LEGAL TRANSITIONS: THE CASE OF RETROACTIVITY IN INCOME TAX REVISION

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I. INTRODUCTION

Proponents of law reform have tended to concentrate their energies on evaluating legal rules and institutions and suggesting that they be replaced by "better" laws or institutions, while paying relatively little attention to the process of transition. Recent scholarly efforts to address problems resulting from changes in law have tended to focus on efficiency and equity considerations which argue for compensating persons who are adversely affected by a revision.¹

This Article concentrates on a related aspect of the transition problem—the question of setting effective dates for new rules. Although this question has received some attention in legal commentary,² these efforts have largely consisted of rhetorical con-

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¹ The classic work on compensation under the takings clause is Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967). See also B. ACKERMAN, *PRIVATE PROPERTY AND THE CONSTITUTION* (1977). On compensation for changing legal rules, see generally Hochman, *Rule Change and Transitional Equity in REDISTRIBUTION THROUGH PUBLIC CHOICE* 320 (H. Hochman & G. Peterson eds. 1974); Tullock, *The Transitional Gains Trap*, 6 BELL J. ECON. 671 (1975).

In the context of changes in income tax rules, the principal arguments for compensation have been advanced by Martin Feldstein. E.g. Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77 (1976). See also U.S. DEP'T OF THE TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM 187-88* (1977) [hereinafter cited as *BLUEPRINTS*].

² The best analytical work on transitional problems arising from tax changes is Chapter 6 of *BLUEPRINTS*, *supra* note 1, at 181. For a good short piece on retroactivity, see McIntyre, *Transition Rules: Learning to Live with Tax Reform*, 4 TAX NOTES, August 30, 1976, at 7. A related discussion on effectuating Internal Revenue Service revenue rulings appears in Note, *Retroactive Revocation of Revenue Rulings*, 42 N.Y.U.L. REV. 91 (1967). See also Galper & Peterson, *The Equity*

demnations of retroactivity.³ The recent enactment of the Tax Reform Act of 1976,⁴ a major substantive revision of the Internal Revenue Code, coupled with announcements from President Carter that another substantial tax revision is impending,⁵ provide an auspicious occasion to reexamine attitudes about one problem of legal transitions—setting effective dates for changes in the income tax laws.

Tax legislation is an excellent vehicle for analyzing retroactivity issues. First, the legislature is relatively free to set whatever effective dates it chooses because constitutional constraints are few.⁶ Second, recent tax legislation reflects a wide variety of effective date provisions with Congress using no discernible principle of date selection.⁷ Finally, the dollar amounts at stake when tax provisions are revised are sufficiently high that practitioners are alert to the effective date issue and can be expected to argue their clients' cause to legislators. With that incentive, at least some legislators can be expected to address the issue explicitly and carefully.

Effects of a Taxable Municipal Bond Subsidy, 26 NAT'L TAX J. 611 (1973) (authors estimate the effects of enacting an elective direct federal subsidy to state and local governments choosing to issue taxable rather than tax-exempt bonds).

³ See, e.g., Committee on Tax Policy, New York State Bar Association, *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). See also Comment, *Limits on Retroactive Decision Making by the Internal Revenue Service: Redefining Abuse of Discretion in Section 7805(b)*, 23 U.C.L.A.L. REV. 529 (1976).

⁴ Pub. L. No. 94-455, 90 Stat. 1520 (1976).

⁵ See N.Y. Times, Feb. 11, at 1, col. 6 (President Carter reveals part of his tax reform plans scheduled for late 1977); *id.* May 13, 1977, § 4, at 1, col. 6 (Carter hopes that tax reform will not result in any change in the level of government revenues); *id.* Apr. 21, 1977, at 1, col. 4 (the President outlines the interrelationship between his tax and energy policies).

⁶ For a comprehensive analysis of the constitutional constraints on retroactivity in tax legislation, see L. Irish, *Time and Law: Retrospectivity and Prospectivity of Statutes and Judicial Decisions 230-70* (Trinity Term, 1971) (unpublished doctoral thesis submitted to Oxford University, on file with University of Pennsylvania Law Review). See also Novick & Petersberger, *Retroactivity in Federal Taxation*, 37 TAXES 407 (1959); Note, *supra* note 3, at 436 n.8 (collecting authorities).

⁷ One commentator has noted that the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969), composed of approximately 152 separate substantive provisions, took effect according to 84 different time schedules employing more than 40 different effective dates. Many provisions were retroactive to one of 20 different pre-enactment dates. See Note, *supra* note 3, at 436. Although no such systematic counting was attempted here, the 1976 legislation seems to contain at least as much variety in effective date provisions, with a somewhat greater penchant for effective dates that are nominally retroactive. See PRENTICE-HALL, CONCISE EXPLANATION OF THE TAX REFORM ACT OF 1976, at 9-15 (1976); examples cited in notes 20-24 *infra*.

II. DEFINING RETROACTIVITY

Retroactivity in tax legislation has been widely criticized.⁸ The following passage is typical:

If a transaction has been consummated prior to any suggestion that the applicable law might be changed, the taxpayer's reliance interest should be paramount. . . . Legislation made effective only from the date of enactment both produces predictability and avoids the problem of selecting an appropriate notice date. . . . Retroactive legislation may provide short-run revenue protection at too high a price in generating among taxpayers a sense of the unfairness of, and disrespect for, the tax system.⁹

Such criticisms of retroactivity in tax legislation have focused upon "nominal retroactivity"—effective date provisions which specifically apply new rules to transactions occurring prior to enactment. The problem of retrospective impact of changes in the tax laws is, however, a far broader problem. A change in the tax law, made effective as of the date of enactment, may also have retroactive effect, most often by changing the value of assets that were acquired prior to "any suggestion that the law might be changed."¹⁰ Revisions having these characteristics will be referred to as "nominally prospective."

For purposes of analysis it is essential to recognize the similarity in impact between a change which is nominally retroactive, and affects the value of transactions that occurred in the past, and one which is nominally prospective, but also has an effect on the value of past transactions. One can conceive of cases where the distinction between a law being nominally retroactive, rather than nominally prospective, is one day's difference between the effective dates. Such minimal differences illustrate the inadequacy of the analysis supporting widespread condemnations of nominally retroactive pro-

⁸ See, e.g., articles cited note 3 *supra*. See also note 79 & accompanying text *infra*.

⁹ *Retroactivity of Tax Legislation*, *supra* note 3, at 23, 26, 28.

¹⁰ For example, a decision to repeal the tax exemption for state and local bonds, effective with respect to interest paid or accrued only after the date of enactment, will immediately reduce the value of such bonds purchased before the change was announced. If the taxpayer had known that the change would occur, he might not have been willing to pay what he did for the bond. Similarly, had the seller known of the future change, he might have sold at a lower price.

visions, often accompanied by benign acceptance of prospective rules.¹¹

The Treasury Department analyzed the problems of transition in tax revision in a publication issued in January, 1977.¹² The Department recognizes that changes in the tax law will have varying relative effects on current wealth depending upon their effective date, and properly notes that this is also true of most variations in public policy.¹³ Treasury identifies two problems "requiring special transitional rules": (1) carryover problems and (2) price changes. The problems are described in the following passage:

Carryover 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. Price changes would occur in those instances where

¹¹ Some analysts have recognized the potential retrospective effects of nominally prospective tax laws, but also perceive differences which are illusory. For example, consider the following excerpt:

In determining the retroactivity of . . . a tax, it seems essential to focus on the economic event being taxed rather than the practical event which triggers it.

The point is made more vivid by comparing the hypothetical tax on capital gains with an estate tax passed the same day and exacting revenue at about the same rates. Suppose the income tax on capital gains is imposed at death on the appreciated but unrealized value of assets held by the decedent at this death. Suppose further that this tax is applied to a man who spent his life creating a large business enterprise on the basis of a minimal initial investment, so that virtually the entire value of the business is attributable to appreciation in value during his life. If he dies the day after the income tax is passed, is it retrospective as to him? The answer seems clearly yes, . . . the tax was merely triggered by a subsequent event; it was measured and imposed upon appreciation in value which occurred prior to its enactment.

By contrast, an estate tax passed the same day as the income tax and applied to the same man who died the next day would not be retrospective even if it yielded precisely the same amount of revenue. The estate tax is not levied upon the privilege of passing property at death; it is measured by the value of the property at death without reference to whether any part of that value is attributable to appreciation. Thus, if both of these taxes were passed the day before the man died and each exacted the same amount of revenue from his estate, one of them would be retrospective and the other prospective even though both were triggered by a post-enactment event.

L. Irish, *supra* note 6, at 314-15.

Why is a tax at death on capital gains classified as retrospective and a new estate tax as prospective, where both have the effect of reducing the value of assets held before enactment and presumably, in Irish's example, by the same magnitude? In both cases the decedent will pass less property to his heirs than he had expected.

¹² BLUEPRINTS, *supra* note 1, at 181-91.

¹³ *Id.* 187.

changes in the tax code altered the expected flow of after-tax income from existing investments *in the future*.¹⁴

The element common to both problems is that relative wealth has been changed because of the change in the tax law. The Treasury Department illustrates the carryover problem by reference to a retiree who has accumulated wealth, (assume from income subject to the federal income tax) which he expects to consume during his retirement. If a new consumption tax is introduced, his wealth will purchase less consumption than if the tax had not been introduced.¹⁵ The change in the tax law reduces the retiree's wealth and frustrates his expectations.¹⁶

Price changes occur whenever a change in the tax law alters the relative taxation of future earnings from an asset. Changes in relative rates of income taxation will produce changes in asset values. If the relative rate of taxation on future income is increased, the value of the asset will fall; if the relative tax is decreased the asset will become more valuable. A change in the average rate of taxation on all income would not likely affect asset values because proportional changes would occur in the taxation of earnings from alternative assets,¹⁷ although an increase in the average rate of taxation would reduce an individual's wealth, perhaps unexpectedly.

Although it may be possible to distinguish some effects described by the Treasury as carryover problems from price changes in that the wealth effects of the former will not necessarily be reflected in the market price of an individual's assets, the two kinds of problems are similar in their broadest economic effects.¹⁸ In the case of the retiree, consumption will necessarily be less than was

¹⁴ *Id.* 181.

¹⁵ *See id.* 182.

¹⁶ The impact of the change on the retiree's wealth, however, is the same as its impact on others with equal wealth and equal propensity to consume. The special concern the Treasury Department exhibits over this case seems justifiable only if the length of the time during which one builds his expectations matters or if the impact of the tax on the retiree's relative wealth is greater than that on a younger person because of his relative inability to work harder to offset the effects of the new tax.

¹⁷ *See* BLUEPRINTS, *supra* note 1, at 183. An overall increase or decrease in the income tax might, however, affect relative prices because demand for some goods is income elastic. Such price effects are unimportant to the analysis here.

¹⁸ Compare *id.* 182:

In general, carryover can be viewed as being conceptually different from changes in the price of assets. In the case of capital gains tax, for example, the change in an individual's tax liability for gains that have arisen by reason of a past increase in asset values does not affect the tax liability of another individual purchasing an asset from him; in general, the asset price depends only on future net-of-tax earnings.

anticipated because of a change in the tax law. Where an asset declines in value because of a tax change, the owner's potential to consume is also decreased. Assuming the decrease in consumption in each case is similar in magnitude, both problems should be treated as a wealth reduction due to the change in law.

Changes in the tax law may affect the price of existing assets (and the wealth of individuals) whether the effective date of the legislation is nominally prospective or nominally retroactive. In either event, expectations may be frustrated. The choice of the effective date, however, will determine which transactions will be affected by the change in law and by how much. Subsequent sections of this Article will discuss how efficiency and fairness considerations inform the choice of an effective date. Prior to that discussion, however, it is essential to isolate the wealth effects of the effective date choice.

III. QUANTIFYING THE EFFECTIVE DATE ISSUE

There may be many variations in the effective date provisions used in tax legislation,¹⁹ but for purposes of this analysis six categories are postulated:

- (1) Nominally Retroactive Effective Dates—the effective date of a provision precedes the date of enactment of the legislation, the date selected often being the date that a proposal for legislation was announced, or a tentative committee decision was reached;²⁰
- (2) Nominally Prospective Effective Dates—a provision is made effective from the date of enactment or from the beginning of the year following enactment;²¹
- (3) Delayed Effective Dates—a provision is made effective only after the passage of some time, for example, five years from the date of enactment;²²
- (4) Phased-In Effective Dates—the change is made effective gradually, for example, one-third in the year after enactment and one-third in each of the two subsequent years;²³

¹⁹ See note 7 *supra*.

²⁰ See, e.g., Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 804, 1013(f)(2), 1302, 2140, 90 Stat. 1520, 1596, 1616, 1617, 1715, 1932 (1976).

²¹ See, e.g., *id.* §§ 502, 902, 1404, 90 Stat. 1520, 1559, 1610, 1733.

²² See, e.g., *id.* §§ 201(c)(3), 301(g)(4), 2111, 90 Stat. 1520, 1527, 1554, 1905.

²³ See, e.g., *id.* §§ 1052, 1401, 1402, 90 Stat. 1520, 1647, 1648, 1731, 1732.

- (5) Grandfathered Effective Dates—future income from transactions entered into prior to the enactment date (or the date of a proposal for legislation or of a tentative committee decision) is exempted from the new rules;²⁴ and
- (6) Holder-Only Grandfathered Effective Dates—an exemption from the new rules applies only to persons who hold assets on a certain date, but the new rules are made applicable if the asset is transferred to another person.

Some simplifying assumptions are necessary to describe the wealth effects of each of these kinds of effective date rules in a manageable fashion. First, the substantive change is assumed to be the repeal of a tax exemption for income derived from certain investment assets. Such a change will alter the relative taxation of earnings from those assets and is the kind of change which most frequently elicits expressions of concern about the effective date rule and proposals for a grandfathered effective date. Such concern is magnified when a person's investment in the tax-favored asset was significantly influenced by the existence of the tax exemption now being repealed.²⁵ The Treasury Department, for example, contends that:

In general, the repeal of code provisions that provide an incentive for certain business-related expenditures or investments in specific assets should be developed to minimize the losses to persons who made such expenditures or investments prior to the effective date of the new law. The principal technique to effectuate this policy would be to grandfather actions under current law.²⁶

A second assumption is that the change affects income from an investment asset that is a long-term fixed claim, such as a state or local bond, and that the asset is not readily substitutable with assets in other industries which have not enjoyed tax-favored status.

²⁴ See, e.g., *id.* §§ 204(c)(2), 505(c), 603, 90 Stat. 1520, 1533, 1567, 1574.

²⁵ In such instances many analysts consider the taxpayer's reliance interest to be greater than in cases in which a tax provision that did not alter primary conduct is repealed. See, e.g., Note, *supra* note 3, at 439. This distinction, however, is not persuasive. The individual's reliance interest may merely be based on an assumption that he will have a specific amount of disposable income after tax. For example, the tax increase caused by repealing the extra personal exemption for blindness would upset the individual's expectations, even though he did not become blind in order to obtain the additional exemption. See note 77 *infra*.

²⁶ BLUEPRINTS, *supra* note 1, at 200.

These assumptions are designed to insure that the substantive change under analysis will create relatively significant wealth or price effects.²⁷

Third, all investments are treated as riskless, except for the risk associated with a possible change in the law that confers tax-favored status.

Fourth, to facilitate computations, it is assumed that the asset produces a regular stream of income paid to the owner at the end of each calendar year, and that the principal investment is repayable after a fixed number of years.

The example used is a long-term bond yielding annual interest payments, with the principal redeemable at a fixed maturity date. Varying the timing of income and return of principal would make the analysis more complex but would not affect the general conclusions reached here.

Finally, two classes of taxpayers are assumed under the income tax, with one class taxed at a rate of 50% and the other class taxed at a 20% rate. This assumption serves to illustrate the effects of a change in the context of a progressive income tax without requiring calculations based on a specific rate schedule.

A. *The Effect of a Change in Law*

A specific illustration of the effect of a change in law using the foregoing assumptions follows. If the before-tax market rate of interest on taxable bonds is 8%, and tax-exempt bonds pay interest at a market rate of 6%,²⁸ with all bonds selling at par value of \$100, the income stream from each kind of bond to each class of taxpayers may be described in the following manner:

²⁷ See BLUEPRINTS, *supra* note 1, at 185:

Immediate asset price changes generally would be greater for long-term fixed claims, such as State and local bonds, than for equity investments; greater for assets specific to a given industry (e.g., apartment buildings) than for assets that can be shifted among industries; and greater for assets the supply of which can only be altered slowly (e.g., buildings and some mineral investments) than for those the supply of which can be changed quickly.

²⁸ This ratio of tax-exempt and taxable interest rates generally conforms with recent experience. See Graetz, *Assessing the Distributional Effects of Income Tax Revision: Some Lessons from Incidence Analysis*, 4 J. LEGAL STUD. 351, 359 (1975). The assumed interest rates necessarily suggest a different rate schedule than that in the text. In particular, they require a marginal purchaser in a 25% tax bracket. See text accompanying note 32 *infra*.

(1) A fifty-percent taxpayer will invest in tax-exempt bonds since his after-tax rate of return will be 6% compared to an after-tax return of only 4% on taxable bonds.²⁹ He would expect to receive the following income stream:

Year	1	2	3	.	.	.	.	.	Maturity
Payment	6	6	6	.	.	.	.	.	106

If the income from the bond were made taxable in year one, the following income stream would be received:

Year	1	2	3	.	.	.	.	.	Maturity
Payment	3	3	3	.	.	.	.	.	103

(2) A twenty-percent taxpayer will invest in taxable bonds since they will produce an after-tax return of 6.4% compared with the 6% return available from tax-exempt bonds. He will expect the following income stream:

Year	1	2	3	.	.	.	.	.	Maturity
Payment	6.4	6.4	6.4	.	.	.	.	.	106.4

When the law is changed and the tax exemption repealed, an increase in demand for the taxable 8% bonds would be expected. Fifty-percent taxpayers holding 6% bonds (now taxable) will realize an after-tax return of only 3% on those bonds, compared to the 4% return available on the 8% bonds, and will, therefore, wish to sell 6% bonds and purchase 8% bonds. As a result, the price of the 6% formerly tax-exempt bonds will fall relative to the 8% taxable bonds. Twenty-percent taxpayers holding 8% bonds will not pay par (\$100) for the 6% bonds because they will yield an after-tax return of only 4.8%. To preserve his 6.4% after-tax rate of return (the after-tax yield from the 8% bond before the change), a twenty-percent taxpayer would pay only \$82.26 for the 6% bond (assuming a 20 year maturity). By comparison, to obtain the 4% after-tax rate of return available to him from the 8% bonds, a fifty-percent taxpayer would pay \$86.41 for the now-taxable 6% bond (again assuming a 20 year maturity).³⁰

The decrease in the price of the formerly tax-exempt bonds should also affect the supply of those bonds. In order to attract

²⁹ The after-tax income stream for taxable income is $C(1-t)$, where C is the taxable income generated by the asset and t is the taxpayer's marginal tax rate.

³⁰ The market price for bonds will, of course, be determined by the marginal purchasers.

investors, suppliers of 6% bonds will have to sell the \$100 par value bonds at a discount that is equivalent to an increase in the nominal rate of interest. Because the cost of borrowing has risen, the quantity of borrowing by the formerly tax-exempt issuers should decrease.

The foregoing illustration confirms the following principles.³¹ Prior to the repeal of the tax exemption, if there is a continuous progressive rate structure, rather than the dichotomized 50%/20% structure assumed above, there will be individuals taxed at a rate, t^* , where net after-tax returns are the same from tax-exempt and taxable investments.³² Individuals subject to higher marginal tax rates will tend to invest in tax-exempt assets while individuals subject to lesser tax rates will purchase taxable assets. The repeal of the tax exemption will reduce the after-tax rate of return available to individuals with tax rates greater than t^* . The price effects of the repeal will vary depending upon the maturity date of the bond; the longer the period until maturity the greater will be the decline in the value of the bonds. This follows from the fact that the greatest relative decrease in changed annual after-tax payments, compared to the unchanged return of principal, exists for those bonds with the latest maturity date.

Formerly tax-exempt bonds of similar maturity dates will suffer similar declines in value regardless of the holders' tax rates since the value of the bond will be determined by the marginal purchaser whose tax rate is t^* . Other effects of the change, however, will vary among individuals depending upon their marginal tax rates.³³ The repeal of the tax exemption reduces the supply of tax-favored assets and will therefore reduce opportunities for high-bracket taxpayers to obtain as great an after-tax rate of return. Thus, future after-tax income for individuals with marginal tax rates greater than t^* may be decreased as a result of the change, even though the decline in asset values is similar for all individuals.³⁴

Past analyses of the effects of a change in law typically have concentrated on those persons nominally affected by the change.³⁵

³¹ These general principles are similar to those set forth in *BLUEPRINTS*, *supra* note 1, at 183-85.

³² In the illustration given, t^* is equivalent to a tax rate of 25%.

³³ See *BLUEPRINTS*, *supra* note 1, at 84.

³⁴ The effect of the interrelation between the changes in the bonds' after-tax rates of interest and in the market value of the assets is more complicated than indicated here. Complexity results from the ordinary income treatment given interest payments as compared to the capital gain or loss treatment afforded to changes in assets' values. Such factors may be ignored for this analysis.

³⁵ See, e.g., *Retroactivity of Tax Legislation*, *supra* note 3; Note, *supra* note 3.

Thus, this illustration has focused on the decline in value of tax-favored investments held by persons prior to the repeal. The effect of a change, however, will often extend to persons other than individuals nominally affected. For example, depending upon the relative size of the market for substitutes (and on other conditions such as the interest elasticity of savings) there may also be a change in the value of assets that were taxable prior to the repeal. Similarly, the change may affect suppliers of assets in both the taxable and tax-exempt sectors. Such secondary effects are difficult to estimate³⁶ and will vary depending upon the kinds of assets which are affected by the change in law. For example, in using a fixed obligation bond as an illustration, one may ignore the possibility of shifting the loss of income resulting from repeal of the tax exemption to the supplier of the bond.³⁷ On the other hand, if the tax-favored asset were rental property, landlords and tenants might share the benefits of the tax reduction prior to the repeal, and both groups might be affected by the exemption's repeal.³⁸ In addition, elimination of such a tax exemption would affect the supply of housing.³⁹ Because of the difficulty of describing these secondary effects of a change in law, the detailed analysis that follows will focus on the holders of tax-exempt assets. This is appropriate given the concern for asset holders that usually underlies proposals for various effective date rules.⁴⁰ The next section considers the impact of various effective date rules on wealth.

B. *Nominally Prospective, Delayed, Phased-In, and Nominally Retroactive Effective Dates*

The impact of different effective dates on asset values may be illustrated by the example of a repeal of a tax exemption for interest from certain bonds. Because asset values are reflective of the expected after-tax income stream to be generated by the investment in the future, this analysis may be easily performed by examining the effect of the various effective date rules on the income stream.

³⁶ See generally, Graetz, *supra* note 28.

³⁷ The supplier of the bond will bear part of the burden of repeal of the exemption with respect to future bond issues. See text accompanying notes 30-31 *supra*. In the absence of any federal subsidies, the suppliers' costs of borrowing will increase. These costs will have their greatest impact on issuers who have developed their financing plans with the tax exemption in mind. See Graetz, *supra* note 28, at 360.

³⁸ See Graetz, *supra* note 28, at 353-54.

³⁹ See BLUEPRINTS, *supra* note 1, at 184.

⁴⁰ See *id.* 187-88; Note, *supra* note 3, at 439.

The income stream from the bond is represented schematically in Figure 1 where C is the annual interest payment on the bond; P is the principal payment; t is the tax rate; m_1 is the year prior to the effective date of the repeal of the exemption; $m_1 + 1$ is the effective date; and m is the maturity date of the bond:

Year	1	2	3	...	m_1	m_1+1	m_1+2	...	m
Payment	C	C	C	...	C	$(1-t)C$	$(1-t)C$	...	$(1-t)C+P$

Figure 1

If the effective date of the tax is a year later, in $m_1 + 2$, the income stream becomes that shown in Figure 2:

Year	1	2	3	...	m_1	m_1+1	m_1+2	...	m
Payment	C	C	C	...	C	C	$(1-t)C$	...	$(1-t)C+P$

Figure 2

The income streams in the two examples are identical except in year $m_1 + 1$, when the difference in income is $(t)C$. The effect, therefore, of choosing to make the tax effective in one year or the immediately subsequent year is a reduction in income equal to one year's tax on the annual interest payment. There is no substantial difference in enacting a change in either one of two years in the future, although delaying the change will, of course, lessen its impact by $(t)(C)$. If the period of the delay is extended, the difference in the income stream will be the tax on the annual interest payment in each of the years of delay.⁴¹

The effect of a phased-in effective date is only slightly different from that of a delayed effective date. If the taxation of formerly exempt income were phased in over a three-year period beginning in year $m_1 + 1$, with one-third of such interest taxable in each of the phase-in years, the income stream that would result is shown in Figure 3:

Year	1	2	3	...	m_1	m_1+1	m_1+2	...	m
Payment	C	C	C	...	C	$(1-\frac{1}{3}t)C$	$(1-\frac{2}{3}t)C$	...	$(1-t)C+P$

Figure 3

The difference between the phased-in effective date and full imposition of the tax in year $m_1 + 1$ is the additional income of

⁴¹ For example, the difference between enacting a change in year $m_1 + 1$ or $m_1 + 4$ is that in the latter case the holder of the tax-exempt bond will receive additional income of $(t)C$ in each of the years $m_1 + 1$, $m_1 + 2$ and $m_1 + 3$. If one is concerned with assessing the effect of the date choice on value at the beginning of the earliest year that the change could be made effective, $m_1 + 1$, this difference in the amount of income should be discounted to that date.

$\frac{2}{3}(t)C$ in year $m_1 + 1$, and $\frac{1}{3}(t)C$ in year $m_1 + 2$. A longer and more gradual phase-in would affect the income stream but not the analysis.⁴²

The differences in income flows noted above indicate that delayed or phased-in effective date rules will have the effect of reducing, somewhat, the magnitude of a change in asset values caused by a change in the law. The precise reduction will depend upon the delay or phase-in scheme selected.

The choice of an effective date rule will, therefore, have an effect on the wealth of individuals subject to the new rules. Unlike the impact of the change itself, this effect is independent of the maturity date for bonds maturing subsequent to the effective date, but will vary depending upon the individual's tax bracket.⁴³ As the above analysis makes obvious, a delayed effective date is more valuable to taxpayers in higher income brackets.

The analysis thus far has described the effects of choosing one year or another in which to make a change in the law effective; nothing has been explicitly stated about the difference between a date which is nominally retroactive and one which is nominally prospective. If a change in the law is enacted at the beginning of year $m_1 + 2$ and is made effective for all interest earned beginning with the year $m_1 + 1$, such a change would be nominally retroactive. The difference between this nominally retroactive tax revision and one which is nominally prospective, taking effect as of the date of enactment, is illustrated by Figures 1 and 2 above. The difference in impact is the tax on one year's interest for the year $m_1 + 1$. It has been argued, however, that nominal retroactivity presents a different case than the nominally prospective choice between year $m_1 + 2$ and $m_1 + 3$, although the impact on asset values is similar. Such arguments are premised on the belief that the nominally retroactive rule has a greater impact on people's expectations.⁴⁴

⁴² In order to compare the effects on asset values of the different phased-in effective date schemes the amount of additional income may be discounted to the beginning of year $m_1 + 1$. See note 41 *supra*. It should be possible to select a phase-in scheme and a delayed effective date which will produce equivalent asset value changes.

⁴³ Compare text accompanying notes 32-33 *supra*.

⁴⁴ Some argue that nominal retroactivity is particularly unnerving to individuals and increases risks in a special way. See, e.g., *Retroactivity of Tax Legislation*, *supra* note 3, at 23-25; Note, *supra* note 3, at 438, 433-34. From a purely financial standpoint, however, the difference is that a nominally retroactive rule creates a current liability in addition to reducing the present value of an asset. So long as the magnitude of the change is constant, there is no difference in the economic effect of these two rules on asset values. Nominal retroactivity may also create supple-

Looking at a taxpayer's expectations at the beginning of year $m_1 + 1$, one can analyze the paradigm case. Assume that at the beginning of that year, *A* sold a 6% tax-exempt bond to *B* at par value \$100. Assume further that taxable bonds of equal par value were paying 8% interest. If a change is enacted in year $m_1 + 2$ making interest on such bonds taxable beginning in year $m_1 + 1$, *B*'s expectations have been upset because he would have either purchased the 8% taxable bond or paid less for the tax-exempt bond. The tax-exempt bond he purchased has declined in value because of the change in the law. Notice, however, that the decline in value occurs primarily because the tax exemption has been repealed. As noted in Figures 1 and 2 above, any difference in value due to nominal retroactivity is slight. The repeal would not be nominally retroactive if it were made effective as of the beginning of year $m_1 + 2$. A nominally prospective change would also decrease the value of *B*'s bond, and *B* would be relatively better off only in that he would not lose the tax on the interest earned during $m_1 + 1$.

If *A* had kept the bond, the analysis would be similar with respect to him.⁴⁵ If expectations are to be protected with regard to this bond, it must be exempted from the change in law. This would require the enactment of a grandfathering provision.

C. Grandfather Rules

A grandfather rule would exempt from the change in law certain transactions entered into prior to the date of enactment.⁴⁶ Such a provision might exempt assets from the change in law regardless of who holds them (grandfathered effective date), or might exempt assets from the new law only as long as they are not transferred by the holder (holder-only grandfathered effective date).

mental costs primarily resulting from the annual accounting period used for tax purposes. These include the costs of filing tax returns, and those caused by underpayments of estimated tax.

⁴⁵ Assuming *A* did not sell the bond to *B*, if one looks at *A*'s expectations at the beginning of year $m_1 + 1$, the analysis is identical to that in the text. If, instead, one considers it more appropriate to evaluate the impact of the alternative effective date rules in terms of *A*'s expectations when he originally purchased the bond, the difference in impact must be discounted to the date of purchase. Such discounting would, of course, reduce the impact below the nominal amount of the tax on one year's interest payments, and this reduction would increase proportionally with the length of time since *A* purchased the bond. See text accompanying notes 74-75 *infra*.

⁴⁶ The critical date might instead be the date of announcement of a proposal for legislation or of a committee decision. The use of such alternatives would not substantially affect this analysis.

The effect of a grandfathered effective date may be illustrated by returning to the example of the tax-exempt bond.⁴⁷ With the enactment of a grandfathered effective date, the effect of the change in the law would be to eliminate the tax exemption on bonds which are issued after the date of enactment; interest on previously issued tax-exempt bonds would remain exempt from tax. Because the bonds are not perpetuity obligations, all bond interest will be subject to tax after the bonds outstanding as of the enactment date reach maturity. With varying maturity dates for the bonds outstanding as of the date of enactment, the supply of tax-exempt bonds will shrink during the period from the date of enactment until they all have matured. The maximum supply of tax-exempt bonds would be fixed as of the date of enactment.

With a grandfathered effective date, the value of the remaining tax-exempt municipal bonds will rise as higher-bracket taxpayers purchase them from lower-bracket taxpayers. This would occur as follows, given interest rates of 6% on the tax-exempt bonds and 8% on taxable bonds, each selling at \$100 par value. As indicated above,⁴⁸ individuals with a marginal tax rate of t^* would be indifferent between tax-exempt and taxable bonds before the change. Persons with marginal rates in excess of t^* would prefer tax-exempt bonds. With the interest rates specified, t^* is a tax rate of 25%. Following the repeal of the exemption interest on all newly issued bonds would be taxable. Assuming that the interest rate on taxable bonds remains unchanged at 8%, a fifty-percent taxpayer would be able to obtain only a 4% after-tax return on new investments.⁴⁹ To obtain a 4% yield from a grandfathered 6% tax-exempt bond, the fifty-percent taxpayer could, for example, pay up to \$127.18 for a bond with 20 years until maturity or \$116.23 for a bond with 10 years until maturity. A taxpayer with a 70% marginal rate would, of course, pay more. A forty-percent taxpayer would pay only \$109.38 for the 10 year bond (to yield 4.8%, his after-tax yield on the 8% taxables). New market prices would develop for grandfathered bonds depending on their maturity dates.

Without empirical work, it is impossible to know exactly what total rise in the price of grandfathered tax-exempt debt would occur, or how the gains from the new market price would be shared between the sellers and buyers of grandfathered bonds. A study by David J. Ott and Allan H. Meltzer using 1960 data estimated that

⁴⁷ See text accompanying notes 28-30 *supra*.

⁴⁸ See text accompanying notes 32-33 *supra*.

⁴⁹ This assumes no other tax shelter opportunities exist.

the elimination of the tax exemption for all state and local bonds, without any exception for outstanding bonds, would cause an approximate 12.5% reduction in the total value of outstanding tax-exempt bonds.⁵⁰ While no estimate was made of the increase in the value of outstanding bonds which would result from a grandfathered effective date, the price effects described above suggest that a substantial premium might be paid.

If the grandfather clause were applied only to tax-exempt bonds in the possession of holders of such bonds as of the date of enactment (holder-only grandfathered effective date) the value of the bonds to new owners would decline in a manner similar to that when no grandfather clause is enacted.⁵¹ There would be a decline in the value of formerly tax-exempt bonds to the extent that the present owners find it necessary to transfer the bonds. So long as the present owners hold the bonds, however, the interest will continue to be tax-exempt; bonds already issued would, therefore, be more valuable to their present holders than newly-issued, taxable municipal bonds.

The increase in the price of grandfathered bonds, illustrated above, results from the relationship between the yield on tax-exempt and taxable bonds, which, in turn, depends upon the tax rate of the marginal purchaser. The demand from purchasers with higher marginal tax rates under the progressive rate structure determines the increase in price. Price increases attributable to grandfather clauses may occur in a wide variety of circumstances, however, without regard to the progressivity of the rate schedule. Assume, for example, that a subsidy is provided to producers of specified goods. The introduction of the subsidy will typically result in a decrease in the price of the subsidized good and an increase in the output of the good. The precise effects of the subsidy on price and quantity will depend upon the elasticities of supply and demand of the good.⁵² If the subsidy is repealed,

⁵⁰ D. OTT & A. MELTZER, *FEDERAL TAX TREATMENT OF STATE AND LOCAL SECURITIES* 88-89 (1963). The quoted figure assumes that the average maturity of outstanding bonds is 10 years. If the average is assumed to be 7½ years, the loss in value would be approximately 10%. *Id.* 89 n.2.

⁵¹ The decline in price would be the same as with the immediate repeal of the tax exemption because any new buyer will view these bonds as substitutes for taxable bonds. Price will, of course, be determined by the marginal buyers.

⁵² For example, if either demand or supply is very inelastic, significant increases in output will not occur. If demand is very inelastic, the subsidy will reduce the price of the goods by almost the amount of the subsidy per unit. Where both supply and demand are moderately elastic in the area of the initial equilibrium, prices will decline and output will increase. *Cf.* R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 444-46 (2d ed. 1976) (effect of sales tax on output and price depends upon elasticities of supply and demand).

ceteris paribus, the output and price would be expected to return to the equilibrium in effect before the subsidy was introduced. If the products of certain firms are grandfathered, however, so that the subsidy is continued for those firms, they will enjoy economic rents. For example, if a subsidy is provided (either directly or through the tax system) to suppliers of housing, the output of housing will increase and rental prices will fall. When the subsidy is repealed rental prices and output will tend to return to the original equilibrium, but an owner of a grandfathered apartment building will also enjoy increasing rental prices because he is now competing with unsubsidized owners. The value of the grandfathered apartment building will increase relative to unsubsidized housing.⁵³

IV. EFFICIENCY AND FAIRNESS CONSIDERATIONS

The preceding analysis of different effective date rules demonstrates that criticism of nominally retroactive effective dates has been misdirected. In the context of a progressive income tax, a change in the law, whatever its effective date, will typically have retroactive impact. Asset prices will likely be affected by the legal change regardless of which effective date rule is applied. The difference in impact between a nominally retroactive change and one which is nominally prospective is often slight. Grandfathering rules do present a distinct situation among effective date variations, because their use may result in an increase rather than a decrease in the wealth of an affected taxpayer. This section of the Article

⁵³ Theoretically at least, it should be possible to structure transitional rules to avoid windfall increases in asset values produced by grandfather rules. Phased-out grandfather rules are one possibility. I am indebted to Emil Sunly of the Department of the Treasury for an additional illustration of how this might be accomplished through the use of taxable subsidies to previously tax-favored assets. In the case of repeal of the tax exemption for interest on municipal bonds, an interest subsidy could be provided for bonds previously issued as follows: Assuming an average yield differential of 25% between tax-exempt and taxable bonds (as in the example in the text with taxable yields of 8% and tax-exempt yields of 6%), a federal subsidy equal to 25% of the gross taxable yield (2% in this case) could be paid on bonds issued prior to repeal. The entire yield, including the subsidy, would then be taxable. Such a subsidy should result in neither a decline nor an increase in the value of previously tax-exempt bonds. The marginal purchaser would be indifferent in choosing between these bonds and other taxable bonds. Infra-marginal purchasers of tax exempt bonds—those with marginal tax rates greater than t^* —would, however, lose their surplus. This mechanism is presented here as a theoretical possibility. Structuring such a subsidy, even in the case of tax-exempt bonds where excellent data concerning yield differentials is available, would be a very difficult practical task because different maturities, discounts and premiums might have to be taken into account. In other contexts where similar data is unavailable, determining the proper level of subsidy would be virtually impossible. Transitional mechanisms such as this will not be considered further here, but they merit additional study.

illustrates how considerations of efficiency and fairness inform the choice of an effective date.

In the discussion which follows, it is assumed that taxpayers suffering losses from changes in the law will not be compensated. If there is a "taking" of property, however, the Constitution requires compensation.⁵⁴ This constitutional requirement limits the situations in which public policy can be changed without spreading the costs of change among the population through compensation from the public treasury.⁵⁵

A. Efficiency Considerations

Evaluating how different effective date rules affect the "efficient" allocation of resources is a difficult task. Although it has become rather common for scholars to utilize efficiency as one normative test of law and legal processes, analysts often leave unsaid exactly what they mean by efficiency. Martin Feldstein, for example, in arguing for compensation, or at least delayed effective dates, in tax reform, states that, "Tax changes make individuals uncertain about the future reliability of the tax laws. Their anticipation of future possible changes induces *inefficient precautionary behavior*."⁵⁶ He does not explain, however, why individual be-

⁵⁴ The Fifth Amendment provides that "private property [shall not] be taken for public use, without just compensation." U.S. CONST. amend. V. The precise delineation of what is and is not a "taking" within the meaning of this provision is beyond the scope of this Article. It is assumed that any tax law changes considered here do not amount to "takings."

⁵⁵ There is also a statute of limitations, which serves as another bound on the potential impact of a change in the income tax law. In the bond example, due to the statute of limitations interest on bonds paid or accrued more than a certain number of years prior to the date of enactment will not be affected by the change in law. Thus, the statute of limitations, generally three years in the income tax law, serves as a limitation on nominal retroactivity and on the amount of loss any one individual can suffer. See I.R.C. § 6501(a). Although § 6501(a) may, of course, be amended so that certain events more than three years in the past could be reached by the substantive change in the law, the placement of the statute of limitations in a section separate from substantive provisions may represent some barrier (if only because of legislative "inertia") to enacting amendments related to isolated substantive changes. But cf. Sekula, *Retroactive Remedial Tax Legislation and the Statute of Limitations—The Silenced Claimant v. I.R.S.*, 9 DUQ. L. REV. 1 (1970) (retroactive tax legislation conferring benefits on taxpayers sometimes opens statute of limitations for refund claims). In any case, the statute of limitations creates an outer time limit beyond which taxable events cannot be reached without such amendment. Losses from legal change are, therefore, not unbounded, but rather are limited by a statute of limitations and by the takings clause.

⁵⁶ Feldstein, *supra* note 1, at 93 (emphasis added). Although Feldstein does not describe why such behavior is inefficient, he generally treats efficiency as maximizing total social welfare. Feldstein himself notes some of the difficulties with the definition of a generalized (typically utilitarian) social welfare function, *id.* 79-86, and the concept has been seriously questioned in the burgeoning social choice literature. See, e.g., Mueller, *Public Choice: A Survey*, 14 J. ECON. LIT. 395

havior which takes into account subjective probabilities of a change in the law is inefficient.

Economists are not reluctant to describe a competitive market as efficient, although it is certainly not unchanging nor even predictable. People typically make long-term capital investments under conditions which produce expectations that these investments will be profitable. Nevertheless, tastes and societal conditions change; technological advances, for example, may render production methods obsolete. Changes of this sort may be of such magnitude that investors will suffer sizeable losses. An economist would not suggest, however, that these losses are inefficient. On the contrary, it is the ability of the market to adjust output to reflect changes in tastes and technology that is often described as its greatest achievement. Protection by law of those who invest in a product or process which is subsequently disdained in the marketplace is not required, nor even suggested by efficiency criteria. Why should efficiency demand a different result when losses occur because a change in tastes or societal conditions is reflected through the political process, rather than in the market? Those who fervently argue for compensation (or other protection, perhaps through a grandfathered effective date) for losses suffered as a result of a change in the law would, no doubt, be appalled if similar protection were proposed for those who had invested in the Edsel or in hula hoop production. What, then, is the difference between market and political processes that justifies protection only from political change? Such a justification becomes particularly difficult in the context of a mixed economy in which the market is so often affected by political decisions.

Efficiency does not require individuals to assess a zero probability of change in the law before they respond to a legal rule. Changes in tastes and technology should be expected to produce changes in political output. The risks of a change in law do not seem necessarily different in kind nor in magnitude from the risks of a change in market demand or technology. A priori, it cannot be said that the latter are less random, more predictable. Absent any convincing empirical showing that the losses from political change are disproportionately distributed or more burdensome on productive output than market-reflected changes, efficiency criteria seem

(1976); Plott, *Axiomatic Social Choice Theory: An Overview and Interpretation*, 20 AM. J. POLITICAL SCI. 511 (1976). Nevertheless, the utilitarian concept of maximum social welfare is often used as the efficiency criterion for evaluating tax systems. For a review of the literature, see Bradford & Rosen, *The Optimal Taxation of Commodities and Income*, U.S. Treasury Dep't, Office of Tax Analysis, OTA Paper 8 (Dec. 1975). See also Musgrave, *ET, OT and SBT*, 6 J. PUB. ECON. 3 (1976).

not to require delayed or grandfathered effective dates. In fact, efficiency may demand that persons expect changes in the law. In the market context, only behavior that takes into account probabilities of change is treated as reasonable.⁵⁷ Reasonable expectations in the political context may, likewise, consist of only those which assess some subjective probability of change in the law.⁵⁸

The Treasury Department apparently takes a contrary view, presumably on the assumption that government processes do not represent an aggregation of preferences through a representative process, but rather are far more subject to control or central direction than are market processes.⁵⁹ This view of the government process would seem to call for compensation for any losses incurred as a result of changes in government policy. A shift in the federal budget from defense spending to health insurance, for example, could not be undertaken without compensation to those who had invested in the defense sector. Likewise, once wage, price or rent subsidies or controls were established, they could not be removed without compensation or, at a minimum, some form of grandfathering.⁶⁰ Such requirements would impose too great a burden on society by inhibiting otherwise efficient changes in government policies.

Only if efficiency is defined as "Pareto-superiority" is a contrary conclusion required. The remainder of this section of the Article discusses this and related efficiency criteria.

1. Pareto-Superiority

Pareto-superiority is sometimes advanced as the appropriate efficiency criterion for evaluating whether one set of legal rules

⁵⁷ The expected utility hypothesis which typically forms the basis for economic analysis of "rational behavior in risky situations" treats individual behavior as "an attempt at the maximization of . . . utility numbers" where "[t]he utility from each alternative is weighted by its probability." A. K. SEN, *COLLECTIVE CHOICE AND SOCIAL WELFARE* 95 & n.9 (1970). See also J. VON NEUMANN & O. MORGENTHAU, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* 17 & n.2 (2d ed. 1947).

⁵⁸ The private individual, even one lacking sophisticated counsel in political affairs, is not without clues regarding potential changes in the law. In some cases, a law will specify an expiration date or otherwise explicitly suggest a future change. For example, special tax breaks for the rehabilitation of low-income housing and for the installation of certain coal mine safety equipment, as first enacted in 1969, contained five-year expiration dates. See I.R.C. §§ 167(k), 187. Even such projected expiration dates are, however, subject to subsequent revision. For example, the provisions of § 167(k) were extended until 1978 by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 203(b), 90 Stat. 1520 (1976).

⁵⁹ See BLUEPRINTS, *supra* note 1, at 187.

⁶⁰ The Treasury Department avoids reaching the foregoing conclusions, without explaining how these examples differ from changes in the tax laws, for which compensation is said to be desirable. See *id.* 187-88.

should be preferred over another.⁶¹ An outcome is recognized as Pareto-superior to another outcome only if at least one person believes himself better off under the former than under the latter outcome and no one believes himself worse off.⁶² Efficiency defined in this fashion would demand unanimity as a decisionmaking rule, and would, therefore, require compensation from those who benefit from a change in law to those who lose or, at minimum, that an effective date rule (perhaps a grandfather clause) be adopted to insure that no one will be made worse off by the change.⁶³

The Pareto criterion is, however, often rejected as unduly limiting.⁶⁴ While more than a majority vote is required for certain legal changes—constitutional amendment, for example,⁶⁵—unanimity is virtually unknown as a requirement for change. The rejection of unanimity as a decisionmaking rule has required economists to accept less conservative evaluation criteria. A widely accepted notion for evaluating policy changes is “potential Pareto-superiority.”⁶⁶ This criterion describes as “optimal” a change from one social state to another in every circumstance in which if those who would gain from the change could pay compensation to those who

⁶¹ See Ackerman, *Introduction* to *ECONOMIC FOUNDATIONS OF PROPERTY LAW* xiii (B. Ackerman ed. 1975); J. BUCHANAN & G. TULLOCK, *THE CALCULUS OF CONSENT* 92-96 (1962); see also A. K. SEN, *supra* note 59, at 21-22.

⁶² For a general discussion of the Pareto criterion see A. K. SEN, *supra* note 57, at 21-27, 83-85.

⁶³ In *The Calculus of Consent* James Buchanan and Gordon Tullock argue that unanimity is the appropriate basis for social choice:

The individualistic theory of the constitution . . . assigns a central role to a single decision-making rule—that of general consensus or unanimity. The other possible rules for choice-making are introduced as variants from the unanimity rule. These variants will be rationally chosen, not because they will produce “better” collective decisions (they will not), but because, on balance, the sheer weight of the costs involved in reaching decisions unanimously dictates some departure from the “ideal” rule.

J. BUCHANAN & G. TULLOCK, *supra* note 61, at 96. Not surprisingly, these authors have argued elsewhere for compensation to those who lose from changes in legal rules, at least where gains from post-change efficiencies so permit. See, e.g., Tullock, *supra* note 1, at 678.

⁶⁴ A. K. Sen, for example, notes:

This method [insisting on unanimity for a change and if there is no unanimity, sticking to the status quo] 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. K. SEN, *supra* note 57, at 25 (footnote omitted).

⁶⁵ See U.S. CONST. art. V.

⁶⁶ See Michelman, *supra* note 1, at 1173-77; Comment, *The General Welfare, Welfare Economics, and Zoning Variances*, 38 S. CAL. L. REV. 548, 554-60 (1965) (discussing authorities); cf. R. MEYER, *MICROECONOMIC DECISIONS* (1976) (adopts “potential Pareto-superiority” in context of economic decisionmaking).

would lose, the change would win unanimous approval.⁶⁷ This definition of efficiency "requires only hypothetical willingness to pay and accept; it does not require actual payment."⁶⁸ Thus, if we limit our discussion to situations where the change in the law is optimal under such a criterion, considerations of efficiency do not preclude the benefit of some at the expense of others.⁶⁹ Whether those who would lose from the change should actually be compensated or protected from loss by an effective date rule is left to ethical considerations and the demands of fairness.⁷⁰

2. Cost-Benefit Analysis

Concepts of efficiency such as avoiding the waste of resources, often formalized by economists as cost-benefit analysis, are related to potential Pareto-superiority. If an activity can take place in an alternative fashion, utilizing fewer resources, it should be possible to make someone better off without anyone being made worse off.⁷¹

⁶⁷ This is the Kaldor-Hicks test of optimality. To avoid circularity it is essential that the losers not be able to bribe the potential gainers to forego the change. This refinement was added by Scitovsky. See A. K. SEN, *supra* note 57, at 30-31; R. MEYER, *supra* note 66, at 360-61.

⁶⁸ Michelman, *supra* note 1, at 1177; see R. MEYER, *supra* note 66, at 361.

⁶⁹ It is conceivable that a change might be efficient under this criterion with one effective date and inefficient with another. Examples, however, are difficult to conceive; if, for instance, the magnitude of a change were reduced through a delayed effective date, both losses and gains would be reduced. In any event, due to problems of information, it seems virtually impossible to identify such circumstances empirically. Information problems will, of course, be exacerbated by strategic behavior in a context where compensation is not actually to be paid. In other circumstances, if the change in the law is efficient under this criterion, it will remain efficient whatever effective date is selected. As a result, even "potential Pareto-Superiority" will be of little use in informing the choice of an effective date.

⁷⁰ See text accompanying notes 78-119 *infra*.

⁷¹ See, e.g., E. J. MISHAN, *ECONOMICS FOR SOCIAL DECISIONS* (1972):

[T]he rationale of existing cost-benefit criteria is ultimately that of a potential Pareto improvement. Ignoring for the present (a) the difficulties of evaluation and (b) the problems that arise when outlays and benefits are expected to appear at different times in the future, the formal requirement of a potential Pareto improvement, and therefore of a cost-benefit criterion, is simple.

. . . [A]ll calculations that enter into a cost-benefit analysis . . . are to be interpreted as contributions, positive or negative, to the magnitude of some resulting potential Pareto improvement. What is to be concluded, then, from a cost-benefit analysis showing, say, an excess gain of \$100,000 is *not* that everyone concerned is made better off in varying degrees; only that it is conceptually possible, by *costless* redistributions, to make everyone better off, in total by an amount equal to \$100,000. . . .

. . . .

. . . A person who agrees to apply the principles of allocative efficiency needs no new assumption to extend his agreement to the application of existing cost-benefit analysis. In sum both the principles of economic

This notion of efficiency suggests evaluating various effective date rules to determine whether certain of them are more wasteful of resources than others. This inquiry requires analysis of potential costs and benefits which might accrue depending upon the effective date rule selected.

The major cost from failure to grandfather repeal of incentive provisions should be an increased revenue cost to the government when tax incentive provisions are enacted. If taxpayers could rely upon grandfathered effective dates as protection against unfavorable subsequent revisions in the law, they would require a lesser incentive to enter into the desired transaction than if they must consider the risk of a change in the law. Absent certain knowledge that a grandfather rule will protect them taxpayers should be expected to demand an additional amount of incentive—an “uncertainty premium”—to compensate for the probability that the incentive might later be repealed. This point can be illustrated by the tax-exempt bond example. Assume that in pursuing a public policy to encourage individuals to invest in certain kinds of bonds, a law is enacted exempting interest on those bonds from taxation. Because of the tax exemption, individuals with positive tax rates will accept a lower rate of interest on tax-exempt bonds than on taxable bonds. The rate of interest demanded, however, may be greater than otherwise expected if the purchaser must take into account the possibility that the interest on a tax-exempt bond may become taxable in the future. If the purchaser knows that a tax-exempt bond will be protected from repeal of the tax exemption by a grandfather clause, he will not require a premium for the risk of change in the law. Even assuming that it is impossible for individuals to be certain that a grandfather clause will be enacted to protect transactions,⁷² it is still true that as the probability of a grandfather rule increases, the uncertainty premium should decrease.

Determining the amount of uncertainty premium which will be demanded in the absence of a consistent policy of grandfathering is a difficult, if not impossible, empirical task. The amount of premium will vary directly with individuals' subjective probabilities as to the risk of a change in the law. For example, if an

efficiency and those of cost-benefit analysis derive their inspiration from the potential Pareto criterion, and a person cannot with consistency accept the one and deny the other.

Id. 14-17.

⁷² There is simply no way to provide complete assurance that a transaction will not be affected by a change in law. Even a constitutional guarantee of grandfathered effective dates would not provide certainty, since the Constitution itself is subject to amendment.

individual assessed the probability of a change in the law to be zero, he would demand no premium. To the extent that individuals' subjective probabilities of change are equal to or less than the government's assessment of the probability of change (if it is meaningful to talk of such a thing), government payment of the premium would be efficient. The government would be paying an additional cost which reflects its determination that the incentive is likely to be desirable for only a fixed period of time.⁷³ To the extent people are risk averse and the government is risk neutral, the premium would be increased. One might view the premium as a payment sufficient for the individual to insure against the risk of loss from a change in the law.

In addition, the amount of the uncertainty premium will vary depending upon individuals' estimates of when a change is likely to occur. Part III of this Article illustrates the impact of various effective date rules by looking to their effect on individual expectations at the time immediately preceding a change in the law—in effect assuming that in holding an asset, an individual decides at each point in time not to sell it. The amount of any premium required because of potential changes in law will, however, depend upon the individual's expectations at the time of purchase. For example, if an individual at the time of purchasing a tax-favored asset estimated with a probability of one that the tax-favored treatment would end at a certain date, the price he would be willing to pay for the asset would be less the closer the date of predicted change to the date of purchase.⁷⁴ Thus, assuming a constant magnitude of change, the effect of the potential change on the amount the individual is willing to pay as of the date of original purchase will be less the greater the period between the date of original purchase and

⁷³ As an alternative, the original incentive legislation might specify a fixed expiration date. Of course, the incentive might subsequently be extended beyond that date (or, less likely, repealed prior to that date). This is not uncommon in the tax law. See, e.g., Tax Reform Act of 1976, Pub. L. No. 94-455, § 203(b), 90 Stat. 1520 (amending I.R.C. § 167(k) (1970 & Supp. V 1975)) (extension of tax incentive for rehabilitation of low-income rental housing); *id.* § 802(a) (amending I.R.C. § 46 (1970 & Supp. V 1975)) (extension of 10% investment credit); *id.* § 2107(b) (amending I.R.C. § 50B (Supp. V 1975)) (extension of welfare employment incentives). Whether the cost of the incentive to the government would be greater in these circumstances than without a "target" date for repeal is difficult to know. In any event, specifying a termination date does not eliminate the question whether a grandfathered effective date is desirable.

⁷⁴ If the fifty-percent taxpayer in our bond example wanted to buy a twenty-year tax-exempt bond, and anticipated a repeal of the tax exemption only at the end of the twenty-year period, he would be willing to pay up to \$127.18 for the bond. If, on the other hand, he expected the tax exemption to be removed after 10 years he would pay only as much as \$110.75.

the date of potential change.⁷⁵ Where individuals expect that no change will occur until the distant future, the amount of premium will be quite small.

Moreover, even if some premium must be paid for eschewing grandfathered effective dates, the costs of such a premium at the date of original enactment must be related to the costs of grandfathering at the time the law is changed in order to determine whether such a premium is wasteful. Paying a premium in lieu of grandfathering is not necessarily inefficient; enacting the grandfather clause at the time of repeal will not be costless. First, grandfathered effective dates will often reduce whatever benefits are expected to be realized from the change in the law. The social gains to be realized from the change will often be delayed with a grandfathered effective date. For example, efficiency gains resulting from the elimination of investment distortions might be deferred. In addition, among the benefits which might be expected from the repeal of a tax-exemption for interest on certain bonds is a reduction in the after-tax income available to high-bracket taxpayers who have purchased such bonds. As long as high-bracket taxpayers can purchase grandfathered tax-exempt bonds, and enjoy tax-free income flow, redistributional policies will be frustrated.

Second, grandfathered effective dates often increase planning and enforcement costs for both taxpayers and the government. Where different substantive rules govern essentially similar transactions because of grandfather rules additional complexity results.⁷⁶

Third, the grandfather clause may itself be wasteful compared to another alternative. Part III above demonstrates that the elimination of a tax advantage by changing the law without a grand-

⁷⁵ Thus, if we are concerned with the impact of various effective date rules on conduct in response to incentive provisions, the more distant in the past the original commitment, the less the taxpayer's present "reliance" interest. The foregoing analysis suggests that either: (1) The date of original purchase is irrelevant and the issue should be treated in terms of persons' expectations immediately before the change, as illustrated in Part III; or (2) The date of original purchase is relevant, and the reliance interest is greatest for those who purchased at a date closest to the date of change; commitments made in the distant past present the least cause for concern. The special concern in the literature for commitments made long ago is in either event misplaced.

⁷⁶ Examples of tax provisions greatly complicated by grandfathered effective dates abound. See, for example, the depreciation recapture provisions of § 1250 of the Internal Revenue Code. I.R.C. § 1250 (1970 & Supp. V 1975), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 202, 90 Stat. 1520. These provisions were first enacted with various grandfathering clauses in 1964, and were amended in 1969, 1975 and again in 1976. See also Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520 (to be codified as I.R.C. § 1023), which provides special grandfather rules for basis determinations of property transferred at death.

fathered effective date will produce losses to holders of previously tax-favored assets. A grandfathered effective date will produce gains to such persons. Without empirical work, it is impossible to know the magnitudes of such gains or losses. Given an assumption that the change in the law is itself efficient, it would be possible to compensate losses where no grandfather clause is enacted. If such compensation would cost less than the increases in asset value resulting from a grandfather clause, it would seem that the grandfather clause would be a more costly alternative than a non-grandfathered effective date, whether or not compensation is actually paid.

Significant costs from current effective date policies in the tax context also result from variations and inconsistencies in effective date rules. In addition to advising clients as to the likelihood of change, tax advisors are often called upon to predict the likely effective date if the law is changed. The costs of such advice would be reduced by the adoption of any consistent or readily predictable effective date policy.⁷⁷

⁷⁷ Some commentators seem to suggest that the principal benefit of enacting a grandfathered effective date at the time of a change in the law results from the avoidance of "demoralization" costs from making the change. Professor Michelman defines demoralization costs as:

the total of (1) the dollar value necessary to offset disutilities which accrue to losers and their sympathizers specifically from the realization that no compensation is offered [in this case the realization that transactions are not grandfathered], and (2) the present capitalized dollar value of lost future production (reflecting either impaired incentives or social unrest) caused by demoralization of uncompensated losers, their sympathizers, and other observers disturbed by the thought that they themselves may be subjected to similar treatment on some other occasion.

Michelman, *supra* note 1, at 1214 (footnote omitted).

No one has conducted a systematic inquiry to ascertain whether such costs are widespread or whether, in fact, they even exist. Proponents of grandfather clauses, however, often emphasize the demoralization resulting from the change in circumstances when those individuals induced to engage in certain activities through beneficial legislation find that the activity is no longer favored because the law has changed and the benefits eliminated. This is a principal argument advanced by the Treasury Department, *BLUEPRINTS*, *supra* note 1, at 181. The Department presumes that demoralization costs will be less if the rule which is changed is not a rule which was originally intended to affect primary conduct. For example, repeal of a specific incentive provision would allegedly produce greater demoralization costs than repeal of a provision that caused no change of primary conduct, for example, repeal of the additional personal exemption for blindness. Presumably, these "demoralization costs" could be avoided by grandfather clauses. Of course, to the extent that people take into account probabilities of changes in the law, demoralization costs will not occur. To the extent that such costs do exist, they may represent nothing more than disappointment that a change in the law occurred in circumstances where an individual underestimated a subjective probability of change. The policy of varying effective date rules, sometimes grandfathering and sometimes not, tends to increase the occasions when actual losses will vary from an individual's

The foregoing discussion of various efficiency criteria demonstrates that grandfathered rules are not necessarily to be preferred in tax reform legislation. Fairness considerations must, therefore, be investigated to determine whether they form a basis for a policy of grandfathering changes in the law.

B. Fairness Considerations

Arguments against retroactivity and in favor of grandfather clauses are often grounded in notions of fairness. It is most frequently argued that fairness demands that persons should be able to rely on current law remaining unchanged with respect to transactions consummated prior to the enactment of a revision.⁷⁸ Determining what fairness requires when legal rules are changed is as difficult and controversial a task as analyzing efficiency considerations supporting various effective date rules. Often a proposal is described by its proponents as fair, just, or equitable without further elaboration. There exists no generally accepted test of fairness that one can apply to this sort of issue. Nevertheless, perhaps by detailing the arguments and, where possible, testing them against widely accepted notions of fairness, a judgment about the fairness of various effective date rules will emerge. The predominant notion of fairness invoked by proponents of grandfathered effective dates is one of "fairness as reliance." This concept will be treated first; considerations of how the concepts of horizontal equity, vertical equity

estimates. If people knew that grandfather clauses would not (or would always) be provided when the tax law is changed, demoralization costs would be reduced.

Although demoralization costs are difficult to estimate, they may well be a major category of costs currently taken into account in the political process. Offsetting costs from grandfathered effective dates, *see* text accompanying notes 75-77 *supra*, on the other hand, seem to have been less readily acknowledged in recent legislation. Compare H.R. REP. NO. 1380, 94th Cong., 2d Sess. 6, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3360 (early version of § 2005 of Tax Reform Act of 1976, providing carryover basis for property passed at death without special grandfathering rule, will "reduce the inefficiency and inequity of the present system" of stepped-up bases for such property) with H.R. CONF. REP. NO. 1515, 94th Cong., 2d Sess. 612, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4251 (modification of early version, so as to provide special grandfather rules, "continues existing law with respect to appreciation in property accruing before January 1, 1977, and provides everyone with a 'fresh start'"; consequent impingement on goals of efficiency and equity, as well as reduction in revenues, are not mentioned). *See also* 122 CONG. REC. S16016 (daily ed. Sept. 16, 1976) (remarks of Sen. Curtis). Moreover, the possible income effect that may result from an increase in income tax makes any "demoralization" effect on individual taxpayer's productivity virtually impossible to rationalize. Thus, the weight properly attached to alleged demoralization costs in setting effective dates for tax changes is open to question.

⁷⁸ *See, e.g.,* Hochman, *supra* note 1, at 322. Hochman argues that "[T]ransitional equity's] concern is with entitlements to certainty that pre-existing rights and endowments sanctioned by a social contract will continue undiminished." *Id.* *See also* *Retroactivity of Tax Legislation*, *supra* note 3; Note, *supra* note 3.

and a contractarian approach to fairness inform the effective date choice will follow.

1. Fairness as Reliance

The principal argument advanced by proponents of "prospectivity" in tax law changes is based on the premise that fairness requires protection of persons who might be expected to have altered their conduct in reliance upon the continued existence of a tax rule. The argument, in effect, would treat the recipient of a tax benefit as if he had entered into a contract with the government, and would preclude the government from disadvantaging such an individual by changing the law. For example, in 1969, Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, argued:

[P]rovisions have been deliberately kept in the tax law over many years, and they constitute standing invitations for taxpayers to erect new buildings, drill for oil, or embark on programs of charitable contributions. Even if we should conclude that it would be unwise to continue some of these benefits or if we should alter some of them, it would not be appropriate to remove the preference precipitously after taxpayers have embarked on programs which they might not have adopted except for these provisions.⁷⁹

Arguments of this kind tend to be based on the fact that many individuals have indeed relied on the expectation that tax-favored investments will likely be protected or even benefited by grandfather rules if the tax incentive is someday repealed. Grandfather rules have allegedly been enacted with sufficient frequency that people now expect them and act in reliance on that expectation. A set of institutionally induced expectations has therefore been created, and reliance on such expectations is considered legitimate—or even a "right". Upsetting these expectations is deemed unfair.

An argument in this form, without more, ends analysis. Rights are created and fairness defined because certain institutional expectations have come into place. In creating such rights, this notion "shields the status quo from normal legislative change with-

⁷⁹ Cohen, *The Administration's Interim Program of Tax Reform and Tax Relief*, 47 TAXES 325, 327 (1969). See also Note, *supra* note 3 at 439; that author states that "[t]he primary effect is taxpayer reliance on existing law. In the tax field precise knowledge of the law is commonly the basis for long-range planning." *Id.* 439. The author also concludes that "a general rule of prospectivity would ensure protection of taxpayer reliance and would simultaneously provide a uniform and predictable standard for setting effective dates in tax bills." *Id.* 455.

out anyone asking whether existing socially based expectations make some larger normative sense.”⁸⁰ The question here, however, is whether it is appropriate for the government to continue to induce that set of expectations or whether another set might be more appropriate. In this context, an evaluation of the fairness argument, like efficiency-based arguments, requires a determination of what kinds of expectations are to be considered reasonable and, therefore, eligible for protection.

First, to the extent that reasonable expectations in this context consist only of those that assess a subjective probability of a change in the law, fairness arguments based upon an individual's expectations that ignore the probability that the law will be altered are not persuasive.⁸¹

Second, individual reliance on the status quo as a justification for grandfathering compels one to inquire whether at some time

⁸⁰ B. ACKERMAN, *supra* note 1, at 105 (1977). Professor Ackerman has pointed out that this kind of argument is common in certain forms of legal discourse.

If this approach is to be followed, a precise delineation of the currently dominant set of institutionally induced expectations is necessary. This is an empirical inquiry which will not be pursued here, although it is not likely that persons expect neither changes in the tax law nor tax increases. Undoubtedly, the empirical results would depend upon what question is asked. It would not be surprising if different answers were given, for example, to the questions: (1) Do you expect changes in government policies which will affect and perhaps reduce your wealth? and (2) Do you expect the government to remove retroactively a tax incentive which you now enjoy?

Moreover, it is not clear from the assertions in the literature whether answering the empirical question is enough, that is, whether the existence of expectations that tax incentives will be continued is both a necessary and sufficient condition to produce unfairness if they are repealed. One suspects that the existence of such expectations is only a necessary condition and that some “adequate justification” could be advanced on behalf of government action upsetting these expectations. If this is the case, justification of the government action would presumably take the form of a normative argument.

In addition, the relationship of this approach to institutions of government is also unclear. In this context, it is well recognized that no constitutional right to compensation would currently be recognized and no constitutional right to grandfather rules has been asserted. The alleged right then becomes a right to legislative outcome based on a “dominant pattern of institutionally induced expectations” when such expectations have necessarily been rejected by the cognizant legislative body. The nature of the relationship between “dominant expectations” and majoritarian legislative institutions is mysterious.

Nevertheless, concern with such expectations explains much of the literature, perhaps including the Treasury Department's special concern with repeal of tax incentive provisions which are likely to affect primary conduct, *see* text accompanying notes 12-13, *supra*, and the emphasis in the literature on nominal retroactivity, *see* note 3, *supra*.

In any event, the assertion that current expectations are the source of a “right” to be protected has force only with regard to current incentives. It does not address the question of the appropriate effective dates with respect to the future enactment and repeal of tax provisions.

⁸¹ *See* text accompanying notes 57-58 *supra*.

such reliance may become unreasonable. If the President proposes a change, is reliance on the status quo still reasonable? May reliance become unreasonable only after a key committee holds hearings, or when it votes a change, or not until the legislation passes one or both houses of Congress?⁸² The difficulty in picking a date when reliance on the status quo is no longer considered reasonable may account for much of the variance in specific dates in tax legislation. The variety of dates selected increases the difficulties of planning and adds complexity to the law.

Third, the effect given to an individual's reliance on the status quo may vary with the structure of the legal rule. For example, in 1972, the Chairman of the House Ways and Means Committee, Wilbur D. Mills, introduced the "Tax Policy Review Act," which was designed to secure congressional review of fifty-four provisions of the Internal Revenue Code. The technique he proposed to insure such a review was the termination of these fifty-four provisions over a three year period. Mr. Mills was careful to note, however, that enactment of the Review Act would imply nothing as to the likelihood of the continued existence of the designated provisions.⁸³ Opponents of the bill argued, on the one hand, that it created "a degree of uncertainty that is unnecessary"⁸⁴ in the tax laws, and, on the other hand, that the purpose of the bill could be achieved by "simply announcing . . . hearings on whatever areas of reform" are considered appropriate.⁸⁵ The reasonableness of continued individual reliance on the existence of the fifty-four provisions could have been considered to depend on whether the sunset legislation was enacted. Likewise, beginning with the Tax Reform Act of 1969,⁸⁶ certain tax incentive provisions were enacted with termination dates.⁸⁷ Although incentive provisions are frequently extended beyond the original termination date, taxpayer behavior which fails to take into account a stated termination date could be considered unreasonable. Thus, the fairness of an effective date

⁸² See Note, *supra* note 3, at 443-44.

⁸³ H.R. 15230, 92d Cong., 2d Sess. (1972). See HOUSE COMMITTEE ON WAYS AND MEANS, 92D CONG., 2D SESS., MATERIAL RELATING TO H.R. 15230, THE PROPOSED "TAX POLICY REVIEW ACT OF 1972" (Comm. Print 1972).

⁸⁴ *Administration Request for Increase in Public Debt Ceiling: Hearings Before the House Committee on Ways and Means*, 92d Cong., 2d Sess. 321 (1972) (statement of Rep. Byrnes) [hereinafter cited as *Byrnes Statement*]; see 118 CONG. REC. 20027 (1972) (statement of Senator Hansen arguing that "business investment would encounter a tax climate of unprecedented uncertainty. The American businessman would become an endangered species.").

⁸⁵ *Byrnes Statement*, *supra* note 84, at 322.

⁸⁶ Pub. L. No. 91-172, 83 Stat. 487 (1969).

⁸⁷ See, e.g., provisions cited in note 58 *supra*.

rule might be considered to vary depending on whether a termination date is stated, even though neither sunset legislation nor stated termination dates eliminate the need for individual assessments of the probability of change. Reliance-based notions of fairness, which seem to imply different effective date rules depending upon the form of legislation, ignore the uncertainty inherent in predicting future congressional action with respect to the tax laws.

Finally, fairness arguments grounded upon individual reliance have tended to concentrate on protecting those individuals who are nominally affected by a change in the law. For example, in the case of the repeal of a tax exemption for bond interest, advocates of compensation to relying taxpayers would compensate only those holding tax-exempt bonds.⁸⁸ A grandfathered effective date rule similarly would tend to protect those who hold tax-exempt bonds.⁸⁹ Thus, while it has been argued that persons who purchase tax-exempt bonds should be entitled to tax-free interest for the life of the bond, it has not been suggested that issuers of tax-exempt bonds, who may well have structured their financing plans on the expectation that the exempt status would continue into the future, are entitled to continuation of the tax exemption because of their "reliance" interest. Nor has it been argued that those who demanded or supplied substitutes, on the assumption that the exemption would continue, should also be protected.⁹⁰ If the fairness of change depends upon individual reliance, then fairness should demand protection of all persons who might be expected to have altered their behavior because of a specific tax rule when that rule is altered to their detriment.

Moreover, the reliance notion of fairness would not appear to be linked exclusively to the tax laws, but evidently requires protection of "reliance" interests whenever any aspect of the legal structure is changed. For example, one analyst of the financial implications of the revision or elimination of federal regulation of domestic air transportation has pointed out that deregulation would

⁸⁸ See, e.g., Feldstein, *Compensation in Tax Reform*, 29 NAT'L TAX J. 123, 125 (1976).

⁸⁹ When the tax-favored asset is a fixed obligation such as a tax-exempt bond, grandfathering is of no benefit to the issuer. If the tax-favored asset is not a fixed obligation, benefits of grandfathering may be split between suppliers and purchasers of the tax-favored asset; for example, a grandfathered repeal of special benefits to producers or consumers of low-income housing will result in new rental prices. See text accompanying notes 38-39 *supra*.

⁹⁰ The impact of the change in law on those who have transacted in the substitute market will tend to vary depending upon relative elasticities of supply and demand in both the market for the tax-favored investment and the substitute market. See text accompanying notes 34-36 & note 58 *supra*.

have financial effects on the investors, consumers and employees of air carriers, airframe manufacturers, and airport operators.⁹¹ In some way each of these groups has relied on the current regulatory scheme, but protection of their financial stake through grandfathering would not receive serious consideration because to do so would significantly reduce gains from a change in the system. In a regulatory context in which the magnitude of changes is large, phased-in or delayed effective dates might be used to lessen the financial impact of the change on those affected, but grandfathering would certainly be eschewed.⁹²

Individual reliance on the status quo simply will not suffice as a basis for compensation or grandfathered effective dates. Consider a situation in which the President announces a program to subsidize a certain activity through income tax deductions or credits, for example, tax credits for the insulation of homes. Members of Congress crucial to the passage of the legislation make speeches embracing the proposal. A company engaged in the manufacture of home insulation materials, in reliance on these statements, purchases additional machinery to manufacture insulation. If the legislation is never enacted and the manufacturer loses, should his losses be compensated or should he be otherwise protected? Does the fact that the legislation passes both Houses of Congress but is not signed by the President alter the result? Why, then, is the repeal of legislation enacted one year earlier thought to present a more compelling case for compensating reliance? Should those who failed to invest in insulation on the assumption that the legislation would not be enacted also be protected?

If fairness demands protection of all whose expectations are upset by a change in law, grandfathered effective date rules will typically be inadequate to the task. Nothing short of perfect stability of legal rules will likely suffice. Uncertainty necessarily produces winners and losers. But a requirement that once a law is enacted it must remain unchanged raises fairness problems itself,

⁹¹ Levine, *Financial Implications of Regulatory Change in the Airline Industry*, 49 S. CAL. L. REV. 645 (1976).

⁹² The reasonableness of reliance seems to relate to the magnitude of the change. Reliance is generally not considered important when a small change is enacted. For example, the fact that an individual might have made a charitable contribution in January, 1977, in reliance on existing law is not considered important when legislation is enacted in May, 1977, which raises the standard deduction. Any financial loss would be quite small. As the magnitude of the change increases, the potential for significant financial losses also increases, and greater concern is voiced for those who might have altered their behavior to take advantage of the prior law. Delayed or phased-in effective dates may reduce the financial impact of such a change. See text accompanying notes 41-43 *supra*.

particularly in a system of laws produced by representative democratic political institutions, subject to periodic changes in representation and political leadership.

2. Horizontal Equity

Perhaps the most widely accepted notion of fairness in taxation is the concept of horizontal equity.⁹³ The classic definition of horizontal equity requires that persons in similar circumstances pay similar amounts of tax.⁹⁴ A determination whether circumstances are "similar" or "the same" is, however, fraught with ethical and theoretical difficulties. The tax literature is replete with disputes concerning whether "similar" or "different" circumstances are being compared.⁹⁵ The horizontal equity concept creates great difficulties in that attempts must be made to ascertain whether a difference in circumstances justifies a difference in tax treatment. Reference to personal value judgments is often required in order to resolve these questions. Nevertheless, the basic notion of horizontal equity—equal treatment of equals—is widely shared and easily understood. This may explain why much of the public debate over income tax revision focuses on deliberate departures from horizontal equity,⁹⁶ and asks whether the "injustice," or "horizontal inequity," is overridden by other public policy considerations.⁹⁷

If one accepts the classic definition of horizontal equity, testing the fairness of non-grandfathered effective dates for changes in the tax law is tautological. For example, if pre-tax incomes are equal but tax burdens unequal prior to the change—as would be the case when certain persons hold tax-exempt bonds—eliminating the tax exemption would improve horizontal equity, and a grandfather clause would inhibit this improvement.

A factor ignored by the traditional definition of horizontal equity, however, is that tax-favored status will necessarily affect pre-tax flows of income.⁹⁸ For this and other reasons, Martin Feldstein has rejected the traditional definition as inappropriate for tax re-

⁹³ See, e.g., H. SIMONS, *FEDERAL TAX REFORM* 8 (1950).

⁹⁴ E.g., L. EISENSTEIN, *THE IDEOLOGIES OF TAXATION* 147 (1961).

⁹⁵ For excellent treatments of this subject, see *id.* 148-77; W. Blum & H. Kalven, *The Anatomy of Justice in Taxation* 23-30 (Occasional Papers from the University of Chicago Law School) (Pub. No. 7 Oct. 1, 1973). See also Feldstein, *supra* note 1; Musgrave, *supra* note 56.

⁹⁶ For example, special treatment of income from oil exploration, farming, and state and local bonds, come to mind.

⁹⁷ See, e.g., S. SURREY, *PATHWAYS TO TAX REFORM* 49 (1973).

⁹⁸ See Graetz, *supra* note 28.

vision, and argues that compensation to persons adversely affected by a change in the tax law is desirable.⁹⁹ Compensation is demanded by Feldstein's definition of "horizontal equity in tax reform" which requires "that if two individuals would have the same utility level if the tax remained unchanged, they should also have the same utility level if the tax is changed."¹⁰⁰ It becomes readily apparent why this definition of horizontal equity requires compensation to those who suffer losses from a tax change if "after-tax income" is substituted for "utility level" in the quoted passage.

While the grandfathered effective date issue is not expressly addressed by Feldstein (he does argue for delayed effective dates), a grandfathered effective date rule may be viewed as a substitute for compensation.¹⁰¹ A grandfathered effective date would allow the holder of a previously tax-exempt bond to maintain the same after-tax income following the change. If, as Feldstein suggests, fairness demands compensation for losses from tax revision, then this concept of fairness also implies a grandfathered effective date if compensation is not to be paid.¹⁰² Application of Feldstein's definition of horizontal equity to the effective date question, therefore, provides clear results.

Professor Feldstein's definition of horizontal equity, however, is inappropriate as a concept of fairness in tax revision. By focusing on "utility levels," or after-tax income, in determining who is "similarly situated", Feldstein defines the pre-change environment as inherently equitable.¹⁰³ Such a definition of horizontal equity necessarily implies that any uncompensated change in the tax system is inequitable. If change is by definition inequitable, there is no basis for evaluating the equity effects of tax rules and no guidance as to when changes should be enacted for reasons of equity. The traditional definition of horizontal equity, by focusing on pre-tax income, generally affords more guidance for evaluating an income tax revision than does Feldstein's definition because the

⁹⁹ Feldstein, *supra* note 1; Feldstein, *supra* note 88.

¹⁰⁰ Feldstein, *supra* note 1, at 95 (footnote omitted).

¹⁰¹ However, it may be a less efficient substitute. See text accompanying note 77 *supra*. This may account for Feldstein's emphasis on compensation.

¹⁰² Although the windfall gains resulting from grandfathering seem somewhat inconsistent with his definition of horizontal equity, Feldstein himself suggests this result; see Feldstein, *supra* note 88, at 128 & n.18. Perhaps rules such as those suggested in note 53 *supra* would better comport with Feldstein's definition of horizontal equity.

¹⁰³ *Id.* 124.

very purpose of tax reform may be to alter the after-tax income of certain classes of taxpayers.¹⁰⁴

3. Vertical Equity

Vertical equity is said to require unequal taxation of persons in different circumstances, and many analysts treat the concept as simply a different view of the horizontal equity question.¹⁰⁵ For present purposes, however, a more limited criterion of vertical equity, that dealing with the distribution of the costs of government (in this case the income tax burden) by income classes, will suffice. Questions of vertical equity are here limited to inquiries about the fairness of the distribution of the tax burden by income classes; fairness concerns raised by circumstances other than differences in the amount of taxpayers' income are considered to be problems of horizontal equity.¹⁰⁶

¹⁰⁴ Where the effect of the tax incentive on pre-tax incomes can be determined with some accuracy, this effect should be taken into account. See text accompanying note 98 *supra*.

¹⁰⁵ For example, Musgrave states that:

This principle of equality, or *horizontal equity*, is fundamental to the ability-to-pay approach which requires equal taxation of people with equal ability and unequal taxation of people of unequal ability. . . .

The requirements of horizontal and vertical equity are but different sides of the same coin. If there is no specified reason for discriminating among unequals, how can there be a reason for avoiding discrimination among equals? Without a scheme of vertical equity, the requirement of horizontal equity at best becomes a safeguard against capricious discrimination—a safeguard which might be provided equally well by a requirement that taxes be distributed at random. To mean more than this, the principle of horizontal equity must be seen against the backdrop of an explicit view of vertical equity.

R. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 160 (1959) (footnote omitted).

In his early work, Henry Simons treated the principles of horizontal and vertical equity as strictly coordinate. See H. SIMONS, *PERSONAL INCOME TAXATION* 30 (1938). Horizontal equity is considered of primary importance in his later work. See H. SIMONS, *supra* note 93, at 11.

¹⁰⁶ Even this limited notion of vertical equity is, however, fraught with difficulties. First, there is no consensus as to what constitutes a "fair" distribution of the costs of government by income class. Debate continues over the fairness of different general schemes of financing government expenditures. Income tax progressivity can be justified as a mechanism for maintaining proper balance in the tax burden borne by individuals with different incomes, by resort to personal interests and ethics, as a mechanism for reducing income inequality, see H. SIMONS, *PERSONAL INCOME TAXATION* 17-31 (1938), or by reason of longevity. Nonetheless, acceptance of progressivity as a valid vertical equity concept does not compel any specific shape of the distribution of tax. How progressive the income tax should be depends upon such matters as one's view of the "appropriate" social welfare function (assuming that it is meaningful to talk about such a thing, see note 56 *supra*), how one accounts for differences in abilities and taste, whether one considers an individual's income to be an "entitlement" or a product of the society, and a host of other factors which serve only to proliferate valid differences of opinion.

There are two approaches to testing the effective date issue against the criterion of vertical equity. First, one might determine whether the change itself is enacted to improve vertical equity through a redistribution of the tax burden. Whenever an income tax change is enacted for redistributive purposes, and is therefore expected (or intended) to improve some notion of vertical equity, a grandfather rule will be likely to delay or obstruct realization of this goal. The tax-exempt bond example is a paradigm case. A grandfather clause would produce gains for holders of tax-exempt bonds and would enable infra-marginal purchasers (those with marginal tax rates greater than t^*)¹⁰⁷ who enjoyed a surplus at the time of their original purchase to continue to enjoy an exemption from tax. Likewise, infra-marginal purchasers of grandfathered bonds, necessarily persons in higher income brackets, will enjoy the same form of surplus as the infra-marginal purchasers of tax-exempt bonds enjoyed before the repeal of the exemption.¹⁰⁸

Grandfathering a change which is motivated by a desire to increase the tax burden on the class of persons who have enjoyed a tax incentive is much like passing a law to redistribute wealth and requiring compensation to those from whom wealth was distributed. Grandfathering such changes produces windfall gains to the class of persons presumably intended to be affected adversely. An ad hoc vertical equity approach to the effective date issue would require an evaluation of the redistributive purposes and consequences of each change in the Internal Revenue Code. Repeal of tax favored treatment enjoyed by higher income taxpayers would not be grandfathered, and grandfather rules would be limited to changes removing provisions which provide tax advantages to middle or lower income taxpayers. Under this approach, repeal of the tax exemption for social security payments might be grandfathered, but

In addition, the failure to consider taxes other than the income tax, benefits from government expenditures, the benefits and burdens of government policies such as price regulation, and inflation, all of which significantly affect the distribution of income, impedes one's ability to thoroughly discuss issues of vertical equity. To illustrate, the overall redistributive impact of government on the economy could be increased by imposing a regressive tax, if the proceeds from that tax were used for specified transfer payments. Looking only at the regressive nature of the tax would be highly misleading.

These objections are so significant that it must be pointed out that it is impossible to evaluate income tax changes in terms of vertical equity without looking at the overall effects of governmental action on the distribution of income. Nevertheless, for purposes of this Article, the vertical equity of income tax changes will be considered with reference only to the income tax, ignoring other government programs and, more importantly, ignoring the benefits of the government expenditures.

¹⁰⁷ See text accompanying note 32 *supra*.

¹⁰⁸ See text accompanying notes 49-50 *supra*.

no grandfather rule would be likely to be enacted if the tax exemption for municipal bond interest were repealed.¹⁰⁹

A second approach in testing the fairness of grandfathered effective dates against the vertical equity criterion requires one to determine whether a consistent policy of grandfathering (or of not grandfathering) would improve the vertical equity of the system. That determination would require that one estimate the distribution by income class of the benefits and burdens from specific provisions in the income tax law.¹¹⁰ It would then be necessary to estimate how repeal of tax provisions with grandfathered effective dates would affect that distribution when compared to repeal without grandfathered effective dates. Given the theoretical and empirical difficulties in developing this information, however, an ad hoc approach, through which each proposal for change is tested against a vertical equity criterion currently seems best, if vertical equity is to be used as a test of effective date fairness.

4. A Contractarian Approach to Fairness

Although the traditional notions of horizontal and vertical equity offer some guidance as to the fairness of effective date alternatives, it is also useful to examine the various rules in a Rawlsian fashion, against contractarian notions of fairness.¹¹¹ The contractarian perspective defines fairness as that set of rules which would be agreed to by all participants under a set of procedural conditions designed to insure a just agreement. By focusing the inquiry at an anarchical or constitutional stage and invoking the devices of the original position and the veil of ignorance, an analytical framework is provided for testing the fairness of various outcomes. The persuasiveness of this methodology turns on one's evaluation of the appropriateness of the original position procedure

¹⁰⁹ This approach would tend to produce results contrary to current practice. A major difficulty with this approach, as with that relying on pre-tax income as a basis for evaluating horizontal equity, is the failure to take into account the effect of the tax incentive in reducing pre-tax income. Where possible, estimates of such effects should be taken into account. See Graetz, *supra* note 28.

¹¹⁰ First-level estimates of that distribution have been made by the Treasury Department and congressional staffs, but these are woefully inadequate for this task. See Graetz, *supra* note 28.

¹¹¹ John Rawls' book, *A Theory of Justice*, has given new impetus to contractarian approaches to issues of fairness, and, in particular, to evaluating substantive outcomes based upon procedural criteria. The original position and the veil of ignorance provide the procedural backdrop to Rawls' work. J. RAWLS, *A THEORY OF JUSTICE* (1971).

rather than on the outcome of that procedure.¹¹² The original position eliminates problems of time, location, and individual preferences by invoking a "veil of ignorance" for the parties to the social contract. The parties are permitted to know general facts about human society, including such matters as the principles of economic theory, social organization and human psychology. Additional data describing society may be provided when a legislative decision is to be made.¹¹³ The parties are not given specific knowledge about themselves. They are ignorant, for example, of physical and intellectual attributes, financial assets, current and potential market productivity, preferences for market and non-market activity, and, of course, neither party will know whether he will hold tax-favored or taxable assets.

Two further observations about this methodology are appropriate. First, the justificatory power of the original position methodology, coupled with a unanimity requirement, stems from a notion that the right of each individual to equal concern and respect must be enforced.¹¹⁴ To the extent that the original position contractarian methodology is appealing, this is undoubtedly due to a widespread notion of egalitarian rights. Secondly, one should not expect unique outcomes to emerge from this criterion of fairness.¹¹⁵

¹¹² Rawls himself would likely resist the use of his methodology in this context. See J. RAWLS, *supra* note 111 at 7-11. The original position was not intended to provide legal theorists with an analytical device severable from the principles it was designed to justify. Nonetheless, Rawlsian methodology may be useful by analogy in informing complex social decisions. For example, in the tax context, William Klein has used Rawls' approach in an effort to justify the proposition that "a fair system is one that distributes material rewards equally among people who are willing to work equally hard." W. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 26 (1976).

¹¹³ J. RAWLS, *supra* note 111, at 137-38. This illustration is not precisely congruent with Rawls' description of the "veil of ignorance," but the parties may need and can be supplied with more specific information than Rawls posits. Rawls' restrictions on the parties' understanding of their own society are not essential to his conception of fairness. Rather, the appropriate social facts made available to the negotiating parties should depend upon the universality of the decision which they are attempting to reach. Parties seeking to negotiate basic principles of social governance, operative across time and changing social circumstances, are entitled to only the most general social facts. Somewhat greater specificity, however, seems appropriate in the current context.

¹¹⁴ See Dworkin, *The Original Position*, in *READING RAWLS* 16, 48-52 (N. Daniels ed. 1974); Scanlon, *Rawls' Theory of Justice* in *READING RAWLS*, *supra* at 169, 171-79. See also A. K. SEN, *supra* note 57, at 136-137.

¹¹⁵ See A. K. SEN, *supra* note 57, at 140; J. Buchanan, *Notes on Justice in Contract*, 12-13 (1976) (mimeo on file with University of Pennsylvania Law Review). But Rawls himself expects unique results to emerge when basic principles of social governance are derived; for example, he views his "difference principle" as uniquely derivative from his methodology. Rawls acknowledges, however, that at the legislative stage, it is not always clear which of several outcomes will emerge and describes the test in this context as "indeterminate." J. RAWLS, *supra* note

A number of outcomes might emerge from this procedure that meet the test of fairness. "Often the best that we can say of a law or policy is that it is at least not clearly unjust."¹¹⁶

In testing the fairness of various effective dates for tax legislation a complete exposition of an original position agreement is not necessary. All that is suggested here is that the following principles might emerge from a negotiation in the original position:

1. Changes in public policy reflected in legal rules and institutions will tend to alter wealth.

2. Because of changes in societal conditions, tastes and technology, the parties will not expect legal rules to be immutable but rather to change from time to time. This requires them to engage in a long-term view.¹¹⁷

3. Because changes in legal rules that occur will tend to alter wealth, the parties are likely to focus on the processes for enacting and changing legal rules to insure that they are not arbitrary. Procedural and substantive conditions for enacting laws will be devised.

4. To maintain the ability of the legal system to respond to changing circumstances, compensation will be paid to those who suffer losses from changes in law relatively rarely.

5. The parties may, or may not, agree on a limit to frequency of change—a stability condition.

6. Knowing that there is great flexibility in possible effective date rules for changes in law, and that selection of an effective date may alter the magnitude of wealth effects resulting from legal change, it seems unlikely that the parties would agree to a unique outcome in terms of effective dates. In particular, no prohibition against non-grandfathered effective dates seem likely to be permitted. In the context of a progressive income tax, the repeal of tax-favored treatment for particular investments would be the least likely category of change for which the parties would agree to require grandfather clauses.

111, at 201. It may well be that whether this methodology will yield unique results depends upon the precise information made available to the parties. An analysis of this question is beyond the scope of this Article.

¹¹⁶ J. RAWLS, *supra* note 111, at 199.

¹¹⁷ *Id.* Accord, Michelman, *supra* note 1, at 1220-24; *see generally* Ackerman, *supra* note 1, at 227 n.3.

It is conceivable that parties in the original position might agree that tax-favored treatment would be enacted from time to time; but the most advantaged persons, in terms of income, would be most likely to gain from a requirement that repeal of such a clause be accompanied by a grandfather clause. Agreements in the original position would be far more likely to accrue to the benefit of the least advantaged.¹¹⁸

7. If a general effective date policy is to be adopted, it may well be that the policy desired is one which would produce the greatest total output. This would require that the effective date rule meet only the criterion of efficiency.¹¹⁹

Although these are not the only outcomes that could emerge from a negotiation in the original position, it is useful to recognize that

¹¹⁸ To this extent, contractarian results would tend to conform to those described in connection with the discussion of vertical equity, *see* text accompanying notes 105-10 *supra*. Agreements which accrue to the benefit of the least advantaged members of society are predicted by Rawls. *See* J. RAWLS, *supra* note 111, at 75. *See also* Buchanan, *A Hobbesian Interpretation of the Rawlsian Difference Principle*, 29 KYKLOS 5 (1976). Buchanan states that:

[T]he interpretation is more readily understood if we assume that cooperative action necessarily introduces a dramatic shift in the technology of producing income or product. The jointness aspects of the basic structure of social arrangements become predominant. By way of a simplified economic illustration, we might say that the Rawlsian model allows Crusoe and Friday to commence fishing with a boat once agreement is reached, whereas in anarchy this degree of cooperation is not possible, and each man has to fish without a boat. The cooperative arrangement involves participation in the provision and use of genuinely public good. In this framework, it becomes impossible to impute separate income shares to the two parties, Crusoe and Friday, since the whole production is clearly a joint product.

Crusoe and Friday agree to act jointly, to become partners in social arrangements; gross production increases dramatically, but there is no means of imputing separate shares.

Id. 8.

Buchanan then suggests that unequal divisions will be acceptable only to the extent that the least advantaged person is better off than he would be with equal sharing. The less advantaged person will withdraw cooperation and force the system back to equal sharing unless work incentives are such that unequal sharing will make *both* persons better off. *Id.* 8-9.

¹¹⁹ Rawls regards his principles of justice as lexically prior to the efficiency criterion, and argues that efficiency will not emerge as the criterion for determining the basic structure of society. J. RAWLS, *supra* note 111, at 67-75. After background institutions are in place, however, Rawls suggests that some questions will be decided by applying the efficiency criterion. For example, Rawls argues for a proportional expenditure tax, rather than a progressive income tax, to finance government expenditures. This argument is grounded in considerations of efficiency: "And if proportional taxes should also prove more efficient . . . this might make the case for them decisive . . ." *Id.* 279. The statement in the text is intended to suggest only that the effective date issue might be regarded by persons in the original position as one of those relatively secondary questions to be governed by the efficiency criterion.

such outcomes are consistent with a contractarian approach to fairness. Thus, contractarian methodology serves to rebut arguments that retroactive changes in the tax law are inherently unfair.

This survey and discussion of fairness criteria, like the preceding analysis of efficiency criteria, demonstrates that grandfather rules are not necessarily to be preferred in exacting changes in the tax laws. Testing effective date rules against the concept of fairness as reliance, or the criteria of horizontal equity, vertical equity, or contractarian methodology, results in no overwhelming preference for grandfathering nor any other form of delayed effective date, contrary to the analyses of other commentators.

V. CONCLUSION

This Article attempts to describe the impact on wealth that may result from the enactment of various effective date rules for changes in the income tax law. This analysis has shown that when the income tax law is changed, no commonly used effective date rule will prevent retroactive impact. If nominally retroactive, nominally prospective, delayed or phased-in effective dates are chosen, holders of tax-favored assets will suffer losses when a tax benefit is repealed. The magnitude of the losses will vary depending upon the specific effective date rule chosen. The difference in impact between a change that is nominally retroactive and one that is nominally prospective is often very slight. On the other hand, grandfathered effective dates will create gains for the holders of assets favored prior to the change.

Although firm conclusions are difficult, given the amorphous quality of the criteria, neither efficiency nor fairness demand grandfathered effective dates. Recent tax legislation has tended to institutionalize expectations of grandfathered effective dates in the tax context. This should be reversed. The tax law must remain a flexible instrument of public policy. When a provision has outlived its usefulness, it should be eliminated without the delay and windfall gains inherent in grandfathering prior transactions. People should make investments with the expectation that political policies may change. Stated termination dates and sunset laws should be considered as possible mechanisms to induce expectations of change. If the impact on wealth of such a change is large, efficiency and fairness concerns may suggest that phased-in or delayed effective dates be used to mitigate that impact. In any event, phased-in or delayed effective dates are often to be preferred to grandfathering.