When Should the Legal System Help Redistribute Income?

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INTRODUCTION

Should legal rules be designed exclusively based on efficiency considerations, or should they also attempt to promote an equitable distribution of social resources? The answer traditionally associated with scholarship in law and economics is that they should focus only on efficiency. Even for a society that cares about achieving an equitable distribution of resources by income, the argument goes, it is generally better to adopt legal rules based exclusively on efficiency considerations while relying on the income tax and transfer system to promote distributional goals.

However, even proponents of the claim that social welfare is best promoted through the adoption of efficient legal rules agree that there are certain conditions under which it does not apply. In particular, the principle of efficient legal design emerges from

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a theoretical model that relies on specific assumptions. When those assumptions do not hold, the best policy may be to design legal rules that deviate from efficiency in order to promote distributional goals.

In this Essay, we consider when legal rules should be efficient and when they should not. We focus on conditions that can cause the socially optimal legal rule to diverge from the efficient legal rule—i.e., the legal rule that would be optimal absent distributional considerations. These conditions include preferences or behaviors that vary over the income distribution, imperfect salience of the incentives generated by legal rules, income tax evasion or avoidance, and regulated activities that generate income. Like the general argument for efficient legal rules, all of these exceptions draw on existing results from the economics literature on optimal taxation. Our goal is to translate these arguments to settings where the question of interest relates to the design of a legal rule rather than, say, the design of a commodity tax. In particular, we seek to clarify the types of arguments that can support the adoption of inefficient legal rules when income taxation is available as a policy tool.[1]

In addition to canvassing conditions that can invalidate the conclusion that legal rules should be efficient when all policy tools are available, we also highlight several real-world institutional and political factors that can make redistribution through legal rules less or more desirable.

I. BASIC FRAMEWORK

We proceed from a welfarist perspective, in which the desirability of a policy is based on how it affects individuals' levels of utility or well-being. This normative starting point is standard in modern economic thought.[2] All else equal, welfarism itself provides a rationale for redistributing resources from higher-income to lower-income individuals. The most commonly cited reason is that the well-being one derives from additional resources declines

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[1] For reviews, see Chris William Sanchirico, *Optimal Redistributional Instruments in Law and Economics*, *in* THE OXFORD HANDBOOK OF LAW AND ECONOMICS: VOLUME 1: METHODOLOGY AND CONCEPTS 321, 346 (Francesco Parisi ed., 2017); Matthew Dimick, *The Law and Economics of Redistribution*, 15 ANN. REV. L. & SOC. SCI. 559, 568–76 (2019).

[2] *See* ANDREU MAS-COLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, MICROECONOMIC THEORY 825 (1995); *see also* Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387, 387 (1954). Some of the early scholarship in law and economics adopted efficiency in itself as the end goal for policy analysis. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 1.2 (9th ed. 2014).

with income.[3] A second reason is that society might disproportionately value the well-being of its worse-off members.[4] The question we are asking is therefore not about the inherent desirability of designing policies that promote an equitable income distribution—most researchers in law and economics would endorse this goal, all else equal. Rather, we are asking whether the availability of an income tax obviates the usefulness of legal rules for pursuing redistributive goals.[5]

Our focus is on comparing efficient and inefficient legal rules. By efficient, we mean that the legal rule would be desirable absent distributive considerations. Put differently, an efficient legal rule is one that we would want to adopt even if the government could costlessly redistribute resources without distorting behavior. In general, this notion of efficiency aligns with Kaldor-Hicks efficiency, for which the efficient rule is the one that maximizes the sum of the individual benefits minus the sum of the individual costs, with both benefits and costs measured in dollars.[6] That is, a policy reform is efficient if the individuals who will be affected are willing to pay a positive amount (on net) to adopt it. And the most efficient policy is the one that the affected parties are willing to pay the most to adopt.

Whereas efficiency reflects the benefits of a policy absent distributional concerns, the optimal policy under a welfarist normative framework is the one that best promotes individuals' well-being. This means that the optimal policy accounts not just for efficiency but also for any societal goals regarding how well-being is distributed.

Four notes about our framework: First, we do not discuss "social preferences," in which how or what people consume enters directly into other people's utility. These preferences would directly change the efficient rule, and we abstract away from them because of the difficulty in measuring them, their broad scope,

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[3] *See, e.g.*, F.Y. Edgeworth, *The Pure Theory of Taxation*, 7 ECON. J. 550, 557–58 (1897).

[4] *See* Derek Parfit, *Equality or Priority?*, *in* THE IDEAL OF EQUALITY 81, 101 (Matthew Clayton & Andrew Williams eds., 2000); *see also* Matthew D. Adler, *Theory of Prioritarianism*, *in* PRIORITARIANISM IN PRACTICE 37, 54–55 (Matthew D. Adler & Ole F. Norheim eds., 2022).

[5] We use income tax as a general term for the income tax and transfer system.

[6] *See* POSNER, *supra* note 2, § 1.2; *see also* Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549, 550 (1939).

and other conceptual challenges.[7] Second, we ask when legal rules should be redistributive. Though the theory applies to questions about all government policies other than cash transfers based exclusively on labor income, we focus on policies most common in a legal context. Third, "redistributive" does not merely mean income differentiated; it means redistributive *relative to the efficient rule*. So, for example, if the efficient rule for a tort is to provide larger economic damages if the harm is to a high-income person's professional prospects compared to a lower-income person's, it would be redistributive to impose the same economic damages in both cases. Fourth, our focus is on whether it is optimal to deviate from efficient legal rules, not the magnitude of the optimal deviation, which could be small or large.

Given the assumptions introduced so far, it could be that the redistributive legal rule is better, all things considered, than the efficient legal rule, depending on the strength of society's distributional goals. The next Part discusses how the availability of an income tax narrows the range of situations under which the redistributive legal rule can be optimal.

II. THE CASE FOR EFFICIENT LEGAL DESIGN

The argument that nontax policies should be efficient goes back at least to Professor Richard Musgrave in 1959.[8] The classic modern articulation comes from a 1994 article by Professors Louis Kaplow and Steven Shavell (henceforth "KS"), titled *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*.[9] In the article, KS considered the design of a damages rule governing a strict liability tort for accidents stemming from some activity.[10] Individuals choose whether to engage in the activity and how much care to exercise in doing so. Exercising care is costly but reduces the risk that the activity will generate an accident. Accidents impose costs on others (the victims). When an accident occurs, the victim collects payment from the tortfeasor

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[7] *See generally* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994) [hereinafter Kaplow & Shavell, *Redistributing Income*].

[8] *See generally* RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY (1959).

[9] *See generally* Kaplow & Shavell, *Redistributing Income*, *supra* note 7. KS themselves drew on earlier results in the optimal taxation literature, most importantly those in A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55 (1976).

[10] Kaplow & Shavell, *Redistributing Income*, *supra* note 7, at 669.

(the one who caused the accident) in an amount determined by the damages rule. The efficient rule entails setting damages equal to the harm that the accident causes to the victim.[11]

In addition to decisions about the regulated activity, individuals make choices about how much income to earn. Everyone is subject to an income tax based on the amount of income they earn. Income tax liabilities may be positive or negative; when negative, they represent a net transfer to the taxpayer. Earning income entails exerting labor effort, which is burdensome to do. Individuals differ from one another in their wages, i.e., how their labor effort translates into income. Because of these differences in earnings abilities, individuals end up earning different amounts of income, generating an unequal income distribution in society.

Consider the damages caused in a motor vehicle accident (with no insurance). Should the legal rule require that a rich tortfeasor pay more to a poor victim than if the roles were reversed? Ignoring the existence of other policies, the law and economics answer could well be yes; after all, the poor person likely has a higher marginal utility of income or lower well-being. However, KS showed that under certain conditions, the presence of an income tax invalidates this conclusion.[12] That is, rather than adopting the redistributive legal rule, both parties—rich and poor—would be better off (at least on average) with an adjustment to the income tax.

To understand KS's reasoning, suppose that there is in place the redistributive legal rule, which imposes larger damages for accidents caused by rich motorists and lower damages for accidents caused by poor motorists. This rule will cause the rich to be inefficiently careful in their driving to avoid the large damages that would be imposed if an accident were to occur. And it will cause the poor to be inefficiently careless in their driving, knowing that the damages they would face from causing an accident would be low. Furthermore, the redistributive legal rule will dampen the incentives for the rich to earn income, knowing that, the more they earn, the worse legal regime they will face. This has become known as the "double distortion"[13]: Both driving decisions and income earning are distorted.

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[11] *Id.*

[12] *See id.* at 674.

[13] *See, e.g.*, Chris William Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797, 799 (2000) [hereinafter Sanchirico, *Taxes Versus Legal Rules*].

Now consider a policy reform that entails switching to the efficient legal rule while also making a specific adjustment to the income tax. This income tax adjustment is determined so that the overall reform leaves each individual with the same level of well-being as they would experience under the redistributive legal rule. In the context of the redistributive damages rule for motor accidents, for example, this bundled reform consists of switching to the efficient damages rule while increasing income taxes on the rich and lowering income taxes on the poor. Intuitively, using the income tax to redistribute also causes a distortion to income-earning incentives but not to decisions related to driving, leaving only a single distortion.

To understand KS's argument in greater detail, note that if the legal rule changed without an income tax adjustment, the rich would be better off—they would face less pressure to exert excessive care while driving and lower damage obligations when accidents do occur. Meanwhile, the poor would be worse off—they would face more pressure to exert care while driving and higher damages when accidents occur. At the same time, because the redistributive damages rule is inefficient, the winners from the change in the legal rule (i.e., the rich) would be willing to pay more to make the change than the losers from the change (i.e., the poor) would be willing to pay to avoid it. This is, after all, what it means for the redistributive damages rule to be inefficient.

To see why the bundled reform can make everyone better off, recall that the income tax change was designed to restore everyone to the level of well-being they had before the reform took place. But—and this is the key point—the reform will generate an increase in tax revenue. This is because restoring everyone to their initial level of well-being means paying out to the losers to compensate for their losses and collecting more from the winners to compensate for their gains. And because the change in legal rule is efficient, the additional dollars collected from the winners will be more than the additional dollars paid out to the losers. Thus, everyone is equally well-off under the reform, but the government collects more tax revenue. The ultimate effect of the reform will therefore be to improve social welfare as long as the government can spend the new revenue it collects to make society better off.

To summarize, the full bundled reform that KS proposed involves three steps. Step 1 is switching from the inefficient legal rule to the efficient legal rule. Step 2 is adjusting the income tax

so that everyone's well-being is the same as it was before the reform (i.e., prior to Step 1). Because the legal reform in Step 1 was efficient, we know that the income tax reform in Step 2 generates a net increase in tax revenue. Step 3 involves spending or refunding the surplus revenue in any manner that improves social welfare. Whenever these three steps work as described, KS's argument establishes that inefficient legal rules are not optimal even if they have some redistributive benefits.

The same reasoning applies in other contexts as well. Consider benefit-cost analysis for government grant funding, which could potentially be designed to favor investments that benefit the poor more than the rich.[14] For example, the government might spend $100 million building a levee to protect homes of rich people that are together worth $120 million. Or it could spend the same amount to protect homes of poor people worth $80 million. It is easy to see how repeating this analysis many times (i.e., for each levee or other investment that is to be built), each time choosing the efficient outcome, will result in richer people tending to get the grant funding; after all, richer people tend to have more valuable homes.[15] Nevertheless, here everyone can be better off, relative to the redistributive spending, if the rich homeowners transfer at least $80 million to the poor homeowners through income taxes and receive the levees.

To summarize, under certain assumptions, whenever one starts from an inefficient legal rule, it is possible to make everyone better off by switching to the efficient legal rule and adopting a carefully constructed reform to the income tax. This bundled policy reform achieves the same level of redistribution as the inefficient legal rule but does so while generating additional revenue that can be used to make people better off than where they started.

III. CONDITIONS THAT CAN FAVOR REDISTRIBUTIVE LEGAL RULES

This Part considers a range of conditions under which it can be optimal to adopt an inefficient legal rule for purposes of income redistribution, even when the income tax is available as a policy

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[14] *See* Zachary Liscow & Cass R. Sunstein, *Efficiency vs. Welfare in Benefit-Cost Analysis: The Case of Government Funding*, 15 J. BENEFIT-COST ANALYSIS 224, 230–33 (2024).

[15] *See id.* at 231; *see also* Zachary Liscow, *Is Efficiency Biased?*, 85 U. CHI. L. REV. 1649, 1681 (2018).

tool. In this Part, we put aside institutional and administrative concerns, to which we return later.

A. Income-Varying Preferences

Consider a damages rule for torts arising from a particular activity. Suppose that high-income people engage in the activity at higher rates than low-income people. The benchmark KS model assumes that individuals have the same preferences over activities; that is, it assumes that if two people were to earn the same income, they would choose to engage in the activity at equal rates.[16] However, an alternative possibility is that the individuals who end up earning higher incomes have stronger preferences to engage in the activity for reasons that are not fully caused by their higher incomes. That is, it could be that even if the lower-income person's income were subsidized so that it was equal to the higher-income person's, the latter would still engage in the activity more than the former.

To illustrate why this distinction matters, consider a modification to the damages rule for motor vehicle accidents discussed above. Under this modification, damages would not depend directly on the income of the tortfeasor but would instead depend on some factor that is correlated with income, such as the retail price of the tortfeasor's car. That is, the rule would impose higher damages on drivers of expensive cars and lower damages on drivers of inexpensive cars. Note that even though it does not determine damages directly based on income, this rule would still tend to redistribute from rich to poor to the extent that higher-income tortfeasors tend to drive more expensive cars. Note also that the rule would still tend to generate an efficiency cost by distorting the regulated activity; in particular, the owners of cheap cars would again face too little incentive to exercise care, and vice versa for the owners of expensive cars. In addition, drivers would face an incentive to purchase cheaper cars than what they would otherwise prefer.

However, unlike the damages rule considered above that would directly depend on income, the car-based rule would not necessarily replicate the efficiency costs of the income tax with respect to decisions about whether to earn income. The reason why relates to the possibility that income differences in preferences for cars are not entirely due to differences in individuals'

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[16] *See* Kaplow & Shavell, *Redistributing Income*, *supra* note 7, at 679.

incomes.[17] In particular, if rich people would remain more likely than poor people to purchase expensive cars even if their incomes were equalized, linking damages to car price would not distort income-earning decisions as much the change to the income tax would.[18]

Consider the perspective of someone deciding whether to earn more income. If the person would spend some of that extra income on a more expensive car (as in the case in which all preference differences are due to differences in income), then adding a new cost to owning expensive cars will reduce the appeal of earning the extra income. In contrast, for a person who has no interest in spending that extra income on a new car, a damages rule tied to car price would not affect one's incentives to earn more income.

Thus, when there are preference differences between the rich and poor that are not caused by differences in income, inefficient legal rules can promote redistribution while potentially avoiding some of the distortions associated with income tax–based redistribution.[19] Because efficiency costs tend to be small for small deviations from the efficient policy, the optimal policy in such cases

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[17] For example, rich people might be rich partly because they particularly like consumption, especially consuming fancy things like expensive cars. Otherwise, they might work less hard or work in less lucrative professions.

[18] It is worth distinguishing this form of preference heterogeneity from another form. Our focus is on preferences that systematically vary across income groups so that everyone with the same income has the same preferences. It may also be the case that there is within-income-group heterogeneity in preferences. To the degree that preferences to engage in an activity are uncorrelated with income itself, the preference heterogeneity does not provide a rationale for pursuing income distribution through the legal rules governing that activity. For discussion, see Sanchirico, *Taxes Versus Legal Rules*, *supra* note 13, at 818; Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 828 (2000) [hereinafter Kaplow & Shavell, *Should Legal Rules Favor the Poor?*]; Ronen Avraham, David Fortus & Kyle D. Logue, *Revisiting the Roles of Legal Rules and Tax Rules in Income Redistribution: A Response to Kaplow & Shavell*, 89 IOWA L. REV. 1125, 1129–31 (2004).

[19] A similar analysis supports the use of indirect taxes in the presence of nonlinear income taxation when preferences for the taxed activity are correlated with earnings ability. *See* J.A. Mirrlees, *Optimal Tax Theory: A Synthesis*, 6 J. PUB. ECON. 327, 347 (1976); Emmanuel Saez, *The Desirability of Commodity Taxation Under Non-Linear Income Taxation and Heterogeneous Tastes*, 83 J. PUB. ECON. 217, 227 (2002); LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 139–40 (2008); *see also* Peter Diamond & Johannes Spinnewijn, *Capital Income Taxes with Heterogeneous Discount Rates*, 3 AM. ECON. J.: ECON. POL'Y 52, 62 (2011).

would generally involve relying to at least some degree on inefficient legal rules.[20]

Another way to understand the intuition for this result comes from the logic of "tagging," or charging different tax rates based on immutable features (i.e., "tags") to enable less tax on behaviors that taxes distort, like working to earn wages.[21] For example, tall people tend to earn more money. It would be optimal to charge tall people higher taxes because they tend to earn more—while relying less on taxes based directly on income, which are more distortionary.[22] Doing so would take pressure off of the income tax. Behaviors (such as engaging in a regulated activity), even though they are mutable, fulfill a similar role as immutable features *if* the underlying preferences persist even if those poorer people were to get richer. If instead the poor people acted just like the rich people when they became richer, the full double distortion would again result, and the behavior would not actually be a tag for people who tend to earn low incomes.

Where might we expect to observe such relationships between preferences and income that could support the adoption of inefficient legal rules to aid in redistribution? First, there might idiosyncratically be differences between rich and poor people. For example, lower-income consumers appear to have stronger preferences for soda compared to higher-income consumers, lowering the optimal tax on soda.[23] Soda taxes correct for biased behavior, but they also hit poorer people harder and, since that preference persists even when low-income people get a little richer, it's optimal to tax soda less. Our stylized example about car accidents, with preferences for expensive cars correlated with earning ability, would also fit into this category of idiosyncratic differences in

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[20] Note that this logic only gives a rationale for *indirect* redistribution through law because if the differences in legal treatment were directly tied to the parties' incomes, it would not avoid the distortion of income-earning decisions.

[21] *See* Zachary Liscow, Note, *Reducing Inequality on the Cheap: When Legal Rule Design Should Incorporate Equity as Well as Efficiency*, 123 YALE L.J. 2478, 2504 (2014); N. Gregory Mankiw, Matthew Weinzierl & Danny Yagan, *Optimal Taxation in Theory and Practice*, 23 J. ECON. PERSPS. 147, 162–63 (2009).

[22] N. Gregory Mankiw & Matthew Weinzierl, *The Optimal Taxation of Height: A Case Study of Utilitarian Income Redistribution*, 2 AM. ECON. J.: ECON. POL'Y 155, 173, (2010).

[23] *See generally* Hunt Allcott, Benjamin B. Lockwood & Dmitry Taubinsky, *Regressive Sin Taxes, with an Application to the Optimal Soda Tax*, 134 Q.J. ECON. 1557 (2019).

that there is no strong theoretical reason we would expect this correlation to hold ex ante.[24]

Second, there might be certain attributes that actually help *cause* some people to be richer or poorer that are correlated with propensity to engage in the regulated activity. For example, a growing body of evidence documents the stickiness of people's ties to their communities, demonstrating that the current residents of a neighborhood often choose to remain even when there are some financial benefits from leaving.[25] People with a stronger preference to stay put might therefore tend to be poorer. Now consider the decision of how a government should conduct benefit-cost analysis of where to fund infrastructure, like a levee or a road. This residential stickiness suggests that it can be optimal to redistribute toward poorer neighborhoods by funding more infrastructure in low-income neighborhoods than the efficient rule would suggest.[26] Similarly, evidence suggests that entrepreneurs are more likely to engage in illicit activities as teenagers—even before they become rich—than others are.[27] If this is how people who turn out to be well-off more broadly behave (and if they would have tended to act this way even if they hadn't ended up well-off), then civil fines on white-collar crime should be larger than is purely efficient.

B. Income Tax Evasion

The income tax is subject to evasion and avoidance.[28] This means that individuals have some (potentially burdensome) way to reduce their income tax liability without adjusting their actual

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[24] Of course, if lower-income people would have an even stronger preference for fancy cars if incomes were equalized, then the conclusion would be reversed, and the optimal redistributive policy would entail higher damages on tortfeasors with less expensive cars.

[25] *See, e.g.*, David Schleicher, *Stuck! The Law and Economics of Residential Stagnation*, 127 YALE L.J. 78, 88 (2017); Benjamin Austin, Edward Glaeser & Lawrence Summers, *Jobs for the Heartland: Place-Based Policies in 21st-Century America*, 2018 BROOKINGS PAPERS ON ECON. ACTIVITY 151, 157–58; Konrad Putzier & Rachel Louise Ensign, *Nobody's Buying Homes, Nobody's Switching Jobs—and America's Mobility Is Stalling*, WALL ST. J. (Aug. 14, 2025), https://www.wsj.com/economy/american-job-housing-economic-dynamism-d56ef8fc.

[26] For evidence of such heterogeneous preferences, see Cecile Gaubert, Patrick M. Kline, Damián Vergara & Danny Yagan, *Place-Based Redistribution* (Nat'l Bureau of Econ. Rsch., Working Paper No. 28,337, 2025). For a different set of place-based reasons to redistribute, see Austin et al., *supra* note 25, at 178–84.

[27] Ross Levine & Yona Rubinstein, *Smart and Illicit: Who Becomes an Entrepreneur and Do They Earn More?*, 132 Q.J. ECON. 963, 975–76, 989 (2017).

[28] For brevity, we use tax evasion to refer either to illegally failing to pay one's true tax liability or to legal adjustments to behavior (other than labor supply) that reduce one's true tax obligations.

income. If similar evasion is not possible for legal rules, that opens up opportunities to improve social welfare by selecting legal rules with an eye toward distributional goals.

To see why this possibility undermines the double-distortion reasoning, consider first the extreme scenario in which labor supply is entirely inelastic, so that people do not adjust their actual earnings in response to changes in tax rates. At the same time, when income tax rates increase, people do increase the extent of their tax evasion.

Within this scenario, consider the desirability of a redistributive legal rule like the one described above that imposes higher damages on those engaging in activities that are correlated with income, such as driving an expensive car. Unlike the case above, increasing redistribution through the income tax or through the legal rule each generates one distortion. The legal rule distorts participation in the regulated activity (e.g., inducing people to avoid buying expensive cars), whereas the income tax causes a diversion of time and money to tax evasion. Depending on which of these distortions is more significant, it may be optimal to redistribute at least somewhat through legal rules rather than the income tax.

The same reasoning holds in the more general scenario in which individuals may adjust both evasion and real-income earning; both the income tax and the legal rule lead to lost revenue due to changes to real-income earning, but only the income tax induces lost revenue from increases in evasion. In general, for small reforms away from the efficient legal rule, we know that the distortion caused by the legal rule will be small,[29] which implies that it is optimal to rely at least somewhat on inefficient legal rules in the presence of tax evasion.[30]

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[29] The explanation behind this result is that small changes around an optimum have only small welfare consequences. Think of a farmer who grows bananas at various points on a mountain: The higher up the mountain, the less productive the banana farming. With a small tax on his product, he'll stop growing at the very top; but that area is pretty unproductive because it's hard to get to, so the welfare consequences are small. But as the tax increases more and more, he abandons increasingly productive banana-growing areas so that the marginal cost of the deviation from the optimum (untaxed) outcome grows.

[30] This argument has been developed previously with respect to the desirability of non–income tax instruments. *See, e.g.*, Robin Boadway, Maurice Marchand & Pierre Pestieau, *Towards a Theory of the Direct-Indirect Tax Mix*, 55 J. PUB. ECON. 71, 83 (1994); KAPLOW, *supra* note 19, at 142–43; David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1, 28–29 (2014).

A natural objection to this line of reasoning is that if evading income taxation is possible, perhaps people could similarly evade their liability for redistributive legal rules. This concern seems most acute for legal rules that directly depend on income, such as the rule that imposes different motor vehicle accident damages for rich and poor drivers. In practice, it seems likely that courts administering such rules would have to rely on proxies for income such as the individuals' tax returns (which are themselves subject to misreporting). In contrast, evasion of redistributive legal rules is likely to be more difficult if the legal rule depends on income only indirectly. For example, high-income tortfeasors who face extra damages from motor vehicle torts by virtue of driving expensive cars could not evade liability by misreporting their incomes (whether on their tax return or in court); their higher liability would be triggered simply by the decision to purchase and drive the more expensive car.

C. Incomplete Salience of Legal Rules

Recall that the basic argument for efficient legal design relies on the reasoning that the legal rule reform would induce the same change in labor supply decisions as would an equivalent-magnitude change in the income tax.[31] In reality, this seems at least somewhat unrealistic, especially for a redistributive legal rule that was formally income neutral but tended to burden activities disproportionately preferred by high-income individuals. Such burdens may not be fully salient (i.e., people may not fully take them into account), especially when they are tied to rare events like accidents. When the changes to labor supply incentives from legal-rule reforms are less salient than the incentive effects of the corresponding income tax reform, the former may induce a smaller labor supply response, and thus yield more revenue, than the latter, reversing the conclusion of the standard argument.[32]

When labor supply incentives from changes in legal rules are less salient than corresponding income tax reforms, it becomes optimal to redistribute, at least somewhat, through legal rules, especially with respect to activities disproportionately engaged in

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[31] *See* Kaplow & Shavell, *Redistributing Income*, *supra* note 7, at 673.

[32] Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1658–74 (1998).

by the rich and for which participation is relatively insensitive to this additional burden.[33]

Although this rationale likely supports some degree of legal redistribution, it is unclear how much, since it is possible that the salience of redistributive legal rules would increase as redistribution was increasingly relied on as a policy tool or as redistributive damage rules came to be accounted for in the setting of insurance premiums.

D. Activities that Increase Government Revenue

In considering the revenue effect of the bundled reform, we have so far focused on benefits to individuals from adjusting the legal rule and how the amount of redistribution through legal rules affects income-earning behavior. But it is also possible that the change in the legal rule itself—apart from the attempt to redistribute through the rule—generates tax revenue by causing individuals to increase the amount of income they earn, thus creating revenue for the public to use. For example, if the inefficient rule reduces the burden of engaging in some form of income-generating activity, switching to the efficient rule could cause people to change their behavior in a manner that reduces revenue.[34] If such effects are large enough—and they generally will be, at least for small deviations from the efficient rule—the optimal legal rule will exhibit at least some inefficiency.[35]

One example of a policy in this category is benefit-cost analysis of spending on public transportation. Analysis that determined how much to spend based only on individuals' willingness to pay would underprovide public transportation. This undersupply occurs because the analysis would miss the tax revenue generated from the additional money earned. Workers could spend more

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[33] *See* Allcott et al., *supra* note 23, at 1575–77 (providing analogous reasoning for the case of whether commodity taxation is desirable given an income tax).

[34] *See* David A. Weisbach & Daniel J. Hemel, *The Legal Envelope Theorem*, 102 B.U. L. REV. 449, 460–65 (2022); *see also* Nathaniel Hendren & Ben Sprung-Keyser, *A Unified Welfare Analysis of Government Policies*, 135 Q.J. ECON. 1209, 1248–54 (2020).

[35] A related condition that favors inefficient legal rules is if the rule regulates an activity that affects the desirability of generating labor income, i.e., if the activity is either a complement or a substitute to labor supply. If such complementarity or substitution effects vary by income, this could give rise to an additional motivation for legal rules that are either contingent on income or that vary in ways that are correlated with income. However, as others have noted, it is difficult to draw general conclusions about what this form of preference heterogeneity looks like across the income distribution—and thus how it should shape legal rule design. *See* Kaplow & Shavell, *Should Legal Rules Favor the Poor?*, *supra* note 18, at 826.

time working and less time commuting, and they could work at better, higher-paying jobs that they could gain access to with better transit connections. Thus, spending on public transportation, which tends to benefit lower-income individuals, would be too low if it were based on the standard efficiency logic.

At the same time, while this tax revenue–generation logic generates deviations from the standard efficient rule, it will often be the case that the deviation may actually benefit higher-income people. The reason is that tax revenue depends crucially on individuals' marginal tax rates, and in the United States today, marginal tax rates are higher for higher-income taxpayers compared to middle-income taxpayers. Since inducing a higher-income person to earn $1 generates more tax revenue than inducing a middle-income person to earn $1, enacting legal changes that encourage the rich to earn will tend to be more beneficial. Thus, an optimal inefficient legal rule could well imply more accommodating legal rules for activities in which low-income or high-income taxpayers tend to generate income, as compared to activities in which middle-income taxpayers tend to generate income.[36] Conversely, for proscribed activities that interfere with income (e.g., certain property crimes or drug use), this rationale would imply larger penalties on crimes that affect taxpayers with incomes associated with higher marginal tax rates.

Of course, this is not what one typically has in mind when considering redistributive legal rules. One could therefore reasonably ask: How does imposing more preferential legal treatment on activities by higher-income taxpayers promote rich-to-poor redistribution? The explanation is that favorable treatment of income-producing activities encourages people to engage in those activities. When high-income people do so (and generate income as a result), their high marginal tax rates mean that a relatively large share of the newly produced income is converted into tax revenue. At the same time, the change in legal rules partially offsets the additional tax burden associated with becoming rich. In this way, favorable legal treatment of income-producing activities by high-income taxpayers can facilitate more redistribution by reducing the efficiency cost of progressive taxation.

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[36] Although striking in the legal rules setting, this rationale can explain why we provide larger subsidies to income-producing expenditures for high-income (or at least high tax bracket) individuals in the form of business tax deductions.

IV. ADDITIONAL CONSIDERATIONS LIMITING THE VALUE OF REDISTRIBUTIVE LEGAL RULES

The previous Part showed how modifying the assumptions of the basic KS model can cause the optimal legal rule to deviate from the legal rule that is most efficient. However, extending the KS model in other directions can cut against this logic. In particular, there are a number of factors we have not yet discussed that can limit the desirability of redistributive legal rules.

One problem is that most legal rules don't systematically affect everyone with a given income level in the same way but rather affect the overall income distribution in a somewhat haphazard manner. The fancy car damages rule considered above, for example, would provide extra benefits to people who happened to get run over by fancy cars, but the vast majority of poor people will never be involved in a motor accident with a fancy car, so they would not benefit from the additional distribution.[37] Moreover, some of the drivers of the fancy cars will not be rich, and some rich people do not drive fancy cars. Thus, even if an indirectly redistributive legal rule is effective on average at promoting a more desirable distribution of resources, this haphazardness may make it less desirable than an income tax—which to a first approximation treats all people with the same income in a uniform way.

Given the haphazard nature of redistribution induced through legal rules, it could be that a more appealing alternative is to adopt a blanket fine or fee associated with whatever activity would be regulated by the legal rule. Thinking of this fee as an excise tax, one can modify KS's conclusion that all redistribution should occur through the *income* tax and transfer system to: All redistribution should occur through the tax system, which encompasses income taxation and transfers as well as excise taxes that do not directly depend on income. Put differently, the optimal policy would involve the use of an efficient legal rule coupled with a suite of income *and excise* taxes.

Whether an excise tax can achieve the same goal as a legal rule depends on the rationale for using the legal rule to redistribute. For example, it may be easier to evade excise taxes than tort-imposed damages, leaving in place the "redistribute through legal rules" conclusion. Or it could be that the individual characteristic associated with high-earning types is propensity to cause a specific type of accident, rather than propensity to undertake the activity

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[37] Some of these differences would be smoothed over by insurance.

more generally. In that case, the damages rule on accidents involving expensive cars would promote redistribution, whereas the simple excise tax on expensive car ownership would not.

Another consideration is the incidence of redistributive legal rules. For rules that disproportionately burden the rich, for example, the ultimate economic effect could fall on lower-income individuals. The rule that imposed higher damages on tortfeasors with fancy cars, for example, could end up depressing demand for fancy cars, which could end up hurting the working-class workers who manufacture them. One could plausibly account for such effects through a carefully designed income tax adjustment, netting out any unintended distributive effects. In contrast, in settings where the law allocates entitlements between contracting parties with flexibility in the other contract terms, we might expect any redistributive effects of the legal rule to be largely or even fully displaced through adjustment of the other contract terms, thereby limiting the scope of legal rules to effectively redistribute resources.[38]

Finally, accounting for various institutional factors could weaken the case for redistributing through legal rules, such as if the legislative bodies that control income tax rates are better positioned to make policy relating to redistribution compared to the bodies that make legal rules.[39] For example, courts may lack the needed expertise or resources to consider the likely distributional effects of a particular legal rule or the offsetting effect on labor supply that would result. Or adding redistribution as a goal in addition to efficiency could in certain contexts add constraints to time-burdened government administrators, thereby harming efficiency in ways other than those that benefit redistribution. For example, extra equity-minded steps could slow down government processes.

V. POLITICAL CONSTRAINTS ENCOURAGING THE USE OF REDISTRIBUTIVE LEGAL RULES

Thus far, our focus has been on conditions under which inefficient legal rules are optimal if the income tax is also fully and flexibly available for redistribution. However, if legal rules can be

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[38] *See* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 158–59 (2d ed. 1989).

[39] *See* David A. Weisbach, *Distributionally Weighted Cost-Benefit Analysis: Welfare Economics Meets Organizational Design*, 7 J. LEGAL ANALYSIS 151, 166–67 (2015).

adjusted in ways that the income tax cannot, the optimal feasible policy may involve inefficient legal rules even under the standard KS assumptions. This is because the argument for efficient legal design is not that the inefficient legal rule is necessarily worse than the efficient legal rule, all else equal; it is rather that the inefficient legal rule is worse than the efficient legal rule coupled with a particular income tax reform. Thus, if the accompanying income tax reform is not feasible, there is no guarantee that the efficient rule on its own will be preferable to the inefficient rule. In particular, the inefficient legal rule could yield higher social welfare—the negatives in terms of efficiency could potentially be outweighed by benefits from additional redistribution.

Why might certain income tax reforms be challenging to achieve? Political or other institutional constraints might limit policymakers' ability to freely adjust the income tax. These limits could include things like political gridlock, a dysfunctional legislative body, or other factors.[40] For example, there may be a mismatch between the government actors that control the legal rule being contemplated and the income tax, such as if the former is a court and the income tax is legislative, or if state legislatures control the legal rule but tax redistribution is controlled principally at the federal level. That said, in the United States (today at least), changes to the income tax rates are reasonably common and substantially more common than for some other areas of law, providing opportunities for subsequent tax changes that offset changes in legal rules.[41] But for that to happen, policymakers would have to view redistribution through different policies as fungible. And the public (and its representatives) may be more comfortable redistributing through noncash policies than through the income tax itself, perhaps because the rich seem to "deserve" their income and the poor do not "deserve" cash transfers yet require certain necessities. This scenario would thwart the needed fungibility and thus counsel in favor of redistributive legal rules.[42]

The real-world complexity of reforming the tax code could also push in favor of inefficient legal rules. Recall that KS's premise is that a tax increase on the rich could offset any gains they

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[40] *See* Lee Anne Fennell & Richard H. McAdams, *The Distributive Deficit in Law and Economics*, 100 MINN. L. REV. 1051, 1084–88 (2016).

[41] *See* David A. Weisbach, *Redistribution with Political Constraints: Legal Rules Compared to Taxes and Transfers*, 129 PENN. ST. L. REV. 25, 39–47 (2024).

[42] Zachary Liscow, *Redistribution for Realists*, 107 IOWA L. REV. 495, 511 (2022) [hereinafter Liscow, *Redistribution for Realists*].

get through a legal rule change.[43] However, consider the ramifications of such a tax change when the real-world income tax code is full of deductions that are criticized as inefficient—and that a higher tax rate would further inefficiently encourage because a deduction from a higher tax rate makes the activity underlying the deduction all the more attractive. For example, the home mortgage interest deduction subsidizes expenditures on expensive homes, arguably inefficiently. An idealized income tax adjustment could accomplish some desired amount of redistribution without affecting such subsidies, like raising marginal tax rates on the rich but reducing their mortgage interest deduction. However, a more realistic possibility is that a reform would change statutory tax rates but leave in place the deductions, which would effectively increase tax expenditure subsidies. That is, an increase in statutory tax rates for high-income taxpayers could entail an efficiency cost in the form of an increased subsidy for home mortgages. Because the inefficient legal rule would avoid this distortion, it is possible that its overall efficiency cost could be lower than the income tax adjustment for real-world income tax systems.

Two counterarguments could limit the applicability of this critique of efficient policymaking. The first applies when the income tax is optimally set in balancing the value of redistribution against distortions to income earning. In that case, even without offsetting taxes and transfers, definitionally, the redistributive benefits and income-distorting costs of additional redistribution through taxation nearly offset each other. The same would also apply to the implicit income tax schedule introduced by redistributive legal rules, so the second part of the double distortion—the distortion to the legal rule—would tend to make any redistribution welfare decreasing.[44] However, if there are political or institutional barriers that limit the ability to use the income tax to achieve desired redistribution, then it will typically be the case that redistributing through legal rules will be at least somewhat valuable.[45]

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[43] *See* Kaplow & Shavell, *Redistributing Income*, *supra* note 7, at 672–73.

[44] Put differently, we know that (1) a change to the income tax is better than the redistributive legal rule, and (2) if the status quo income tax is optimal, then the status quo is better than any change to the income tax. Together, (1) and (2) imply that the status quo is better than any potential redistributive legal rule.

[45] And, indeed, relative to the baseline of what the optimal income tax would be based on the risk aversion implied by individuals' behavior, the tax code appears far less

The second potential objection is that even if the tax-and-transfer change is not explicitly made along with a move to an efficient legal rule, policymakers controlling the income tax will ultimately make it to keep the desired level of redistribution equal to societal preferences. Here, this seems somewhat implausible in practice, and empirical evidence suggests it is not the case as a descriptive matter.[46]

More broadly, the analysis in this Part supports a basic lesson reflected in KS, which is that the optimal policy can depend crucially on the set of alternative policies that are also available.[47]

CONCLUSION

Two caveats are in order in concluding. First, our discussion adopts a perspective that is internal to law and economics, drawing on results from formal economic models and evaluating the quality of alternative policies with a conventional welfarist metric. Alternative methodological or normative approaches to evaluating questions of legal design could yield different conclusions. Second, we do not attempt to resolve the debate about whether there should be a general presumption of efficient legal design. Answering this question requires some assessment of how frequently the conditions that support it will hold as an empirical matter, and we do not make any claims on that front. Rather, our goal has been to clarify the types of arguments that are relevant to determining whether and how legal rules should deviate from what is efficient.

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redistributive than a utilitarian would want. Liscow, *Redistribution for Realists*, *supra* note 42, at 523–24.

[46] *See* Zachary Liscow, *Are Court Orders Sticky? Evidence on Distributional Impacts from School Finance Litigation*, 15 J. EMPIRICAL LEGAL STUD. 4, 29 (2018); Alex Raskolnikov, *Distributional Arguments, in Reverse*, 105 MINN. L. REV. 1583, 1624 (2021).

[47] Another political economy reason to deviate from the efficient rule comes from the "policy feedback" literature in political science. *See, e.g.*, Paul Pierson, *When Effect Becomes Cause: Policy Feedback and Political Change*, 45 WORLD POL. 595, 598–603 (1993). That is, it could be good to redistribute to empower some group politically, which could help maintain good policies or promote further good policies.