

1. Retroactivity in Law & Economics

When disadvantageous changes in tax rules are introduced, taxpayers should not receive transition relief.

Pro: [DS]

1. A correct case-by-case transition analysis would look at the incentive effects of taxpayer expectations and at taxpayers' ability to address the risk of a change in law. No general rule (such as allowing transition gain and loss either always or never) can possibly be correct all the time. The case against generally favouring transition relief holds that support for cushioning taxpayer losses – while inconsistently permitting taxpayers to reap transition gains – is likely to be too strong, rather than too weak.

2. When tax preferences for particular assets are repealed, grandfathering can lead to unjustified windfall gains. For example, a grandfathered repeal of tax preferences for owner-occupied housing would likely raise the value of existing housing stock, by reducing expected future home construction. It is hard to see why we should cushion taxpayers' direct loss from the removal of preferences for existing housing, yet permit them to reap indirect gain.

3. In practice, transition relief upon the repeal of tax preferences results in an unjustified asymmetry, in which taxpayers are more likely to win when tax preferences for existing assets are expanded than to lose when the preferences are repealed. Given the general desirability of base-broadening, it is hard to see why transition policy should be tilted against it.

4. Inducing taxpayer anticipation of legal changes is often desirable, whether because a given change is good policy or due to its ineluctable effects (even if bad policy) on the future use and value of assets.

5. Taxpayers often can adjust appropriately to the economic risk created by the prospect of a change in government policy, such as by diversifying their portfolios or hedging particular asset risks. Where they deliberately bet on future tax policy, it makes no sense to let them keep the upside while offering them transition relief against the downside. In cases where they cannot easily diversify properly (e.g., middle class home ownership), the ex post case for transition relief is admittedly stronger, but ex ante this may indicate that the preferences are inducing undesirable under-diversification.

Con: [CC]

1. If transition relief is expected when disadvantageous tax rules are introduced, governments will be far less likely to change tax rules. Although this relief requirement may present obstacles to the introduction of new policies, over the long run it will ensure that only those policies that promise significant overall improvements will be adopted.

2. Tax rules can be important instruments of public policy, but they cannot operate as such, or they will be prohibitively expensive, unless they are relatively stable and therefore taxpayers can plan their responses to them in advance.

If tax rules can be changed without transition relief, the cost of using them as instruments of public policy will be affected in two ways. First, the reward to taxpayers for engaging in the desired behaviour must be increased to account for the risk that the behaviour will not in fact be rewarded. Second, the reward must be provided relatively early in order to decrease the chance of that it will not remain available. When the reward must be provided early, the mechanisms for enforcing the criteria for eligibility for the reward are likely to be cumbersome and the reward in general is less likely to be efficient.

3. If there is no expectation of transition relief, changes in tax rules could be introduced which were, even though justified as appropriate policies, in fact inappropriately punitive measures. An expectation of transition relief cannot prevent all such inappropriately punitive measures, but by increasing their cost, it can reduce the likely of their occurrence.

4. Most arguments against the provision of transition relief rely in some way on the idea that the risk of change in tax rules and the government policies embodied in them is essentially similar to other market risks, and that taxpayers should not expect the government to ensure them against such risks. This premise may not hold in at least one key aspect: Although society as a whole benefits when private actors have appropriate incentives to identify risks and protect themselves against them, it is not clear that private individuals are in the best position to identify the risks associated changes in government policies.