Legislative Compromise and Tax Transition Policy

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The extensive literature on legal transitions has formed a general position in favor of establishing a governmental transition policy; the primary debate concerns whether the policy should be one of systematically mitigating or not mitigating transition losses. Arguments on both sides generally have assumed a sharp dichotomy between a substantive legal change and the transition treatment associated with the substantive change. Focusing on federal tax legislation, this Article challenges that assumption and the normative conclusions that it supports.

Specifically, this Article identifies compromise as an important component of the tax legislative process and argues that the ability to provide or not to provide transition relief on an ad hoc basis facilitates such compromise. A policy either to mitigate or not to mitigate tax transition losses would remove this mechanism and, consequently, would cause legislators to pursue compromise through other means, such as by scaling back the substantive policy changes they otherwise would enact. This effectively tilts substantive tax policy toward the status quo.

The analysis yields three main conclusions. First, tax transition policy is not exogenous to substantive tax policy. Second, the likely effects of tax transition policy on the development of substantive tax policy raise doubts about the normative arguments that have been made for tax transition policy. Finally, contrary to the general consensus of the literature, the ad hoc approach to tax transitions in current practice yields results that may be no less desirable than the results of following a formal tax transition policy.

INTRODUCTION

Government regularly changes existing law through new statutes, rulings, and regulations. No area of the law is insulated from the possibility of change, and no participant in the legal system can expect that every rule in place today will remain so in the future. Against this background, legal scholars appropriately ask how the law should approach rule changes. The question presents itself with particular force because of the stubborn fact that legal transitions produce winners and losers. Legal change often comes about when private actors pursue change for their own gain; yet, other actors who ordered their affairs around the prior rules may find themselves made worse off by

change. Much of the existing analysis of legal transitions has centered on the proper treatment of transition losers—in particular, whether government should compensate such losers through transition relief.

The transitions literature has formed a general (but not unanimous) position in favor of establishing and following a governmental transition policy, and the primary debate concerns whether the policy should be one of mitigating or not mitigating transition losses. The principal arguments favoring the systematic mitigation of transition losses—what is sometimes called the "old view" of transition issues[1]—have assumed several forms: that fairness requires private actors to be compensated for their losses whenever the government changes legal rules on which they have relied;[2] that a policy to mitigate transition losses prevents opportunistic behavior by the government, which otherwise might repeal legal rules after private actors have incurred the costs of complying but before the government has provided all the associated benefits;[3] and that such a policy reduces rent extraction by legislators and rent seeking by interest groups.[4] Arguments against the mitigation of transition losses—sometimes called the "new view" of transition issues[5]—have centered on the efficiency of a policy that encourages private actors to minimize the losses from their own invest-

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[1]   See Daniel Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* 2 (Chicago 2000) (describing the "old view" as a policy of grandfathering investments that would be adversely affected by a transition).

[2]   This reliance argument is seldom advanced in scholarly writing but is frequently asserted in political discourse. For arguments from the scholarly literature, see Martin Feldstein, *Compensation in Tax Reform*, 29 Natl Tax J 123, 124 (1976) (arguing for transition relief in tax reform); Martin Feldstein, *On the Theory of Tax Reform*, 6 J Pub Econ 77, 95–97 (1975) (same); Note, *Setting Effective Dates for Tax Legislation: A Rule of Prospectivity*, 84 Harv L Rev 436, 438 (1970) (arguing for general prospectivity when setting dates upon which tax legislation will become effective). For examples from political discourse, see Michael D. Shear, *Lawmakers Gird for Tax Reform; Plans to Modernize System Fraught With Political Peril*, Wash Post A1 (Sept 14, 2003) (describing Virginia politicians' plans to mitigate negative tax changes for the elderly); Richard W. Stevenson, *Itching to Rebuild the Tax Law*, NY Times sec 3 at 1 (Nov 24, 2002) (noting a proposal's attempt to lessen the burden on people in lower tax brackets through rebates).

[3]   See Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 Mich L Rev 1129, 1138–40 (1996) (arguing that a government precommitment to full transition relief generally would minimize inefficiencies resulting from opportunistic government behavior).

[4]   See J. Mark Ramseyer and Minoru Nakazato, *Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow*, 75 Va L Rev 1155, 1171–73 (1989) (arguing that, in the context of tax reform, guaranteed transition relief slows the legislative "protection racket" under which legislators and special interest groups inhibit desirable substantive legislative change).

[5]   See Shaviro, *When Rules Change* at 3 (cited in note 1) ("[C]elebrated articles . . . partly displaced the old view . . . in favor of a 'new view' that transitional relief and, in particular, grandfathering protection upon the repeal of tax preferences generally should not be provided.").

ment decisions by anticipating future legal change[6] and the possibility that, in certain contexts, a policy not to mitigate transition losses may guide legislative behavior toward better substantive outcomes.[7]

The arguments on both sides of this debate generally have assumed a sharp dichotomy between a substantive legal change and the transition treatment associated with such change; certain of these arguments have even assumed that the government's approach to transitions will not affect its approach to substantive policy.[8] However, the assumption that transition policy is exogenous to substantive policy—although important to the normative positions staked out in the literature—seems sufficiently doubtful to merit closer examination.

This Article pursues that examination within the context of federal tax legislation; specifically, it analyzes how tax transition policy affects substantive tax policy. The analysis proceeds in three parts. Part I examines tax transition issues generally and sets out in greater detail the principal arguments for and against the mitigation of tax transition losses. Part II examines the tax legislative process and, following certain predictions of political theory, identifies compromise among legislators as a critical component of tax legislation. Part III analyzes the implications of legislative compromise for tax transition policy. Specifically, Part III argues that the ability to provide or not to provide transition relief on an ad hoc basis constitutes an important mechanism for compromise among legislators. A standing government policy either to mitigate or not to mitigate tax transition losses would not change the underlying conditions that encourage compromise among legislators, but it would remove an important mechanism for compromise. Consequently, such a transition policy likely would cause legislators to pursue compromise through other means, such as by scaling back the substantive policy changes that they otherwise would enact. This effectively would favor the status quo.

As developed in Part III, this analysis yields three main conclusions. First, contrary to the assumption normally made in analyses of tax transitions, a governmental tax transition policy *does* affect the development of substantive tax policy; that is, tax transition policy is not exogenous to substantive tax policy. Second, the effects of tax transition policy on the development of substantive tax policy raise significant doubts about the normative arguments made in the litera-

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[6]   See Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 Harv L Rev 509, 513 (1986) (arguing that "transitional relief is inefficient because it insulates investors from the real effects of their decisions, and thus distorts their behavior").

[7]   See Shaviro, *When Rules Change* at 13–14 (cited in note 1) (arguing that denial of transition relief will facilitate development of "good" substantive tax policy).

[8]   See notes 66–70 and accompanying text.

ture for a policy either to mitigate or not to mitigate tax transition losses. Finally, contrary to the general consensus of the transitions literature, the ad hoc approach to tax transitions in current legislative practice yields results that may be no less desirable than the results of following a formal tax transition policy.

I. Tax Transitions and Tax Transition Policy

This Part provides an introduction to tax transitions and tax transition policy. Part I.A sets out a general overview of tax transition issues. Part I.B analyzes the two dominant normative positions regarding tax transition policy: the position favoring a policy under which government *does not* mitigate losses that result from changes in substantive tax policy and the position favoring a policy under which government *does* mitigate such losses. Part I.C identifies and discusses a critical aspect of tax transition policy that has not received adequate attention in previous analyses—the effects of tax transition policy on the development of substantive tax policy. This Part lays the groundwork for a critical reassessment, developed in Parts II and III, of the existing literature.

A. Overview of Tax Transition Issues

Tax transition losses and gains arise when government changes substantive tax rules. These transition effects are perhaps most salient in the repeal of tax preferences. As illustrated by the standard example of the transitions literature, repealing the tax exclusion for interest on state and local government bonds may leave certain taxpayers worse off than before the change. If the repeal applies to outstanding bonds, taxpayers holding bonds at the time of repeal will suffer an immediate economic loss: the bonds will decline in value because their after-tax yield will fall.[9]

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[9]   See Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U Pa L Rev 47, 54–57 (1977). Graetz uses this example to demonstrate how "prospective" legislation can result in transition losses only marginally smaller than those resulting from "retroactive" legislation. See id at 57–60 (arguing that a nominally prospective change would leave the bondholder better off than a nominally retroactive change, assuming a one-year gap between the two, only in that the holder would not lose the tax on the interest earned during the first effective year of the change). Subsequent scholarship has continued to distinguish between prospectivity and retroactivity. See Saul Levmore, *The Case for Retroactive Taxation*, 22 J Legal Stud 265, 266–72 (1993). See also Charles Sampford, *Retrospectivity and the Rule of Law* 266 (Oxford 2006) (arguing that the rule of law generally, though not always, requires prospectivity for legal change); Ann Woolhandler, *Public Rights, Private Rights, and Statutory Retroactivity*, 94 Georgetown L J 1015, 1016–18 (2006) (analyzing constitutional limitations on retroactive legislation); Stephen R. Munzer, *A Theory of Retroactive Legislation*, 61 Tex L Rev 425, 441–45 (1982) (proposing a normative theory for when legislatures may appropriately enact retroactive legisla-

However, current bondholders are not the only transition losers upon repeal of the interest exclusion. State and local governments will be worse off because they will face an increased cost of borrowing for existing projects once they can no longer pay excludable interest on their debt.[10] Additionally, an investor who purchased call options to buy state and local bonds will find that the options are less valuable after the repeal, traders and analysts specializing in state and local bonds will find their professional expertise less in demand, and employees of state and local governments may suffer layoffs or declines in wages if the increased cost of governmental borrowing strains public budgets. The change may also produce transition winners. For example, an investor who had purchased put options on state and local bonds prior to repeal will be able to sell the bonds at an above-market price, and holders of corporate bonds may find that their investments have become more valuable.

Congress could mitigate the transition losses resulting from repeal of the interest exclusion; it could also appropriate the transition gains. A familiar mechanism for reducing the transition losses would be to grandfather the bonds outstanding at the time of repeal such that remaining interest payments would continue to be excludable.[11] Although grandfathering would relieve the transition losses of current bondholders, it would provide less relief for state and local governments and for other taxpayers suffering transition losses. Alternatively, Congress could delay the implementation of the repeal or phase the repeal in over time. In theory, Congress could also make a compensatory payment to any taxpayer suffering a transition loss.[12]

Under current law and practice, a change in substantive tax policy does not entail a predetermined treatment of the resulting transition losses and gains. Instead, policymakers decide on an ad hoc basis whether government should fully or partially mitigate transition losses and fully or partially appropriate transition gains. Thus, in the case of substantive tax policy changes implemented through the legislative process, Congress decides, by setting the effective dates for the

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tion); Stephen R. Munzer, *Retroactive Law*, 6 J Legal Stud 373, 381–84 (1977) (setting out an analytic account of what should be considered retroactive legislation).

[10]   See Graetz, 126 U Pa L Rev at 77 (cited in note 9) (arguing that, under the reliance theory, issuers of tax-exempt bonds should be protected from detrimental subsequent legal changes).

[11]   See, for example, Shaviro, *When Rules Change* at 2 (cited in note 1).

[12]   Congress effectively authorized such payments when it repealed the investment tax credit under former Internal Revenue Code § 48, codified at 26 USC § 48 (1982), as part of the Tax Reform Act of 1986, Pub L No 99-514, 100 Stat 2085, 2166, codified at 26 USC § 49 (1988), by making accrued but unused credits refundable. See, for example, Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U Pa L Rev 1, 73 (1990) (noting that one transition rule permitted steel companies to receive cash refunds for unused investment tax credits).

changes and by providing or not providing transition relief, whether to let the losses and gains fall where they may. Several scholars have observed that this ad hoc approach appears to favor the mitigation of transition losses over the appropriation of transition gains, resulting in a transition "gain/loss asymmetry."[13]

Academic analyses of these decisions to mitigate or not to mitigate transition losses often distinguish—implicitly, if not explicitly—between transition losses borne "directly" by the taxpayers nominally affected by a substantive tax policy change (such as the bondholders who lose the interest exclusion) and transition losses borne "indirectly" by other taxpayers (such as the issuers of state and local bonds whose cost of capital for existing projects is increased when bondholders lose the interest exclusion).[14] Grandfathering bonds issued prior to repeal is often considered complete transition relief,[15] even though it provides little or no mitigation of the indirect transition losses suffered by taxpayers other than the bondholders and even though the indirect losses of those other taxpayers might be larger than the direct losses of the bondholders.

But the distinction between direct and indirect transition losses is tenuous at best. Both the individual holding a bond at the time the interest exclusion is repealed and the state or local government that must pay higher interest on all future debt—including debt to finance projects existing at the time of repeal—suffer genuine economic losses from repeal.[16] In both cases, the change in substantive tax policy affects existing economic arrangements; in both cases, those economic arrangements are less valuable after the change than before the change.

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[13]   See, for example, Shaviro, *When Rules Change* at 88–91 (cited in note 1) (noting that in practice, Congress predominantly uses transition rules to compensate taxpayer losses). See also Saul Levmore, *Changes, Anticipations, and Reparations*, 99 Colum L Rev 1657, 1661, 1665 (1999); Kaplow, 99 Harv L Rev at 554–55 (cited in note 6) (noting that "those advocating mitigation of windfall losses virtually never recommend taxation of similar windfall gains"). For convenience, this Article focuses on the treatment of tax transition losses.

[14]   Indirect losses often are marginalized in analysis of tax transition issues. See, for example, Logue, 94 Mich L Rev at 1159 (cited in note 3) (suggesting that transition policy for incentive-subsidy provisions should not account for indirect transition losses); Graetz, 126 U Pa L Rev at 57 (cited in note 9) (expressly avoiding an analysis of "secondary effects" in tax transitions). But see Kaplow, 99 Harv L Rev at 516 (cited in note 6) (recognizing that transition issues affect any investments having future effects).

[15]   Grandfathering might even result in windfall gains for current bondholders if repeal of the exclusion for future bonds and grandfathering of current bonds causes the value of the current bonds to rise (which would not occur if the grandfathering were limited to the taxpayers actually holding bonds at the time of repeal). See Graetz, 126 U Pa L Rev at 61 (cited in note 9) (arguing that the price of bonds subject to grandfathered effective dates will rise as higher-bracket taxpayers purchase them from lower-bracket taxpayers).

[16]   See id at 57 n 37, 77 (demonstrating that, in addition to the immediate effects that the bondholder suffers, the government's future cost of issuing bonds will increase).

Transition analysis therefore should take both direct and indirect transition losses into account, even though the prevailing approach in tax transition scholarship is to marginalize or ignore the indirect losses. As developed more fully below,[17] properly accounting for indirect transition losses is important for analyzing the relationship between tax transition policy and substantive tax policy and, therefore, for assessing the desirability of tax transition policy.

B.   The Mitigation and Nonmitigation Norms

Tax transition analysis addresses the normative question of how government should treat winners and losers when implementing changes in substantive tax policy. Most scholars examining tax transition issues advance arguments for the optimal tax transition policy.[18] The literature has centered on two formulations of the optimal tax transition policy: a policy to mitigate transition losses (the "mitigation norm") and a policy not to mitigate transition losses (the "nonmitigation norm"). The arguments for these policies rest on defined assumptions and qualifications; their proponents do not maintain that the mitigation or nonmitigation of transition losses would be desirable under all possible conditions. However, the arguments for the mitigation norm and the nonmitigation norm do make strong claims that, where the necessary conditions are satisfied, pursuing the optimal transition policy will increase social welfare.[19]

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[17]   See Part I.C.

[18]   But see Levmore, 99 Colum L Rev at 1657 (cited in note 13) (analyzing tax transitions without advocating an optimal tax transition policy); Kirk J. Stark, *The Elusive Transition to a Tax Transition Policy*, 13 Am J Tax Policy 145, 147 (1996) (same); Graetz, 126 U Pa L Rev at 47 (cited in note 9) (same). In light of subsequent work building on his analysis, it is common to characterize Graetz as endorsing the position that government should not mitigate transition losses. That overstates his conclusions. Although he presents a strong case that neither efficiency nor fairness generally requires the mitigation of transition losses, he ultimately endorses a case-by-case approach to the treatment of tax transitions. Id at 87 (noting that "firm conclusions are difficult" and that "tax law must remain a flexible instrument of public policy"). See also Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 Harv L Rev 1575, 1650 (1979) (noting that "the question remains under what circumstances expectations should be protected").

[19]   Transitions scholarship generally emphasizes the aspects of tax transitions that are common to legal transitions generally. See, for example, Kaplow, 99 Harv L Rev at 515–19 (cited in note 6); Graetz, 126 U Pa L Rev at 47–48 (cited in note 9). See also Shaviro, *When Rules Change* at 89 (cited in note 1). Implicit in the analysis has been the assumption that the optimal transition policy for tax law may be similar to the optimal transition policy for the law as a whole. That approach has resulted generally in a de-emphasis of content and context; Levmore, 22 J Legal Stud at 265 (cited in note 9) (using tax retroactivity analysis to make comparative observations about retroactive legislation as a whole). But see Shaviro, *When Rules Change* at 89 (cited in note 1) (distinguishing the area of legislative tax law changes from takings and from legal transitions in general); Jill E. Fisch, *Retroactivity and Legal Change: An Equilibrium Approach*, 110 Harv L Rev 1055, 1102 (1997) (advocating the use of equilibrium analysis, which focuses on the contextual setting).

1.   The nonmitigation norm.

Previous scholarship has brought forth two principal lines of argument supporting the nonmitigation norm. The first is Louis Kaplow's well-known economic analysis.[20] Kaplow argues that a government policy not to mitigate transition losses generally results in the optimal tradeoff between risk bearing and ex ante incentives for taxpayers to anticipate efficient changes in substantive policy.[21] Under his analysis, the question of how to treat transitions implies a fundamental issue about the risk that government will effect a change in substantive policy at some unknown time and in some unknown manner: transition relief reduces both the upside and downside risk of that substantive policy change.[22] However, transition policy also implicates a fundamental issue concerning incentives: by shielding investors from the full costs and benefits of their investment decisions, transition relief encourages overinvestment in activities that have legally preferred status.[23]

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[20]   Kaplow, 99 Harv L Rev 509 (cited in note 6). More recently, Kaplow has maintained that his analysis of the optimal transition policy should not be construed as "advocating particular transition rules in general or in specific contexts," but rather as an attempt "to emphasize certain factors that need to be considered in most settings and, in many instances, to suggest how some of the analysis should be undertaken." Louis Kaplow, *Transition Policy: A Conceptual Framework*, 13 J Contemp Legal Issues 161, 164 (2003).

[21]   Kaplow, 99 Harv L Rev at 541 (cited in note 6) (arguing against government compensation for tax transitions because "[p]rivate arrangements . . . often provide full risk spreading without distorting incentives, and, when this is impossible, balance risk spreading and maintenance of incentives in the most efficient manner"). For present purposes, Kaplow's argument is discussed in terms of tax transitions; however, he expressly focuses on the issues common to all types of legal transitions. Importantly, his analysis expressly assumes, and is conditioned on, the premise that the underlying substantive policy changes are "desirable" when made. See id at 521 (acknowledging that the analysis assumes that policymakers are pursuing the best outcomes and that the substantive policies do not depend on transition policies). See also Levmore, 99 Colum L Rev at 1663 (cited in note 13) (assuming that "new law is more often than not good law").

[22]   Kaplow, 99 Harv L Rev at 527–28 (cited in note 6) (contending that government compensation, like insurance, is a technique for mitigating the risk of undesirable government action).

[23]   Id at 528–29 (claiming that "the encouragement [to invest] resulting from the assurance that compensation or other protection will be provided in the event of change results in overinvestment"). Kaplow notes that compensating taxpayers for transition losses suffered in connection with their investments shifts part of the costs of those investments to the government. This protection from downside risk "distorts an otherwise efficient decisionmaking process." Id at 531. By contrast, Graetz argues that the potential magnitude of a taxpayer's loss from a pending substantive policy change should, as a general matter, be "the crucial variable" in determining whether to provide transition relief. See Michael J. Graetz, *Retroactivity Revisited*, 98 Harv L Rev 1820, 1826 (1985). This cuts against Kaplow's analysis of using the nonmitigation norm to provide ex ante incentives to anticipate desirable legal change: this "crucial variable" encourages taxpayers to overinvest in tax-preferred goods and services so that, in the event of repeal of the tax preference, they will have a stronger claim to transition relief. Kaplow's analysis concludes that these are precisely the incentives that transition policy should prevent.

Kaplow compares the risk of substantive policy change to market risk.[24] He argues that, in general, government does not mitigate market risk because of the superiority of market mechanisms for addressing that risk and, importantly, because of the adverse effects that governmental mitigation would have on ex ante incentives of private actors to take risk into account when making investment decisions.[25] Similarly, optimization of the risk/incentives tradeoff in the case of transitions implies that government should not mitigate transition losses in the case of welfare-enhancing substantive policy change.[26] For example, if repeal of the interest exclusion for state and local bonds would be efficient, the welfare gains of repeal would be increased by giving bond investors and bond issuers reason to anticipate the change and to adjust their behavior accordingly (perhaps by allocating more resources to other financial instruments).[27]

For these reasons, Kaplow's analysis "generally favors a transition policy of nominally prospective implementation of changes in government policy with no transitional relief."[28] However, as part of his

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[24]   See Kaplow, 99 Harv L Rev at 533–35 (cited in note 6) (concluding that, except for some institutional factors, "there is little to distinguish losses arising from government and market risk"). See also Kaplow, 13 J Contemp Legal Issues at 177 (cited in note 20) (stressing that, from the perspective of private parties, market risk and government-created risk have the same impact).

[25]   Additionally, Kaplow argues that, even if one suspends the assumption that markets operate perfectly, market failures such as moral hazard, adverse selection, transaction costs, and market access do not justify governmental mitigation of transition risk. Kaplow, 99 Harv L Rev at 536–50 (cited in note 6).

[26]   Id at 534–36 (maintaining that accepting the proposition that government action cannot improve upon traditional market responses to the risk and incentive problems posed by uncertainty leads one to conclude that government mitigation of risks is inefficient). Kaplow argues that the analogy between market risks and government risks erases "transition policy . . . as a separate concern." Id at 535. To the extent that one accepts the notion that the market operates efficiently, including as to the imposition and bearing of risk, there is no more reason for government to mitigate the risk of a future substantive policy change than there would be for government to mitigate any other type of risk. Id. See also Kaplow, 13 J Contemp Legal Issues at 179 (cited in note 20) ("[G]overnment relief tends to interfere with the efficiency of private risk mitigation.").

[27]   Another commentator restates the argument in the following terms: "[I]f a policy change makes sense, then it should apply to past decisions as well, so that prior investors, exhibiting rational expectations, might take the potential change into effect." Alan J. Auerbach, Book Review, 39 J Econ Lit 590, 591 (2001), reviewing Shaviro, *When Rules Change* (cited in note 1). For criticisms of the rational-expectations assumption in the transitions context, see Kyle D. Logue, *Legal Transitions, Rational Expectations, and Legal Process*, 13 J Contemp Legal Issues 211, 213 (2003) (offering a behavioralist perspective of the economic transitions framework); Barbara H. Fried, *Ex Ante/Ex Post*, 13 J Contemp Legal Issues 123, 124–25 (2003) (presenting philosophical and behavioral economics critiques of the rational-expectations perspective of welfarism).

[28]   Kaplow, 99 Harv L Rev at 551 (cited in note 6). See also Kaplow, 13 J Contemp Legal Issues at 181 (cited in note 20) ("[W]ith regard to the efficiency of private actors' behavior, no relief tends to be optimal."). Kaplow argues that this conclusion applies both to direct compensation for transition losses and to other mechanisms for providing transition relief, such as grand-

analysis of ensuring welfare-maximizing ex ante incentives, he also argues for "fully retroactive" application of substantive policy changes in the particular cases where the previously permitted activity was "undesirable."[29] Finally, he argues for symmetrical treatment of transition gains and losses.[30]

Daniel Shaviro sets forth a markedly different argument for the application of the nonmitigation norm to substantive tax policy changes.[31] Following critical insights from public choice analysis, he suspends Kaplow's assumption that policy changes effected through the legislative process systematically improve social welfare.[32] He argues that the tax

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fathering, delayed implementation, and phase-ins. See Kaplow, 99 Harv L Rev at 581–92 (cited in note 6).

[29] See Kaplow, 99 Harv L Rev at 551 (cited in note 6) ("The incentives analysis developed above favors precisely such retroactive application when the justification for a reform suggests that the prior activity was undesirable."). See also Kaplow, 13 J Contemp Legal Issues at 181–82 (cited in note 20) (advocating full retroactive taxation of harms caused prior to the reform because "the anticipation of such a transition rule would lead producers to take into account the full harm that their products may cause"). Kaplow's commitment to full retroactivity in these cases is among the strongest formulations of the nonmitigation norm; rather than deny transition relief, he would maximize transition losses (and gains) in particular cases. Presumably, he would argue as well for full retroactivity in the event that Congress were to repeal a tax preference that is shown to be (and to have been) welfare diminishing.

[30] See Kaplow, 99 Harv L Rev at 553–55 (cited in note 6) (advocating symmetrical treatment because "changes in government policy typically generate gains and losses in the same manner"). As with the nonmitigation of transition losses, Kaplow argues that allowing transition winners to keep their transition gains provides them with appropriate incentives. See id. This analysis—like the analysis of transition losses that it mirrors—depends on the notion that the substantive policy change is in fact desirable. To the extent that the substantive policy change that produces the transition gain is wasteful, allowing the transition gain simply increases the wastefulness.

[31] See Shaviro, *When Rules Change* at 13 (cited in note 1). Shaviro generally refers to changes in substantive policy having retroactive effects as "policy change retroactive taxes." See id at 7. He distinguishes these from "accounting change retroactive taxes," which affect the "accounting content of a tax rule," defined as "details in [the rule's] implementation that could in principle be changed without affecting its policy content." Id at 53–54. He argues that tax transition policy should both mitigate transition loss and appropriate transition gain in the case of accounting change retroactive taxes. See id at 101–03 (concluding that "the constitutional norm for accounting change retroactive taxes should support preventing their imposition and providing transitional adjustment to mitigate both gain and loss"). He initially made an additional claim—applicable both to policy change retroactive taxes and accounting change retroactive taxes and, in fact, trumping the norms for both types of retroactive taxes—that Congress should not impose "nominally retroactive taxes, as loosely defined by current practice." Id at 104–10. However, he later tempered that claim. See Daniel Shaviro, *When Rules Change Revisited*, 13 J Contemp Legal Issues 279, 291 (2003).

[32] Shaviro identifies three "core defects of public political choice" that undermine the notion that political outcomes are "presumptively good." See Shaviro, *When Rules Change* at 66 (cited in note 1). He refers to the first of these defects as "problems of aggregation," in which he includes Arrow's Theorem and voting paradoxes. These phenomena call into question any notion that collective decisions reflect the aggregation of individual preferences. Id at 67–69. The second he calls "problems of organization," by which he means the generally superior capacity of small groups or groups with concentrated interests to organize effectively and, therefore, to have a disproportionate influence on political decisionmaking. This, of course, facilitates both rent seeking and rent extraction. Id at 69–71. The third defect is that of "information problems"—whether

legislative process in particular is "seriously flawed" and that decision-making in tax legislation is "notoriously poor in quality."[33] Consequently, he strongly emphasizes the gain/loss asymmetry in current tax transition practices under which Congress mitigates tax transition losses to a greater degree than it appropriates tax transition gains.[34]

Having rejected the position that substantive tax policy changes are presumptively optimal, Shaviro orients sound tax policy using the norm of a comprehensive tax base.[35] That substantive norm implies a first-best transition norm of mitigating transition gains and losses when tax preferences are expanded but not mitigating transition gains and losses when tax preferences are curtailed.[36] Shaviro rejects such a transition norm as not politically feasible.[37] He further assumes that, over time, substantive tax policy changes are essentially random relative to the norm of a comprehensive tax base; that is, the changes do not move the tax law systematically closer to or further from a comprehensive tax base.[38] That observation implies a possible transition norm of mitigating transition gains and losses in order to minimize transition risk, but he rejects such a transition norm as likely widening the existing gain/loss asymmetry.[39] Therefore, he settles on the non-mitigation norm—applicable to both tax transition gains and tax transition losses—as the "best politically feasible constitutional norm" insofar as it likely reduces "Congress's predilection, through its transition policy, to favor tax preference expansion over curtailment."[40]

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the information is bad but systematically neutral or bad but systematically biased in one direction or the other. Id at 71–73.

[33] Id at 86–88.

[34] See id at 90 (noting methods by which Congress moderates tax losses that are generally not applied to gains).

[35] See id at 93–94. He does not commit to either a comprehensive income tax base or a comprehensive consumption tax base. See id at 95–98. Instead, he generically describes the comprehensive tax base by noting that tax would apply uniformly to economic income or economic consumption, with minimal preferences and dispreferences. See id at 94.

[36] Id at 99.

[37] See id.

[38] See id at 99–100 (predicting that tax base changes "are not much more likely to improve the tax law than to worsen it").

[39] See id at 100–01 ("I think it considerably more likely that the marginal effect of an old-view-type, pro-transition relief norm would match the average effect, thus increasing the asymmetry between the elimination of transition losses and transition gains.").

[40] Id at 101. Although somewhat truncated, the reasoning runs as follows: At present, Congress mitigates transition losses more than it appropriates transition gains; thus, tax preference curtailments ordinarily have grandfather rules while tax preference expansions ordinarily do not. The nonmitigation norm, if followed for both transition losses and transition gains, would result in both preference curtailments and preference expansions being effective for investments made prior to enactment. Thus, the nonmitigation norm would narrow the gain/loss asymmetry. In effect, Shaviro argues that, failing the first-best norm of mitigating transition losses and gains for preference expansion but not for preference curtailment, the second-best norm is simply to treat transition gains and losses the same. Appropriating transition gains seems politically

2.   The mitigation norm.

The literature has developed two principal arguments supporting the mitigation norm for certain types of substantive tax policy changes. First, J. Mark Ramseyer and Minoru Nakazato construct a public choice argument for adopting a policy to compensate transition losers on the repeal of tax preferences.[41] They begin by challenging the assumption that the tax legislative process generally produces efficient results,[42] and they argue that, in any event, the mitigation norm[43] does not impede the enactment of welfare-enhancing substantive tax policy changes.[44]

The core of their argument is that the tax legislative process constitutes a "protection racket" in which the "self-interested strategies" of legislators "dramatically increase the social costs of tax reform."[45] In their view, rent-extracting legislators propose or threaten to propose tax reform in order to "demand campaign contributions, honoraria, and bribes" in exchange for not pursuing the legislation.[46] The mitiga-

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unlikely, so he settles for not mitigating transition losses. In certain respects, this is a surprising conclusion to the analysis that precedes it. His rejection of the position that substantive tax policy changes are presumptively desirable and his confidence that most transition risk can be managed effectively without government intervention eliminate both incentives and risk as dominant considerations in his transition analysis. Therefore, one might expect him to reject the search for a transition norm and endorse a case-by-case approach. Instead, he commits to a norm that can achieve its stated objective of narrowing the gain/loss asymmetry only if Congress is more willing to impose transition losses on taxpayers who are already losers under a substantive policy change than to deny transition gains to taxpayers who are already winners under the change. This seems implausible, especially in light of the defects in the tax legislative process that he documents so persuasively.

41   See Ramseyer and Nakazato, 75 Va L Rev at 1157 (cited in note 4) (arguing that "[i]f people spend time and money fighting over tax laws, grandfather clauses may improve the world dramatically"). Ramseyer and Nakazato limit their argument to legislation repealing tax preferences. See id at 1158 n 11 (excluding the issue of whether Congress should promise to grandfather *all* tax provisions).

42   See id at 1163–66. Ramseyer and Nakazato argue that efficient tax legislation is a public good, presenting substantial freerider problems that prevent the formation of a constituency for an efficient tax system. See id at 1163–64 ("If (i) everyone can enjoy the good, regardless of whether he or she helped produce it, and (ii) no one person's role is large enough to determine whether the good will be produced, then everyone will try to free-ride on everyone else."). Following standard interest group theory, they argue that the tax legislative process is driven by the small groups that are better able to organize and secure tax preferences to benefit their members. See id at 1165.

43   They refer to the mitigation norm as the "tax-guaranteed strategy"—that is, "a promise to grandfather, coupled with a promise to pay damages for breach" in the event a preference is repealed. Id at 1171.

44   Ramseyer and Nakazato reason that, in the case of a Kaldor-Hicks-efficient substantive tax policy change, Congress can apply the change to existing investments, compensate the transition losers by providing them with the net present value of the tax benefits they expected to receive in the future, and still enhance social welfare. See id at 1167–69.

45   Id at 1171 (detailing the ways in which legislators can use tax changes as an opportunity to lure constituents into making donations and other wealth transfers).

46   Id at 1171–72.

tion norm frustrates the legislative protection racket because taxpayers who benefit from tax preferences "will not care what Congress does with existing projects" and legislators cannot "extract protection money" from indifferent interest groups.[47] Additionally, they argue, the mitigation norm will minimize the amounts the interest groups will spend to defend existing tax preferences against repeal.[48] Therefore, the mitigation norm enhances social welfare by foreclosing rent extraction and by minimizing post-enactment lobbying costs. For this reason, "Congress should promise to protect taxpayers from its own later tax reform projects."[49]

Kyle Logue develops the second principal argument for the mitigation norm.[50] His argument centers on the repeal or substantial reduction of "incentive subsidies"—tax preferences "whose primary purpose is to alter taxpayers' decisions regarding how they will invest their resources."[51] He argues that the practice of curtailing incentive subsidies without mitigating transition losses will cause taxpayers to demand that any future incentive subsidy be increased to compensate for the possibility of similar repeal; that is, taxpayers in the future will demand that any new incentive subsidy bear a "default premium."[52] To

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[47]   Id at 1172. Ramseyer and Nakazato argue that, in the absence of the mitigation norm, taxpayers who confront the possibility that Congress will repeal an existing tax preference from which they benefit will incur lobbying costs up to the value of the expected tax benefit in resisting repeal. This allows legislators to extract payoffs of any equal or lesser amount not to implement repeal. See id at 1172–73.

[48]   See id at 1173 ("Because the tax-guaranteed approach insures tax benefits, it conserves the resources investors would otherwise spend to protect them."). In the view of Ramseyer and Nakazato, a precommitment to the mitigation norm will neither increase nor decrease the lobbying costs incurred prior to enactment of the tax preference because taxpayers will be indifferent (assuming they are not risk averse) between a tax subsidy with a binding precommitment to compensate for any transition losses on repeal and a tax subsidy with no such precommitment, as long as the net present values of the two subsidies are equivalent. Id.

[49]   Id at 1158. Ramseyer and Nakazato note that their conclusion applies not to existing tax preferences enacted with no express or implicit commitment to grandfathering, but only to tax preferences enacted after Congress commits to the mitigation norm. See id at 1162. Similarly, their conclusion does not apply to substantive tax policy changes that would not encourage "intense lobbying." Id at 1168 n 37.

[50]   See Logue, 94 Mich L Rev at 1131 (cited in note 3) ("This article challenges the conventional academic wisdom that nominal retroactivity is presumptively efficient."). For other arguments in favor of the mitigation norm, see Eric Chason, *The Economic Ambiguity (and Possible Irrelevance) of Tax Transition Rules*, 22 Va Tax Rev 615, 640–42 (2003) (arguing generally for transition relief on the basis of the cost to government in providing tax subsidies); Daniel S. Goldberg, *Tax Subsidies: One-time vs. Periodic: An Economic Analysis of Tax Policy Alternatives*, 49 Tax L Rev 305, 305–06 (1994) (advocating generally for transition relief on the basis of economic disruptions caused by uncompensated repeal of periodic tax subsidies).

[51]   Logue, 94 Mich L Rev at 1138 (cited in note 3).

[52]   Id at 1139. Graetz called this the "uncertainty premium." Graetz, 126 U Pa L Rev at 69 (cited in note 9). Logue makes the debatable assumption that Congress enacts incentive subsidies specifically to induce marginal changes in taxpayer behavior. Therefore, he quantifies the default premium by reference to a taxpayer's "subjective estimate of the probability that the

avoid incurring the cost of this default-premium effect, "the government must make a credible public *precommitment* to provide transition relief."[53]

Logue then constructs an analogy between the enactment of incentive subsidies and the establishment of a contractual relationship between the government and a private counterparty.[54] He observes that, in the case of government contracts, we have a strong norm against the government acting opportunistically (for example, by refusing to perform after the counterparty has performed).[55] He reasons that the norm against opportunism in government contracts represents a policy choice as to the "tradeoff between default-premium concerns and government-flexibility concerns,"[56] and he concludes that often "the optimal transition policy would be to provide full transition relief in the form of grandfathered effective dates" when incentive subsidies are repealed or reduced.[57]

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government will repeal [the subsidy] without providing relief." Logue, 94 Mich L Rev at 1140 (cited in note 3). See also Graetz, 126 U Pa L Rev at 69–70 (cited in note 9) ("The amount of premium will vary directly with individuals' subjective probabilities as to the risk of a change in the law."). However, much of the rent seeking by organized interest groups that leads to the enactment or expansion of tax preferences concerns tax subsidies for existing behavior. Although taxpayers in such a position surely would not refuse the benefits of a default premium, it seems highly unlikely that they would demand it as a condition for claiming a subsidy for their existing investments.

[53]   Logue, 94 Mich L Rev at 1140 (cited in note 3). Logue recognizes the argument that paying the default premium might be less costly than the precommitment to mitigate transition losses. But he anticipates that taxpayers ordinarily will assume a higher probability of uncompensated repeal than will the government, resulting in a lower cost for the mitigation norm than for the default-premium effect. See id at 1139–41 (describing taxpayer response to repeal at various stages of risk sensitivity and concluding that—because taxpayers would know that the government decided to "burn" them—they would become more sensitive to risk and would demand more in default premia than mitigation would cost). Compare Graetz, 126 U Pa L Rev at 70 (cited in note 9) (contending that the efficiency of avoiding default premia depends on government and taxpayers' sensitivity to risk).

[54]   See Logue, 94 Mich L Rev at 1143–49 (cited in note 3) ("[I]n both contexts, there are enormous efficiency benefits to the government's keeping its word").

[55]   Id at 1145–46 ("[W]e typically do not allow our government (federal or state) to break its contractual agreements without paying contract damages to the nonbreaching party."). For Logue, the evidence for this norm in government contracting is the simple fact that the government must pay damages in the event of contractual breach. He notes that the norm under which the government is subject to ordinary contract law in such cases is "uncontroversial." Id at 1146–47 (examining normative, institutional, and efficiency-based foundations for nonbreach of contract by governments).

[56]   Id at 1148.

[57]   Id. The validity of Logue's analogy between legislative tax preferences and governmental contracts is open to question. When the government enters into a contract with a private counterparty, it seeks to affect the counterparty's behavior in a specific manner. Thus, an opportunistic breach by the government likely would lead to future counterparties demanding default premia in order to alter their behavior in the manner contemplated by the government under the terms of a proposed contract. However, as indicated above, Congress often enacts tax preferences, including incentive subsidies, without regard to whether the benefits will induce a change in future behavior or will simply subsidize behavior that would happen anyway. This raises the

In effect, Logue argues that the dead weight of the default-premium effect results in a net decrease in social welfare.[58] Therefore, under his argument, the government probably should precommit to mitigate transition losses in the context of incentive subsidies.[59] Rather than encourage taxpayers to anticipate the repeal of these tax preferences (as Kaplow argues), the government should encourage taxpayers to behave as if their tax preferences will never be repealed by providing a strong assurance of compensation.[60]

C.   The Relationship of Tax Transition Policy to Substantive Tax Policy

The preceding section sets forth the principal arguments developed in the literature favoring a government policy for the treatment of tax transitions. Although different in important respects, including their normative conclusions, the arguments share certain assumptions. As developed more fully in this section, the arguments also share a common limitation in that they generally do not examine how a tax transition policy affects the development of substantive tax policy; they largely assume that tax transition policy is exogenous to substantive

question of whether taxpayers really would demand default premia in the event of an opportunistic governmental repeal of existing tax preferences. The default premium is supposed to protect the taxpayer from costs incurred by making an investment in reliance on the expected tax preference; if the taxpayer would have made the investment with or without the tax preference, the default premium is irrelevant and would not be included in the tax preference whether or not it was preceded by an opportunistic governmental repeal of earlier tax preferences.

[58]   By contrast, Graetz suggests that the costs of grandfathering may exceed the costs of the default premium. See Graetz, 126 U Pa L Rev at 71 (cited in note 9) (arguing that "[p]aying a premium in lieu of grandfathering" might be efficient because (1) "grandfathered effective dates will often reduce whatever benefits are expected to be realized from the change in law," and (2) "grandfathered effective dates often increase planning and enforcement costs for both taxpayers and the government").

[59]   See Logue, 94 Mich L Rev at 1131, 1148–49 (cited in note 3). Interestingly, on Logue's analysis, the repeal of incentive subsidies is singled out for the protection of the mitigation norm. On Kaplow's analysis, repeal of such preferences is the quintessential case for application of the nonmitigation norm.

[60]   Logue's initial articulation of the argument for the mitigation norm recognized that the conclusion would run the other way if the cost of the default premium were sufficiently small. See id at 1149 n 69. His subsequent articulation of the argument was more guarded, indicating only that the mitigation norm "may" be the optimal transition policy in the case of repeal of incentive subsidies. See Kyle D. Logue, Book Review, *If Taxpayers Can't Be Fooled, Maybe Congress Can: A Public Choice Perspective on the Tax Transition Debate*, 67 U Chi L Rev 1507, 1513–15 (2000) (noting, after taking rational-expectations analyses into account, that his earlier conclusion "depends on a series of difficult conceptual and empirical questions"). Without abandoning his qualified support for the mitigation norm in the case of incentive subsidy repeal, Logue later identified narrow classes of transitions (including repeal of tax shelter provisions) in which the nonmitigation norm might be optimal. See Logue, 13 J Contemp Legal Issues at 229–35 (cited in note 27) (pointing out that the nonmitigation norm could also be optimal in certain circumstances of products liability law).

tax policy. For this reason, the existing arguments also do not analyze how the effects of tax transition policy on substantive tax policy may undermine the normative case for establishing a tax transition policy in the first instance.

As demonstrated in Part I.B, current scholarship anchors tax transition analysis by the search for the optimal tax transition policy. In almost every case, the inquiry rejects the ad hoc approach to tax transitions currently in legislative practice and aims to define a governmental rule or norm providing for the consistent treatment of tax transitions. A critical aspect of such a policy, to have the effects claimed by proponents, is that it be known and believed ex ante by private and governmental actors.[61] The policy ordinarily is conceived of as being less than absolutely binding, although more than merely suggestive, with the varying degrees of constraint attributable in part to differing views of the legal and practical obstacles of establishing a genuine governmental precommitment.[62]

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[61]   Kaplow makes this assumption explicit in setting out his argument that the nonmitigation norm optimizes the risk/incentive tradeoff. See Kaplow, 99 Harv L Rev at 520 (cited in note 6) ("[T]he analysis assumes that the transition policy to be employed in a given context is well-known in advance and will be followed consistently in the future."). As a corollary, he argues that application of the nonmitigation norm to substantive policy changes that have been enacted or are pending when the nonmitigation norm is first announced will not result in the desirable ex ante incentive effects that justify the nonmitigation norm. See id at 557–58. Thus, he regards it as crucial that the governmental precommitment to the nonmitigation norm "is known by all in advance and is credible." Id at 557. See also Kaplow, 13 J Contemp Legal Issues at 172 (cited in note 20) (assuming stability and widespread knowledge of transition policies). The same point is true to a greater or lesser extent with respect to all the arguments set forth in Part I.B. Ramseyer and Nakazato argue for the mitigation norm on the ground that it will reduce rent extraction and rent seeking; if this is true at all, it is true only to the extent that taxpayers know and believe the policy to mitigate transition losses and so become indifferent to the potential repeal of existing tax preferences. Similarly, Logue's argument hinges on taxpayers believing the governmental commitment to grandfathering so that they will not demand default premia upon the enactment of tax preferences. The point is perhaps weakest with respect to Shaviro, who largely sets ex ante incentive effects to the side and endorses the nonmitigation norm as an indirect method of narrowing the gain/loss asymmetry. Even so, his norm is intended to influence governmental actors and, as such, must be known by those actors when they determine transition rules for specific substantive tax policy changes.

[62]   Graetz argues that "[t]here is simply no way to provide complete assurance that a transaction will not be affected by a change in law" because even a constitutional commitment to mitigate transition losses could be changed. Graetz, 126 U Pa L Rev at 69 n 72 (cited in note 9). Shaviro addresses that point by de-emphasizing the notion of the government binding itself; he searches instead for proper "constitutional norms"—norms that provide long-term rules or aspirations that "constrain[] or at least influence[] political behavior." Shaviro, *When Rules Change* at 92 (cited in note 1). In fact, Shaviro indicates that he would argue for a different transition norm if he believed that such a norm could be binding on Congress. See id at 13–14 (asserting that "no norm for policy change retroactive taxes will in fact be applied with rigorous uniformity"). Ramseyer and Nakazato appear less skeptical about the legal obstacles to Congress binding itself than about the political prospects of Congress committing to a mitigation norm that would, in the end, sharply reduce its own opportunities for rent extraction. See Ram-

For analytic purposes, however, one can and should make simplifying assumptions on this point. In an important sense, questions about whether a governmental precommitment is practicable and, if so, how strong that precommitment can be are tangential to the normative claims made under current tax transition scholarship. Almost universally, the claims are that one transition policy or the other will improve social welfare,[63] and those claims can be analyzed meaningfully by assuming that a tax transition policy is in place. For example, it is possible to test Kaplow's claim that a policy not to mitigate transition losses will improve social welfare without concluding that an actual governmental precommitment is in fact possible or even likely. Indeed, sidestepping the question of practicability allows for better scrutiny of those normative claims because positing a strong version of the mitigation norm or the nonmitigation norm should produce the

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seyer and Nakazato, 75 Va L Rev at 1170–71, 1175 (cited in note 4). Logue presents the most thorough analysis of the problems presented by a governmental precommitment and the most sanguine conclusions about the possibility of such a result. See Logue, 94 Mich L Rev at 1181–94 (cited in note 3) (exploring a variety of methods by which Congress could precommit, including application of contract principles, procedural roadblocks, allocation of authority to administrative agencies, termination dates, and "up-front subsidies").

[63] The efficiency claims of the arguments set out in Part I.B are readily apparent. Kaplow's argument concludes that the nonmitigation norm will provide ex ante incentives for taxpayers to anticipate efficient substantive policy changes (such as the elimination of undesirable tax preferences), thereby optimizing the risk/incentive tradeoff. See notes 20–30 and accompanying text. Shaviro argues that the nonmitigation norm will narrow the deviations from the welfare-enhancing norm of a comprehensive tax base by minimizing the transition gain/loss asymmetry. See notes 31–40 and accompanying text. Logue's central claim is that the mitigation norm avoids having the government incur the additional cost of default premia that taxpayers otherwise would demand to protect their investments in tax-preferred goods and services from opportunistic repeal. See Logue, 94 Mich L Rev at 1142 (cited in note 3) ("Given the costs associated with the uncompensated repeal of or reduction in an incentive subsidy, an argument can be made that the government should attempt to precommit to a policy of providing guaranteed grandfather treatment for all incentive-subsidy provisions."). Logue appears relatively confident that the mitigation norm yields the more efficient results, arguing that "the analogy to government contracts . . . would suggest that, absent some powerful argument to the contrary, the optimal transition rule [in the case of incentive subsidies] would be for the government to precommit to provide full transition relief." Id at 1149. However, he does qualify his claim by noting the serious difficulty of marshalling empirical evidence to support it. See id at 1157 ("[W]hether binding the government to its promises . . . will prove efficient is ultimately an empirical question on which there is essentially no direct data."). Although Ramseyer and Nakazato argue that the mitigation norm minimizes rent extraction by legislators and postenactment rent seeking by organized interest groups, see notes 41–49 and accompanying text, it is not always clear how strong an efficiency claim they are making. At times, they appear to make only a tentative commitment on this point, arguing that "grandfather clauses *may* be economically efficient." Ramseyer and Nakazato, 75 Va L Rev at 1157 n 9 (cited in note 4) (emphasis added). At other times, they are more definite about the welfare-enhancing effects of the mitigation norm, arguing that "society benefits if Congress commits itself to insulating outstanding investments from tax reform," and that such a commitment could "dramatically benefit society." Id at 1158, 1162. They conclude that "the efficient strategy is often the one that guarantees tax benefits" and that "the optimal strategy is one in which Congress promises to grandfather existing projects." Id at 1174–75.

maximum benefits that the norm in question can yield. Thus, assuming a strong nonmitigation norm should (if Kaplow's underlying claim is valid) produce the greatest possible ex ante anticipation of future substantive policy changes and, to the extent those substantive policy changes are themselves efficient, should maximize the resulting increase in social welfare. Therefore, the remainder of this Article will make this simplifying assumption and will ignore the weighty questions about whether, how, and to what degree the government could make an actual precommitment to a particular tax transition policy.[64]

The arguments set out in Part I.B actively engage the potential effects that substantive tax policy may have on tax transition policy. In particular, proponents of the mitigation norm and the nonmitigation norm have examined the extent to which their claims are dependent on the assumption that substantive tax policy changes are themselves optimal. For example, Kaplow's argument supporting the nonmitigation norm depends (in his view) upon the optimality of those substantive tax policy changes.[65] Rejecting the presumed optimality of sub-

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[64]   For an analysis of difficulties associated with a governmental precommitment to a transition policy in the context of tax legislation, see Stark, 13 Am J Tax Policy at 147 (cited in note 18) (attempting "to show that fundamental institutional characteristics of Congress in general, and the tax writing committees in particular, make *advance* transition rules . . . very difficult to sustain"). Just as it sets aside the practicability of governmental precommitment, this Article also does not engage the debate over legislative entrenchment. Compare John O. McGinnis and Michael B. Rappaport, *Symmetric Entrenchment: A Constitutional and Normative Theory*, 89 Va L Rev 385, 388–89 (2003) (setting out arguments against federal legislative entrenchment other than "symmetric" entrenchment), with Eric Posner and Adrian Vermeule, *Legislative Entrenchment: A Reappraisal*, 111 Yale L J 1665, 1665–66 (2002) (setting out arguments favoring federal legislative entrenchment).

[65]   Accordingly, Kaplow expressly predicates his analysis on the assumption that legal change enhances welfare, see Kaplow, 99 Harv L Rev at 521 (cited in note 6) ("[T]he discussion assumes that the reforms themselves are desirable at the time they are made."), and he suggests that the mitigation norm might be preferable to the nonmitigation norm where the assumption is not valid, see Kaplow, 13 J Contemp Legal Issues at 173 (cited in note 20) ("[W]hen reform is undesirable, transition relief that tends to undermine the effects of reform is beneficial."). Although the general superiority of market mechanisms to address risk bearing is not dependent on that assumption, the creation of ex ante incentives for private actors to anticipate desirable legal change is dependent on the question of whether the legal change is in fact desirable. Id at 191 ("The main point at which the optimality of government policy is relevant involves assessment of the efficiency of ex ante incentive effects."). See also Shaviro, *When Rules Change* at 48–51 (cited in note 1) (discussing how "the desirability of inducing people to anticipate a rule change does indeed depend on the change being a good one"). Graetz makes this point in connection with his demonstration of the high costs attendant to grandfathering as a mechanism for mitigating transition losses. See Graetz, 126 U Pa L Rev at 72 (cited in note 9) (probing the effect of an efficient change in law on the wisdom of enacting grandfather clauses instead of providing other forms of mitigation). See also Levmore, 99 Colum L Rev at 1659 (cited in note 13) (arguing that the "anticipation-oriented approach" to transition policy "is more attractive the more new law is in fact good law, the more this good law would have been yet better if enacted or conformed to earlier, the more new losers have informational advantages, and the more likely it is that new losers will facilitate good law rather than work wastefully or successfully to block it."). For an insightful

stantive tax policy may, as Ramseyer and Nakazato argue, set a foundation for the mitigation norm; but even where substantive tax policy changes appear random relative to optimal policy, there might still be reasons, as Shaviro argues, not to mitigate tax transition losses.

By contrast, there has not been adequate attention in the literature to the effects that a tax transition policy would have on the development of substantive tax policy. Nor has there been adequate attention to the implications of those effects for the underlying normative arguments supporting the idea of a tax transition policy. In some cases, these effects have been assumed not to exist or have simply been disregarded.[66] In other cases, it has been assumed that the establishment of a tax transition policy would result in a substantive tax policy adjustment that offsets the presence or absence of transition relief.[67] Shaviro examines the general consequences of transition policy for future political decisionmaking,[68] but he does not apply that analysis to his own argument for the nonmitigation norm.[69] In short, the existing analyses

analysis of the role that positing the optimality of substantive governmental action plays in the anticipation-based argument for the nonmitigation norm, see Logue, 13 J Contemp Legal Issues at 249–57 (cited in note 27) (using products liability and tax law reform to illustrate that the likelihood of good law or bad law emanating from the legislature almost certainly has some important explanatory power with respect to transition norms). Drawing in part from the public choice considerations identified by Shaviro, see note 32, Logue argues against the assumption that substantive tax policy either steadily improves or worsens over time. See Logue, 13 J Contemp Legal Issues at 256 (cited in note 27) ("All of this is not to say, however, that one should expect the tax law to get steadily worse over time. Rather, the better prediction would be one of cyclical swings in tax policy."). For a broader criticism of the assumption of optimal substantive governmental action, see Richard A. Epstein, *Beware Legal Transitions: A Presumptive Vote for the Reliance Interest*, 13 J Contemp Legal Issues 69, 71–77 (2003) (arguing that legal changes increase administrative costs and reflect interest group victories).

  66 Kaplow expressly assumes that the choice of transition policy does not affect substantive policy. See Kaplow, 99 Harv L Rev at 521 (cited in note 6) (restricting his focus to how transition policies affect private, not legislative, actors). Without explanation, he argues that "[i]n many instances [this] assumption is accurate, or is at least a reasonable approximation." Id at 566. However, he recognizes the importance of this assumption and invites inquiry about how his incentives-based analysis would differ if the assumption were suspended. See Kaplow, 13 J Contemp Legal Issues at 173–74, 190 (cited in note 20) (recognizing the possibility of the transition regime influencing government actors). Indeed, he argues that "it is entirely possible that the transition policy that governments will have to follow may affect which underlying substantive reforms are implemented." Id at 174.

  67 This is evident, for example, in Logue's analysis. For Logue, a tax transition policy affects substantive tax policy as to the presence or absence of the default premium. See notes 52–53 and accompanying text.

  68 Shaviro argues that transition policy should aim not only to optimize transition decisions but also "to encourage better decisions regarding steady-state policy by affecting political incentives and information in light of the transition consequences that a new enactment would likely have." Shaviro, *When Rules Change* at 74 (cited in note 1).

  69 Shaviro argues for the nonmitigation norm as a means of narrowing the gain/loss asymmetry in the treatment of tax transitions. See id at 98–101 (concluding that "the marginal effect of an old-view-type, pro-transition relief norm would match the average effect, thus increasing the asymmetry between the elimination of transition losses and transition gains"). He implicitly

have not fully considered how the existence of a tax transition policy—regardless of whether it is a mitigation or nonmitigation policy—would affect the development of substantive tax policy.[70]

The need to analyze this intersection of tax transition policy and substantive tax policy appears critical; at a minimum, the question deserves much closer scrutiny than it has received.[71] Such scrutiny requires an examination of the substantive policymaking process, and this Article focuses that examination on the tax legislative process. Following certain observations of political theory, Part II will identify compromise as a critical strategy of tax legislation. Part III will then develop the implications of legislative compromise for tax transition policy. More specifically, Part III will argue that a tax transition policy—whether to mitigate or not to mitigate transition losses—generally favors the status quo, especially as to the repeal of tax preferences. That, in turn, raises new doubts about the normative claims that have been made on both sides of the debate over the optimal tax transition policy.

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assumes that, whether the legislature follows the nonmitigation norm or the mitigation norm, it will pursue the same level of tax preference curtailment and tax preference expansion. According to his argument, the only aspect of the legislation that is affected by the choice of transition policy is the actual effective date of the legislation. Thus, he argues that the mitigation norm would be unlikely to be followed closely because of the legislature's strong proclivity to confer transition gains when expanding tax preferences. Yet he also assumes that the nonmitigation norm would tend to eliminate transition losses resulting from the curtailment of tax preferences (thereby matching the grant of transition gains resulting from preference expansion). He does not envision that the nonmitigation norm would make the underlying preference curtailments or expansions more or less likely as a matter of substantive policy. Thus, Shaviro stands in the mainstream of existing tax transition scholarship in generally assuming a dichotomy between tax transition policy and substantive tax policy.

[70] See Jill E. Fisch, *The Implications of Transition Theory for Stare Decisis*, 13 J Contemp Legal Issues 93, 119–20 (2003) ("Although some commentators have identified the possibility that transition relief will cause government actors to internalize the costs of legal change, thereby reducing the likelihood of legal change, the analysis has not fully explored the relationship between transition policy and the lawmaking process."); Fried, 13 J Contemp Legal Issues at 129 n 11 (cited in note 27) ("[M]ost transitions analysis at least in the tax context has simply ignored the government side of the picture, focusing on the supposed effects of compensation on individual investor behavior."); Levmore, 99 Colum L Rev at 1662 (cited in note 13) (noting the "implicit assumption" in much of the transition literature "that encouraging a different pace of change will not adversely affect its content"). Levmore's analysis of the interplay between transition policy and substantive policy is the most extensive, although he expressly limits that analysis to the effect on the "pace" rather than the "content" of substantive policy developments. See id at 1658 (focusing "on compensation and other tools as means of affecting the pace of change, rather than as implements for influencing the content of new law").

[71] See Kaplow, 13 J Contemp Legal Issues at 191 (cited in note 20) ("A more complete analysis of government behavior might well be expected to generate different conclusions [about transition policy] in different settings, which in turn suggests an important set of reasons that optimal transition policies may vary by context.").

II. Compromise in the Tax Legislative Process

The federal income tax presents some of the most intractable controversies of public policy. From its inception in the early twentieth century as a tax on the wealthiest Americans and continuing through its expansion to a mass tax during the Second World War, the federal income tax has been the focus of deep disagreements about how to distribute the costs of government.[72] Additionally, as an instrument for regulating behavior, tax policy is at the center of debates over fundamental questions of economic and social policy. Even beneath these ideological issues, tax policy implicates basic disputes at the level of interest group and institutional politics.

Despite such divisions, Congress produces tax legislation with impressive regularity. The Internal Revenue Code (IRC) has been amended every year during the last half century, and, over the past generation, there has been a substantial item of tax legislation in more years than not.[73] Typically, major tax bills are organized around a central policy objective that affects all or a very large segment of taxpayers—such as an increase in marginal tax rates (1993), a decrease in marginal tax rates (2001), an economic stimulus (1981 and 2003), a reorganization of tax administration (1998), or fundamental tax reform (1986). These centerpiece provisions provide a vehicle for hundreds,

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[72] For an intellectual history of the establishment of the federal income tax, see generally Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L Rev 1793, 1794–1803 (2005) (chronicling the paradigm shift in the American tax regime from indirect taxation to a progressive income tax and pointing to a group of economists as the agents behind the change). See also Robert Stanley, *Dimensions of Law in the Service of Order: Origins of the Federal Income Tax, 1861–1913* 13–14 (Oxford 1993) (positing that the income tax was not the product of bitter political disputes, but rather a centrist ideological consensus on "a state-sponsored capitalist status quo maintained by official trustees through an understanding of the subtle uses of law"). See generally John F. Witte, *The Politics and Development of the Federal Income Tax* (Wisconsin 1985).

[73] See, for example, Pension Protection Act of 2006, Pub L No 109-280, 120 Stat 780; American Jobs Creation Act of 2004, Pub L No 108-357, 118 Stat 1418; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub L No 108-27, 117 Stat 752; Job Creation and Worker Assistance Act of 2002, Pub L No 107-147, 116 Stat 21; Economic Growth and Tax Relief Reconciliation Act of 2001, Pub L No 107-16, 115 Stat 38; Internal Revenue Service Restructuring and Reform Act of 1998, Pub L No 105-206, 112 Stat 685; Taxpayer Relief Act of 1997, Pub L No 105-34, 111 Stat 788; Small Business Job Protection Act of 1996, Pub L No 104-188, 110 Stat 1755; Uruguay Round Agreements Act, Pub L No 103-465, 108 Stat 4809 (1994); Omnibus Budget Reconciliation Act of 1993, Pub L No 103-66, 107 Stat 312; Omnibus Budget Reconciliation Act of 1990, Pub L No 101-508, 104 Stat 1388; Technical and Miscellaneous Revenue Act of 1988, Pub L No 100-647, 102 Stat 3342; Revenue Act of 1987, Pub L No 100-203, 101 Stat 1330; Tax Reform Act of 1986, Pub L No 99-514, 100 Stat 2085; Deficit Reduction Act of 1984, Pub L No 98-369, 98 Stat 494; Social Security Amendments of 1983, Pub L No 98-21, 97 Stat 65; Subchapter S Revision Act of 1982, Pub L No 97-354, 96 Stat 1669; Tax Equity and Fiscal Responsibility Act of 1982, Pub L No 97-248, 96 Stat 324; Economic Recovery and Tax Act of 1981, Pub L No 97-34, 95 Stat 172.

even thousands, of additional provisions that expand or contract tax preferences and dispreferences for particular taxpayers or particular groups of taxpayers.

This Part argues that, notwithstanding the divisions underlying substantive tax policy, the players in the tax legislative process customarily resolve their differences and successfully produce legislation by pursuing compromise outcomes. In certain cases, the legislative dealmaking occurs at the highest levels, limited at times to players in the majority party; this occurred, for example, both in 1993 (when the Democrats in Congress and President Clinton increased taxes to achieve their stated objective of reducing the federal deficit) and again in 2003 (when the Republicans in Congress and President Bush lowered taxes to achieve their stated objective of stimulating economic growth). At the other extreme, legislative compromise may involve only one or two legislators with a stake in a provision that favors or disfavors a particular interest group. In any case, the demonstrated tendency among legislators to resolve policy differences, where possible, through compromise constitutes an important component of the tax legislative process.

Part II.A examines briefly the dimensions of conflict in the tax legislative process, observing that legislators are best understood as acting primarily in their own self-interests (including the interests of their constituents) and that this results in conflict. Parts II.B and II.C demonstrate the tendency of these self-interested legislators to establish compromise outcomes in the production of tax legislation. The analytic and normative implications for tax transition policy are then developed in Part III.

A.   Ideological and Political Conflicts in Tax Legislation

The tax legislative process entails conflict at several levels. This Part examines three overlapping yet distinct dimensions of that conflict: fundamental tax policy issues, interest group politics, and institutional politics.

1.   Fundamental tax policy issues.

The first dimension of conflict in tax legislation comprises the most basic questions of tax policy.[74] These include such issues as whether the tax base should include capital income, whether tax rates should be progressive or proportional, whether the production or con-

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[74]   For an overview of fundamental tax policy issues, see C. Eugene Steuerle, *Contemporary U.S. Tax Policy* 9–30 (Urban Institute 2004).

sumption of particular goods and services should be subsidized through the tax system, whether the tax system should be structured to encourage or discourage traditional family structures, whether the income tax produces adequate revenue for the government, and other fundamental issues in economic and social policy.

Many legislators—probably most of those who serve on the Ways and Means Committee (the tax writing committee in the House) or the Finance Committee (the tax writing committee in the Senate)—and many presidents have strong commitments to a particular vision of tax policy. For example, many legislators place great importance on progressivity and what they regard as a fair distribution of the tax burden; others, for example, believe strongly in flattening marginal rates or simply replacing the income tax with an entirely different source of federal revenue. Differences on these and other fundamental tax policy questions provide a primary and often intense source of conflict.[75]

2. Interest group politics.

A second dimension of conflict in tax legislation is that of interest group politics. Standard analysis of collective action issues indicates that the disproportionate power of small, well-organized groups (such as oil or timber companies) often enables those groups to benefit at the expense of large, disorganized groups (such as all other taxpayers).[76] Recognizing the substantial influence of interest groups in the tax legislative process does not require committing to a strong version of the economic theory of legislation (under which legislation is a good purchased with political and financial support). Organized groups exist, they act to affect the outcome of the tax legislative process, and legis-

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[75] For accounts of conflict over fundamental tax policy in the development of the Tax Reform Act of 1986, see generally Timothy J. Conlan, Margaret T. Wrightson, and David R. Beam, *Taxing Choices: The Politics of Tax Reform* (CQ 1990); Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (Random House 1987).

[76] The customary point of reference is Mancur Olson, Jr., *The Logic of Collective Action: Public Goods and the Theory of Groups* 3 (Harvard 1965) (offering a seminal analysis of "the 'exploitation' of the *great* by the *small*"). See also Shaviro, *When Rules Change* at 69–71 (cited in note 1) (arguing that "small groups with concentrated interests can disproportionately either win or lose in the political process, depending on details of group organization and broader coalition formation"); Daniel A. Farber and Philip P. Frickey, *Law and Public Choice: A Critical Introduction* 12–33 (Chicago 1991) (presenting interest group theory and the economic theory of legislation); William N. Eskridge, Jr., *Politics without Romance: Implications of Public Choice Theory for Statutory Interpretation*, 74 Va L Rev 275, 285–90 (1988) (discussing how interest groups' demand and legislators' responsive supply allow one to predict, based on the incidence of costs and benefits, the likely legislative output). For a discussion of interest group politics in the particular context of tax transition issues, see Levmore, 22 J Legal Stud at 279–88 (cited in note 9) (arguing that "retroactive *benefits* will often be legislated because powerful interest groups will work for self-serving legislation that advantages identifiable interests").

lators undertake to advance their interests. Those simple facts imply the inevitability of conflict among legislators.[77]

In contrast to the ideological conflicts over fundamental tax policy issues that often engage presidents and party caucuses, conflicts over interest group politics ordinarily are concentrated among a small number of legislators. For example, a legislator who champions a tax preference for a particular group may encounter opposition from the chair of a tax writing committee who must produce a tax bill within specific revenue parameters or from another legislator who objects to the social costs imposed by the group's rent seeking.[78] At other times, legislators will come into conflict for the straightforward reason that they are representing interest groups seeking inconsistent legislative outcomes.[79]

3. Institutional politics.

A third dimension of conflict among legislators is institutional politics; that is, the relations among legislators within the institution of Congress. Tax legislative power is very concentrated. Of the 435 Members of the House, only 41 currently serve on the Ways and Means Committee;[80] of the 100 Senators, only 21 currently serve on the

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[77]   See, for example, Shaviro, 139 U Pa L Rev at 22 (describing the Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984—both of which curtailed tax preferences—as "pushed through by congressional leaders, principally Senate Finance Committee Chairman Robert Dole, over the opposition of the business groups whose tax preferences were reduced"), 24 (describing "massive political opposition from various interest groups" to the Treasury's tax reform proposal in 1984) (cited in note 12). The fact that interest group politics may lead to conflicts among legislators can be obscured by the fact that the conflicts may be resolved through logrolling. See, for example, Michael J. Graetz, *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go from Here* 137–39 (Norton 1999) (describing vote trading during enactment of the Tax Reform Act of 1986).

[78]   See Shaviro, 139 U Pa L Rev at 94 (cited in note 12) (arguing that "policy entrepreneurship" by legislators is "the principal alternative to interest group politics, making possible legislation that pits widely dispersed benefits against narrowly concentrated costs"); Eskridge, 74 Va L Rev at 287 (cited in note 76) ("[U]norganized interests may still have an impact if their preferences are strong and commonly held, for public opinion itself works as an important constraint on legislative action.").

[79]   Shaviro argues that interest groups "almost never" oppose tax favors for other groups and that "[i]n most cases, opposition to tax breaks comes only from the Treasury Department, congressional tax staffers[,] . . . and a handful of public interest lobbying groups." Shaviro, 139 U Pa L Rev at 55–56 (cited in note 12). He is surely correct that Treasury and Hill staff, both participants in the tax legislative process, often raise objections to rent seeking tax proposals and that these objections can form the basis for conflict in the tax legislative process. However, interest groups do oppose preferences for other groups or, more subtly, respond to a proposed preference for another group by seeking an expanded preference for themselves. See, for example, John D. McKinnon and Greg Hitt, *Financial Firms Battle over Bush Savings Plan*, Wall St J A4 (Dec 19, 2003) (describing a fight over tax-preferenced individual savings that pitted "annuity sellers and pension-plan advisers . . . against banks and mutual-fund companies").

[80]   Committee on Ways and Means, *Members of the 109th Congress*, online at http://waysandmeans.house.gov/members.asp?comm=0 (visited Apr 17, 2007).

Finance Committee.[81] Within those two tax writing committees, disproportionate power resides in the position of the chair, who determines whether and when any tax bill will be brought before the full committee and who, through the drafting of the "chairman's mark," ordinarily determines the content of each tax bill prior to any committee or floor amendments. The chairs use the tax legislative process to consolidate and augment the authority of their positions.[82] At the same time, junior committee members use the process to try to increase their own standing.[83]

With committee chairs seeking legislative victories and ambitious junior members seeking to move upward, the likelihood of conflict between the two committee chairs, among committee chairs and junior members, and among junior members is readily apparent. Often, this will incorporate elements of conflict over fundamental tax policy or interest group politics, but the disputes may be that much more intractable when institutional politics are at stake.

B.   Resolution of Tax Legislative Conflicts through Compromise

Part II.A observes that legislators, acting with divergent ideological commitments and self-interested objectives, often find themselves in conflict with one another. Time and again, however, these conflicts yield to compromise outcomes. Although not every item of successful tax legislation necessarily involves compromise, it is often a critical element.[84] This pattern is familiar to scholars of the tax legislative process.

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[81] United States Senate Committee on Finance, *Committee Members*, online at http://finance.senate.gov/sitepages/committee.htm (visited Apr 17, 2007).

[82] See Shaviro, 139 U Pa L Rev at 82–84 (cited in note 12) (noting "power and prestige" as key objectives of members and the importance of "legislative victories" for tax writing committee chairs). See also Graetz, *The U.S. Income Tax* at 132 (cited in note 77) ("[Former Chairman Daniel] Rostenkowski . . . said he regarded the [Tax Reform Act of 1986] as his opportunity to 'prove that [he] could be Chairman of the Ways and Means Committee.'"), quoting Rosina B. Barker and Jasper L. Cummings, Jr., *Interview with the Honorable Dan Rostenkowski*, ABA Section of Taxation Newsletter 12 (Winter 1996); Birnbaum and Murray, *Showdown at Gucci Gulch* at 268–69 (cited in note 75) (noting that Rostenkowski and Packwood "knew that their reputations [as chairmen] would be permanently sullied by defeat").

[83] Shaviro, 139 U Pa L Rev at 84 (cited in note 12) (noting that junior members of the House Committee on Ways and Means or the Senate Committee on Finance "can gain stature from involvement in the drudgery of committee work and the development of [tax] legislation").

[84] An important point to bear in mind is that the conflicting interests among legislators and the resolution of conflicts through compromise outcomes need not fall along partisan lines. In many cases, intraparty compromise may be as important as—or more important than—interparty compromise to successful legislation. This was true, for example, for both the Omnibus Budget Reconciliation Act of 1993 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. Both acts were passed as essentially partisan tax bills, but both acts also required extraordinarily difficult negotiations among party members (the Democrats in 1993 and the Republicans in 2003).

Michael Graetz, for example, notes the "inevitability of political compromise" in tax legislation because of "the fact that the nation's tax laws always are a response to competing ideologies, competing interests, and competing groups."[85] These inevitable compromises in tax legislation mirror broader compromises in the general legislative process.[86]

Political theory suggests that this tendency toward compromise outcomes reflects a stable equilibrium of mutual cooperation among lawmakers who are consistently pursuing their own interests. Game theory studies of the Prisoner's Dilemma "supergame" identify the conditions under which players, pursuing their own self-interests, cooperate without any external compulsion.[87] Although a one-shot play of the Prisoner's Dilemma leads to mutual defection,[88] cooperation can emerge as an equilibrium if the Prisoner's Dilemma is played repeatedly with no predetermined end point.[89] What matters critically in

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[85]   Graetz, *The U.S. Income Tax* at 184 (cited in note 77). Additionally, the mere fact of conflict among legislators—whether based on institutional politics or not—provides opportunities for other legislators to enhance their status by forging successful compromise. Shaviro, 139 U Pa L Rev at 84 (cited in note 12) ("[E]ven a junior member can gain influence [within Congress] by emerging as a compromise broker and coalition builder.").

[86]   See Eskridge, 74 Va L Rev at 288 (cited in note 76) ("[W]hen a legislator cannot avoid conflictual demand patterns, she will try to satisfy all the relevant interest groups through a compromise statute acceptable to all concerned."); Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 Cornell L Rev 43, 46 (1988) ("Competition among rival pressure groups with drastically differing views about what the legal landscape ought to look like leads to legislative compromise, not because compromise is in the public interest, but because it is the most effective strategy politicians have for maximizing political support."). As Farber and Frickey note, empirical data indicate that compromise outcomes tend to trump the random cycling otherwise predicted for legislative behavior. Farber and Frickey, *Law and Public Choice* at 50 (cited in note 76) ("Theoretically, the results of voting should wander over all possible outcomes, but in reality voting has a strong tendency to favor compromise outcomes.").

[87]   See, for example, Michael Taylor, *The Possibility of Cooperation* 60, 104–05 (Cambridge 1987) (noting that in the Prisoner's Dilemma—a repeated hypothetical scenario in which two self-interested actors must decide either to cooperate with or betray one another—uncoerced cooperation is likely in a small community of players or when sanctions are imposed); Peter C. Ordeshook, *Game Theory and Political Theory: An Introduction* 442–48 (Cambridge 1986) (noting that cooperation in the Prisoner's Dilemma may emerge under conditions of "infinite repetition, preplay communication, tradition, [or] evolutionary selection"). See also Roger B. Meyerson, *Game Theory: Analysis of Conflict* 323 (Harvard 1991) (defining "supergame" as a "repeated game in which there is only one possible state of nature and the players know all of each other's past moves").

[88]   Taylor, *The Possibility of Cooperation* at 19 (cited in note 87) ("In the case of the [one-shot] Prisoner's Dilemma, rational action unequivocally leads to a Pareto-inferior outcome."). See also Douglas G. Baird, Robert H. Gertner, and Randal C. Picker, *Game Theory and the Law* 167 (Harvard 1994) (noting that the Prisoner's Dilemma results in both players adopting a strategy that leaves them jointly worse off than an alternative strategy).

[89]   Taylor, *The Possibility of Cooperation* at 62 (cited in note 87) (identifying repetition of indefinite duration as a necessary condition for sustained cooperation). See also Baird, Gertner, and Picker, *Game Theory and the Law* at 167 (cited in note 88) (using reverse induction to demonstrate that each player will play its dominant—that is, noncooperative—strategy in a game that is repeated a finite number of times); Ordeshook, *Game Theory and Political Theory* at 443

the iterated Prisoner's Dilemma is the present value that the players assign to their future payoffs. If the players have low discount rates (so that they place a high present value on future payoffs), mutual cooperation can emerge as a Nash equilibrium.[90] Similar results occur in a supergame involving more than two players; that is, if discount rates are low, strategies of conditional cooperation can result in equilibria and can produce sustained mutual cooperation.[91]

    Political theorists have argued that the conditions for the emergence and stability of cooperation identified in the Prisoner's Dilemma supergame often can be found in the legislative process.[92] Certainly in the case of tax legislation, chairs and other members of the tax writing committees, who typically have several tax bills under consideration at a single time, cannot possibly understand their work on any item of tax legislation as a one-shot event. Rather, they know that each congressional session yields numerous tax bills and that each tax bill presents new opportunities for a winner to become a loser and a loser to become a winner, and they are always mindful of the out-

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(cited in note 87) (same). However, the "perfectness" of this model is open to question in real legislative scenarios. See id (noting that, when applied to politics, "we cannot analyze [situations that require an extensive form of unknown or infinite duration] by backward induction . . . because the terminal node is unknown, or, in the case of an infinite repetition, because such a node does not exist").

    [90] See Taylor, *The Possibility of Cooperation* at 66–67 (cited in note 87) (emphasizing that whether a potential move yields any gain depends on a player's individual discount rate). See also Baird, Gertner, and Picker, *Game Theory and the Law* at 172–74 (cited in note 88) ("[R]epetition itself creates the possibility of cooperative behavior."); Ordeshook, *Game Theory and Political Theory* at 446 (cited in note 87) (observing that "if people do not discount the future too much, then the cooperative outcome can prevail as an equilibrium"). For a general overview of the Nash Equilibrium, see Baird, Gertner, and Picker, *Game Theory and the Law* at 19–23 (defining the Nash Equilibrium as "[t]he combination of strategies that players are likely to choose . . . in which no player could do better by choosing a different strategy given the strategy the other chooses").

    [91] See Taylor, *The Possibility of Cooperation* at 82–105 (cited in note 87). The likelihood of cooperation generally decreases as the number of players increases, in part because of an increased difficulty in monitoring the cooperation of other players. Id at 105. Note, however, that the concentration of tax legislative power in the hands of a few key lawmakers suggests that the tax legislative "game" has few players.

    [92] Game theorists who have examined cooperation in the indefinitely repeated Prisoner's Dilemma have noted its explanatory power as a model for legislative behavior. See, for example, Ordeshook, *Game Theory and Political Theory* at 443, 446 (cited in note 87) (suggesting that legislatures are supergames of infinite duration because even outgoing legislators may wish to reenter the political scene, and that cooperative norms learned early in the game are self-enforcing). Although legislators (unlike prisoners held in separate rooms) are able to communicate with each other regarding their intentions, the Prisoner's Dilemma remains a useful model for legislative interaction because the inability of legislators to enter into binding commitments among themselves leaves them in a position similar to that of the prisoners who are unable to communicate with each other. See Baird, Gertner, and Picker, *Game Theory and the Law* at 32–34 (cited in note 88) (emphasizing that the absence of communication in the Prisoner's Dilemma leads to the absence of guaranteed cooperation and other mechanisms need to intervene).

comes from their future interactions.[93] Thus, the norm of compromise in the tax legislative process appears consistent with general theoretical predictions about legislative behavior. Stated differently, political theory implies what can be readily observed: there is a stability and robustness to the pursuit of compromise in tax legislation.

C. Compromise Outcomes in Tax Legislation

The proposition that tax legislation often entails compromise is underscored by consideration of actual tax legislative results. This section continues the more general analysis of Part II.B by describing several examples of legislative compromise on ideological and political grounds in the formation of tax policy.

1. The treatment of dividends under the Jobs and Growth Act of 2003.

A recent example of compromise at a high political level in the tax legislative process was the enactment of new rules for corporate dividends as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Jobs and Growth Act).[94] Under prior law, individuals generally had to include corporate dividends in gross income for taxation at ordinary income rates.[95] The Jobs and Growth Act both lowered the tax rates on capital gains[96] and provided that "qualified dividend income" would be taxed at those lower capital gains rates.[97] These changes had the effect of reducing the top marginal tax rate on dividend income from 38.6 percent to 15 percent. Congress provided for a "sunset" of the lower capital gains rates and capital gains treatment of dividend income in taxable years beginning after December 31, 2008.[98]

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[93]   See Graetz, 98 Harv L Rev at 1824 (cited in note 23) ("In a majoritarian system, legislators continually enact, amend, and repeal laws; winners in one period may become losers in the next."); Levmore, 99 Colum L Rev at 1682 (cited in note 13) (noting that, even under the non-mitigation norm, "[t]oday's winners can be tomorrow's losers").

[94]   Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub L No 108-27, 117 Stat 752, codified in various sections of Title 26 (2003).

[95]   26 USC § 61(a)(7) (2006) (including dividends in definition of gross income).

[96]   26 USC § 1(h)(1)(B)–(C) (2006). The 20 percent rate under prior law was reduced to 15 percent, and the 10 percent rate under prior law was reduced to 5 percent (and to 0 percent beginning in 2008).

[97]   26 USC § 1(h)(11)(B) (2006). The term "qualified dividend income" is generally defined as dividends received from domestic corporations and specific types of foreign corporations (with certain exclusions, such as for dividends paid by tax-exempt corporations and certain deductible dividends).

[98]   26 USC § 1 note (2003) ("All provisions of, and amendments made by, this title shall not apply to taxable years beginning after December 31, 2008."). Congress extended the sunset to December 31, 2010 in the Tax Increase Prevention and Reconciliation Act of 2005, Pub L No 109-222, 120 Stat 345, 346.

The path to capital gains treatment of corporate dividends was anything but direct, and it illustrates the critical role of compromise in resolving the conflicting policy and political objectives of the players in the tax legislative process. On January 7, 2003, the President announced a "jobs and growth" plan that included a legislative proposal to exclude dividends from gross income.[99] He reiterated his call for the dividend exclusion during the State of the Union address on January 28, 2003.[100] With the release of his fiscal year 2004 budget a few days later, he formally proposed legislation "to integrate the corporate and individual income taxes so that corporate earnings generally will be taxed once and only once."[101] The Treasury Department estimated that the dividend exclusion would lose more than $385 billion of federal tax revenue in fiscal years 2004 through 2013;[102] this represented more than half of the nearly $665 billion of tax cuts proposed by the President under his economic plan.[103] The President pushed for enactment of the tax cut by Memorial Day.[104]

The President's dividend exclusion proposal encountered significant obstacles in Congress. Key senators objected to the size of the President's proposed tax cut and insisted that it be reduced to no more than $350 billion,[105] a ceiling that would not even allow for full

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[99]   White House Press Release, Fact Sheet: *President Bush Taking Action to Strengthen America's Economy* (Jan 7, 2003), online at http://www.whitehouse.gov/news/releases/2003/01/20030107.html (visited Apr 17, 2007) ("The President's plan would eliminate the double taxation of dividends for millions of stockholders—allowing taxpayers to exclude dividend payments from their taxable income.").

[100]   Adam Nagourney, *Bush's Words Reflect an Eye Toward 2004*, NY Times A14 (Jan 29, 2003).

[101]   Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals* 1 (Feb 2003), online at http://www.treas.gov/offices/tax-policy/library/bluebk03.pdf (visited Apr 17, 2007) (summarizing revenue proposals for 2004, including "the economic growth package of proposals, which is designed to reinvigorate the economic recovery, create jobs, and enhance long-term economic growth") ("Treasury Bluebook" hereinafter). The Treasury Department observed that corporate profits were taxed both at the corporate level (generally at a 35 percent rate) and then again at the shareholder level (at a top marginal rate of 38.6 percent) and argued that this double taxation created "significant economic distortions." Id at 11. In essence, the legislative proposal was to allow "public and private corporations . . . to distribute nontaxable dividends to their shareholders to the extent that those dividends are paid out of income previously taxed at the corporate level." Id at 12. In both its economic and policy analysis, the proposal echoed the integration study released by the Treasury Department more than a decade earlier. See generally Department of the Treasury, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (GPO 1992), online at http://www.ustreas.gov/offices/tax-policy/library/integration-paper/ (visited Apr 17, 2007) (defining four prototypes for integration, including the exclusion of dividends).

[102]   Treasury Bluebook at 151 (cited in note 101).

[103]   Id.

[104]   David Firestone and David E. Rosenbaum, *House GOP Leaders Agree to Eliminate Dividend Tax*, NY Times A28 (May 21, 2003).

[105]   David Firestone, *Republicans Have Tax-Cutting Ax to Grind with One Another*, NY Times A28 (Apr 24, 2003) ("[T]wo Republican senators, George V. Voinovich of Ohio and

exclusion of corporate dividends. Additionally, the Chairman of the House Ways and Means Committee raised policy objections to the dividend exclusion, arguing that a reduction in capital gains tax rates would be more effective in stimulating economic growth.[106]

The Ways and Means Committee marked up its version of the jobs and growth legislation on May 6, 2003.[107] The Ways and Means bill provided for capital gains tax rates to be lowered to 15 percent (from 20 percent) and 5 percent (from 10 percent).[108] The bill also provided for most corporate dividends to be taxed at the new capital gains rates, rather than excluded entirely from income.[109] The Joint Committee on Taxation estimated the ten-year cost of these provisions at just over $31 billion for the capital gains rate reduction and just under $246 billion for the new treatment of corporate dividends; the total tax cut in the Ways and Means legislation was estimated to cost almost $550 billion.[110] The full House passed the bill, including the capital gains taxation of dividends, on May 9, 2003.[111]

The Senate Finance Committee marked up the legislation on May 8, 2003. The initial Chairman's mark provided for $415 billion of tax cuts, including just under $91 billion for a modified version of the

Olympia J. Snowe of Maine . . . joined Democrats to hold Mr. Bush's tax cut to $350 billion."). See also Patti Mohr and Warren Rojas, *Centrists United behind $350 Billion Growth Cap*, Tax Notes Today Doc 2003-8321 (Apr 2, 2003) ("[Senator Max] Baucus asserted that a firm $350 billion cap could mean the administration's full dividend exclusion . . . might soon be off the table."); Gary Locke, *Democrats' Response to Bush's Address to Congress*, NY Times A13 (Jan 29, 2003) (arguing that the government "shouldn't spend hundreds of billions of dollars on [this] plan").

[106] Jonathan Weisman, *In House, Fight Brews over Bush Tax Plan: Ways and Means Panel Targets President's Centerpiece—Dividend Cut—for Overhaul*, Wash Post A5 (Apr 27, 2003) ("In effect, [Chairman] Thomas would cut the tax on dividends in half, since most dividend taxes are paid by the affluent in the highest tax bracket . . . [and the plan] would also cost the Treasury considerably less through 2013."). See also David E. Rosenbaum, *House GOP Tax Cuts Outdo Bush Plan in Favoring Wealthy*, NY Times A13 (May 3, 2003) ("The best way to improve the economy, in the Republican view, is to give money to the people who are most likely to invest it.").

[107] See generally Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 2, the "Jobs and Growth Tax Act of 2003" (JCX-40-03) (May 5, 2003), online at http://waysandmeans.house.gov/media/pdf/hr2/jcx-40-03.pdf (visited Apr 17, 2007) (detailing Chairman Thomas' plan to reduce individual capital gains rates).

[108] Id at 22 ("These lower rates apply to both the regular tax and the alternative minimum tax. . . . [and] apply to assets held more than one year.").

[109] Id at 23 ("[D]ividends received by an individual shareholder from domestic corporations are treated as net capital gain for purposes of applying the capital gain tax rates.").

[110] See generally Joint Committee on Taxation, Estimated Revenue Effects of a Chairman's Amendment in the Nature of a Substitute to H.R. 2, the "Jobs and Growth Tax Act of 2003" (JCX-41-03) (May 5, 2003), online at http://waysandmeans.house.gov/media/pdf/hr2/jcx-41-03.pdf (visited Apr 17, 2007) (listing the cost, after amendment, of the changes to capital gains rates and to the treatment of dividends).

[111] Jobs and Growth Reconciliation Tax Act of 2003, HR 2, 108th Cong, 1st Sess (Feb 27, 2003), in 149 Cong Rec H 3956 (May 9, 2003).

dividend exclusion.[112] After further changes, the legislation that
emerged from the Finance Committee provided for total tax cuts of
just under $350 billion, including a partial dividend exclusion costing
just over $81 billion of revenue.[113] However, the bill was changed sig-
nificantly by a floor amendment to increase the dividend exclusion to
50 percent for 2003 and 100 percent for 2004 through 2006.[114] The full
Senate passed the legislation, with this tiered dividend exclusion, on
May 15, 2003.[115]

Thus, at that point, the relative policy positions of the House, the
Senate, and the President on the tax bill stood as follows: the House
was committed to an overall tax cut of $550 billion but wanted divi-
dends to be taxed at lower capital gains rates rather than excluded
from income entirely; the Senate was willing to exclude dividends re-
ceived through 2006, but it would not approve a tax cut of more than
$350 billion; and the President had proposed a tax cut of more than
$550 billion, including a full dividend exclusion, and he demanded a
bill to sign by Memorial Day.[116] These divisions led to initial uncer-

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[112] See generally Joint Committee on Taxation, Estimated Revenue Effects of the Chair-
man's Mark of the "Jobs and Growth Tax Act of 2003" (JCX-43-03) (May 6, 2003), online at
http://www.house.gov/jct/x-43-03.pdf (visited Apr 17, 2007) (listing the cost, after the initial
Chairman's mark, of the changes to capital gains rates and to the treatment of dividends). The
original Senate Finance Committee version of the dividend exclusion provided for a phase-in of
the amounts eligible for new treatment during the years 2003 through 2005; although the exclu-
sion was to be fully implemented in 2005, it was also to be terminated in 2006 and subsequent
years. See Joint Committee on Taxation, Description of the "Jobs and Growth Tax Act of 2003"
(JCX-42-03) 22 (May 6, 2003), online at http://www.house.gov/jct/x-42-03.pdf (visited Apr 17, 2007).

[113] Joint Committee on Taxation, Estimated Budget Effects of the "Jobs and Growth Tax
Relief Reconciliation Act of 2003" (JCX-50-03) 1 (May 13, 2003), online at http://www.house.gov/
jct/x-50-03.pdf (visited Apr 17, 2007). The partial exclusion allowed an individual to exclude the
first $500 of dividends plus 10 percent (rising to 20 percent in 2008) of dividends in excess of
$500. Joint Committee on Taxation, Description of the Chairman's Modification to the Provi-
sions of the "Jobs and Growth Tax Act of 2003" (JCX-44-03) 5 (May 8, 2003), online at
http://www.house.gov/jct/x-44-03.pdf (visited Apr 17, 2007) (describing how individual taxpayers
would benefit under the proposed act). See also generally Joint Committee on Taxation, Descrip-
tion of Additional Chairman's Modifications to the Provisions of the "Jobs and Growth Tax Act
of 2003" (JCX-46-03) (May 8, 2003), online at http://www.house.gov/jct/x-46-03.pdf (visited Apr
17, 2007).

[114] Jobs and Growth Tax Relief Reconciliation Act of 2003, S 1054, 108th Cong, 1st Sess
(May 13, 2003), in 149 Cong Rec S 6433–34 (May 15, 2003). Senator Nickles stated that "[t]he
amendment I sent to the desk . . . would accomplish the President's objective of eliminating
double taxation of dividends . . . [by providing a] 50-percent exclusion on dividend income in
2003, and 100 percent in 2004, 2005, and 2006."). Id.

[115] 149 Cong Rec S 6407–15, 6421–28, 6429–45, 6451–75 (May 15, 2003) (passing by 51 yeas
to 49 nays).

[116] Patti Mohr, *House, Senate Republicans Talk Tax Cut Strategy at White House*, Tax Notes
Today Doc 2003-12501 (May 20, 2003) ("Senate GOP leaders said they want to settle differences
with the House and vote on final passage by [the Memorial Day recess].")); David Firestone and
Richard W. Stevenson, *House Republicans Retreat from Ending Dividend Tax*, NY Times A26
(May 2, 2003) ("Once the bill is in conference . . . Mr. Bush will insist on eliminating the dividend

tainty about the outcome: there were threats to "ping-pong" the legislation between the two chambers, public acrimony between the members of the House and the Senate, and a sense that the conflicting stances might lead to an impasse.[117]

Instead, the result was a compromise under which the House, the Senate, and the President each secured specific priorities and relinquished others: the overall tax cut was limited to the Senate ceiling of $350 billion,[118] the treatment of dividends followed the House approach of taxation at capital gains rates,[119] and the bill, which provided some of the tax relief that the President had originally sought for corporate dividends, was sent to him on May 23, 2003, three days before his Memorial Day deadline. In short, once the policy positions of the players had crystallized, they pursued a compromise outcome, ensuring the enactment of legislation that provided something to all of them and everything to none of them.

2. Limitations on S corporation ESOPs.

Compromise is particularly evident in the repeal or curtailment of tax preferences. The enactment of "prohibited allocation" rules[120] for S corporation employee stock ownership plans (ESOPs)[121] as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[122] illustrates a complex compromise among the Treasury

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tax."); Firestone and Rosenbaum, *House GOP Leaders Agree*, NY Times at A28 (cited in note 104) ("House Republican leaders agreed . . . to go along with the White House and the Senate and eliminate the tax on stock dividends, if only briefly.").

[117] Timothy Catts and Heidi Glenn, *House-Senate Tax Conference Uncertain*, Tax Notes Today Doc 2003-12431 (May 19, 2003) ("[I]n the wake of the Senate's passage of a $350 billion tax package late May 15 . . . it was unclear whether the House would appoint conferees or seek an 'alternative approach.'").

[118] Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 2 the "Jobs and Growth Tax Relief Reconciliation Act of 2003" (JCX-55-03) 2 (May 22, 2003), online at http://www.house.gov/jct/x-55-03.pdf (visited Apr 17, 2007).

[119] Jobs and Growth Act § 302, 117 Stat at 760–64 (providing that dividends are to be taxed as net capital gain).

[120] 26 USC § 409(p) (2006) (proscribing allocation of certain benefits under an S corporation ESOP to any "disqualified person" during a "nonallocation year").

[121] An "S corporation" is a corporation that meets statutory requirements to be taxed on a pass-through basis (so that the business profits of the S corporation are taxed only once, at the shareholder level, rather than at both the corporate and shareholder levels). 26 USC §§ 1361, 1363 (2006) (defining S corporations and the manner in which their taxable income is to be determined). An ESOP is a retirement plan that qualifies for preferential tax treatment and that is designed to invest primarily in securities issued by the employer whose employees are covered by the plan. 26 USC § 4975(e)(7) (2006) ("[An ESOP is] a defined contribution plan . . . designed to invest primarily in qualifying employer securities"). Thus, an "S corporation ESOP" is an ESOP that is maintained by an S corporation for the benefit of the S corporation's employees and that invests primarily in shares of the S corporation.

[122] Pub L No 107-16, 115 Stat 38, codified in various sections of Title 26 (2006).

Department, a small number of legislators, and powerful interest groups, resulting in the curtailment of a substantial tax benefit for certain business owners.

The issue has its roots in the Small Business Job Protection Act of 1996 (SBJPA).[123] This act included a provision allowing an ESOP to own shares of an S corporation[124] but requiring the ESOP to pay unrelated business income tax (UBIT) on its share of the S corporation's business profits.[125] A year later, Congress decided it was not appropriate to tax S corporation business profits once at the ESOP level and then again at the individual level when the ESOP distributed benefits to its participants, and the Taxpayer Relief Act of 1997 (TRA)[126] removed the requirement that the ESOP pay UBIT on the S corporation's business profits.[127] Thus, because of the "pass-through" tax treatment of the S corporation and the tax-exempt status of the ESOP, part or all of the business profits of an S corporation owned by an ESOP could accumulate on a tax-deferred basis.

Almost immediately, it became evident that the removal of the UBIT requirement opened up significant opportunities to avoid taxation. In particular, it became possible for investors to transfer ownership of an S corporation to an ESOP, allow profits to accumulate on a tax-deferred basis, and then reacquire ownership of the S corporation by exercising stock options or other equity-based rights.[128] In effect, the exception from UBIT created a "tax holiday" for S corporation profits.[129] The Treasury Department responded in February 1999 with a legislative proposal to restore the UBIT requirement for S corporation ESOPs.[130] Interest groups denounced the proposal, with one lob-

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[123] Pub L No 104-188, 110 Stat 1755 (seeking to "provide tax relief for small businesses, to protect jobs, to create opportunities, [and] to increase the take home pay of workers").

[124] 26 USC § 1361(c)(6) (1996) (providing that certain exempt organizations, including tax-qualified retirement plans, are permitted as shareholders in S corporations).

[125] 26 USC § 512(e) (1996) ("If an organization described in section 1361(c)(7) holds stock in an S corporation . . . such interest shall be treated as an interest in an unrelated trade or business."). UBIT applies to certain investments made by tax-exempt organizations and tax-qualified retirement plans. 26 USC §§ 511–15 (1996) (defining and describing the implementation of the unrelated business income tax). In general terms, the UBIT is intended to equalize the treatment between taxable businesses and tax-exempt entities in cases where the tax-exempt entities make investments not related to the purpose for which they are exempt from tax.

[126] Pub L No 105–34, 111 Stat 788, codified in various sections of Title 26 (1997).

[127] 26 USC § 512(e)(3) (1997).

[128] See generally Martin D. Ginsburg, *The Taxpayer Relief Act of 1997: Worse than You Think*, 76 Tax Notes 1790 (1997).

[129] Id at 1793.

[130] See Department of the Treasury, General Explanations of the Administration's Revenue Proposals 110 (1999), online at http://www.treas.gov/press/releases/docs/grnbk99.pdf (visited Apr 17, 2007).

byist calling it "tax policy McCarthyism."[131] The groups turned to Senator Breaux, their legislative champion, who pressured the Treasury Department to provide a commitment of cooperation in crafting a legislative response to the tax-avoidance potential of S corporation ESOPs.[132]

After several months of close work with several interest groups opposed to the Treasury Department proposal and other legislators sympathetic to those groups,[133] Senator Breaux introduced a bill to enact new "prohibited allocation" requirements for S corporation ESOPs, which ultimately was enacted as part of EGTRRA.[134] With great complexity, the prohibited-allocation rules attempt to strike a middle ground between the Treasury Department's preferred outcome of applying UBIT to S corporation ESOPs and the interest groups' preferred outcome of unrestricted and untaxed S corporation investments by ESOPs. The intricate rules are drawn to prevent structures under which ESOP interests are concentrated in a few shareholders of the S corporation. The substantive compromise is complemented by a delayed effective date for S corporation ESOPs in existence in March of 2001—allowing an additional four years of tax deferral for those arrangements.[135] These prohibited-allocation provisions illustrate not only that interest group participation can be part of the process for curtailing a tax preference from which the group benefits but, relatedly, that a compromise outcome produced by such participation does not necessarily generate desirable results.[136]

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[131] *ESOP Association Blasts President's Budget Attack on S Corp ESOPs*, PR Newswire (Feb 1, 1999) (noting the ESOP community's "disappoint[ment] with this surprise attack on ESOPs").

[132] Stephen Norton, *Lubick Offers Conciliatory Tone on Tax Loophole Issue*, Natl J Cong Daily (Apr 27, 1999) (noting that Treasury Assistant Secretary for Tax Policy Donald Lubick "pledged cooperation to Sen. John Breaux . . . on a proposal designed to curtail manipulation of employee stock ownership plans for small businesses").

[133] The groups included the ESOP Association, the Committee to Preserve Private Employee Ownership, and the Employee-Owned S Corporations of America. See *Ramstad, Breaux Introduce Bills to Protect Retirement Savings; Program Will Complement Social Security for Tens of Thousands of Workers*, PR Newswire (Oct 14, 1999) (listing legislative and private supporters of the bill).

[134] EGTRRA § 656(a), 115 Stat at 131–34; 26 USC §§ 409(p), 4979A (2006) (detailing the new requirements regarding prohibited allocations of securities in an S corporation and describing the tax on prohibited allocations of qualified securities).

[135] Section 409(p) is effective for plan years beginning after December 31, 2004, in the case of any S corporation established on or before March 14, 2001. 26 USC § 409 note (2000 & Supp 2003).

[136] Martin Ginsburg, in identifying the tax avoidance potential created by the repeal of UBIT for S corporation ESOPs, had recommended that Congress simply reinstate UBIT for those arrangements, but he accurately predicted that Congress might try to remedy the situation "in some more complicated and far more foolish way." See Ginsburg, 76 Tax Notes at 1792 (cited in note 128). Since late 2002, the Treasury Department has attacked several schemes intended to effect an end run around section 409(p). See Temp Treas Reg § 1.409(p)-1T (addressing structures involving "management" S corporation ESOP structures and nonqualified deferred compensation to avoid prohibited-allocation rules); Rev Rul 2004-4, 2004-1 Cum Bull 414–19 (at-

3. The Clergy Housing Allowance Clarification Act of 2002.

Compromise in the tax legislative process, even as it affects tax preferences, does not necessarily require protracted negotiations. The Clergy Housing Allowance Clarification Act of 2002 (CHACA)[137] offers an example of "prepackaged" compromise that had the effect of avoiding judicial review of a longstanding tax preference benefiting any "minister of the gospel."

The legislation was prompted by an order from the U.S. Court of Appeals for the Ninth Circuit in *Warren v Commissioner of Internal Revenue*.[138] The taxpayer, Reverend Warren, had prevailed over the IRS in the U.S. Tax Court on whether he could exclude from gross income the entire amount of the "housing allowance" paid to him by his congregation.[139] The Tax Court rejected the position of the IRS that the exclusion applies only to the lesser of the rental value of the minister's home or the minister's actual housing expenses.[140] The Tax Court's holding effectively enlarged the tax exclusion.

The Ninth Circuit surprised both Reverend Warren and the government when it sua sponte ordered briefing on the constitutionality of the exclusion for housing allowances.[141] Alarmed at the apparent threat to the tax preference, the Church Alliance, an interest group representing the clergy, immediately sought legislation to preempt the court's review. The group's legislative proposal built a compromise around both substantive tax policy and the effective date: it allowed Reverend Warren to retain the benefit of his victory in the Tax Court but, for all future cases, codified the IRS position that limited the exclusion.[142] This structure was calculated to elicit maximum support in

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tacking structures involving subsidiaries of S corporations created to avoid prohibited-allocation rules); Rev Rul 2003-6, 2003-1 Cum Bull 286–88 (attacking structures involving "shelf" S corporation ESOPs intended to postpone the effective date of prohibited-allocation rules).

[137] Pub L No 107-181, 116 Stat 583 ("[C]larify[ing] that the parsonage allowance exclusion is limited to the fair rental value of the property.").

[138] 282 F3d 1119 (9th Cir 2002).

[139] *Warren v Commissioner of Internal Revenue*, 114 Tax Ct 343, 351 (2000). At the time, 26 USC § 107(2) provided that, "[i]n the case of a minister of the gospel," gross income did not include either the rental value of a home or a "rental allowance" provided to the minister as compensation.

[140] For an explanation of the IRS position, see Rev Rul 71-280, 1971-2 Cum Bull 92 ("[T]he taxpayer may exclude from his gross income as a rental allowance only an amount equal to the fair rental value of the home acquired . . . plus the cost of utilities.").

[141] See *Warren*, 282 F3d at 1119–20. The order required briefing on three questions: whether the court had the authority to consider the constitutionality of the exclusion, whether the court should exercise that authority, and whether the exclusion was constitutional under the Establishment Clause of the First Amendment.

[142] The legislation amended § 107 to provide that the housing allowance was excludable "to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the costs of utilities." 26 USC § 107 (2006). The general effective date of the change was for taxable years beginning after December 31, 2001.

Congress and nonopposition from the Treasury Department. In effect, the clergy used the legislative process to bargain away the larger exclusion granted by the Tax Court in order to avoid constitutional review of that exclusion by the Ninth Circuit. The ingenious, if somewhat cynical, compromise proved successful: Congress swiftly passed the legislation with no opposition from the Treasury Department,[143] the government and Reverend Warren immediately moved to dismiss the case as moot,[144] and the Ninth Circuit granted their motions without reaching the constitutional issue.[145]

III. Implications of Legislative Compromise for Tax Transition Policy

The preceding Part identified compromise as an important component of tax legislation. This Part examines the analytic and normative implications of legislative compromise for tax transition policy. Part III.A argues that a governmental tax transition policy—whether it is a policy to mitigate transition losses or a policy not to mitigate transition losses—affects the development of substantive tax policy by

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CHACA § 2(b)(1), 116 Stat at 583. To preserve Reverend Warren's victory in the Tax Court, a grandfather rule provided that "notwithstanding any prior regulation, revenue ruling, or other guidance issued by the Internal Revenue Service, no person shall be subject to the limitations added to section 107 … by this Act for any taxable year beginning before January 1, 2002." CHACA § 2(b)(3), 116 Stat at 583. However, a special rule prohibited any minister who, unlike Reverend Warren, had followed the IRS position for years before 2002 from filing a refund claim to obtain the benefit of the grandfather rule. CHACA § 2(b)(2), 116 Stat at 583 ("The amendment … also shall apply to any taxable year beginning before January 1, 2002, for which the taxpayer … on a return filed before April 17, 2002, limited the exclusion under section 107.").

[143] The House approved the legislation 408 to 0, and the Senate approved it by unanimous consent. HR 4156, 107th Cong, 2d Sess (Apr 10, 2002), in 148 Cong Rec H 1306–07 (Apr 16, 2002); S 2200, 107th Cong, 2d Sess (Apr 18, 2002), in 148 Cong Rec S 3887 (May 2, 2002). The President signed the legislation shortly afterward. Pub L No 107-181, 116 Stat at 583 (approved by the President on May 20, 2002).

[144] Douglas H. Frazer, *The Clergy, the Constitution, and the Unbeatable Double Dip: The Strange Case of the Tax Code's Parsonage Allowance*, Tax Notes Today Doc 2004-3859 (Feb 26, 2004) ("The Act … pretty much gave both parties in *Warren* what they wanted. … On May 22, 2002, both parties moved to dismiss the case.").

[145] See *Warren v Commissioner of Internal Revenue*, 302 F3d 1012, 1013 (9th Cir 2002) (dismissing the appeal and denying a motion to intervene by the court-appointed amicus). Though the court sidestepped the constitutional issue, the tax literature has had much to say about the case. For arguments regarding constitutionality, contrast Edward A. Zelinsky, *Dr. Warren, the Parsonage Exclusion, and the First Amendment*, 95 Tax Notes 115, 120 (2002); Edward A. Zelinsky, *Dr. Warren, Section 107, and* Texas Monthly*: A Reply*, 95 Tax Notes 1663, 1667–69 (2002), with Eric Rakowski, *Are Federal Income Tax Preferences for Ministers' Housing Constitutional?*, 95 Tax Notes 775, 783–85 (2002). For a discussion of how lower courts should approach the issue, see Eric Rakowski, *The Parsonage Exclusion: New Developments*, 96 Tax Notes 429, 431–33, 436–37 (2002). Other commentators have suggested that § 107 be altered or interpreted differently to avoid the constitutional question. See Ellen P. Aprill, *Parsonage and Tax Policy: Rethinking the Exclusion*, Tax Notes Today Doc 2002-19666 (Aug 27, 2002); Boyd Kimball Dyer, *Redefining 'Minister of the Gospel' to Limit Establishment Clause Issues*, 95 Tax Notes 1809, 1812 (2002).

generally favoring the status quo. Part III.B analyzes this point's implications for the claims made in the existing literature in support of a tax transition policy. Part III.C develops the broader normative implications of the analysis.

A. Legislative Compromise in Tax Transitions

Compromise is evident in the current treatment of tax transitions, particularly for the repeal of tax preferences. In those cases, legislative proponents of repeal face opposition from legislative defenders of the tax preference (who likely represent one or more interest groups that would suffer losses from repeal). Thus, for example, Legislator A might propose to repeal the interest exclusion for state and local bonds, provoking opposition from Legislators B and C because of the potential for losses by current bondholders and by state and local governments. In all likelihood, Legislators A, B, and C will at some point try to determine whether their policy dispute can be resolved through compromise.[146]

One familiar mechanism for implementing a strategy of compromise would be to mitigate the transition losses that the constituents of Legislators B and C would suffer from the policy change proposed by Legislator A. This mitigation might include grandfathering (which would provide considerable relief for the current bondholders but less relief for the state and local governments), a delayed or phased-in effective date (which would provide more relief for the state and local governments), or a combination of these devices.[147] The exact terms of any such compromise would, of course, be determined in the particular details of the negotiations. Certainly, the architects of the Tax Reform Act of 1986 shrewdly used transition relief to reward their legislative colleagues who participated in necessary compromises.[148] But the important point is that the mitigation of transition losses provides a mechanism for the legislators to pursue their long-term strategy of compromise in tax legislation; the possibility of mitigating transition losses gives them bargaining space to avoid impasse. This helps to account for the

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[146] The claims made in Part III—including the claims made about likely legislatively behavioral responses to the adoption and implementation of a tax transition policy—are theoretical, not empirical.

[147] But see Levmore, 22 J Legal Stud at 283 (cited in note 9) ("A positive political theorist could say that grandfathering provisions, delayed effective dates, and other familiar features of our legislative reform packages are evidence of the fact that it is the workings of interest-group politics that hinders retroactivity.").

[148] See, for example, Birnbaum and Murray, *Showdown at Gucci Gulch* at 146–47, 241–43 (cited in note 75) (describing different selective transition measures provided by Representative Rostenkowski to his legislative allies and added to garner support on Senate floor).

fact that tax legislation very often includes transition relief, even without any formal government policy to mitigate transition losses.[149]

This is not to suggest that mitigation of tax transition losses through the effective date of a substantive tax policy change provides the only possible mechanism for compromise. Changes to the substance of the legislation, vote trading, and logrolling also serve as important vehicles for legislators to compromise and thereby avoid the undesirable results associated with sustained policy conflict. However, interest group theory suggests that mitigating transition losses generally may be a preferred mechanism for compromise in the case of tax preference repeal. In such a case, the potential losses are concentrated on particular groups, which presumably have a better capacity to organize effectively and resist the repeal. Specific mitigation of the transition losses otherwise suffered by those groups may therefore be necessary to secure sufficient nonopposition to the proposed change.[150] By contrast, the losses from tax preference expansions ordinarily are spread over taxpayers as a whole. The collective action problems that face such a large group suggest a lower level of opposition to tax preference expansion, so vote trading and logrolling—which can be used to confer separate tax preferences on the constituents of individual legislators—may be sufficient to persuade those individual legislators to support the legislation. And, in fact, it is not uncommon for legislators to roll dozens or even hundreds of tax preference provisions into a single tax bill. These provisions likely could not be enacted on a stand-alone basis, but the assembled package commands the support of enough legislators to pass.[151] Thus, the gain/loss asymmetry in the

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[149] Although Kaplow recognizes that transition relief can provide "political lubrication" for the enactment of substantive policy changes, he inexplicably asserts that "[o]f course, the use of transition mechanisms for such political purposes will often be unnecessary." Kaplow, 99 Harv L Rev at 571–72 (cited in note 6). By contrast, Graetz acknowledges that providing transition relief is often necessary to the enactment of a welfare-enhancing substantive policy change. See Graetz, 98 Harv L Rev at 1826 (cited in note 23) ("Transitional relief . . . seems most appropriate—and sometimes may be indispensable to passage of a desirable tax change—when the changes in the law would have a large effect on economic values.").

[150] For a full development of the relationship between the identifiability of the taxpayers potentially burdened with transition losses and the mitigation of transition losses, see Levmore, 22 J Legal Stud at 279–88 (cited in note 9).

[151] See, for example, the American Jobs Creation Act of 2004, Pub L No 108-357, 118 Stat 1418, codified in various sections of Title 26. This Act passed in the House by 251 votes to 178, HR 4520, 108th Cong, 2d Sess (June 4, 2004), in 150 Cong Rec H 4432–33 (June 17, 2004), and was passed by voice vote in the Senate, 150 Cong Rec S 8221 (July 15, 2004). For discussions of lobbying and special interest provisions, see Albert B. Crenshaw, *No Rest for the Bleary: New Tax Turns to Ponder*, Wash Post F1 (Oct 31, 2004) (listing some of the particular winners and losers from the act); Steven Pearlstein, *Tax Legislation Worthy Only of the Trash Heap*, Wash Post E1 (June 9, 2004) (opining that the "bills are grab bags of special-interest provisions designed to reward the well-connected at everyone else's expense").

current treatment of tax transitions may derive, at least in part, from the differing policy payoffs for legislators and organized interest groups that result from tax preference repeal and tax preference expansion.

The importance of transition relief as a vehicle for legislative compromise, particularly in the case of tax preference repeal or curtailment, indicates the effects that a tax transition policy would have on the development of substantive tax policy. In adopting a tax transition policy ex ante, the government would restrict or even eliminate the treatment of tax transitions as a mechanism for compromise among legislators. By definition, a tax transition policy establishes beforehand how any unknown future change in substantive tax policy will or should be implemented with respect to potential transition winners and losers; the result is that proponents and opponents of a particular pending policy change cannot negotiate along that dimension. In the example above, Legislator A would be less able or even unable to compromise with Legislators B and C as to the effective date of A's proposed repeal of the interest exclusion; the government policy on transition treatment would discourage or foreclose any such compromise.[152]

But the elimination of transition treatment as a mechanism for compromise neither changes the underlying interests of legislators, rebalances their relative power, nor eliminates the conditions in the tax legislative process that make compromise an attractive strategy. Even if transition policy removes a familiar (and perhaps preferred) medium for striking a deal, the players in the legislative process will seek out new bargaining space to effect their basic strategy of compromise. Unable to negotiate on a proposed substantive tax policy change by setting an effective date that deviates from the established transition norm, they may instead compromise on the proposed substantive policy change itself. This often will take the form of scaling back the substantive policy change that would otherwise be enacted.[153]

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[152] One possible objection is that this assumes a strong version of the tax transition policy—that is, something approaching a binding governmental precommitment to mitigate or not to mitigate transition losses. As Levmore states, "[A] legal system guided by the value of anticipatory behavior need not precommit either to the noncompensation norm or to a rule requiring compensation (or other protection) for those who relied on old law." Levmore, 99 Colum L Rev at 1665 (cited in note 13). However, a weaker version of a tax transition policy would still imply the consequences outlined here, but it would imply those consequences in a correspondingly weaker form. At the same time, a weaker transition norm would also imply a weaker version of the efficiency claims made for those norms. See Parts I.B and I.C. For present purposes, the argument is presented by assuming a strong version of the tax transition policy and, therefore, a strong version of the efficiency claims favoring the tax transition policy. Parallel conclusions would follow, *mutatis mutandis*, if one assumed a weaker version of tax transition policy.

[153] Kaplow characterizes scaled-back reform as a type of transition relief. See Kaplow, 99 Harv L Rev at 588 (cited in note 6) (referring to "partial implementation" as "provid[ing] transitional relief by reducing the magnitude of losses imposed by a reform"). See also Shaviro, *When*

The scaling back may have important substantive tax policy consequences, but it will serve its intended purpose from the perspective of the legislators as long as it provides a basis for compromise.

Scaling back substantive tax policy change is not the only potential mechanism for pursuing compromise under a tax transition policy, but there is good reason to think it would emerge as the preferred mechanism. Direct payments to potential transition losers, such as through the appropriations process, would be inferior because of the differing membership of congressional tax-writing and appropriations committees. If Legislator X and Legislator Y, both members of a tax-writing committee, bargain over X's proposed repeal of a tax preference that would adversely affect Y's constituents, it is much easier for X and Y to reach a compromise within the confines of that legislation than through an agreement that requires other legislators to appropriate compensatory payments to Y's constituents. The direct dealing between Legislators X and Y allows for a readily enforceable compromise as long as the deal is limited to the legislation before them. If Legislator Y is to make a concession to Legislator X in exchange for a promise from Legislator X, Legislator Y will want the promise to be made in a currency that is under the control of Legislator X. Once they agree that the compromise will be made within the parameters of the proposed repeal of the tax preference, the likely scope of the compromise becomes apparent. The repeal of the tax preference affects either the future or the past or both the future and the past. If a tax transition policy dictates the treatment of the past, the two legislators' compromise likely will focus on the treatment of the future. That implies a scaling back of the substantive tax policy change.

To the extent that it causes legislators to scale back substantive tax policy changes, a governmental tax transition policy would have the long-run effect of generally favoring the status quo to a greater degree than does the ad hoc mitigation of transition losses through grandfathering, delayed effective dates, or phased-in effective dates. Under the current practice of determining effective date rules on an ad hoc basis, a substantive tax policy change with full grandfathering or other effective-date relief results in the permanent or temporary continuation of the status quo for investments outstanding when the

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Rules Change at 225 (cited in note 1) (referring to "partial immediate implementation" as "an alternative to delay where grandfathering is the inferior instrument or has been ruled out for political or administrative reasons"). Although this characterization has analytic appeal, it is not particularly useful in assessing tax transition policy because it presupposes meaningful knowledge about the counterfactual baseline. What could it possibly mean for government to have a policy not to pursue "partial implementation" of a legal change? Is a repeal of 50 percent of the interest exclusion for state and local bonds inherently partial implementation or is it in fact full implementation of a desired policy outcome?

policy change is enacted. Over time, this closed class diminishes in size, ultimately disappearing entirely so that all investments become subject to the new substantive tax policy. By contrast, any scaling back of the substantive tax policy change preserves the status quo, although on a reduced basis, into the indefinite future for both pre-enactment and post-enactment investments.[154] Thus, the elimination of the ability to compromise on transition treatment skews future substantive tax policy changes toward the status quo.

Importantly, this bias for the status quo would occur regardless of whether the transition policy implements the nonmitigation norm or the mitigation norm. In the case of the nonmitigation norm, the link between relocating compromise from the effective date to the substance of the policy change and the scaling back of the policy change is relatively straightforward. For example, assume again that Legislator A proposes to repeal the interest exclusion for state and local bonds in the shadow of a policy not to mitigate transition losses resulting from substantive tax policy changes. Legislators B and C will oppose the change, and the three may pursue compromise by scaling back the proposed repeal. Thus, Legislator A might agree with Legislators B and C to only a partial repeal of the interest exclusion, accepting the lower policy payoff (relative to full repeal) in order to avoid the still-lower policy payoff of leaving the exclusion unchanged. The nonmitigation norm does not necessarily make compromise among the legislators more or less difficult to achieve, but it does relocate the bargaining space for the legislators such that compromise would likely lead to more modest changes in steady-state substantive tax policy.[155]

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[154] For example, a decision to repeal the interest exclusion for state and local government bonds but to grandfather all bonds outstanding at the time of repeal preserves the status quo only with respect to the grandfathered bonds. As the grandfathered bonds mature, the new substantive tax policy replaces the status quo ante. By contrast, if the substantive tax policy change were instead to repeal half of the interest exclusion, the status quo ante would continue, in scaled-back form, indefinitely.

[155] Kaplow effectively acknowledges this point. For example, he states that a policy of "stringent transition relief" would make "change in general more difficult." Kaplow, 99 Harv L Rev at 575 n 191 (cited in note 6) ("To support such a result one would have to believe that the preponderance of changes was undesirable."). See also Kaplow, 13 J Contemp Legal Issues at 195–97 (cited in note 20) ("Transition mitigation—such as proscriptions of retroactive legislation—can in some cases help to alleviate . . . problems . . . [and reduce] opposition to desirable reforms."). Others have noted that the nonmitigation norm may lead to entrenchment of the status quo in substantive tax policy. See, for example, Fisch, 13 J Contemp Legal Issues at 120 (cited in note 70) (arguing that "[p]rivate actors who have predicted legal change accurately may be able to block the proposed change" with the result that the nonmitigation norm may encourage organized interest groups to prevent "socially valuable legal change"); Logue, 13 J Contemp Legal Issues at 220 (cited in note 27) ("[I]f there were a Congressional norm of applying all tax-law changes nominally retroactively . . . , one might expect to see much more intense lobbying against tax-law changes by those who have a stake in the old law than if there were no such

A government policy to mitigate tax transition losses would have similar effects on substantive tax policy. As discussed in Part I, potential transition losers are not limited to the parties nominally affected by a substantive tax policy change. For example, in the case of the proposed repeal of the interest exclusion for state and local bonds, potential transition losers include current bondholders, state and local governments, bond traders and analysts, and others whose investments in physical or human capital might lose value by reason of any repeal of the interest exclusion. Under the current ad hoc practice of granting or not granting transition relief, legislators address the losses of these various transition losers to the extent necessary for a viable compromise. Thus, for example, repeal of the interest exclusion might ultimately include both grandfathering for existing bonds (which mitigates the losses of current bondholders) and a delayed effective date (which mitigates the losses of state and local governments, bond traders and analysts, and perhaps others), or it might include only one of those transition mechanisms if that is all that is needed to pass the repeal.

A transition policy implementing the mitigation norm, however, must determine the contours of transition relief ex ante. One possibility is that the mitigation norm would guarantee grandfathering.[156] In the case of repeal of the interest exclusion, that formulation of the mitigation norm would defuse opposition from bondholders with respect to the bonds they already hold and from state and local governments with respect to the bonds they have already issued. But that approach would provide little relief either to state and local governments that will suffer losses after the repeal raises their costs of borrowing or to bondholders who anticipate investing in state and local bonds in the future.[157] Therefore, the state and local governments and

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rule."); Levmore, 99 Colum L Rev at 1665 (cited in note 13) ("[A] vulnerability of the anticipation-oriented approach . . . is that it gives new losers a new (and unfortunate) incentive to block change entirely."). However, these scholars have not fully examined the implications of this point for the incentive-based argument that supports the nonmitigation norm. For a discussion of those implications, see Part III.B.1.

[156] Both the version of the mitigation norm advocated by Ramseyer and Nakazato and the version advocated by Logue employ grandfathering as the mechanism for delivering transition relief. See Ramseyer and Nakazato, 75 Va L Rev at 1175 (cited in note 4) ("[T]he optimal strategy is one in which Congress promises to grandfather existing projects, and guarantees that promise with an agreement to pay damages."); Logue, 94 Mich L Rev at 1131 (cited in note 3) ("[F]or certain types of tax transitions, the efficient transition policy entails full transition relief in the form of guaranteed grandfathering.").

[157] Graetz observes this distinction in arguing that reliance-based expectations claims for the mitigation norm draw arbitrary distinctions among taxpayers differentially affected by a substantive tax policy change:

[W]hile 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 bondholders who would not be compensated by the mitigation norm would still oppose repeal of the interest exclusion and would still demand a deal in the legislative process.[158] Because they would fall outside the scope of the government's tax transition policy, any compromise with them would more likely involve an agreement to scale back the repeal.

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the exempt status would continue into the future, are entitled to continuation of the tax exemption because of their "reliance" interest.

Graetz, 126 U Pa L Rev at 77 (cited in note 9) (contending that "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"). Others, however, challenge the notion that state and local governments issuing tax-exempt bonds would require any consideration of transition relief upon repeal of the interest exclusion. See Avishai Shachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 Harv L Rev 1581, 1598 (1984) ("[T]o the extent that current and prospective issuers of tax-exempt bonds are identical, additional protection for prospective issuers is unwarranted."). In Avishai Shachar's view, any increase in the value of an asset resulting from a policy change "has an equal and offsetting impact on the 'burden' of a liability." Id at 1586–87 (contending that "one must consider the rules' effects on both holders of assets and holders of liabilities" when choosing among various transition rules). Thus, repeal of the interest exclusion would result in "windfall" transition gains for state and local governments that correspond exactly to the transition losses of bondholders, and compensating the state and local governments for the transition losses attributable to their higher costs of capital in the future would be "unwarranted." Id at 1598 (contending that protection is unnecessary because "in the absence of a grandfathered-effective-date rule, current issuers of tax-exempt bonds would enjoy a gain in wealth as a result of the change"). Shachar argues that, under a mitigation norm, state and local governments would actually demand a premium before issuing tax-exempt bonds because of the risk that the interest exclusion might be repealed with grandfathering treatment, thereby denying state and local governments transition gains. See id at 1591 ("A rational borrower, knowing that a grandfathered-effective-date rule will be applied to any change in the tax law, might ask for a larger tax incentive before assuming debt."). In other words, Shachar maintains that the uncompensated repeal of the interest exclusion benefits state and local governments, notwithstanding that their future borrowing will be more expensive. This conclusion would certainly surprise state and local governments, their lobbyists, and the legislators who protect the preference. It also rests on a questionable foundation. See Howard E. Abrams, *Rethinking Tax Transitions: A Reply to Dr. Shachar*, 98 Harv L Rev 1809, 1810–11 (1985) (arguing that "Shachar errs in concluding that tax reforms result in equal and offsetting gains and losses to holders of assets and liabilities"); Graetz, 98 Harv L Rev at 1821 (cited in note 23) (contending that Shachar's "central analytical premise—that '[e]ach increase in the price of an asset has an equal and offsetting impact on the "burden" of a liability'—is surely wrong"). But see Avishai Shachar, *The Importance of Considering Liabilities in Tax Transitions*, 98 Harv L Rev 1842, 1842, 1862 (1985) ("reiterat[ing] and expand[ing]" the theory that "transitional wealth losses are always offset by transitional wealth gains").

[158] Levmore posits that, in such a case, the state and local governments and the bondholders who anticipate future investments "exert much less pressure" than the current bondholders. See Levmore, 22 J Legal Stud at 285 (cited in note 9) (suggesting that "the critical value is identifiability rather than numerosity" and that current bondholders are more identifiable). That conclusion seems highly doubtful. Even if one assumes that future bondholders are a diffuse group with collective action problems, state and local governments are not. Indeed, the exclusion for interest on their debt instruments is one of the few direct stakes that state and local governments have in the federal income tax scheme, and it seems very strained to assume that, notwithstanding the amounts at stake and their comparative ease of organizing effectively, they would not fiercely oppose repeal of the interest exclusion simply because outstanding bonds had been grandfathered.

One might argue that the transition policy could be reformulated to provide mitigation for *all* transition losses. If the policy provided not only grandfathering but also other mechanisms to buy off any opposition from state and local governments and others whose transition losses would not be satisfactorily addressed by grandfathering, there would be no further concern that these potential transition losers would force substantive compromise as the proposed repeal moves through the legislative process. However, the more broadly one formulates the transition policy to mitigate as many tax transition losses as possible, the closer one in fact moves to entrenching the status quo of substantive tax policy. As Graetz observed, if the goal is protection of all interests, "[n]othing short of perfect stability of legal rules will likely suffice."[159]

The alternative, then, would be to formulate the transition policy of mitigating tax transition losses in a manner that necessarily would not cover all transition losses. By not providing relief for certain transition losses, the mitigation norm would not remove all opposition to tax preference repeal. But by establishing ex ante what the government's approach to transitions would be—that is, by predetermining which transition losses will be covered and which will not be covered—a transition policy implementing the mitigation norm would limit or remove transition treatment as a basis for compromise. Thus, to resolve the conflicts involving uncovered transition losers, legislators likely will compromise on the substance of the tax policy change—specifically, they likely will agree to enact a scaled-back substantive tax policy changes.[160]

The first significant implication of legislative compromise for tax transition policy, then, is that the establishment of a tax transition policy, whether it is a policy to mitigate or not to mitigate transition losses, would affect the development of substantive tax policy. Legislators like to cut deals with each other. They prefer compromise over noncom-

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[159] Graetz, 126 U Pa L Rev at 78 (cited in note 9) (asserting that "[i]f 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").

[160] Others have recognized that the mitigation norm would favor the status quo. See Levmore, 99 Colum L Rev at 1666 n 24 (cited in note 13) (arguing that "[t]he flexibility of law, in the form of the power to compensate or not, often creates more bargaining room"); Stark, 13 Am J Tax Policy at 182–83 (cited in note 18):

> [T]he enacting Congress, by not committing one way or the other to grandfather rules, has in effect granted the repealing Congress a negotiating chip (the possibility of uncompensated repeal) with which that later Congress can extract legislative gains. Promising to anything in advance (either no-relief or guaranteed-relief) eliminates that chip, resulting in an additional cost to the government.

Again, however, these prior inquiries have not fully examined the implications of this point for the validity of the arguments that are made in support of the mitigation norm. For a discussion of those implications, see Part III.B.2.

promise. A tax transition policy has the effect of telling the legislators that they cannot compromise on the effective date of the legislation and that they must use another mechanism for compromise, such as logrolling or scaling back substantive policy changes. Thus, the governmental tax transition policy eliminates a basis for compromise among legislators without eliminating either the need for compromise or the attractiveness of compromise as a lawmaking strategy.

Tax transition policy is simply not exogenous to the underlying substantive tax policy; establishing the shape of one ex ante very likely will change the shape of the other. The question of adopting a transition policy is not so much whether transition relief should be provided but how it will be provided, through the setting of the effective date or through the substantive policy change of the legislation itself. In either case, the potential transition winners and losers will negotiate the terms of the legislation.[161] If the tax transition policy makes it difficult for the potential winners to compensate the potential losers through transition treatment, the potential winners can agree to a more modest change in substantive policy. Because a governmental transition policy pushes their compromise away from the effective date and into the substantive tax policy change, the likely effect of either the mitigation norm or the nonmitigation norm is to tilt substantive tax policy toward the status quo.[162]

B.   Reassessing the Claims for Tax Transition Policy

The relationship of tax transition policy to substantive tax policy described in Part III.A has important implications for the normative claims that have been made in support of establishing and following a tax transition policy. This Part III.B analyzes those implications and argues that, once the significance of compromise to the tax legislative process is taken into account, the effects of tax transition policy on private and governmental actors become more indeterminate, and the idea of an optimal tax transition policy becomes more problematic.

1.   Implications under the nonmitigation norm.

In arguing for the nonmitigation norm, Kaplow maintains that a known and credible government policy that requires taxpayers to bear

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[161] See Levmore, 99 Colum L Rev at 1665–66 (cited in note 13) ("A plausible, but admittedly blissful, view is that where losers have sufficient power to delay or block desirable change, winners (including the polity as a whole) find it worthwhile to compensate losers in order to go forward with good new law.").

[162] It may be that, as between the two norms, the nonmitigation norm would result in the greater bias toward the status quo.

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tax transition losses provides appropriate ex ante incentives for them to anticipate welfare-enhancing changes in substantive tax policy.[163] However, the analysis in Part III.A raises questions about that argument. The importance of legislative compromise implies that legislators operating under a nonmitigation norm would be more likely to scale back substantive tax policy changes than they would in the absence of the nonmitigation norm.[164] Although taxpayers will anticipate nonmitigation of tax transition losses resulting from future changes in substantive tax policy, they also will adjust their assessments of the prospects for future change in substantive tax policy; that is, they will anticipate diminished change in substantive tax policy because they will expect Congress to engage in greater scaling back of the reforms that it otherwise would have enacted.[165]

This point is perhaps best understood by comparing a tax transition policy implementing the nonmitigation norm to the current legislative practice of addressing tax transition losses on an ad hoc basis. Following Kaplow's analysis, it is evident that, even today, taxpayers have some incentives to anticipate future changes in substantive tax policy. The strength of those incentives is a function of a taxpayer's assessment of both the probability of a change taking place and the probability that government will not mitigate any tax transition loss

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[163] See notes 65–66. As discussed there, Kaplow expressly assumes that substantive policy is welfare enhancing. Although he notes that "the positive analysis of how private actors would behave and of the risk they would bear is largely independent of whether the government reforms they predict or are subject to are welfare maximizing," he also cautions that "[t]he main point at which the optimality of government policy is relevant involves assessment of the efficiency of ex ante incentive effects." Kaplow, 13 J Contemp Legal Issues at 191 (cited in note 20). His point is that giving taxpayers incentives to anticipate undesirable legal change increases the welfare loss from that change. If Congress enacts a wasteful tax preference under a tax transition policy implementing the nonmitigation norm, the overall waste from the tax preference would be increased by reason of taxpayer investments made in anticipation of the enactment of that wasteful tax preference.

[164] It should be repeated that these claims are theoretical and not empirical; thus it cannot be said conclusively that scaling back will occur. Compiling empirical evidence would prove a difficult task, as even legislative history ordinarily would not shed light upon the extent to which legislation is the result of compromise outcomes. See, for example, Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, in Amy Gutmann, ed, *A Matter of Interpretation: Federal Courts and the Law* 3, 29–37 (Princeton 1997) (demonstrating the inconclusiveness of the use of legislative history in legal interpretation).

[165] See Graetz, 98 Harv L Rev at 1825 (cited in note 23) (contending, given the context of substantive policy changes, that "people should take precautions based upon their assessment of the probabilities of legislative change"); Kaplow, 99 Harv L Rev at 517 (cited in note 6) ("[N]ot only do reforms themselves trigger changes in value, but significant changes in the likelihood of reforms do so as well."). For skepticism about assessing the probabilities of substantive policy changes ex ante, see Fried, 13 J Contemp Legal Issues at 142 (cited in note 27) ("In the realm of legal change, we are dealing with . . . the product of deliberate, human agency . . . mak[ing] it almost meaningless to try to extrapolate the odds of future tax reform based on past experience.").

resulting from the change. Kaplow's nonmitigation norm would set the probability that government will not mitigate tax transition losses as close to a certainty as possible, and in that respect it would increase the incentives for ex ante anticipation. However, predetermining the outcome with respect to tax transition losses very likely alters the outcome with respect to the underlying substantive tax policy changes. Therefore, under the nonmitigation norm, taxpayers will have an expectation of an increased probability of nonmitigation, but they will also have an expectation of a decreased probability that the full substantive policy changes will be enacted.

Consider, for example, the potential repeal of the interest exclusion for state and local bonds. Under the ad hoc tax transition approach in effect today, investors in those bonds have some incentive to anticipate that the interest exclusion will be repealed and that the repeal will apply both to bonds issued in the future and to bonds outstanding at the time of repeal. Kaplow's nonmitigation norm (advanced on the assumption that repeal would be efficient) increases ex ante anticipation relative to current law through a policy not to mitigate transition losses. However, his nonmitigation norm also causes the bondholders to discount more sharply the probability of full repeal. Perhaps they will assume that, under the nonmitigation norm, Congress would only repeal one-half or one-third of the interest exclusion. Or perhaps they will assume that, under that norm, there is only a minimal chance that Congress will curtail the interest exclusion in any way.

The degree of such discounting cannot be quantified before the fact. Because the tax legislative process incorporates a strategy of compromise, and because the precise outcome of that process is uncertain beforehand, it is not possible to know how much scaling back would take place for any particular tax preference repeal or curtailment under the nonmitigation norm. For this reason, it is not possible to determine how much the diminished anticipation of a substantive tax policy change would offset the increased anticipation of nonmitigation of tax transition losses.[166] There is no reason to suppose that the one effect would perfectly offset the other effect in any particular case.

Additionally, the mere fact of scaling back a substantive tax policy change that is otherwise assumed to be efficient implies a potential loss in overall welfare relative to the expected results in the absence of the nonmitigation norm. For example, if one assumes that the re-

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[166] The uncertainty would not be addressed by positing a stronger or weaker version of the tax transition policy. While a stronger policy should result in a judgment that there is a greater likelihood that there will be no transition relief, it should also result in a judgment that there is a smaller likelihood of the underlying substantive change taking place. Conversely, a weaker policy may make the underlying substantive change more likely but would also make transition relief more likely.

peal of the interest exclusion for state and local bonds would be desirable substantive policy, the partial repeal that might result under the nonmitigation norm does not produce as great an increase in social welfare. One could counter that scaling back the repeal of a tax preference does not necessarily decrease both costs and benefits proportionately, leaving a net welfare enhancement from the scaled-back repeal.[167] However, this counterargument loses force as the magnitude of the scaling back increases, and the uncertainties of the legislative process leave one unable to predict with any confidence whether the nonmitigation norm will lead to large or small reductions in particular instances of tax preference curtailment. Even Kaplow argues that, assuming the same quantum of transition relief, scaling back substantive tax policy changes is less efficient than grandfathering[168]—yet scaling back is precisely where the nonmitigation norm directs substantive tax policy in its efforts to avoid grandfathering.

It is important to note that these implications do not refute—and do not purport to refute—the basic argument made by Kaplow.[169] His incentives-based argument depends on the assumption that tax transition policy does not affect the development of substantive tax policy. The analysis here shows why that assumption is problematic[170] and further demonstrates that suspending the assumption raises questions and doubts about the incentives for ex ante anticipation from which Kaplow draws his normative conclusion. Thus, the implications of legislative compromise in tax transitions suggest a new reason for skepticism about Kaplow's claims, but they do not challenge the analysis that draws those claims out of his assumptions.

Shaviro's argument for the nonmitigation norm is different from Kaplow's, but it too faces new questions when analyzed in light of the

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[167] See Kaplow, 99 Harv L Rev at 588 n 242 (cited in note 6) ("As one moves away from the optimum . . . disproportionately small reductions [will be produced] for small reductions in the level of implementation."). The argument is, essentially, that marginal benefits equal marginal costs at the point of optimal policy change. Therefore, accepting a small reduction in the policy change moves to a point where marginal benefits increase relative to marginal costs.

[168] See id at 587–88 ("[P]artial implementation is inefficient because, as with partial compensation, its mitigation exceeds market provision for risk."). See also Kaplow, 13 J Contemp Legal Issues at 187 (cited in note 20) ("Thus, for a given level of relief, delayed and partial implementation are worse than grandfathering, which in turn is worse than compensation."). In any event, there is no reason to assume that, under the nonmitigation norm, Congress would provide the same quantum of transition relief through the scaling back of substantive tax policy changes that it would have provided under current law through grandfathering or another transition relief mechanism.

[169] This same point is generally true of the arguments made by Shaviro, Ramseyer and Nakazato, and Logue, although some of those arguments seem less robust than others, with or without the analytical apparatus developed in this article.

[170] Kaplow himself acknowledges that the assumption is problematic, although for different reasons. See note 66.

tendency toward legislative compromise. Shaviro argues that the nonmitigation norm will move substantive tax policy toward the norm of a comprehensive tax base by narrowing the transition gain/loss asymmetry evident under current legislative practice.[171] However, the analysis set out above implies that the nonmitigation norm will tilt substantive tax policy in favor of the status quo through the scaling back of tax preference curtailment and repeal. At the same time, the nonmitigation norm is likely to have more modest effects on tax preference enactment and expansion because there, legislators generally face less pressure to buy off policy opponents and, accordingly, less pressure to compromise. For example, the nonmitigation norm would make it more likely that any future restriction of the interest exclusion for state and local bonds would be less extensive than it would have been if legislative proponents and opponents were to compromise by mitigating transition losses resulting from the restriction. However, the nonmitigation norm likely would have less effect on any future expansion of the exclusion because of the collective action problems facing opponents of tax preference expansion, who typically represent the interests of taxpayers as a whole rather than the interests of particular groups.

Thus, it seems probable that the nonmitigation norm would lead to a reduced level of tax preference restriction but a less-reduced level of tax preference expansion. Even on Shaviro's assumptions, that should move substantive tax policy, at the margins, away from the norm of a comprehensive tax base. Furthermore, it seems reasonable to think that, on the whole, the reduction in tax preference restriction may undermine the desired effects, relative to the norm of a comprehensive tax base, achieved by narrowing the gain/loss asymmetry. Although the nonmitigation norm would conform the treatment of tax transition losses to the treatment of tax transition gains (as Shaviro expects), the corresponding cost from the perspective of tax base integrity would be the greater entrenchment of existing tax preferences without a fully offsetting reduction in the enactment of new tax preferences.

2. Implications under the mitigation norm.

Ramseyer and Nakazato argue that the mitigation norm will increase social welfare through the minimization of rent extraction by legislators and reductions in post-enactment lobbying by organized interest groups that want to protect existing tax preferences. Thus, they argue that the mitigation norm reduces the social costs of tax reform

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[171] See notes 63 and 69.

and facilitates the enactment of efficient substantive tax policy.[172] Again, the importance of compromise in the tax legislative process raises questions about this claim.

Their argument assumes that a government policy to mitigate tax transition losses attributable to investments made before the repeal of a tax preference will leave taxpayers indifferent between retention and repeal of the preference; they assume that the guarantee of transition relief will disarm interest groups so that they no longer oppose reformist legislation or respond to threats about the enactment of reformist legislation. However, as discussed in Part III.A, the mitigation norm covers some tax transition losses but leaves other tax transition losses uncovered. That failure to mitigate all the transition losses generated by the repeal of a tax preference undermines the benefit of adopting the mitigation norm in the first instance.

Taxpayers whose transition losses would not be covered by the mitigation norm will still oppose repeal of tax preferences, respond to rent extraction by legislators, and lobby to prevent tax reform.[173] Additionally, in many cases, members of a single interest group will bear both mitigated and unmitigated tax transition losses, raising the possibility that the compensation provided by the mitigation norm may have little or no marginal effect in preventing rent extraction or protective lobbying. Indeed, merely putting a tax preference "in play" through proposed repeal certainly would arouse the interests of those who currently benefit from the preference, even if some of their potential tax transition losses are covered by the mitigation norm.[174] Thus,

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[172] For a similar argument that the mitigation norm facilitates desirable legal changes, see Fisch, 110 Harv L Rev at 1091 (cited in note 19) ("If a new rule is more efficient with respect to future transactions, a lawmaker can adopt it exclusively for those transactions, thereby avoiding the transition costs associated with changing the applicable rules midstream.").

[173] One possible response to this point is to propose a broader scope for the mitigation norm to cover these transition losses as well. However, any such expansion of transition loss mitigation quickly exceeds any rational or practical boundaries. See notes 156–58. With existing bonds and existing bondholders, one can quantify the transition losses that would result from an immediate repeal of the interest exclusion for all outstanding bonds, and one can quantify a measure of full mitigation for those losses. In the case of bonds not yet issued at the time of enactment, any attempt to quantify transition losses dissolves into speculation. The only effective mechanism for fully mitigating those losses would be to prohibit Congress from repealing the exclusion in the first instance.

[174] It simply is not plausible to assume that the legislative objectives of rent seeking interest groups are coextensive with preserving the status quo; rather, one must assume that such groups will seek to expand their socially costly preferences at any available opportunity. The government policy to mitigate part of the interest groups' transition losses therefore might encourage, rather than discourage, further rent seeking by those interest groups. State and local governments, for example, that have the benefit of a full interest exclusion and guaranteed grandfathering for outstanding bonds but face the prospect of substantial unmitigated losses with respect to future bond issues have little reason not to lobby for an even larger tax preference—perhaps a 150 percent exclusion (so that every dollar of interest offsets fifty cents of other income).

rather than lowering the social costs of enacting efficient substantive tax legislation, the mitigation norm proposed by Ramseyer and Nakazato for repeal of tax preferences likely makes those preferences no less difficult to repeal. This failure of the mitigation norm to facilitate tax reform—or even to minimize rent extraction and protective lobbying—raises doubts about any claim that the norm represents the best transition policy.

Logue's efficiency claim for the mitigation norm derives from his proposition that the benefit of avoiding the default-premium effect[175] probably exceeds the cost of diminished governmental flexibility to repeal tax preferences "without having to provide transition relief."[176] Thus, he measures efficiency by reference to revenue costs for the government.[177] Even on that standard, however, the analysis in Part III.A implies that Logue has not fully accounted for the costs of a government policy to mitigate transition losses. Under the mitigation norm (as under the nonmitigation norm), legislators seeking to compromise on the proposed repeal of an existing tax preference will be less able (or even unable) to do so with respect to the effective date of the repeal. Instead, they are more likely to scale back the repeal itself.[178] Thus, the governmental cost of the mitigation norm is not simply a diminution in the government's ability to repeal a tax preference without having to provide transition relief; rather, it is a diminution in the government's ability to repeal a tax preference at all. The policy of mitigating tax transition losses avoids the default-premium effect but favors the substantive status quo, making it more difficult for legislators to repeal tax preferences with respect to any investments, not just pre-enactment investments. This both increases the costs of the tax preferences to the government in the first instance[179] and decreases the

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[175] As argued above, the supposition of the default-premium effect rests on the debatable assumption that tax preferences are enacted to affect marginal behavior, as opposed to subsidizing behavior that has occurred in the past or that would occur in the future without regard to the tax preference.

[176] Logue, 94 Mich L Rev at 1140 (cited in note 3).

[177] For a criticism of Logue's approach, see Kaplow, 13 J Contemp Legal Issues at 183–84 (cited in note 20) ("[O]ne cannot compare transition regimes using revenue costs as the metric.").

[178] As was the case under the mitigation norm envisioned by Ramseyer and Nakazato, the mitigation norm endorsed by Logue would only mitigate certain tax transition losses, but would necessarily leave other tax transition losses unmitigated. Taxpayers bearing those unmitigated transition losses would continue to oppose the substantive tax policy change. See notes 41–49 and accompanying text.

[179] For example, if the mitigation norm were in effect at the time the interest exclusion for state and local government bonds were first enacted, the total cost to the government of the preference would include both the cost of providing grandfathering treatment in the event of any future curtailment and the difficulty of enacting a full repeal of the exclusion at a later time. See Jacob E. Gersen, *Temporary Legislation*, 74 U Chi L Rev 247, 263 (2007) (distinguishing between "*enactment* costs, realized only in time periods when legislation is enacted, and *maintenance*

probability that Congress will enact desirable substantive tax policy over the long run. That, in turn, raises doubt as to whether avoiding the default-premium effect actually enhances or diminishes social welfare (even if one accepts revenue costs as the proper metric).

C.   Normative Implications for the Treatment of Tax Transitions

The analysis set out here has ambiguous normative implications for the treatment of tax transitions. As shown in Part III.A, a government policy implementing either the mitigation norm or the nonmitigation norm favors the status quo because it discourages or precludes legislators from using the effective date of a substantive tax policy change as a vehicle for compromise and, instead, encourages them to compromise on the substantive terms of the change. As shown in Part III.B, that raises doubts about the principal claims that have been made in support of the mitigation and the nonmitigation norms. Those claims, which for the most part have assumed that the implementation of a tax transition policy would not affect the development of substantive tax policy, generally become more indeterminate once a different account of legislative behavior demonstrates that tax transition policy is not exogenous to substantive tax policy.

This suggests two possible normative conclusions—one weak and one strong—regarding the idea of a tax transition policy. The weak normative conclusion follows the indeterminacy of the claims for the mitigation and the nonmitigation norms to conclude that a government tax transition policy may or may not increase social welfare relative to a baseline of continuing to address tax transitions on an ad hoc basis. To consider for the moment only the claims made by Kaplow for the nonmitigation norm, Part III.B.1 argues that the nonmitigation norm may or may not actually increase ex ante incentives to anticipate efficient change in substantive tax policy, depending on how taxpayers compare the increased likelihood that any change in substantive tax policy would not include mitigation of transition losses to the decreased likelihood that the change in substantive tax policy would take place at all. It seems impossible to predict with any confidence

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costs, realized only in periods after enactment, deriving from efforts to repeal, amend, or avoid any changes to existing legislation"). One would have to compare that to the cost of the tax preference as adjusted for the default-premium effect. Id at 264 (showing that "temporary legislation allocates enactment costs to the sunset period, while permanent legislation concentrates them in the initial time period. Any aggregate effect then depends on the degree of difference between costs in the initial time period and the factor by which future period costs are discounted"). Although it remains uncertain, it would seem reasonable that the additional revenue cost of the government's increased difficulty to effect full repeal of a tax preference would exceed the amount (if any) by which the default-premium effect itself exceeds the cost of guaranteed grandfathering.

that, in all or even most cases, taxpayer judgments about the outcomes of the political process will lead them to greater anticipation of desirable substantive tax policy change.

Such a comparative evaluation by taxpayers would require assumptions about the degree to which otherwise efficient substantive tax policy changes might be scaled back or even abandoned by reason of the nonmitigation norm. There is no reason for taxpayers or legislators to assume that compromising on the substantive tax policy change itself rather than on the effective date of the substantive change would necessarily produce the same quantum of transition relief that might have been provided, in the absence of the nonmitigation norm, through grandfathering or another adjustment to the effective date. It may be that scaling back the reform would leave the transition losers worse off than they would have been under a grandfathering rule; it may be that the losers would be better off; or it may be that some transition winners instead would become transition losers.

Once the effects of tax transition policy on the development of substantive tax policy are identified and taken into account, it becomes difficult to maintain the *ceteris paribus* assumption that supports the confident claims made in the existing literature for the optimality of a particular transition norm. Thus, the weak normative implication of the analysis set out in this Article would be agnosticism about whether the better approach would be a defined tax transition policy or a case-by-case resolution of transition issues as they arise in connection with particular substantive policy changes. That conclusion acknowledges that a particular tax transition policy is not necessarily more or less efficient than the ad hoc approach to tax transitions found in current practice.[180]

The second and stronger normative implication emphasizes the effect of any government tax transition policy on favoring the status quo. In the abstract, there should be scaling back of both efficient and inefficient substantive tax policy changes. To the extent that one ex-

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[180] See Levmore, 99 Colum L Rev at 1684 (cited in note 13) (arguing that flexibility in transition issues might yield the best substantive outcomes). Although Graetz generally endorses a case-by-case approach (with a strong slant against grandfathering rules), Kaplow argues that a case-by-case transition policy compromises the incentive effects "of clear, general transition rules that can be relied upon in advance." Compare Graetz, 126 U Pa L Rev at 87 (cited in note 9) ("The magnitude of the losses will vary depending upon the specific effective date rule chosen. . . . [F]irm conclusions are difficult, given the amorphous quality of the criteria."), with Kaplow, 99 Harv L Rev at 560 (cited in note 6) ("[F]ailure to specify transition policy in advance creates a needless additional risk."). It is curious that Kaplow rejects the case-by-case approach by appealing to the benefits of the reliability inherent in a governmental precommitment. He expressly argues that transition policy is simply different from substantive policy in that government can determine the efficient transition policy in advance.

pects the future development of substantive tax policy to be more in-efficient than efficient, a policy implementing a tax transition norm may be superior to the ad hoc approach of current practice because the bias toward the status quo would impede the general move toward welfare-diminishing legislation. To the extent that one expects the re-verse, the bias would impede the general move to welfare-enhancing legislation and would be inferior to the current ad hoc practice. To the extent that one expects no systematic bias either way for the future development of substantive tax policy, neither the ad hoc approach nor a formal policy would be clearly preferable.

Thus, the strong normative implication, to the extent defensible at all, ultimately turns on what one expects from future substantive tax policy—a question that almost defies reasoned response. Even if one could make a confident prediction that the general course of tax legis-lation is likely to be welfare diminishing and that a government tax transition policy is therefore preferable, this analysis would not sug-gest which transition policy is preferable. The relative merits of the mitigation norm and the nonmitigation norm would still be indeter-minate because of the open-ended effects of those norms on the de-velopment of substantive tax policy. Under those conditions, a tax transition policy would constitute an arbitrary rule for the treatment of transition winners and losers as an indirect means of impeding the development of substantive tax policy. Certainly the treatment of transition winners and losers under the ad hoc approach of current practice is not more arbitrary than that.

CONCLUSION

The foregoing analysis of transition policy within the specific con-text of tax legislation suggests that a governmental policy implement-ing a particular tax transition norm may not be superior to an ad hoc approach. That conclusion, which questions the strong claims made for both the mitigation norm and the nonmitigation norm, turns on the propositions that tax legislation often entails compromise among leg-islators and that the elimination of transition treatment as a basis for compromise likely favors the status quo of substantive tax policy. Fur-ther inquiry could examine how well this analysis accounts for legisla-tive interactions in substantive contexts outside tax policy. It may be that the strategy of compromise constitutes an equilibrium in other aspects of legislative activity. If so, the conclusion suggested here might apply more broadly to other legislative transition issues.

Whether the same conclusion applies in nonlegislative transition set-tings is more doubtful. Substantive policy changes developed through the judiciary do not typically arise through the cooperation of the key players. The paradigm for adjudication is not the dealmaking that

characterizes the legislative arena but rather a pitched battle before an impartial decisionmaker who awards victory on a winner-take-all, loser-take-nothing basis. When a court decides for one litigant and, in so doing, effects a change in substantive policy, that change is not the function of compromise between the court and the prevailing litigant or between the litigants themselves. Thus, in the adjudicative context, transition policy might be exogenous to substantive policy.[181]

Administrative transitions pose an intermediate case because decisionmaking by administrative agencies may tend toward either the legislative model or the adjudicative model at different times, or may even exhibit characteristics of each simultaneously. At one extreme would be such practices as negotiated rulemaking in which administrative agencies promulgate rules and regulations through an open process that includes formal participation by organized interest groups. In those cases, compromise among interest groups and between interest groups and the administrative agency is a stated objective of the process, and one might expect that a transition policy would have a demonstrable effect on the substantive outcome of the rulemaking. At the other extreme would be the quasi-adjudicative functions of certain agencies, such as the activities of administrative law judges who are expected to act and render decisions in the manner of judges rather than that of legislators.

Finally, the effect of a particular transition policy in favoring the status quo underscores the importance of assessing whether one can expect that, over time, substantive policy develops in a welfare-enhancing direction, a welfare-diminishing direction, or in a neutral direction. This suggests that further inquiry on transition policy should examine this point closely. It may well be that such an inquiry requires distinguishing among substantive legal areas. It may be necessary to draw further distinctions even within a single discipline. Quite possibly, this analysis would suggest no reliable conclusions about the direction of substantive policy development.

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[181] Kaplow makes a similar observation when he argues that transition policy may be less likely to affect the development of substantive policy in the common law. See Kaplow, 99 Harv L Rev at 601 (cited in note 6) ("Whether or not the court's new interpretation of the common law may be applicable to prior investments or actions has no apparent effect on its incentive to adopt one substantive rule or another."). For a contrary view, see Levmore, 99 Colum L Rev at 1672–73 (cited in note 13) ("[T]here is a case to be made for some diversification, with courts reviewing legislation and regulation and deciding how aggressively to apply change."). See also Shaviro, 139 U Pa L Rev at 115–17 (cited in note 12) ("To the extent that courts, when interpreting statutes, ought either to function as agents of the enacting legislature or to use their own judgment about increasing social welfare, theories about legislative behavior may affect the question of what broad interpretive principles the court should follow.").

Thus, a critical point that emerges from this analysis of tax transitions is the importance of institutional and substantive context. Previous inquiries have rightly emphasized the elements that are common to legal transitions in a wide variety of settings. But any normative conclusions about transition policy demand thorough analysis of how transition policy affects the development of substantive policy.