

## Note

# Taxing Political Donations: The Case for Corrective Taxes in Campaign Finance

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Campaign finance lives in a time warp, untouched by the regulatory revolution of the past generation.

—Bruce Ackerman and Ian Ayres<sup>1</sup>

### INTRODUCTION

Incentive-based regulations are generally more efficient than command-and-control measures.<sup>2</sup> One of the primary categories of incentive-based regulations—and one that has gained significant support of economics scholars over the past few decades—is corrective taxation.<sup>3</sup> Corrective

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1. BRUCE ACKERMAN & IAN AYRES, VOTING WITH DOLLARS: A NEW PARADIGM FOR CAMPAIGN FINANCE REFORM 1 (2002).

2. See THOMAS J. SCHOENBAUM ET AL., ENVIRONMENTAL POLICY LAW 15 (2002) (“[E]conomists have long questioned the efficiency of centrally-determined, uniform standards.”); see also Dennis D. Hirsch, *Symposium Introduction: Second Generation Policy and the New Economy*, 29 CAP. U. L. REV. 1, 6-7 (2001); Jonathan Baert Wiener, *Global Environmental Regulation: Instrument Choice in Legal Context*, 108 YALE L.J. 677, 682 (1999) (claiming that there is a consensus among analysts that “incentive-based instruments such as taxes and tradeable allowances should generally be chosen over technology requirements and fixed emissions standards”).

3. For a brief summary of the debate between the merits of corrective taxes and quantity regulations, see ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 626-29 (5th ed. 2000). For a more sophisticated account of these arguments, see WILLIAM J. BAUMOL & WALLACE E. OATES, THE THEORY OF ENVIRONMENTAL POLICY (2d ed. 1988); and Louis Kaplow & Steven Shavell, *On the Superiority of Corrective Taxes to Quantity Regulation*, 4 AM. L. & ECON. REV. 1 (2002).

taxes, under various guises, are used in numerous areas of the law:<sup>4</sup> “Sin taxes” are the method of choice for regulating goods such as cigarettes and alcohol,<sup>5</sup> pollution taxes are familiar tools of environmental law,<sup>6</sup> and liability rules play a central role in tort law.<sup>7</sup> Nevertheless, the potential of corrective taxes has been overlooked in the debates over campaign finance reform.<sup>8</sup>

The equivalent of command-and-control measures in campaign finance law are contribution ceilings, which lie at the heart of the American approach to regulating campaign finance.<sup>9</sup> Current law places a \$2000 ceiling on donations from individuals to political candidates.<sup>10</sup> This limit is supplemented by a \$5000 ceiling on donations from individuals to political

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4. The economics literature often uses the term “Pigouvian” taxes in the place of “corrective taxes.” See, e.g., BAUMOL & OATES, *supra* note 3, at 1-3.

5. See, e.g., David J. DePippo, Comment, *I’ll Take My Sin Taxes Unwrapped and Maximized, with a Side of Inelasticity, Please*, 36 U. RICH. L. REV. 543, 551-54 (2002).

6. See, e.g., Douglas A. Kysar, *Law, Environment, and Vision*, 97 NW. U. L. REV. 675, 679 (2003).

7. See, e.g., Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713 (1996). Liability rules are essentially the private law equivalent of corrective taxes. Although the revenue from corrective taxes generally goes to the government while the revenue from liability rules generally goes to the victims, some proposals for corrective taxes distribute revenue to parties harmed by the externalities they regulate, and some forms of liability rules permit the government to collect the tortfeasors’ payments.

8. While this Note is the first proposal for using corrective taxes in campaign finance, a few scholars have suggested taxing campaign donations for other reasons. Most analogously, several scholars have mentioned the possibility of taxing wealthy donors and subsidizing poor ones. Guido Calabresi has discussed these ideas in class lectures at the Yale Law School, but he has never published his thoughts nor has he formally presented them. The first published reference to a proposal of this sort comes as an aside in Edward B. Foley, *Equal-Dollars-Per-Voter: A Constitutional Principle of Campaign Finance*, 94 COLUM. L. REV. 1204, 1233-35 (1994). More recently, Bruce Ackerman and Ian Ayres briefly reject a Calabresi-like proposal as an alternative to their plan for campaign finance reform. See ACKERMAN & AYRES, *supra* note 1, at 40-44. The Supreme Court is not likely to permit taxation of campaign donations based strictly on donor wealth. See *infra* note 104.

More generally, a number of scholars have debated taxing campaign expenditures under the framework of the corporate or gift tax sections of the Internal Revenue Code. See, e.g., Daniel L. Simmons, *An Essay on Federal Income Taxation and Campaign Finance Reform*, 54 FLA. L. REV. 1 (2002); Donald B. Tobin, *Anonymous Speech and Section 527 of the Internal Revenue Code*, 37 GA. L. REV. 611, 648-53 (2002). Yet, unlike corrective taxes, these proposals are either designed to raise revenue or else to target specific forms of independent expenditures.

9. Richard Briffault, *The Future of Reform: Campaign Finance After the Bipartisan Campaign Reform Act of 2002*, 34 ARIZ. ST. L.J. 1179, 1211-12 (2002). A few scholars have recently begun criticizing the preoccupation with command-and-control measures in campaign finance. See, e.g., ACKERMAN & AYRES, *supra* note 1, at 3-5; Cass R. Sunstein, *Political Equality and Unintended Consequences*, 94 COLUM. L. REV. 1390 (1994). However, these scholars’ suggestions for “incentive-based” alternatives are mostly limited to voucher proposals and other forms of public financing. Curiously, even their footnotes fail to consider corrective taxes.

10. Bipartisan Campaign Reform Act (BCRA) of 2002 § 307(a)(1), 2 U.S.C.A. § 441a(a)(1)(A) (West 2003). Before the recent BCRA legislation, this ceiling was set at \$1000. 2 U.S.C. § 441a(a)(1)(A) (2000) (amended 2002).

action committees,<sup>11</sup> a \$25,000 ceiling on donations from individuals to national party committees,<sup>12</sup> and an assortment of additional ceilings on numerous other forms of political donations.<sup>13</sup> Contribution ceilings have become an enduring component of our system of campaign finance regulation.<sup>14</sup>

There are critics of this reliance on contribution ceilings.<sup>15</sup> Some argue that caps on campaign contributions violate First Amendment rights,<sup>16</sup> help incumbents against challengers,<sup>17</sup> and lead donors to divert their contributions through regulatory loopholes.<sup>18</sup> The (mostly conservative) adherents of this position favor allowing donors to contribute unlimited sums to political campaigns. Meanwhile, others argue that permitting even moderately sized donations is incompatible with true political equality.<sup>19</sup> The (mostly liberal) adherents of this position would replace private donations with government-financed campaigns or a regulated system of public debates.

This Note is not directed at either of these positions.<sup>20</sup> Instead, I begin with the premise that political donations are neither categorically harmful nor categorically benign. I accept the underlying purpose of contribution ceilings: to limit the size of political donations without completely banning

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11. 2 U.S.C.A. § 441a(a)(1)(C).

12. *Id.* § 441a(a)(1)(B).

13. Most crucially, the aggregate amount of hard money an individual can donate is capped at \$95,000 per election cycle. *See id.* § 441a(a)(3).

14. Contribution ceilings were first introduced at the federal level in 1940. Anthony Corrado, *Money and Politics: A History of Federal Campaign Finance Law*, in THE NEW CAMPAIGN FINANCE SOURCEBOOK (Anthony Corrado et al. eds., forthcoming 2003) (manuscript at 13), <http://www.brookings.org/gs/cf/newsOURCEbk.htm>. Many state campaign finance systems also rely on contribution ceilings, although the levels of these caps vary widely. *See* The Gubernatorial Campaign Finance Database, at <http://www.unc.edu/~beyle/laws.html> (last visited Feb. 1, 2003).

15. *See, e.g.*, POLITICAL MONEY: DEREGULATING AMERICAN POLITICS (Annelise Anderson ed., 2000) (collecting a variety of short pieces arguing for and against campaign finance regulation on a number of grounds).

16. *See, e.g.*, Colo. Republican Fed. Campaign Comm. v. Fed. Election Comm'n, 518 U.S. 604, 640 (1996); Williamson M. Evers, *Liberty of the Press Under Socialism*, in POLITICAL MONEY: DEREGULATING AMERICAN POLITICS, *supra* note 15, at 94.

17. *See, e.g.*, Bradley A. Smith, *Faulty Assumptions and Undemocratic Consequences of Campaign Finance Reform*, 105 YALE L.J. 1049 (1996).

18. This argument is often labeled the "hydraulic" critique. For a particularly eloquent articulation of this position, see Kathleen M. Sullivan, *Political Money and Freedom of Speech*, 30 U.C. DAVIS L. REV. 663 (1997). *See also* Samuel Issacharoff & Pamela S. Karlan, *The Hydraulics of Campaign Finance Reform*, 77 TEX. L. REV. 1705 (1999).

19. *See, e.g.*, Foley, *supra* note 8; Richard L. Hasen, *Clipping Coupons for Democracy: An Egalitarian/Public Choice Defense of Campaign Finance Vouchers*, 84 CAL. L. REV. 1 (1996); Jamin Raskin & John Bonifaz, *The Constitutional Imperative and Practical Superiority of Democratically Financed Elections*, 94 COLUM. L. REV. 1160 (1994).

20. Critics of contribution ceilings might still find my ideas to be of some value. Opponents of capping donations might support contribution taxes as a second-best alternative to their ideal of no regulation, and contribution taxes might interest opponents of private financing as a means for supplementing, or funding, a regime of public financing. But these arguments are not the focus of my Note.

them. In order to achieve such an end, this Note applies the logic of corrective taxes to the problem of campaign finance. Specifically, I argue for replacing contribution ceilings with “contribution taxes.”<sup>21</sup> Rather than capping the size of political donations at a specified dollar level, I propose taxing donations based on a schedule of graduated rates—the larger the size of a contribution, the higher the rate of taxation.<sup>22</sup> The argument proceeds on a highly theoretical level; questions about design variables are largely outside the scope of this Note.<sup>23</sup> Instead, I present an economic argument for why contribution taxes are superior to contribution ceilings.

My argument stems from a single observation: As compared to contribution ceilings, contribution taxes affirmatively select for donors with a greater willingness to pay taxes on their donations. To demonstrate this point, imagine that donors were required to obtain government permits before contributing any given amount to a candidate. Under this hypothetical, a contribution ceiling would grant every donor a permit to contribute up to the amount of the ceiling. In contrast, contribution taxes would distribute permits based on a donor’s willingness to pay the tax. Donors with greater willingness to pay taxes would receive permits allowing them to donate larger amounts, while donors who were unwilling to pay the taxes would be allowed to donate only small amounts.<sup>24</sup> Instead

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21. I use the term “contribution tax” loosely to refer to any form of corrective tax that might be levied on campaign donations.

22. The assumption that taxes can be set at graduated rates is important for my conclusions. Economists writing about environmental regulation often assume that it is administratively impossible to set taxes at graduated rates. When tax rates must be flat, direct quantity restraints (such as contribution ceilings) may be superior to pricing mechanisms (such as contribution taxes), depending on the relative slopes of the marginal harm and marginal cost abatement functions. See Martin L. Weitzman, *Prices vs. Quantities*, 41 REV. ECON. STUD. 477 (1974).

23. This economic argument for using quantity regulations instead of corrective taxes no longer applies, however, when taxes can be set at graduated rates. See Kaplow & Shavell, *supra* note 3. In the campaign finance setting, this seems eminently feasible: As long as an administrative agency can keep records on the various donations made by each individual, it should be possible to implement a system of contribution taxes with graduated rates. For instance, we could require donors to send contribution checks to a candidate’s account at the Federal Election Commission (FEC) rather than directly to candidates. The FEC could then deduct the appropriate amount of tax—based on a database of the individual’s previous contributions—before sending the funds on to the candidate.

24. There are numerous ways to implement a policy of contribution taxes. For instance, although it would probably be administratively easier to levy the taxes on candidates, the taxes could also be levied on donors. Yet questions about design variables are not unique to the discussion of contribution taxes. There are also numerous possibilities for implementing a system of contribution ceilings. Compare Daniel Hays Lowenstein, *On Campaign Finance Reform: The Root of All Evil Is Deeply Rooted*, 18 HOFSTRA L. REV. 301, 351-60 (1989) (proposing \$100 contribution ceilings and aggregate limits on contributions from PACs), with Norman Ornstein, *Eight Modest Ideas for Meaningful Campaign Finance Reform*, in A USER’S GUIDE TO CAMPAIGN FINANCE REFORM 149, 153-56 (Gerald C. Lubenow ed., 2001) (proposing \$3000 contribution ceilings and additional disclosure provisions).

25. This claim assumes a zero-percent tax rate for small donations. Otherwise, a donor unwilling to pay any taxes would not be able to contribute at all. In any case, donors would need to purchase the “permits” from the government for the amount of the tax.

of capping all donors at the same level, contribution taxes allow donors to contribute up to the maximum amount at which they are still willing to pay the associated tax.

There are two advantages to allowing donors with greater willingness to pay taxes to contribute larger amounts. First, in a sense, these donors derive greater value from contributing. According to microeconomic theory, the value someone receives from purchasing a good or service can be measured by the amount the person would be willing to pay for the good or service.<sup>25</sup> The difference between the amount a consumer would be willing to pay for a good and the cost of producing the good equals the economic surplus created by the transaction.<sup>26</sup> In the case of campaign donations, a donor's economic surplus equals the maximum level of contribution taxes the donor would be willing to pay for the privilege of making a donation. As compared to contribution ceilings, contribution taxes create more total surplus by affirmatively selecting for donors with greater willingness to pay taxes—donors who derive greater surplus from contributing.<sup>27</sup>

The second advantage comes from the possibility of donors diverting their contributions through “regulatory loopholes” when prevented from contributing directly.<sup>28</sup> The regulatory system has proven unable to block all of the ways in which donors can spend money on behalf of a candidate. When prevented from contributing directly, some donors divert their funds into independent expenditures or other methods of indirectly aiding their favored candidates. Diversions of this sort are an endemic problem of campaign finance regulation. Still, not all donors will divert their funds when prevented from contributing directly. Ideally, a system of campaign finance regulation would only block donations to the extent they can be limited without causing donors to divert their funds.<sup>29</sup> Contribution taxes come much closer to this goal than contribution ceilings. Contribution ceilings prevent all donors from contributing more than a fixed amount, regardless of the likelihood that donors will divert their funds in response. In contrast, contribution taxes only block donors who are unwilling to pay

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25. PINDYCK & RUBINFELD, *supra* note 3, at 123-27.

26. The presence of externalities complicates the calculation of economic surplus. *See infra* Subsection I.A.1.

27. The increased surplus generated by contribution taxes over contribution ceilings may come in the form of tax revenue, private surplus retained by the donors, or a combination of the two factors. *See infra* Subsection I.A.1.

28. The term “regulatory loopholes” is not meant to be pejorative. Generally speaking, one person’s loophole is another person’s free speech. For our purposes, it suffices to say that constitutional and practical constraints prevent lawmakers from completely stopping donors from diverting their funds. *See infra* Subsection I.B.1.

29. More accurately, an ideal system of campaign finance regulation would strive to minimize both the harm caused when donors divert their funds and the harm caused when donors contribute more than is socially optimal. *See infra* Section I.B.

the tax. All else being equal, we can expect a strong correlation between donors who are willing to pay large taxes and donors who are likely to divert their funds. Hence, when the two policies are set based on the same goals, contribution taxes should cause less diversion than contribution ceilings.

My argument proceeds on two levels. Part I models the advantages of contribution taxes in greater detail. As compared to contribution ceilings, contribution taxes generate more total surplus and less overall diversion. The Introduction has already explained the basic intuitions behind these two advantages. Part I demonstrates that these intuitions are robust in the face of more rigorous economic analysis.

Part II relaxes some of my assumptions to argue that contribution taxes remain superior to contribution ceilings in the real world. Hence, Part II discusses questions that my model assumes away: Would contribution taxes exacerbate the problems of corruption or inequality? Are contribution taxes constitutional? Can we actually quantify the harms caused by donations? This Part does not attempt to fully resolve these questions nor to respond to all possible objections, but merely aims to show that contribution taxes do not generate any disadvantages serious enough to overpower the two advantages demonstrated by Part I.

#### I. A COMPARATIVE MODEL OF CONTRIBUTION CEILINGS AND CONTRIBUTION TAXES

I begin with the premise that private donations are neither categorically harmful nor categorically benign. Both contribution ceilings and contribution taxes are mechanisms for limiting the size of private donations without completely banning them. Either policy mechanism can place more or less severe restrictions on private donations. Just as a \$20,000 contribution ceiling is less restrictive than a \$200 contribution ceiling, a 9% marginal tax rate is less restrictive than a 90% marginal tax rate. Whereas contribution ceilings reduce the size of large donations by capping the donations at a specified dollar level, contribution taxes reduce the size of large donations by the amount of the tax. Some donors may increase the amount they contribute in order to offset the effects of the tax, but taxes will still tend to reduce the after-tax size of political donations. A sufficiently high tax rate can reduce the average size of political donations by the same amount as any contribution ceiling.

The question, then, is whether contribution ceilings or contribution taxes are a better method of limiting the size of private donations. If the two policies are set to reduce the average size of political donations to the same level, which policy option preserves the most benefit while reducing the

most harm? To answer this question, this Part builds a model based on three simplifying assumptions:

1. Neither the externalities generated by a contribution, nor the transaction costs associated with diverting a contribution, are directly correlated with donor willingness to pay contribution taxes (Assumption of No Correlation).
2. Contribution taxes are a constitutionally acceptable method of regulating campaign donations (Assumption of Constitutionality).
3. Policymakers can and will set the tax rates at their socially optimal levels (Assumption of Perfect Implementation).

When combined with the basic maxims of microeconomic theory, these assumptions allow me to model the choice between contribution ceilings and contribution taxes using a simplified form of cost-benefit analysis. The model assumes that the harms and benefits of campaign donations can be quantified—that there is a direct relationship between the amount a donor contributes and the level of harm and benefit generated by her donation.

We can express this relationship through a set of functions; for any amount a donor could contribute, we can determine a single value for total benefit and a single value for total harm.<sup>30</sup> As a result, we can calculate a socially optimal contribution size for every individual donor<sup>31</sup>—the point at which total benefit exceeds total harm by the maximum possible amount.<sup>32</sup> We can judge a regulatory policy by how close it brings donors to contributing at socially optimal levels.<sup>33</sup>

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30. For example, where  $x$  represents donation size, one donor's contributions might generate a level of total harm equal to  $x^2$  and a level of total benefit equal to  $1000x$ , while a second donor's contributions might generate a level of total harm equal to  $x^3$  and a level of total benefit equal to  $150x^2$ . Although it need not be the case that different donors' contributions create different benefits and costs relative to their magnitude, see *infra* Subsection I.A.2, the model that this Note employs accounts for such a possibility.

31. Continuing from the previous footnote, we can calculate the donors' socially optimal contribution sizes based on the marginal harm and benefit created by each additional dollar of their contributions. Taking the derivative of total harm and benefit with respect to donation size (in order to determine the donation size at which the two values are equal for each donor), the marginal harm is  $2x$  for the first donor and  $3x^2$  for the second, while the marginal benefit is  $1000$  for the first donor and  $300x$  for the second. Consequently, the socially optimal amount for each donor to contribute is \$500 for the first donor and \$100 for the second.

32. It is possible for donors to have more than one socially optimal contribution size. But we can ignore this possibility in constructing the model. By definition, we should be indifferent among the multiple socially optimal contribution points at which a donor might contribute and we can treat these donors as having only one socially optimal point.

33. Some donors might have socially optimal contribution points at zero or at infinity. Yet the initial premise that donations should be limited, but not banned, dictates that most donors cannot have socially optimal contribution points at these levels.

Unfortunately, we cannot simply command donors to contribute socially optimal amounts. Nor can we custom-tailor our regulations to individual donors. As an underlying premise, this Note assumes that we cannot differentially tax donors based on the harms caused by their donations—harms such as corruption and inequality.<sup>34</sup> Contribution taxes would become even more efficient if we could adjust the tax rates based on donors' wealth or on the degree to which donors seek to corrupt the political process. Yet contribution ceilings could also be made more efficient by adjusting the caps based on these factors. My model assumes that the Constitution, practical reality, and political considerations require that both contribution ceilings and contribution taxes use a donation's size as the primary proxy for its tendency to cause harm. But as long as regulations cannot be completely tailored to individual characteristics, changing this assumption would not undermine the conclusions of the model.

Hence, under a policy of contribution ceilings, all donors face the same ceilings; under a policy of contribution taxes, all donors face the same tax rates. Still, contribution taxes are more custom-tailored than contribution ceilings. Where contribution ceilings cap all donations at the same level, contribution taxes selectively regulate donors based on their willingness to pay the taxes. Consequently, as compared to contribution ceilings, contribution taxes generate more total surplus and less overall diversion. Section A models this result assuming donors cannot divert their funds, and Section B expands the model to incorporate diverted funds.<sup>35</sup>

#### A. *Modeling the Two Policy Options Assuming Donors Cannot Divert Their Funds*

Economic transactions create surplus because consumers prefer purchased goods to any alternative uses for their money and producers prefer receiving the money to keeping their goods. The same rule holds for campaign donations. Although it is not entirely clear what donors are purchasing when they make campaign contributions, the donors must prefer the results of contributing to any alternative uses for their money or else they would not contribute. When regulations prevent donors from contributing as much as they would like, the regulations deprive donors of

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34. For further discussion of these harms, see *infra* Subsections II.A.1-2.

35. It is worth noting that this argument differs from the standard economic case for corrective taxes. The standard case is based on information asymmetries—the taxed parties are assumed to have better knowledge about the costs and benefits of their behavior than the government. I briefly discuss the implications of information asymmetries in Section II.C, after relaxing the Assumption of Perfect Implementation.

some of the value they would have received from contributing at their desired level. As such, the regulations reduce donor surplus.

Of course, regulations may also prevent social harm. When regulations eliminate more social harm than donor surplus, the regulations create a net benefit for society. But the donor surplus is still lost. If an alternative regulation could prevent the same amount of social harm without eliminating the donor surplus, this regulation would produce an even greater net benefit for society.

A critic might object that this definition for surplus implies that wealthy donors derive greater surplus from contributing on account of their greater ability to afford the costs of making a donation. Yet this result is inherent to the concept of economic efficiency.<sup>36</sup> Any negative social consequences from inequality are factored into the total harm caused by the donation. Again, if an alternative regulation could prevent the same amount of inequality and other harms without eliminating donor surplus, this regulation would produce a greater net benefit for society.<sup>37</sup>

This result holds even if we think donors do not deserve their surplus for some moral reason. The government has numerous tools—such as taxes and fees—for expropriating a donor's private surplus or for transferring that surplus to other private parties. These tools are often inefficient in the sense that a portion of the private surplus may be lost in the course of the expropriation or transfer. Still, the government should be able to absorb at least some percentage of the private surplus enjoyed by "undeserving" donors. When regulations destroy private surplus, they harm society even if the original possessors of that surplus were thought to be undeserving. Regardless of how we feel about the reasons donors derive private surplus from contributing, an alternative regulation capable of mitigating harms without destroying surplus would still produce a greater net benefit for society.

The remainder of this Section argues that contribution taxes can do just that. When contribution taxes are set so as to prevent the same amount of harm as a policy of contribution ceilings, they can preserve more total surplus. To demonstrate this point, this Section models how donors respond to the alternative policies of contribution ceilings and contribution taxes, ignoring for now the possibility that donors will divert their funds when prevented from contributing directly.

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36. For a sophisticated discussion of this dilemma, see BAUMOL & OATES, *supra* note 3, at 235-56.

37. In the Conclusion, I briefly discuss the question of whether we might devalue donor surplus for nonwelfarist reasons.

### 1. *Defining the Elements of Surplus*

Donors decide how much to contribute based on the private benefit they receive from contributing. A donor will only contribute a given amount if she receives more private benefit from donating than it costs for her to make the donation. Donor private benefit encompasses all of the reasons donors make political contributions.<sup>38</sup> For instance, if a donor thinks that making a large contribution will corrupt the political process, then the donor's private benefit will be reduced by the degree to which the donor values not creating this type of corruption. Still, donors will frequently undervalue the social consequences of their contributions when deciding how much to donate.<sup>39</sup> The degree to which the social consequences of a contribution diverge from the donor's private benefit is labeled as externalities.<sup>40</sup> Positive externalities refer to any desirable social consequences of contributing that donors do not factor into their private benefit, and negative externalities refer to any harmful social consequences of contributing that donors do not factor into their private benefit. Since our goal is to reduce the size of donations, we can assume that negative externalities tend to exceed positive ones.<sup>41</sup> Hence, for simplicity, I use the term "externalities" to refer to net negative externalities—total negative externalities minus total positive externalities.

Without regulation, a donor will base the size of her contribution on the relationship between her private benefit and the cost of the donation. The difference between these two factors is her private surplus. As long as the marginal surplus she receives from adding an additional dollar to her contribution is positive, she will increase the size of her donation; in doing so, she will contribute up to the point where her marginal surplus becomes

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38. As such, private benefit is an inherently subjective concept. I assume that donors are at least somewhat rational and that the government does not understand a donor's private benefit any better than the donors do themselves. A more in-depth examination of the nature of private benefit is well beyond the scope of this Note.

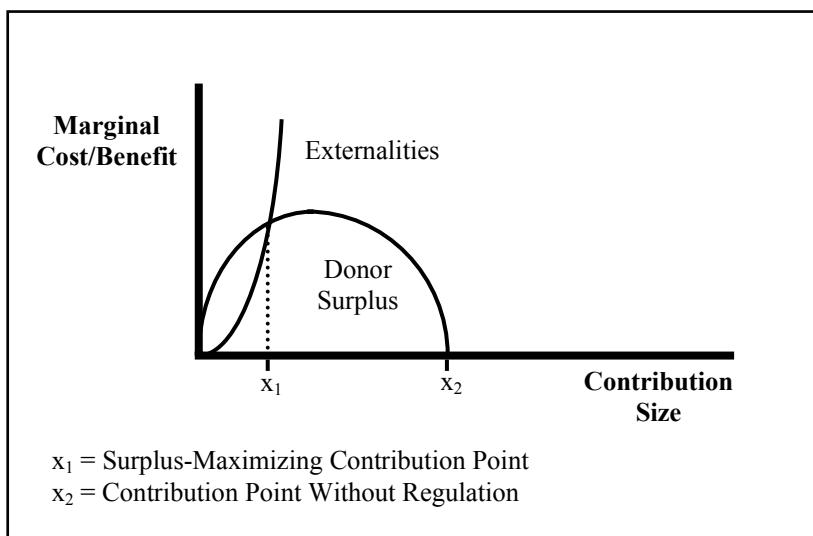
39. If donors fully internalized the social consequences of their donations, there would be no need to regulate campaign donations. Hence, we assume that donations produce negative externalities based on the initial premise that donations ought to be limited.

40. Unlike traditional microeconomic analysis, this model factors any benefit that candidates receive from a donation into the calculation of externalities. The model will therefore not include any term equivalent to "producer" (i.e., candidate) surplus. The reason for this is that candidates should value a contribution at a level exactly equal to its dollar amount. We could make a more complicated model that would include a measure of candidate surplus—perhaps as the difference between the dollar amount of a contribution and the candidate's cost of soliciting the contribution, or as the additional degree of prestige or legitimacy that each contribution confers upon a given candidate. But introducing complexity of this sort would only obscure the basic point of the model.

41. If positive externalities exceeded negative ones, an optimal regulatory policy would strive to increase the amount donors contributed rather than to reduce the size of private donations. For small donations, where positive externalities may exceed negative ones, a policy of contribution taxes should include a zero-percent tax bracket—or even a potential contribution tax credit.

zero. The social consequences of a contribution can be measured by the difference between donor surplus and externalities. At the point where donors contribute without regulation, marginal donor surplus is zero and marginal negative externalities will tend to exceed positive ones. Consequently, in the absence of regulation, donors will contribute above the level at which their contributions would generate the maximum amount of total surplus—the donors' surplus-maximizing amounts. Figure 1 illustrates this result.

FIGURE 1. CONTRIBUTIONS MADE BY UNREGULATED DONORS



This merely restates the premise that unregulated donors will contribute above their socially optimal levels. When donors cannot divert their funds to other means of political financing, a donor's socially optimal contribution size equals the donor's surplus-maximizing contribution size.

Under a regime of contribution ceilings, total surplus consists of two elements: donor surplus and externalities. Thus, under a system of contribution ceilings, a donor's surplus-maximizing contribution size is the point where marginal donor surplus equals marginal externalities. Moving to a regime of contribution taxes introduces a third element to total surplus—tax revenue. Under a system of contribution taxes, a donor's surplus-maximizing contribution size is the point at which marginal donor surplus plus marginal tax revenue equals marginal externalities. Still, the mere fact that contribution taxes generate revenue is not a reason for adopting them. The government has numerous means for generating revenue. Additional revenue is not the advantage of contribution taxes; rather, tax revenue is merely a byproduct of the additional flexibility that a

system of tax constraints—as opposed to a uniform limit on political contributions—creates. This flexibility is the true advantage of contribution taxes, and is what accounts for the increased surplus generated by replacing contribution ceilings with contribution taxes.

In general, taxes create disincentives to engage in the taxed behavior. As a result, taxes deter transactions that would have created surplus for both parties to the transaction in the absence of a tax. Economists label this lost surplus “deadweight” loss.<sup>42</sup> As with all corrective taxes, contribution taxes are designed for the express purpose of creating disincentives to engage in the taxed behavior—the giving of large campaign donations. Yet corrective taxes regulate activities that produce negative externalities—activities where private parties, left to their own devices, generate deadweight loss by engaging in too much of the regulated activity. Consequently, corrective taxes generate social surplus rather than deadweight loss.<sup>43</sup>

As Robert Cooter explains, regulations like contribution taxes “raise revenues for the government by correcting distortions in the allocation of resources rather than by creating such distortions. The revenues raised by nondistorting taxes can be substituted for the revenues raised by distorting taxes like the income tax, thus increasing efficiency.”<sup>44</sup> The revenue raised by contribution taxes is essentially free money, as it is raised not by creating economic inefficiency, but rather as a means of avoiding such inefficiency. In a sense, the need to pay taxes forces donors to transfer to the government some of the private benefit they receive from contributing, and as a result, to bear the costs (“internalize”) some of the negative externalities that their donations create. Tax revenue is subtracted from the donors’ private surplus, and instead becomes surplus that belongs to the government. As such, the revenue generated by contribution taxes remains an important component of total surplus, but one that is not in the hands of the donor. Whereas total surplus equals donor surplus minus externalities under a system of contribution ceilings, under a system of contribution taxes, total surplus equals tax revenue (government surplus) plus donor surplus minus externalities.

## 2. Holding Both Externalities and Surplus Constant Across Donors

If all donors were the same with respect to both externalities and private benefit, the contribution taxes and contribution ceilings would be equally efficient. Both policy options strive to reduce donations to their

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42. See, e.g., PINDYCK & RUBINFELD, *supra* note 3, at 292.

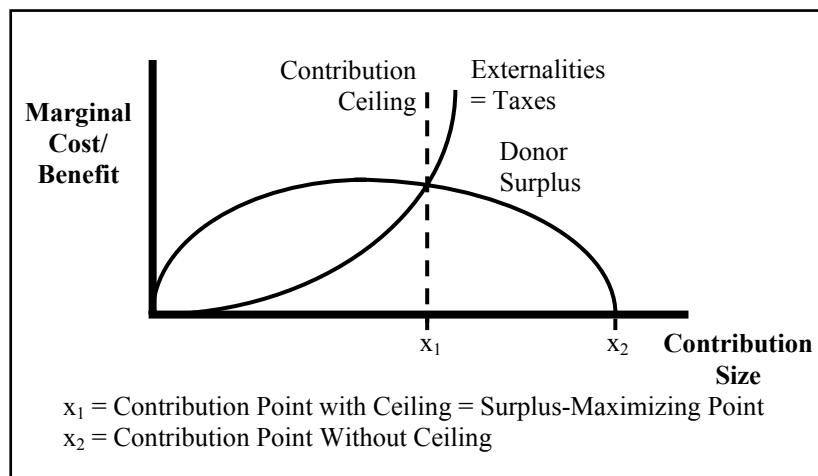
43. Of course, this only holds true when the contribution taxes are designed to implement regulatory goals. A contribution tax set to maximize tax revenue might cause deadweight loss by over- or underdeterring donations.

44. Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1536 n.29 (1984).

surplus-maximizing levels. The surplus-maximizing amount for a donor to contribute is determined by the interaction of externalities and the donor's private benefit. Consequently, in a world where all donors are the same with respect to both externalities and private benefit, every donor would have the same surplus-maximizing contribution point.

One method of inducing donors to contribute surplus-maximizing amounts would be to set a contribution ceiling equal to their surplus-maximizing contribution size. By definition, a ceiling set at this level would prohibit donors from contributing above their surplus-maximizing amounts. Also by definition, a donor's private benefit must exceed the cost of contributing at the donor's surplus-maximizing level, and thus donors would not contribute less than this amount. As a result, a properly set contribution ceiling would lead all donors to contribute at surplus-maximizing levels.

FIGURE 2. EXTERNALITIES AND PRIVATE SURPLUS  
HELD CONSTANT ACROSS DONORS



An appropriately set schedule of contribution taxes would also lead all donors to contribute surplus-maximizing amounts. Contribution taxes would raise the cost of making a donation and thereby reduce donors' private surplus by the amount of the tax. In order to lead donors to contribute surplus-maximizing amounts, contribution taxes must be set equal to the level of externalities accompanying contributions. As such, the marginal tax rate on each additional dollar of a contribution must equal the marginal level of externalities. With tax rates set in this fashion, donors would internalize the level of externalities into their decisions of how much to contribute. By reducing donors' private surplus to zero at the surplus-

maximizing contribution size, contribution taxes would lead all donors to contribute surplus-maximizing amounts.

As a result, contribution ceilings and contribution taxes would be equally efficient in a world where all donors were the same with respect to both externalities and private benefit. Figure 2 above illustrates this result.

Contribution taxes would transfer a portion of the donor surplus to the government in the form of tax revenue. But both regulatory systems would lead donors to contribute at the same surplus-maximizing levels. The two regulatory systems would produce equivalent amounts of total surplus.

### *3. Holding Externalities Constant Across Donors While Allowing Private Surplus To Vary*

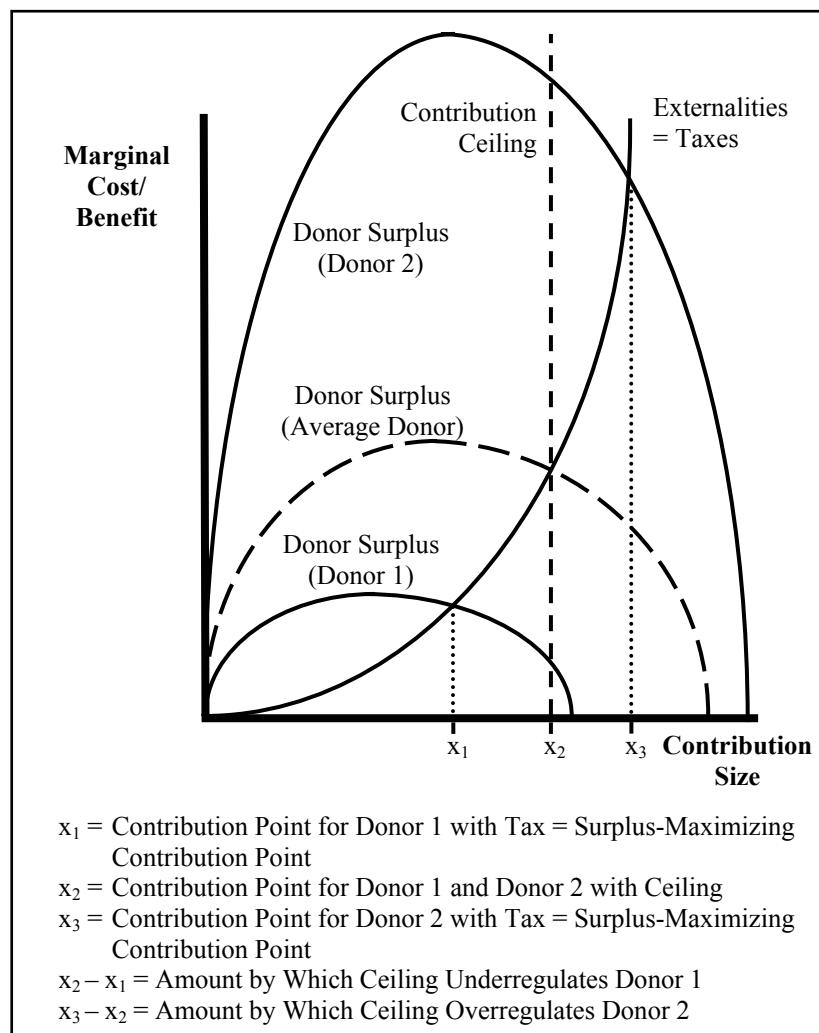
Once we allow private surplus to vary among donors, we begin to see how contribution taxes generate more surplus than contribution ceilings. Consider a hypothetical world where all donors are the same with respect to externalities but differ with respect to private benefit. Since private surplus would vary among individual donors while externalities remained constant, the surplus-maximizing contribution sizes would also vary among individual donors. Contribution taxes would still lead all donors to contribute at their surplus-maximizing levels, but contribution ceilings would overregulate some donors and underregulate others.

Since it is not possible to set separate contribution ceilings for each individual donor, contribution ceilings must be set based on the harms and benefits caused by the average contribution. In other words, policymakers must set the ceiling at the point that maximizes overall social surplus. This point will not be surplus-maximizing with respect to any individual donor whose private surplus differs from the average. Consequently, setting a contribution ceiling at this point creates errors of overregulation and of underregulation. The ceiling would reduce some donations to below their surplus-maximizing sizes, while also failing to limit other donations sized above their surplus-maximizing amounts.

In contrast, contribution taxes would lead all donors to contribute at their surplus-maximizing levels. Setting the taxes equal to externalities would cause donors to internalize the social consequences of their contributions. Donors would only contribute a given amount if their private surplus exceeded the externalities. Hence, taxes would not generate errors of underregulation. In addition, donors would never contribute less than their surplus-maximizing amount, as the marginal private surplus they would receive from increasing the size of their contribution would exceed the marginal tax rate. Taxes would therefore not generate errors of overregulation. Whereas contribution ceilings must be set based on externalities and private benefit, taxes can be set based only on the level of

externalities. As such, contribution taxes remain efficient even when the level of private surplus varies across individual donors. Figure 3 illustrates this result.

FIGURE 3. EXTERNALITIES CONSTANT ACROSS DONORS,  
PRIVATE SURPLUS VARIES



#### 4. *Allowing Both Externalities and Private Surplus To Vary Across Donors*

Now consider the situation in the real world, where donors differ with respect to both externalities and private benefit. Under these circumstances, contribution taxes can no longer be perfectly efficient. As donors will

generate different levels of externalities, the tax rates can no longer be set equal to externalities for all donors. As a result, contribution taxes will generate errors of underregulation and of overregulation. Nevertheless, the use of contribution taxes will still generate fewer regulatory errors than contribution ceilings, and thus produce more total surplus.

When externalities differ, the contribution tax rates must be set equal to expected externalities, or the level of externalities generated by the average contribution.<sup>45</sup> The taxes will overregulate contributions that produce a smaller level of externalities than average and underregulate contributions that produce a larger level of externalities than average. Nevertheless, setting the tax rates at this level maximizes overall surplus. Although donors will no longer internalize the actual externalities generated by their contributions, they will still internalize the expected level of externalities. As a group, the donors who still contribute after paying the tax will generate more total private surplus from contributing than total externalities. And, as a group, the donors deterred by the tax would have generated less total private surplus from contributing than total externalities.

In comparison, a policy of contribution ceilings must either ban all donations of a given size or else leave all donations of the given size unregulated. For instance, consider donations of size  $x$ . If we set the contribution ceiling equal to  $x$  or higher, we will effectively leave all donations of size  $x$  unregulated. Conversely, if we set the contribution ceiling below  $x$ , we will effectively ban all donations of size  $x$ . As such, contribution ceilings are a far blunter instrument for minimizing errors of overregulation and underregulation.

Contribution taxes generate errors of overregulation when a donation's externalities are below average and errors of underregulation when a donation's externalities are above average. Still, for any given size of donations, the combined errors of overregulation and underregulation produce less total harm than would either banning all donations of a given size or leaving all donations of that size unregulated.<sup>46</sup> Since tax rates will be set equal to expected externalities, donors will only contribute a given amount when they receive more private surplus than the expected externalities of their contribution. Hence, for any given size of donations, the total surplus generated by permitting donors to contribute at the given size must be positive.<sup>47</sup> We could generate even more surplus with

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45. For a mathematical explanation for why optimal tax rates should be set equal to expected externalities in the field of environmental regulation, see Kaplow & Shavell, *supra* note 3.

46. It is worth reemphasizing that this conclusion depends on the Assumption of No Correlation.

47. This conclusion will not hold if the expected level of externalities is so high as to exceed the private surplus received by all donors. See *infra* Subsection I.A.5.

regulations that were custom-tailored to fit the level of externalities that each individual's contributions would create. But if such a policy is impossible or impracticable, contribution taxes produce more surplus than would completely banning all donations of the given size (as would occur under a contribution ceiling regime). Likewise, setting tax rates equal to expected externalities only deters donors from contributing a given amount when their private surplus is less than the expected level of externalities. Consequently, the overall surplus generated by deterring this group of donors must be positive.<sup>48</sup> Again, custom-tailored regulations would generate even more surplus, but contribution taxes still produce more surplus than would leaving all donations of a given size unregulated (the result under a contribution ceiling). Combining these two propositions, even though contribution taxes are less efficient than custom-tailored regulations, taxing donations of a given size produces more surplus than either completely banning all donations of the size or leaving all donations of the size unregulated—the two options available under a contribution ceiling. As such, contribution taxes still generate more total surplus than contribution ceilings when donors differ with respect to externalities.

##### *5. Comparing the Policy Options with Respect to the Largest and Smallest Donations*

Under the assumptions of the model, contribution taxes produce more total surplus than contribution ceilings. However, contribution taxes are not necessarily more efficient across the entire range of donation sizes. We can still imagine scenarios where the two policies would be equally efficient with respect to a subset of the largest or the smallest donations.

Contribution ceilings only generate errors of overregulation when the private surplus received by a donor exceeds the level of externalities. If the externalities were always larger than a donor's private benefit, the ceilings would not generate errors of overregulation. Similarly, contribution ceilings only generate errors of underregulation when the private surplus received by a donor is smaller than the level of externalities. If the externalities were always less than a donor's private benefit, ceilings would not generate errors of underregulation. Of course, contribution taxes could also avoid generating regulatory errors under these scenarios. But, in either of the scenarios, contribution taxes would no longer generate more surplus than contribution ceilings.

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48. This conclusion will not hold if the expected level of externalities is so low as to be smaller than the private surplus received by all donors—perhaps if positive externalities exceed negative ones. See *infra* Subsection I.A.5.

Our initial premise that private donations should be limited but not completely banned tells us that neither of these scenarios is accurate with respect to the entire range of donation sizes. If all donors faced a level of expected externalities in excess of their private surplus, we would be better off completely banning all donations. Likewise, if all donors enjoyed more private surplus than the expected level of externalities, we would be better off leaving all donations unregulated. Nevertheless, these scenarios might hold true for a subset of the largest or smallest donations.

With respect to the smallest donations, the level of expected externalities might well be less than the private surplus received by all donors. Many commentators favor encouraging small donations rather than limiting them.<sup>49</sup> To this end, some scholars advocate using subsidies to persuade more donors to contribute small amounts.<sup>50</sup> Hence, we might reasonably conclude that small donations do not generate net negative externalities. Indeed, they might even generate net positive externalities. If this is true, an ideal regulatory system would not limit small donations. Contribution ceilings achieve this result as the ceilings only block donations sized larger than the cap. Yet contribution taxes can also achieve this result when the tax rates are set equal to net negative externalities. If the positive externalities generated by small donations exceed the negative ones, we can easily set a zero-percent tax bracket for the small donations.<sup>51</sup> Consequently, both policy options can leave small donations unregulated.

Similarly, both policy options ban the largest donations. Even without regulation, donors cannot contribute infinite sums. At some point, the cost of donating must exceed all donors' private surplus. By increasing the cost of donating by the amount of the tax, contribution taxes lower the maximum point at which any donor is willing to contribute. If the level of expected externalities exceeds all donors' private surplus for a subset of large donations, a tax rate set equal to expected externalities would prevent all of these donors from contributing. With respect to the largest donations, a tax rate set equal to expected externalities is equivalent to a contribution ceiling.

Altogether, then, we may be indifferent between contribution taxes and contribution ceilings as applied to the largest and smallest donations. Yet

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49. DAVID ROSENBERG, BROADENING THE BASE: THE CASE FOR A NEW FEDERAL TAX CREDIT FOR POLITICAL CONTRIBUTIONS 1 (2002) ("[M]any observers, from the left and right, agree that the inclusion of small, local donors in political campaigns is vital to the overall health of our democracy.").

50. See, e.g., ACKERMAN & AYRES, *supra* note 1; HERBERT E. ALEXANDER, TAX INCENTIVES FOR POLITICAL CONTRIBUTIONS? (1961) (proposing the use of tax credits); ROSENBERG, *supra* note 49; Sunstein, *supra* note 9 (proposing the use of vouchers).

51. A subsidy, such as a tax credit or matching grant, might produce even more surplus under these conditions. Evaluating the merits of a subsidy plan or a negative tax rate is beyond the scope of this Note. A policy of subsidies might run into administrative problems that are not present in a system of contribution taxes.

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contribution taxes still produce more total surplus when applied to the wide array of donations sized between these two extremes.

For a contribution ceiling to be optimal, two conditions must be met. First, private surplus must exceed expected externalities for all donations smaller than the ceiling. And second, private surplus must be smaller than expected externalities for all donations larger than the ceiling.

Considering that donors vary widely in the private surplus they receive from contributing, there should be a large band of contribution sizes where expected externalities exceed private surplus for some donors but not for others. Most voters able to contribute to political campaigns choose not to do so.<sup>52</sup> Based on any realistic distribution of private surplus, many donors must value the results of contributing only marginally above the cost of making a contribution.<sup>53</sup> On the other extreme, some donors clearly receive a great deal of surplus from contributing. For example, George Soros recently pledged to spend over \$10 million to defeat President Bush.<sup>54</sup> He seems willing to spend this money even though campaign finance laws prevent him from donating directly to his chosen candidate, presumably reducing the effectiveness of his donation. It is hard to know how much surplus donors like Soros derive from contributing. Still, the fact that George Soros is willing to contribute \$10 million suggests that at least some donors would still be willing to contribute large amounts even when faced with a tax. Thus, we can reasonably conclude that many donors receive great surplus from making political donations. Although Soros is an outlier, he is an outlier who proves the overall point. If Soros represents the upper bound of donor surplus, and the lower bound of donor surplus approaches zero, there should be a wide range in the amount of surplus donors derive from contributing. In any case, we can safely conclude that the level of expected externalities does not jump dramatically at the level of the contribution ceiling. If a typical contribution of \$2000 produces only minimal harm, a typical contribution of \$2001 should produce only minimal harm as well.

Consequently, there should be a wide band of donation sizes where donor surplus sometimes, but not always, exceeds expected externalities. Within this band, contribution taxes generate more surplus than contribution ceilings. Both policies overregulate some donors and

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52. In the 2002 congressional campaigns, only 0.22% of the U.S. voting-age population contributed more than \$200—the minimum threshold for disclosure regulations. ADAM LIOZ, U.S. PIRG EDUC. FUND, THE ROLE OF MONEY IN THE 2002 CONGRESSIONAL ELECTIONS 4 (2003).

53. Donor surplus probably follows a normal distribution, more or less. Since the bulk of potential donors do not contribute, average surplus is below zero and all donors who actually contribute fall within the same tail of the distribution. Consequently, more donors will enjoy zero surplus than any larger amount.

54. Ted Bunker, *Reform Only Diverts Soft Campaign Cash*, BOSTON HERALD, Sept. 1, 2003, at 21.

underregulate others, but contribution taxes bring donors much closer to contributing at their surplus-maximizing levels.

### B. *Expanding the Model To Incorporate Diverted Funds*

Up to now, I have modeled the decision to donate as a binary choice. Donors could choose either to contribute money to a candidate or to spend their money on unrelated goods or services. Yet in the real world, donors also have the option of diverting their money into independent expenditures or other methods of indirectly aiding their chosen candidates.

The American system of campaign finance regulation does not limit all of the ways money can be spent to aid a political campaign.<sup>55</sup> The Supreme Court has repeatedly protected an individual's right to make independent expenditures even when those expenditures are intended to "advocate the election or defeat of a clearly identified candidate for federal office."<sup>56</sup> Under the Court's current jurisprudence, Congress is constitutionally prohibited from limiting the amount an individual can divert into independent expenditures.<sup>57</sup> The Court has also protected the rights of certain nonprofit organizations to gather individual donations and spend them on behalf of a candidate.<sup>58</sup> I argue in Section II.B that contribution taxes are constitutional when levied on direct contributions, but the Court would likely strike down contribution taxes placed on independent expenditures or other forms of diverted funds.<sup>59</sup> Hence, anyone willing to make independent expenditures or contribute to an appropriate nonprofit organization can spend unlimited sums to aid a political campaign.

Without exploring all of the ways a donor might divert her funds to aid a favored candidate, I can still factor the possibility of diversion into the model. For the purposes of the model, it suffices that donors always have the option of diverting their funds into independent expenditures. To begin exploring the effects of this option, it is instructive to compare the harms

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55. While the precise scope of individuals' abilities to spend money on behalf of a candidate is somewhat in doubt after the Court's decision last year in *McConnell v. Federal Election Commission*, 124 S. Ct. 619 (2003), at a minimum, some opportunities for diversion will remain beyond the reach of permissible regulation.

56. *Buckley v. Valeo*, 424 U.S. 1, 44 (1976) (per curiam); *see also Colo. Republican Fed. Campaign Comm. v. Fed. Election Comm'n*, 518 U.S. 604, 608 (1996) (extending the right to make independent expenditures to political parties).

57. *Buckley*, 424 U.S. at 44.

58. *Fed. Election Comm'n v. Mass. Citizens for Life, Inc.*, 479 U.S. 238 (1986). There is some doubt as to the continued viability of this holding in the wake of *McConnell*.

59. Congress can only tax First Amendment speech as part of a broad-based tax scheme or to promote a compelling state interest. *See infra* Section II.B. Considering that the Court has already ruled that Congress cannot place contribution ceilings on independent expenditures, it seems unlikely that Congress would be able to use contribution taxes instead. *See Mass. Citizens for Life*, 479 U.S. at 265 ("[W]e must be as vigilant against the modest diminution of speech as we are against its sweeping restriction.").

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caused by diverted funds with the harms caused by direct contributions in a world without transaction costs.

1. *Examining the Implications of Diverted Funds in a World Without Transaction Costs*

Imagine for a moment that diverted funds could aid a political campaign just as effectively as direct contributions. Further imagine that donors would derive the same value from diverting their funds as they would from contributing directly. In this hypothetical world, there would not be any transaction costs involved in diverting funds. Political candidates would be indifferent between receiving direct contributions and having funds diverted on their behalf. As a result, diverted funds would create all of the same harms as direct contributions.

Furthermore, diverted funds would also create at least three additional harms: First, diverted funds reduce transparency. When donors contribute directly to candidates, voters can track the sources of the candidate's funds. In contrast, it can be very difficult to track diverted funds. Although disclosure does not alleviate all of the harms caused by large contributions, it can hold politicians accountable for particularly egregious fundraising practices. For example, during the 1996 election, President Clinton suffered in the polls after the Dole campaign attacked his fundraising scandals.<sup>60</sup> Disclosure can also inform voters about a candidate by associating the candidate with well-known causes or interest groups.<sup>61</sup> Additionally, disclosure can make it harder for candidates to pander to special interests by helping voters to recognize this activity as pandering.<sup>62</sup> As the old saying goes, sunshine is the best disinfectant. Most scholars of campaign finance agree that disclosure has salutary effects.<sup>63</sup>

Second, diverted funds increase the appearance of corruption—or, as Kathleen Sullivan describes the problem, diverted funds increase the “symbolic costs from subterfuge.”<sup>64</sup> In her words, “Public perception of a campaign finance system gone out of control rests at least in part on the view that politicians, parties, and donors skirt existing laws by exploiting evasive ‘loopholes.’ To the extent that all functional contributions are made as explicit contributions,” the public might regain confidence in our

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60. Sullivan, *supra* note 18, at 689-90.

61. See ELIZABETH GARRETT & DANIEL A. SMITH, VEILED ACTORS: THE REAL THREAT TO CAMPAIGN DISCLOSURE STATUTES (Univ. of S. Cal. Law Sch., Pub. Policy Research Paper No. 03-13, 2003), [http://lawweb.usc.edu/cleo/working-papers/olin/documents/03\\_13\\_paper.pdf](http://lawweb.usc.edu/cleo/working-papers/olin/documents/03_13_paper.pdf).

62. Sullivan, *supra* note 18, at 689.

63. See GARRETT & SMITH, *supra* note 61, at 1 (stating that “disclosure elicits fairly widespread support”).

64. Sullivan, *supra* note 18, at 689.

political system.<sup>65</sup> Many scholars worry that voters are becoming increasingly alienated from politics and from government.<sup>66</sup> Increasingly, voters seem to feel that all politicians are corrupt.<sup>67</sup> Rampant cynicism and disengagement are the predictable results.<sup>68</sup> Diverted funds are only one cause of this problem, but they are a cause capable of being addressed.

Third, diverted funds lead to more polarizing attack ads and negative politics. According to Samuel Issacharoff and Pamela S. Karlan, “[G]roups that engage in independent advocacy have strong incentives to stress one issue around which to mobilize supporters and contributors as opposed to the range of programmatic positions that candidates must take.”<sup>69</sup> Single-issue ads of this sort can polarize the political debate by focusing attention on the issues that are least susceptible to compromise.<sup>70</sup> Whereas candidates are often reluctant to issue attack ads for fear of voter retaliation, most groups funding independent expenditures will not be deterred by the fear of voter retaliation. Consequently, reducing the prevalence of diverted funds might go a long way toward improving the tenor of political campaigns.

In a world without transaction costs, diverted funds would cause all of the same harms as direct contributions, in addition to reducing transparency, increasing the appearance of corruption, and inducing more attack ads and negative politics. Since donors would be indifferent between making direct contributions and diverting their funds, both contribution ceilings and contribution taxes would have wholly negative effects. Any donor wishing to contribute above the amount of a ceiling would simply divert her funds instead. And any donor confronted with a contribution tax would divert her funds in order to avoid paying the tax. As these diverted funds would create all of the same harms as direct contributions, plus additional negative effects, society would be better off without any form of campaign finance regulation.

## 2. Exploring the Implications of Transaction Costs

Fortunately, in the real world transaction costs decrease the effectiveness of diverted funds. Transaction costs refer to all of the reasons donors might prefer to make direct contributions instead of diverting their funds. For example, if a donor feels that diverting her funds is unethical,

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65. *Id.*

66. See, e.g., Peter M. Shane, *Back to the Future of the American State: Overruling Buckley v. Valeo and Other Madisonian Steps*, 57 U. PITTS. L. REV. 443, 443 (1996).

67. Fred Wertheimer & Susan Weiss Manes, *Campaign Finance Reform: A Key to Restoring the Health of Our Democracy*, 94 COLUM. L. REV. 1126, 1127-31 (1994).

68. *Id.*

69. Issacharoff & Karlan, *supra* note 18, at 1714-15.

70. See MICHAEL J. MALBIN & THOMAS L. GAIS, THE DAY AFTER REFORM: SOBERING CAMPAIGN FINANCE LESSONS FROM THE AMERICAN STATES 100 (1998).

she will likely face high transaction costs as a result. Similarly, donors face transaction costs to the extent that they need to spend time and resources investigating methods of diverting their funds.

Arguably, the most important components of transaction costs come from regulations intended to decrease the effectiveness of diverted funds. For instance, campaign finance regulations prohibit coordinated expenditures. Hence, independent expenditures cannot be “controlled by or coordinated with [a] candidate.”<sup>71</sup> Without coordination, independent expenditures will usually be less effective than direct contributions. Whereas candidates choose how to spend the money from direct contributions, independent expenditures will typically not be spent in the fashion that a candidate would find most useful. According to the Supreme Court, “[I]ndependent expenditures may well provide little assistance to the candidate’s campaign and indeed may prove counterproductive.”<sup>72</sup> And as Issacharoff and Karlan explain, “Independent expenditures risk alienating both the supported candidate whose campaign control was compromised and the unsupported candidate, who was visibly not supported . . .”<sup>73</sup>

Independent expenditures are less effective than direct contributions, but they usually provide some benefit to a candidate. Groups would not engage in independent expenditures if they were not at least somewhat helpful. Evidence from the states’ experiences with contribution ceilings suggests that independent expenditures rise in response to the regulation of direct contributions.<sup>74</sup> Independent expenditures may produce less “bang for their buck,” but if enough bucks are diverted into independent expenditures they can still produce a sizeable bang. In the words of Daniel Lowenstein, although “independent spending is not *always* helpful . . . [o]rdinarily, independent spending will be helpful, at least to some degree.”<sup>75</sup>

Consequently, transaction costs reduce the effectiveness of diverted funds. Most donors derive greater value from direct contributions, but still derive some value from diverting their funds. Transaction costs measure the difference between the value a donor derives from contributing directly and the value the donor would have received from diverting her funds. When blocked from contributing directly, donors will divert their funds if and only if the surplus they would have received from contributing directly exceeds their transaction costs. Furthermore, under a contribution tax

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71. *Buckley v. Valeo*, 424 U.S. 1, 46 (1976) (per curiam). Sections 202 and 212 of the Bipartisan Campaign Reform Act contain a definition of coordination. See Bipartisan Campaign Reform Act of 2002 §§ 202, 212, 2 U.S.C.A. §§ 434, 441a(a)(7) (West 2003). For the pre-BCRA definition, see General Public Political Communications Coordinated with Candidates and Party Committees, 11 C.F.R. §§ 100.16, 100.23, 109.1, 110.14 (2002).

72. *Buckley*, 424 U.S. at 47.

73. Issacharoff & Karlan, *supra* note 18, at 1714.

74. *Id.*

75. Lowenstein, *supra* note 23, at 360.

system, donors will only engage in diversion if the transaction costs of doing so are less than the taxes they will pay for direct contribution.

### 3. *Holding Transaction Costs and Externalities Constant Across Donors*

To model whether a restriction on direct contributions would cause donors to divert their funds, we can start by picturing a world where all donors face the same transaction costs and the same externalities. In this hypothetical world, the transaction costs would create a pseudo-tax on the value a donor would receive from diverting her funds. By definition, the benefit a donor receives from making a direct contribution exceeds the benefit she would receive from diverting her funds by the amount of the transaction costs. Hence, if direct contributions were left unregulated, donors would never divert their funds.

Likewise, an ideal regulatory system must not cause any donors to divert their funds. Under the old model in Section A, an ideal regulatory system would have led all donors to contribute at their surplus-maximizing levels. Without the possibility of diversion, surplus-maximizing contribution sizes were also socially optimal. However, as the term is used in this Note, total surplus does not include any of the benefits associated with inducing donors to contribute directly rather than diverting their funds.<sup>76</sup> Diverted funds create all of the same externalities as direct contributions in addition to further harms. Hence, a regulatory system that leads all donors to contribute at their surplus-maximizing levels cannot be socially optimal if it causes donors to divert their funds.

Under the old model, a donor's socially optimal contribution size was the point at which marginal donor surplus equaled marginal externalities—the surplus-maximizing level. Yet under the expanded model, a donor's surplus-maximizing amount is not socially optimal if preventing the donor from contributing more than that amount would cause her to divert her funds. Consequently a donor's socially optimal contribution size cannot be larger than her minimum nondiversion point—the smallest point where her contribution can be capped without leading her to divert her funds. As such, a donor's socially optimal contribution size is equal to either her surplus-maximizing point or her minimum nondiversion point, whichever is larger. Restating this relationship in terms of donor surplus, the socially optimal

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76. Some readers may be uncomfortable with defining surplus in this fashion. Essentially, this definition limits the concept of externalities to not include any of the harms that would have been generated had a contribution been diverted instead of sent directly to a candidate. The analytical result is the same if one instead defines surplus and externalities more broadly to include the effects of diversion, but I use these more limited definitions because they provide a more helpful organizational structure to the argument.

contribution size becomes the larger of either the point where marginal donor surplus equals marginal externalities (the surplus-maximizing point) or the point where marginal donor surplus equals marginal transaction costs (the minimum nondiversions point).

When all donors are the same with respect to both transaction costs and externalities, contribution taxes can lead all donors to contribute at their socially optimal levels. An optimal contribution tax schedule would either set the tax rates equal to marginal externalities or to an amount just below the marginal transaction costs, whichever is smaller. Since contribution taxes reduce donors' contributions to the level where marginal donor surplus equals the marginal tax rate, donors will contribute at the larger of either their surplus-maximizing point or their minimum nondiversions point. Hence, under the terms of the hypothetical, an optimal contribution tax schedule would lead all donors to contribute socially optimal amounts.

In contrast, even an optimal contribution ceiling would cause some donors to divert their funds. If we continued to set our contribution ceilings equal to the surplus-maximizing contribution size of the average donor, all donors whose private surplus exceeds transaction costs at the level of the ceiling would divert their funds. Consequently, contribution ceilings cause some donors to divert their funds while allowing other donors to contribute above their surplus-maximizing amounts.<sup>77</sup> An optimal contribution ceiling must be set to minimize the combined harm from these two types of regulatory errors. Since diverted funds cause greater externalities than the same amount of direct contributions, an optimal contribution ceiling would need to be set above the surplus-maximizing contribution size of the average donor—the level of the ceiling under the old model. By definition, a ceiling set at the surplus-maximizing contribution size minimizes the combined errors of overregulation and underregulation with respect to total surplus. Hence, raising the ceiling above this level destroys more surplus by introducing errors of underregulation than it creates by eliminating errors of overregulation. As compared to contribution taxes, contribution ceilings produce even less total surplus under the new model than under the old model. Whereas contribution taxes lead all donors to contribute socially optimal amounts, contribution ceilings cause some donors to divert their funds while allowing others to contribute above their socially optimal levels.

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77. This conclusion assumes that the level of marginal transaction costs does not exceed the level of marginal private surplus for all donors. However, in a world where donors vary greatly in their motives for donating and where many but not all donors divert their funds, this assumption seems reasonable.

#### 4. *Allowing Transaction Costs and Externalities To Vary Across Donors*

Within a world where all donors face the same externalities and the same transaction costs, contribution taxes would lead all donors to contribute socially optimal amounts. However, in the real world, donors will typically differ with respect to both transaction costs and (as discussed previously) externalities.<sup>78</sup> As we have already seen, if externalities vary, optimal tax rates can no longer be set equal to actual externalities, but instead must be set equal to expected externalities. Tax rates set at these levels minimize the combined harm from errors of overregulation and of underregulation.

Similarly, if transaction costs vary, optimal tax rates can no longer be set just below the level of actual transaction costs. We could instead set the tax rates just below the expected level of transaction costs, but this would cause some donors to divert their funds. As such, optimal contribution tax rates must be set to balance the additional harm caused by leading donors to divert their funds against the harm caused by allowing donors to contribute above their socially optimal levels. For simplicity, however, let us assume that optimal tax rates are set at the minimum of expected externalities and expected transaction costs. Whether these tax rates are actually optimal depends on the total harm caused by donors diverting their funds as compared to the total harm caused by donors contributing above their socially optimal levels; as long as the magnitude of these two harms is roughly proportional, tax rates set at the minimum of expected externalities and expected transaction costs should be close to optimal.

Tax rates set at this level cannot completely prevent donors from diverting their funds, nor can they lead all donors to contribute socially optimal amounts. Still, for any given size of contributions, setting tax rates at these levels is preferable to either completely banning all contributions of the given size or leaving all contributions of the given size unregulated. Completely banning the donations would create more harm by leading donors to divert their funds than it would reduce by preventing donors from contributing above their socially optimal levels. Similarly, leaving all donations unregulated would create more harm from allowing donors to contribute above their socially optimal levels than it would reduce by no longer leading donors to divert their funds. As such, when compared to

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78. Wealthy donors may generate more externalities in the form of inequality, and donors contributing in exchange for corrupt quid pro quo deals may generate more externalities in the form of corruption. See *infra* Section II.A. Donors are also likely to differ with respect to transaction costs. For instance, donors may be more or less concerned about the ethics of diverting their funds through regulatory loopholes. Donors could also face different costs in determining how to divert their contributions in the most effective manner.

contribution ceilings, contribution taxes generate more total surplus and less overall diversion. These advantages add to the superiority of contribution taxes under the old model. Given the additional difficulties of—and potential externalities arising from—diversion, contribution taxes produce even more additional surplus over contribution ceilings under the new model than under the old model, by virtue of being able to generate less overall diversion.

##### *5. Comparing Policy Options with Respect to the Largest and Smallest Donations*

Under the old model, where donors could not divert their funds, an optimal policy of contribution taxes included a zero-percent tax bracket for the smallest donations and tax rates effectively reaching 100% for the largest donations. Factoring in the possibility of diversion does not change this result with respect to the smallest donations. An optimal policy of contribution taxes would still include a zero-percent tax rate for any donations with net positive expected externalities. Since optimal tax rates are set at the minimum of expected externalities and expected transaction costs, when expected externalities are below zero, the magnitude of expected transaction costs is irrelevant. In contrast, factoring in the possibility of diversion should greatly reduce the subset of the largest donations where tax rates effectively become 100%.

An optimal policy of contribution taxes sets the tax rates at the minimum of expected externalities and expected transaction costs. Tax rates set according to this rule minimize the combined harm from needlessly eliminating surplus and from diverting funds. We could ignore expected transaction costs when regulating the smallest donations, where expected externalities approach zero. But the expected externalities generated by the largest donations can be very high. Campaign donations are generally thought to generate increasing marginal externalities. A \$10,000 donation is generally thought to produce far more harm than one thousand \$10 donations. In contrast, marginal transaction costs probably decline as donations grow in size. The transaction costs involved in diverting one thousand \$10 donations are probably much higher than the transaction costs involved in diverting a single \$10,000 donation. Some elements of transaction costs are likely to be fixed with respect to donation size. The costs involved in researching how to divert funds or in hiring a lawyer to advise the transaction may be the same for a \$10 diversion as for a \$10,000 diversion. Therefore, expected transaction costs are far more likely to be lower than expected externalities for large donations. Since optimal tax rates are set at the minimum of expected externalities or expected transaction costs, factoring in the possibility of diversion causes us to

reduce the tax rates we impose on the largest contributions. Keeping the tax rates at the old surplus-maximizing levels would cause many of the largest donors to divert their funds.

## II. RELAXING THE ASSUMPTIONS OF THE MODEL

Under the assumptions of the model presented above, contribution taxes produce two powerful advantages over contribution ceilings—more total surplus and less overall diversion. These advantages make out a *prima facie* case for replacing contribution ceilings with contribution taxes. Nevertheless, it remains to be seen whether these advantages hold once I relax the assumptions of the model. This Part relaxes these assumptions one by one in order to analyze whether the case for contribution taxes survives in the real world. Along the way, I attempt to anticipate and respond to some of the objections likely to be raised against contribution taxes. Still, as this Note is the first proposal for using corrective taxes in campaign finance, I can only speculate about what critiques might be levied against contribution taxes.

Would contribution taxes exacerbate the problems of corruption or inequality? Are contribution taxes constitutional? Can we actually quantify the harms caused by donations? In Part I, my assumptions answered these questions by default. In Part II, I begin the process of examining these questions. As a result, where Part I relied on fairly rigorous economic analysis, Part II necessarily engages in more speculative discussions.

### A. *Relaxing the Assumption of No Correlation*

The Assumption of No Correlation dictates the following: Neither the externalities generated by a contribution, nor the transaction costs associated with diverting a contribution, are directly correlated with donor willingness to pay contribution taxes.

Contribution taxes allow individuals with greater private surplus to make larger contributions; Part I assumed that these individuals do not also create larger externalities. If private surplus and externalities were strongly correlated, however, contribution taxes might not result in more social surplus: Donors with greater private surplus would derive more surplus from contributing, but they would also generate more externalities.

Similarly, Part I showed that donors with higher private surplus are more likely to divert their funds, because donors only divert their funds when private surplus exceeds transaction costs.<sup>79</sup> But if private surplus and transaction costs were strongly correlated, contribution taxes might result in

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79. See *supra* Subsection I.B.2.

less diversion. These donors' greater private surplus would make them more likely to divert their contributions, but their higher transaction costs would have the opposite effect.<sup>80</sup>

Hence, relaxing the Assumption of No Correlation could greatly weaken the case for contribution taxes. I suspect most readers will agree that donor surplus is probably uncorrelated with transaction costs.<sup>81</sup> But I anticipate many readers will worry about the connection between donor surplus and the externalities of corruption and inequality—the two harms generally cited as the reasons we regulate campaign finance.<sup>82</sup>

As long as transaction costs and donor surplus are not strongly correlated, contribution taxes still produce more total surplus and less overall diversion than contribution ceilings.<sup>83</sup> The analysis in Section I.B does not depend on the relationship between externalities and donor surplus. A correlation between these factors would not change the conclusion that contribution taxes strike a better balance between leading donors to contribute surplus-maximizing amounts and minimizing the problem of diverted funds.

However, a strong correlation between donor surplus and externalities might undermine the conclusions from Section I.A. Part I assumed that the donors who would contribute more generate the same level of externalities as the donors who would contribute less. Yet if externalities and private surplus were positively correlated, the donors who generate below-average externalities would reduce the size of their contributions in response to contribution taxes by more than the donors who generate above-average externalities. Thus, the act of taxing donations would raise the expected level of externalities generated by large donations, and lower the expected level of externalities generated by small donations.

Still, we might set tax rates equal to the expected externalities generated at the level donors would actually contribute when faced with the tax. Raising the tax rates imposed on large donations might increase their expected level of externalities, but it would also increase the level of the tax, thereby incorporating such an increase in externalities into the internalized incentives of high-level donors. Likewise, reducing the tax rates imposed on small donations might decrease their expected level of externalities, but it would also decrease the level of the tax in tandem with these reductions of externalities. Depending on the strength of the

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80. Again, this assumes the correlation is positive. A negative correlation would have the reverse effect.

81. See *infra* Subsection II.A.3.

82. See David A. Strauss, *Corruption, Equality, and Campaign Finance Reform*, 94 COLUM. L. REV. 1369 (1994); Thomas S. Ulen, *Money and Politics*, 2003 ILL. L. REV. 1037 (reviewing ACKERMAN & AYRES, *supra* note 1).

83. This result also assumes that the problem of diverted funds remains a significant source of concern.

correlation as compared to the relative magnitudes of externalities and private surplus, there might be an equilibrium solution where tax rates can be set equal to the expected externalities generated at the level donors would contribute when faced with the tax.<sup>84</sup>

This Note is not the place for an attempt to measure the actual magnitude of these factors.<sup>85</sup> Nevertheless, I doubt that donor surplus is sufficiently correlated with either corruption or inequality to prevent tax rates from being set equal to the expected externalities generated at the level donors would actually contribute when faced with the taxes. Even if this belief is mistaken, we can safely conclude that donor surplus is not strongly correlated with transaction costs. Hence, contribution taxes remain superior to contribution ceilings as long as diversion remains a significant challenge to regulating campaign finance.<sup>86</sup>

### 1. *The Harm of Corruption*

Most commentators agree that preventing corruption is an important goal of campaign finance regulation.<sup>87</sup> The Supreme Court has even held that the aims of preventing corruption and the appearance of corruption are the only constitutionally valid justifications for restricting campaign donations.<sup>88</sup> Nevertheless, "corruption is a notoriously elusive concept."<sup>89</sup>

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84. Readers versed in economics literature will recognize that the task of setting the tax rates becomes a form of the adverse selection problem. Restating the question, we need to determine whether increasing the tax rates to equal expected externalities would raise the level of expected externalities by more than the tax. This vicious cycle might continue until the optimal tax rates become zero percent for small donations and 100% (or an amount large enough to prevent all donors from contributing) for large donations, thus turning our optimal contribution tax into a contribution ceiling. However, this cycle will be limited by the potential for donors to divert their funds.

85. For a mathematically rigorous look at the effects of similar correlation on the choice of pollution control instruments, see Robert N. Stavins, *Correlated Uncertainty and Policy Instrument Choice*, 30 J. ENVTL. ECON. & MGMT. 218 (1996). However, Stavins assumes that corrective taxes must be linear and his conclusions do not apply when the tax rates can be graduated. See Kaplow & Shavell, *supra* note 3, at 9 n.6. I am not aware of any models for measuring the effects of correlation when tax rates can be graduated. Developing a model of this sort is well beyond the scope of this Note, and probably beyond my mathematical ability as well. In any case, a precise model for measuring the effects of correlation would be of only questionable value when applied to nebulous concepts like corruption and inequality.

86. Even without the vigorous First Amendment rights enforced in American law, diversion would likely remain a serious concern. For instance, if blocked from making political advertisements, donors could purchase their own media outlets to spread a message favorable to candidates, pay for direct-mail campaigns or get-out-the-vote efforts, or otherwise use their money to influence the political process. See Sullivan, *supra* note 18, at 687-88.

87. See Strauss, *supra* note 82, at 1369-70 (recognizing this general consensus, but arguing that concerns about corruption derive from inequality and the nature of the democratic process).

88. Fed. Election Comm'n v. Nat'l Conservative Political Action Comm., 470 U.S. 480, 496-97 (1985).

89. Lillian R. BeVier, *What Ails Us?*, 112 YALE L.J. 1135, 1170 (2003) (reviewing ACKERMAN & AYRES, *supra* note 1).

There is substantial disagreement about what it means for a donation to foster corruption.<sup>90</sup> This Note is not the place to delve into that debate. Still, some readers may worry that contribution taxes would exacerbate the problem of corruption.

Both contribution ceilings and contribution taxes target corruption by using a donation's size as a proxy for its tendency to foster corruption. Contribution ceilings ban all donations larger than the ceiling, and contribution taxes impose higher tax rates on large contributions. To the extent that corruption is correlated with contribution size, contribution taxes can prevent corruption more effectively than can contribution ceilings.<sup>91</sup> But the case for contribution taxes would be weaker if, even after controlling for contribution size, the degree to which a donation fosters corruption were positively correlated with donor surplus. Nevertheless, I am not aware of any studies suggesting such a correlation, and there are good reasons for doubting that such a correlation exists.<sup>92</sup>

Certainly, donors who contribute in exchange for large corrupt awards might be more willing to pay taxes than donors who contribute in exchange for only moderately sized gains. But donors who contribute out of relatively benign motives should also be more willing to pay taxes when they care deeply about the reasons they contribute. The amount a donor is willing to pay in contribution taxes equals the donor's private surplus, regardless of whether the donor is pursuing corrupt or benign ends.

Donors can derive substantial surplus from contributions made for legitimate purposes. For instance, Eugene McCarthy's insurgent campaign against the Vietnam War was initially financed by a few extremely large donations.<sup>93</sup> Although it can be difficult to separate corrupt contributions

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90. On one side of the spectrum, some scholars and early Supreme Court cases present a relatively narrow view of corruption, including only explicit quid pro quo exchanges. *See, e.g.*, Buckley v. Valeo, 424 U.S. 1 (1976) (per curiam); Lillian R. Bevier, *Money and Politics: A Perspective on the First Amendment and Campaign Finance Reform*, 73 CAL. L. REV. 1045 (1985). On the other side of the spectrum, many scholars and recent Court cases advocate a broader view of corruption, potentially including any donations that distort the political process or make politicians overly compliant with the interests of large donors. *See, e.g.*, Nixon v. Shrink Mo. Gov't PAC, 528 U.S. 377, 389 (2000); Austin v. Mich. State Chamber of Commerce, 494 U.S. 652, 659-60 (1990); Lowenstein, *supra* note 23, at 323.

91. Contribution ceilings generate more errors of overregulation and of underregulation. *See supra* Section I.A.

92. Since this Note is the first proposal for contribution taxes, scholars have not previously had reason to study how donors might respond to a system of contribution taxes. There are studies examining the characteristics of donors who contribute at given levels under regimes of contribution ceilings and under unregulated environments. *See, e.g.*, JOHN GREEN ET AL., CTR. FOR RESPONSIVE POLITICS, INDIVIDUAL CONGRESSIONAL CAMPAIGN CONTRIBUTORS: WEALTHY, CONSERVATIVE AND REFORM-MINDED (1998), *at* <http://www.opensecrets.org/pubs/donors/donors.htm>. But these studies do not shed light on the question at hand. Studies of this sort might help with the task of setting contribution tax rates, but they would not aid in determining whether donor willingness to pay taxes is still correlated with the tendency to produce corruption after controlling for contribution size.

93. Smith, *supra* note 17, at 1073.

from benign ones on a conceptual level, antiwar donations to a long shot like Eugene McCarthy should fit comfortably on the benign side of the spectrum. Similarly, in the current election cycle, as of November 2003, George Soros and Peter Lewis had each pledged about \$10 million to fund independent expenditures against President Bush.<sup>94</sup> Considering that Bush's opponent had yet to be named, these donors were probably motivated more by ideology than by a desire for influence.<sup>95</sup> We can only guess how these donors would respond to contribution taxes, but at least some relatively benign donors should be willing to increase the amount they contribute when faced with taxes.

More generally, donors frequently express passionate commitment to ideological causes.<sup>96</sup> Replacing contribution ceilings with contribution taxes might make it easier for donors to gain influence through large contributions, but it would also make it easier for ideological crusaders to assist candidates who support their crusades. We lack the information necessary for determining which of these groups would be more willing to pay taxes. Recent empirical studies suggest most donors treat political contributions more like charitable donations than like business investments.<sup>97</sup> These results hold equally true both for large donors such as top corporate executives and for small donors.<sup>98</sup> Ultimately, we can only speculate about the connection between corruption and donor willingness to pay taxes. But the current state of empirical research does not support the proposition that these factors are strongly correlated.

Moreover, even if these factors were strongly correlated, contribution taxes might still reduce corruption more effectively than contribution ceilings. For example, imagine that all relatively benign donors greatly decrease the amount they contribute in the face of taxes, leaving only extremely corrupt donors to contribute large amounts. For simplicity, imagine all corrupt donors seek exemptions from antipollution laws. Even if the pollution were to harm society in the amount of \$10,000 per donor, not all donors would receive the same private benefit from being able to

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94. Glen Justice, *A Hard Road for Democrats in a Day of No 'Soft Money,'* N.Y. TIMES, Nov. 20, 2003, at A27.

95. One could characterize nearly any contribution as a pursuit of influence. Still, at a minimum, these contributions were probably not exchanged for quid pro quo promises.

96. GREEN ET AL., *supra* note 92 (claiming that "ideologues," or donors especially motivated by ideology, "are among the most active contributors").

97. *See id.* (indicating that only 29% of donors contribute to pursue "instrumental goals"); Stephen Ansolabehere et al., *Why Is There So Little Money in U.S. Politics?*, J. ECON. PERSP., Winter 2003, at 105.

98. Ansolabehere et al., *supra* note 97, at 117-19 (showing that top corporate executives give "about 0.05 percent of their annual compensation to political campaigns" and arguing that this level of giving indicates that donors are motivated by consumption motives rather than by motives more akin to business investments).

pollute.<sup>99</sup> If we set the tax rates equal to the \$10,000 harm, only the donors whose profits from polluting exceeded the costs would gain the right to pollute. As these donors would compensate society for the harm they cause through their taxes, everyone would benefit from allowing these donors to contribute.<sup>100</sup> Even when all relatively benign donors have low willingness to pay taxes, contribution taxes can still be more effective at reducing corruption than contribution ceilings. Contribution taxes are more effective as long as tax rates can be set equal to the expected externalities generated at the levels donors would actually contribute when faced with the tax.<sup>101</sup>

The above example might come out differently if we assumed a perfect correlation between donor willingness to pay taxes and the harm from corruption. If the donors who profited the most from polluting also generated the most harm, it might become impossible to set tax rates equal to the expected externalities generated at the levels donors would actually contribute. However, considering the variety of forms corruption can take, it seems unlikely that corruption and private benefit would be so strongly correlated as to make it impossible to set tax rates equal to expected externalities for every possible donation size. There is room for a great deal more empirical work on the connection between corruption and donor willingness to pay taxes. But even ignoring the effects of diverted funds, we have reason for optimism that contribution taxes can more effectively regulate corruption than contribution ceilings.

## 2. *The Harm of Inequality*

After corruption, the desire to limit inequality is the main justification cited for regulating campaign donations.<sup>102</sup> Any regulatory system that

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99. Not all donors interested in polluting will be in the same market with respect to end goods. Hence, end prices and profits are likely to differ.

Of course, donors will often seek to rewrite major areas of legislation rather than secure individual exemptions from the laws. But the principle from the above example still applies. Imagine that three groups of donors—donors seeking to rewrite the Clean Air Act, donors seeking lax securities law enforcement, and donors seeking to repeal worker safety laws—would all cause \$1 million of harm if allowed to donate in pursuit of their legislative ends. Setting the tax rates equal to \$1 million would lead only those groups whose private benefit exceeds net externalities to contribute. Setting the individual tax rates to reflect the harm caused by the group in equilibrium is a more difficult problem than the simple example above, but the principle that private surplus and the harm from corruption are not likely to be perfectly correlated still applies.

100. This result might not hold if corruption or other obstacles prevented us from using the tax revenue to compensate those harmed by the corruption. But the contribution taxes would still be efficient in a Kaldor-Hicks sense.

101. Alternatively, ignoring the effects of diverted funds, contribution taxes would be equivalent to contribution ceilings if these tax rates ended up being either 0% or 100% (or an amount effectively equaling 100%) for all donation sizes.

102. See, e.g., Smith, *supra* note 17, at 1049; Strauss, *supra* note 82, at 1369. Scholars and policy advocates frequently design campaign finance regulations based, at least partially, on a desire to limit inequality. See, e.g., David Adamany, *PAC's and the Democratic Financing of*

permits private donations will generate some measure of inequality.<sup>103</sup> Supreme Court precedent prevents us from setting tax rates based on a donor's wealth.<sup>104</sup> Hence, both contribution ceilings and contribution taxes target inequality by using a donation's size as a proxy for the degree to which it generates inequality.<sup>105</sup>

All else being equal, wealthy donors can afford to pay higher taxes than poor donors. Nevertheless, the relationship between a donor's wealth and the degree to which her contribution fosters inequality is not as clear as it might seem. Numerous scholars have written about the harm of inequality in campaign finance. Those who believe that inequality is a serious problem frequently describe the harm as a violation of the one-person, one-vote principle,<sup>106</sup> or of the notion that "wealthy citizens should not be permitted to have a greater ability to participate in the electoral process simply on account of their greater wealth."<sup>107</sup> These scholars all speak of the inequality generated from "large contributions by wealthy individuals."<sup>108</sup> Yet none of these scholars takes a position on whether inequality is created by the fact that these contributions are large or by the fact that the wealthy are doing the contributing.

To the extent that the harm of inequality arises from the size of a contribution, we can counteract the harm by setting tax rates equal to expected externalities. This result only becomes problematic if the harm of inequality comes from the fact that it is the wealthy who contribute large sums, rather than from the fact that large sums are contributed.<sup>109</sup> Scholars of inequality seldom consider whether donor wealth affects the inequality resulting from a donation, because such a question is irrelevant for their purposes.<sup>110</sup> Yet answering this question is essential to determining whether

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*Politics*, 22 ARIZ. L. REV. 569 (1980); Joel L. Fleishman & Pope McCorkle, *Level-Up Rather than Level-Down: Towards a New Theory of Campaign Finance Reform*, 1 J.L. & POL. 211 (1984); J. Skelly Wright, *Money and the Pollution of Politics: Is the First Amendment an Obstacle to Political Equality?*, 82 COLUM. L. REV. 609 (1982).

103. Wealthy donors can afford to make even small donations more easily than less wealthy donors.

104. The Court has repeatedly held that inequality is not a constitutionally valid target of campaign finance reform. *See, e.g.*, Meyer v. Grant, 486 U.S. 414, 426 n.7 (1988); Citizens Against Rent Control v. City of Berkeley, 454 U.S. 290, 295-96 (1981); First Nat'l Bank v. Bellotti, 435 U.S. 765, 790-91 (1978); Buckley v. Valeo, 424 U.S. 1, 48-49 (1976) (per curiam). Although these cases all deal with ceilings rather than taxes, they would probably prohibit wealth-based taxes as well.

105. If Congress actually followed the Court, contribution ceilings might not target inequality at all. However, at least a few legislators must have thought about inequality when determining the level of contribution ceilings to support.

106. *See, e.g.*, Strauss, *supra* note 82, at 1382.

107. Foley, *supra* note 8, at 1204.

108. Strauss, *supra* note 82, at 1387.

109. By "large sums" I mean any donation large enough to generate inequality. Hence, even "small" donations of \$100 or less might qualify.

110. This question has been ignored largely because it does not affect the degree to which inequality justifies a policy of contribution ceilings or public financing. These policies reduce

contribution ceilings or contribution taxes are more effective at limiting inequality.

At some level, a donor's wealth probably does influence the degree to which her contribution generates inequality. Consider two different contributions of \$1000, the first made by a poor donor who becomes so inspired by a candidate that she decides to contribute her entire life savings to his campaign, the second made by a wealthy businessperson who regularly donates large amounts to political campaigns. I expect many readers would argue that the second contribution creates more problems of inequality than the first.<sup>111</sup> Since rich donors will generally be more willing to pay contribution taxes than poor and middle-class donors, we might be tempted to conclude that contribution taxes exacerbate the problem of inequality.

Yet this conclusion would ignore the fact that poor and middle-class donors do not generally contribute at the levels affected by the choice between contribution taxes and contribution ceilings.<sup>112</sup> If our current regulatory system set contribution ceilings at \$100, it might be argued that moving to a regime of contribution taxes could harm the poor and middle class. But this argument simply does not apply to replacing contribution ceilings set at \$2000 or larger.<sup>113</sup> Poor and middle-class Americans almost never make contributions of that size. Although contribution taxes would also tax donations smaller than \$2000, the poor and middle class would still be largely unaffected by the taxes.<sup>114</sup>

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inequality regardless of whether the inequality is caused by the size of large contributions or by the fact that it is the wealthy who do the contributing. In contrast, replacing contribution ceilings with contribution taxes reduces the average size of large contributions without reducing the overall ability of the wealthy to contribute.

111. I could plausibly argue that inequality is only a function of donation size. For instance, a donation might only produce inequality to the extent that other donors do not make equivalently sized donations of their own. A strict adherence to the principle of one-person, one-vote might lead us to be equally concerned when one donor contributes more than another out of a greater interest in politics and when the donor contributes more due to her greater wealth. According to this logic, a \$1000 donation could generate the same amount of inequality regardless of whether it was made by a millionaire or a poor donor contributing her entire life savings. However, I personally find arguments of this sort unpersuasive, and I anticipate many readers will share my skepticism.

112. A survey of donors in the 1996 congressional elections found that 78% of the donors who contributed \$200 or more had family incomes in excess of \$100,000. Peter Francia et al., *Donor Dissent: Congressional Contributors Rethink Giving*, PUB. PERSP., July-Aug. 2000, at 29, 30.

113. Our current regulatory system caps donations from individuals to candidates at \$2000 and most other forms of donations at much higher levels. See Corrado, *supra* note 14 (manuscript at 46-47); *supra* text accompanying notes 9-14.

114. If the zero-percent tax bracket extended to \$200, for example, less than one-quarter of the donors affected by the contribution tax would likely have family incomes of less than a \$100,000. See Francia et al., *supra* note 112, at 30. Most of these donors would be taxed at low marginal rates. In contrast, 96% of the donors who contribute a total amount of \$8000 or more have family incomes in excess of \$100,000. *Id.* These donors would likely be taxed at much higher levels.

Indeed, replacing contribution ceilings with contribution taxes might enhance the influence of poor and middle-class donors. An optimal policy of contribution taxes would almost certainly include a zero-percent tax bracket for small donations and tax larger donations at increasingly graduated rates.<sup>115</sup> As such, the small and medium-sized donations typically made by the poor and middle class would be left untaxed or only minimally taxed. In contrast, the large donations typically made by the wealthy would be taxed at much higher rates. Replacing contribution ceilings with contribution taxes might enhance the influence of superwealthy donors, who are able to increase the size of their contributions by more than the amount of the tax. Yet this increased influence would come at the expense of the moderately wealthy donors who previously contributed around the level of the contribution ceilings. If the tax rates are set appropriately, poor and middle-class donors should not lose influence as compared to the entire class of wealthy and superwealthy donors.<sup>116</sup>

Consequently, the real question in analyzing whether private surplus is correlated with inequality is whether a \$1000 contribution is more harmful when made by a donor in the top one-percent income bracket as opposed to a donor in the top five-percent income bracket.<sup>117</sup> Controlling for contribution size, are donations by the superwealthy more likely to foster inequality than donations by the merely wealthy? Unfortunately, the existing accounts of inequality do not answer these questions, and a thorough discussion of the relationship between equality and campaign finance is well beyond the scope of this Note.

Still, I suspect that those whose concern is inequality are not thinking about distributional issues between the wealthy and the superwealthy. Intuitively, the concern that donors in the top five-percent income bracket might lose influence to donors in the top one-percent income bracket does not strike me as a sufficient reason for rejecting a reform proposal that would otherwise benefit society as a whole. One reason we might be concerned about redistributing power from the wealthy to the superwealthy is the fear that a small group of donors could gain disproportionate influence over the political process, thereby distorting policy outcomes further away from the preferences of the public at large. However,

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115. See *supra* Subsection I.A.5.

116. Assuming the poor and middle class at least partially benefit from the tax revenue, they should enjoy a net gain from replacing contribution ceilings with contribution taxes. In colloquial terms, contribution taxes “enlarge the total pie” while maintaining the “share of the pie” enjoyed by poor and middle-class donors. Even if we view campaign donations as a zero-sum game, the poor and middle class would still benefit as the superwealthy paid to gain influence at the expense of the merely wealthy.

117. The top five-percent income bracket consists of Americans with family incomes in excess of \$100,000. LIOZ, *supra* note 52, at 17. This seems like a reasonable cutoff point for labeling donors as “wealthy” but not “superwealthy.” My decision to label donors in the top one-percent income bracket as superwealthy is completely arbitrary.

redistributing political influence from the wealthy to the superwealthy would not necessarily distort policy outcomes in this fashion.

A redistribution of this sort might even bring policy outcomes more into line with the preferences of the general population. Empirical studies have demonstrated that, as a class, “large contributors are not representative of the general population; they are more conservative than the public at large on a variety of issues ranging from environmental protection to taxes, health care, and poverty reduction programs.”<sup>118</sup> Whereas the general voting public is more or less evenly split between Democrats and Republicans, donors are far more likely to be Republican,<sup>119</sup> and Republicans enjoy significant fundraising advantages over Democrats.<sup>120</sup> To the extent we can characterize the preferences of superwealthy donors, they do not appear to share the biases of large donors as a whole. According to Bradley Smith, “Historically, candidates with large constituencies among the poor and the working class have obtained their campaign funds from a small base of wealthy donors.”<sup>121</sup> Although some superwealthy donors contribute large sums to Republicans,<sup>122</sup> as a class, the superwealthy appear to contribute more to Democrats.<sup>123</sup> Indeed, to the extent Democrats have been able to maintain fundraising parity, they have been far more dependent on soft money and other methods of evading the caps on direct contributions.<sup>124</sup> We might think of the superwealthy as being relatively idiosyncratic in the causes they support. To the extent this is true, any advantage the superwealthy enjoy as a class on account of their greater ability to contribute could be offset by the tendency of their contributions to work at cross-purposes. As David Strauss writes, “To the extent that the problem of inequality is that Hollywood stars make contributions so that candidates will promote environmental causes, that is not obviously a

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118. *Id.* at 7.

119. GREEN ET AL., *supra* note 92 (showing that only 31% of donors contributing \$200 or more are “liberal Democrats” or “other liberals/Democrats” while 49% are “conservative Republicans” or “other conservatives/Republicans”).

120. Lowenstein, *supra* note 23, at 362.

121. Smith, *supra* note 17, at 1082.

122. For instance, Carl Linder has already contributed \$2.5 million to President Bush. Kelley Beaucar Vlahos, *Billionaires Bundle Funds for Democrats*, FOX NEWS CHANNEL, Nov. 28, 2003, at <http://www.foxnews.com/story/0,2933,104352,00.html>.

123. One Republican fundraiser was quoted as saying “we don’t have any billionaire conservatives like the billionaire liberals.” *Id.* More generally, 50% of donors contributing between \$200 and \$8000 contribute to Republicans, as compared to 31% to Democrats; 64% of those same donors have family incomes of between \$100,000 and \$500,000. In comparison, only 31% of donors contributing more than \$8000 contribute to Republicans, as compared to 50% to Democrats; 52% of these donors have family incomes in excess of \$500,000. Francia et al., *supra* note 112, at 30.

124. Justice, *supra* note 94 (explaining that in the previous election cycle, Democrats received 56% of their contributions from soft money as compared to 39% for Republicans, and that Democrats have turned to other forms of diverted funds in the face of the BCRA’s soft money ban).

problem that needs to be remedied, whether or not the contributions are offset by those of wealthy business executives opposed to environmental regulation.”<sup>125</sup>

I do not intend to argue in favor of redistributing influence from the wealthy to the superwealthy. Nor do I mean to suggest that we should favor contribution taxes out of a desire to help the Democratic Party or other liberal causes. I think it is far from clear how contribution taxes would affect the political parties and related interest groups. In any case, I would hope that partisan motives are not our primary criterion for evaluating campaign finance reform proposals.<sup>126</sup> My only goal in this discussion has been to question the notion that contribution taxes would exacerbate the problem of political inequality. Redistributing influence from the wealthy to the superwealthy is probably not desirable, but it should not overpower the advantages of replacing contribution ceilings with contribution taxes. There is room for a great deal more work on the relationship between donor wealth, contribution size, and inequality. However, based on the information we do have, it does not seem that there should be a strong correlation between the harm of inequality and donor willingness to pay taxes. These factors may be somewhat correlated, but the correlation is probably not strong enough to prevent us from setting tax rates equal to the expected externalities generated at the levels at which donors would actually contribute when faced with the tax. Hence, even ignoring the effects of diverted funds, contribution taxes can probably limit inequality more effectively than contribution ceilings.

### 3. *The Effect of Transaction Costs*

I doubt many readers will object to my claim that donor surplus is uncorrelated—or not strongly correlated—with transaction costs. Compared to corruption and inequality, transaction costs are far less likely to vary across individual donors. The factors influencing transaction costs are largely external to donors.<sup>127</sup> Still, donors probably differ somewhat with respect to transaction costs.

Some donors may find it less costly to acquire the information needed to divert their funds effectively. Wealthy donors may have better access to campaign finance lawyers, and donors who care more about politics may be more aware of opportunities for diverting funds. Yet this relationship would

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125. Strauss, *supra* note 82, at 1388.

126. For a discussion of how partisan and political motives affect the debate over campaign finance reform, see Lowenstein, *supra* note 23.

127. For instance, some of the most important components of transaction costs arise from legal rules against coordination. However, this conclusion does not apply to the costs related to a donor’s access to information about diversion and attitudes about the appropriateness of such diversion.

strengthen the case for contribution taxes. Wealth and interest in politics are positively correlated with donor surplus. To the extent these donors are both more willing to pay taxes and more likely to divert their funds, contribution taxes would be preferred still more over contribution ceilings.

Alternatively, independent expenditures might be more effective at supporting the causes of some donors over others. And donors might differ in whether they care about moral arguments against diverting funds. But if these factors are strongly correlated with donor willingness to pay taxes, I fail to see why. I would welcome empirical studies to investigate these connections, but I feel safe in concluding that donor surplus is not strongly correlated with transaction costs.<sup>128</sup>

Consequently, the case for contribution taxes survives even if donor surplus is perfectly correlated with corruption and inequality. Contribution taxes produce more total surplus and less overall diversion even when the tax rates cannot be set equal to expected externalities. In contrast to tax rates set at either zero or 100% (a contribution ceiling), tax rates set equal to expected transaction costs strike a better balance between maximizing surplus and minimizing the problem of diverted funds.<sup>129</sup> As compared to contribution ceilings, contribution taxes more effectively mitigate externalities like corruption and inequality, while leading fewer donors to divert their funds. A correlation between private surplus and externalities might weaken the case for contribution taxes, but contribution taxes would remain superior to contribution ceilings.

### B. Relaxing the Assumption of Constitutionality

The Assumption of Constitutionality does just what it says: It assumes the constitutionality of contribution taxes as a method of regulating campaign donations.

Campaign finance is a highly unsettled area of the law. It can be extremely difficult to predict how the Court will react to a novel method of regulation. The constitutionality of contribution ceilings was established in *Buckley*,<sup>130</sup> and has been reaffirmed in a series of cases since.<sup>131</sup> But the Court has never reviewed a policy similar to contribution taxes. As such, we can only speculate how the Court would respond to a contribution tax

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128. Or, if these factors are correlated, the correlation would be negative and would thus strengthen the case for contribution taxes.

129. See *supra* Section I.B.

130. *Buckley v. Valeo*, 424 U.S. 1 (1976) (per curiam).

131. See, e.g., *Nixon v. Shrink Mo. Gov't PAC*, 528 U.S. 377, 389 (2000); *Austin v. Mich. State Chamber of Commerce*, 494 U.S. 652, 659-60 (1990). While the Supreme Court's recent decision in *McConnell v. Federal Election Commission*, 124 S. Ct. 619 (2003), has placed some of the precedents cited in this Section in doubt, I do not expect that my conclusions will be affected by this ruling.

regime. Still, based on the logic of its prior cases, it seems unlikely that the Court would hold a system of contribution taxes unconstitutional.

The Court typically grants Congress wide latitude in designing systems of taxation,<sup>132</sup> but campaign contributions are protected First Amendment activities.<sup>133</sup> Congress retains broad discretion to tax First Amendment freedoms as long as the tax is part of a broad-based tax scheme,<sup>134</sup> or is a nominal fee used to defray the cost of administering the First Amendment activity in question.<sup>135</sup> Neither of these principles holds for contribution taxes. Contribution taxes both intentionally discriminate against political donors and generate more revenue than is strictly needed to administer the donation process.<sup>136</sup>

Consequently, contribution taxes will be subjected to a heightened standard of review.<sup>137</sup> “[I]f a tax singles out and burdens freedoms protected by the First Amendment, the tax is unconstitutional ‘unless the State asserts a counterbalancing interest of compelling importance that it cannot achieve without differential taxation.’”<sup>138</sup> This rule originates from the landmark *Minneapolis Star* case, in which the Court struck down a tax on newspaper publishing. According to *Minneapolis Star*, First Amendment activities can be taxed in order to achieve a sufficiently important state interest, but the government’s need to raise revenue, by itself, does not qualify as such an interest.<sup>139</sup> Although raising revenue is an important government interest, the state has other means for raising revenue that do not differentially restrict First Amendment freedoms. Hence, contribution taxes can only be constitutional if they further a sufficiently important government interest other than raising revenue.

This rule of heightened scrutiny might pose a serious problem for contribution taxes, except that contribution ceilings were upheld using the

132. See, e.g., MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 57 (rev. 4th ed. 2002) (“[T]here are few serious procedural or substantive constitutional impediments on congressional power in enacting tax legislation. Exceptions occur only when the tax law interferes with such fundamental rights as the freedoms of speech or religion granted by the First Amendment.”).

133. *Buckley*, 424 U.S. at 14; see also Bevier, *supra* note 90; J. Skelly Wright, *Politics and the Constitution: Is Money Speech?*, 85 YALE L.J. 1001 (1976); Note, *Regulation of Campaign Contributions: Maintaining the Integrity of the Political Process Through an Appearance of Fairness*, 56 S. CAL. L. REV. 669, 677-81 (1983).

134. See Ark. Writers’ Project, Inc. v. Ragland, 481 U.S. 221, 229 (1987) (“[A] genuinely nondiscriminatory tax on the receipts of newspapers would be constitutionally permissible . . . .”); *Minneapolis Star & Tribune Co. v. Minn. Comm’r of Revenue*, 460 U.S. 575, 586 n.9 (1983).

135. See *Cox v. New Hampshire*, 312 U.S. 569, 577 (1941).

136. Although corrective contribution taxes are not intended to be revenue-maximizing, the tax rates will undoubtedly be much higher than they would need to be if our only goal was to collect sufficient revenue to defray administrative costs such as the costs of running the FEC.

137. See *Vt. Soc’y of Ass’n Executives v. Milne*, 779 A.2d 20, 23 (Vt. 2001) (“[I]f plaintiffs are correct that §264a is a special tax burdening First Amendment interests, we apply a heightened standard of review . . . .”).

138. *Id.* at 26 (quoting *Minneapolis Star*, 460 U.S. at 585).

139. *Minneapolis Star*, 460 U.S. at 586.

same rule.<sup>140</sup> According to Lillian BeVier, “The Court has suggested that [limitations on independent expenditures] should receive strict first amendment scrutiny . . . Contribution limitations, however, may evoke less first amendment concern.”<sup>141</sup> In *Buckley*, the Court held that although “contribution and expenditure limitations both implicate fundamental First Amendment interests, . . . expenditure ceilings impose significantly more severe restrictions on protected freedoms of political expression and association than do . . . limitations on financial contributions.”<sup>142</sup> Contribution ceilings are not held to a standard of strict scrutiny because the Court feels that contributions contain only some elements of political communication. Specifically, the *Buckley* Court rejected the notion that the indirect speech of campaign contributions deserves the same protection as the direct speech of independent expenditures.<sup>143</sup> The same rationale applies to contribution taxes. Contribution taxes are only constitutionally suspect to the extent that campaign contributions are protected First Amendment activities. As such, *Buckley*’s holding that limitations on campaign contributions are more permissible than limitations on independent expenditures applies equally to contribution taxes as to contribution ceilings. Both contribution ceilings and contribution taxes are constitutionally valid if and only if “the State demonstrates a sufficiently important interest and employs means closely drawn to avoid unnecessary abridgment” of donors’ First Amendment freedoms.<sup>144</sup> Neither policy is constitutional unless it furthers a compelling state interest, and any interest that justifies one policy should also justify the other.

Both contribution ceilings and contribution taxes are justified by the government’s interest in preventing “corruption and the appearance of corruption.”<sup>145</sup> In the Court’s own words,

To the extent that large contributions are given to secure a political quid pro quo from current and potential office holders, the integrity of our system of representative democracy is undermined. . . .

Of almost equal concern as the danger of actual quid pro quo arrangements is the impact of the appearance of corruption

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140. *Buckley v. Valeo*, 424 U.S. 1, 24-26 (1976) (per curiam).

141. BeVier, *supra* note 90, at 1051.

142. *Buckley*, 424 U.S. at 23.

143. See *id.* at 21 (“While contributions may result in political expression if spent by a candidate or an association to present views to the voters, the transformation of contributions into political debate involves speech by someone other than the contributor.”). For a critique of this view, see BeVier, *supra* note 90, at 1062-65. For an argument in support of this view, see Archibald Cox, *The Supreme Court, 1979 Term—Foreword: Freedom of Expression in the Burger Court*, 94 HARV. L. REV. 1, 62-63 (1980).

144. *Buckley*, 424 U.S. at 25.

145. *Id.*

stemming from public awareness of the opportunities for abuse inherent in a regime of large individual financial contributions. . . .

. . .

We find that, under the rigorous standard of review established by our prior decisions, the weighty interests served by restricting the size of financial contributions to political candidates are sufficient to justify the limited effect upon First Amendment freedoms caused by . . . contribution ceiling[s].<sup>146</sup>

Yet contribution taxes are more effective at preventing corruption than are contribution ceilings. If preventing corruption were our only concern, we would ban all private donations. Instead, we try to balance the goal of preventing corruption against our desire to maintain the benefits of private donations. Contribution taxes can strike this balance more effectively than contribution ceilings.

Moreover, contribution taxes preserve more opportunities for conveying the intensity of a donor's support. A \$10 donation might communicate support for a candidate, but it would not communicate the same intensity of support as a \$10,000 donation.<sup>147</sup> In the words of Judge J. Skelly Wright, "[A] government which hopes to maintain stability must preserve for its citizens some means of demonstrating intensity of feeling."<sup>148</sup> Compared to the gradual limits of contribution taxes, the all-or-nothing formula of contribution ceilings is far more restrictive of a donor's ability to convey the intensity of her support. Under a system of contribution ceilings, donors who contribute at the level of the ceiling cannot increase the size of their donations. Contribution ceilings lead numerous donors to contribute the exact amount of the ceiling.<sup>149</sup> As a result, donors find it more difficult to use the size of their donations to communicate different levels of support. For example, if a donor regularly contributes the maximum amount to candidates, she cannot contribute more to a particularly favored candidate in order to express an extra level of

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146. *Id.* at 26-29.

147. According to *Buckley*, the fact that contribution ceilings prevent a donor from conveying the full intensity of her support is not a ground for holding them unconstitutional. *See id.* at 21. But the ability of a contribution tax to limit corruption without impinging on this intensity remains a real benefit.

148. Wright, *supra* note 133, at 1013-14. Of course, the size of a contribution reflects a donor's wealth in addition to the intensity of her beliefs. But intensity of beliefs is still conveyed through contribution size, and contribution ceilings prevent some donors from communicating the intensity of their convictions by increasing the size of their contributions.

149. *See, e.g.*, REFORM VOTER PROJECT, THE NUMBERS TELL THE STORY: BUSH/CHENEY '04 INC. RELIES HEAVILY ON LARGE DONATIONS 5 (2003), <http://www.campaignmoney.org/factsheets/bushreliesheavily/bushrelies03.pdf> (showing that, in the second quarter of 2004, 82% of the money donated to the Bush/Cheney campaign in increments of \$200 or more came from donations of exactly \$2000).

support. In contrast, the graduated limits of contribution taxes make it easy for donors to differentiate the size of their donations. Under a regime of contribution taxes, individuals would find it easier to convey the intensity of their support.<sup>150</sup>

Consequently, contribution taxes can limit corruption more effectively than contribution ceilings while preserving more opportunities for political expression. Since contribution ceilings are constitutionally justified by the goal of reducing corruption and the appearance of corruption, contribution taxes should be constitutional as well.

Another way of viewing this argument is to examine the effects both policies have on individual donors. Contribution ceilings prevent all donors from making donations larger than the ceiling. Essentially, contribution ceilings place a 100% tax on these extremely large donations. Contribution taxes also limit these large donations, but with tax rates lower than 100%. Hence, contribution taxes place weaker restrictions on large donations than do contribution ceilings. If the Constitution permits us to completely ban these large donations, it should also permit us to tax them at rates below 100%.

Contribution taxes might also limit smaller donations that are not currently restricted by contribution ceilings.<sup>151</sup> However, the Court does not second-guess Congress's judgment as to how restrictive contribution ceilings should be. As the Court ruled in *Buckley*, once it is "satisfied that some limit on contributions is necessary, a court has no scalpel to probe, whether, say, a \$2,000 ceiling might not serve as well as \$1,000." Such distinctions in degree become significant only when they can be said to amount to differences in kind."<sup>152</sup> Based on this logic, Congress could have

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150. Only the wealthy are likely to be affected by contribution ceilings set at their current levels. *See supra* Subsection II.A.2. This fact may reduce the force of my argument, but should not defeat it. The wealthy also deserve the right to express the intensity of their support through differentiated contribution sizes.

151. The zero-percent tax bracket of a contribution tax schedule should probably not extend all the way to \$1000—the level of the cap on donations from individuals to political candidates that the Court found constitutionally acceptable in *Buckley*.

152. *Buckley*, 424 U.S. at 30 (quoting *Buckley v. Valeo*, 519 F.2d 821, 842 (D.C. Cir. 1975)) (citation omitted). Like large donations, small donations can foster corruption or the appearance of corruption. By bundling large numbers of small donations into a single package, donors can obtain the same influence from small donations as from large ones. Many bundlers solicit donations from "employees, suppliers, subcontractors, clients and others" with economic ties to the bundler. Thomas B. Edsall, *Campaign Financing Reshaped: Bush Edge Making Public Funds Moot*, WASH. POST, Aug. 5, 2003, at A1. Donors might find it more costly to corrupt politicians through bundles of small donations. If large donations are subject to high taxes while small ones are immune from taxation, however, donors may decide to bear these costs. Congress might try to make bundling more difficult, but Congress cannot stop groups of donors from informing candidates that their contributions are intended to achieve the same end or from nominating a spokesperson to represent their collective interests.

Small donations can thus generate the same corruption as large ones. It is true that a single \$1000 donation is not likely to corrupt a federal politician. Yet, as with smaller donations, the corrupting power of \$1000 donations arises from the potential for bundling numerous

set contribution ceilings well below the \$1000 level.<sup>153</sup> Consequently, the Court should still uphold contribution taxes that limit donations smaller than \$1000, as long as the limitations are not so severe as to constitute a difference “in kind,” rather than a difference in degree.<sup>154</sup>

Overall then, there is some risk that the Court would hold contribution taxes unconstitutional. Unlike contribution ceilings, the Court has never reviewed a policy similar to contribution taxes. We can only speculate how the Court would respond. Still, the Court’s current jurisprudence suggests that contribution taxes should be constitutionally acceptable.

### C. Relaxing the Assumption of Perfect Implementation

The Assumption of Perfect Implementation amounts to this: Policymakers can and will set tax rates at socially optimal levels.

The first question under this assumption is whether policymakers *can* set tax rates appropriately—do policymakers have the information needed to set tax rates at their socially optimal rates? In order to set tax rates correctly, policymakers need to estimate the level of expected externalities and transaction costs generated by donations of various sizes. This task is particularly difficult because there is wide disagreement about what constitute the harms and benefits of campaign donations.<sup>155</sup> Moreover, the expected magnitude of these factors may change between election cycles and even within an election cycle. Campaign finance is a fluid enterprise and the social consequences of donating to a candidate are likely to change depending on which candidates are running for office, how the candidates use their campaign funds, how many other donors are also making political donations, and numerous other factors. If the tax rates are set incorrectly, we cannot guarantee the superiority of contribution taxes over contribution ceilings.

However, policymakers also need to estimate the expected level of externalities and transaction costs when setting contribution ceilings. In fact, policymakers need more information to set optimal contribution ceilings than they need to set optimal contribution taxes.<sup>156</sup> In addition to

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contributions of this size into a coordinated attempt to gain influence. See Lowenstein, *supra* note 23, at 357. Consequently, the difference between taxing \$1000 donations and \$250 donations is a difference in degree, not a difference in kind.

153. For a discussion of the minimum permissible limits for setting contribution ceilings, see William J. Connolly, Note, *How Low Can You Go? State Campaign Contribution Limits and the First Amendment*, 76 B.U. L. REV. 483 (1996).

154. *Buckley*, 424 U.S. at 30.

155. Consider, for example, the debate about what constitutes corruption. See *supra* note 90.

156. For an analogous argument in reference to pollution taxes, see Cooter, *supra* note 44, at 1550-51 (“To compute the efficient tax, government officials must know the amount of external harm caused by the polluter and nothing more. By contrast, to discover the efficient standard,

information on externalities and transaction costs, setting an optimal contribution ceiling requires information on donor surplus.<sup>157</sup> To the extent that policymakers lack perfect information about donor surplus, they will find it more difficult to set an optimal policy of contribution ceilings than an optimal policy of contribution taxes.

A critic might argue that setting the level of contribution ceilings only requires estimates for donations sized around the level of the ceiling, while setting efficient tax rates requires estimates across the entire range of donation sizes. After all, a contribution ceiling is a single limit while contribution taxes require a comprehensive schedule of tax rates. However, it is hard to imagine policymakers being able to estimate the harms and benefits from a contribution of a specific size without also having some information about the harms generated by larger and smaller donations. Even if policymakers lack good information about donations in a certain size range, this does not justify using contribution ceilings as a default. In effect, contribution ceilings give policymakers a binary choice between setting tax rates at 100% or 0%. The first choice blocks all donations that create net benefits in addition to the donations that generate net harms; the second choice permits all donations generating net harms in addition to those generating net benefits. If we have reason to believe that all donations above a certain size generate net harms or that all donations below a given size generate net benefits, we can supplement our regime of contribution taxes with a 100% or a 0% tax bracket. But in the absence of information, we are no better off setting tax rates at 100% or 0% than we would be splitting the difference. If policymakers have any information, no matter how poor, they are better off estimating an appropriate tax rate than setting the default rate at 100% or 0%. It is not easy to determine an optimal system of contribution taxes, but it is even harder to set levels for an optimal system of contribution ceilings.

The second part of the Assumption of Perfect Implementation asks whether policymakers *will* set tax rates at appropriate levels. Policymakers are motivated by more than just the abstract pursuit of the public good. When evaluating a proposal for campaign finance reform, legislators may be influenced by parochial concerns such as how the proposal will affect their electoral chances or those of their party. Hence, policymakers may structure systems for regulating campaign finance based on hidden agendas—purposes other than their publicly declared goals such as

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officials must balance the external harm against the cost of abatement, which requires complete information on each polluter's abatement technology.”).

157. Whereas optimal contribution tax rates are set equal to the minimum of expected externalities and expected transaction costs, optimal contribution ceilings are set at the expected point where donor surplus exceeds the minimum of externalities or transaction costs by the maximum possible amount.

reducing corruption or promoting equality.<sup>158</sup> This concern is particularly worrisome when the specific measures in question lack salience with the general public. If voters do not realize that measures are designed for purposes other than improving our system of campaign finance, politicians cannot be held accountable for promoting their hidden agendas.

Consequently, one argument against contribution taxes claims that tax rates are less salient than ceilings. A \$2000 ceiling on contributions is much easier to understand than a graduated schedule for tax rates with numerous tax brackets. Arguably, voters could find it more difficult to understand contribution taxes and politicians could find it easier to adjust tax rates to advance their hidden agendas.

A related argument worries that contribution taxes grant politicians more flexibility in promoting their hidden agendas. Whereas a contribution ceiling can only be raised or lowered, a tax schedule can also be altered in a number of additional ways. The tax rate for each bracket can be raised or lowered, and the overall tax schedule can be made more or less graduated. As Bruce Ackerman and Ian Ayres argue in critiquing a system of subsidies, “specifying the precise formula would provoke a partisan battle royal—with Democrats and Republicans fiercely manipulating the subsidy schedule to their partisan advantage. . . . [T]he parties would be tempted to revisit the issue and rejigger the formula constantly to reflect changes in the political balance of forces.”<sup>159</sup> By giving politicians more variables to fight over, contribution taxes could result in more partisan warfare.

Yet both of these arguments rely on an unrealistic picture of our current system of contribution ceilings. Contribution ceilings are neither simple nor transparent. While it is convenient to think of the ceilings as consisting of a single \$2000 limit on contributions from donors to candidates, there are numerous additional rules and regulations governing transactions of all kinds.<sup>160</sup> Politicians might alter any of these provisions in the search for personal or partisan advantage. Replacing the ceilings with taxes would not significantly change this situation. Indeed, nearly all of the partisan dispute in recent years has been over regulating nonstandard forms of donations. The recent Bipartisan Campaign Reform Act did raise the level of the contribution ceiling on donations from individuals to candidates

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158. For instance, opponents of contribution ceilings frequently worry that campaign finance regulations are designed to protect incumbents against challengers. See, e.g., *Buckley*, 424 U.S. at 251 (Burger, C.J., concurring in part and dissenting in part).

159. ACKERMAN & AYRES, *supra* note 1, at 41.

160. To provide just a few examples, our current system of contribution ceilings caps individuals’ donations to national party committees at \$25,000 per election cycle. 2 U.S.C.A. § 441a(a)(1)(B) (West 2003). An individual’s donations to state and local party committees are capped at \$10,000 per election cycle. *Id.* § 441a(a)(1)(D). An individual’s donations to PACs are capped at \$5000 per election cycle, *id.* § 441a(a)(1)(C), and an individual’s total hard money donations may not exceed \$95,000 per election cycle, *id.* § 441a(a)(3).

from \$1000 to \$2000, but this change came almost as an afterthought to the fierce disputes over limiting soft money and electioneering communications.<sup>161</sup>

Overall then, contribution taxes may be slightly more prone to political manipulation. The details of implementing a system of contribution taxes may be somewhat more complicated than the details of implementing a system of contribution ceilings. But considering how complicated the details of contribution ceilings already are, the marginal added complexity that might result from replacing contribution ceilings with contribution taxes should not significantly change the overall picture. Hence, contribution taxes should not result in significantly more political manipulation than contribution ceilings. Political manipulation is a fact of democratic government and should not be seen as a unique disadvantage of contribution taxes. Contribution taxes will not be implemented in a perfect fashion, but there is no reason to think that our current implementation of contribution ceilings is any more perfect.

#### CONCLUSION

It is time for campaign finance scholars to consider incentive-based regulations. Contribution taxes might not be a panacea for all our campaign finance ills, but they have enough potential to merit a thorough debate. This Note is an attempt to spark that debate by presenting the initial case for contribution taxes.

To this end, I have argued that, compared to contribution ceilings, contribution taxes produce more total surplus and less overall diversion. I have also responded to the potential objections that contribution taxes would exacerbate the problems of corruption and inequality, be held unconstitutional, or result in the tax rates being set incorrectly. A great deal more remains to be said on these issues. Nevertheless, I believe my arguments constitute a *prima facie* case for contribution taxes. I leave it to future papers to expand the parameters of this debate.

One possibility for future research would be to question the economic orientation of my approach. It might not be possible to quantify the harms and benefits of campaign donations as I do in my model. If the harms of political contributions are nonwelfarist in nature, tax revenue might prove unable to compensate society for these harms. However, the fact that contribution ceilings limit private donations without banning them suggests that donations can be measured through utilitarian analysis. I find it hard to imagine a justification for contribution ceilings that does not involve some form of tradeoffs or cost-benefit analysis. If \$2000 donations generate more

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161. See LIOZ, *supra* note 52, at 6.

benefit than harm, I suspect the harm generated by a \$2001 donation could easily be offset by monetary compensation.<sup>162</sup>

Still, taxing campaign donations might communicate a negative social message. We might worry that contribution taxes would express the idea that politicians can be bought as long as one is willing to pay a sufficiently high price. In this fashion, contribution taxes might increase the appearance of corruption. Yet considering the corrupting potential of bundled contributions and diverted funds,<sup>163</sup> I doubt that contribution taxes could uniquely produce a message of this sort. Nevertheless, the appropriateness of subjecting campaign finance regulation to economic analysis is certainly open to debate.<sup>164</sup>

It might also be worth investigating how contribution taxes would affect the balance of power between political parties and related interest groups. If contribution taxes enhance the political influence of the superwealthy at the expense of the moderately wealthy, contribution taxes could advantage liberal Democrats.<sup>165</sup> However, to the extent contribution ceilings would cause these donors to divert their funds, subjecting their donations to taxes might instead benefit conservative Republicans. For similar reasons, we might expect contribution taxes to benefit tax-averse libertarians and other donors particularly likely to divert their funds in response to the taxes. But if these donors face transaction costs high enough to prevent them from diverting their funds, their greater aversion to contribution taxes could decrease their relative influence. The effects of contribution taxes on a group of donors will largely depend on how likely the donors would be to divert their funds in response to contribution ceilings.

Ultimately, without empirical studies, we can only speculate about the overall effects of replacing contribution ceilings with contribution taxes. Space constraints prevent me from discussing all of the assumptions that went into my model, and lack of foresight limits my ability to anticipate every objection that might be raised against contribution taxes. Nevertheless, I believe my Note succeeds in making out an initial case for such taxes.

In addition to theoretical arguments, future work will be needed to determine the appropriate setting for design variables. I would favor forcing donors to send their checks through the Federal Election Commission so

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162. Furthermore, campaign donations are constitutionally protected speech that can only be limited in the pursuit of a compelling state interest. *See supra* Section II.B. This fact strongly suggests that large donations are not categorically bad in the sense that no amount of tax revenue could compensate for their harms.

163. See, respectively, *supra* note 152 and Subsection I.B.1.

164. For a general discussion of why certain values should not be subjected to economic analysis, see Margaret Jane Radin, *Market Inalienability*, 100 HARV. L. REV. 1849 (1987).

165. *See supra* notes 118-126 and accompanying text.

that tax revenue might be deducted before any funds were made available to candidates.<sup>166</sup> Alternately, some centralized bureaucracy might be established to track donors' contributions if taxes are set at graduated rates. But donations need not pass through the hands of regulators: Taxes could be levied directly on either donors or candidates.

Other issues also remain for future consideration. First, a plan for contribution taxes might specify the intended use for the tax revenue; many may be attracted to contribution taxes as a mechanism for funding public financing of campaigns.<sup>167</sup> Second, contribution taxes could also replace the current ban on donations from corporate and union sources.<sup>168</sup> Third, future work might investigate the possibility of adjusting the tax rates based on factors such as donor wealth. Finally, scholars should also discuss the appropriate levels for a contribution tax schedule.<sup>169</sup> Empirical work will be needed to determine how donors respond to various tax rate schedules.

Many other questions will also need to be answered if contribution taxes are to become a plausible option for reform. Still, "[o]ver the past two decades, the clear trend in regulation has been away from command-and-control rules and toward incentive-based . . . systems."<sup>170</sup> Eventually, campaign finance should catch up with these broader regulatory trends. This Note hopes to begin the discussion of how to incorporate incentive-based methods into campaign finance. Whether as contribution taxes or in some other form, incentive-based regulations are the likely future of campaign finance reform.

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166. The FEC would probably need to be reformed for this method to be effective. See generally BROOKS JACKSON, BROKEN PROMISE: WHY THE FEDERAL ELECTION COMMISSION FAILED (1990).

167. For an argument in favor of public financing, see Richard Briffault, *Public Funding and Democratic Elections*, 148 U. PA. L. REV. 563 (1999). For an argument against such reform, see Bradley A. Smith, *Some Problems with Taxpayer-Funded Campaigns*, 148 U. PA. L. REV. 591 (1999).

168. For a discussion of this ban, see Jill E. Fisch, *Frankenstein's Monster Hits the Campaign Trail: An Approach to Regulation of Corporate Political Expenditures*, 32 WM. & MARY L. REV. 587 (1991); and Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103 (2002).

169. Concerns about simplicity and administrative costs will probably necessitate that the tax brackets be set according to a stepwise function, like those of the income tax, rather than as a continuous function like the one I assume in my model. This constraint could weaken, but not defeat, the case for contribution taxes.

170. Jon D. Hanson & Kyle D. Louge, *The Cost of Cigarettes: The Economic Case for Ex Post Incentive-Based Regulation*, 107 YALE L.J. 1163, 1174 (1998).