less developed economies collect a low share in taxes.\textsuperscript{189} This correlation is caused in part by the large size of the informal sector in developing countries. Countries with large informal sectors cannot tax large portions of the economy. However, causation likely goes in the other direction as well: countries that raise less revenue will lack the administrative capacity to


\textsuperscript{188} Id. at 76.

\textsuperscript{189} According to Timothy Besley and Torsten Persson, low-income countries collect taxes of between 10 to 20\% of GDP while high-income countries collect taxes of around 40\%. Timothy Besley & Torsten Persson, \textit{Why Do Developing Countries Tax So Little?}, 28 J. ECON. PERSPSS. 99, 99 (2014).
enforce taxes or provide public goods, which means that they will have a larger informal economy.

Citizens of developed countries generally take the capacity to tax as a given. Tax debates center around the proper tax base or the appropriate level of progressivity. The capacity to tax, however, is a central problem of the well-being of residents of developing countries. Governments without adequate tax revenues cannot provide the necessary institutions, such as an impartial justice system, or public goods such as roads, access to clean water, and physical security. The informal economy and the resulting effects on taxation are a first-order problem for billions of people around the world.

We explore two examples of legal rules that can affect the size of the informal economy: rules that raise the cost of transacting in cash (and thus the cost of informality), and rules that reduce the cost of financial services (and thus the cost of formality). Changes to these rules to improve the functioning of the tax system are likely to have their greatest impact in developing countries, where the informal sector is larger. All countries, however, face problems of informality to some extent, and our analysis applies to advanced as well as developing economies.

1. Raising the Cost of Cash

Cash is a central component of the informal economy. Cash is used for relatively benign activities, such as by informal vendors that abound in developing economies. Cash is also central to far less benign activities. In a recent book on the effects of cash, Kenneth Rogoff observes that cash is central

---

190 See, e.g., Rafael La Porta & Andrei Shleifer, Informality and Development, 28 J. ECON. PERSPS. 109, 121 (2014) (finding that developing countries with larger informal sectors struggle with tax collection, thus affecting public benefits).

191 See id.

192 There is an ongoing debate about the reasons for informality. In a recent survey, Rafael La Porta and Andrei Shleifer suggest three different lines of argument. In one, epitomized by the Peruvian economist Hernando de Soto, the informal economy is held back by government regulation or by insecure property rights—by legal rules. Id. at 109. Under this theory, adjusting those rules, such as by reducing barriers to entry or by providing a better system of property rights, will generate a shift to the formal sector, generating growth. Not incidentally, for our purposes, changing these legal rules would generate more tax revenue. Another theory is that informal firms stay informal to avoid taxes and regulation, which means that the right approach to reducing informality is better enforcement. Id. Legal rules can still play a role. By reducing the costs of formality and increasing the benefits, changes to legal rules can reduce the incentives of firms to stay informal. Finally, firms may be informal because they are simply less productive than formal firms, which means that they lack the incentives to become larger and join the formal economy. Id. at 109-10. The informal economy shrinks as human capital grows and people become more productive. This last theory, which is La Porta’s and Shleifer’s preferred theory, leaves a smaller role for legal rules. Id. at 116-19.
Governments have to make choices about what types of cash they should issue. In a sense, the choice of cash denominations is a formal legal rule—it is a decision about what bills and coins qualify as legal tender. Large cash transactions will be extraordinarily costly if, for example, a government allows only one-unit notes (e.g., one-dollar bills). Conversely, the cost of cash transactions will likely also be quite high if a government printed notes of every possible denomination (one-unit, two-unit, three-unit, and so on, all the way up to a very large number, thus requiring individuals to engage in involved arithmetic exercises every time they buy anything). Governments must balance these competing considerations in determining the optimal number of note types and the corresponding denominations.

A sizeable scholarly literature in economics, operations research, and related fields seeks to specify the optimal denomination structure for banknotes and coins. Leo Van Hove characterizes the optimal denomination structure as a multicriteria optimization problem in which the most important criterion is the “principle of least effort”: the settlement of transactions should involve as few notes and coins as possible. Other criteria include compatibility with the decimal system (to make mental arithmetic easier); “surveyability” (the idea that the number of denominations should be small enough that members of the public can easily recognize and sort the different denominations by size, shape, color, image, etc.); and the minimization of central-bank production costs.

Consequences for the size of the informal economy are largely left out of the optimal-denomination-structure literature. Now suppose that a government comes to understand the nefarious role of cash, such as in human trafficking, drug sales, and the like. Many of the activities

---


196 Van Hove, supra note 195, at 1015.

197 See id. at 1019; see also Y. Bouhdaoui, D. Bounie & L. Van Hove, Central Banks and Their Banknote Series: The Efficiency-Cost Trade-off, 28 ECON. MODELLING 1482, 1488 (2011) (arguing that transactional-efficiency gains must be weighed against central-bank production costs); Bouhdaoui & Van Hove, supra note 195, at 256 (arguing that central banks could achieve substantial transactional-efficiency gains with small incremental production costs by increasing number of denominations).
listed above rely on relatively large denomination notes. As Rogoff documents, the $100 bill is the most important unit of currency globally for these activities, but in any given country, large denomination notes may play a role in domestic transactions.\textsuperscript{198} If we leave aside taxes for a moment, the government should want to reduce the circulation of large denomination notes to reduce nefarious activities associated with these notes. Whatever the right balance of different types of currency was desirable absent concerns about illegal activities, it should shift toward smaller denomination notes once concerns about illegal activities are taken into account.

Tax enters the calculus in much the same way. As Rogoff demonstrates, large denomination notes are important for tax evasion.\textsuperscript{199} Unlike most other forms of payment, large denomination notes are largely untraceable (except, quite imperfectly, through serial numbers).\textsuperscript{200} The government should reduce the availability of large denomination notes because of the opportunities for tax evasion that they create.

India followed this logic in November 2016 by making all 500 and 1,000 rupee notes (86\% of all cash then in circulation in the country) invalid as legal tender.\textsuperscript{201} To prevent criminals from planning around the demonetization, the announcement was a surprise and took effect at midnight the next day. In his address to the nation, Prime Minister Narendra Modi said that the ban would reduce the use of fake notes, thus cutting off a funding source for terrorists who derive income from counterfeiting. Modi also said that the ban would aid in the fight against corruption and “black money” (i.e., untaxed black market activity).\textsuperscript{202} This was the third time that India had demonetized large denomination notes.\textsuperscript{203} On the first two occasions—in 1946 and in 1978—the goal of reducing tax evasion figured more prominently in the official justification for the government’s actions.\textsuperscript{204}

\textsuperscript{198} See Rogoff, supra note 193, at 31-32.
\textsuperscript{199} Id. at 59.
\textsuperscript{200} Id. at 72.
\textsuperscript{201} Vidhi Doshi, India Withdraws 500 and 1,000 Rupee Notes in Effort to Fight Corruption, GUARDIAN (Nov. 8, 2016, 2:22 PM), https://www.theguardian.com/world/2016/nov/08/india-withdraws-500-1000-rupee-notes-fight-corruption [https://perma.cc/9R2F-49EQ].
\textsuperscript{202} Id.
\textsuperscript{203} See Amartya Lahiri, The Great Indian Demonetization, 34 J. ECON. PERSPS. 55, 58-59 (2020) (highlighting two previous demonetizations by Indian government).
\textsuperscript{204} Id. at 59.
The Modi government has said that the move led to a sharp uptick in income tax filings, but independent analyses have questioned that claim. Disentangling the effects of demonetization from secular trends in tax collections is difficult without a control group. Our objective here is not to defend demonetization but to illustrate how changes to nontax legal rules fit into our framework.

Rogoff argues that the United States should make a similar move. He would begin by eliminating all notes from the $50 bill on up, and if that proves successful, he would proceed to phase out smaller-denomination bills as well. Rogoff argues that this intervention would reduce tax evasion as well as other black-market criminal activity. At the same time, it would almost certainly increase transaction costs for some cash-reliant individuals and firms—for a period, if not in the long term.

The Legal Envelope Theorem provides a framework for weighing the tax-revenue gains from demonetization against the transactional-efficiency losses. Consider an individual who is roughly indifferent between the informal and formal sectors: the additional cost of operating in the informal sector (e.g., weaker protection of property rights) is approximately equal to the additional regulations she would have to comply with if she operated in the formal sector. Now imagine that a small change in the denomination structure—e.g., the elimination of $100 bills—increases her costs in the informal sector by enough that she switches some of her activities over to the formal sector, causing her to pay more taxes. She is not materially better off or worse off than before, but the extra taxes she pays are an increase in the total resources available to society.

The Legal Envelope Theorem instructs us to weigh these benefits against other costs (and benefits) of the rule change. If the change affects the government’s administrative costs and these costs were not already accounted for in the simple efficiency calculus, the decrease (or increase) in administrative costs would enter the calculus as an additional benefit (or cost) of the change.

---


207 Prior to Rogoff’s proposal, then-Harvard Law School student James Henry issued a prescient call for the elimination of $50 and $100 bills nearly forty-five years ago. See James Henry, Calling in the Big Bills, WASH. MONTHLY, May 1976, at 26, 31.

208 ROGOFF, supra note 193, at 95-96.

209 Id. at 92.

210 No longer having to print a certain denomination banknote may reduce costs for the government mint. On the other hand, having to print a larger number of low-denomination
Note, though, that for a small change from a denomination structure that satisfied simple efficiency, the change in costs to banknote users does not have a first-order effect on the total resources calculus. The reason for this is that a simple-efficient denomination structure balances the marginal benefit of fewer denominations (e.g., increased surveyability) against the marginal cost (e.g., a larger number of banknotes required to complete a transaction).  

The analytical framework is fundamentally the same regardless of the details of the tax system, though—of course—the parameter values will depend entirely on country-specific factors. The demonetization of high-denomination banknotes may be more desirable in developing countries, like India, where the potential revenue gain is proportionally greater, or it may be more desirable in developed countries, like the United States, where the transactional-efficiency loss from shifting toward noncash forms of payment is likely to be low for most market actors.  

Our argument is not that the demonetization of 500 and 1,000 rupee notes was wise, nor that $50 and $100 bills should be removed from circulation (though we are certainly amenable to that idea). Our more modest—but also much broader—claim is that all of these questions can be assessed using the BETR and the Legal Envelope Theorem to estimate the effect on society’s total resources.

2. Reducing the Cost of Financial Services

The cash example above involved a legal rule change that raises the cost of transacting in the informal sector. Another way to reduce the size of the informal sector is to make transactions in the formal sector less expensive (and thus more attractive). One strategy for accomplishing this latter objective—which we explore in detail here—is to change certain rules related to the financial sector.

The formal and financial sectors are not synonymous, but they are closely related. In many countries, banks share customer-related information with tax authorities. Firms that evade taxes thus must forgo the opportunity to use banks. Apart from information sharing between banks and tax authorities, banks may be reluctant to lend to firms that operate in the informal sector and evade taxes, both because these firms tend to have less reliable financial information, and because these firms are at significant risk of default in the event banknotes may increase mint costs. Enforcing the demonetization rule might increase costs for other agencies.

211 If the starting-point denomination structure failed to take into account the nontax negative externalities of cash transactions (e.g., the devastating costs of human trafficking), the effect on those externalities also would enter the total resources calculus.

212 See, e.g., Besley & Persson, supra note 189, at 99 (noting lower tax-collection rates in developing countries compared to developed countries).

213 Roger Gordon & Wei Li, Tax Structures in Developing Countries: Many Puzzles and a Possible Explanation, 93 J. PUB. ECON. 855, 856 (2009).

214 Id.
that their evasion is detected.\textsuperscript{215} Reducing the cost of financial services therefore serves to increase the opportunity cost of tax evasion for firms.\textsuperscript{216}

To analyze the relationship between tax evasion and the cost of financial services, Roger Gordon and Wei Li propose a model of taxation in which only firms using the formal financial sector can be taxed (and only firms that pay taxes can use the formal financial sector).\textsuperscript{217} In developed economies, the value added by the financial sector is sufficiently high that most firms choose to operate in the formal, taxed sector.\textsuperscript{218} By contrast, Gordon and Li hypothesize that in developing economies, the value added by the financial sector is low enough to generate a large informal sector.\textsuperscript{219} Gordon and Li use this model to explain a number of otherwise puzzling policies consistently used by developing countries, such as inflation, tariffs, a narrow tax base, and government ownership of capital intensive industries.\textsuperscript{220} For example, inflation operates as a tax on cash holdings, which causes firms to shift from using cash to using the formal financial sector (where interest rates compensate for inflation).\textsuperscript{221}

Our particular interest is in the application of Gordon and Li’s model to nontax legal rules. Gordon and Li suggest, in passing, that if the government can raise the return that firms receive from making use of the financial sector, it should do so, because that will cause some firms on the margin between the informal and formal economy to shift into the formal economy and pay additional taxes.\textsuperscript{222} Gordon and Li do not explain how the government might do this, but the Legal Envelope Theorem offers potential insights.

Consider, for example, rules related to bank reserve requirements. While capital requirements, discussed above, address the risk of insolvency (i.e., the risk that the bank won’t have sufficient assets to meet its liabilities), reserve requirements address the risk of illiquidity (i.e., the risk that the bank won’t have sufficient cash on hand to satisfy its immediate obligations). Reserve

\textsuperscript{215} Thorsten Beck, Chen Lin & Yue Ma, Why Do Firms Evade Taxes? The Role of Information Sharing and Financial Sector Outreach, 69 J. FIN. 763, 765 (2014). Based on survey evidence regarding tax evasion across countries, Beck, Lin, and Ma find that smaller firms are less likely to evade taxes in countries where bank branch penetration is higher. \textit{Id.} at 767.
\textsuperscript{216} \textit{Id.} at 766 (finding that countries with better credit information-sharing tools increase costs of tax evasion).
\textsuperscript{217} Gordon & Li, \textit{supra} note 213, at 862.
\textsuperscript{218} \textit{See id.} at 856 (noting lower value received from financial sector in poorer countries compared to richer countries).
\textsuperscript{219} \textit{Id.}
\textsuperscript{220} Traditional explanations for these policies are that governments of developing countries simply did not understand which policies were desirable or that they were captured by sectoral interest. Gordon and Li argue that because these policies are pervasive and long-standing, they are unlikely to be because of lack of information. Capture does not explain many of the existing tax structures. \textit{See id.} at 864.
\textsuperscript{221} \textit{See id.} at 862.
\textsuperscript{222} \textit{Id.} at 864.
requirements specify the amount of cash that the bank must hold as a percentage of deposit liabilities. A 10% reserve requirement would mean that a bank with $100 of deposits would need to have at least $10 of cash in its vault or in its account with the central bank.

Reserve requirements are typically understood to raise the cost of bank deposits. Higher reserve ratios mean that banks must keep more of their deposited cash in their vault, and thus cannot earn income from lending that cash out. The benefit of higher reserve requirements is that they reduce the risk of bank failure. Some of this benefit is internalized by the bank and its customers, but some of the benefit accrues to the rest of society. The failure of one bank to meet immediate obligations may cause a run on other banks. A series of bank failures can in turn produce contagion effects that impose costs on other sectors of the economy. Bank failures also may impose costs on taxpayers if the government steps in to bail out failed banks and cannot recoup bailout money as part of the resolution process.

Absent tax considerations, the simple-efficient bank reserve requirement would strike a balance between the above-mentioned benefits and costs. Wherever this balance is struck, the discussion here suggests a reason to reduce the reserve requirement somewhat. This deviation from simple efficiency operates as a subsidy from other sectors (which stand to bear some of the costs from bank runs) to the financial sector. Importantly, for our purposes, it has the collateral consequence of reducing the cost of financial services, thus making the formal sector more attractive to firms on the margin.

To be sure, reserve requirements are not the only way that the government can reduce the cost of financial services and make the formal sector more attractive. For example, an alternative policy—which is currently being pursued in a number of developing countries, including India—is to subsidize

---

224 See id. at 7.
225 See id. at 4.
226 See id. at 2 (pointing to role of interbank lending in 2007-2009 U.S. banking crisis).
227 See, e.g., id. at 34.
228 Id. at 9.
229 The Legal Envelope Theorem case for adjusting reserve requirements downward becomes even stronger if some of the social cost of bank failure is borne indirectly by the informal sector.
230 Our analysis of bank reserve requirements does not necessarily apply to bank capital requirements. Reducing bank capital requirements also may reduce the cost of financial services, thus causing firms to shift from the informal sector to the formal sector. However, reducing bank capital requirements also likely means that banks will shift away from equity toward debt, which will reduce tax revenue insofar as debt is tax advantaged.
231 Gordon and Li note that if foreign banks do not share information with home-country tax authorities, the government may choose to impose otherwise inefficient restrictions on foreign banks so as to increase tax capacity. See Gordon & Li, supra note 213, at 857, 864.
electronic payment systems. The Indian government has developed the Unified Payment Interface ("UPI"), which provides a simple and secure electronic payments system that is as cheap and easy as cash. According to some reports, the UPI has been more effective than demonetization at reducing the size of the informal sector, and it has much greater long-term potential.

In sum, legal rules can affect the choice of firms to be informal (tax-noncompliant) or formal (tax-compliant) both by raising the cost of informality and reducing the cost (or, equivalently, increasing the benefit) of formality. Although these effects are likely to be largest in countries with sizeable informal sectors, they have implications for legal analysts everywhere.

D. Property

We end where we started, with property. Rather than review our initial motivating example of changes to property rules in early-modern Europe, we illustrate how property rules can affect taxation with another historical example, the enactment of the Statute of Frauds in England in 1677. We then turn to modern-day applications.

1. The Statute of Frauds

The Statute of Frauds is incorporated into the law of every U.S. state other than Louisiana. It typically requires that “any conveyance of a property right in land,” aside from a short-term lease, must be put “in writing and signed by at least one of the parties.” The Statute of Frauds also generally applies to contracts that cannot be performed within one year and, under the Uniform Commercial Code, to contracts for the sale of commercial goods at a price of $500 or more. The Statute of Frauds is taught across law schools both in property courses and contract courses. We focus here on its property law manifestation.

---


234 See, e.g., id. (explaining importance of UPI providing same level of comfort as cash transactions “in a society where 95% of transaction[s] are still based on cash”).


236 Id.

237 See Braunstein, supra note 49, at 394-95 nn.44-45.

Over the years, scholars have imputed various purposes to the Statute of Frauds: “to prevent people from fraudulently convincing courts that nonexistent contracts exist,”239 “to caution the promisor that he is entering into a binding relationship,”240 and “[increase] the overall security of property rights,”241 among others. The legal scholar Philip Hamburger, however, has argued that the original enactment of the Statute of Frauds was intimately connected to a debate in seventeenth-century England over the legibility of property holdings and the collection of tax.242

Hamburger notes that fraudulent land transfers had become a serious problem by the mid-sixteenth century in England.243 The medieval system of preventing fraudulent conveyances relied on “a combination of community ceremonies, rules of inheritance, and court rolls, which together often made known who had title to land.”244 In some instances, the parties to a transfer would conduct “a ritual known as livery of seisin,” in which “a twig or clod of earth would be transferred in the presence of local inhabitants.”245 Otherwise, transfers were largely governed by the laws of primogeniture, whereby property would pass upon the holder’s death according to mandatory rules of inheritance that privileged the property holder’s eldest son.246 Some transfers, but far from all, were recorded on local court rolls.247

Over time, these safeguards against fraudulent transfers “gradually eroded,” according to Hamburger, most importantly because of the advent of a new form of property called the “use.”248 A use—or what we would now call “equitable ownership”—allowed one party “to benefit from land legally held by another.”249 As parties transferred equitable ownership informally without relying on the livery of seisin or the laws of primogeniture, it became difficult to know who owned a particular parcel of land.250 This uncertainty generated fresh opportunities for fraud.251

241 Merrill & Smith, supra note 235, at 860.
243 Id. at 358.
244 Id. at 355.
245 Id.
246 See id.; A.W.B. Simpson, AN INTRODUCTION TO THE HISTORY OF LAND LAW 53-60 (1961).
247 See Hamburger, supra note 242, at 355.
248 Id. at 355-56.
249 Id. at 356.
250 See id.
251 See id.
The most prominent proposal to reduce fraudulent conveyances was mandatory registration of all land transfers. But a registry would do more than just fight fraud: it also would provide the Crown with information that it could use to assess and collect land taxes. In the terminology we introduced at the outset, it would enhance legibility. As Hamburger illustrates, seventeenth-century commentators understood this point well at the time.

For the same reasons the Crown supported a land registry, landowners opposed it. A registry would reduce landowners’ independence from the Crown and “would facilitate collection of the hated land tax, not to mention other forms of confiscation.” In addition, landowners feared having to justify their claims to ownership on initial registration. Lawyers also opposed a registry because it would have eliminated the rents they enjoyed from the legal work required to limit fraud. Given the opposition by landowners and lawyers, the Crown’s proposal for a registry could not pass Parliament.

The English judge Matthew Hale’s idea of the Statute of Frauds was able to satisfy both the Crown and landowners (and lawyers!). The core of the proposal was a requirement that almost all conveyances of land be in writing along with voluntary enrollment of transactions concerning land. Voluntary registration rather than mandatory registration effectively threaded the needle between the various interests in land conveyances. What the Statute of Frauds did not do is centralize all information about land ownership in the hands of the Crown such that the Crown could use that data to collect land taxes. To be sure, the Statute of Frauds does appear to have raised revenue—albeit indirectly. By deterring fraud, as Hamburger notes, Hale’s system increased the value of land, and thus expanded the base for the rickety land-tax regime.

---

252 See id. at 358-59.
253 See id. at 361.
254 See id. at 361-62 & nn.32-35.
255 See id. at 362.
256 Id. at 361.
257 Id. at 362.
258 Id.
259 See id. at 361-65.
260 See id. at 367.
261 One might wonder why simply requiring a written document would resolve the problem of fraudulent conveyances, given the ease of forgery. One important factor may have been the limits of literacy: a significant portion of the English population still could not read or write at the time, and thus would have had trouble conjuring up false documents. On literacy in England over the last five centuries, see Max Roser & Esteban Ortiz-Ospina, Literacy, OUR WORLD IN DATA (Sept. 20, 2018), https://ourworldindata.org/literacy [https://perma.cc/UND7-ZV9G].
262 See Hamburger, supra note 242, at 364-79.
263 See id. at 365.
264 See id. at 382.
265 See id.
To use our terminology, it was likely a move in the direction of simple efficiency, at least relative to the status quo. Increases in simple efficiency often will raise revenue insofar as they generate more wealth, meaning that more can be taxed.

The logic of the Legal Envelope Theorem would have favored the land registry approach over the Statute of Frauds approach because a land registry—in addition to increasing simple efficiency relative to the status quo—also would have enhanced legibility. What is especially striking about the Statute of Frauds case is that key actors understood this logic nearly three-and-a-half centuries ago, though they defied it because, at the time, they favored a weaker state. Although the participants in the seventeenth-century debate would not have had the language of modern economics to describe their insight, they—like the state-builders in Scott’s story—intuitively understood the importance of tax-collection considerations in the design of nontax legal rules.

2. Modern-Day Analogues

Scott’s and Hamburger’s historical examples have parallels in modern legal systems. Just as communal landholding structures in rural Russia and Elizabethan England flummoxed tax collectors, complex allocations of ownership everywhere from the “pueblos jóvenes” of Peru to the private banks of Switzerland stymie contemporary tax authorities.266 The debate in seventeenth-century England over land registration and the Statute of Frauds finds analogues across the world today.

The Peru example is perhaps the clearest correlate to the controversy in seventeenth-century England that culminated in the Statute of Frauds, though the distributional dynamics differ importantly. There, it is in the pueblos jóvenes (literally, “young towns,” or what outsiders might call “shanty towns”) where landholdings are often opaque to outsiders.267 The Peruvian economist Hernando de Soto has argued that the prevalence of informal property rights in these areas—such as the holding of land by squatters—makes it difficult for residents to obtain credit and to seek legal remedies for business conflicts.268 Formal property rights would allow owners to borrow against their property, to buy and sell the property, to assure protection against third parties, and to otherwise obtain access to the legal system.

De Soto has led programs to give formal legal title to property holders—first in Peru, and subsequently across the developing and post-communist world.269

267 Id. at 190-91.
268 Id. (providing that “person living in an extralegal housing settlement” would have to go through “728 bureaucratic steps” to obtain legal title of home).
While de Soto emphasizes the potential for land titling to improve economic outcomes for low-income individuals, he also has noted the important tax-collection consequences.\(^{270}\) He reports that when he and his team set up voluntary land registries in Peru, the 267,000 formerly extralegal businesses that registered their holdings paid an additional $1.2 billion in taxes four years later.\(^{271}\) Studies of land titling in Thailand and India find dramatic effects on tax revenue as well.\(^{272}\)

Efforts to encourage land titling in the developing world focus on the lower end of the income distribution. In many advanced economies, the emphasis is on increasing the legibility of the holdings of the rich.\(^{273}\) Today’s governments cannot readily observe who owns property that is hidden using shell corporations, trusts, bearer securities, and other mechanisms of the global tax evasion industry.\(^{274}\) One oft-cited study suggests that before recent changes in the law, about 8% of household financial wealth was held in tax havens, and much of the resulting income evade taxation.\(^{275}\)

A full analysis of the nontax legal tools available to address the problem of high-end tax evasion lies beyond our scope. But notably, one mechanism that...

\(^{270}\) Id. at 51.

\(^{271}\) Id. at 154.

\(^{272}\) See Klaus Deininger & Gershon Feder, Land Registration, Governance, and Development: Evidence and Implications for Policy, 24 WORLD BANK RSCH. OBSERVER 233, 248, 259 n.15 (2009).


\(^{274}\) Much of what we know about modern tax evasion comes through two major leaks: one from HSBC Private Bank Switzerland, the Swiss subsidiary of the London-headquartered financial institution, and one from the Panamanian law firm Mossack Fonseca. For a detailed description of the latter leak, see generally Bastian Obermayer & Frederik Obermaier, The Panama Papers: Breaking the Story of How the Rich and Powerful Hide Their Money (2016). For academic work using data from the HSBC and Mossack Fonseca leaks, see Alstadsæter et al., supra note 273, at 2074; and James O’Donovan, Hannes F. Wagner & Stefan Zeume, The Value of Offshore Secrets: Evidence from the Panama Papers, 32 REV. FIN. STUD. 4117, 4119 (2019).

some jurisdictions have settled upon is the same solution that the Crown sought in seventeenth-century England: a central property registry.

The Canadian province of British Columbia provides a case in point. In 2016, an investigation by the nongovernmental organization Transparency International Canada revealed widespread tax evasion as well as money laundering in the Vancouver real estate market. The tools used to evade tax there are strikingly similar to those of seventeenth-century England. Wealthy individuals—often non-Canadians—buy real estate through shell companies, trusts, or nominees. These arrangements can be used to avoid real estate transfer taxes, for example, by selling shares of a shell company or interests in a trust rather than transferring the property itself. They can also be used to avoid capital gains tax on home sales. Canadian tax law allows an exemption for income from the sale of a principal residence, so wealthy individuals selling investment properties sometimes appoint nominees who claim that they use the investment property as their home.

Spurred by high-profile revelations of money laundering and tax evasion in Vancouver, the British Columbia government moved in 2019 to establish a registry of beneficial ownership in land, with penalties of up to $100,000 or 15% of the assessed property value (whichever is greater) in the event of noncompliance. It remains to be seen whether requiring registration will prove to be enough to stop high-end evasion, though some local experts express

---


277 Id. at 27. Nominees are individuals appointed to hold property on behalf of a principal. Id. at 19. Nominee arrangements, also called “bare trusts,” share some similarities with typical trusts, but the nominee’s authority is significantly narrower than the authority of a typical trustee. See Douglas S. Ewens, Rosemarie Wertschek & James R. Wilson, Income Tax Implications of Utilizing Bare Trusts, 37 Can. Tax J. 499, 499-500 (1989). Transparency International Canada revealed that 26% of high-priced properties sold in Vancouver over the previous five years had been nominally owned by students or homemakers with no apparent income stream. See Transparency Int’l Can., supra note 276, at 31.


279 See id. at 29.


281 See Transparency Int’l Can., supra note 276, at 29 (providing example of how businessman used investors to hold title and secure mortgages).

optimism. The key point for our purposes is that British Columbia is very explicitly engineering its real property law in order to advance a tax objective. The relationship between tax and nontax legal rules, so often relegated to the shadows, is in the limelight.

CONCLUSION

The fact that nontax legal rules can facilitate or frustrate the collection of revenue is not—to be clear—an insight new to the proponents of the British Columbia beneficial-ownership registry. Nor is it new to this Article. Participants in property law debates three-and-a-half centuries ago grasped the connection between nontax legal rules and taxation. Indeed, one reason why the subject deserves our attention is precisely because our nontax laws reflect tax-collection imperatives. To understand how nontax laws shape society, one also must understand how those laws grease the wheels of tax collection (or, in some cases, throw sand into their gears).

In an era of wide wealth inequality, the connection between nontax legal rules and tax-collection capacity plays an even larger role. The advanced economies that have been most successful at closing the wealth gap are also the ones whose nontax legal rules best reflect the Legal Envelope Theorem’s lessons. Their experiences serve to underscore that how much we can redistribute depends in substantial part on how efficiently we can do so. The promise of the Legal Envelope Theorem is that it allows economic analysis of nontax legal rules to integrate tax-collection considerations into an efficiency framework. Some of these tax-collection considerations already are integrated into nontax law. But we believe—especially now—that there is room for much more.

284 See e.g., Hamburger, supra note 242, at 361-62 & nn.32-35.
285 See supra note 91 and accompanying text.