

*Law & Economics Working Papers*  
*Law & Economics Working Papers Archive:*  
*2003-2009*

---

University of Michigan Law School

*Year* 2003

---

Legal Transitions, Rational Expectations,  
and Legal Progress

Kyle D. Logue  
University of Michigan Law School, [klogue@umich.edu](mailto:klogue@umich.edu)

# UNIVERSITY OF MICHIGAN

JOHN M. OLIN CENTER FOR LAW & ECONOMICS

## LEGAL TRANSITIONS, RATIONAL EXPECTATIONS, AND LEGAL PROGRESS

KYLE D. LOGUE

WORKING PAPER #03-006



THIS PAPER CAN BE DOWNLOADED WITHOUT CHARGE AT :

MICHIGAN JOHN M. OLIN CENTER WEBSITE

[HTTP://WWW.LAW.UMICH.EDU/CENTERSANDPROGRAMS/OLIN/PAPERS.HTM](http://www.law.umich.edu/centersandprograms/olin/papers.htm)

## Legal Transitions, Rational Expectations, and Legal Progress

Kyle D. Logue<sup>1</sup>

### I. Introduction

This Article focuses on two questions that bear critically on the choice of a welfare-maximizing transition policy. First, under what circumstances will private parties – whether individuals or firms – make unbiased assessments of the likelihood and nature of legal change and of the transition policy that will be applied? Second, should legal change be expected, over the long run, to move in a desirable direction? To put this second question differently, in what areas or with respect to what types of law can we assume that there will be “legal progress”? As it turns out, according to the consequentialist framework that has come to dominate legal scholarship on transition issues, how these two sets of questions are answered will determine whether certain types of legal change should be applied retroactively or prospectively and, more generally, the extent to which the government should seek to eliminate transition losses and gains.<sup>2</sup>

---

<sup>1</sup> Professor of Law, University of Michigan Law School. I am grateful for comments received from numerous colleagues at the University of Michigan Law School and from the participants at the Columbia Law & Economics Workshop and the participants at the Legal Transitions Conference at the University of San Diego Institute for Law and Philosophy. Financial support for this project came from the Elkes Fund and the Cook Fund at the University of Michigan Law School.

<sup>2</sup> The terms “retroactivity” and “prospectivity” are notoriously imprecise. One way of understanding them is relative to each other. Thus, if a legal transition is applied retroactively, it will have a higher probability of affecting pretransition investments (or will have larger effect on, or will reach more of, such investments) than if the law change is applied prospectively. A more precise taxonomy, however, is possible. For example, a “nominally prospective” tax change is one that applies only to future tax returns, although such a change can have retroactive effects on the value of investment made before the change occurred if those investments produce income or expenses over several years. To make a tax change “fully prospective,” some sort of grandfather rule would need to be included as well. By contrast, to make a tax change “nominally retroactive” would be to apply the new rule to all pre-transition tax years, not just to pre-transition investments. *See generally* Michael J. Graetz, *Legal Transitions: The Case for Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47, 49-50 (1977)

Part II briefly summarizes the consequentialist framework for analyzing legal transitions. It focuses on one key (and, to my mind, under-emphasized) aspect of that framework: the fact that transition norms can usefully be analogized to tort liability rules and thus can be evaluated on the basis of their effects on incentives and risk-bearing. Part III then brings a behavioralist perspective to the economic transitions framework. Specifically, if the possibility of various cognitive biases are taken seriously, any incentive-based approach to transition policy will encounter problems. This behavioralist qualification may have special force when the law in question affects the decisions of individuals rather than businesses. The intuition here is that business corporations face evolutionary competitive pressures that will over the long run (an important qualification) tend to weed out firms that systematically misestimate risks, including the risk of legal change; whereas, individuals do not face the same sort of competitive, evolutionary pressures. A tentative conclusion that follows from this intuition is that, if policymakers are going to rely on incentive-based justifications of a given transition norm, the argument will be most persuasive in contexts involving corporate actors – or other commercially sophisticated actors who face similar competitive pressures. This conclusion, of course, must be qualified by the fact that corporations have their own sources of decision-making bias, some of which may persist over the long run. In any event, one conclusion of this Article’s analysis is that, with respect to laws that primarily affect individual rather than corporate incentives, policymakers should be suspicious of incentive-based justifications of alternative transition policies, or for that matter of alternative tort liability rules or other legal rules. The focus should instead be on other considerations, such as distributional concerns.

A final resolution of the issues raised in Part III, which have importance not only for transition policy but for legal rules generally, will depend on the further development of empirical and experimental research on biases in human decision-making. Part IV, however, raises a conceptual

---

(coining terms “nominal retroactivity” and “nominal prospectivity”); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 Harv. L. Rev. 509, 515-16 (1986) (using same terms); and Daniel Shavero, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* 104-15 (2000) (adopting similar terminology and discussing implications of “anti nominal retroactivity” norm in tax legislative context).

problem that is peculiar to the economic analysis of legal transitions and that raises profound difficulties for the incentive-based case for retroactivity. According to the economic transitions framework, the best argument for applying a legal change retroactively relies on the *anticipatory* incentive effects on private actors: If legal change is expected to be applied retroactively, private parties will be induced to anticipate that change, and this anticipation can lead to a beneficial form of cost-internalization. This incentive-based or anticipation-based argument, however, depends entirely on the assumption that legal change can be expected over the long run to move in a desirable direction, that the law will make progress over time. As a result, the incentive-based justification for retroactivity works, if at all, only for certain types of legal change. For one example, sometimes legal change will be prompted when new and better information reveals that the original law was based on a factual mistake or misunderstanding of the situation. With respect to that type of legal change, there is an efficiency argument for retroactivity to give private parties the incentive to anticipate such policy adjustments or error corrections.

For some other types of legal change, however, the anticipation-based story generally has little to say. For example, when legal change occurs merely because there is a change in the political power structure – say, the Republicans boot the Democrats out of office, or vice versa – the anticipation-based argument for a retroactivity norm has little force. This is because, in circumstances in which legal change is best understood as the product of a game of political tug-of-war (such as the flip-flopping of control that can occur in a democratic country that is closely divided on ideological issues), the notion of legal progress may just not make sense.<sup>3</sup> For that sort of legal change, the focus should be less on incentives and more on minimizing risks of expropriation, a shift in focus that would seem to counsel for significant limits on retroactive legal change. The upshot of all this, then, is that perhaps the biggest

---

<sup>3</sup> There also is a type of legal transition with respect to which the legal progress assumption is sometimes irrelevant: transitions that actually destroy property or, more precisely, cause property to decline in value in ways that cannot be restored by a reversal of the transition in question. For such “destructive transitions,” it is possible to fashion an incentive-based argument for retroactivity that ignores the legal progress issue, although the reasonable expectations assumption will still be important. *See infra* Part IV.

challenge for transitions theory will be to distinguish categories of legal change that can be characterized as *legal progress* in some objective sense – for example, those changes that involve error correction or uncertainty resolution – from those that involve pure shifts in political power or ideology. Most transitions, of course, involve some combination of these characterizations (that is, they are in part political shifts and in part error corrections or responses to unforeseen circumstances). As a result, often the best transition rule will be some intermediate transition norm, something between pure retroactivity and pure prospectivity.

A tentative conclusion of this Part’s legal-progress analysis is that the incentive-based justification for the use of a retroactivity transition norm is strongest in situations in which the transition in question involves (or has the characteristics of) incremental changes in the common law, especially changes that reflect the incorporation of a new scientific discovery or a newly developing consensus within the scientific community. This conclusion admittedly depends on optimistic accounts both of incremental decision making and of scientific progress. This conclusion also supports and reinforces the longstanding tradition of courts’ applying new product liability decisions retroactively. The analysis of this Part also supports the application of a retroactivity norm to regulatory and even to legislative change, *in cases in which those changes have the characteristics of common law decision-making*, characteristics of “error correction” or “uncertainty resolution.” There is a critical sense, for example, in which that certain types of tax-law change – namely, moves by either Congress or the Treasury Department to identify and eliminate abusive tax shelters – can be usefully analogized to the incremental change embodied in common law adjudication, including the products liability context. What follows from this analogy is that, as with the case for retroactivity with respect to incremental change in the area of product safety regulation, there is a fairly strong incentive-based argument for nominal retroactivity with respect to the elimination of unintended tax loopholes, or opportunities for self-serving and abusive interpretations of the tax law. Interestingly, the current transition norm for such tax changes is almost precisely the opposite: When a tax shelter or loophole is explicitly eliminated by Congress or by the Treasury, the change is almost always made nominally prospective.

The other major conclusion of this Article’s analysis is that, insofar as we cannot confidently

identify areas of law where progress is to be expected, and insofar as we cannot have confidence in the rational expectations assumption, perhaps the focus on incentive-based justifications of alternative transition policies should be redirected. That is, perhaps consequentialist transitions scholarship should focus not on the deterrence side of the framework but on the insurance and distributional side. For the most part, I leave that task for another day.

## II. The Consequentialist Transitions Framework

In the literature on legal transitions, the term “transition policy” is generally understood to mean a rule or norm that influences policymakers’ decisions concerning the extent to which legal change should be accompanied by transition relief. Legal change within this framework is defined broadly, and somewhat counter-intuitively, to include any resolution of the uncertainty regarding what the law will be in the future or how the law will be applied to future circumstances. Thus, a legal change would obviously include an unexpected repeal of a tax provision, such as the home-mortgage interest deduction, or a shift in tort law from a negligence or fault-based regime to a strict liability regime.<sup>4</sup> Perhaps less obviously, however, a legal change will also be said to have occurred under this framework in circumstances in which the statutory law or the formal common law rule remains unchanged, but is applied in some way or to some circumstance that the relevant private parties were not expecting. Thus, “a transition issue [and hence the need to choose a transition policy] will be said to arise whenever an act has future consequences and the legal regime applicable to those future consequences is not known with certainty at the outset.”<sup>5</sup>

---

<sup>4</sup> Transition issues arise only when the legal change is unexpected by private parties. Thus, if Congress were to enact a tax provision that was scheduled to expire on a particular date, the expiration of that law according to the original schedule would not produce a legal “change” under this definition, assuming the expiration was expected. By contrast, if it were expected that the legislature would vote to extend the law (say, that had been the practice for many years with respect to other expiring tax provisions), then the failure to extend the provision *would* be a legal change.

<sup>5</sup> Louis Kaplow, *Transition Policy: A Conceptual Framework*, J. CONTEMP. LEGAL ISSUES p.2 (2003).

Transition relief can take a number of forms, from grandfather rules or phase-ins to direct compensation for transition losses. Real-world transition polices include the common law tradition of applying new judicial interpretations of law retroactively, the legislative norm of applying legislative changes nominally prospectively, and the constitutional law principle of providing compensation for government “takings” of private property for public use. All transition policies, if they are effective, have a quasi-constitutional character, in the sense that they limit the ways in which future government decision-makers can apply new laws across time. With some types of transitions, this means that the transition policymaker will be making quasi-constitutional rules to bind itself or some future version of itself. An example of this would be the informal norm within Congress that calls generally for making tax-law changes prospective. With other types of transitions, however, one decision-maker in some sense *makes* the transition policy, which is in turn applied to constrain or limit the actions of some other government decision-maker. An obvious example of this would be the constitutional prohibition against uncompensated government takings, a prohibition that limits the actions of a wide range of government officials, who in turn had no say in the creation of the rule.

Most of the legal scholarship on transition issues produced in the past 25 years has adopted a consequentialist framework that focuses on the economic and political consequences of alternative transition policies.<sup>6</sup> This transitions framework originated in the tax scholarship of Michael Graetz,<sup>7</sup> was first fully developed and generalized to a range of legal fields by Louis Kaplow,<sup>8</sup> and received perhaps

---

<sup>6</sup> The particular form of consequentialism that dominates transitions scholarship, and that dominates normative law-and-economics scholarship generally, is sometimes called “welfarism.” Welfarist policy analysis evaluates alternative public policies on the basis of their ability to maximize social welfare, which is defined as being some function of the well-being of individuals’ in society. For example, utilitarianism, a type of welfarism, employs a social welfare function that maximizes the sum of all individuals’ subjective well-beings. For the purposes of this paper, when I use the term consequentialist I generally mean welfarist.

<sup>7</sup> Graetz, *supra* note 2.

<sup>8</sup> Kaplow, *supra* note 2.

its most exhaustive treatment in a recent book by Daniel Shaviro.<sup>9</sup> The normative questions that these and other transition scholars have focused on are: under what circumstances should there be a transition policy of providing relief or compensation for the losses caused by unexpected legal change (or, symmetrically, a policy of taxing windfall gains); and under what circumstances should there be a policy of no relief or only partial relief.

The consequentialist transitions framework has developed into a complex blend of economic and political considerations. The economic side borrows heavily from the economic analysis of legal default rules, such as tort liability rules. This part of the framework concentrates on the incentive and risk-bearing (“deterrence” and “insurance”) effects of alternative transition policies.<sup>10</sup> For example, the now famous argument in favor of a pro-retroactivity transition norm in certain settings – associated with Graetz and Kaplow – builds on the idea that such a norm, if made credible (that is, if made in some sense binding on future government decision-makers), would give private parties an incentive to anticipate legal change.<sup>11</sup> Thus, if taxpayers have reason to believe that Congress will apply tax-law

---

<sup>9</sup> Shaviro, *supra* note 2. Numerous authors besides Graetz, Kaplow, and Shaviro have made important contributions to the consequentialist framework. For a review of this literature, see Saul Levmore, *Retroactive Taxation*, 3 *The New Palgrave Dictionary of Economics and the Law* 340-44 (1998); Kaplow, *supra* note 2; Shaviro, *supra* note 2. It is fair to say, however, that the transition scholarship of Graetz, Kaplow, and Shaviro have been especially influential. Although there is significant overlap among the three, there are important differences as well. For example, Graetz’s 1977 article, which was pathbreaking in many ways, was more narrowly focused on tax law than the transitions scholarship of either Kaplow or Shaviro. Graetz’s analysis, however, at least purported to incorporate non-utilitarian sorts of arguments; whereas, Kaplow and Shaviro’s analyses were explicitly welfarist. Kaplow’s article appeared almost 10 years after Graetz’s, but it was the first to develop a comprehensive economic framework for analyzing transitions of many types and was the first explicitly to introduce the analogy of transition norms to liability rules. Although Kaplow did address public-choice issues, which he called “institutional concerns,” as well as distributional issues, those parts of his analysis were emphasized somewhat less compared to his efficiency analysis. Shaviro’s book, however, which owes a considerable debt to the work of Graetz and Kaplow, seeks more fully to integrate the public-choice, distributional, and efficiency issues into a single framework.

<sup>10</sup> Kaplow, *supra* note 2, at 522; Shaviro, *supra* note 2, at 27.

<sup>11</sup> Graetz, *supra* note 2; Kaplow, *supra* note 2; Shaviro, *supra* note 2. This position is sometimes called the “new view” in contrast to the so-called “old view,” which focuses more on

changes retroactively to pre-transition investments, those taxpayers will have an incentive to anticipate such rule changes and adjust their investments accordingly. In other words, a transition policy of making tax-law changes retroactive would have the effect of forcing taxpayers to internalize the costs of those changes in their ex ante investment decisions.<sup>12</sup>

That is the deterrence or incentive part of the consequentialist framework. As for the insurance part, a pro-retroactivity tax-transition policy would also allocate the risk of retroactive tax-law changes to the private parties who invest in reliance on the old law. If those parties are risk averse, they can shed or reduce that transition risk in some way. By contrast, if the government adopts a transition policy of providing transition relief for certain types of transition losses (say, government compensation for takings of private property for public use), such a policy can be understood as a form of government-provided insurance.<sup>13</sup> Thus, the consequentialist analysis of transition policy focuses on the question what transition policy creates the most efficient ex ante investment incentives for private parties as well as the efficient allocation of transition risk.

In addition to deterrence and insurance concerns, the consequentialist framework also considers distributional issues, both unintentional redistribution and intentional redistribution. Recall first that whenever there is a rule change not accompanied by full transition relief there will inevitably be some redistribution *away from* those who made investments in reliance on the old law and *toward* anyone who benefits from the rule change. Thus, with any uncompensated legal transition, a redistributive transfer is made from the new losers to the new winners. To the extent that such redistribution is an unintentional byproduct of legal change, the consequentialist framework would analyze it as a pure insurance question— that is, a question of transition risk. An example of this sort of redistribution would be a government taking of an individual’s property for public use. With such a

---

fairness and reliance concerns and tended to disfavor retroactivity generally. Levmore, *supra* note 9.

<sup>12</sup> Thus, Saul Levmore has called this the “anticipation-based” new view of legal change, in contrast to the more “reliance-based” old-view perspective. Levmore, *Changes, Anticipations, Reparations*, 99 *Colum. L. Rev.* 1657 (1999).

<sup>13</sup> Kaplow, *supra* note 2, at 536-58; Shaviro, *supra* note 2, at 36-43.

taking, there is no (or should be no) intent on the part of the government to reduce the homeowner's wealth per se; the government just happens to need *that* piece of property.<sup>14</sup> However, to the extent the resulting redistribution *is* intentional (that is, to the extent the reason for the policy change is to reduce the wealth of the party disadvantaged by the transition), such redistribution must be evaluated on its own terms, as a matter of distributive justice. An example of this sort of intentional redistribution would be an increase in property taxes that is intended to fall disproportionately on wealthy individuals.

At this point, the consequentialist transitions framework looks very much like the consequentialist framework for analyzing legal rules generally. Again, the focus on deterrence and insurance (and to some extent even the consideration of distributional issues) draws heavily from the standard economic analysis of legal rules in torts, contracts, and property law – but especially in the area of products liability law.<sup>15</sup> What makes the consequentialist analysis of transition issues uniquely complex, however, is the necessity of simultaneously considering not only the efficiency and distributional issues just mentioned, but also issues of public choice or interest group politics. Public-choice scholarship can be understood as the application of the rational-actor expected-utility-maximizing model of economics to the study of government actors and government institutions. In the study of static legal rules (at least in the private law context), public-choice concerns can be, and usually are, ignored. Accordingly, the standard economic analysis of the choice between a negligence or a strict liability rule in tort focuses entirely on deterrence and insurance concerns and never asks the question how will each rule affect the lobbying activity of potential injurers and victims. And that makes perfect sense. The same reasonable simplifying assumption, however, cannot be made when the “liability rule” in question is one that allocates the costs of policy changes, changes that are made through political action. Accordingly, consequentialist transition scholars evaluate transition norms not only for their effects on the incentives of private actors but also for their effects on the incentives of political actors, whether those actors are government officials making decisions about public policy or private parties seeking to influence those decisions.

---

<sup>14</sup> Kaplow, *supra* note 2, at 519.

<sup>15</sup> Shaviro, *supra* note 2, at 37.

With respect to affecting the incentives of government actors, some scholars have argued that a norm of compensation for government takings of private property has the benefit of forcing government officials to internalize the full social costs of their decisions.<sup>16</sup> Others within the consequentialist tradition question this conclusion, in part because of the worry that forcing government decision makers to treat the transition *losses* caused by their decisions as a budget item without doing something similar with respect to transition *gains* may cause the former to be overvalued in the political process and thus inhibit desirable legal change.<sup>17</sup> To put the argument slightly differently, some contend that no requiring government to compensate for harms caused is *not* necessary to ensure desirable, or prevent undesirable, legal change. In addition, some scholars argue that, in any event, government agencies cannot be expected to “internalize costs” imposed on them by tort-like liability rules in the same way that firms can, because government officials do not face the same sort of market-driven selection mechanisms that private managers do.<sup>18</sup>

The choice of a transition policy can also affect the political (lobbying) activity of private parties. Thus, if there were a Congressional norm of applying all tax-law changes nominally retroactively (which, again, is not currently the rule), 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 rule. For that reason, even a hard-core advocate of retroactivity (and opponent of transition relief) should, if she is a consequentialist, be willing to compromise on that view and thus, for example, be open to allowing grandfathering or phase-ins in some situations, in order to increase the likelihood of getting desirable tax-law changes enacted. Similarly, even the most committed believer in a reliance-based view of

---

<sup>16</sup> Lawrence Blume & Daniel Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 Cal. L. Rev. 569, 620-22 (1984); Lawrence Blume, Daniel Rubinfeld & Perry Shapiro, *The Taking of Land: When Should Compensation Be Paid?*, 99 Q. J. Econ. 71, 88-90 (1984); and Frank Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law*, 80 Harv. L. Rev. 1165, 1218 (1967).

<sup>17</sup> Kaplow, *supra* note 2, at 567-71.

<sup>18</sup> Daryl Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. Chi. L. Rev. 345, 355-56 (2000).

transitions, if she is a consequentialist, must be prepared to make accommodations to certain political realities. For example, even with respect to explicit government contracts (which arguably represents the strongest case for a reliance-based insistence on government compensation for “transition” losses), something short of a norm of full compensation for government breaches of contract might be appropriate if it can be shown that a full-compensation rule tends to induce an excessive amount of illegitimate interest group involvement in procurement policymaking.

### III. The Rational Expectations Question

#### A. *The Products Liability Analogy*

As mentioned, the consequentialist framework focuses on the effects of alternative transition policies on the ex ante choices of private decision-makers. Therefore, a key assumption of the framework is that those private parties will make rational, unbiased assessments of (a) the likelihood of legal change, (b) the nature of legal change, and (c) the way in which the legal change will be applied to them, which will be governed by the so-called transition policy. If we assume that private decision-makers will on average make unbiased assessments of these aspects of legal change, we would conclude that they are exhibiting macroeconomists call “rational expectations.”<sup>19</sup> Note that rational expectations is not an assumption of perfect or costless information on the part of private actors. Rather, it is an assumption only of unbiased decision-making. This assumption, therefore, will not be satisfied, and hence any incentive-based justification of a particular transition policy will be undermined (or at least made much more complicated), to the extent that private parties exhibit systematic biases in

---

<sup>19</sup> Professor Shaviro has emphasized the importance of the rational expectations to the transitions debate. Shaviro, *supra* note 2, at 19.

their decision-making in one direction or another.<sup>20</sup> To see the significance of this point, it will be useful to explore an analogy that is at the core of the consequentialist model of transitions – the analogy to products liability law.

But first it is important to emphasize here that the rational expectations assumption – the assumption of unbiased decision-making – is essential not only to incentive-based justifications of alternative transition policies, but also to the *normative economic analysis of legal rules generally*.<sup>21</sup> According to canonical economic analysis of law, the efficiency of a legal rule depends largely on the ex ante incentive effects of that rule. Thus, in designing optimal legal rules, law-and-economics scholars generally assume, explicitly or implicitly, that private parties affected by the rule in question will on average correctly assess (a) what the law is, (b) the likelihood that the law will be applied to them, and (c) how the law will be applied to their situation. The importance of these assumptions can be illustrated by examining particular type of liability rule to which transition policies can be and have been analogized.

Consider, then, the well-known law-and-economics question concerning the choice of the optimal products liability rule, that is, the rule that achieves optimal product risk deterrence and insurance. If we begin with the assumption that consumers and manufacturers exhibit rational expectations with regard to both the risks of product accidents and the tort liability rules that will be applied in the event of a product accident, a good incentive-based case can be made for a rule of no

---

<sup>20</sup> As will explain below, there is considerable evidence that individual decision-making under conditions of uncertainty is often biased.

<sup>21</sup> For the majority of this Article, I will ignore the insurance and distributional aspects of the economic analysis of legal rules and transition policies.

liability, one that leaves the parties to work out issues of risk sharing via contract, such as through product warranties and disclaimers. Following this reasoning, it is conventional to conclude that, if both consumers and manufacturers make unbiased risk assessments and if transactions costs are otherwise low, the competitive market will produce the optimal level of care and activity on both sides. Another way of putting this conclusion is that, assuming rational expectations and low transaction costs, there is a fairly decent argument that the risks of product accidents are best handled via contract rather than tort law.

*B. Where Incentive-Based Arguments Run into Trouble: Taking Behavioralism Seriously*<sup>22</sup>

If, however, we introduce the assumption that consumers tend systematically to underestimate certain types of low probability risks (such as product accident risks), a no-liability tort rule – one that defers entirely to contracts between the parties – would lead to both suboptimal care (both by manufacturers and consumers) and excessive activity levels. Moreover, if we adopt the assumption of consumer under-estimation of risk, and if we also assume (critically) that manufacturers do not exhibit a similar or offsetting bias, a good incentive-based argument can be made for expanding products liability law and forcing manufacturers – through a rule of enterprise liability or something close to it – to internalize product accident costs that would otherwise be externalized due to the consumer bias. Indeed, it is just this sort of argument that has served as one of the primary theoretical justifications for the expansion of products liability law over the past several decades, from a regime based in contract,

---

<sup>22</sup> This phrase is borrowed from Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. 630 (1999).

to one based in fault, to one that has elements of absolute enterprise liability.<sup>23</sup>

This argument, again, depends on two assumptions: an assumption that there is systematic consumer underestimation of risk and an assumption that there is no systematic bias on the part of manufacturers. As to the first assumption, it is now well-known that the rational-actor model of neo-classical economics is a fiction. Cognitive psychologists and behavioral researchers have for years documented through experimental investigation what was before a commonly held intuition: human beings often do not behave in a manner that is consistent with standard model of *homo economicus*.<sup>24</sup> Such a conclusion would not necessarily be a problem for policymakers, if the various behavioral heuristics and biases all lined up in a single direction, or at least in predictable directions. For example, if research consistently revealed that consumers generally tend to underestimate all types of product risks in a certain way, a strong case could be made for adopting a regime of enterprise liability for all types of product accidents.<sup>25</sup> Alternatively, if the research consistently indicated that consumers tend to

---

<sup>23</sup> See generally Steven P. Croley & Jon D. Hanson, *Rescuing the Revolution: The Revived Case for Enterprise Liability*, 91 Mich. L. Rev. 683, 706-12 (1993); George L. Priest, *The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law*, 14 J. Legal Stud. 461, 517 (1985) (both attributing the trend towards enterprise liability in part to the problem of uninformed consumers); see also *Enterprise Responsibility for Personal Injury*, 1 A.L.I. 230 (1991) ("The principle assumption in the literature supporting a role for legal liability is that consumers underestimate product defect risks and, as a consequence, put insufficient market pressure on firms to produce safety.").

<sup>24</sup> Kaplow, *supra* note 2, at 548-59.

<sup>25</sup> See, e.g., Robert A. Prentice & Mark E. Roszkowski, "Tort Reform" and the Liability "Revolution": Defending Strict Liability in Tort for Defective Products, 27 Gonz. L. Rev. 251, 291 (1991-1992); and Howard A. Latin, "Good" Warnings, Bad Products, and Cognitive Limitations, 41 UCLA L. Rev. 1193, 1194-95 (1994). Note that, according to this argument, product warnings will not generally solve the problem of consumer over-optimism, and thus cannot serve as an alternative to strict liability, because the same cognitive quirks that produce under-estimation of product risks will inhibit accurate assessment of warnings. See generally, Croley & Hanson, *supra* note 23.

overestimate all product risks, then strict liability would clearly not be the optimal rule, but would instead lead to overdeterrence.<sup>26</sup>

As it turns out, however, the behavioral research comes to neither of these easy conclusions. The best reading of the evidence is that in some situations consumers will likely underestimate risks and in other situations overestimate them.<sup>27</sup> Even this finding would not necessarily be problematic for policymakers, if the different domains of over- and underestimation of product risks could be clearly specified. In such a case, an argument could be made, for example, for having strict liability for some product risks and not for others. But the evidence also does not support such a convenient categorization of product risks, not yet anyway.<sup>28</sup> Whether one should expect under- or overestimation of a given risk in a given context will depend on a range of factors: whether the risk in question involves a “very low,” “low,” or “high” probability of occurrence (which would lead to under-, over-, and under-estimation, respectively); the extent to which the “availability,” “anchoring,” and “representativeness” heuristics come into play (which can lead to over- or under-estimation, depending on the situation); the extent to which the individual feels that they have “control” over the probability of the harm (which pushes toward under-estimation); and the extent of the general “optimism bias” under which individuals tend to underestimate the likelihood of bad things happening to them personally even if

---

<sup>26</sup> See, e.g., W. Kip Viscusi, *Individual Rationality, Hazard Warnings, and the Foundations of Tort Law*, 48 Rutgers L. Rev. 625 (1996).

<sup>27</sup> *Enterprise Responsibility for Personal Injury*, 1 A.L.I. 223 (1991) (“[T]he degree to which there is overestimation or underestimation of injury risk varies with the character of the risk and the particular market context. Empirical evidence indicates that there are tendencies to both overestimate and underestimate the risk in different circumstances.”).

<sup>28</sup> See Hanson & Kysar, *supra* note 22, at 715-18 (1999).

the correctly assess (or even overestimate) the likelihood for group of which they are a part.<sup>29</sup> In sum, the behavioral evidence leads to inconclusive results for products liability law, and perhaps for other areas of law as well. This indeterminacy conclusion, however, does not imply that policy-makers can ignore the behavioralist evidence and return to the traditional rational actor framework. That framework has been severely undermined in this setting. Rather, what the indeterminacy conclusion suggests is that the incentive-based approach to evaluating legal rules, including as tort rules, has profound limitations.

*C. How Behavioralism Limits the Incentive-Based Case for Retroactivity*

If I am right about that conclusion, a similar point can be made about incentive-based arguments in the transition context. Arguments that seek to justify one transition norm over another on the basis of the relative ex ante incentive effects are significantly limited by the behavioralists' findings. This point can be seen most clearly in the anticipation-based argument in favor of retroactivity. A central assumption of that argument is that the parties affected by the law will rationally anticipate changes in that law, as well as the way in which those changes will be applied to them. Thus the anticipation-based argument assumes that, although it may well be that no single person knows the precise probability of a given law's being changed in any particular year, the relevant group of individuals who are affected by the law will *on average* behave as if they are reasonably informed. Put differently, even if they are uninformed, they are randomly uninformed; and their decisions in the aggregate will tend to cluster around an unbiased estimate of the likelihood of future policy changes and

---

<sup>29</sup> For a thorough summary of the behavioral literature as applied to the products liability question, see *id.*

of how the new law will be applied intertemporally. Thus, the anticipation-based justification for a transition policy of retroactivity – of not providing transition relief for transition losses and gains – entails an assumption that the private parties who will be affected by that transition norm will, on average and over the long run, rationally take into account that policy and hence the potential uncompensated costs of legal change, in their ex ante investment decisions.

The behavioralist's findings cast doubt on this line of reasoning. It seems likely that the same cognitive quirks that affect consumers' assessments of product risks, and of risks more generally, will affect individuals' guesses about the likelihood of legal change, the nature of the change, and the way in which transition costs and benefits will be handled. Consider, first, an example of a federal tax provision that is valued by many individual taxpayers, and which could conceivably be repealed: namely, the home-mortgage interest deduction. The anticipation-based argument here would say that we should have a tax transition norm that requires the repeal of the mortgage-interest deduction to be made fully retroactive and that no relief should be provided for those individuals who bought a home in reliance on that deduction. The idea again is to induce taxpayers to internalize the possibility of such a repeal. But for the argument to work, it must be shown that individual taxpayers (specifically homeowners) will on average correctly estimate, among other things, the likelihood of the interest deduction's repeal. But depending upon whether this possibility is considered by taxpayers to be a *very low probability*, a *low probability*, or a *high probability* event, there may be systematic bias in either the over- or underestimation direction. What's more, the perceived likelihood of repeal would likely fluctuate over time in a way that makes useful generalizations impossible. For example, the repeal of the mortgage-interest deduction, as of this writing, seems a remote possibility, as the attention of

Congress and the President are on other matters. If I am right about that, then most individuals probably just ignore this risk completely, or regard it as having zero probability. However, on some future date, if the national policy agenda were to change such that serious tax reform were back in the news, the probability of such a repeal might be perceived merely as “low” and hence overestimated. Similarly, if some other tax provision were to be repealed, increasing the salience factor, there might be a temporary boost in the probability estimate of the interest deduction’s repeal.

A similar story could be told about other types of transitions that have received considerable attention in the literature. Consider, for example, the government’s decision to take an individual’s property for use in building a highway. The anticipation-based consequentialist argument for a policy of no compensation assumes that individual property owners can be expected to engage in a rational, unbiased cost-benefit analysis of the prospects of their property’s being taken by the government. Under that assumption, the argument goes, a regime that promises compensation would induce property owners to engage in various types of moral hazard, such as building in anticipation of the taking, which would increase the social cost of the transition. The risk of a taking, however, is enough like other types of risks that the behavioralist insight begs to be applied: For example, into which category would a taking fall? Would it be very low probability, or just low probability, or maybe even high probability? Obviously, again, it would depend on the situation. Some takings are extremely low probability events. In those cases, one can easily imagine the property owners – especially if they happen to be homeowners – systematically underestimating the risk. If that were so, a policy of providing government compensation in such cases would not necessarily create bad incentives, and

might provide an reasonably effective form of takings insurance.<sup>30</sup>

Indeed, there is some evidence that individual homeowners do behave this way. For example, many individual homeowners continue to build new houses in disaster-prone areas, even though many of them do not have insurance for disaster losses and even though the government-provided ex post compensation – in the form of FEMA grants and SBA loans – for such losses is minimal.<sup>31</sup> If this phenomenon is attributable to the underestimation of disaster risk (whether from the optimism bias or some other cognitive phenomena), a potential solution to the moral hazard problem would be compulsory disaster insurance.<sup>32</sup> Obviously, if disaster insurance – or, for that matter, takings insurance – were made compulsory, ex post government compensation would not be necessary; compensation would come from the insurer. Likewise, if there were compulsory takings insurance, it would be the insurer who would have an incentive to anticipate the government's takings decisions.<sup>33</sup>

---

<sup>30</sup> Kaplow, *supra* note 2, at n.116.

<sup>31</sup> A significant percentage of homeowners in California and in Florida do not purchase earthquake and hurricane insurance, respectively, even though FEMA grants pay only a relatively small fraction of the cost of damaged homes. Even in flood zones, where federal lenders are required by law to insist on a proof of flood insurance before issuing a mortgage loan, a substantial percentage of new homes in those areas do not carry flood insurance. See generally <http://www.fema.gov/nfip/intnfip.htm>; see also Edward T. Pasterick, *The National Flood Insurance Program, in Paying the Price: the Status and Role of Insurance Against natural Disasters in the United States* 125 (1998).

<sup>32</sup> Kaplow, *supra* note 2, at 549-50. It may be that the homeowners who build in disaster-prone areas and do not buy private insurance wrongly believe that ex post federal disaster relief is more fully compensatory than it is. If that is the explanation of the uninsured building in disaster areas, then it provides evidence that a promise of government compensation in takings situations might also have inefficient incentive effects.

<sup>33</sup> As I argue below, I generally have more confidence in the rational expectations of business decision makers, who face competitive pressures, than in the rational expectations of individual consumer decisions. Thus, putting a takings-insurer on the hook for the loss rather than an individual

On the other hand, anecdotal evidence suggests that, in some situations, the possibility of compensated takings *can* have serious moral hazard effects. This is especially true as the probability of the taking increases, perhaps because as that probability increases (and perhaps moves into the “low probability” range), the problem of *underestimation* may disappear and might be replaced by the problem of *overestimation*, which could in turn lead to inefficient overbuilding, again assuming a regime in which takings are compensated by the government. Or maybe not. The difficulty presented by all of these possibilities, of course, is that we cannot predict in advance which types of takings will be affected by which bias in which direction, nor can the various biases be expected to offset each other in any systematic way or be eliminated by experience. Depending, then, on how all of these and other behavioral phenomena interact at any given time, individual taxpayers and homeowners on average may over- or underestimate the likelihood of the provision’s repeal, and of receiving transition relief. Thus, the case for adopting a transition norm (or transition “liability rule”) that requires individuals to rationally anticipate law change is relatively weak.

*C. Where Incentive-Based Arguments Work: Deterrable Manufacturers/Deterrable Taxpayers*

The next question is whether the conclusion of the previous section implies that incentive-based

---

may provide incentive benefits. Insurers, however, would have to be allowed to charge premiums that were roughly actuarially fair. The key difficulty would enforcement. People may be tempted to build without the requisite insurance, despite the threat of an uncompensated taking, just as they often build now on flood plains even when they have no flood insurance or the hope of full ex post flood relief. Presumably, building permits could be made conditional on getting takings (and disaster) insurance, but that approach would put a great deal of pressure, financial and political, on the licensing authorities.

arguments can never be used to justify one transition policy over another. That may be the appropriate conclusion. In other words, until we have a better understanding of how individuals actually make decisions under conditions of uncertainty, perhaps consequentialist scholars and policy-makers considering the choice of an optimal transition policy – or an optimal products liability rule for that matter – should focus on issues other than the effect of those policies or rules on individuals’ incentives. Most legal scholars, however, presumably would not go that far. This is because either most scholars hold the view that individuals (including consumers and taxpayers) can learn or be educated over time to act rationally (that is, they can be “debiased”<sup>34</sup>) or they hold the view that incentive-based arguments still have considerable force when applied to corporate or business decision-makers rather than individuals. It is the latter argument that I want to focus on in the remainder of this Part.

There are reasons to believe that over the long run the decisions of corporate managers and of business decision-makers generally tend to be rational; that is, they tend not to be subject to the same biases that plague individuals acting in their capacities as consumers, at least not to the same degree.<sup>35</sup>

---

<sup>34</sup> For an argument that draws on the work of behavioralist researchers to argue that debiasing consumers with respect to product risks may be very difficult to achieve, see Hanson & Kysar, *supra* note 22.

<sup>35</sup> Kaplow made a similar observation in his original transition article. Kaplow, *supra* note 2, at 549 (“As a rough approximation, one might expect that institutional investors and corporations are in rather good positions to make such probability estimates. In contrast, less sophisticated (often, less wealthy) individual investors may lack sufficient incentives to collect the information to make good estimates and are thus more likely to be subject to systematic cognitive biases that would lead to poor risk assessments.”) A similar point has been made by some behavioral law-and-economics scholars. See, e.g., Christine Jolls, Cass Sunstein, & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 *Stan. L. Rev.* 1471, 1525 (1988) (“We think that defendant overoptimism is likely to be a much smaller factor for firms than for individual defendants, since firms that make systematic errors in judgment will be at a competitive disadvantage.”).

This assertion will be either controversial or obvious, depending on one's perspective. On the one hand, corporate managers are people too, and they are doubtless subject to the same cognitive biases as the rest of us. Indeed, there may be reasons to believe that successful corporations tend to attract leaders who are relatively optimistic in their outlook; moreover, successful corporations may tend to be characterized by cultures that foster such systematic optimism.<sup>36</sup>

On the other hand, notwithstanding the recent findings of behaviorist researchers, few readers would dispute that businesses in general seek to maximize profits and that successful businesses, if operating within reasonably competitive markets, tend to equalize marginal cost and marginal revenue. And if a business diverges too far from that maxim, it will tend to be competed out of business. As a result, so long as companies are allowed to fail, and so long as labor and capital are allowed (and are able) to migrate relatively freely (even if not costlessly) across and within various types of businesses and industries, market competition will provide a selection mechanism that will tend to weed out companies that routinely or systematically underestimate products risks or legal risk more generally over the long term. This is not to say that corporate decision making cannot be shortsighted or overly optimistic or too narrowly focused or just plain stupid. Corporate decision-making is notoriously subject to agency problems owing to the separation of ownership and control, and such agency problems obviously do not afflict individual decision-making. Nevertheless, businesses whose managers systematically under- or over-estimate risks will tend to be less successful and less long-lived

---

<sup>36</sup> See, e.g., Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. Pa. L. Rev. 101, 140-41 (1997) (reviewing psychological and management studies finding that some business cultures tend to promote overconfidence among executives).

than firms that find ways to minimize such problems. If we take this conclusion seriously, as most scholars and policy makers (and certainly most citizens) do, some of the force is returned to incentive-based arguments.

In any event, the strongest case for the rational expectations assumption involves corporate or commercially sophisticated business decision-makers. This conclusion is of central importance to what I regard as the two most rhetorically powerful examples illustrating the consequentialist incentive-based case for a norm of retroactivity. The first, which deals with evolving tort standards or product safety regulation more generally, is probably the most often-cited and most compelling example of the new-view's anticipation-oriented approach to retroactivity. The second example, which deals with a particular type of tax-law change, is, in my view, an equally convincing illustration of when a strong retroactivity norm can be desirable. In the following discussion of these two examples, the point is to focus on the rational expectations assumption. As a result, the discussion in this Part assumes that the legal changes in question are desirable, that they represent legal progress the anticipation of which by the relevant parties would unambiguously increase social welfare. Part IV below examines the question under what circumstances that assumption would be plausible for these two cases.

*D. Two Strong Cases for Retroactivity: Evolving Tort Law and Closing Tax Loopholes*

1. The Products Liability Example: Rational Manufacturers

The first example derives from Louis Kaplow's 1986 article, although versions of the example appear in the work of a number of consequentialist transition scholars.<sup>37</sup> The legal change at issue is the

---

<sup>37</sup> Kaplow, *supra* note 2, at 598-601. Other versions of this example, or similar examples involving product safety or environmental regulation, can be found in other descriptions of the new-view

expansion or reinterpretation of products liability law that results in a product manufacturer's being held liable for the first time for the harm caused by its product. The question is whether and to what extent this new extension of tort law should be applied to a manufacturer that made fixed investments in the infrastructure necessary to make and distribute the product, *before the new rule was announced*. If the court decides to apply its decision retroactively, and thereby creates a binding or at least influential precedent, the resulting transition norm would have the benefit of giving other manufacturers an incentive to anticipate such expansions of tort law in the future.<sup>38</sup> Thus, a transition norm of uncompensated legal change – which, again, is the generally prevailing norm in products liability cases – gives manufacturers an incentive to anticipate desirable change in products liability law.

Part of what makes this example compelling is that one can easily imagine product manufacturers in fact responding to the adoption of a retroactivity transition norm in just this way, precisely because of the effects of competitive market forces on corporate rationality. Companies that fail to anticipate such legal change, given the retroactivity norm, will be out-competed by firms that do. Of course, the presence of such a retroactivity norm also increases the manufacturer's incentives to take political action to prevent courts from being able to expand tort law in this way. For example, because the transition norm here entails retroactivity, product manufacturer trade groups are likely to

---

case for a retroactivity norm. See, e.g., Levmore, *supra* note 12, at 1661-62 (emphasizing incentive benefits of retroactive product ban in situation in which product is originally declared safe but then subsequently found to cause harm); Shaviro, *supra* note 2, at 48 (the same). I develop more detailed version of this tort/regulatory example below.

<sup>38</sup> Jon D. Hanson & Kyle D. Logue, *The Costs of Cigarettes: The Economic Case for Ex Post Incentive-Based Regulation*, 98 *Yale L. J.* 1163, 1301-06 (1998) (making this point in support of holding tobacco companies retroactively liable for the harms caused by cigarettes).

spend more money on “tort reform” legislation that would protect them against expansions in tort law than if the norm were prospectivity. But that phenomenon will always be present and implies only that the overall optimal transition policy may be something less than full retroactivity. The point here is that the retroactivity norm in tort law is especially likely to have the desired incentive effect in the case of products liability law, when the reasonable expectations assumption seems plausible, even compelling.

## 2. The Tax Law Example: Hyper-Rational Taxpayers

Now consider an equally compelling example, this time from tax law. I have already expressed skepticism about the applicability of the rational expectations assumption to tax-law changes involving individuals’ tax returns, at least for the average individual taxpayer. The repeal of the home-mortgage interest deduction is such an example. In this section, however, I want to focus on a class of examples involving more commercially sophisticated taxpayers, examples that present, in my view, perhaps the strongest case for the rational expectations assumption in any legal setting. These examples involve various forms of tax shelters, and the taxpayers in question are either corporations who have in-house and/or outside tax counsel or individuals who are sufficiently wealthy to hire sophisticated tax advisors.

The term tax shelter is use loosely here. To label a particular transaction as a tax shelter is to imply the conclusion that Congress could not reasonably have intended the transaction to receive the tax treatment that the taxpayer asserts for it. That conclusion is true enough, but not very informative. Another possible way of describing tax shelters would be those transactions that are entered into purely for tax reasons. But that definition is obviously over-inclusive. Congress often enacts provisions that are clearly intended (or at least understood) to affect taxpayers’ incentives. Indeed, that is the whole point of such provisions. Examples of these include the tax exemption for state and local bonds and

accelerated depreciation; and for these provisions, there is at least a plausible policy justification that can be offered, whether it be to subsidize state and local governments or to subsidize certain sorts of investments in business property. Perhaps a better definition of a tax shelter, then, would be a tax-motivated transaction that relies on a nonobvious (or, in some cases, implausible) interpretation of the Internal Revenue Code that is highly beneficial to the taxpayer (in terms of lowering their taxes) and that has no plausible policy justification.<sup>39</sup>

Tax shelter activity, defined this way, can be thought of as being entirely wasteful, as creating a sort of negative externality for society.<sup>40</sup> And the analogy to products liability law thus can usefully be applied here as well. Indeed, in recent years the tax departments in most corporations have begun to understand themselves as “profit centers.”<sup>41</sup> What this means is that the tax managers or inside tax counsels of these firms are expected to come up with new “products” designed to help the company make money. In this case the products in question are new tax shelters. Because of competitive pressures, these tax managers will shop for the most creative and aggressive tax-shelter products available. Also part of this hyper-competitive dynamic are the shelter “promoters,” the law firms, accounting firms, or investment banks who employ exceptionally bright and hardworking tax experts who, among other things, scour the Internal Revenue Code and the regulations for ambiguities or

---

<sup>39</sup> I am assuming that reduction of the corporate or individual tax base generally is not a “plausible policy justification.”

<sup>40</sup> David Weisbach makes the social argues that it is not just tax shelters which produce social waste but all “tax planning.” David A. Weisbach, *Ten Truths about Tax Shelters*, 55 *Tax L. Rev.* 215, 223 (2002).

<sup>41</sup> Janet Nobak and Laura Sanders, *The Hustling of X-Rated Shelters*, *Forbes* December 14, 1998.

inconsistencies that, when exploited creatively can produce millions in tax savings.<sup>42</sup>

Part of what seems to fuel the market for tax shelters, or at least what allows this market to thrive, is the largely prospective nature of tax enforcement. Under current practice, if the Treasury Department or Congress finds a tax loophole and closes it, they typically do so nominally prospectively from the date of the new regulation or the new corrective legislation.<sup>43</sup> Sometimes those decisions are made retroactive to some earlier date, for example, the date on which the IRS issued a notice indicating the Service's interpretation of the provision and Treasury's intent to issue clarifying regulations.<sup>44</sup> But that is typically as far back as the repeal will reach. Of course, if a particular shelter gets challenged by the IRS as lacking economic substance or a substantial business purpose, and the taxpayer ends up losing the case in court, such decisions, like most court decisions, are in fact applied nominally retroactively. Many tax shelter transactions, however, never reach that point, largely because of the

---

<sup>42</sup> For an excellent recent symposium on the phenomenon of tax shelters and the appropriate responses to them, see Symposium on Corporate Tax Shelters, 55 Tax. L. Rev., Issues 2 & 3 (2002).

<sup>43</sup> The general rule is that new Treasury Regulations cannot be applied to tax years ending before the date that notice of the regulation is publicly released. IRC § 7805(b)(1). That is, Treasury Regulations must generally be applied nominally prospectively and cannot be applied nominally retroactively. *See supra* note 2 for a discussion of this distinction. Note that, prior to 1996, under the old 7805, the Treasury Department had more discretion to apply regulations retroactively, and that rule was changed in 1996 as part of the "Taxpayer Bill of Rights." For a discussion of what led up to this change, see Shaviro, *supra* note 2, at 115-17. Under the new prohibition against nominally retroactive Treasury Regulations, there are exceptions. Regulations issued within 18 months of the enactment of the rule to which the regulations relate can be nominally retroactive. Section 7805(b)(2). In addition, if necessary "to prevent abuse," Treasury Regulations can be applied nominally retroactively. Section 7805(b)(3).

<sup>44</sup> Notice 98-5, 1998-1, C.B. 334 (notice of Treasury Department's intention to issue regulations shutting down abusive tax-motivated use of foreign tax credits, which regulations would be applied retroactively only to date of notice).

audit lottery or because, even on audit, the IRS may miss the issue; or the court may apply a weak version of the economic substance doctrine.

An important transition question, then, is whether and to what extent the Treasury Department (and, when necessary, Congress itself) should apply its interpretations of the Code nominally retroactively. Under the current general rule of nominally prospective Treasury Regulations (which can be retroactive only to the year of first public notice),<sup>45</sup> the effect may be to *increase* the demand for shelters, rather than to deter their creation.<sup>46</sup> In a sense, then, current tax enforcement practices, because of the prospectivity norm with respect to legislation and the prospectivity rule with respect to new regulations, serve as a sort of planned obsolescence for tax shelters, artificially creating a need for the newest model. Moreover, according to at least one major tax-shelter promoter, the supply will be able to keep up with demand, as promoters continue to mass-produce tax shelter ideas that can then be marketed to specific clients.

In these circumstances, a norm of retroactive tax liability if applied vigorously would create some serious deterrence.<sup>47</sup> The analogy to the products liability context is, again, obvious. Just as

---

<sup>45</sup> See *id.*

<sup>46</sup> One prominent New York tax lawyer made the following observation regarding the general effect of the prospective application of tax regulations: “Taxpayers today ... have little concern about the risk fo retroactive regulations. They assume that any notice stopping a transaction will announce regulations that will only apply to subsequent transactions.” Michael Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 *Tax L. Rev.* 325, 370 (2002).

<sup>47</sup> Because not every shelter will be caught, some element of punitive damages or penalties may be necessary, just as in tort cases. For an argument that tax shelter deterrence could be largely achieved without radical changes in current deterrence policy through the use of blacklists for prohibited shelters and through enforcement against shelter promoters, see Mark P. Gergen, *The Logic of*

product manufacturers are likely to take into account the threat of products liability lawsuits in designing and manufacturing their products and hence internalize the full social cost that their products cause, so too would corporate taxpayers begin to internalize the costs of their aggressive tax planning, if they were to face a more broadly applicable transition rule of nominal retroactivity. Indeed, my main point here is to emphasize the extreme, almost hyper-, rationality exhibited by sophisticated taxpayers and their tax advisors not only with respect to what the existing tax laws are, but also with respect to how those laws are likely to be changed.

To take the products liability analogy one step further, we might imagine a system of joint and several liability, which would put shelter promoters on the hook along with taxpayers for the potential retroactive tax deficiency. On the other hand, joint and several liability might not be necessary. If retroactivity were adopted and applied only to the taxpayers themselves, the demand for tax advice might respond in interesting ways. For example, with a serious threat of nominally retroactive repeal, sophisticated taxpayers may put pressure on their tax advisors or on the shelter promoters or both to put their money where their mouth is. The taxpayers might go so far as to demand that the advisors bond their opinions by, in effect, providing retroactive tax insurance. The lawyers and accountants might in turn either self-insure this risk (if they have the courage of their convictions) or alternatively shift some of it to their malpractice carriers, who would, in turn, hire their own in-house tax lawyers to assist in the underwriting process. And so on. This infinite regress of lawyers, insurers, and more lawyers

---

Deterrence: Corporate Tax Shelters, 55 Tax L. Rev. 255 (2002). I generally like the idea of blacklisting certain prohibited shelters and of going after both taxpayers (the sophisticated ones) and promoters. See *infra* discussion in the text immediately below. My main point is that there is a very good case – both on rational expectations and legal progress grounds – that such efforts should be made nominally retroactive. I will return to the legal progress piece of this argument in Part IV below.

would mirror what we see in the tort context, where efficient deterrence has long been assumed to involve the threat of at least some degree of retroactive liability, the risk of which is shared with one's liability insurance carrier, who then has an incentive to keep an eye on the insured. Something similar could arise with respect to retroactive tax risk.

In addition to corporate taxpayers, the retroactivity rule might also be profitably applied to individual taxpayers who seek to benefit from various cockamamie interpretations of the Code being pushed by tax promoters. For example, many wealthy individuals, desperate to avoid estate and gift tax liability, will sign on to very aggressive interpretations of the trust provisions or life insurance provisions in the Code if those interpretations are endorsed by an accountant, lawyer, or shelter promoter. In those cases too, the use of sophisticated tax counsel will increase the deterrence benefit of the retroactivity norm, and the adoption of such a norm might lead individual tax-shelter promoters also to insure their advice.

In sum, a transition norm of nominal retroactivity with respect to the elimination of tax shelters likely would have the desired deterrent effect, precisely because of the rationality of such taxpayers. Part of the reason I suspect that a retroactivity norm would provide some useful deterrence in the tax shelter context is that, when the suggestion is made to apply tax-shelter repeals nominally retroactive, tax practitioners become apoplectic. This strong reaction to the retroactivity idea suggests, of course, that if such a transition policy were adopted, the affected taxpayers would suddenly have a new incentive to work extra hard to lobby Congress and, to the extent possible, the Treasury Department to avoid having their transactions characterized as illegitimate shelters in the first place. Thus, public-choice theory reminds us that some concession may have to be made to the political reality, lest we

substantially reduce the likelihood of good law changes occurring. As usual, this public-choice argument is difficult to respond to. For those of us who are relative optimists about the Treasury department's independence from lobbying taxpayers, however, the possibility of nominally retroactive shelter repeals seems worth trying.

#### IV. The Legal Progress Question

Under the consequentialist framework, with respect to *some types* of legal change, one of the essential and explicit assumptions has to do with whether the change in question is good or bad. For example, the incentive-based argument in favor of retroactivity in tort law and tax law explicitly assumes that the legal change in those areas is desirable.<sup>48</sup> The consequentialist approach, recall, is an anticipation-based argument; it depends specifically on the claim that, if private parties expect law change to be applied retroactively, they will have an ex ante incentive to make investments in anticipation of this change.<sup>49</sup> For a large class of legal changes (which, again, seem to fall heavily in the tort, tax, and regulatory areas), such anticipatory moves on the part of private actors will be desirable *if and only if* the law change in question is itself expected to be desirable – that is, only if legal progress is assumed for that type of law change.<sup>50</sup> Symmetrically, if such laws are expected to move in an undesirable direction, it makes sense under this framework to adopt a transition policy that discourages

---

<sup>48</sup> Kaplow, *supra* note 2, at 521-22, 601-02; Levmore, *supra* note 12, 1661-63; Shaviro, *supra* note 2, 48-49.

<sup>49</sup> Levmore, *supra* note 12, at 1658 (“The suggestion [of new view scholars] is that transition rules be ‘anticipation-oriented,’ designed to encourage parties to anticipate new law.”).

<sup>50</sup> Shaviro, *supra* note 2, 48-49.

anticipatory investments.<sup>51</sup> For these types of law change, a legal *progress* assumption would support retroactivity (or no transition relief), and a legal *regress* assumption would support the opposite.

According to the consequentialist framework, however, the legal-progress assumption is not a necessary part of the incentive-based, anticipation-oriented argument favoring retroactivity (and disfavoring transition relief) in *every* context of legal change. Thus, an important question that consequentialists must answer is when does legal progress matter and when not? Once that is answered, a set of equally critical, and perhaps unanswerable, follow-up questions arise: Can we identify situations in which we can expect law to make distinct, identifiable, long-term progress over time? Can we identify situations in which law should be expected *not* to make progress, where the law is expected instead to cycle back and forth between various policies either based on alternative and mutually exclusive visions of the good or, less optimistically, based on shifting coalitions among interest groups? If we identify situations in the latter category, what can transition policy do, if anything, about it? This Part will offer some tentative thoughts on these questions. A more complete set of answers will have to await another day.

A. *When Legal Progress Does Not Matter: Destructive Transitions and Other Legal Disasters*

For the anticipation-based pro-retroactivity argument, when does the legal progress or regress assumption matter? As it turns out, the assumption seems to matter most in areas such as taxation, tort law, or regulatory law more generally; situations in which the new law or policy or regulation imposes some burden on the parties who relied on the prior law, *but not so much of a burden as to destroy*

---

<sup>51</sup> Kaplow, *supra* note 2, at 601-02.

*their property entirely or to reduce the value of their pre-transition investment in a way that could not be reversed by a reversal of the legal change in question.*<sup>52</sup> This last qualification is essential, and the best way to understand is to consider an example of a situation in which the legal progress assumption does not matter.

The example that is emphasized in the literature is a particular type of government taking of private property, one that involves the destruction or demolition of improvements, for example, buildings to make room for some public project. Here again, it is the ex ante incentive effects that matter. Consider the case of an individual who is thinking of constructing a house on a site where, the individual happens to know, the government may at some point in the future to build a highway. If the highway is built, the question is whether the individual should be compensated for the value of the building, which must be destroyed to make room for the highway. To ensure that the individual has the right ex ante incentives (that is, to force her to internalize the cost of her decision to build on this site), the consequentialist framework would say no to the compensation question, assuming away for now the behavioralist critique of the rational expectations assumption from the previous Part. And this answer would apply even if the government's decision to build the road were a bad idea.<sup>53</sup> That is, society would want the individual to take into account the possibility that the government may (mistakenly or foolishly) destroy the building. In such a case, the government's decision to destroy the building can be thought of as being analogous to a natural disaster; and government-provided no-strings-attached

---

<sup>52</sup> Kaplow, *supra* note 2, at 572; Shaviro, *supra* note 2, at 48-50.

<sup>53</sup> *Id.*

compensation for natural disasters is generally undesirable from an incentives/deterrence perspective.<sup>54</sup> Thus, we want a property owner to anticipate a government taking that involves the destruction of property, even if the taking in question turns out to be bad policy.

A similar conclusion would apply to any transition that in effect *destroys* property value, that renders property worthless or substantially reduces its value under circumstances in which that value cannot easily be restored, at least not without incurring substantial new costs to do so. Various types of aggressive public regulation might fit within this idea of transition. For example, consider a product ban that permanently renders useless some significant asset of a product manufacturer.<sup>55</sup> More specifically, imagine that a manufacturer, Acme, invests a large sum of money to build a new plant for making a particular product, widgets, say, and imagine further that the plant (including the building and machinery within) are highly specialized and could not be converted to an alternative use except at enormous expense. Now consider the effect if, six weeks after the new widget plant opens, widgets are permanently banned by a federal agency because of the harm caused by widgets to individual users or to the environment, and, importantly, assume that the ban is applied to Acme. The value of the facility would fall substantially, perhaps by something close to the amount of the cost of retrofitting the plant and equipment.

The transition question, then, is whether, after the ban is adopted, compensation should be paid

---

<sup>54</sup> Kaplow, *supra* note 2, at 529. That conclusion assumes that individual property owners would, in the absence of government disaster compensation, either be forced to purchase private insurance or would in some other way internalize the cost of their decision to build in a disaster-prone area.

<sup>55</sup> Kaplow, *supra* note 2, at 572.

to Acme for the loss of its investment in the plant and equipment.<sup>56</sup> Assuming Acme and companies like it have something approaching rational expectations, the answer to the transition question is probably no. And what is important for current purposes, this answer probably does not depend on whether the product ban was in fact a good idea. Irrespective of the wisdom of the product ban, it would be socially desirable for the manufacturer to take the possibility of such a legal disaster into account in deciding whether to go into the widget business and how much to invest in making widgets safe for individuals and for the environment. This conclusion assumes that there is no prospect that the ban on widgets might be lifted in time for the manufacturer to resume production and recover the value of its investment. Rather, it assumes that the ban will be in force long enough to force the manufacturer to sell the property at a loss, abandon it, or incur significant additional costs to retool the plant for another purpose. It is in this sense that such a regulatory change, as with the destructive taking, have the quality of a disaster loss.

Put this way, we can also imagine a similar result from an extreme tort suit, or even from a new confiscatory tax. All that must be assumed in those cases is that the decline in value resulting from the new law be substantial and largely irreversible, so that the only plausible form of compensation would be direct compensation. The general lesson is that, when private parties anticipate such destructive transitions, some social gain will be produced, irrespective of the desirability of the transition itself.

There is an alternative version of this example in which the legal progress question may in fact matter. What if Acme, when widgets were banned, simply ceased production and moth-balled the

---

<sup>56</sup> Note that the example assumes that the product ban is applied retroactively to Acme and that the only form of available transition relief is direct compensation. In the next section in the text, we take up the possibility of other forms of transition relief.

plant, hoping that the ban would be repealed. Now assume that the ban was repealed and that this repeal was optimal, because the original ban was a mistake. Then the question whether to compensate Acme for the period of nonuse (or for the decline in value) of its widget plant would turn on whether we thought Acme had bet correctly on the long run future of widget regulation. Thus, if Acme had bet correctly that the initial ban was wrong-headed and would shortly be reversed in favor of the previous and socially optimal non-ban, it would be a good idea to compensate Acme ex post for that loss of value. That way future Acmes would be encouraged not to destroy or convert their plants and equipment in situations in which the ban is likely to be reversed.<sup>57</sup> Depending on how broadly one reads this exception, it is possible that the importance of the legal progress assumption to transition questions is significantly larger, and hence that the destructive-transition example is less significant, than was previously thought.<sup>58</sup>

*B. When Legal Progress Matters: Of (Non-Destructive) Torts and Taxes*

Now let us return to the tort, tax, and regulatory transitions for which the legal progress assumption is uncontroversially essential. For these types of transitions, the anticipation-inducing effects of a retroactivity norm will be desirable if and only if the transition itself is desirable.<sup>59</sup> And if the transition is undesirable, the optimal transition policy, from a consequentialist perspective, would be a

---

<sup>57</sup> It is also possible of course that the widget ban was optimal and its repeal non-optimal, which is the sort of possibility that makes the transition question so difficult to answer definitively. See *infra* Part IV.

<sup>58</sup> Reading this exception for all its worth, the set of truly destructive transitions may actually be limited to government takings that involve literal destruction of property.

<sup>59</sup> And again, this class of transitions may be small or quite large, depending on one's interpretation.

norm that actually discourages anticipation of the law change and encourages reliance on old law, such as a norm of “full prospectivity” (including “grandfather” treatment).

### 1. The Products Liability Example

To illustrate this point, consider a more elaborate version of the classic tort-transitions example from the previous section. Suppose, again, that Acme makes widgets, which is a type of consumer product that is used in millions of homes. For many years widgets have been made, sold, and used by consumers without incident, except for the occasional injury caused by an obvious misuse or by a production defect. More recently, however, there is mounting scientific (epidemiological or engineering) evidence suggesting that widgets have a design flaw that causes serious harm to consumers, harm that is not manifest until several years after the initial purchase. Based on the new studies, all of which confirm the plaintiffs’ causation theory, a court has now decided to hold Acme liable for this harm. Assume that the liability rule in question, which does not change in this version of the story, is something like strict liability with no defense of contributory (call it, enterprise liability), which the courts (or the legislature) originally adopted because of their belief in the cost-internalizing deterrence benefits of such a rule. The only change that has occurred, then, is the court’s decision to accept the new scientific evidence of causation.

Now the question is what transition rule should apply. Acme could be held liable for all harms caused by its widgets, including those produced before the new rule was announced.<sup>60</sup> That approach, which might be called *nominal retroactivity*, is the prevailing transition norm in tort cases as well as in

---

<sup>60</sup> The only limit on the application of the new rule, then, would be the statute of limitations for tort cases. With certain types of long-latency injuries, however, part of the legal transition might be to interpret the statutory period as beginning to toll only after the new evidence concerning the link between widgets and the injury was made evident.

most other types of court decisions.<sup>61</sup> Nominal retroactivity gives the new rule its maximal retroactive effect; it reaches back as far as rules can reach.<sup>62</sup> Alternatively, Acme's liability could be limited to future production of widgets, including those produced from plants that were built before the new rule was announced. That would amount to *nominal prospectivity* (to use Graetz's term), and it would obviously entail some retroactive effect as well; that is, under such a transition rule, the court's decision of liability would produce a decline in value of Acme's investment in the old widget plants.<sup>63</sup> Finally, to take the most extreme case, there is the *full prospectivity* or *grandfathering* approach. Under that transition rule, the new, more expansive interpretation of tort law would apply only to widgets produced from widget plants constructed (or substantially begun) after the announcement date would face liability. This approach would essentially give Acme (and all other current manufacturers of widgets) a pass for all harms arising from past and future widget production from widget manufacturing plants that were in

---

<sup>61</sup> See sources cited supra note 2. It is sometimes suggested that the prevailing norm of applying common law decision retroactively stems from the pre-realist traditional understanding of the role of common law courts as finding or interpreting the law rather than making it.

<sup>62</sup> This statement assumes that statutes of limitations are not negotiable. If they are, then there is almost no limit to how far back the law could, in theory, reach, though in practice there would be obvious limits. From a plaintiff's perspective, dead people and bankrupt corporations are not attractive tort defendants.

<sup>63</sup> See sources cited supra note 2. If such a transition norm were the rule, of course, it would also eliminate a plaintiff's incentive to bring the case in the first place. We can put that issue to one side for the current analysis, given that the problem could be addressed either by making an exception for the first plaintiff or by reformulating the example as a government lawsuit or a pigouvian tax. Or we could allow recovery in this case (to encourage suit), but limit recovery in other suits to future widget production.

operation (or perhaps under construction) at the time of the decision.<sup>64</sup>

To see the incentive or deterrence benefits of retroactivity in this example, compare the effects on Acme's incentives of the nominal retroactivity and full prospectivity alternatives, which are the two opposites on the transition continuum. If nominal retroactivity had been the transition norm, and Acme had known this to be so (i.e., if Acme had had rational expectations with respect to that issue), then when Acme first became aware of the mounting scientific evidence confirming the harmfulness of widgets, the company might have decided not to build its most recent widget plant, or it might have decided to implement additional socially-cost-justified safety improvements that would have dramatically reduced the risk of injury. If, by contrast, the norm had been (and Acme had rationally anticipated) grandfather treatment, even if Acme became aware of the new scientific studies, there would have been no tort-driven incentive for them to take into account the harm caused by their product. In addition, they would have received a windfall gain from the transition, since only their widget plants – and perhaps others that had been operating before the transition – would be allowed to continue operating under the old, lower cost regime.<sup>65</sup> In short, nominal retroactivity would have made

---

<sup>64</sup> If widgets were proven to represent profound health risks, a more likely form of transition relief would be to ban the product but then to compensate Acme for the cost of its lost investment. That would be roughly analogous to fully prospective tort liability, although the latter would actually be better than fully compensatory, as all pre-existing widget manufacturers would have a unique cost advantage over their competitors.

<sup>65</sup> This observation is analogous to the one made by Graetz regarding the effect of grandfathering the repeal of the exemption from federal income taxes of income from state and municipal bonds. The holders of the bonds that were tax exempt at the time of the repeal would receive a windfall gain. Graetz, *supra* note 2, at 82 (“Grandfathering a change which is motivated by a desire to increase the tax burden on the class of persons who have enjoyed a tax incentive is much like passing a law to redistribute wealth and requiring compensation to those from whom wealth was distributed. Grandfathering such changes produces windfall gains to the class of persons presumably

Acme internalize the externality it was producing; however, a grandfathered transition rule would force new producers only to internalize the externality caused by widgets, but not existing producers; and a nominally prospective rule would internalize some to the old companies and some to the new.

The choice of the optimal transition rule, at least on incentive grounds, seems obvious. Given the assumptions of the example, nominal retroactivity – which again is the prevailing norm for common law decisions – provides the most efficient level of deterrence, because it creates the maximum incentive for Acme and other manufacturers to anticipate desirable rule changes. The rhetorical power of this example, however, lies in the plausibility of its assumptions. Specifically, note how the desirability of the retroactivity norm in this example depends on the assumption of legal progress. This can be seen by observing how our intuitions change if we imagine that the courts are just as likely to accept bad scientific evidence as good. In that case, it can be argued that society is made worse off by inducing anticipation of the latest scientific findings. Likewise, if we thought that enterprise liability were not the efficient liability rule in the first place, that such a rule inhibits efficient product innovation and results in underproduction of socially desirable products and services, or if even our policy makers and citizens were divided on these questions, then anticipatory investments in expectation of the next application of that rule would not necessarily be a good thing. In both of those cases, society might be better off with a transition norm that called for new applications of enterprise liability to be nominally prospective only. In any event, the incentive-based case *in favor of* retroactivity evaporates.<sup>66</sup> Again,

---

intended to be affected adversely.”).

<sup>66</sup> If policy makers reach a consensus that enterprise liability overdeters and that scientific evidence is unreliable, the appropriate remedy is to change the liability rule and perhaps the rules of evidence. The point here is only that, if we are pessimistic rather than optimistic about the pattern of

the same point could be applied to various non-tort forms of regulation as well.

## 2. The Tax Example

We can also tell a similar story using a tax example, one that nicely illustrates both the best case for tax-transition retroactivity and the importance of the legal progress assumption. The standard example in the literature for illustrating the incentive benefits of a retroactivity norm in the tax context, which comes from Graetz's 1977 article, involves the repeal of the federal income tax exemption for state and municipal bonds.<sup>67</sup> To highlight the centrality of the legal progress assumption, assume that the reason for the repeal is this: A steady stream of economic studies have begun to reveal that the bond exemption has over the years produced a substantial degree of allocative inefficiency by distorting the investment choices of individual investors. As a result of these studies, Congress has now decided to eliminate the provision. The question then becomes how to apply the new tax law – the repeal of the provision – intertemporally. Among the possible transition rules, again, are nominal prospectivity, full prospectivity (with grandfathering), and nominal retroactivity. A nominally prospective repeal would apply only to future tax years, but would apply to the income earned from bonds purchased prior to the rule change. Interest on those pre-transition bonds, in other words, would not exclude interest. As Graetz pointed out, such a nominally prospective change can nevertheless have a substantial retroactive effect on the value of the bonds.<sup>68</sup> By contrast, full prospectivity, which would include a grandfather

---

legal development over time, we lose the incentive-based justification for retroactivity in certain important settings. This reasoning does not necessarily lead to the opposite conclusion – that the optimal incentives will be created by the opposite of retroactivity.

<sup>67</sup> Graetz, *supra* note 2.

<sup>68</sup> *Id.* at 49.

rule, would come close to full compensation for the transition loss. And finally, nominal retroactivity, which is rare in the tax context, would presumably apply not only to future tax years but to prior, unclosed tax years as well.<sup>69</sup> In Graetz's example, the repeal is ungrandfathered but made nominally prospective; and the question is whether grandfathering would produce a better outcome.

The answer, according to the consequentialist argument, is no, again assuming rationale expectations and desirable legal change. If the repeal is a good idea, as we have assumed, then the more retroactive the transition rule (the farther back into the past the new rule reaches), the better. This is because the more retroactive the repeal is expected to be, the more likely it is that the possibility of repeal would have induced taxpayers to ignore the tax exemption in the first place, a result that would have minimized the loss of social welfare attributable to the exemption. In such a situation, then, a transition norm of nominal retroactivity would be best, because the expectation of such a repeal would have done the most to prevent reliance on the tax exemption when it was enacted. The next best rule, following this argument, would be a transition rule of ungrandfathered nominal prospectivity, which protects some subset, though not all, pre-transition investments; and full prospectivity, or grandfather treatment, for all pre-transition owners of tax-exempt bonds would produce the worst outcome because taxpayers, even if they knew the exemption would eventually be repealed, would still be induced to invest in reliance on it, as their investment would be fully protected from retroactive taxation.

Now consider how all of these conclusions change if the legal progress assumption is relaxed.

---

<sup>69</sup> When transition scholars talk about nominal or full retroactivity, they almost always mean retroactivity that does not try to go back further than the relevant statute of limitations allows. Thus, there is a sense in which even this conception of nominal retroactivity is not full retroactivity.

Assume instead that the latest economic research reveals that the bond exemption has in fact been *very beneficial* overall to the economy and that, if left in place, would continue to maximize overall societal welfare. Under this assumption, repealing the provision would by definition be a bad idea. In that case, the best transition policy would be one of full transition relief, perhaps in the form of a promise to grandfather any future repeal, because such a norm would maximize taxpayer reliance on the welfare-enhancing exemption, despite the risk of its being repealed. Thus, if the legal progress assumption is replaced with a legal regress assumption (that is, if it is assumed that repeal of a particular tax subsidy provision would reduce social welfare), then a transition norm of full transition relief, or something close to it, would be optimal.

### 3. Summary

These tort and tax examples highlight the most troublesome issue for the consequentialists' transitions framework: If the choice of the optimal transition policy depends on the plausibility in various contexts of the legal progress assumption, the question then is how to determine which areas of law (if any) will generally move in a desirable direction, and which not? Can we ever say definitively that tort law should move in a particular direction or that particular tax code provisions should be maintained or eliminated? And even if it were possible to define areas of legal progress (or, for that matter, legal regress), it would remain unclear whether such categories could be drawn sufficiently precisely as to allow for the creation of transition norms that distinguish the former from the latter. Framed this way, the legal progress question poses a potentially insurmountable obstacle for the incentive- or anticipation-based argument for retroactivity. Given how difficult it is for legal policymakers and scholars to reach consensus on basic normative legal issues – questions concerning what the law ought

to look like in any given area – it seems unlikely that there will be consensus on the question concerning where the law in a particular area is headed and whether that direction is generally desirable. The practical difficulties with coming to terms with a legal *regress* assumption are even more profound. Even if we could identify areas of true legal regress, areas where we expected the law to move in a bad direction (or at least not in a consistently positive direction), adopting a transition norm based on that assumption would be deeply problematic. Imagine asking Congress to adopt a transition rule of applying tax law changes prospectively only because such changes are expected in general to be undesirable.<sup>70</sup> Thus, perhaps the best that can be hoped for is to identify general types of law or legal change that can be expected to move, over the long run, in a generally (even if not uniformly) desirable direction. And those would then be areas where it would make sense to adopt a strong norm of retroactivity, from the incentive- or anticipation-based perspective.

### *C. Taking Legal Progress Seriously*

This section attempts to take the idea of legal progress seriously in two ways. First, it hints at the sort of analysis that would be required to identify general categories of legal change with respect to which progress is more or less likely. Second, this section discusses two examples of types legal change that present exceptionally strong cases for adopting a legal progress assumption. Also, as discussed in Part III above, these examples happen to be strong cases for the rational expectations assumption as well. As a result, these are examples for which the consequentialist incentive-based justification for retroactivity is strongest. As a preliminary matter, however, let us consider briefly how

---

<sup>70</sup> Both Kaplow and Shaviro noticed this problem. Kaplow, *supra* note 2, at 566; Shaviro, *supra* note 2, at 49.

one might go about identifying areas of legal progress.

1. Courts vs. Legislatures: Evolutionary Theories and Interest-Group Politics

If it is possible to identify categories of legal change that can be expected to move in a desirable direction over time, the most promising approach may lie in some sort of structural or political explanation. Thus, an obvious distinction might be drawn between legal change that emanates from courts and legal change that emanates from legislatures. The idea would *not* be that judges are any smarter or more public-spirited than legislators, but would be that the judicial process – or the process of case law adjudication – is more likely than the legislative process to produce desirable or social-welfare-enhancing outcomes over time. There is an ambitious version of this claim, and a more modest version.

The ambitious version harkens back to a movement in law-and-economics scholarship that reached its peak during the 1970s and early 1980s in which scholars put forth models to explain why the common law should be expected to tend towards efficiency. Motivated by Richard Posner's famous claim that the common law could best be understood as furthering the goal of economic efficiency,<sup>71</sup> a number of scholars set out to do what Posner had not (at least not originally) attempted to do: to identify a selection mechanism by which the common law might evolve toward efficiency. The arguments were creative, if not wholly persuasive. For example, one argument built on the idea that, because inefficient rules produced relatively large social losses, such rules would have a greater likelihood of being litigated – and thus would be more likely on average to be overturned, the result being that inefficient rules would tend to be selected out for extinction and, by default, efficient rules for

---

<sup>71</sup> Richard A. Posner, *Economic Analysis of Law* (1<sup>st</sup> ed. 1972).

survival.<sup>72</sup> In addition, if one is allowed to assume that judges themselves tend to place value on the goal of efficiency in their decisions (either for reasons of personal politics or perceived institutional comparative advantage), the evolutionary story strengthens considerably.<sup>73</sup>

Although these evolution-towards-efficiency arguments concerning the common law purport to be only positive or predictive in nature, they are consistent with (and complementary to) well known normative arguments for promoting efficiency through the common law.<sup>74</sup> What is interesting for

---

<sup>72</sup> See, e.g., Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977); and John Goodman, *An Economic Theory of the Evolution of the Common Law*, 7 J. LEGAL STUD. 393 (1978). See also William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. Legal Stud. 235, 261 (1979) (arguing that efficient rules would have a greater tendency to be litigated but that, because of precedential effects, such a tendency would lead the common law toward efficient outcomes).

<sup>73</sup> There are, of course, many reasons to doubt the optimistic evolutionary story concerning the common law. For starters, the argument assumes that inefficient rules impose concentrated losses, leading to repeated litigation and eventual changes in the rule. If, however, the social costs caused by inefficient rules were instead widely dispersed, the selection mechanism would fail, as individuals would not have an increased incentive to litigate even the most inefficient rules. See, e.g., Richard A. Posner, *Economic Analysis of Law* 573-75 (6th ed. 2003) (pointing out some of the flaws in the evolution-towards-efficiency story). Again, however, if judges are assumed to care about efficiency (as well as about the precedential effect of their decisions), it becomes much easier to tell a plausible evolution-towards-efficiency type of story. *Id.* It is worth noting here that arguments concerning the evolutionary trend of the common law towards efficiency are distinct from, though similar in some respects to, arguments concerning the tendency of social norms to evolve towards efficiency. See, e.g., Robert Axelrod, *The Evolution of Cooperation* (1984); Randal C. Picker, *Simple Games in a Complex World: A Generative Approach to the Adoption of Norms*, 64 U. Chi. L. Rev. 1225 (1997). For a recent argument that even repeat-play interactions, in the presence of so-called “mismatch risk,” will not necessarily lead to the selection of efficient norms, see Paul G. Mahoney & Chris W. Sanchirico, *Competing Norms and Social Evolution: Is the Fittest Norm Efficient?*, 149 U. Pa. L. Rev. 2027 (2001). The recent literature on the proper interaction between norms and institutions, including courts, is of course voluminous.

<sup>74</sup> It is conventional wisdom in law-and-economics circles that the primary goal of the common law ought to be some version of Kaldor-Hicks efficiency. This is not to say, of course, that law-and-

purposes of this analysis is that, for those scholars who see the common law as generally moving in the direction of efficiency and who see that as a desirable trend, the consequentialist transitions framework – and, most importantly, the incentive-based argument for retroactivity – should have special resonance. Thus, it should come as no surprise that the argument for applying court decisions retroactively would be the most universally accepted application of the consequentialist framework at least within the law and economics community.

Given the amount of intellectual energy that has been directed toward defending, positively and normatively, the efficiency of the common law, it is striking how few law-and-economics scholars have explicitly made similar sorts of evolutionary arguments with respect to legislative change. For whatever reason, such arguments have gotten less attention than their common-law counterparts and certainly have not taken hold in the literature.<sup>75</sup> To the contrary, if there is a general trend in legislative scholarship in recent years, it would be in a much more pessimistic direction. A principal contribution

---

economics scholars care only about efficiency. To the contrary, most legal economists willing to be explicit about their normative commitments tend to favor some version of utilitarianism, or welfarism more generally, which can accommodate concerns of distributive justice. Law and economics scholars do, however, hold to the idea of a separation of functions between institutions, with the common law or private law fields (such as tort, property, and contracts) focusing exclusively on wealth maximization and the tax-and-transfer regime being the exclusive tool for wealth redistribution. See generally Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Tort Rules, and Insurance*, *Tax L. Rev.* (forthcoming 2003).

<sup>75</sup> There is an alternative account of legislative change that is more optimistic, and such an optimistic story can be grounded in a similar sort of evolutionary model. See, e.g., Jack Hirshleifer, *Evolutionary Models in Economics and Law: Cooperation Versus Conflict Strategies*, in 4 *Research in Law and Economics* 1, 47 (observing that evolution-towards-efficiency stories are “by no means limited to the arena of common law litigation. With minimal modifications the same logic can be applied also to the forces determining statute law and constitutional interpretation.”); see also Levmore, *supra* note 12, at 1662-63 (applying a relatively optimistic evolutionary story as to the ability of various types of law, including legislation, to make progress over time).

of the public-choice movement in legal and political science scholarship, for example, is to emphasize the extent to which legislative and sometimes regulatory outcomes can be best understood in terms of interest-group conflict and redistributions of wealth and power among such groups. Applying this lens to the transitions debate, an obvious conclusion to draw would be that legislative change in any given area should not be expected necessarily to evolve towards efficiency, or towards any other conception of the general good for that matter. By the same token, however, there would be no compelling reason to expect legislative change necessarily to move in a steadily worse direction, from the perspective of overall optimality. Rather, the clearer prediction of public-choice analysis might be that legislative change would tend to move in cycles, as various well-organized and relatively narrow interest groups, in effect, compete (and sometimes collude) to enrich themselves at the expense of the diffuse majority of taxpayers, who, except on rare occasions involving high-salience reform movements (perhaps organized by the proverbial policy “entrepreneurs”), are relatively powerless to prevent such abuse.<sup>76</sup>

This pessimistic account of legislative change, which admittedly is a caricature of the public-choice position, leads to the more modest version of the claim that legal progress is more likely to characterize court decisions than legislative decisions: that is, even if one is not fully convinced of the general efficiency of the common law, it has *got* to be better than most legislative lawmaking. The idea is that the legislative process is often dominated by well-organized and relatively narrow interest groups that have, at best, only an indirect interest in promoting overall social welfare (and a very direct interest

---

<sup>76</sup> There is also a cycling, or oscillation, story that can be told about shifts in the common law between the use of rules and the use of standards. Jason Scott Johnston, *Uncertainty, Chaos, and the Torts Process: An Economic Analysis of Legal Form*, 76 *Cornell L. Rev.* 341 (1991).

in redistributing to themselves); whereas, the same jaundiced assessment cannot be applied to the judicial process, at least not to nearly the same degree. And although there are obvious limits to the use of courts as a means of social policymaking, those same limits prevent the court system from being used to implement large-scale illegitimate redistribution. The most obvious difference, of course, is that to redistribute through the court system, it is necessary for one party to sue another. The beneficiaries of the redistribution (or their representatives) must formally notify the target of the redistribution (or their representatives) that redistribution is being sought; and the latter have a chance to defend themselves against the former. By contrast, in the legislative process, the most troublesome type of redistribution (exemplified proverbially by pork-barrel legislation) typically gets enacted without the average taxpayer's ever knowing about it. If this stylized picture has any real-world validity, there is a case, then, for having somewhat more confidence in the legal progress assumption in the judicial setting than in the legislative setting.<sup>77</sup>

---

<sup>77</sup> It is true that lawsuits too can have an effect similar to a redistributive tax on a widely diffuse group. For example, a series of products liability verdicts against the manufacturers of a given type of product will tend to increase the price of that product, thus passing the cost of the litigation on to the (perhaps oblivious) consumers. Even in such cases, however, the consumer's interests are being represented by, on the one hand, the plaintiffs (who are in essence "lobbying" for safer products) and the defendants (who are trying to hold costs down). And the judges or juries who adjudicate these claims are much less likely to be in a position to accept side payments in exchange for a favorable decision for either side – less likely, that is, than a legislative decision-maker. Those who are more optimistic about the legislative process (even if they are realistic about the relative likelihood of corruption) will expect to see similar alignments of interests between diffuse taxpayer groups and certain well organized groups. And those who are more pessimistic about the judicial process will doubt this picture of the unity of interest among consumers, products liability plaintiffs, manufacturers. Nevertheless, the basic point seems to hold: judicial decision-making – and thus the legal change that occurs as the common law evolves – seems less subject to untoward interest group influence, and thus somewhat more likely to produce legal progress (albeit incrementally), than is the case for legislative decision making.

These political and functional distinctions between courts and legislatures, and the resulting effects on the likelihood of good law or bad law emanating from either source, almost certainly have some important explanatory and justificatory power with respect to the existing transition norms. In the next sections, however, I want to take the analysis further, by trying to identify two cases of legal change in which (a) legal progress of a certain sort is especially likely (that is, optimism regarding the path of law in these examples is, in my view, warranted), and (b) the rational expectations assumption seems most likely to apply. Thus, I will identify two examples of legal change with respect to which the consequentialist incentive-based justification of retroactivity is likely to have the most force. Put differently, if retroactivity is not a good idea in these cases, it may never be a good idea. These examples, unsurprisingly, are the ones I have been emphasizing throughout the article: involving expanding tort law and eliminating tax shelters.

## 2. The Products Liability Example (one more time): Incorporating Scientific Progress

The first example I want to discuss involves court decision, or perhaps the decisions of a regulatory agency. In particular, let us return to the products liability example of Acme the widget-maker. Why is nominal retroactivity so obviously the right transition norm in that case, besides the structural/political story from the previous section?<sup>78</sup> Consider the following two factors: First is the plausibility of the rational expectations assumption here, as discussed in Part III above. Second is the plausibility of the legal progress assumption, which is what this section is focusing on. Recall that the only legal transition that occurred in the Acme widget story was the incorporation by the courts of the

---

<sup>78</sup> Again, a version of this example, or of the variant that involves a retroactive product ban, is almost always cited as the paradigmatic case illustrating the consequentialist's incentive-based argument for nominal retroactivity.

latest scientific evidence concerning the causal link between widgets and the harm in question. What makes this tort example so compelling is that the legal change in question is not a change in the substantive liability rule or in the choice of a measure of damages, but is an example of the law (here a court) simply resolving uncertainty as to the application of existing law. And the uncertainty resolution in this case happens to take the form of law incorporating a change in science. In fact, one might reasonably question whether this example represents a legal transition at all, as legal change is conventionally understood. However, there can be no doubt that this sort of resolution of uncertainty as to the application of existing law clearly (and rightly) fits within the notion of legal change set out by the consequentialist framework.

The importance of scientific progress to this particular example, however, cannot be overestimated. In my view, to the extent that judicial (or, for that matter, legislative) legal change can be characterized as primarily involving incorporation of new scientific discoveries, the case for applying the changes retroactively, assuming the effected parties can be expected to have rational expectations with respect to such discoveries, is reasonably strong. This conclusion is admittedly based in large part on the view that science (by which I mean the so-called “hard sciences”) itself makes progress over time. This is a view that has some force, notwithstanding Thomas Kuhn’s arguments to the contrary.<sup>79</sup>

Kuhn famously argued that science should not be understood as making cumulative progress over time. On Kuhn’s view there are periods of “normal science,” when progress is made within the existing scientific “paradigm.” In Kuhn’s view, however, although there may be long periods of progress within normal science, crises will eventually arise within the prevailing scientific paradigms,

---

<sup>79</sup> Thomas S. Kuhn, *The Structure of Scientific Revolutions* (1962).

typically prompted by problems that could not be solved using the extant assumptions. Such crises then sometimes, though not always, get resolved through what Kuhn calls a “scientific revolution” in which a new paradigm replaces all or part of the old one. The move from Ptolemaic to Copernican astronomy is the classic example.<sup>80</sup> Critically, Kuhn argues that such periods of revolution should *not* generally be understood as being cumulative in any meaningful sense, which had been the previously prevailing view of scientific progress. When such a revolution occurs, Kuhn says, the previous knowledge is considered, not just out of date, but largely wrong and is often discarded, sometimes no longer even to be taught to young scientists except in history-of-science classes. Kuhn’s views have been highly controversial within the scientific community, and I will not rehearse the criticisms here.<sup>81</sup> It should be noted, however, that Kuhn regarded science as being the one field of inquiry in which progress, at least during periods of stable paradigms, could actually be made: “If we doubt, as many do, that non-scientific fields make progress, that cannot be because individual schools make none. Rather, it must be because competing schools, each of which constantly questions the very foundations of the others. The man who argues that philosophy, for example, has made no progress emphasizes that there are still Aristotelians, not that Aristotelianism has made no progress.”<sup>82</sup>

Whatever Kuhn’s views may have been, there is a sense in which it is impossible to deny that there has been *some* degree of progress in science over the centuries. We obviously know more now

---

<sup>80</sup> *Id.* at 162-63.

<sup>81</sup> To some extent, in fact, he revised his views in response to these criticisms. Thomas S. Kuhn, *The Road Since Structure* (2000) (eds. James Conant and John Haugeland).

<sup>82</sup> Kuhn, *supra* note 83, at 162-63.

about the causes of and how to treat some diseases than we did 100, 200, or 500 years ago. That medical science has made advances is self evident. The eradication of polio and small pox, for example, have to be evidence of major scientific progress, not to mention the technological and engineering marvels represented by the personal computer and the automobile. There are of course the occasional, well-publicized scientific reversals, such as the recent news about hormone replacement therapy, when a scientific consensus takes a sudden about-face. But such reversals are most remarkable for their rarity. Moreover, once the science gets to a certain point, when a basic conclusion having been confirmed repeatedly by study after study for many years, reversals seem extraordinarily unlikely. For example, it is almost inconceivable at this point that, given the volumes of studies done over many years linking tobacco use to various illnesses, there will come a future point at which the tobacco companies will be fully scientifically exonerated (although legal exoneration may still be possible).<sup>83</sup>

Unlikely as they may be, scientific reversals nevertheless do occur, and when they do they can produce two types of error relevant to product safety regulation. Some products thought harmless will later turn out to be harmful (a false negative), and some thought harmful will be found to be harmless (a false positive). When designing transition policy in this context, then, it is important to understand the

---

<sup>83</sup> A true skeptic might here point out that for many centuries the prevailing view among medical “scientists” was that bleeding was a useful response to a wide range of health problems, and that to suggest otherwise at the time would have seemed preposterous. And yet here we are, in an age and living under a medical paradigm in which the general view among modern doctors is decidedly anti-bleeding. This observation is difficult to answer. Perhaps the best response is to say that, if I had a time machine that would allow me to go either backward or forward to find medical remedies to whatever current illness I have, I, for one, would much prefer to go forward in time; and I suspect most others would as well.

circumstances in which false negatives and false positives are relatively easy to remedy, and when they present problems that cannot easily be fixed. False negatives, for example, are relatively easily fixed by the use of nominal retroactivity itself, so long as the rational expectations assumption applies and so long as manufacturers are not judgment proof. The Acme-widget example from above involves the response to an initial false negative error on the part of science. Widgets were initially believed to be harmless. However, when that error was corrected by the accumulation of scientific knowledge to the contrary, the new information could be readily incorporated into the law through a nominally retroactive finding of liability. And expecting the application of such a retroactivity transition norm, Widget manufacturers would have been given the incentive to root out and anticipate just the sort of false negatives that were eventually discovered and corrected by the courts in this example.

That conclusion, of course, again assumes rational expectations on the part of product manufacturers. Such an assumption, according to some commentators, is unwarranted with respect to some product risks, in particular, product risks that could not possibly (or could not reasonably) have been anticipated even by sophisticated product manufacturers. The standard example of this is the asbestos case. There, the argument goes, the definitive studies linking asbestos exposure to various lung diseases involved epidemiological studies of huge populations of exposed individuals and required a fairly long period of time to sort out. Until those studies were completed, no one knew there was a link, and once those studies were completed, everyone knew; and as soon as they knew, the manufacturers of asbestos largely stopped making it, and users stopped using it. And all of this happened well before any asbestos manufacturer was found liable in tort. If a reasonable amount of investment in research and development by the manufacturer would not have changed that result, then

making the law-change retroactive may not have the desired internalizing effect.<sup>84</sup> Likewise in our example, if Acme could not have known that widgets would cause harm, because the studies revealing the harm would not be available until years after the widgets in question had already been made, sold, and used by the victims, then a transition norm of nominal retroactivity would have had little incentive benefit. Because it may be difficult or impossible, however, for a court hearing a products case after the fact to determine whether the manufacturer *ex ante* could reasonably have anticipated a given type of risk, we may decide nevertheless to impose retroactive enterprise liability in order to make sure that manufacturers have the proper incentive to invest in research and development with respect to such risks.<sup>85</sup>

What then of the problem of false positives – when a product is initially found to cause harm, but subsequent science proves that conclusion wrong? Such errors seem especially difficult to remedy or reverse. Take for example a situation with all the hallmarks of a mass tort: there is a large group of plaintiffs alleging a present injury that they say was caused by exposure many years in the past (or over a period of many years) to the manufacturer’s product; and the plaintiffs are asking the court to hold the manufacturer liable, even though there is no definitive, irrefutable scientific evidence that the product

---

<sup>84</sup> Alan Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 *J. Legal Stud.* 689 (1985).

<sup>85</sup> In the alternative, retroactive liability could be subject to be applied using a sort of fault or reasonableness standard of the following sort: If the product maker is found not to have invested reasonably in research and development into the harmfulness of its products, we will hold it retroactively liable for the harm its products cause. This is similar to the rule favored by Alan Schwartz, *supra*. However, if we thought courts generally lack the competence to determine *ex post* what the optimal *ex ante* amount of research and development is, we might prefer an enterprise liability approach.

caused the plaintiffs' harms. Now imagine that the court finds for the plaintiffs and holds the company liable. If this holding at some later date is shown to have been a mistake (based on subsequent scientific research), there is no obvious remedy for the manufacturer, who may well be in bankruptcy due to a plethora of such cases (hence the term "mass" tort) and may not be easily compensated for this disaster. And indeed, if this sort of holding amounts to a destructive taking, of the sort discussed in Part IV.A. above, we may not want to compensate the manufacturer in this, lest manufacturers not be given an incentive to anticipate the possibility of being wrongly held liable and having their businesses wiped out by a single lawsuit. We may want manufacturers to anticipate the possibility just as we want them to anticipate hurricanes and earthquakes.

One response to the problem of scientific reversals, however, is to set a relatively high evidentiary standard for courts hearing certain types of cases. For example, under the old *Frye* test, courts faced with the question of the admissibility of scientific evidence would ask whether that evidence was "generally accepted" within the relevant scientific field.<sup>86</sup> This standard has now been replaced by the considerably more liberal (that is, less exclusive) formulation found in the Federal Rules of Evidence, as interpreted by the Supreme Court in the *Daubert* case.<sup>87</sup> The analysis of this Part suggests that this liberalization of the admissibility rules with respect to scientific evidence may be

---

<sup>86</sup> *Frye v. United States*, 293 F. 1013 (D.C. Cir. 1923).

<sup>87</sup> *Daubert v. Merrill Dow Pharmaceuticals*, 509 U.S. 579 (1993). In *Daubert*, which involved tort suits against the makers of the anti-nausea drug Bendectin, the Court held that judges applying the Federal Rules of Evidence must rule on the admissibility of expert scientific testimony by engaging in a two-part analysis. First, the judge must determine whether the expert's testimony reflects scientific knowledge, whether his or her findings are based on the scientific method, and whether his or her work product amounts to "good science." Second, the judge must ensure that the expert testimony is relevant and that it logically advances a material aspect of the party's case. *Id.* at 589-92.

unwise for tort cases involving a substantial degree of retroactive liability – for example, the typical mass tort, long-latency products cases. While evidentiary standards in tort cases involving scientific evidence can be set too low (raising the likelihood of false positives), they can also be set too high. And if that happens, even fully retroactive tort law could never deter, as science might never conclusively find causation, even if there was considerable evidence of harm. I do not claim here to know what the optimal evidentiary standard is for products liability cases. My only point is that the choice of the appropriate evidentiary standard is one tool for dealing with the problem of false positives; whereas, the problem of false negatives are generally less serious.

To summarize, the prevailing norm of nominal retroactivity with respect to products liability decisions seems to find support in the consequentialist transitions framework, for several reasons. First, as discussed in Part III above, product manufacturers are likely to exhibit rational expectations with respect to both likelihood of their being held liable in tort and the likely transition norm. Second, there are structural reasons to expect legal progress to be more likely in the case of judicial decisions than in the case of legislative decisions. Third, the legal progress assumption seems especially applicable in the products context, insofar as legal change here tends to be tied closely to scientific progress. Finally, even insofar as there are worries about the effects of scientific errors on products liability cases, those worries can be reduced by carefully calibrating evidentiary rules.

### 3. The Tax Reform Cycle

It seems to be the prevailing view among U.S. tax scholars that there is little reason to be optimistic about the long term future of the tax code overall. That is, despite a growing consensus among those scholars that tax reform of one sort or another (such as legislation to broaden the tax base

a flatten the rates) would be a good idea, the prospect of serious and lasting reform of the tax laws seems unlikely.<sup>88</sup> Part of the problem, of course, is that even tax scholars who agree that the current tax code is a mess cannot agree on what the optimal or ideal tax regime would look like. But there is a more profound problem: Irrespective of the latest scholarly view (whether there is a consensus or not), the real world tax code is more likely to be shaped by interest-group politics than by academic research. To put the point in standard public-choice terms, the well-organized and interested few (namely, those taxpayers who tend to benefit from a particular tax subsidy and who tend therefore to lobby in favor of its enactment and against its repeal) should be expected to win out in over the poorly organized and dispersed taxpaying general public, whose taxes will have to go up to pay for the various tax subsidy provisions.<sup>89</sup> As Professors Ramseyer and Nakazato put the point in their critique of a legal progress assumption in the tax legislative context, “if there is no political constituency for efficient tax regimes, neither is there any general evolutionary mechanism that will cause them to develop.”<sup>90</sup>

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, with a period during which various tax subsidy or tax expenditure provisions are enacted (at the behest of various interest groups, including some economists who may believe that such provisions are good for the economy),

---

<sup>88</sup> Indeed, this is one of the main themes of Daniel Shaviro’s book on legal transitions in which he offers, among other things, a public-choice account of why tax law cannot be expected to progress over time. See, e.g, Shaviro, *supra* note 2, at 86-91.

<sup>89</sup> *Id.* at 86-87; see also J. Mark Ramseyer & Minoru Nakazato, *Tax Transitions and the Protection Racket: A Reply to Professors Graetz and Kaplow*, 75 *Va. L. Rev.* 1155, 1162-66 (1989).

<sup>90</sup> *Id.* at 1165.

followed perhaps by brief episodes of tax reform in which many of the subsidies are repealed and a more “comprehensive tax base” is adopted, followed in turn by periods of new subsidies (or new versions of the old subsidies), and so on. Again, there are disagreements about the desirability of both the tax subsidy provisions, and the comprehensive tax base idea. Nevertheless, almost no tax expert worth his or her salt would bet money on a prediction that Congress over time will tend to improve the overall tax code.<sup>91</sup> As a result, the consequentialist preference for nominal retroactivity on incentive or anticipation grounds just does not make sense for most legislative tax-law change, and the anti-nominal-retroactivity norm that currently prevails does.

#### 4. Revisiting the Tax Shelter Problem: Tax Shelter Deterrence as Legal Progress

There is a type of tax law change, however, with respect to which nominal retroactivity makes sense on incentive grounds. As I argued in Part III.D. above, tax law changes that serve only to eliminate tax shelters can have much the same welfare-enhancing incentive effect as a nominally retroactive tort liability decision. In making this argument, I am associating myself with those tax scholars who have argued that tort-like standards can have an important cost-internalizing role in the

---

<sup>91</sup> Shaviro makes a similar assessment of the future path of tax law:

Given the lengthy period over which income tax politics has been unfolding, there is no general reason why we should expect things to be getting either systematically better or worse. Applying this assumption in light of the CTB [comprehensive tax base] norm and related skepticism about tax politics, tax base changes are close to random from the standpoint of good policy; they are not much more likely to improve the tax law than to worsen it.

Shaviro, *supra* note 2, at 99-100 (footnote omitted).

normally “rule-based” system of the Internal Revenue Code, in particular, an important role in deterring tax-motivated transactions that are based on highly aggressive interpretations of the tax laws.<sup>92</sup> I agree with that position, and I would take the point one short step further: Just as with the application of tort standards in the products liability context, the application of anti-abuse standards in the tax context ought to be applied nominally retroactively, not only by courts (as is already the case) but by the Treasury Department when it issues new shelter-defeating regulations and even by the Congress when it closes loopholes legislatively.

In Part III.D. above, I made the case that, with respect to such tax law changes, the rational expectations assumption almost certainly applies. More to the point, if it applies anywhere, it applies with respect to tax shelter behavior by corporate taxpayers, or to any taxpayer who has retained sophisticated tax counsel. Now the question is why one would expect such changes to tend toward legal progress. That is, if we are to adopt a norm of nominal retroactivity with respect to anti-tax-abuse actions by the government, what confidence do we have that such actions will tend on average to be desirable? That is a fair question, and the answer is similar though not identical to the one provided in the products liability context.

First, with respect to judicial decisions applying anti-tax-abuse principles against taxpayers, there is a structural/political argument similar to the one already discussed. Courts, including courts hearing tax cases, are relatively well insulated from interest group influence. Second, it is my intuition,

---

<sup>92</sup> A prominent proponent of the use of standards in the tax context is David Weisbach. See, e.g., David Weisbach, *Formalism in the Tax Law*, 66 U. Chi. L. Rev. 860 (1999). For a general discussion of the rules/standards distinction from an incentives perspective, see Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 Duke L J 557, 568-88 (1992).

though I cannot prove it, that the Treasury Department is, as agencies go, relatively insulated from political influence as well, in part because of the wide diversity of constituencies it represents and in part because of the culture of that institution. Moreover, even if the Treasury Department (and the IRS) were susceptible to undue influence by some particular constituency, it seems highly unlikely that Treasury decisions to stop abusive tax avoidance would be a product of such influence. That is, if the Treasury Department were somehow to manage, despite powerful political interests to the contrary, to shut down a particular tax shelter, we should have some confidence that the change is optimal from a societal perspective. Third, if this argument has any force, it should apply not only to agency actions but to legislative efforts to shut down tax shelters as well. Thus, there is a class of tax legislative change that, in my view, is more likely than not over time to move in the direction of progress, and that is targeted rule-based anti-abuse legislation – by which I mean, tax legislation designed to correct a particular abusive misinterpretation of a given code section or sections.<sup>93</sup>

It is important to my analysis that this example involves the elimination, by some arm of the government (whether a court, an agency, or the legislature) of ambiguity in the tax statute. That is, tax shelters – or abusive tax-avoidance transactions – by definition depend on “aggressive” interpretations of legislative language. It is well understood that Congress when enacting particular language in the Internal Revenue Code cannot possibly anticipate all conceivable interpretations and thus cannot eliminate those interpretations that tend systematically to benefit sophisticated taxpayers or taxpayers with sophisticated tax advisors. And taxpayers, absent a credible threat of retroactivity, will have a

---

<sup>93</sup> For an argument, however, that this sort of rule-based targeted response by Congress to abusive tax avoidance leads to excessive complexity in the tax laws, see Weisbach, *supra* note 92. Weisbach thus argues in favor of greater use in the tax area of more general anti-abuse standards. *Id.*

powerful incentive to look for such latent (and, again, inevitable) ambiguities and to interpret them systematically in their favor. That is what tax lawyers do. And this systematic bias with respect to tax law interpretation will exist no matter what the likelihood of audit and ultimate detection and no matter what the penalty for engaging in such transactions, *if anti-abuse tax transitions are not applied nominally retroactively*. This is because there will always remain the incentive to exploit existing ambiguities at least until they are found out by either the Treasury Department or Congress, so long as taxpayers can expect that they will at least get to benefit from their self-serving interpretation during the interim period. The Acme-widget example is apt here. If widget-makers knew that any court decision holding them liable for the harms caused by their product (or any regulatory decision banning their product) would be grandfathered, there would be an enormous financial incentive for them to ignore those harms costs until the decision actually came down. Indeed, they might even temporarily have the reverse incentive: to accelerate widget production before the change is made in order to receive a short-term windfall gain. Analogously, to grandfather anti-tax-abuse decisions would produce a similar incentive to actually increase the use of tax shelters prior to legislative or regulatory repeal.

In sum, the very nature of the tax compliance situation creates a dynamic in which there is a systematic bias towards abusive, self-serving, and hence nonoptimal interpretations of the tax laws. Thus, there is reason to believe that legislative and regulatory decisions – just as much as judicial decisions – eliminating such interpretations would tend to be welfare enhancing. The conclusion that then follows from the consequentialist transitions framework is straightforward: The more retroactive such decisions can be, the better. This conclusion obviously ignores the public choice dynamic discussed in Part II, whereby the move to a transition norm of retroactivity would increase the incentive

of those who benefit from the abusive interpretations of the tax laws to expend political resources to stop this particular type of desirable legal change – the elimination of those interpretations.<sup>94</sup> Therefore, introducing a new norm of nominal retroactivity for regulatory and legislative anti-tax-abuse transitions – to bring them in line with the norm that applies to judicial decisions – may reduce the likelihood of such desirable transition. This is the sort of tradeoff between political and efficiency concerns that plague virtually all examples of legal transitions, certainly legislative transitions; and the ultimate consequentialist conclusion may be that something short of full nominal retroactivity should be the norm. However, the main point of my analysis here is to emphasize the clear incentive-based or anticipation-based benefits of a retroactivity norm in this context.

## **V. Conclusion**

This Article has argued that the prevailing normative framework for evaluating legal transitions – the consequentialist or economic framework – relies critically on two assumptions: the assumption that private parties (whose incentives are sought to be affected by the choice of transition norm) will behave with rational expectations and the assumption that the law will tend to change in a desirable direction. Perhaps the most important, and certainly the most well-known, insight of the consequentialist framework has been that, if both of these assumptions hold, a powerful case can be made in favor of a norm of applying legal change retroactively. To the extent, however, that these assumptions do not apply, the case for retroactivity becomes considerably weaker, at least on incentive- or anticipation-

---

<sup>94</sup> See Ramseyer & Nakazato, *supra* note 90, at 1171-73 (making a similar point).

grounds. I have argued that those assumptions are quite likely to apply – and hence a retroactivity norm will likely make good sense – with respect to two fairly narrow types of legal change: expansions in products liability law that are based on the incorporation of the latest (adequately confirmed) scientific discoveries, and moves, by Congress, courts, or the IRS to eliminate abusive tax shelter transactions. In both of those cases, there is a strong case to be made that the relevant parties – manufacturers in one and sophisticated taxpayers in the other – can rationally predict the future course of law and its application to them. And there is a strong case that these types of legal change will tend to be desirable. One way of putting my conclusion is that, if retroactivity is ever going to make sense on incentive grounds, it will make sense in these cases. The more interesting question, perhaps, is whether there are any other examples. Put differently, besides these two examples, how much real world significance does the consequentialists' incentive-based arguments for retroactivity have? That is a good question.