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Retroactivity Revisited

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RETROACTIVITY REVISITED

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IN three prior articles, I considered transitional problems of changes in the tax law.[1] My general analysis and its specific application to the adoption of a consumption tax were criticized last year in this journal by Avishai Shachar.[2] By taking liabilities explicitly into account in considering tax transition rules, Shachar extended the fundamental principles generated by my theory of legal transitions. Shachar, however, misunderstood or mischaracterized much of my earlier work.[3]

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[1] The first of these articles set forth a general analysis of changes in laws governing economic transactions, focusing in particular on setting effective dates for new tax rules. *See* Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977) [hereinafter cited as Graetz I]. The second applied this general theory of legal transitions as part of an extensive analysis of the general problems of substituting a progressive consumption tax for the current income tax. *See* Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979) [hereinafter cited as Graetz II]. The general theory also provided the foundation for a third article suggesting that the minimum tax provisions of the current income tax might be used as a transitional mechanism for moving to a broad-based, low-rate income tax. *See* Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a "Flat-Rate" Tax*, 56 S. CAL. L. REV. 527 (1983).

[2] Shachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 HARV. L. REV. 1581 (1984).

[3] For example, Shachar ranks me first among those who "argue that the new tax laws should take effect on the date of enactment" and who "reject the argument that the effective date of those provisions should be grandfathered for particular tax-favored or -disfavored assets or activities." *Id.* at 1583 & n.12 (citing Graetz I, *supra* note 1, at 87). In fact, I argued that "neither efficiency nor fairness demand grandfathered effective dates" and that "phased-in or delayed effective dates are often to be preferred to grandfathering" for mitigating large impacts on wealth resulting from changes in the tax law. *See* Graetz I, *supra* note 1, at 87.

Shachar also contends that I "implicitly assumed" a certain "misguided" approach, *see* Shachar, *supra* note 2, at 1590–91, an approach that I, in fact, eschewed. Shachar argues that I "implicitly assumed that it is possible to determine whether, in all circumstances, a grandfathered-effective-date rule would be more efficient than a prospective-effective-date rule." *Id.* Instead, I argued that different effective-date rules may be appropriate depending on the extent of the loss that would otherwise be suffered by certain taxpayers when a tax benefit is repealed. *See* Graetz I, *supra* note 1, at 87.

Indeed, Shachar's article fails even to describe accurately my proposal for a transition to a consumption tax. Shachar asserts that I recommend that no general transitional relief be extended to mitigate or offset losses resulting from transition from an income tax to a consumption tax. *See* Shachar, *supra* note 2, at 1581. In fact, I suggested that the effects of the change from an income tax to a consumption tax could be mitigated by a delayed effective date for all taxpayers coupled with special transitional relief for the elderly. *See* Graetz II, *supra* note 1, at 1649–59; *infra* pp. 1837–40.

Much of Shachar's article, therefore, attacks a straw man — whom, regretably, Shachar has chosen to name Michael Graetz. I respond here, however, neither to defend Straw Man nor to offer a detailed correction of Shachar's mischaracterization of my earlier work, but rather to reassert briefly my earlier conclusions and to demonstrate the flaws in Shachar's approach.

In this comment, I respond briefly to Shachar's criticisms. In Part I, I set out the context and conclusions of my general theory and suggest that Shachar agrees with its principal insights. In Part II, I show that, although Shachar correctly suggests that a comprehensive analysis of transitional rules must take liabilities into account, his central analytical premise — that "[e]ach increase in the price of an asset has an equal and offsetting impact on the 'burden' of a liability" — is surely wrong.[4] I also demonstrate in that Part several difficulties with Shachar's general approach to transitional problems. Finally, in Part III, I comment briefly on his specific recommendations for transition to a consumption tax.

I. MY GENERAL CONCLUSIONS REGARDING LEGAL TRANSITIONS

The legal literature that preceded my general analysis of legal transitions consisted largely of rhetorical condemnations of retroactivity,[5] which, in this context, means the application of new rules to transactions that have already been consummated. Similarly, the relevant economic literature called for compensation of those who would otherwise suffer losses resulting from changes in legal rules.[6] The dominant political approach toward transitions in tax law, both then and now, has generally reflected these views.[7] Thus, tax legislation has usually contained provisions, commonly known as "grandfathered" effective dates, that exempt from the new law future income or deductions derived from transactions consummated before the legis-

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[4] Shachar, *supra* note 2, at 1586–87 (footnote omitted). Shachar defines the "burden" of a liability as "the hypothetical value in money terms that is assigned by the market to a liability — that is, the sum of money that, if paid in a hypothetical transaction, would suffice to purchase relief from the liability." *Id.* at 1587 n.31.

[5] *See, e.g.*, Committee on Tax Policy, Tax Section, N.Y. State Bar Ass'n, *Retroactivity of Tax Legislation*, 29 TAX LAW. 21 (1975); Note, *Setting Effective Dates for Tax Legislation: A Rule of Prospectivity*, 84 HARV. L. REV. 436 (1970); Comment, *Limits on Retroactive Decision Making by the Internal Revenue Service: Redefining Abuse of Discretion Under Section 7805(b)*, 23 UCLA L. REV. 529 (1976).

[6] *See, e.g.*, Feldstein, *Compensation in Tax Reform*, 29 NAT'L TAX J. 123 (1976); Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 94–98 (1976) [hereinafter cited as Feldstein, *Theory*]; Hochman, *Rule Change and Transitional Equity*, in REDISTRIBUTION THROUGH PUBLIC CHOICE 320 (H. Hochman & G. Peterson eds. 1974); *cf.* U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM, ch. 6 (1977) [hereinafter cited as BLUEPRINTS].

[7] *See* Graetz II, *supra* note 1, at 1650 (commenting on the political climate). Representative Dan Rostenkowski, chairman of the House Ways and Means Committee, recently promised that any tax legislation in 1985 would avoid "'abrupt and arbitrary changes,'" remarking that "[n]o person should be penalized tomorrow for doing something that's perfectly permissible today." *Legislator Hopeful on Tax Plan*, N.Y. Times, Feb. 26, 1985, D1, col. 6, D21, col. 3. *But cf.* 1 U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 229–32 (1984) (suggesting delayed and phased-in implementation or immediate implementation as alternatives to grandfathered effective dates for some of the Treasury Department's proposed tax reforms) [hereinafter cited as TREASURY REPORT].

lation's enactment date. My first article offered five general conclusions about effective dates in tax legislation — each of which contradicted the existing literature.[8] They warrant brief recapitulation here to place Shachar's article in its proper context.

A. All Effective Dates Are Retroactive

Because all changes in law, whether nominally retroactive or nominally prospective, will have an economic impact on the value of existing assets or on existing expectations, the distinctions commonly drawn between retroactive and prospective effective dates are illusory.[9] Skills are developed, locations selected, and employment accepted or terminated based upon people's expectations about the future burdens and rewards of such decisions. Likewise, the economic value of a physical asset reflects people's expectations about the asset's earning prospects.[10] Therefore, purportedly prospective changes in the law that alter people's expectations about their earning prospects or their potential savings or consumption, or, as is very often the case, alter the value of an asset (or liability, as Shachar points out) have retroactive effects. Understood in this way, all changes in tax law — indeed, I think, all changes in economic laws — are inherently retroactive. A major contribution of my earlier work was to demonstrate the essential similarity in economic impact between a change in law that is nominally retroactive and a change that is nominally prospective but that also has an effect on the value of past transactions.[11] Whenever a change in law alters the relative value of an asset (or liability) or an individual's expectations about her earning prospects or her ability to consume or save from accumulated wealth, it can properly be classified as retroactive. Consequently, one should evaluate all possible types of effective dates[12] without concern for the

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[8] Although congressional sentiment remains largely unchanged, *see, e.g.*, *Packwood/Rostenkowski Statement on Effective Dates of Tax Reform Plans*, 26 TAX NOTES 1192 (Mar. 25, 1985) ("We believe that the effective date of [the tax law change] should not be inconsistent with the legitimate and reasonable expectations [of the taxpayer] based on law . . . in effect at the time the [asset] was purchased."), my conclusions have since received support from a number of quarters, *see, e.g.*, Munzer, *A Theory of Retroactive Legislation*, 61 TEX. L. REV. 425, 426 & n.4, 448 & n.68 (1982); Special Comm. on Simplification, Section of Taxation, Am. Bar Ass'n, *Evaluation of the Proposed Model Comprehensive Income Tax*, 32 TAX LAW. 563, 676–86 (1979).

[9] *See* Graetz I, *supra* note 1, at 49–63.

[10] The economic value of both human and physical capital depends on expectations. For human capital, skills developed now have value because of the expectation that they will prove useful in the future. For physical capital, the present value of an asset is determined by the stream of earnings (or services) it is expected to produce in future years. To the extent that these future earnings are diverted by government action — by increased taxation, for example — the asset's present value will decline.

[11] *See* Graetz I, *supra* note 1, at 49–63.

[12] I identified six categories of effective dates in my previous article: (1) nominally retroactive

pejorative label "retroactive" or the misleading and undoubtedly hypothetical designation "prospective."

B. Fairness Does Not Require Protection of Existing Expectations

Proponents of grandfathering assert that a change in the law upsets expectations unfairly if it directly changes asset (or liability) values. They claim that people should be able to rely on current law remaining unchanged with respect to transactions consummated before the enactment of a revision. Fairness, the argument runs, requires compensation or grandfathered effective dates to protect people who might have altered their conduct "in reliance" upon the continued existence of a tax benefit (or burden).[13] This expectation-based argument, however, is circular. In short, the argument asserts that people have a right to protection merely because either they now expect such protection or they expected such protection when they entered into a transaction; their expectations allegedly create a right and their asserted rights legitimate their expectations. Often this expectation-based argument amounts to nothing more than an assertion that the status quo should be shielded from normal legislative change — an odd claim since people surely expect legislative change. That such expectations actually exist with respect to a particular transaction does not create a right, or even break the circularity of the argument, because these expectations arise in large part simply because grandfather rules or other similar protections have typically accompanied changes in tax law in the past.[14]

The evaluation of claims for transitional relief should be guided not by the existence of expectations, but rather by some independent normative vision of what people should be entitled to expect. A person's claim that she "relied" on existing law or did not "expect" the change cannot, without more, serve as a justification for protection from change or for transitional relief. For example, claimants most deserving of relief, if judged by the unforeseeability of a legal change, would be those who purchased long-lived assets or made long-term

effective dates, which precede the date of enactment of the legislation; (2) nominally prospective effective dates, whereby the provision takes effect on the date of enactment or at the beginning of the year following enactment; (3) delayed effective dates, whereby the provision takes effect some time after enactment; (4) phased-in effective dates, whereby the change is made effective in stages over several years; (5) grandfathered effective dates, which exempt from the new rules future income from transactions entered into before the enactment date; and (6) holder-only grandfathered effective dates, which exempt from the new rules future income derived by persons who held the relevant assets on a certain date but not by those who acquired the assets afterwards. *See id.* at 52–53; *see also* Zodrow, *Implementing Tax Reform*, 34 NAT'L TAX J. 401 (1981) (considering the merits of delayed and phased-in effective dates relative to "immediate partial enactment").

[13] For further elaboration of this argument, see Graetz I, *supra* note 1, at 73.

[14] *See id.* at 74.

commitments long before the change was openly contemplated. These same claims for relief, however, may be very weak if judged by the impact that the change, if perfectly foreseen, would have had on the value of the transaction at the outset.[15] Tax laws providing subsidies or other economic benefits are not contractual obligations of the government, nor can they be so understood without significantly inhibiting the government's ability to adapt to changes in circumstances, technology, or the tastes and preferences of the populace. Expectations do not provide a criterion for evaluating claims for transitional relief, but must themselves be evaluated in light of some criterion of fairness or efficiency.[16]

C. *Economic Efficiency Does Not Require Protection of Existing Expectations*

Some commentators have argued that grandfathered effective dates, or, alternatively, rules directly compensating those who suffer losses because of changes in the tax law, are economically efficient because they reduce the economic costs of uncertainty.[17] Martin Feldstein, for example, has stated: "Tax changes make individuals uncertain about the future reliability of the tax laws. Their anticipation of future possible changes induces inefficient precautionary behavior."[18]

Uncertainty, however, is a pervasive feature of both market and political processes. In a majoritarian system, legislators continually enact, amend, and repeal laws; winners in one period may become losers in the next.[19] A system of majority rule therefore has inherent redistributive tendencies.[20] Our constitutional system of government

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[15] *See generally id.* at 68–73. I argue that "[t]he special concern in the literature for commitments made long ago is . . . misplaced" because "the more distant in the past the original commitment, the less the taxpayer's present 'reliance' interest." *Id.* at 71 n.75. The "uncertainty premium" that purchasers might demand to compensate for potential changes in the law will decrease as the period between the date of original purchase and the expected date of the change increases. *See id.* at 70–71.

[16] For arguments that other widely accepted criteria of fairness — for example, notions of horizontal and vertical equity — also do not routinely justify grandfathered effective dates, see *id.* at 79–87.

[17] *See, e.g.,* Feldstein, *Theory, supra* note 6, at 91–94, 98–99.

[18] *Id.* at 93.

[19] Although more than a majority vote is required for certain legal changes — constitutional amendments, for example — unanimity is virtually unknown as a requirement for change. The Pareto criterion, by which a change is preferable to the status quo only if no one would oppose the change, is therefore often rejected as unduly limiting. "This method is one of supreme conservatism. Even a single person opposing a change can block it altogether no matter what everybody else wants. . . . Clearly there is something grotesquely unsatisfactory about a social decision rule like this." A. SEN, COLLECTIVE CHOICE AND SOCIAL WELFARE 25 (1970) (footnote omitted).

[20] Outcomes of majoritarian procedures are inherently unstable. There are no practical voting procedures that have equilibriums and choose efficient points. *See, e.g., id.* at 200. This

not only guarantees the existence of losers in majoritarian processes, but also assures that political output will change over time. Given this institutional context, people should take precautions based upon their assessment of the probabilities of legislative change. The costs of uncertainty in the law do not seem necessarily different in kind or in magnitude from the costs of uncertainty in markets arising from, for example, changing technology or demand. Markets, as well as laws, tend to be unpredictable and can produce sizeable economic losses. Both often reflect underlying changes in tastes and societal conditions. An economist would not suggest that even sizeable losses suffered in a market economy by investors as a result of changes in tastes or circumstances are inefficient. On the contrary, the ability of the market to adjust output and prices to reflect changes in tastes and technology is often described as its greatest quality. Why should efficiency demand that losses be treated differently when they flow from changes in the political process? Different treatment of the two kinds of changes often seems to be justified simply by accepting the theology that changes induced by political processes are inherently inefficient.[21]

The efficiency of legislative change, including any accompanying transition rule, should be determined by whether it creates surplus or reduces costs.[22] In fact, grandfathered effective dates have significant costs that are often ignored.[23] First, grandfathered effective dates often significantly delay and sometimes permanently reduce the benefits that are expected to be realized from the change in the law. Second, grandfathered effective dates often substantially increase complexity and create both planning costs for taxpayers and enforcement costs for the government. Third, a common practice of grandfathering often rewards taxpayers and tax advisors who have taken extremely aggressive tax planning positions. Fourth, the grandfather clause's exemption of future income may be unnecessary and even wasteful when compared with alternatives such as delayed or phased-in effective dates.

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observation is detailed in the so-called public choice literature, which analyzes voting rules in terms of the problems of aggregating individual preferences to satisfy some set of normative principles. *See, e.g.*, Mueller, *Public Choice: A Survey*, 14 J. ECON. LITERATURE 395, 395, 402–06 (1976) (discussing majority rule).

[21] Market outcomes are sometimes distinguished from political outcomes on the grounds that the market operates impersonally and therefore does not purposefully impose losses on individuals or groups. The kinds of changes in law considered here should, for our purposes, be assumed to be of relatively general application and not purposefully designed to impose losses upon a political minority.

[22] *See* Graetz I, *supra* note 1, at 67–68 (suggesting that proposed policy changes be evaluated on efficiency grounds under a "potential Pareto-superiority" criterion, often termed the Kaldor-Hicks criterion, which would favor change whenever "those who would gain from the change could pay compensation to those who would lose").

[23] *See id.* at 71–72.

D. *The Critical Variable Is Typically the Magnitude of the Loss or Gain*

If all economic legislation can be labeled retroactive, identifying those transactions that merit some protection from transitional gains and losses should depend primarily on the magnitude of the gains or losses. As the magnitude of economic impact from the change increases, the potential for significant financial losses (or gains) increases. Claims based on the ground that taxpayers altered their behavior or incurred unwarranted risks become more persuasive as magnitude increases. Large losses (and perhaps large gains) resulting from changes in law not only seem more compelling in terms of fairness or efficiency than do smaller effects, but, as a political matter, they may also inhibit the willingness of Congress to enact otherwise desirable changes. Transitional relief, therefore, seems most appropriate — and sometimes may be indispensable to passage of a desirable tax change — when the changes in the law would have a large effect on economic values. Nevertheless, magnitude of loss may not be the only relevant variable. The Treasury Department, for example, has recently recommended immediate repeal of "provisions that are particularly objectionable in terms of violating equity principles."[24] But as a general guideline for justifying relief in legal transitions, the magnitude of economic gains or losses ought to be the crucial variable. Grandfathered, delayed, or phased-in effective dates and immediate partial enactment can all reduce the magnitude of these effects.[25]

E. *Phased-in or Delayed Effective Dates Are Often Preferable to Grandfathered Effective Dates*

My general analysis of effective-date rules, which demonstrated that magnitude, not retroactivity, is the relevant criterion and that neither fairness nor efficiency mandates grandfathered effective dates, led me to argue against congressional practices and policies that tend to institutionalize expectations of grandfathered effective dates in tax legislation.[26] It frequently may be politically expedient to avoid imposing large losses in order to enact otherwise desirable changes. In my earlier work, I suggested that phased-in or delayed effective dates should often be used instead of grandfathering to mitigate particularly large losses that result from changes in the law.[27]

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[24] 1 TREASURY REPORT, *supra* note 7, at 331. For a fuller discussion, see Graetz I, *supra* note 1, at 63–87.

[25] *See* 1 TREASURY REPORT, *supra* note 7, at 229; Graetz I, *supra* note 1, at 54–63; Zodrow, *supra* note 12, at 401.

[26] *See* Graetz I, *supra* note 1, at 87.

[27] *See id.*

II. Shachar's Extension

Although Shachar appears to agree generally with these five basic conclusions of my earlier work, we clearly have different emphases. For example, he seems less willing than I to view the magnitude of gains and losses as the crucial criterion for evaluating the need for transitional relief.[28] And Shachar does not clearly either accept or reject my recommendation that delayed or phased-in effective dates should frequently be the mechanism used to mitigate large gains or losses resulting from changes in law.[29] In addition, we do not share some important empirical assumptions.[30] Most of our genuine disagreement, however, seems to concern the implications of Shachar's useful analytical addition — the consideration of the effects of transitional rules on liabilities.

A. Taking Liabilities into Account

My analysis of tax transitions focused primarily on the effect of changes in tax law on the value of previously acquired assets. Shachar correctly points out that such changes may also have important effects on liabilities. He incorrectly concludes, however, that the introduction of liabilities into the analysis completely alters the transitional problem. He asserts that "[e]ach increase in the price of an asset has an equal and offsetting impact on the 'burden' of a liability."[31] In his view, analyzing the effect of transition rules on liabilities as well as on assets demonstrates that "what is at stake is not a net gain or loss by society, but a transfer of wealth between individual taxpayers."[32] Transition thus becomes a problem solely of distributing the offsetting gains and losses among the holders of assets and the holders of their corresponding liabilities. Shachar then follows what is now the standard economic analysis of law[33] to conclude that such losses should

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[28] *See infra* pp. 1831–37.

[29] *Compare* Shachar, *supra* note 2, at 1596 n.61 (stating that he "assume[s] that the burden of the transition cannot be minimized or eliminated by means of a phased-in or delayed-effective-date rule"), *with id.* at 1589 n.** (noting that phased-in or delayed effective dates "might be employed to minimize the change in asset values"). *Cf. id.* at 1585 ("Under a delayed-effective-date rule or a phased-in effective-date rule, the effect of the change in the tax law . . . is less than that under most of the other transition rules.") (footnotes omitted).

[30] *See infra* pp. 1833–37.

[31] Shachar, *supra* note 2, at 1586–87 (footnote omitted).

[32] *Id.* at 1592. Shachar in general ignores the effects of changes in the tax laws on government revenues (and the related effects on government debt or spending). The revenue effect means that losses to those involved in the transaction, or even in general, will not, as he suggests, be precisely offset by gains. *Compare* Shachar, *supra* note 2, at 1586 & n.28 (discussing revenue effects), *with id.* at 1587 (finding losses exactly offset by gains). Moreover, if the change in law is itself efficient in the Kaldor-Hicks sense, *see supra* note 22, gains necessarily exceed losses.

[33] *See* Shachar, *supra* note 2, at 1590–99. Shachar adopts the economic analysis of law

be allocated to the "adversely affected class of taxpayers . . . best able to bear the risks or spread the losses associated with a given transition rule."[34] This conclusion relies principally on his extension of my analysis of a hypothetical repeal of the income tax exemption for interest on state and local bonds.

Shachar and I agree that immediate repeal of the tax exemption without grandfathering would produce a decline in the value of state and local bonds,[35] which would lead holders of such bonds to demand a grandfathered effective date or compensation. Shachar contends that this loss in value would be exactly offset by a gain accruing to the bond issuers, who "will be able to discharge their liabilities by repurchasing the bonds at the lower market price."[36] He concludes that "bondholders' losses will always be matched by issuers' gains."[37]

This conclusion immediately seems doubtful. The suggestion that issuers of tax-exempt bonds somehow gain from the repeal of the tax-exemption — in an amount that exactly offsets the loss to holders of such bonds — fails to comport with common sense. If this asserted gain is real, why do state and local governments not clamor for repeal of the tax exemption? The answer, ignored by Shachar, is that the issuers would also suffer a loss: they would no longer be able to issue low-interest tax-exempt bonds. Although state and local governments would be able to repurchase their old bonds for less than par, they would have to issue new bonds paying a higher rate of interest if they wished to continue financing whatever expenses were financed by the repurchased bonds. The additional cost of issuing new bonds at higher interest rates would entirely absorb the issuer's apparent gain from its repurchase of old bonds.

To see this result more concretely, assume that a local government issued a bond for $1,000 par value paying 6% tax-exempt interest when interest rates on taxable bonds of comparable risk and duration were 8%.[38] Repeal of the tax exemption should cause the price of the bond to fall to somewhere between $822.60 and $864.10; the 6% interest on the now-taxable municipal bond would equal the 8% return on comparable corporate bonds.[39] The local government then might,

developed, for example, in Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961), and G. CALABRESI, THE COSTS OF ACCIDENTS (1970).

34 Shachar, *supra* note 2, at 1609.

35 *See* Graetz I, *supra* note 1, at 55–56; Shachar, *supra* note 2, at 1583–84.

36 Shachar, *supra* note 2, at 1587 (footnote omitted).

37 *Id.* (footnote omitted).

38 Shachar uses this numerical example in his article. *See id.* at 1583–84.

39 The difference depends on the marginal rates of the taxpayers who would purchase the formerly tax-exempt bonds. A taxpayer in the 50% bracket would pay up to $864.10 for the tax-exempt bond, whereas a taxpayer in the 20% bracket would pay no more than $822.60. *See id.* at 1584.

as Shachar suggests,[40] repurchase the bond and enjoy an apparent gain representing the difference between the $1,000 received upon issuance of the bond and the repurchase price of, for example, $850. But to continue financing its projects the local government would have to issue new bonds and pay interest of 8% rather than 6%. The local government could issue a new bond of the same maturity as the bond that paid 6% interest only by giving the purchaser of the new bond a discount equal to its prior gain on the sale of the old bond.

Shachar errs in his analysis of the repeal of the tax exemption for state and local bonds because he fails to examine the positions of the parties immediately before and after the change.[41] After repeal the bondholder is worse off, because the value of his asset has declined. The issuer is, with respect to bonds outstanding, no better off, because its costs of financing will not be reduced over the life of the bond. And, in the long run, the issuer is worse off, because it can no longer issue bonds at lower, tax-exempt interest rates.[42] Once one puts aside Shachar's flawed attempt to demonstrate offsetting gains and losses for holders of assets and liabilities, one may construe Shachar as merely suggesting that, with respect to bonds outstanding at the date of enactment of the tax change, issuers as well as bondholders potentially could bear the burden of immediate repeal.[43]

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[40] *See id.* at 1587.

[41] This perspective might be regarded as inappropriate in some other contexts, but it seems crucial in evaluating effective dates for transitions. Shachar seems to take the view that the argument about tax transition rules is related to the dispute about whether capital gains due to changes in the interest rate are income. *See id.* at 1586–87 & n.28, 1599–1600; *see also* N. KALDOR, AN EXPENDITURE TAX 44–46, 69–70 (1955) (suggesting that capital gains caused by a decline in interest rates do not constitute income as it is currently defined). As Professor Warren has suggested, this dispute turns on which comparison is deemed to be relevant — a comparison between a bondholder's spending power before and after the change in interest rates or that between the bondholder and a second bondholder who does not purchase the bond until after the decline in the interest rates. *See* Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?* 89 YALE L.J. 1081, 1109–12 (1980). Regardless of how one comes out in this dispute, in a context in which alternative transitional rules are being evaluated, the relevant comparison seems to be the status of bondholders and state and local governments before and after the change in law. One need not agree with Kaldor's position that capital gains caused by interest rate changes are not income to conclude that proper analysis of transitional rules should compare the status of issuers and bondholders before and after the change in law. It should be irrelevant in evaluating alternative transitional rules whether an issuer would be better off compared to local governments that had issued no tax-exempt bonds, or fewer bonds, or bonds with shorter maturities, or, alternatively, compared to what the issuer's status would have been if the tax exemption had never existed. Such comparisons, however, seem to be at the core of Shachar's analysis of both debt and equity assets.

[42] For a different critique of Shachar's bond example, see Abrams, *Rethinking Tax Transitions: A Reply to Dr. Shachar*, 98 HARV. L. REV. 1809 (1985).

[43] To impose the burden of repeal on state and local governments rather than on bondholders, Congress could require such governments to increase the interest payable to bondholders, thereby allowing the bondholders to maintain their after-tax income (and the value of their bonds).

Shachar's analysis of the effect of a grandfathered effective date suffers from a parallel flaw. If the tax exemption on state and local bonds were repealed with a grandfathered effective date, the price of the outstanding bonds would rise because taxpayers in the highest bracket, when faced with a dwindling supply of tax-exempt bonds, would bid up their price.[44] The issuers, Shachar suggests, "would be able to discharge their liabilities *only* by paying the higher market price [and thus] would suffer a loss in wealth, whereas the bondholders would experience an offsetting gain."[45] Shachar fails to see, however, that the issuers need not redeem the bonds at their new higher price; the issuers are free to leave the bonds outstanding and continue paying below-market interest on their debts. In fact, higher-bracket taxpayers would always be willing to pay more for the remaining tax-exempt bonds than would state and local governments, because such governments, already fully exempt from income taxation, would not receive any tax benefits from the bonds. If the effective date of the repeal of the tax preference for interest on state and local bonds were grandfathered, although the issuers would no longer be able to repurchase their bonds at par, they would suffer no loss with respect to bonds outstanding upon enactment of the tax change. Therefore, the inescapable implication of Shachar's analysis — that state and local governments would strongly prefer repeal of the tax exemption without grandfathering to repeal with grandfathering — is clearly false.

The flaw in Shachar's analysis becomes even more apparent when he turns to equity assets and their "offsetting liabilities." Shachar contends that the same inevitable parity of bondholders' losses and issuers' gains also holds for the "value of equity assets and the 'burden' of equity liabilities."[46] He attempts to demonstrate this proposition by considering the situation of an owner-lessor who receives tax-exempt rents on an industrial building subject to a fixed-rent, twenty-year lease.[47] Given Shachar's assumptions about the competitiveness of the relevant rental market,[48] this case is economically identical to

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Shifting the burden of repeal to state and local governments, however, might well run afoul of a constitutional prohibition relating to that barring the impairment of contracts. *See* U.S. CONST. art. I, § 10, cl. 1 (contract clause); *cf.* Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978) (invalidating under the contract clause the Minnesota Private Pension Benefits Protection Act as applied retroactively to existing pension plans); United States Trust Co. v. New Jersey, 431 U.S. 1 (1977) (holding that the contract clause prohibited New York and New Jersey from repealing a covenant limiting the ability of their jointly-established port authority to subsidize rail transportation). The contract clause applies only to the states, but a due process claim might be raised against a federal requirement of the sort set forth above.

[44] Shachar and I are in agreement on this proposition. *Compare* Shachar, *supra* note 2, at 1587 n.30 (stating that "bonds' market value would rise"), *with* Graetz I, *supra* note 1, at 61 (stating that the supply of bonds will shrink, and their value will rise).

[45] Shachar, *supra* note 2, at 1587 n.30 (emphasis added).

[46] *Id.* at 1588.

[47] *See id.*

[48] *See id.* at 1588 n.31.

the tax-exempt bond case. Upon repeal of the tax-exemption for rent, the argument runs, the loss to the lessor from the decline in value of the building "offsets" the gain to the lessee, who, because his rent is now below-market, could sell his interest in the lease at a premium above its pre-repeal value. As in the bond example, Shachar again ignores the fact that the lessee, if he wanted to continue in business, would then have to use that premium to pay higher rents elsewhere.[49]

Shachar has extended his analysis to equity assets and "equity liabilities" by hypothesizing an obligation that creates a relationship that is identical to the debtor-creditor relationship in his tax-exempt bond example. The new example merely illustrates that some equity assets have the same economic characteristics as those of assets routinely labeled debt.[50] But not all equity assets present such relationships. Assume, for example, that the current tax exemption for the imputed rental value of owner-occupied homes were repealed. Shachar's lease example implies that each homeowner's loss from the resulting decline in the value of his house would exactly offset his gain from the increase in "the value of his right to occupy the premises."[51] Shachar's analysis suggests that homeowners should be indifferent about the repeal of the tax exemption, since they are on both the "winning" and "losing" sides of this transition. The homeowners, however, would more likely regard their losses as real and their gains as illusory; they would surely contend that their reliance on the tax exemption when they purchased their homes entitles them to a grandfathered effective date or other transitional relief.

Shachar seems to assume that in the absence of macroeconomic changes, aggregate personal income remains constant.[52] He therefore might respond to my criticism by contending that any decline in the price of certain equity assets that is caused by a change in tax law will be offset by a rise in the price of other assets rather than by a gain to liability holders. The lease example then becomes simply a special case that easily demonstrates who (the lessee in that case) would enjoy the asserted offsetting gain.[53] When the price of some

[49] Even gains that are not fictional will not offset losses when assets are held by parties taxed at different marginal rates. Assume, for example, that a lessor would pay up to $100 to the lessee for release from the lease. If both parties were taxed at a marginal rate of 50%, the lessor would lose $50 after tax on the transaction, and the lessee would gain $50 after tax. If, however, the lessor were taxed at a marginal rate of 50% but the lessee were taxed at a marginal rate of 20%, the lessor would lose $50 while the lessee would gain $80. The market cannot adjust for all of these differentials. *See, e.g.*, Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, 16 SAN DIEGO L. REV. 735, 739–44 (1979). Shachar takes variations in marginal rates into account on some occasions but not on others.

[50] This point has been amply illustrated by, for example, the difficulties of drawing a clear distinction between debt and equity for purposes of the income tax. *See* I.R.C. § 385 (1982) (setting forth factors that should be considered in determining whether an interest in a corporation is stock or indebtedness).

[51] *See* Shachar, *supra* note 2, at 1588.

[52] *See id.* at 1586 n.28.

[53] Professor Warren has advanced the position that a decline in the value of equity assets

equity assets declines because of repeal of their tax-favored status, Shachar might argue, the price of other equity assets rises a corresponding amount. Shachar might therefore argue, for example, that repeal of the tax exemption for owner-occupied homes might cause not only a decline in the value of such housing but also an offsetting rise in the value of substitutes such as apartment buildings. Similarly, repeal of the tax preference for capital gains would cause a decline in the value of capital assets and presumably an offsetting rise in the value of ordinary income assets such as inventory. Shachar would presumably have us compare the loser's losses on a given equity asset with the "offsetting" winner's gains on all substitute assets. If this comparison is what Shachar means to capture in his argument, his transformation of all transitional issues into questions of the appropriate distribution of offsetting gains and losses loses much of its analytical power. As I suggest in the next Section, analyzing the distribution of transitional gains and losses is useful only when the gains and losses accrue to the members of a relatively small, discrete group, such as "bond issuers." When gains, losses, or both instead accrue to the members of a large, generalized group such as "all asset holders," Shachar's proposed criteria for distinguishing among transitional rules will always yield the same unhelpful results.

B. Shachar's View of Equitable and Efficient Transitions

Taking liabilities into account does not eliminate the need to evaluate alternative transitional rules for both fairness and efficiency. Despite the many flaws in his basic analytical premise — that impacts on liabilities always offset impacts on assets — Shachar's proposed framework for evaluating transitional rules merits comment. I first examine Shachar's suggested equitable criteria for evaluating transition rules and then discuss his approach to efficiency.

1. Shachar's Equitable Criteria. — According to Shachar, one can examine transitional rules for fairness by evaluating their capacity, first, to spread losses and, second, to protect the rational expectations of taxpayers.[54] The first criterion, loss spreading, is designed "to minimize the concentration of transition-related losses in wealth on any single individual or class of individuals"; therefore, he argues, "the legislature should select a transition rule that will place the losses on the party that is best able to spread it to the general public."[55] In the case of tax-exempt bonds, Shachar asserts that "the public is more

always offsets gains in the value of other assets. *See* Warren, *supra* note 41, at 1086–90. Warren defines income in the societal sense as "the product of the whole society's private capital and labor during the accounting period," *id.* at 1086, and in the personal sense as the sum of consumption and net accretions in wealth, *see id.* (cited in Shachar, *supra* note 2, at 1586 n.28).

[54] *See* Shachar, *supra* note 2, at 1609.

[55] *Id.* at 1595–96.

capable than individual bondholders of absorbing the burden without extraordinary hardship" and that the issuers — state and local governments — can better "spread the burden to the public" than can the bondholders.[56] Therefore, he concludes, his first equitable criterion favors a grandfathered effective date for the repeal of the tax-exemption for bonds.[57]

If, as Shachar asserts, transitions create offsetting gains and losses between discrete groups of holders of assets and corresponding liabilities, one might be able to compare usefully the loss-spreading abilities of the two groups. But, as I demonstrated in the preceding Section, such offsetting gains and losses do not always exist. In fact, Shachar's conclusion that equity favors grandfathering for tax-exempt bonds does not depend on his earlier analysis of liabilities. Whether or not bond issuers realize offsetting gains upon repeal of the tax exemption, the general public could bear the losses that bondholders suffer by compensating them directly or by implementing grandfathered effective dates.[58] Because compensation or grandfathering spares the bondholders any loss and passes the entire burden of tax transitions to the federal fisc — that is, spreads losses to the public — grandfathering will tend to be the favored transitional rule under a loss-spreading criterion.[59] Although Shachar denies that he is arguing for a presumption in favor of grandfathering, his loss-spreading criterion resurrects just such a presumption.[60] Moreover, Shachar assumes that phased-in or delayed effective date rules are not available to reduce the burden of transitions on groups such as the bondholders and therefore fails to consider their capacity for spreading some portion of the losses to the general public. Thus, in this context at least, he ignores the course that I recommended.[61] His loss-spreading criterion therefore fails to accomplish its stated purpose of differentiating among alternative transition rules.

The second criterion of Shachar's equity analysis, which he characterizes as the capacity of a transition rule to protect taxpayers' reliance and expectation interests,[62] also suffers from infirmities. Shachar explicitly accepts my conclusion that taxpayers have no right

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[56] *Id.* at 1596 (footnote omitted).

[57] *See id.*

[58] This proposition, when stated prescriptively, is Professor Feldstein's basic argument, *see* sources cited *supra* note 6, with which my work disagrees.

[59] Professor Feldstein also has chosen the general public, or large segments of the public, to bear the losses caused by tax transitions. *See* sources cited *supra* note 6; *cf.* Calabresi, *supra* note 33, at 518 (favoring enterprise tort liability as a means of "allocating losses in ways which spread the burden over as many people and over as long a time as is possible," typically through lower employee wages and higher consumer prices).

[60] Shachar considers direct compensation of losses to be an alternative to grandfathered effective dates. *See* Shachar, *supra* note 2, at 1597 n.64.

[61] *See supra* p. 1826.

[62] *See* Shachar, *supra* note 2, at 1596.

to expect all tax laws to remain forever unchanged.[63] He contends, however, that taxpayers may "legitimately expect" government to adopt transition rules that allocate transition-related losses efficiently, that is, "in a manner that reflects the market's previous allocation of the *risk* of a change in tax policy."[64] Shachar does not explain why this expectation is legitimate; rather he seems merely to assert that whatever economic efficiency demands is necessarily fair.[65]

Indeed, by defining fairness in relation to the market's previous allocation of the risks of change, Shachar implicitly renders taxpayers' expectations irrelevant to any consideration of equity. He asserts that "the market automatically capitalizes the risk of a change in the tax law and allocates the cost of bearing that risk to the superior risk bearer."[66] I do not have space here to detail the uncertainty and controversy over what the market in fact capitalizes in connection with tax-favored (or tax-disfavored) assets and liabilities.[67] If, however, the market not only capitalizes tax benefits to equate after-tax returns, but also capitalizes the risks of changes in the tax law, transitions would seem to raise few problems of equity or efficiency.[68] As Richard Posner has queried: why should we worry about either the equity or efficiency consequences of changes in the tax law for persons who engaged in market transactions on terms that appropriately reflected the risks of such changes?[69] After all, he suggests, the

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[63] *See id.*

[64] *Id.*

[65] Shachar's focus on taxpayers' expectations as a criterion of fairness for transitional rules seems likely to reinstate a presumption for grandfathering. *See* Graetz I, *supra* note 1, at 74–79; *supra* pp. 1823–24.

[66] Shachar, *supra* note 2, at 1597.

[67] General works on this topic include Bittker, *supra* note 49; Galper & Toder, *Measuring the Incidence of Taxation of Income from Capital*, 75 NAT'L TAX ASS'N — TAX INST. OF AM. PROC. 57 (1983); Graetz, *Assessing the Distributional Effects of Income Tax Revision: Some Lessons from Incidence Analysis*, 4 J. LEGAL STUD. 351 (1975); and Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719 (1981). For example, Warren makes the following observations concerning market adjustments to the corporate income tax:

> The validity of the proposition that the market has fully capitalized in share prices the detriments of current law is certainly questionable. . . . [I]t may be that any discount [in the price of a corporation's stock] is due to the difference between ordinary income and capital gains rates, rather than the corporate tax.

Warren, *supra*, at 757 (footnotes omitted).

[68] Shachar asserts in a footnote that the model of the market underpinning this second equity criterion — perfect allocation of risk to the superior risk-bearer — "applies only if there is no information about the way that government is likely to act during a transition." Shachar, *supra* note 2, at 1597 n.63. Notwithstanding the well-known fact that information asymmetries may cause certain kinds of market failure, I question this premise; for example, the existence of widespread information about government's prior transition policies may reduce the perceived risk that government will alter its policies, but why would the market fail to allocate to the superior risk-bearer any remaining risk?

[69] Posner made this query when I presented a draft of Graetz I, *supra* note 1, at a University

market price of such transactions offered buyers a discount for bearing the risk of losses and afforded sellers a premium for forgoing possible future gains.

Shachar further suggests that the market will capitalize people's expectations that arise as a result of government's consistent transitional policies; therefore, he argues that government must honor these expectations by keeping its approach to transitions constant. But this argument simply restates the circle of expectations. People become entitled to grandfathering because the government previously grandfathered, which created an expectation of grandfathering, which expectation needs to be fulfilled by implementing grandfathering. Furthermore, if the market can so cleverly capitalize both the benefits of tax-favored treatment and the risks of changes in such treatment, why does it not also capitalize the risks of a change in the government's approach to transitional rules? And if the market capitalizes all of these risks, why should we worry about the effects of changing either the substantive tax law or the policy regarding transitions? The market, if it is as powerful as Shachar apparently believes, would seem to have appropriately and "automatically" allocated the entire risk "to the superior risk bearer" — the very allocation that Shachar also suggests economic efficiency requires.[70]

2. *Shachar's Efficiency Criterion.* — Shachar suggests that one can evaluate alternative transition rules for economic efficiency as well as for equity by comparing the risk-bearing abilities of those whom each rule would adversely affect. Unlike his two fairness criteria, this efficiency criterion might well provide some independent basis for evaluating the merits of taxpayers' claims for transitional relief.

The notion that legal rules should impose losses on the superior risk-bearer, "the party who can more efficiently insure against the particular risk in question,"[71] is not novel, although it has been applied principally with respect to private law. As Shachar notes, this approach has been offered as a test for the efficiency of contract law,[72] and it also forms the basic premise of the economic analysis of tort rules for allocating the risks of accidents.[73] The risk-spreading criterion has also recently been used to evaluate changes in public law,[74] and Shachar's proposal that we consider how it might apply to changes in tax law deserves attention.

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of Chicago workshop in 1977. One may still worry for efficiency reasons about the consequences of changes in the tax law. *See infra* pp. 1835–37.

[70] *See* Shachar, *supra* note 2, at 1597. Market failures may cause such "automatic" risk allocations to prove less than perfectly efficient even if most people take risks of change into account.

[71] *Id.* at 1593 n.52.

[72] *See id.*

[73] *See, e.g.*, G. CALABRESI, *supra* note 33; Calabresi, *supra* note 33.

[74] *See, e.g.*, Blume & Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CALIF. L. REV. 569 (1984).

As Shachar suggests, assessing relative risk-bearing capacities may be informed by determining to whom the market would have allocated these risks if it had been able to do so appropriately. He follows the general literature by suggesting that one might approach this question by determining which transitional rule would carry the lowest cost in a hypothetical market for insurance against the risks of alternative transitional rules.[75] Unfortunately, Shachar's discussion of the risk-spreading criterion has limited value. Shachar again ignores the risk-spreading capabilities of phased-in or delayed effective dates.[76] Moreover, his discussion here also turns on his mistaken conclusion that every change in the tax law that causes a loss to an asset holder entails an equal, offsetting gain to a liability holder.[77] For example, when considering transitional rules that allocate the burden of the repeal of a tax exemption for bonds, Shachar compares the risk-bearing capability of bond issuers and bondholders. But whether issuers could theoretically bear risks better than bondholders is irrelevant, because bond issuers in fact do not bear the risk of loss or gain with respect to outstanding bonds. A change in the tax law would not affect the cost of the issuers' obligation or the "burden" of its liability.

Although I do not here rigorously evaluate the validity of risk-bearing as a distinguishing criterion, a full treatment of it seems likely to support the principal conclusions of my general theory of transitions. The magnitude of risk will certainly prove to be a critical variable:[78] when people can insure against risk, generally they choose to insure against disasters — by passing the risk to superior risk-

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[75] *See* Shachar, *supra* note 2, at 1596. It is not at all clear why no such insurance market exists. Insurance is available, for example, against the risks of expropriation by foreign governments. In the tax context, it may be simply that the practice of grandfathering adverse changes is so widespread that there is little demand for insurance protection. Insurance companies might also fear the withdrawal from the political process of persuasive proponents of grandfathering, if such advocates were insured. *See infra* note 82 and accompanying text. Shachar also notes that an income tax itself may provide some appropriate spreading of risks. *See* Shachar, *supra* note 2, at 1597 n.64; *cf.* Blume & Rubinfeld, *supra* note 74, at 594–95 (viewing the property tax as partial "coinsurance" against regulatory changes that would alter property value "because property losses result in lower tax liabilities"). For discussion of the inherent risk-spreading tendencies of a capital income tax, see J. Strnad, The Taxation of Risky Investments: An Asset Pricing Approach (Calif. Inst. of Tech. Soc. Sci. Working Paper No. 546) (1984). Shachar further implies that taxpayers' abilities to diversify might affect their risk-spreading abilities. *See* Shachar, *supra* note 2, at 1594.

[76] *See supra* note 61. Shachar also blurs the relevant distinctions between risk- and loss-spreading. For example, he contends that one should ask in the case of tax-exempt bonds whether issuers or borrowers are better able to insure against the risk of change in the law. *See* Shachar, *supra* note 2, at 1593. He adds that the loss should then be imposed on the party better able to spread it to the general public. *See id.* at 1595–96.

[77] *See supra* pp. 1827–32.

[78] *See supra* p. 1826. For a related view that administrative costs may be significant for a compensation system and therefore compensation should not always be pursued, see Blume & Rubinfeld, *supra* note 74, at 624.

bearers — and choose to bear the risk of small losses themselves.[79] Transitional relief in the form of a phased-in or delayed effective date, or even grandfathering, may thus be more appropriate for tax law changes involving large losses or affecting assets that comprise a large portion of an individual's wealth — a principal residence, for example — because in such cases the individual might not be able readily to self-insure by diversifying.[80] Similarly, changes affecting income from occupations that require significant job-specific education or training expenses might warrant relief because of the taxpayers' inability to diversify risks. For example, if the formerly tax-exempt fringe benefits of airline pilots became taxable, a pilot might not be able to react to her reduced after-tax income by readily transferring her skills and experience to some other occupation.

In contrast, large corporations and wealthier individuals are typically well diversified and would be less deserving of protection through grandfathering.[81] Moreover, because wealthier people and large corporations often exercise a disproportionate influence over political outcomes, they might present special problems of "moral hazard" that would also argue against grandfathering.[82] Finally, people's relative aversion to risk is also important to an analysis of risk-spreading. The standard assumption that risk aversion declines as wealth increases suggests that wealthier people may have less need than poorer people for grandfathering to protect them from losses resulting from changes in tax law. Thus, contrary to the impressions given by Shachar's incomplete analysis, a risk-bearing criterion might well support far less grandfathering than he seems to suggest — certainly far less than is routinely provided by the legislative process.

III. THE TRANSITION TO A CONSUMPTION TAX

When I considered the problems of transition from an income tax to a progressive consumption tax, I applied the general principles set forth in Part I to suggest that transitional relief might be most appro-

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[79] *See* Blume & Rubinfeld, *supra* note 74, at 591.

[80] *See id.* at 591–92, 606–10.

[81] *See id.* at 588. Such diversification against the risks of a change in law, for example, might provide an explanation for why high-bracket taxpayers hold taxable corporate bonds of comparable risk to tax-exempt state or local bonds in circumstances in which the latter would produce a higher after-tax rate of return.

The conclusion that wealthier people are less deserving of relief is set forth in my earlier work applying traditional notions of vertical equity. *See* Graetz I, *supra* note 1, at 81–83.

[82] "Moral hazard" is a term commonly used by economists to describe a particular type of market failure common to insurance markets. Moral hazard occurs when a party who is to be insured can affect the probability or the magnitude of the event that produces insurance compensation. In this context, moral hazard might occur because the person might be able to affect the outcome of the political process. For a discussion of this failure and other relevant potential insurance market failures, see Blume & Rubinfeld, *supra* note 74, at 593–97.

priate for elderly taxpayers, who would tend to suffer relatively large increases in tax burdens without comparable offsetting benefits from such a shift and that grandfathered effective dates should generally be rejected in favor of phased-in or delayed effective dates.[83] I rejected general transitional relief for pre-enactment assets because the benefits of such relief did not seem to exceed its costs in the form of increased tax rates, complexity, and expenses of enforcement and administration. Moreover, the consumption tax deduction for reinvestment would serve generally to mitigate hardships suffered by owners of significant amounts of assets.

I also concluded, however, that if general "relief is to be granted with respect to assets acquired before enactment, it should take the form of an immediate deduction of the basis of assets held on the date of enactment (perhaps limited to a maximum dollar amount . . .)."[84] Shachar makes a similar recommendation,[85] but instead of noting the similarity, he characterizes my position as simply recommending "that no general transitional relief be extended to mitigate or offset [transitional] losses."[86] Although my discussion did not address similar transition problems for liabilities, I tend to agree with Shachar that if Congress were to prevent windfall losses for asset holders through a special basis rule, it should prevent windfall gains for liability holders by using parallel restrictions.

Shachar and I do differ over the appropriate method for analyzing what both of us, following the Treasury Department's suggestion,[87] label "carryover problems." Carryover problems occur in the transition from an income tax to a consumption tax because people have accumulated wealth under an income tax that they consume under a consumption tax. As a Treasury report explains, "[c]arryover problems would occur to the extent that changes in the tax code affect the taxation of income earned in the past but not yet subject to tax or, conversely, income taxed in the past that may be subject to a second tax."[88] Shachar defines carryover problems as those that "reflect the tax system's failure to account for all relevant items of a taxpayer's tax basis."[89] He regards carryover problems as "clearly distinguishable" from changes in law that are reflected by changes in asset (or

[83] *See* Graetz II, *supra* note 1, at 1653, 1657–58. My rejection of grandfathered effective dates in favor of phased-in or delayed effective dates was reached in a long, general article on implementing a progressive consumption tax. For a discussion of issues raised by transition from an income tax to a consumption tax, see Graetz II, *supra* note 1, at 1649–59; Shachar, *supra* note 2, at 1599–1608.

[84] Graetz II, *supra* note 1, at 1655.

[85] *See* Shachar, *supra* note 2, at 1608.

[86] *Id.* at 1581.

[87] *See* BLUEPRINTS, *supra* note 6, at 182–85; Graetz II, *supra* note 1, at 1655; Shachar, *supra* note 2, at 1581.

[88] *See* BLUEPRINTS, *supra* note 6, at 181.

[89] Shachar, *supra* note 2, at 1605.

liability) prices because they are "not endemic to all tax transitions: they arise only when the tax transition entails a change in the method of calculating the tax base."[90]

Although Shachar regards losses due to carryover problems as analytically different from losses attributable to price changes, he does not suggest what this difference implies. In fact, he treats carryover problems similarly to price changes by analyzing them under his general transitional methodology.[91] He also fails to consider that special transitional relief would not be costless; for example, it would almost certainly require higher tax rates to maintain a revenue-neutral shift to a consumption tax.[92]

Shachar's approach to carryover problems is distinctive because he suggests that one should evaluate the fairness of transitional relief with reference to any fundamental shift in norms that accompanies a shift in the approach to taxation. For example, as Shachar puts it, the shift from an income tax to a consumption tax would indicate that "society perceived . . . 'spending power' to be a more relevant indicator of economic welfare than" earning power.[93] I agree that one should be alert for any such shift in norms.[94] Ultimately, however, Shachar seems to slip into expectation-based arguments for protecting taxpayers from losses due to carryover problems.[95] To the extent that such arguments form the basis of proposals for transitional protection, I reject them for the reasons set forth above.[96]

I also remain unpersuaded by Shachar's assertion that one should, in general, treat gains and losses from carryover problems differently from gains and losses from price changes. I continue to believe that the basic "element common to both problems is that relative wealth has been changed because of the change in the tax law" and that the "problems are similar in their broadest economic effects."[97] Moreover, the relevant criterion for evaluating claims for transitional relief should not be the expectations of taxpayers but rather the magnitude of their gains and losses. The taxpayer who faces large losses, whether attributable to carryover problems or price changes, has the stronger case for transitional relief. Finally, I reassert my previous stance that

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[90] *Id.*

[91] *See id.* at 1609.

[92] *See* Graetz II, *supra* note 1, at 1655.

[93] Shachar, *supra* note 2, at 1609.

[94] I have no quarrel with Shachar's suggestion that one should be alert to the norms underlying the reason for the change; I argued in my first article on this subject that the equity and efficiency of transitional rules in income tax revisions should be evaluated with reference to the basic norms of income taxation. *See* Graetz I, *supra* note 1, at 79–81.

[95] *See* Shachar, *supra* note 2, at 1605 (emphasizing expectations of persons who "planned" to sell assets before maturity).

[96] *See supra* pp. 1823–25.

[97] Graetz I, *supra* note 1, at 51.

delayed or phased-in effective dates can often provide relief more fairly and efficiently than grandfathering.

IV. Conclusion

Shachar and I seem to find some significant common ground. I regard him as supporting rather than rejecting the major conclusions of my earlier work, and I agree with his basic suggestion that one should take into account the effects of liabilities on transitional rules in tax reform generally and in any transition from an income tax to a consumption tax. Nevertheless, I reject a large part of Shachar's argument. First, I reject his basic analytical premise that every "increase in the price of an asset has an equal and offsetting impact on the 'burden' of a liability."[98] Moreover, in considering losses that result from changes in the law, I disagree with Shachar's view that choices among transitional rules should turn on who is best able to spread losses. Notwithstanding Shachar's denial, this aproach would effectively reaffirm grandfathering as the dominant transitional practice. Some of our disagreements, however, are far less significant. For example, I agree that examining the relative risk-spreading ability of affected taxpayers seems to be a potentially useful inquiry when evaluating transitional rules, but it is not the only relevant inquiry. Although Shachar unfortunately did not develop the policy implications of a risk-spreading criterion, such an evaluation would seem generally to support my earlier analysis and to affirm the appropriateness of transitional rules similar to those that I have previously proposed. In any event, a risk-spreading criterion would justify far fewer occasions for grandfathering tax changes affecting wealthier individuals and corporations than Shachar seems to suggest. Finally, although I have recommended more limited relief, I have no quarrel with Shachar's principal new suggestion for dealing with a transition from an income tax to a consumption tax; he correctly proposes that if the basis of assets is exempted from consumption tax receipts, Congress should not allow deductions for the repayment of pre-enactment liabilities.

In sum, I adhere to my earlier conclusions that arguments grounded in condemnations of "retroactive" changes are fundamentally flawed and analytically incoherent, that arguments based on taxpayers' expectations are generally circular, and that the need for transitional relief should generally depend upon the magnitude of losses resulting from changes in the law. Congress often seems unwilling to impose the economic losses that would result from otherwise desirable changes in law. In the tax context, at least, a general policy of reducing large losses may well be necessary to ensure the willingness

[98] Shachar, *supra* note 2, at 1586–87 (footnote omitted).

of representative democratic political institutions to respond to changes in tastes or circumstances. But large losses can frequently be better mitigated by phased-in or delayed effective dates than by grandfathering. The political appeal of grandfathered effective dates to neutralize opposition to changes in law by those who would otherwise suffer from the change has produced in Congress a virtually automatic tendency to adopt grandfathered effective date provisions. This tendency in turn creates expectations of grandfathering for future changes. Nothing in Shachar's article or in the events of the nearly ten years since I first analyzed the problem of transitions has led me to waver in my recommendation that this practice should cease. The search for other imaginative approaches to the problems of transitions must continue.