The Collision of Tribal Natural Resource Development and State Taxation: An Economic Analysis

Robert William Alexander

Recommended Citation
Available at: https://digitalrepository.unm.edu/nmlr/vol27/iss2/4

This Article is brought to you for free and open access by The University of New Mexico School of Law. For more information, please visit the New Mexico Law Review website: www.lawschool.unm.edu/nmlr
THE COLLISION OF TRIBAL NATURAL RESOURCE DEVELOPMENT AND STATE TAXATION: AN ECONOMIC ANALYSIS
ROBERT WILLIAM ALEXANDER *

I. INTRODUCTION

Indian tribes enjoy a unique, though not necessarily enviable, position in the American governmental system. Within their reservations, tribes retain a degree of sovereignty vis-a-vis state governments, but their powers and very existence are dependent on the will of Congress. At the same time, the federal government holds a trust responsibility to Native Americans and their land, requiring Congress to protect Native Americans' rights and provide for their standard of living.2 By most objective economic indicators, the federal government has done a poor job.3 Promoting the dual goals of encouraging tribal self-government and a decent standard of living on reservations seems an almost Herculean task considering that many Indian reservations are on some of the most remote and barren land in the United States.4 Nevertheless, and perhaps ironically, some of these very same reservation lands—chosen in part for their apparent worthlessness5—in fact contain enormous natural resource reserves, especially large reserves of coal, oil, gas, and uranium.6 Developing these valuable

---

* Clerk, Judge Carlos F. Lucero, United States Court of Appeals for the Tenth Circuit. J.D., University of Colorado School of Law; LL.M. University of Michigan Law School. I thank Stu Stuller and Luis Toro for their helpful suggestions.
4. See generally VINE DELORIA, JR. & CLIFFORD M. LYTLE, AMERICAN INDIANS, AMERICAN JUSTICE 1-24 (1983) (documenting the United States land policies calculated to strip tribes of lands perceived to be valuable).
5. See generally id.
6. Indian tribes are the third largest holders of such energy reserves in the United States, after the federal government and private railroad companies. See MARJANE AMBLER, BREAKING THE IRON BONDS: INDIAN CONTROL OF ENERGY DEVELOPMENT 74 (1990). Indian natural resources include about 33% of the coal west of the Mississippi River (16% of the nation's total coal reserves), at least 3% of known oil and gas reserves, and between 16% and 37% of national uranium deposits. See id.; see also INDIAN MINERAL RESOURCE HORIZONS 1 (Bureau of Indian Affairs Div. of Energy and Mineral Resources) (May 1992) (valuing estimated resource value of tribal mineral deposits alone to exceed $1.5 trillion). Most of these reserves are undeveloped. See Douglas Richardson, What Happens After the Lease Is Signed?, 6 AM. INDIAN J. 11 (1980).
resources would allow tribes to gain economic self-sufficiency while maintaining their political independence.\textsuperscript{7}

Unfortunately, tribes generally do not have the capital resources or technical expertise necessary to develop their resources independently.\textsuperscript{8} Several factors contribute to this state of affairs. First, tribal ability to raise initial capital is limited by the nonalienability of tribal land, preventing tribes from offering land as collateral.\textsuperscript{9} Second, Indian tribes have sovereign immunity from private suit, which increases the risk for private bankers contemplating loaning capital to tribes.\textsuperscript{10}

Lacking the ability to develop their resources themselves, tribes, at the urging of the federal government, have contracted with non-Indian private firms to develop their natural resources. Revenues from these arrangements often constitute large percentages of tribal budgets.\textsuperscript{11}

As economic activity on Indian reservations has substantially increased, state and tribal taxing interests have clashed.\textsuperscript{12} This conflict probably is inevitable.


8. See Wood, supra note 7, at 157-58.

9. The federal Nonintercourse Act of 1790 provides that no conveyance of lands from an Indian tribe "shall be of any validity in law or equity, unless the same be made by treaty or convention." Ch. 33, 1 Stat. 137 (1790) (codified at 25 U.S.C. § 177 (1994)). The Nonintercourse Act, in large part, is a relic of an earlier age, used to protect Indians from overreaching outsiders. See, e.g., Alonzo v. United States, 249 F.2d 189, 196 (10th Cir. 1957). The Nonintercourse Act has continuing vitality in protecting the tribal land base from market forces and state tax assessors. The act's significance is not altogether paternalistic, as it does help protect a separate Indian culture and identity. See Cohen, supra note 1, at 509-10.

10. See Oklahoma Tax Comm'n v. Citizen Band Potawatomi Indian Tribe, 498 U.S. 505, 509 (noting tribal sovereign immunity). However, tribes may set up corporations that are subject to suit, thus enhancing their creditworthiness. See, e.g., 25 U.S.C. § 490 (1994).

11. See AMBLER, supra note 6, at 119.

considering the overlapping boundaries of states and Indian reservations and the overlapping interests of states and tribes in regulating and benefiting from resource extraction.\(^{13}\)

In the absence of congressional direction, the United States Supreme Court has struggled to define proper jurisdictional limits for state and tribal taxation on Indian reservations. In the past twenty years, the Court has created a fairly elaborate and increasingly refined, but ultimately inconclusive, doctrine to deal with the question of which aspects of what transactions are subject to tribal taxation, state taxation, or both. The policy parameters informing this doctrine are the federal interest in enhancing Indian welfare, the tribes' position as sovereigns within the American system of government, and the states' interests in taxing economic activity within their jurisdictions.

Although the Court and commentators critiquing the Court's decisions invoke economic analysis to support their conclusions, little actual economic analysis has been done to determine the probable effects and burdens of the taxation doctrine that has developed. In particular, none of the Court's decisions discuss the transaction costs associated with the effects of resource taxation. This Article explores the economic consequences created when tribes tax non-Indian activity on reservations, as well as the corresponding consequences of permitting states to tax the same transactions. In particular, this Article applies the concepts of transaction-cost economics to illustrate how current statutory and case law affect the ability of tribes and private parties to enter into transactions.\(^{14}\) The analysis is limited to transactions involving the development of tribal natural resources,\(^ {15}\) where tribes act as both resource owners and sovereigns with the ability to tax the activity.\(^ {16}\)

---

13. Other prominent sovereignty struggles between state and tribal governments involve zoning and environmental regulation of Indian country land owned by nonmembers in fee, see Brendale v. Confederated Tribes and Bands of the Yakima Indian Nation, 492 U.S. 408, 412 (1989) (holding that a tribe cannot zone in the "open lands" inside its reservation), and state jurisdiction within reservations, see Carole E. Goldberg, Public Law 280: The Limits of State Jurisdiction over Reservation Indians, 22 UCLA L. REV. 535, 538 (1975).


This Article also does not directly address tribal development of renewable resources, although many of the economic principles discussed here can be applied to such activities. These enterprises include logging, fishing, and, to some extent, tourism. To the extent that exploitation of a resource requires extensive future commitments and diminishes the opportunities for future exploitation, tribes must consider commitments to sell a renewable resource in the same way they would consider a commitment involving a nonrenewable resource.

This Article concludes that tribal taxation of natural resource extraction by non-tribal private parties is superior to state taxation from both efficiency and equity standpoints, and is more consistent with the explicit federal goals of tribal self-government and economic self-sufficiency. Specifically, while both state and tribal taxation of natural resource development shift tax burdens to parties receiving no or few benefits from the taxing government, and are subject to criticism on that front, tribal taxation is less likely to create misallocation of resources, less likely to cause overconsumption of public goods, and more likely to internalize negative externalities of the transaction than is state taxation. Additionally, tribal taxation might have positive economic effects, including reducing bargaining and long term transaction costs between a tribe as a resource owner and a non-tribal private entity as resource producer. Finally, state taxation can “crowd out” and otherwise impede a tribe’s ability to maximize its rights in resources it owns.

The remainder of this Article is divided into three parts. Part II describes the legal regime governing tribal resource development, explaining in some detail the history of federal regulation of tribal resource development and the continuing congressional desire to facilitate this development to promote both tribal independence and the development of domestic resources. Part II also outlines the taxation regime created by the dual sovereignty of states and tribes, focusing on the problems created by dual sovereignty claims over the lands from which natural resources are extracted.

Part III provides an introduction to the economics of resource development and resource taxation. In particular, this section describes the variation between markets and the forces determining supply and demand functions for different natural resources; the phenomenon of economic “rents” created by resource extraction; the various methods governments use to tax resource development; and there are ethical and policy considerations associated with allowing a government to tax a party for transactions in which the government is also a party. See generally Kyle D. Logue, Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment, 94 MICH. L. REV. 1129, 1146-52 (1996) (analyzing the moral hazards associated with governments upsetting settled expectations through changes in the tax regime). While these concerns are addressed more fully in Part IV, infra, this Article demonstrates that tribal rent seeking is both morally acceptable behavior in its relationship with non-Indian economic partners and consistent with congressional intent.

17. “Efficiency” and “equity,” or ethical fairness, are treated as very general concepts in Law and Economics jurisprudence. Judge Richard Posner, perhaps the best known and most influential proponent of Law and Economics, defines the concept of an efficient transaction as a transaction where the added benefit to the party better off exceeds the loss, if any, to the party worse off. See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 14-15 (3d ed. 1986). This concept is known also as “Kaldor-Hicks” efficiency. See id. at 12. Concepts of distributive justice are left out of much Law and Economics literature because judgments regarding the proper distribution of wealth are considered inherently arbitrary and subjective. See id. at 436-39.


19. An “externality” is a cost external to the decisionmaking process of those involved in the transaction. See POSNER, supra note 17, at 62. For example, a company manufactures widgets and sells them to its customers for one dollar each. Unfortunately, the manufacturing process creates pollution that lowers the value of the surrounding area. If the company does not pay for the damage its pollution causes, it has no need to raise its widget price, and the customer has no need to pay the increased cost; thus, the cost of the production process is made “external” to the economic exchange.
the probable economic consequences of the different taxes. This section also
explains the phenomenon of "tax shifting," the ability of a taxed entity to shift the
cost of the taxes onto other parties. The possibility that a taxed party might be
able to shift the economic burden onto others creates a variety of incentives to
those affected by the transaction.

Through a basic understanding of the economics of resource extraction and
resource taxation, the reader can then understand the effects that different taxation
scenarios may have on a tribe which enters into development deals with private
parties. Whether a tribe enters into a development deal with a private party
ultimately determines, for now at least, whether a tribe will develop its resources.

Finally, Part IV demonstrates how tribal taxation advances tribal sovereignty
and economic welfare—the articulated goals of Congress—and how state taxation
of private developers of tribal natural resources impedes the goals of tribal
welfare and sovereignty in both obvious and insidious ways. The Article
ultimately concludes that Congress easily could remedy the current uncertainty
created in the case law by explicitly preempting such state taxation.20

II. TAXATION AND NATURAL RESOURCE DEVELOPMENT
ON INDIAN RESERVATIONS

The legal status of Indian reservations, tribal rights in reservation resources, and
the tax status of activity on reservations have all undergone a series of changes
over the course of the last century.21 Congress, in its role as trustee of tribal
interests,22 has developed most of the laws dealing with tribal natural resource
development,23 while the United States Supreme Court, in its role as monitor of
the scales of federalism, has been primarily responsible for developing doctrines
regulating tribal and states' rights to tax tribal resource development.24 In order

20. Some observers of the development of Indian law, and its effect on tribes as sovereign entities within
the United States, treat the economic welfare of reservations as a concomitant part of any sovereignty analysis.
See Wood, supra note 7, at 150. While this Article does not venture into competing theories of sovereignty or
the proper direction of Native Americans, their tribes, and their governments, it presumes that to the extent any
government acts on behalf of its constituents, its decisions reflect in some part the will of those citizens.
Admittedly, some commentators question the economic freedom tribal councils have in making decisions. See
id. at 157. In any event, to the extent that tribes wish to develop their natural resources, the focus of this Article
is to identify the legal regime that would best facilitate such efforts.

"federal Indian policy has always been the product of the tension between two conflicting forces—separatism
and assimilation—and Congress has never made a final choice as to which of the two it will pursue").

of a common-law trust are present: a trustee (the United States), a beneficiary (the Indian allottees) and a trust
corpus (Indian timber, lands, and funds"); Seminole Nation v. United States, 316 U.S. 286, 296 (1942)
(emphasizing "the distinctive obligation of trust incumbent upon the [Federal] Government in its dealings with
these dependent and sometimes exploited people").


24. See discussion infra Part II.C.
for the reader to understand the economic analysis in this Article, a description of tribal natural resource development and taxation follows.25

A. The Trust Relationship and Natural Resources Policy

Indian reservations exist at the sufferance of Congress.26 The relationship between Congress and Indian tribes can alternatively be characterized as a trust relationship, where Congress, acting through the Department of Interior and the Secretary of Interior (Secretary), fulfills the fiduciary obligations it owes to tribes,27 and as a relationship between two sovereign actors, with Congress as the dominant sovereign and tribes as the subordinate sovereign.28 These competing views of the federal-tribal relationship have created radically different policies. At times, Congress has pursued goals of assimilating Indians into the dominant culture by eliminating the reservation system;29 at other times, it has emphasized enhancing Indian welfare through strengthening tribal independence and self-sufficiency.30 Since the early 1960s, federal Indian policy has settled on the latter course.31

25. The following description of tribal natural resource development and taxation ignores significant issues of Indian law, particularly issues relating to the status of Indian lands that are not held collectively by tribes and those lands held by tribes in fee, i.e., lands that tribes own without any restrictions on alienation. Whether a state may tax tribal lands held in fee is beyond the scope of this Article. See generally Leech Lake Band of Chippewa Indians v. Cass County, 908 F. Supp. 689 (D. Minn. 1995) (holding that lands held in fee by a tribe may be taxed by the state); United States ex rel. Saginaw Chippewa Tribe v. Michigan, 882 F. Supp. 659 (E.D. Mich. 1995) (same). In addition, the laws regulating non-alienable lands held as allotments by individual tribal members are quite complex and are also beyond the scope of this Article. See United States v. Mitchell, 445 U.S. 535, 542 (1980) (holding that the General Allotment Act creates only a limited trust relationship between the United States and the allottee, and creates no duty on the former to manage the allottee’s resources). Both these types of property ownership are due to the vagaries of historical circumstance. Because neither of these forms of property ownership is significant in terms of tribal resource development, and each creates serious complications in the relevant economic analysis, this Article ignores them.


27. See Reid Peyton Chambers, Judicial Enforcement of the Federal Trust Responsibility to Indians, 27 STAN. L. REV. 1213 (1975). This relationship has been extended to other federal departments as well. For example, the 1992 IERA requires the Secretary of Energy to consult with Indian tribes “in a manner that is consistent with the Federal trust and the Government-to-Government relationships between Indian tribes and the Federal Government.” 25 U.S.C. § 3502 (1994).


30. See COHEN, supra note 1, at 127-206.

Congress has targeted industrial growth, and the development of energy resources in particular, as an integral part of its plan to solidify tribal independence. This policy goal, shared by the federal executive branch, has the interest of both the nation as a whole and tribes at heart:

With regard to energy resources, both the Indian tribes and the nation stand to gain from the prudent development and management of the vast coal, oil, gas, uranium, and other resources found on Indian lands . . . . [T]hese resources can become the foundation for economic development on many reservations, while lessening our nation's dependence on imported oil . . . .

It is the free market which will supply the bulk of the capital investments required to develop tribal energy and other resources.  

While some commentators are hostile, suspicious, or cynical of the effects of such a development policy, others emphasize the importance of improved economic conditions to future tribal independence and recognize the importance of resource development to tribal sovereignty.  Rather than weigh-in on this important debate, this Article is limited by the assumption that tribes interested in resource development know what they are doing.

B. Statutory Constraints on Reservation Resource Development

The law buttressing Congress's policy of tribal self-determination and self-sufficiency through resource development is best explained historically. Before 1938, no uniform federal policy or law controlled Indian natural resources. Rather, different federal laws applied depending on the resource being extracted, the status of tribal property, whether the tribal rights were created by Congress or the President, and in which state(s) the reservation was located. In addition to being complex, federal law authorized the Secretary to sell tribal resources without tribal consent. Increasingly after 1919, the Secretary acted upon this authority.

33. See generally Wood, supra note 7.
35. See generally Kevin Gover and Jana L. Walker, Escaping Environmental Paternalism: One Tribe's Approach to Developing a Commercial Waste Disposal Project in Indian Country, 63 U. COLO. L. REV. 933, 942 (1992) (decrying, as paternalistic racism, the assumption that tribal governments are less able to make intelligent development decisions than are other governments).
36. That same year, the Supreme Court held in United States v. Shoshone Tribe, 304 U.S. 111 (1938), that minerals underlying reservation lands were a constituent part of the land held in trust for tribes. This was an affirmation of the general policy Congress and the Secretary of the Interior (Secretary) had adopted for several decades. See COHEN, supra note 1, at 529-34.
38. See id. at 554-55.
39. See id. at 555-56.
In 1938, Congress passed the first comprehensive set of laws regulating Indian natural resources development. The Indian Mineral Leasing Act of 1938\(^40\) (1938 Act) established uniformity in lease transactions between tribes and private parties, and marginally increased tribal control over resource development. The primary method of leasing resources was the "competitive bid" system.\(^41\) The term "competitive bid leases" is a misnomer because all the lease terms were standardized and not subject to competitive bidding.\(^42\) Standardized terms included the length of leases, royalty rates, rental terms, and maximum size of tracts.\(^43\) Only the bonus term varied between leases.\(^44\)

Under the competitive bid system, a tribe would advertise the tract up for lease and the party offering the highest bonus payment for the lease would win the right to develop the resources, unless the bid was rejected by the Secretary.\(^45\) Tribes had no practical ability to vary terms or negotiate leases independently.\(^46\) In practice, tribal resources were not adequately advertised and bids far below the market value of the resource were accepted—a problem exacerbated by royalty and rental terms in the standard lease that were below market value and not adjustable.\(^47\) Moreover, a tribe's ability to rescind or cancel an inadequate lease was severely restricted; thus an "efficient breach" was not an available remedy for tribes.\(^48\)

Under the 1938 Act, the Secretary was delegated the trust responsibility to ensure tribes "the greatest return from their property."\(^49\) Among other responsibilities, the Secretary was required to ensure that only leases fair to tribes were approved, monitor the resource development under the leases, and make sure that tribes were paid all revenues due them under the leases.\(^50\) Complying with these trust obligations entailed substantial information and monitoring costs.\(^51\) As a result, the Secretary often fell short of his obligations.\(^52\)


\(^{42}\) See Royster, supra note 37, at 561.

\(^{43}\) See id. at 566.

\(^{44}\) See id.


\(^{46}\) See Royster, supra note 37, at 552-57.

\(^{47}\) See AMBLER, supra note 6, at 65-67.

\(^{48}\) See generally United Nuclear Corp. v. United States, 912 F.2d 1432 (Fed. Cir. 1990). An "efficient breach" is a breach where it would be in the economic interest of one party to breach the contract, pay the other party its expectation and incidental damages, and then recontract at a profit with another party. See William J. Woodward, Contractarians, Community, and the Tort of Interference with Contract, 80 MINN. L. REV. 1103, 1138-39 (1996).

\(^{49}\) H.R. REP. No. 75-1872, at 2 (1938).

\(^{50}\) See generally 30 C.F.R. § 218 (1996).

\(^{51}\) As discussed below in Part II.A.1.a., it is difficult, and thus expensive, to learn the value of an undeveloped resource and to determine the efficient, orderly, and fair development of the resource.

\(^{52}\) See AMBLER, supra note 6, at 56-58; Wood, supra note 7, at 140, 162-63. Until 1983, it was unclear whether tribes could sue the federal government for breach of its trust obligations in overseeing leases. See United States v. Mitchell, 463 U.S. 206 (1983).
More recently, the federal government has enacted two laws to correct some of the inadequacies of the 1938 Act. In 1982, Congress passed the Indian Mineral Development Act (IMDA). The IMDA gives tribes flexibility in negotiating leases and provides funds and technical assistance to help tribes bargain with sophisticated natural resource development companies. The IMDA also encourages tribes to enter into joint ventures and other natural resource development arrangements such as "service contracts" by which they can share in the risks and potential profits of the resource estate.

Ten years after enacting the IMDA, Congress passed the Indian Energy Resources Act of 1992 (IERA) to intensify its commitment to increased tribal involvement in resource development, specifically the development of energy resources. The IERA authorizes technical and financial assistance to tribes interested in vertically integrating energy development, and particularly emphasizes electricity production. The IERA also authorizes the creation of a commission to recommend to Congress proposals on tribal resource development.

In short, the IMDA and the IERA offer the promise of greater tribal control of, and involvement in, natural resource development. Additionally, the two acts could help tribes develop strategies for capturing a larger share of their resource wealth. Indeed, one important change in tribal resource development has already occurred: the move away from the rigid standardized leases of the 1938 Act to negotiated leases.

While negotiated leases are a substantial improvement over the 1938 Act's leasing system, fulfillment of the promise of optimized tribal resource development nonetheless appears to be in the distant future. So far, non-tribal resource developers have been largely unwilling to join tribes in alternative resource development schemes. Additionally, tribes possess neither the capital nor the technical resources to develop their natural resources by themselves, even after the passage of the IMDA and the IERA. Finally, because natural

55. See Royster, supra note 37, at 585-88.
57. A producer is vertically integrated when it is involved in more than one stage of production. For example, an electric company which mines coal for its coal-fired electricity generating plant is vertically integrated.
59. See id. § 3505; see also Royster, supra note 37, at 596-601.
60. See Judith V. Royster, Equivocal Obligations: The Federal-Tribal Trust Relationship and Conflicts of Interest in the Development of Mineral Resources, 71 N.D. L. REV. 327, 336 (1995) ("Although standard mineral leases under the 1938 Act are still available to tribes, they are little used today. Most tribes developing mineral resources now prefer the flexibility and potentially greater economic returns of mineral agreements under the [IMDA]."); see also AMBLER, supra note 6, at 85-117.
61. See Task Force No. 7, AMERICAN INDIAN POLICY REVIEW COMM'N, 94TH CONG., FINAL REPORT ON RESERVATION AND RESOURCE DEVELOPMENT AND PROTECTION 6-13 (Comm. Print 1976) [hereinafter FINAL REPORT]; see also Madeline Cohen, Note, A New Menu for the Hard-Rock Cafe: International Mining Ventures and Environmental Cooperation in Developing Countries, 15 STAN. ENVTL. L.J. 130 (1996) (describing the need for major capital infusion in large-scale mining ventures and the dangers of corporate colonialization associated
resource leases are long-term agreements, much resource development occurring today is probably still done within the inflexible regime of standardized leases made before 1982. Even in new negotiations, standardized terms are prominent and often constitute the structure, if not the dollar amounts, of the natural resource developer's first offer. Moreover, leaving revenue collection of royalty payments to the federal Mineral Management Service risks the dangers of mismanagement, and creates the appearance, if not the reality, of delegating a sovereign function—collecting revenue owed the tribe—to a federal entity.

As Part IV demonstrates, tribal taxation, by contrast, assists tribes in gaining more control over natural resource development within their reservations. Tribal taxation also enables tribes to receive a larger share of the return from their natural resources. However, current law tends to inhibit the most efficacious use of tribal taxing power.

C. Tribal and State Authority to Tax On-Reservation Natural Resources Production

Tribal taxing power is based on two distinct but interrelated legal theories: the right to exclude nonmembers from the reservation (which includes the lesser power to allow entry only upon fulfillment of a condition, such as consenting to tribal taxation) and inherent governmental authority to regulate activity within its jurisdictional boundaries. Of course, Congress may limit a tribe's taxing power, or specifically authorize regulations by which the tribe may tax. When taxing, tribes must act as sovereigns and provide governmental services to the taxed party for activities within their jurisdictions. There is, however, no rule of proportionality between the amount of taxes and the value of services provided.

All reservations are located within states, but tribes' sovereign status and federal protection limit states from imposing, within reservation borders, laws applicable to the rest of the state. Thus, federal Indian preemption and interference with tribal sovereignty are legal barriers to state taxation. As a

with such ventures). Although the FINAL REPORT predated the IMDA and the IERA, it seems unlikely that many tribes have developed the necessary capital and expertise to go it alone.

62. See Royster, supra note 60, at 335-38.

63. See Wood, supra note 7, at 162-63 (describing the Bureau of Indian Affairs' failure to properly account for revenues due tribes and to protect their interests in securing payment for the development of their resources).


65. See Cohen, supra note 1, at 434-35.

66. See Merrion, 455 U.S. at 158-59.

67. See id. at 158. The Supreme Court has made much of the distinction between a tribe as a commercial partner and a tribe as a sovereign to justify the additional compensation that tribes extract through taxing a transaction to which they are a party. See id. at 145-47; see also Kerr-McGee Corp. v. Navajo Tribe of Indians, 471 U.S. 195, 200 (1985). While from a political point of view this justification might be appropriate, it is not an economically tenable justification if the taxes imposed far exceed the value of governmental services rendered.

68. See Worcester v. Georgia, 31 U.S. (6 Pet.) 515 (1832); Cohen, supra note 1, at 259-70.

69. Federal Indian preemption differs from the general federal preemption analysis of situations where Congress has legislated in a particular area. See, e.g., Maryland v. Louisiana, 451 U.S. 725, 746 (1981) (stating
general rule then, states may not impose taxes on Indians for activity carried on within the reservation unless Congress has expressly authorized such taxes.70

While state authority to tax Indians for on-reservation activities is clearly restricted, courts struggle in determining when states can tax non-Indians for activities within a reservation and, particularly, when states can tax non-Indians for on-reservation economic transactions with Indians.71 Generally, courts have been willing to uphold state taxation on a transaction so long as the tax falls, as a "legal" matter, on the non-Indian.72 Whether the "legal incidence" of the state tax is one for which a tribe or its members are legally liable, or whether the tax may be collected only from non-Indians, has spawned a somewhat artificial doctrine.73 Nonetheless, the Supreme Court has demonstrated an unwillingness to venture away from the legal incidence test, leaving Congress to articulate explicitly the scope of preemption.74 The Supreme Court's treatment of state taxation of reservation activity has been unpredictable, in part because Congress has not given the Court clear guidance, and in part because the legal incidence of a tax is difficult to harmonize with the economic consequences of a tax.75

71. See, e.g., Salt River Pima-Maricopa Indian Community v. Arizona, 50 F.3d 734, 736 (9th Cir. 1995) (recognizing the many factors going into the preemption analysis of state taxes borne by non-Indians, "including: 'the degree of federal regulation involved, the respective governmental interests of the tribes and states (both regulatory and revenue raising), and the provision of tribal or state services to the party the state seeks to tax.'" (quoting COHEN, supra note 1, at 413)).
73. See Department of Taxation and Fin. v. Milhelm Attea & Bros., Inc., 512 U.S. 61 (1994); see also Salt River, 50 F.3d at 736 (listing factors to determine when the legal incidence of tax on the non-Indian is preempted).

Early in this century, the Supreme Court applied two other doctrines to preclude state taxation of non-Indians doing business with tribes: the federal instrumentality and the intergovernmental immunity doctrines. See, e.g., Gillespie v. Oklahoma, 257 U.S. 501, 505 (1922), overruled by Helvering v. Mountain Producers Corp., 303 U.S. 376, 387 (1938). In Gillespie, the Court found that treating non-Indian commercial partners as federal agents furthered the federal goal of making the best deal for its wards. See Gillespie, 257 U.S. at 504-07. Because the non-Indian commercial partners were treated as federal agents, they were cloaked with the federal government's sovereign immunity from state taxation. See id. As the Court stated in one opinion (echoing the strains of McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819)), "[a] tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them." Gillespie, 257 U.S. at 505. In the 1930s and 1940s, the Court diminished its use of the intergovernmental immunity doctrine and overruled the federal instrumentality doctrine. See Oklahoma Tax Comm'n v. Texas Co., 336 U.S. 342 (1949).

74. See Oklahoma Tax Comm'n v. Chicksaw Nation, 115 S. Ct. 2214, 2220-21 (1995). The history of the legal incidence test in Indian law derives from state attempts to tax federal contractors. See generally Washington v. United States, 460 U.S. 536 (1983) (holding that the federal rule prohibiting states from taxing the federal government directly or indirectly does not extend to an analysis of whether the taxed party can pass the tax on to the United States; a state tax of general application will not be struck down unless it discriminates against the United States or those doing business with it).
75. In Ramah Navajo School Board, Inc. v. Bureau of Revenue, 458 U.S. 832 (1982), a case in which the Court invalidated a state tax on the private construction firm hired by the Navajo Nation to build school facilities, the Supreme Court appeared to move away from a pure legal incidence test, noting that the economic burden of the tax would, as a practical matter, be borne by the tribe. While Ramah Navajo appears to downplay
Prior to the 1938 Act, Congress sometimes specifically permitted state taxation of tribal mineral interests. The Supreme Court did not decide that the 1938 Act preempted these earlier laws until 1985, and many states, in accordance with pre-1938 law, continued to tax lease transactions, including tribal royalty interests in reservation mineral production.

In 1985, in *Montana v. Blackfeet Tribe*, the Court held that the 1938 Act repealed Congress’s earlier permission to states to tax natural resources production from reservation leases, at least to the extent that tribes would bear the legal incidence of the tax. The Court thus created a two-step process for analyzing the permissibility of state taxation. First, a court must determine whether the legal incidence of the tax falls on a tribe, in which case the court should look for express congressional authorization for the state’s taxation. Second, if the tax falls on a non-Indian, a court must determine whether Congress intended to preempt the state taxation or whether the tax interferes with essential tribal sovereignty.

Issues of preemption become more complicated when a tribe and a state tax the same transaction. For example, in *Cotton Petroleum v. New Mexico*, a non-Indian producer challenged a tax regime under which the State of New Mexico taxed a developer approximately 8% of the sales price of its oil and gas production and the Jicarilla Apache Tribe taxed the developer another 6%. The tribe also was paid the standard 12.5% royalty on gross production revenues. The Court held that the state’s oil and gas severance tax and privilege tax on the non-Indian lessee’s production were not preempted by the 1938 Act, under which the leases were made, and were not invalid as an imposition on the tribe’s essential sovereignty. The Court further ruled that the state’s taxes were not otherwise barred because the state did provide some services both to the tribe and to the non-Indian producer. Finally, although the value of the state’s services equaled only a small fraction of the state taxes collected, no proportionality was required to justify the taxes.

---

79. See *Royster*, supra note 37, at 572 & n.203.
81. See id. at 766.
83. See id. at 142-45.
85. See id. at 169.
86. See id. at 168 n.3.
87. See id. at 193.
88. See id. at 173 n.9.
89. See id. at 185 & n.15.
Significantly, because the state taxes were assessed on the resource sales price after subtracting tribal royalties, the Court found no economic burden on the tribe and no impairment of the tribe’s ability to tax.\(^{90}\) While admitting that the state taxes would “impose[] some limit on the profitability of Indian oil and gas leases,”\(^ {91}\) and would “have at least a marginal effect on the demand for reservation leases,”\(^ {92}\) the Court approved the lower court’s determination that the indirect effect of the taxes on tribal revenue created no economic burden on the tribe.\(^ {93}\) The Court admitted that, while the 1938 Act was intended to help provide the maximum return for the tribal minerals, it was not intended “to remove all barriers to profit maximization.”\(^ {94}\)

The Court distinguished \textit{Cotton Petroleum} from a Ninth Circuit case which it had summarily affirmed the previous year. In \textit{Montana v. Crow Tribe},\(^ {95}\) the Court upheld the Ninth Circuit’s invalidation of Montana’s 30\% severance tax to the extent it applied to coal produced by a non-Indian lessee. The Ninth Circuit had concluded that the 30\% state severance tax, when combined with the tribe’s own tax, put the tribe’s coal at a competitive disadvantage to coal produced off the reservation.\(^ {96}\) By contrast, in \textit{Cotton Petroleum}, the 8\% New Mexico tax did not, as a factual matter, put the tribe’s resource at a competitive disadvantage.\(^ {97}\) Thus, non-tribal private parties contemplating entering into leases with tribes to develop natural resources could be subjected to taxation by both the state and the tribe.

Although the \textit{Cotton Petroleum} framework purports to consider the economic effects of the state taxation, it does so in a conclusory manner, never analyzing the economic realities facing tribes interested in natural resource development, and never comparing the economic consequences and burdens of different governments taxing an activity.\(^ {98}\) The Court’s analysis fails to reconcile the opposite outcomes of \textit{Cotton Petroleum} and \textit{Crow Tribe}, and, indeed, reconciling these two outcomes would be difficult.

The doctrine created by \textit{Cotton Petroleum}, in which the Court pays lip service to the economic impact of state taxes while actually hastening the demise of a strong preemption analysis, could have been otherwise. As described above, state taxes may be prohibited either by federal preemption or by incompatibility with tribal sovereignty. The Court has stated that these are “two ‘independent but

\(^{90}\) See id. at 191.
\(^{91}\) Id.
\(^{92}\) Id. at 197.
\(^{93}\) See id. at 186-87, 191.
\(^{94}\) Id. at 180. In a pointed dissent, Justice Blackmun (joined by Justices Brennan and Marshall) stated that he would have invalidated the state taxes for three related reasons: (1) the state taxed a producer engaged in developing natural resources on which the tribe’s future depended; (2) the 1938 Act’s central concern was tribal sovereignty and self-sufficiency; and (3) the state’s interest in taxing was little more than a desire to increase its general revenues at the expense of tribal economic development. See id. at 193-211 (Blackmun, J., dissenting).
\(^{95}\) 484 U.S. 997 (1988).
\(^{96}\) See Montana v. Crow Tribe, 819 F.2d 895 (9th Cir. 1987).
\(^{97}\) See 490 U.S. at 186-87.
\(^{98}\) See generally 490 U.S. 163.
related' barriers to the exercise of state authority over commercial activity on an Indian reservation.99 The barriers to state taxation are related because, in this area of overlapping sovereigns, tribal self-government as a federal interest provides the background by which one measures unclear federal enactments.100 Hence, the preemptive scope of federal law is determined with sensitivity to tribal government interests.

In White Mountain Apache Tribe v. Bracker101 and Ramah Navajo School Board, Inc. v. Bureau of Revenue,102 the Court recognized that neutral state taxes could not be levied on private contractors’ commercial activities with Indian tribes, noting, in contrast to the Cotton Petroleum decision, the economic impact on the tribe.103 Both of these cases, however, are based on federal preemption of the state taxes rather than on the impacts of the state taxes on tribal sovereignty.104

Had the Cotton Petroleum Court more closely examined the state taxes’ interference with tribal sovereignty, the economic impact on the tribal government might have been sufficient to disallow the tax. Conversely, had the Court considered Indian preemption in the spirit of White Mountain Apache and Ramah Navajo, keeping in mind the federal interest in tribal self-government and tribal economic development, it easily could have concluded that state taxes predicated on a “generalized desire to collect revenue”105 are always preempted by the 1938 Act and the extensive federal regime administering tribal mineral development.106 The conclusion has particular force where a tribe itself taxes the same transaction. After all, a tribe’s ability to tax is “an essential attribute of tribal sovereignty”107 and “an essential instrument of self-government.”108 As early as 1982, the Solicitor General of the United States suggested a similar approach by presuming that the dormant Indian Commerce Clause109 forbids state intrusion into a tribe’s on-reservation activities, even in the absence of comprehensive federal regulation.110

100. See White Mountain Apache, 448 U.S. at 143.
101. Id.
102. 458 U.S. 832.
103. See Ramah Navajo, 458 U.S. at 838-39; White Mountain Apache, 448 U.S. at 152. Justice Stevens dissented in both cases. In Cotton Petroleum, Justice Stevens authored the majority opinion and narrowly construed the federal preemption rule as applied in White Mountain Apache and Ramah Navajo. See Cotton Petroleum, 490 U.S. at 184-86.
104. See Ramah Navajo, 458 U.S. at 84; White Mountain Apache, 448 U.S. at 152.
105. Ramah Navajo, 458 U.S. at 845.
110. See Ramah Navajo, 458 U.S. at 845-46.
The Court, however, did not move in this direction,\textsuperscript{111} and we are left with a framework that requires courts to decide, on an ad hoc basis, whether a state tax on a non-tribal resource developer so interferes with essential attributes of tribal sovereignty that the tax cannot stand. This decision will be guided by economic factors. As the remainder of this Article explains, the proper analysis must consider, in a more dynamic fashion, factors in addition to those relied on by the majority opinion in \textit{Cotton Petroleum},\textsuperscript{112} (e.g., whether the state tax either contributes to a tribe's transaction costs or captures rents that otherwise would go to the tribe).

The balance of this Article investigates the economic effects the current dual taxing regime has on Congress's goals of tribal resource development,\textsuperscript{113} demonstrating how the Supreme Court's developing reliance on the legal incidence of a state tax creates economic outcomes that are repugnant to Congress's desire to enhance tribal self-sufficiency and self-determination through natural resources development.

\section*{III. THE ECONOMICS OF RESOURCE DEVELOPMENT AND TAXATION}

In order to appreciate the effects of the current Supreme Court doctrine created by \textit{Cotton Petroleum}, one must analyze the underlying economic realities informing the doctrine. Only by understanding the economics of natural resource development, as well as the relevant economics of taxation, can one appreciate the problems associated with the current state of the law.

\subsection*{A. Resource Development}

1. General Economics Underlying the Decision to Develop Natural Resources

Natural resource development, like other economic ventures, is geared to maximize return on capital invested. In other words, the party developing the resource is attempting to make as great as possible a profit on its investment. Development decisions are constrained by market demand for the resource and the costs of developing the resource. Where the resource producer already has property rights in the undeveloped resource, it should develop the resource if the expected discounted present value of the income stream\textsuperscript{114} from selling the resource, including a return on capital, exceeds the total time-discounted costs\textsuperscript{115}

\begin{footnotesize}
\begin{enumerate}
\item The \textit{Ramah Navajo} Court rejected this proposed course as unnecessary. \textit{See id.} at 846. Perhaps Justice Marshall, who authored the majority opinion in \textit{Ramah Navajo}, did not anticipate the application given his analysis in \textit{Cotton Petroleum}.
\item \textit{See discussion infra Part IV.}
\item The discounted present value of an income stream is simply the total value today of a flow of income received over time. \textit{See William J. Baumol & Alan S. Blinder, Economics: Principle and Policy} 543-44 (2d ed. 1979).
\item \textit{See id.}
\end{enumerate}
\end{footnotesize}
of developing the resource.\textsuperscript{116} If the resource developer already owns the property rights to develop the resource, the costs that drive the producer’s decision are the capital and labor costs of isolating, developing, and extracting a marketable product, and anticipated taxes.\textsuperscript{117} If the quantity or quality of the resource is unknown, or the price is unstable, a risk factor must be included in the calculation of the expected costs.\textsuperscript{118}

\section*{a. Factors Contributing to Complexity in Resource Development}

Natural resources development is more complex than the above model suggests for several reasons. First, extracted resources are nonrenewable. Therefore, the owner of a resource may be able to exert a certain amount of monopoly power and the producer may not face a horizontal (i.e., perfectly elastic) demand curve for its supply.\textsuperscript{119} This is particularly true when the market is relatively small.\textsuperscript{120}

Second, fixed development costs are usually very high, both in absolute terms and relative to variable costs, because a large amount of infrastructure usually must be developed before the resource is extracted.\textsuperscript{121} For example, a resource development decision involves incurring exploration costs and obtaining sophisticated technology and know-how, and creating transportation infrastructure from the often remote area where the resource is extracted to the market where it is sold.\textsuperscript{122}

Third, resource development entails a high degree of risk. Resource recovery often involves a large amount of uncertainty regarding the precise location, quantity, and quality of undeveloped reserves. There also are uncertainties arising from price volatility, a risk magnified by the length of time between the decision to invest and the time the resource is marketed. Added to this already high degree of risk are the unknown costs associated with future jurisdictional taxation

\begin{itemize}
\item \textsuperscript{117} Taxes on the producer can take a variety of forms, including severance taxes, paid by the producer at the point of extraction; or property or income taxes, paid by the producer on the leasehold or on gains from the production activity. Of course, taxes can be assessed not just on the natural resource producer, but can also take the form of an excise tax that is added to the price paid by the purchaser. As discussed in more detail below, both tribes and states prefer to tax the producer, who is subject to their jurisdiction, rather than the resource customer, who might not be directly subject to the tax. See infra Part III.B.2.
\item \textsuperscript{118} See generally Albert M. Church, \textit{Economic Rent, Economic Efficiency, and Distribution of Natural Resource Tax Burdens: Copper and Coal}, 22 \textit{NAT. RESOURCES J.} 559, 564 (1982) (discussing increased rate of return essential to accommodate risk).
\item \textsuperscript{119} A good is considered elastic if a small increase in price will cause a relatively large decrease in quantity demanded. Conversely, if a price increase of a good causes a relatively small decrease in demand, then the good is inelastic. Thus, demand for a good is perfectly elastic only if a marginal price rise would cause demand for the good to fall to zero.
\item \textsuperscript{120} Some resource markets are global (e.g., copper) and some are regional (e.g., coal), depending mainly on state regulation, transportation costs, and end uses. See generally Church, supra note 118, at 573-75 (discussing factors which determine the geographic scope of a resource’s market).
\item \textsuperscript{121} See, e.g., Cohen, supra note 61, at 136-38 (stating that mining requires substantial infrastructure development).
\item \textsuperscript{122} See, e.g., id.
\end{itemize}
and regulation of the resource development. These unknown costs are termed "sovereign risk." Developers may compensate for sovereign risk by asking for a higher return on their investment or requiring a shorter payback period on their investment. Resource development is thus not for amateurs; not surprisingly, many natural resource development industries are characterized by fairly tight oligopolies.

While natural resource development poses many risks, it also offers many rewards, including a large incidence of economic rent. Economic rent is generally defined as a return to the seller above costs, including a prescribed return on capital. In natural resource production, economic rent can be more specifically defined as a return on capital above that which the capitalist would accept from a venture of equal riskiness.

b. Economic Rents in Natural Resources Production

Economic rent in natural resources development can arise for a number of reasons. Each concentration of resources is unique. To the extent a resource can be extracted either today or in the future, the opportunity cost of extraction should, discounting for risk, be at equilibrium when the producer is indifferent to the timing of production because the value of the resource will be the same as the opportunity cost of all investments. In other words, if, in the short term, supply of a resource can meet demand, no rent will occur. In practice, however, natural resources have a scarcity value because property rights to all available resources are not preassigned or readily assignable—that is, a corporate customer cannot always get its hands on as much of a resource as it wants when it needs the resource, regardless of how much it is willing to pay. Thus, the property owner of a developed resource can capture rent in advance of potential scarcity.

Additionally, because some natural resources markets are regionalized, a resource owner is more likely to have a degree of monopoly power over the market. This monopoly power enables the producer to extract the resource more slowly than would be required in a competitive market. Slower production enables the producer to capture monopoly rents by selling above the competitive equilibrium price. This source of rent is especially prevalent in mineral extraction because the quality of the resource in the ground is not uniform and costs of extraction can vary. In a perfectly competitive market, a producer would need to produce at the efficient rate, that is,
at the rate where total costs of extraction equaled price. Because a natural resource monopolist does not have the same competitive pressures as a producer in a perfectly competitive market, it may choose to produce the most inexpensively recoverable ore or the highest quality ore—whichever will maximize profits.

This behavior captures rent because the returns actually obtained exceed those needed to induce the investment when the returns over the life of the mine were calculated. This production decision scheme is so common in mining that the industry has coined a name for it: “high grading.”

Economic rents from natural resources development might also occur due to good luck windfalls not taken into account when a producer initially determined the rate of return. Unanticipated windfalls can be of three types—discovery windfalls, market windfalls, and government policy windfalls. Discovery windfalls occur when quantity or quality of the natural resource found exceeds the probabilistic distribution of reserves anticipated when exploration began. Prominent examples of such bonanzas are the Klondike gold rush or the Alaska North Slope oil find. Market and government windfalls produce rents when unanticipated political or scientific events affect normal market equilibrium. Examples of these windfalls include the Arab oil embargo of 1974 or the mandatory use of catalytic converters in automobiles, which require platinum.

Finally, rents occur when involuntary or unpriced property exchanges occur, such as in forced sales between a resource owner and a resource producer. These can be thought of as unpriced externalities because the producer does not pay the full costs of its activity. When a producer is able to get a resource for less than the market price (for example through noncompetitive leasing of federal or Indian mineral rights), it gains rents from production. I would include in this category exchanges made through negotiations where the producer had superior knowledge of the resource, or was able to mislead the resource owner as to the actual value of the resource, which as a consequence, reduced the producer’s risk below that normally associated with development of the resource.

132. The point at which the quality of the resource becomes so low that it is economically unrewarding to develop—that is, when marginal cost exceeds marginal revenue—is called the “cut-off grade.” The cut-off grade will vary with the market price of the mineral. See Robert F. Conrad, Variable Rate Severance Taxes: Impact and Incidence, 22 NAT. RESOURCES J. 527, 528 (1982).

133. See Church, supra note 118, at 564-65.


135. Note again that the higher returns required to attract capital to natural resource production because of the riskiness associated with the activity are not rents. See GARNAUT & ROSS, supra note 123, at 33-34.

136. See Church, supra note 118, at 564.

137. Some economists do not consider discovery windfalls to be true rents because future exploration and development decisions are based on probabilities ascertained through past experience. Hugely unexpected returns must be combined in the distribution matrix with all exploration efforts that turn out to be busts. An alternative term for discovery rent is “quasi-rent.” See GARNAUT & ROSS, supra note 123, at 33-34.

138. See Church, supra note 118, at 564.

139. See id.

140. See POSNER, supra note 17, at 12-15.

141. See AMBLER, supra note 6, at 66-67.

142. High grading also can create production rents for the developer if the party selling the resource rights
2. The Economics Underlying a Tribe's Decision to Develop Its Resources: A Transaction-Cost Analysis

As discussed above, Indian tribes traditionally have not developed their own resources, but have sold their property rights to large natural resources development firms. Today, the rights to undeveloped natural resource reserves are sold by tribes in exchange for a fixed percentage of the gross revenue received by the developer when the resource is sold. These rights are termed "royalties." The transactions are usually efficient exchanges because private companies specializing in natural resources development can develop and market the resource more efficiently and competitively than could a tribe, and tribes prefer the revenue to leaving the natural resource in the ground.

Coase's Theorem provides a good model for determining whether a tribe—as an economic actor—will sell its natural resources to a producer. The theorem posits that in the absence of transaction costs, property rights will be transferred to their most efficient use—that is, to the party that most highly values them. If, however, transaction costs accompany the transfer, exchanges will be made only if the gains from the trade exceed the costs of the transaction. This reasoning is a central tenet of the transaction-cost economics approach.

Tribes face a number of obstacles once they do decide to venture into a natural resources development arrangement with a private entity. Because natural resources development involves substantial initial capital investment and a high amount of risk and uncertainty with respect to the value of the undeveloped natural resources, making informed investment decisions requires both the tribe and the potential developer to invest a fair amount in initial information costs. Moreover, because each natural resource deposit and each development situation to the developer is paid a flat sum for the right at the outset instead of as the mineral is extracted. The high grading produces rent because the seller does not share in the extra returns received by the developer, although it expected to when it entered into the agreement. See Church, supra note 118, at 565.

143. In the last subsection, the property right(s) to the resources was not an economic consideration in the production decision to the extent that the party developing the natural resource reserve also owned it. If tribes developed their own natural resources, this Article would be unnecessary. Tribes presumably would not tax themselves, and states are severely limited in their ability to tax tribes or their members directly for activity on a reservation. See McClanahan v. Arizona State Tax Comm'n, 411 U.S. 164 (1973).

144. See supra notes 8-11 and accompanying text.

145. This of course assumes that economic returns are compatible with other attributes of tribal cultural goals. See Jane B. Baron & Jeffrey L. Dunoff, Against Market Rationality: Moral Critiques of Economic Analysis in Legal Theory, 17 CARDOZO L. REV. 431, 434-44 (1996) (describing how environmental ethics may be incommensurable with economic analysis approaches); see also supra note 7.

146. What has become known as "Coase's Theorem" was first articulated in Ronald H. Coase, The Problem of Social Cost, 3 J. L. & ECON. 1 (1960).

147. See id. at 15-16.

148. See id. at 15. Some critics of Law and Economics point out that in the transaction-cost economics universe everything must be reduced to actual or potential commodities, and find this an unhelpful, indeed noxious, enterprise. See Margaret Jane Radin, Market-Inalienability, 100 HARV. L. REV. 1849, 1860 (1987). This critique complements the scholarship of indigenous peoples who criticize the spiritual vacuum of the industrial model of tribal development. See supra note 7.
is unique to a certain extent, contract flexibility is valuable and most leases are negotiated rather than competitively bid.  

Two-party negotiations also have significant transaction costs. Usually both the resource owner and the potential resource developer incur information costs about each other and about the resource, and each has, in a sense, a monopoly position with respect to the exchange. This creates the possibility of "bilateral monopoly" bargaining problems.  

I should emphasize that the term "bilateral monopoly" does not refer to an absolute monopoly in the classic sense that there are no competitors in the market. Rather, it refers to the case where, because of the parties' unique positions as negotiations proceed, neither party faces competitive pressures and the two parties are, to some degree, forced to deal with each other. In the case of the resource owner and the resource developer, each can provide the other a bargain that others cannot: the resource owner will have problems finding other developers who will commit to the exploration and planning efforts (costs) that its negotiation partner already has taken; the developer cannot abandon the negotiations without losing its information investment, and finding a new natural resource deposit may be just as difficult and expensive. Thus, each party gains a form of monopoly power over the opposing party's investment because each will be reluctant to abandon a transaction into which it has already placed a great deal of effort. The lack of competitive pressure provides both parties a wide latitude in bargaining by which each can try to capture the majority of the gains from the transaction.

In its attempt to capture the gains from trade, each party will adopt different bargaining strategies. Not only are the mechanics of this bargaining expensive, but negotiations may break down, and even economically efficient exchanges will not be consummated. In a bilateral bargaining situation, each party might adopt its optimal strategy against an array of possible opponent strategies, yet the same strategy might fail against any particular opponent strategy, thus creating an impasse. Moreover, if one party determines during negotiations that it cannot

149. This was a shortcoming of the 1938 Act which the IMDA was specifically intended to address. See H.R. REP. No. 97-746, at 4-5 (1982).

150. See Stewart E. Sterk, Neighbors in American Land Law, 87 COLUM. L. REV. 55, 69-76 (1987) (explaining market failures associated with bilateral monopolies; these failures are caused primarily when both parties are so determined to capture the lion's share of the gains of trade that efficient transactions are frustrated).

151. See id. at 70.

152. To give a familiar example, take the case of buying a used car. After expending time in researching different cars and going through grueling negotiations with the salesman, the would-be buyer takes the car to her mechanic. Thereafter, the salesman raises the price; only now does the buyer realize that she has put the salesman into a monopoly position with respect to this car. Because of the amount of time and money she has expended, the rational buyer may purchase the car at a higher price than others would.

153. Natural resource developers and tribes have additional bargaining pressures to consider. The natural resource developer is a very important source of employment on reservations, both directly in the labor it hires and indirectly through employment caused by increased economic activity in and around the reservation. Thus, from a tribe's perspective, a tribal hiring preference is an important Indian demand in negotiations. See Royster, supra note 60, at 361; 25 C.F.R. § 274.38 (1982) (section removed Sept. 1996) (Bureau of Indian Affairs may require contracts to contain clauses giving Indian workers preferential treatment).

154. See Sterk, supra note 150, at 71; see generally DOUGLAS BAIRD ET AL., GAME THEORY AND THE LAW
get a good deal, it may opt out of the bargaining altogether, concluding that the costs of negotiation are likely to outweigh its share of benefits. The long-term contract is one device that can minimize the expense of bilateral negotiations. By spreading the negotiation costs over the longest possible transaction, the parties can reduce the inefficiencies of negotiations as a proportion of economic benefit from the exchange. Hence, not surprisingly, most natural resource development leases have very long durations, often with terms of twenty or more years. Long-term contracts themselves can cause problems between parties because the long-term contract is risky to both parties and this risk translates into higher transaction costs (and demands of a higher rate of return). To minimize this risk and to accommodate changes over time, long-term contracts often contain “most-favored-nation” clauses, indexed price-escalators, and contract term reopeners. Economists have concluded that the transaction-cost theory best explains the need for these complex contract terms. These terms require sophistication to draft and time to negotiate.

In sum, natural resources development is a high stakes and complex industry. Although the preceding principles of market and exchange behavior are not unique to natural resources development, this industry’s requisite large capital investment, high degree of risk, and possibility of earning rents cause transaction costs to be substantial. The complexity and importance of transaction costs are thus factors for a taxing jurisdiction to consider when contemplating the effects of its tax regime.

B. Economics of Taxing Natural Resources Development

Tax policy is guided by two separate goals: allocative efficiency and tax shifting. When tax decisions are based on allocative efficiency, the taxing
body tries to minimize the market distortions caused by the tax.\textsuperscript{161} Tax shifting decisions, on the other hand, focus not on the macroeconomic efficiency of the tax, but on the tax's economic effects on particular groups.

1. Distortion Effects of Taxation

In a simplified neoclassical economic model, under free and perfect competition (that is, without government intervention or firms with monopoly power), forces of supply and demand will cause price and quantity to reach an equilibrium point where consumer welfare is maximized.\textsuperscript{162} If a tax is imposed either on the production of the good or on its price, however, both the price and quantity of the good will be altered (assuming that demand is not perfectly inelastic).\textsuperscript{163} If the government does not spend the tax revenues in the exact same way consumers prefer, a "tax distortion" is said to occur.\textsuperscript{164} The distortion exists because, in a perfectly competitive free market, consumers demand an amount of each good corresponding to the marginal utility of the good and producers supply each good at a perfectly competitive price.

Under a neoclassical economic model, tax distortions are disfavored. If a tax is imposed on producers of one good, the supply curve will shift upwards (i.e., the cost of the good will increase at all quantities of output) and consumers will demand less of that good and substitute a different good with lower utility (which now appears relatively more attractive).\textsuperscript{165} Tax distortions lower society's total utility or benefit by causing people to consume less of the taxed good than they otherwise would and more of the substitute good than they otherwise would consume.\textsuperscript{166} Producers, accordingly, would oversupply the non-taxed good relative to the taxed good.\textsuperscript{167}

One exception to the problem of tax distortions is the tax on economic rents. By definition, economic rent is earnings above the earnings necessary to induce producers to supply a good (their opportunity cost).\textsuperscript{168} Thus, if the tax on

\textsuperscript{161} Tax shifting refers to determinations of who ultimately bears the burden of the tax. See id.

\textsuperscript{162} See Church, supra note 118, at 559-60.

\textsuperscript{163} See id. at 560-61.

\textsuperscript{164} If the tax is added, for example, to the price of the good itself, the total quantity demanded at the new price will be lower than at the old price and total revenues to the supplier will drop (assuming the supplier was producing at the efficient level in the first place). If the tax is imposed directly on the supplier, its marginal costs will rise, and because the quantity produced is determined by the point where marginal costs equal marginal revenue, less will be produced than at the initial price.

\textsuperscript{165} See Church, supra note 118, at 559-60.

\textsuperscript{166} See id. at 566.

\textsuperscript{167} For example, assume that the costs of producing and marketing apples and pears are the same, and that the market for fruit is perfectly competitive. If a 100 percent tax was added to the price of apples and the price of other fruit remained unaltered, consumers would eat fewer apples and more of other fruit, including pears. Apple producers would receive less revenue and shift production to meet demand for other fruit. Because consumers' tastes have not changed, consumers lament their loss of enjoying apples. The tax has diminished social benefit, conceived in purely economic terms.

producers only captures rents that the producers would otherwise keep, the producers, theoretically, would be willing to supply the same amount of a good at the same price and still receive an acceptable rate of return on their investment. Because the price would remain the same, the supply curve would not shift up and no distortion would occur. Unfortunately, it is not easy to impose a tax only on rents. It is difficult to determine before imposing the tax what part of a producer's profits are rents as opposed to a normal rate of return, because normal profit rates vary depending on the anticipated risk associated with the venture.\textsuperscript{169}

Most taxes have some distorting effects and thus reduce total economic efficiency.\textsuperscript{170} Such inefficiencies may be justified if counterbalanced by other social benefits, such as provision of public or collective goods, or wealth redistribution.\textsuperscript{171} The social welfare aspects of tax decisions obviously must be considered in any taxing calculation.

2. Burden Shifting Effects of Taxation

Tax shifting is concerned with who pays the tax.\textsuperscript{172} Once society accepts a certain amount of economic inefficiency as the price of achieving other social goals, the economic burden (or “incidence”) of a tax becomes an important policy decision. The economic incidence of a tax on a particular good will be determined by the method or type of taxation and on the short and long-run elasticities of the supply and demand curves for the good.\textsuperscript{173}

Tax shifting is particularly important if the taxing jurisdiction does not encompass the entire market. For example, if all of a good is consumed within the taxing jurisdiction (say a state) and there is no viable supply from outside the state, economic distortion would occur only within the state. The state could then reallocate the tax revenues to counterbalance the inefficiency. If, however, the taxed good is consumed outside of the taxing jurisdiction, and the producer is able to pass along some of the additional tax cost to its customers, out-of-state customers would effectively pay some of the tax. To the extent that a state receives revenues from out-of-state sources, where it has no obligation to provide

\textsuperscript{169} See GARNAUT & ROSS, supra note 123, at 34.

\textsuperscript{170} One should note that taxes which initially appear to reduce welfare might actually have the opposite effect of internalizing externalities, i.e., forcing the parties to the transaction to pay for the costs that otherwise would have been borne by third parties. For example, surface mining laws require producers to pay a per unit tax on production. See, e.g., 30 U.S.C. § 1232 (1994) (coal mining). The proceeds from the tax go into a fund that is used to reclaim the mined land when mining is completed. See id. § 1231. These taxes, if properly calculated, do not produce distortion effects and could be considered to be capturing rents the producer was making from externalizing costs. Such indirect regulation can be particularly beneficial to tribes who lack enforceable control over externalities caused by private developers. See Harbison, supra note 34, at 349.

\textsuperscript{171} States justify severance taxes on other grounds. They claim that severance taxes are compensation for depletion of non-renewable state resources. See Ronald Kaiser & James Fletcher, State Policies and Practices in Coal Severance Taxation, 27 NAT. RESOURCES J. 591, 596-97 (1987). To the extent that a state owns the resources that are being depleted, this justification makes sense. But if a competing sovereign, such as a tribe, has a superior claim to the resource, this justification is less persuasive.

\textsuperscript{172} See Church, supra note 118, at 568.

\textsuperscript{173} As noted earlier, the economic incidence of a tax denotes the party to a transaction or series of transactions who is unable to pass along the burden of the tax. The legal incidence of the tax is merely concerned with the party that is legally responsible for a tax at the outset.
governmental services, it is engaged in "tax exporting." States always will try to export taxes because the additional revenues to the state government can be distributed to its citizens, who in effect receive a net gain from the tax.

Natural resources production is particularly susceptible to tax exporting policies because natural resource deposits are immobile. This allows the state to tax the natural resource production activity knowing the producer cannot simply move its operation outside the taxing jurisdiction, as it otherwise might be able to do to escape the tax.

Nevertheless, tax exporting can bring unintended negative consequences for the taxing jurisdiction. For example, if a taxed good has a high demand elasticity (i.e., consumers will substitute other goods given a relatively small increase in price), the tax will put in-state producers at a competitive disadvantage to out-of-state producers who are not subject to the tax, and will reduce demand for the in-state producers' product. As the in-state producers sell less, the state's tax revenues drop. Moreover, the producers might have to cut costs, perhaps by reducing wages or laying off workers. Underpaid and unemployed workers, in turn, can cause additional demands on state services.

Additionally, by imposing the tax, the state may forego benefits that would have occurred absent the tax. Greater amounts of economic development, which ostensibly would occur absent the tax, create positive externalities or benefits that themselves can indirectly affect tax revenues. For example, increased production enhances economic activity that, in turn, increases payrolls and local expenditures. A portion of these expenditures can be captured by the state through other taxes. Of course, benefits from the new economic activity must be balanced against the negative externalities of increased production, which might include increased environmental damage and "boomtown effects" once the resource is depleted and jobs cease to exist. But, then again, tax revenues from the activity might be used to offset these costs.

A per-unit tax on a natural resource can be shifted forward to purchasers or backward to the inputs of production, particularly a producer's employees and

176. A prominent example of states chasing economic development with tax breaks is the decision by Alabama to grant Mercedes Benz over $250 million in tax incentives to locate an auto plant in the state. See E.S. Browning & Helene Cooper, Ante Up: States Bidding War over Mercedes Plant Made for Costly Chase, WALL ST. J., Nov. 24, 1993, at A1, available in WESTLAW, WSJ database, 1993 WL-WSJ 674798.
177. See Kaiser & Fletcher, supra note 171, at 596-97.
178. Taxes on resources by one jurisdiction in a market affect the entire supply within the market, and the distortions can have a ripple effect. For example, if one state taxes coal produced within it, all competing coal has a price advantage. This marginal advantage can be considered a governmental windfall rent to the out-of-state producers and other jurisdictions have the incentive to tax the surplus away. If all jurisdictions impose taxes, all coal prices will rise. However, if the first jurisdiction was taxing only rent, this general price rise due to the taxation will not have distorting effects. This could explain why western coal-producing states, whose coal has been thought to produce rents, responded to Montana's 30 percent severance tax by raising or imposing their own coal taxes, rather than attempting to capture a portion of Montana's market share by keeping taxes low. See Shelton & Vogt, supra note 175, at 550.
This shifting is independent of the existence of rent in the particular activity; tax shifting considerations exist regardless of the economic efficiencies or inefficiencies of the transaction. If rent exists, the question becomes: from whom is the rent being taxed away? It is possible that, absent the tax, consumers might be capturing rent—that is, paying less than they would have been willing to pay for the same quantity. Similarly, the providers of the inputs of production might be enjoying the rents: labor, through above competitive wages; capital, through an above normal return (even after accounting for risk); and land, through a higher than necessary return on the sale of the resource. In any event, a tax falling purely on rents should not cause product substitution and the accompanying economic distortions described above.

IV. EFFECTS OF TRIBAL AND STATE TAXES ON RESOURCE DEVELOPMENT AND FEDERAL INDIAN POLICY

A tribe that wishes to develop its nonrenewable natural resources almost invariably must contract with non-Indian developers. Because the tribe is both the property owner of the resource and the sovereign within the boundaries of the reservation, it can receive revenue for parting with its resources in two ways: royalties and taxes. The primary difference between these two revenue sources is that royalties are explicitly negotiated with the developer while taxes are ostensibly unilateral and do not require the developer's consent. In reality, economic forces tend to collapse this distinction, and to the extent this distinction exists, the differences might actually reduce transaction costs.

Allowing tribes to receive returns from selling their resources through taxes, rather than through negotiated royalties, might have two distinct effects. First, tribal authority to tax could reduce transaction costs associated with exchanges of natural resource rights. Second, a tax on natural resource production could

---

179. See id. at 539-40.
180. See id. at 556-57.
181. See generally Church, supra note 118, at 563-65 (discussing sources of rent and ways that different parties capture rent).
182. See id. at 560.
183. See supra notes 7-11 and accompanying text.
184. As a legal matter, tribes receive royalties in exchange for selling their natural resource rights and also receive tax revenues in return for governmental services provided to the lessee within the reservation. See Merrion v. Jicarilla Apache Tribe, 455 U.S. 130, 145-47 (1982). But, from an economic standpoint, these legal distinctions are of marginal significance because there is no proportionality requirement between the revenue a sovereign receives in taxes and the value (or cost) of the services it provides the lessee. See Cotton Petroleum v. New Mexico, 490 U.S. 163, 190 (1989).
185. There are other mechanical differences between the two methods. Royalties are calculated by and paid to the Mineral Management Service, an agency within the federal Department of Interior and which works on behalf of tribes, while taxes are calculated by and paid directly to tribes. See 30 U.S.C. §§ 1701-1757 (1994); 30 C.F.R. pt. 218 (1996).
186. Courts, at least in the Ninth Circuit, have noted the fungible nature of recovering revenue from a resource through royalty or taxation. See, e.g., Peabody Coal Co. v. Navajo Nation, 75 F.3d 457, 469 (9th Cir. 1996); Montana v. Crow Tribe, 819 F.2d 895, 899 (9th Cir. 1987).
187. See discussion infra Part IV.A.
188. See discussion infra Part IV.A.
capture economic rents that a tribe might otherwise lose to a non-Indian developer or the resource consumer.¹⁸⁹

For macroeconomic and social policy reasons, tribal natural resource taxes are superior to state taxation of the natural resource. First, because tribes have more incentive to avoid taxing non-rent returns from the natural resource production than do states, it is less likely that tribal taxes will cause allocative inefficiencies or market distortions. Second, while both state and tribal taxes tend to cause tax exporting, tribal tax exporting is not as prominent and tends to be progressive because the tax probably will be borne by wealthier persons (i.e., residents of states); conversely, state taxes on tribal resource development tend to be exported, at least in part, to the Indian reservations, and are thus generally regressive because reservation inhabitants, as a whole, are likely to be less wealthy than their state counterparts.¹⁹⁰

A. Tribal Taxes Can Reduce Transaction Costs

Currently, tribal natural resource rights are leased to non-Indian developers through bilateral, negotiated agreements. Tribes tend to be wary of dealmaking under these circumstances for a variety of reasons. First, natural resources producers have superior technical abilities and usually come to the negotiating table knowing more about the quantity, quality, and location of the natural resource deposit than tribes do.¹⁹¹ Second, development companies are repeat players in the bargaining game and their negotiators are often more experienced and sophisticated than the tribes' negotiators.¹⁹² Understandably, tribes are wary of concluding long-term agreements involving their most valuable economic resources if they believe that they might be sold at too low a price, or that developers will capture rents they will not share with the tribes.¹⁹³ If a tribe feels that it faces only a small probability of capturing a large part of the value of its resource, it might opt out of negotiations altogether, even if the exchange would have been efficient.

Moreover, both tribes and developers might be constrained in their negotiating positions. Prior to 1982, almost all Indian mineral lease terms, including royalty rates, were standardized and relatively inflexible.¹⁹⁴ Since the 1982 passage of

¹⁸⁹. See discussion infra Part IV.B.
¹⁹⁰. See supra note 3.
¹⁹¹. See, e.g., AMBLER, supra note 6, at 66. This is, of course, not invariably the case. For example, the Navajo Nation has a well-developed and sophisticated natural resources division, including geologists and hydrologists. Moreover, the Council of Energy Resource Tribes, headquartered in Denver, Colorado, provides its members with economic and scientific expertise.
¹⁹². Again, this is not always true, particularly in the case of tribes such as the Navajo Nation that have repeated experience in negotiating resource contracts. If negotiations can be thought of as games of skill, repeat players gain efficiency through negotiation. See BAIRD, supra note 154, at 79-113.
¹⁹³. The percentage royalty system allows tribes to share in price increases and in economic rents. Still, if the royalty percentage remains constant, and if the price rises unexpectedly (causing rents) or the value of the property rights increases (causing rents), resource developers gain an increasingly higher proportion of the rents than do tribes. (I am indebted to Paul Cort who demonstrated this point to me through the use of a mathematical equation.)
¹⁹⁴. See supra notes 40-46 and accompanying text.
the IMDA, tribes and developers have had greater flexibility in structuring leases. However, because drafting new terms from scratch can be expensive and time consuming, and because some parties are familiar with pre-IMDA terms, pre-IMDA terms tend to be the starting positions for many negotiations. While future negotiations may be less likely to be conducted in the shadow of 1938 Act terms, contract flexibility is subject to other constraints.

“Most favored nation clauses” and other linked contract terms also can inhibit developers from varying a proposed contract’s provisions. A resource owner that has a “most favored nation” clause in its contract has the right to the same beneficial price that the developer may give to a later-contracting resource owner. Thus, if a producer modifies a formerly standard term of a lease with one tribe, it might be obligated to modify leases with other tribes enjoying most favored nation clauses.

Tribal taxation is one way to overcome such difficulties. Tribes who are able to tax natural resource production in addition to receiving royalties may be more willing to strike a deal in the face of uncertainty. Tribal taxation also allows tribes to protect themselves in case the contract terms are below market in the long term or if producers are capturing substantial rents from a natural resource.

Finally, a tribe’s power to tax also gives it valuable leverage in creating incentives for existing lessees to renegotiate standard leases made under the old 1938 Act. In short, because the terms of a contract will be less important to a tribe if it can gain revenues from its resource(s) outside of the contract, negotiation costs could be reduced.

While the non-Indian lessee will be wary of subjecting itself to the unilateral imposition of taxes, it can protect itself in at least two ways. First, the lease could include a tax-royalty cap prescribing a maximum percentage of revenue that can go to the tribe. This would limit the lessee’s exposure to sovereign risk, at least as far as the tribe is concerned. Second, a lessee can exert a

195. Familiarity with a certain system, such as the system for reaching natural resources leasing agreements on tribal lands, may lead to employing the system in future situations. This principle is termed a “positive network externality.” A positive network externality exists where user familiarity or compatibility with a certain system makes that system more valuable than it would be on its own. For example, because the DOS computer operating system was made so widely available during the embryonic stage of personal computing, consumers and software manufacturers became more familiar with that system and it soon displaced the Apple computing system as the standard computing system, even though the Apple system had some advantages over the DOS system. The DOS system thus gained efficiencies unrelated to its intrinsic design. See generally Marcel Kahan & Michael Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior, and Cognitive Biases, 74 WASH. U. L.Q. 347, 350-54 (1996).

196. See Royster, supra note 60, at 336.


199. The long term coal contracts between the Navajo and Hopi tribes and the Peabody Coal Company contains such a tax-royalty cap. See Peabody Coal Co. v. Navajo Nation, 75 F.3d 457, 469 (9th Cir. 1996).

200. Tax caps also eliminate sovereign risk by establishing a limit beyond which a tribe may not tax. A tax cap thus provides lessees more certainty in development decisions. See Logue, supra note 16, at 1148-49 (governmental precommitment produces social and economic benefits from creating settled expectations,
tremendous amount of economic pressure on a tribe to ensure that excessive taxes are not imposed on the lessee when the lessee cannot pass the taxes on to its customers. Natural resource developers constitute a major source of direct employment and create demand for tribal services on many reservations. If the lessee can pass the tax on to its customers (because the consumer is capturing rent through paying below market prices), then no change in production should occur. If, however, the tax cuts into the lessee’s normal profits, then production would be reduced. A reduction in production would impact tribal returns from the resource development through lower tax revenues, as well as lower royalty revenues and lower economic activity on the reservation. Admittedly, tribes often will manage to export their taxes in the short run, but in the long run only taxes on rents will be captured without affecting the level of reservation revenue.

To the extent there is an absence of legal controls on tribal taxation, contractual and economic considerations provide developers a nonjudicial mechanism to control any potential tribal excesses. Because there are external controls on tribal taxation, natural resources producers should be willing to subject themselves to potential tribal taxation.

B. Tribal Tax Captures Economic Rents from Tribal Resources

Tribal taxes on natural resources generally are of two types. The first type is a severance or value added tax, and is assessed as a flat amount per unit or, more commonly, as a percentage of the final sales price. The second type of tax, which generically could be termed a property or leasehold interest tax, is assessed as a percentage of the value of the property interest held by the non-Indian developer.

The severance or value added tax, if paid initially by the developer, raises production costs. If the producer has not been capturing rent, it will be forced to pass the cost on to its customers. The increased price should cause the quantity demanded to decrease, at least marginally, in the long run. However, because customers might be unable to shift demand away from their normal

201. See AMBLER, supra note 6, at 75-76 (stating that “thousands” of Navajos have earned good incomes as miners).

202. See discussion infra Part IV.B. An additional restraint on excessive tribal taxation is the ability of the Secretary, in many cases, to approve any new tribal taxation. See Merrion v. Jicarilla Apache Tribe, 455 U.S. 130, 155 (1982).


204. There are many methods of taxing resource development. See generally ALBERT M. CHURCH, TAXATION OF NONRENEWABLE RESOURCES (1981).

205. See generally id. at 16-17, 71-74; see also David Redhorse & Theodore R. Smith, American Indian Tribal Taxation of Energy Resources, 22 NAT. RESOURCES J. 659, 663-66 (1982).


207. Because natural resource purchasers usually (but not always) reside outside a tribe’s taxing jurisdiction, the lessee, on whom the legal incidence of the tax falls, will pay the tax in the first instance, unless it has contracted with its customers to pass the tax costs on to them.
supplier to competitors or to substitutes due to contractual or transaction cost restraints, the quantity demanded might not decrease at all in the short run.\textsuperscript{208} Of course, if the tax captures rent the producer was not sharing with the tribe, the producer might not increase price or shift to other ventures because the rate of return on capital would still exceed the alternative rates of return it faced. Moreover, if the producer is capturing rent it may choose to avoid raising prices even if short run demand is inelastic (i.e., even if a price increase would not proportionally reduce the quantity demanded),\textsuperscript{209} because the producer might not want to encourage customers to make preparations that will allow them to shift demand in the future.\textsuperscript{210} Whether the producer will pass along the costs of a severance tax to its customers without a corresponding drop in demand is thus a function of both the elasticity of the demand curve and whether the producer is capturing economic rents.\textsuperscript{211}

The property-type tax captures rent in a manner different from the severance or value added tax. Property-type taxes are usually determined by assessing the net value of the leasehold interest, (a type of "going concern" valuation) measured by calculating the present value of the natural resource in the ground and subtracting the discounted anticipated costs associated with developing and selling the resource.\textsuperscript{212} If anticipated profits increase, the tribe shares in them through the leasehold tax. To the extent that the developer enjoys profits above those it can receive elsewhere, there will be no distorting effect from the tax.\textsuperscript{213}

Regardless of whether a tribe's natural resource reserves are generating economic rents, tribal taxes do tend to be exported, at least in the short run. The taxes are exported in two different senses, though. True tax exporting occurs when the taxes are passed on to the lessee's customers off-reservation. To the extent that the customers' demand curve for the tribal natural resources is

\textsuperscript{208} If the customer is a large coal-fired power plant, for example, it could face such obstacles.

\textsuperscript{209} It is intuitive that the supply curve for the natural resource producer is quite inelastic because shifting capital resources used in resource extraction is nearly impossible and a short run substitution of alternative sources of supply is not feasible.

\textsuperscript{210} For example, in the short run, a coal-fired power plant will have to buy the higher-priced coal—it is an economic hostage. \textit{See generally} Oliver E. Williamson, \textit{Credible Commitments: Using Hostages to Support Exchange}, 73 \textit{AM. ECON. REV.} 519 (1983) (describing techniques parties adopt to avoid having to settle disputes in court). But if the plant anticipates long-term coal prices above the cost of long-term substitutes like natural gas, it may convert its operations so that the it can substitute natural gas to fire the plant.

\textsuperscript{211} Consumers might be enjoying rents that the resource producer can control. For example, a natural resource developer might be high grading its mining production and selling to customers below the market price. In this situation, the customers are capturing the rents from the low sales price. After the tax, the consumers are forced to pay a price closer to the market price. Conversely, the developer might be controlling the market price by limiting its production (supply) and capturing monopoly rents. In this case, the producer could not pass along the tax without cost. On the other hand, if the natural resource developer is producing at the competitive level and if demand is weak or demand substitutes are easily available, the natural resource producer could raise its price and reduce output as demand fell.

\textsuperscript{212} This is how the Navajo Nation's Possessory Interest Tax operates. \textit{See, e.g.}, \textit{NAVAJO NATION CODE tit. 24, §§ 201-245} (1995). A property-type tax is similar to a tax on gross profits over the life of the resource.

\textsuperscript{213} It should be noted that a lease tax of this type encourages the lessee to increase rather than decrease production because the less the value of the natural resource remaining in the ground, the lower the tax. A lease tax discourages artificial rent seeking behavior such as high grading or monopolistic production.
inelastic, they will not reduce their consumption by an amount proportionate to
the tax. For example, empirical data suggests that consumer demand for coal
does tend to be inelastic, at least in the short run.\textsuperscript{214}

Tribes also engage in "quasi-tax exporting." Although a tribe must provide
some governmental service in order to have the right to tax, there is no
requirement that the value of the tribal services be proportionate to the taxes
paid.\textsuperscript{215} Tribes, like states, in all likelihood do not provide governmental
services of a value equivalent to the taxes they collect from non-Indian
corporations doing business on the reservation.\textsuperscript{216} To the extent that a tribe
receives tax revenues from the non-Indian producer in excess of the services it
provides, it engages in tax shifting.\textsuperscript{217} Still, from a social policy standpoint,
even the risk of some distortion is not necessarily bad if the tax burden shifts
revenue to persons economically worse off from those better off.\textsuperscript{218}

C. Effects of State Taxation

State taxation of natural resource development on reservations has all of the
negative economic potential associated with taxation generally, but none of the
positive effects justifying tribal taxation. A state tax on the sales price of the
resource has the same likelihood of causing tax distortions as a tribal tax.\textsuperscript{219}
However, a state has fewer incentives to set its taxes at a level that will capture only
rents that inure to the non-tribal resource producer. A high state tax could decrease
demand and reduce production, but, unlike a tribe, a state does not suffer from the
resulting fall in royalty revenues; it only suffers a lower tax base. Moreover, a tribe
is much more sensitive to the indirect effects of a distorting tax. To the extent that
an increase in production costs or a decrease in demand causes the producer to lower
wages or lay off workers, it is tribal members who are more likely to suffer. Thus,
while nonjudicial remedies are available to private development partners who are
"overtaxed" by tribes, such economic leverage is minuscule with respect to state
taxation. Because private developers cannot use diminishing production revenue as
economic leverage against states that over-tax, states face fewer economic restraints
on their propensity to tax the tribal resource development.

\begin{itemize}
  \item \textsuperscript{214} See Shelton & Vogt, supra note 175, at 556-57.
  \item \textsuperscript{215} See Cotton Petroleum v. New Mexico, 490 U.S. 163, 190 (1989).
  \item \textsuperscript{216} See id. at 185 n.15.
  \item \textsuperscript{217} Tribes can justify this tax shifting as compensation for depletion of their reservations’ resources. States
    who do not own their subsurface natural resources wrongly use the same justifications for their severance taxes.
  \item \textsuperscript{218} See John Rawls, A Theory of Justice 156-58 (1971) (arguing that only governmental decisions that make the worse off less so are acceptable from a justice standpoint). Another equitable way to view transfer
    of wealth from non-Indians living off reservations to tribes is to treat the wealth transfers as reparations for various atrocities and unfair dealings. Reparations are payments made for past wrongs inflicted—a view that has a long history in international law. See generally Naomi Mezey, Note, The Distribution of Wealth, Sovereignty and Culture Through Indian Gaming, 48 Stan. L. Rev. 711 (1996); cf. Mari J. Matsuda, Looking to the Bottom: Critical Legal Studies and Reparations, 22 Harv. C.R.-C.L. L. Rev. 323, 362-85 (1987).
  \item \textsuperscript{219} States are preempted from imposing a property tax on the non-Indian lessee. See Cohen, supra note 1, at 270. Because such a tax might be better at capturing rents (in that it only taxes expected profit streams, though admittedly normal profits as well as rents), the state tax on the producer’s activity itself, or on the product as sold, is more likely to cause distorting effects. As noted above, such tax distortions reduce total efficiency.
\end{itemize}
Regardless of whether a state tax will capture rents, a state is likely to export most of its tax burden to tribes, lessees, and natural resource customers. Because states have very few obligations to Indian reservations, the consequences for states of levying taxes on activity occurring within reservations is not much different from the consequences of capturing tax revenue from out-of-state citizens. A state tax on the sales price of a natural resource might be shifted forward to consumers. To the extent that consumers of the taxed resource are citizens of the taxing state, there will be no tax shifting. If, however, consumers live outside the state, a forward shifted tax will be exported to those consumers. If the tax is shifted backward to the owner’s of the components of production, the state will have exported the tax, at least in part, to the reservation. For the tax to be shifted backwards, the supply curve must be more inelastic than the demand curve. There are reasons to believe that this will be the case in the long run. As previously noted, shifting the tax back to the reservation will result in lower wages for Indian employees and lower royalty revenue for the tribal government. This sort of regressive tax effect has exactly the noxious attributes that the Supreme Court tried to avoid in the Ramah Navajo case. 

State taxes, unlike tribal taxes, cannot be justified by arguing that they decrease transaction costs in negotiations between developers and tribes. In fact, to the extent state taxes “crowd out” a tribe’s ability to tax developers, the economy loses potential transaction benefits flowing from tribal flexibility in recovering revenue from its resource. Furthermore, state taxes also impose a higher degree of sovereign risk on the developer, the latter having less economic leverage to discourage state taxation. Additionally, the royalty-tax cap is an existing mechanism for developers to reduce their tax exposure to tribal taxation; there is no corresponding method to limit state taxation because states are not parties to

220. For example, in Cotton Petroleum v. New Mexico, New Mexico received more than twenty-four times as much tax revenue from the lessee than the value of services it provided. See 490 U.S. 163, 185 (1989).

221. See supra notes 172-175 and accompanying text.

222. The reason for this is intuitive. First, if, in the long run, resource customers can substitute other products or technologies for a particular resource (increasing the elasticity of demand for the resource), the producers will have a more difficult time shifting tax increases to their customers. Second, if producers cannot shift their production to alternative deposits from lower-taxing jurisdictions (decreasing the elasticity of supply for the resource), they will be unable to avoid the tax. Producers thus will be forced to absorb the effect of the tax, either by taking a smaller return on capital or by lowering the costs of production, including wages and other associated costs.

223. See supra notes 209-210 and accompanying text. Over time, natural resource consumers can find substitutes and non-taxed competitors can enter the market; but once the lessee has incurred up front development costs it is very difficult for it to shift production. There is, thus, at least an intuitive reason to believe that the taxed producer’s long-run production function is more inelastic than the demand function.

224. See Ramah Navajo Sch. Bd., Inc. v. Bureau of Revenue, 458 U.S. 832, 845 (1982) (refusing to allow a state tax to be levied on the private contractor building a tribal school; the state justification was no more than a general desire to raise revenue and the effect of the state tax would be to burden the tribe’s effort to create and maintain educational opportunities for its members’ children).

225. State taxes “crowd out” tribal taxes in the sense that state taxes have a priority in capturing rents. If the tribe taxes gains other than rents, the burden of the tax will in part be shifted onto it, thus leading to the adverse effects of lower wages and a reduced tax base. Thus, a tribe is left to taxing the rent remaining after the state takes its “bite.”
the development contract. The increased risk might cause developers to demand a higher rate of return in its bargaining position, which tribes might misinterpret as a demand by the lessees to gain more of the gains of trade, and cause tribes to opt out of bargains altogether.226

The economic justifications identified to allow tribal taxation of reservation natural resources do not exist for state taxation. State taxes create barriers to tribal natural resources development. They discourage private developers from entering into agreements with tribes and reduce the revenue available to tribes through taxes of their own. The taxes siphon off natural resources rents to which states have no moral or equitable claim—states neither own the extracted resource nor provide substantial benefits to the taxed party. Most importantly, of course, state taxation thwarts Congress's interest in protecting tribes and encouraging their economic and political independence.

Congress and the United States Supreme Court need to be more sensitive to economic effects as they determine the legal regime for taxation by these dual sovereigns. While dual taxation is not unreasonable in the abstract, in the case of natural resources developed on tribal reservations, the better policy, the one leading to the goals envisioned by Congress, is to preempt state taxation while allowing tribal taxation of the non-Indian producer.

V. CONCLUSION

Resolving questions of overlapping tax jurisdiction is difficult. When one of the overlapping sovereigns is an Indian tribe, the Supreme Court frequently heeds the federal policy of enhancing tribal economic welfare and self-sufficiency through promoting tribal independence and sovereignty. In many areas, implied federal preemption forbids states from encroaching on the sovereign status of reservation lands.227 However, in the area of taxation of non-Indians doing business on reservation lands, the Court has hesitated to insulate the non-Indian party from state taxation merely because it was doing business on a reservation.228

Through the legal incidence test, that is, allowing state taxes whose legal incidence is on the non-Indian party,229 the Court has claimed to address the competing interests of tribal self-government and state economic regulation. Such a rule might be appropriate for some forms of tribal-commercial activity (especially where a tribe is in essence marketing its sovereignty), but inappropriate when the taxed activity is the development of a tribe's nonrenewable resources. Even more problematic is the Court's economic justification for its rule. The Court in Cotton Petroleum v. New Mexico found that the state tax did not reduce the marketability of the tribe's resources, but did not consider that this might be because state taxes were only capturing rent from

226. See supra notes 150, 154-155, and accompanying text.
227. See Ramah Navajo, 458 U.S. 832 (holding that federal law implicitly preempted state gross receipts tax on non-Indian contractor doing business on reservation land).
228. See Part II.C.
229. See supra notes 82-83 and accompanying text.
the resource production. Clearly, Congress, in its many enactments promoting tribal resource development, did not intend natural resource development rent from tribal natural resources production to be siphoned off by state taxes. Yet, the Court has never considered the possible long term or insidious effects of state taxation.

With respect to taxing private resource developers on the reservation, we are thus left with one bright-line rule and one rule yielding indeterminate results. As to the first rule, the Supreme Court has determined that a tribe may, in its sovereign capacity, tax a private producer so long as the tribe provides some governmental services. While the Court's reasoning is predicated exclusively on notions of sovereignty rather than economics, by serendipity, this rule also might create beneficial economic incentives to tax.

As to the second rule, the presumption is that the state may also tax the producer, but as shown in Montana v. Crow Tribe, the presumption can be overcome by demonstrating that the tax is an imposition on essential tribal sovereignty. Given the robust and complex variables affecting the economic relationship between tribes and their commercial resource development partners, the Supreme Court's economic analysis appears somewhat barren. In one case, a state tax of approximately 30% is preempted; in another, a state tax of 8% is not. The Supreme Court's simplified economic analysis in Cotton Petroleum leads to indeterminate results, and bolsters the argument that policy decisions requiring refined economic calculations should be left to the legislative or administrative branches. As an institutional matter, the legislative or administrative branches are better able to develop expertise in calculating the effects of a state tax regime on tribal resource development and the allocation of the fruit of the production.

Congress appears to have noticed this predicament. The recently enacted IERA authorizes establishment of a commission to, among other things, "develop proposals to address the dual taxation by Indian tribes and States of the extraction of natural resources on Indian reservations." As advocated in this Article, the better regime, i.e., one that enhances tribal self-government and economic

232. The incentives include, among other things, reduced transaction costs and the ability to capture economic rents rather than create tax distortions.
234. Compare Cotton Petroleum, 490 U.S. at 168 (upholding State's 8% severance tax), with Montana, 819 F.2d at 897 (barring state severance taxes amounting to 32.9% of the sales price).
235. 106 Stat. 3113 (1992) (codified at 25 U.S.C. § 3505(k)(1) (1994)). Unfortunately, it does not appear that a commission has been established yet, or that any proposals have been developed.
development, would forbid states to tax private resource developers on reservations, whether or not tribes themselves tax the developers. 236

236. Nevertheless, in fairness, states should be allowed to recoup actual governmental expenditures made for the benefit of a tribe or a private developer. This could be accomplished by allowing a state offset to be paid out of a federally administered surcharge on the resource production, not unlike the current Black Lung Trust Fund framework. See Black Lung Benefits Act, 30 U.S.C. §§ 901-945 (1994) (providing for excise tax on coal production to provide revenue to the Black Lung Disability Trust Fund administered jointly by the Secretaries of Labor, Treasury, and Health and Human Services). This accommodation is but one of many cost-recovery alternatives Congress could choose that would be superior to the current taxation regime.