THE ACHES AND PAINS OF TRANSITION TO A CONSUMPTION TAX: CAN WE GET THERE FROM HERE?

Daniel S. Goldberg[*]

TABLE OF CONTENTS

[*] Carole & Hanan Sibel Research Professor of Law, University of Maryland School of Law. A.B., University of Rochester (1968); J.D., Harvard Law School (1971). The author wishes to thank Valerie Brezina, a University of Maryland law student, for her assistance in preparing this Article.

I. INTRODUCTION

Tax scholars and government policy makers are giving serious consideration to a shift from the current income tax to a consumption tax.[1] Even if there were agreement that a consumption tax was superior to an income tax, however, there would still be significant obstacles to accomplishing the shift.

This Article discusses probably the most significant obstacle to the adoption of a consumption tax: the negative effects on existing wealth that the transition from the income tax to most forms of a consumption tax would have. The Congressional Budget Office (CBO) in its 1997 study analyzed the question of "how to get there from here."[2] The difficulty with transition and the changes in the tax

---

[1] *See* PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 151–90 (2005) [hereinafter GROWTH AND INVESTMENT PROPOSAL] (proposing two Internal Revenue Code (Code) reform options, one of which is entitled the Growth and Investment Tax Plan); *see also* Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 TAX LAW. 1 (2003) [hereinafter Goldberg, *The U.S. Consumption Tax*] (asserting that the current income tax system has already evolved into an income tax-consumption tax hybrid, leaning toward the consumption tax side); Daniel S. Goldberg, *E-Tax: Fundamental Tax Reform and the Transition to a Currency-Free Economy*, 20 VA. TAX REV. 1, 11–17 (2000) [hereinafter Goldberg, *E-Tax*].

[2] CONGR. BUDGET OFFICE, THE ECONOMIC EFFECTS OF COMPREHENSIVE TAX REFORM (1997) [hereinafter CBO STUDY] (analyzing the major economic effects of several tax reform plans).

law since the CBO study, however, prompt the more basic question: "Can we get there from here?" This Article deals with this question by examining the effects of transition on existing wealth under a variety of consumption tax systems and the likely responses of transition relief under each of the systems. The consumption tax proposals considered and analyzed include direct consumption taxes (like a consumed income tax and yield exemption tax), indirect consumption taxes (like a retail sales tax and various forms of value added taxes), and combinations of the two (like the Flat Tax, X Tax, and E Tax proposals), which involve a two-tier tax structure.

Part II of the Article describes the four basic methods of operating a consumption tax and the effects of the adoption of each of these methods on existing wealth. They are (1) a consumed income tax, (2) a value added tax (VAT), which could take the form of a subtraction method VAT, a credit invoice VAT, or a retail sales tax (RST), which is analytically equivalent to a VAT, (3) a two-tier consumption tax based on a VAT, and (4) a yield exemption tax. Legislative proposals have sometimes blended two or more of these approaches. Such a blended approach was taken in the recent Growth and Investment (GIT) Plan of the President's Advisory Panel on Federal Tax Reform.[3]

Taxes are characterized based upon legal incidence of the tax (i.e., who bears the legal obligation to pay the tax), even if the economic incidence of the tax (i.e., who ultimately bears the burden of the tax) falls on someone else. Thus, taxes can be characterized as either direct taxes or indirect taxes. The consumed income tax and yield exemption tax are direct consumption taxes, because the tax is imposed directly on the individual taxpayer. The subtraction method VAT, credit invoice VAT, and retail sales tax are indirect consumption taxes, because the tax is imposed on the seller of goods and services, even though it may ultimately be paid by the individual taxpayer. Because a retail sales tax and a VAT raise identical issues, the retail sales tax will be included in the VAT discussion. A two-tier consumption tax based on a VAT is largely an indirect tax, with a direct tax component for wage earners.

As a general proposition, a consumption tax in the form of either a consumed income tax or a VAT reduces the tax on newly invested capital to zero.[4] In contrast, a consumption tax in the form of a yield

---

[3] GROWTH AND INVESTMENT PROPOSAL, *supra* note 1.

[4] Joseph Bankman & Barbara H. Fried, *Winners and Losers in the Shift to a Consumption Tax*, 86 GEO. L.J. 539, 539 (1998).

exemption tax reduces the tax on *all* capital — including existing capital — to zero.[5] The difference, then, is in the treatment of existing or "old" capital. This important proposition, as well as its significance for purposes of transition, will be explained in Part II.

In addition, these consumption tax alternatives may differ in their macro-economic effects, that is, their effects on price levels, wage levels, interest rates, and the time it would take for all of these effects to work their way through the economy. These considerations are important in choosing a replacement tax system as well as transition considerations and are dealt with in Part III.

Transition relief for existing wealth is certain to be considered in any serious proposal for fundamental change to a consumption tax. The transition issues that arise in the shift from the income tax to each of these forms of consumption tax are closely related and in many respect the same, but the mechanisms by which they operate differ depending upon the legal incidence of the form chosen. Part IV discusses transition relief issues.

Part V and VI of the Article addresses the implications of the foregoing analysis on the form of the consumption tax chosen and the prospects for change in the current landscape. Finally, an Appendix containing a simple numerical example is included in this Article in order to make the theoretical discussion of principles more concrete.

II. METHODS OF ACHIEVING A CONSUMPTION TAX AND THEIR EFFECTS ON EXISTING WEALTH

A. The Consumed Income Tax

One way to measure personal consumption is to begin with a taxpayer's income and then subtract savings or increase in wealth. Income is generally defined for economic purposes as a taxpayer's (1) personal consumption during the year plus (2) increase in wealth during the year.[6] As such, the tax base in an income tax would generally encompass both of those elements. By subtracting savings from income, the resulting tax base would capture only a taxpayer's personal consumption. In that manner, the tax would be levied directly on consumption.[7] This model of the consumption tax is

---

[5] *Id.* at 540.

[6] HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

[7] *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). Under Andrews's formulation, a taxpayer would also include borrowings in his tax base and deduct repayments.

sometimes referred to as the "cash flow consumed income tax" or simply the "consumed income tax."[8]

The consumed income tax would be computed and collected at the individual level.[9] The taxpayer would include all income, both from labor and from capital, and borrowing, and then subtract savings.[10] The amount remaining after the subtraction would constitute the taxpayer's consumption and be subject to the tax.[11] Thus, for example, an individual who saves $10,000 from his $100,000 income for the year would only be taxed on his net of $90,000.[12]

Under Professor Andrews's original proposal, the tax base would include borrowing, as indicated above, although the analysis differs somewhat for commercial and consumer loans. Commercial loans would be treated as income in the year received, with repayments of interest and principal deductible when paid.[13] However, because commercial loans are often taken out for capital investments (which are deductible under the consumed income tax), the inclusion of the commercial loans in income would not result in significantly larger tax payments in the year of the loan.[14] Consumer loans could also be included in income as a way of dealing with negative savings, but the same consumption tax effect could be achieved by excluding the consumer loan from current tax and including repayments of the consumer loan as taxable consumption expenditures, the only

---

[8] *Id.* at 1120. The consumed income tax was originally proposed by William Andrews, a Professor of Law at the Harvard Law School, in a 1974 Law Review article published in the *Harvard Law Review*. That article is generally regarded as the genesis for serious thinking about the consumption tax as a replacement for the income tax.

[9] *See generally id.* at 1120. If only an individual level tax were imposed, then individuals would be subjected to a tax on their pro-rata share of their business entities' business level consumed income in a manner similar to the current Code's subchapter K addressing partnerships.

[10] *Id.* at 1149.

[11] *Id.*

[12] Administratively, this type of consumption tax is problematic since a method must be devised to establish the amount of a taxpayer's savings. The likely solution would be to designate qualified accounts at savings banks, security brokerage houses, and other types of financial institutions to track these savings. *See, e.g.*, Paul H. O'Neill & Robert A. Lutz, *Description and Explanation of the Unlimited Savings Allowance Income Tax System*, 66 TAX NOTES 1482, 1522 (Mar. 10, 1995) (describing the type of form which would be used to keep track of savings and investments).

[13] Andrews, *supra* note 7, at 1153.

[14] *Id.* at 1154.

difference being that of timing to the advantage of the consumer.[15]

One could take account of the business activities of a taxpayer by looking through the business entity and viewing entity transactions as having been conducted by its owners. Alternatively, counterpart tax could be imposed on the business entity. Thus, in the event business taxpayers are taxed separately and their consumed income is not viewed as income of their owners, the entity would measure consumption as net income less savings and investment. As such, the consumed income tax applied at the business entity level would permit that entity to deduct from gross income any amounts spent on investment in plant and equipment or inventory during the year (in addition to ordinary operating expenses).[16] In contrast, the income tax applied at the business level would require capitalization of such expenditures if they created an asset or benefit extending beyond the year of the expenditure.[17]

This form of consumption tax was incorporated into a legislative proposal known as the USA Tax (which also incorporated a subtraction VAT at the business level).[18] The USA Tax was a hybrid consumption tax, imposed in part directly on individuals as a consumed income tax and in part indirectly by taxing businesses, to be passed on to consumers who purchased products or services from those businesses. The USA Tax did not attempt to tax consumption out of previous savings, on which tax had previously been paid. This attempt at fairness towards retirees[19] gave rise to perhaps the most significant problem with the proposal, which was the difficulty of accounting for existing liquid assets owned by taxpayers at the time of enactment, thereby leaving room for wealthy taxpayers to avoid future taxation. Moreover, there was a perceived need to prevent wealthy taxpayers from financing their consumption tax-free through borrowing, which would be possible if the tax base were limited to a

[15] *Id.*

[16] *See*, *e.g.*, Lawrence Zelenak, *Radical Tax Reform, the Constitution, and the Conscientious Legislator*, 99 COLUM. L. REV. 833, 836 (1999) (explaining that under a tax such as the USA Tax, businesses would pay tax on their total sales, reduced by inputs from other firms and for purchases of business products, such as plants and equipment). See the detailed discussion of the subtraction VAT in the text *infra* note 31.

[17] I.R.C. § 263; Treas. Reg. § 1.263(a)-2(a) (1987).

[18] The USA Tax actually couples the consumed income tax at the individual level with a subtraction VAT at the business level. *See* Murray Weidenbaum, *The Nunn-Domenici USA Tax: Analysis and Comparisons*, *in* FRONTIERS OF TAX REFORM 54 (Michael J. Boskin ed., 1996).

[19] *Id.* at 55.

taxpayer's income (reduced by savings).[20] One may consider the inclusion of borrowing in the tax base of a consumed income tax as a way of accounting for negative savings. The inclusion of borrowing in the tax base (and allowance of deductions for repayments), however, was deemed too difficult for the general public to either understand or accept.[21]

A shift to a consumed income tax would place the burden of the entire tax on that portion of income that is not saved or invested, namely consumption. The composition of the tax base, and therefore the definition of income, in this context will be very important with regard to existing wealth. In its purest form, any cash withdrawn from savings or investments and spent on consumption would be included in the tax base in the same way as if it constituted income.[22] This form would subject all existing wealth to the new tax when spent on consumption, even if the earnings that gave rise to the wealth had already been subjected to the income tax.[23] See Appendix, Example

---

[20] Henry J. Aaron & William G. Gale, *Economic Effects of Fundamental Tax Reform*, 73 TAX NOTES 967, 971 (Nov. 25, 1996) ("The USA [T]ax raises administrative problems[,] . . . . [many of which] revolve around the need to keep track of assets in existence at the time the new tax would take effect and to distinguish them from assets created later."); *see also* Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238, 2252 (2003) ("[The USA Tax] failed to include borrowing in income. A taxpayer could pay for consumption with borrowed funds and deduct salary as savings, leaving the taxpayer owing no tax.") (*citations omitted*); Alvin C. Warren Jr., *The Proposal for an "Unlimited Savings Allowance"*, 68 TAX NOTES 1103, 1108 (Aug. 28, 1995) (stating that the USA Tax "assumes that basis represents previously taxed amounts, but th[is] assumption is not valid for assets purchased with borrowed funds"). This is problematic, because it allows a deferral of taxation beyond the date of consumption and creates a timing mismatch that could be important if the graduated rates change between borrowing and repayment. *Id.* An additional problem with the USA Tax was that it failed to repeal the estate and gift taxes, and critics claimed that this was inconsistent, because "anyone who believes that each person should be taxed according to what he actually withdraws from the economic pie should . . . support the termination of estate and gift taxes because these transfers of wealth do not entail any actual consumption." LAURENCE S. SEIDMAN, THE USA TAX 58 (1997).

[21] Bank, *supra* note 20, at 2252 (stating that "the USA [T]ax was never seriously considered," both because of its inconsistencies, such as its failure to include borrowing as income and because it was deemed "overly complicated").

[22] *See* Andrews, *supra* note 7, at 1148–62.

[23] John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095, 2127 (2000) ("[I]f the United States enacted a pure transactional consumption or expenditure tax . . . it would impose huge losses on holders of existing wealth, because consumption funded by the previously taxed

1, for a numerical example of this consequence.

Presumably, the shortfall in collections resulting from eliminating a tax on saved income would be made up for by an increase in the tax rate on the smaller tax base.[24] The initial impact of an increase in tax rate would be to increase a taxpayer's cost of consumption by the increase in the tax rate, thereby leaving the taxpayer with a reduced amount of after-tax wealth to be spent on consumption.[25] Thus the value to the taxpayer of his gross amount of consumed income could be further reduced by the increase in the tax rate, with a similar impact on existing wealth. Further, one would expect demand for consumption goods to decline as a result of the effective price increase resulting from the tax incurred by spending on consumption and that some of the tax would be borne by producers and their factors of production.[26]

The first level effect of the tax would be to reduce the purchasing

wealth would be taxed again under the new form of tax.").

[24] Eliminating the tax on capital income means that higher rates must be applied to the smaller remaining tax base (i.e., labor income). *See* Jane G. Gravelle, *The Flat Tax and Other Proposals: Who Will Bear the Tax Burden?*, 69 TAX NOTES 1517, 1520 (Dec. 18, 1995) (noting that exemption of old capital from tax will result in higher taxes for the smaller base). While the exemption of such consumption may seem fairer, transition relief for old capital also fundamentally changes the nature of a consumption tax, making it essentially a wage tax. Aaron & Gale, *supra* note 20, at 969.

[25] McNulty, *supra* note 23 ("Prices probably would rise[,] . . . . [but] [e]ven if prices did not rise, the purchasing power of existing wealth would probably drop by a percentage equal to the new consumption tax rate, applied on top of old prices."). However, for those without substantial pre-transition savings who intend to save later (i.e., the young), the exemption from any tax on earnings from savings would be "large enough to offset the slightly higher tax rate imposed." Gravelle, *supra* note 24, at 1520–21.

[26] McNulty, *supra* note 25, at 2127 (pointing out that the institution of a wage tax at a higher rate could cause price changes resulting from changed demand of assets). However, it is worth noting that whether or not price increases will decrease demand depends on the relative elasticity of demand for a given good. Demand for inelastic goods does not generally decline and therefore there would not be downward pressure on prices for staples. For these goods, the producers would not share in the wealth reduction and the effective price increase would be borne by consumers alone. For a further discussion of elasticities of supply and demand, see Goldberg, *E-Tax*, *supra* note 1, at 14–15. Moreover, the timing of adjustments may be relevant. According to classical Keynsian economic theory, prices do not adjust in the short run, but the neo-Keynsian and neo-classical economic theories posit long-run price adjustment. Hence, the issue is not only which prices are capable of adjustment, but also when they may adjust. *See* Jeff Strnad, *Some Macroeconomic Interactions with Tax Base Choice*, 56 SMU L. REV. 171, 174–76 (2003).

power of a taxpayer's existing assets — that is, wealth — by a percentage equal to the amount of the tax rate less the portion of the tax, if any, borne by the producers.[27] Moreover, even if the consumed income tax represents a shift from the existing income tax, the net effect on existing wealth will also be as described above. For example, a taxpayer with no income from services but who sells investment assets in order to consume would be taxed on the full amount of those sales proceeds, which under the income tax would have been subject to tax only to the extent those proceeds exceeded the taxpayer's basis in those assets.

Thus the adoption of the cash flow consumed income consumption tax in the absence of transition relief would erode existing wealth in the form of cash by subjecting it to tax and thereby diminish its purchasing power by the amount of the tax. There would be a similar effect in the case of non-cash assets to the extent that the asset has a basis close to the fair market value of the asset. These effects would be offset by the prospect of an increase in the value of existing capital resulting from the freedom of the return on that capital from future taxation, because return on capital would be excluded from the tax base unless consumed.[28] Indeed, some owners of wealth may even derive a net benefit from these effects if they can accumulate wealth and defer consumption sufficiently.[29] Further, different assets would be affected differently. These effects will be discussed in Part III.

B. VAT Systems and Retail Sales Tax

A second way to tax consumption is to impose a tax on the sellers of goods and services (other than employees) and thereby tax consumption indirectly. One model of this indirect consumption tax is the subtraction method VAT. A subtraction method VAT is computed on an annual basis by the seller and could be collected annually at each stage of production.[30] The tax due is computed by multiplying the VAT rate by the excess of the taxpayer's gross

[27] *See supra* notes 24–26 and accompanying text

[28] *See* Shounak Sarkar & George R. Zodrow, *Transitional Issues in Moving to a Direct Consumption Tax*, 46 NAT'L TAX J. 359 (1993); *see also* William M. Gentry & R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, 11 TAX POL'Y & THE ECON. 1 (1997).

[29] *See* Sarkar & Zodrow, *supra* note 28; *see also* Gentry & Hubbard, *supra* note 28.

[30] Goldberg, *E-Tax*, *supra* note 1, at 37.

receipts over its deductible expenditures for the year.[31] The cost of raw materials and capital would be deductible in computing value added.[32] In contrast, the cost of labor and returns on capital would not.[33]

An alternative way to enact a VAT or its equivalent is to adopt a European style credit invoice VAT or a retail sales tax. Indeed, when most lay people think about a consumption tax, they think about a tax levied indirectly on consumption at the point of sale. These tax structures employ "point of sale taxation," or "transaction taxation," instead of annual taxation as under a subtraction VAT. A credit invoice tax is best understood in terms of a retail sales tax. A retail sales tax imposes a tax on the retail purchase of commodities, which could include labor.[34] Sales at stages earlier than the retail level are not subject to the tax. As discussed in a prior article, imposing the tax on the gross amount of retail sales ensures that all of the component costs of production (i.e., raw materials, labor, etc.) as well as returns on capital (i.e., interest, rent, and profits) are included in the tax base, because they will be reflected in the price of the product.[35]

A general sales tax imposes the tax at a uniform rate.[36] In contrast to a general sales tax, a selective sales tax or excise tax is levied at

---

[31] *Id.*; *see also* Alan Schenk, *Radical Tax Reform for the 21st Century: The Role for a Consumption Tax*, 2 CHAP. L. REV. 133, 139 (1999).

[32] *See generally* 3 U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984). The cost of capital is only fully deductible in a consumption style VAT, not a Gross Domestic Product (GDP) or Income Type VAT. *Id.* at 5–7.

[33] *See id.*; *see also* Gilbert E. Metcalf, *The Role of a Value-Added Tax in Fundamental Tax Reform*, *in* FRONTIERS OF TAX REFORM 91, 97 (Michael J. Boskin ed., 1996) (pointing out that value added includes the value of labor and return to capital, and therefore they would be included in the tax base). Facially, a subtraction method VAT resembles the corporate income tax, except that investments are expensed and no deduction is allowed for labor and interest costs. JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 198 (1996); *see also* U.S. DEP'T OF THE TREASURY, *supra* note 32, at 7–8. It thereby would enjoy a great deal of legitimacy and public acceptance in broad concept. If wages and interest income were taxed to the respective recipients but allowed as a deduction at the business tax level, then the remaining distinction between a subtraction method VAT at the business level and a business income tax would be the treatment of capital expenditures — deductible under a VAT but capitalized and depreciated, if appropriate, under a business income tax.

[34] *See* HARVEY S. ROSEN, PUBLIC FINANCE 441 (5th ed. 1999).

[35] Goldberg, *E-Tax*, *supra* note 1, at 34.

[36] *Id.* at 33–34 (referencing ROSEN, *supra* note 34, at 441).

different rates (including zero) on different commodities.[37] For simplicity, the analysis that follows will assume a general sales tax that is an ad valorem tax[38] like the national sales tax that is under consideration to replace the income tax.[39]

A credit invoice VAT, in substance, works like a sales tax.[40] It differs from a retail sales tax in that it is collected in stages.[41] It is this difference that results in its compliance advantages: it has built-in protection from evasion.[42] Each producer pays a tax on the value added to the product being sold.[43] The tax is implemented by means of a tax imposed at the full rate on the full value of the product when sold at retail.[44] Thus the price of the product to the consumer includes the tax computed by applying the VAT rate to the tax-exclusive price of the product or service.[45]

Under a credit-invoice method VAT, the retail seller is permitted a credit against the tax that must be remitted upon retail sale of the product.[46] The credit equals the VAT that the seller paid for raw materials, inventory, and equipment (but not wages), which was included in the price paid by the seller.[47] In this manner, the retail seller is required only to remit a net tax payment equivalent to the VAT rate times the value that the retail seller added to the product.[48]

---

[37] *Id.* at 34 (referencing ROSEN, *supra* note 34, at 442 and referring to a selective sales tax as "an excise tax, or a differential commodity tax").

[38] *See* ROSEN, *supra* note 34, at 442 (explaining that an ad valorem tax is calculated based on the percentage of the purchase price); Laurence J. Kotlikoff, *Saving and Consumption Taxation: The Federal Retail Sales Tax Example*, *in* FRONTIERS OF TAX REFORM 160, 176 (Michael J. Boskin ed., 1996) (describing a tax based on a percentage of purchase price).

[39] The national retail sales tax that has been proposed as a replacement for the current income tax, like state sales taxes, is an ad valorem tax. Ad valorem taxes are taxes imposed as a percentage of the price. Goldberg, *E-Tax*, *supra* note 1, at 34.

[40] *See* DAVID F. BRADFORD, FUNDAMENTAL ISSUES IN CONSUMPTION TAXATION 34 (1996).

[41] Schenk, *supra* note 31, at 139.

[42] *Cf.* Alan Schenk, *Value Added Tax: Does This Consumption Tax Have a Place in the Federal Tax System?*, 7 VA. TAX REV. 207, 285–87 (1987) (arguing that the VAT might reduce evasion, but this benefit would not outweigh the "attendant tax administration and taxpayer compliance costs").

[43] Schenk, *supra* note 31, at 139–40.

[44] *Id*.

[45] *Id.*

[46] Metcalf, *supra* note 33, at 93–94; *see also* Schenk, *supra* note 42, at 286.

[47] *See* Metcalf, *supra* note 33, at 93–94.

[48] Schenk, *supra* note 31, at 139.

Thus, a credit invoice method VAT collects a tax at each stage of production through ultimate retail sale, but the aggregate amount of tax collected is no greater than the amount that would be collected as a retail sales tax at the final sale.[49] The credit VAT carries the advantage of being able to be tracked and collected electronically.

If a VAT or retail sales tax were instituted in an otherwise tax-free world, prices faced by consumers would experience a one-time increase by the amount of the tax to reflect inclusion of the tax (although some of the tax may be borne by producers and their factors of production in the same manner as in a cash flow consumed income tax discussed earlier).[50] See Appendix, Example 1. The extent to which the price increase would not be as large as the new tax amount, would depend upon how the cost of the tax was shared by producers and consumers.[51] It is difficult to know *a priori* exactly how the VAT would be shared between consumers and producers and the extent to which the portion borne by producers would be passed on to wage earners and other factors of production.

On the other hand, if the VAT or sales tax completely replaced the current individual income tax, a taxpayer with earnings would have more of those earnings available to spend, having been freed from the burden of the direct tax on those earnings (assuming wages were not decreased to reflect their freedom from tax, perhaps an unrealistic assumption). The taxpayer's existing wealth as well as earnings, however, would be burdened with the new tax when spent, even if the existing wealth had previously been subjected to income

---

[49] *Id*.

[50] Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 301 (2002) ("When it first takes effect, the consumption tax might produce consumer price increases equal to the amount of the tax . . . ."); *see also* Stephen E. Shay & Victoria P. Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029, 1047 (1997) ("The economic effect [of a destination-based consumption tax] would be a one-time price increase by the tax rate . . . ."). Some of the price increases would be offset by reduced demand and some would be expected to be passed back to factors of production. *See supra* notes 24–26 and accompanying text. Moreover, if the tax were instituted in lieu of the current income tax, the price increase would be offset by the increase in their weekly paychecks due to the elimination of the income tax and therefore would have little adverse impact for the majority of taxpayers. Graetz, *supra* note 50.

[51] *See* Goldberg, *E-Tax*, *supra* note 1, at 14 (noting that the more elastic the demand curve for a product, the smaller the tax burden borne by the consumer, while the more elastic the supply curve for a product, the smaller the portion of the tax that will be borne by producers).

tax. Existing wealth, therefore, would lose purchasing power because the price of consumption goods would effectively include the new tax.[52] See Appendix, Example 2. This devaluation of the purchasing power of assets would be most easily seen with respect to cash, which would suffer from the one-time devaluation or "inflationary shot" of the inclusion of the VAT in prices of goods. Wealth in the form of property, however, would also suffer the devaluation (to the extent of its basis). On the other hand, there may be offsetting effects, including the relief that the wealth would enjoy from the burden of future tax on any income or gain that is not spent on immediate consumption by virtue of the elimination of the income tax. Further, different kinds of property will be differentially affected. In short, these effects should be the same as under the consumed income tax, absent transition relief. The potential effect on various kinds of property, including business assets and equity interests, will be discussed later.

C. Two-Tier Consumption Tax

A variation of the subtraction method VAT discussed above is the Hall-Rabushka Flat Tax, which is a subtraction method VAT that allows a deduction for wages as if they were purchases of materials.[53] Wage earners would be taxed on those wages at rates that could be set as graduated or flat, with or without a zero bracket amount, and with or without personal exemptions and deductions.[54] Hall and Rabushka proposed a flat rate equal to the VAT rate, with a limited zero bracket amount and limited individual deductions.[55]

David Bradford also proposed a two-tier consumption tax, which he called the "X Tax."[56] The X Tax consists of a modified subtraction VAT on the business side, in which wages are allowed as deductions and the remaining base is taxed at a single rate, coupled with a graduated rate wage tax on the individual side in which the top tax rate is set at the VAT rate.[57] Most recently, Bradford suggested that

[52] *See* Sarkar & Zodrow, *supra* note 28, at 362; *see also* Gentry & Hubbard, *supra* note 28, at 10–11.

[53] ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 62 (2d ed. 1995).

[54] *See id.* at 58–59.

[55] *See id.*

[56] David F. Bradford, *Principal Paper: Blueprint for International Tax Reform*, 26 BROOK. J. INT'L L. 1449 (2001).

[57] David Bradford has written extensively on this proposal, most recently in David F. Bradford, *A Tax System for the Twenty-first Century*, *in* TOWARD

the compensation tax component depart from a wage tax and instead take the form of a cash flow consumed income tax.[58]

A third two-tier consumption tax proposal is this author's "E Tax."[59] The E Tax combines a credit invoice VAT at the business level with a wage tax at the individual level. Its essential claimed advantage over the Flat Tax is that the use of the credit VAT facilitates automatic and electronic collection of the tax.[60]

A two-tier consumption tax would entail the same consequences for existing wealth as a consumed income tax or a VAT, but the mechanics would be partly those involved with each form, as discussed previously. See Appendix, Example 1.

D. Yield Exemption Tax: Exclusion from Tax of Investment Earnings

The fourth way to tax consumption is to tax all income from labor and business, regardless of whether it is saved or spent, but exclude income earned on investment assets. This method of consumption tax is referred to as "yield exemption."

Under certain assumptions and circumstances, yield exemption is the theoretical economic equivalent of the consumed income version of a consumption tax. These assumptions and circumstances are (1) uniform tax rates over time,[61] (2) the deduction produces an immediate tax saving determined by that uniform rate, and (3) the tax savings from the deduction will yield the same return as the rest of the investment.[62] Under these assumptions and circumstances, yield exemption will replicate the effect of allowing the deduction for savings as under the consumed income tax model.[63] To the extent,

---

FUNDAMENTAL TAX REFORM 11 (Alan J. Auerbach & Kevin A. Hassett eds., 2005). This was his last writing before his untimely recent death.

[58] *Id.* at 29. Under Bradford's most recent modification, the X Tax could capture the receipt of a worker's qualified retirement savings in the individual's tax base without having to view it as a type of deferred wages, which would be the case if the compensation tax component took the form of a wage tax under which investment returns were excluded from the tax base. *Id.*

[59] Goldberg, *E-Tax*, *supra* note 1.

[60] *Id.* at 48–51.

[61] This assures that the tax saved by virtue of the deduction will be collected at the same rate upon sale of the asset.

[62] This equates a yield exemption investment with an immediately deductible investment of the same amount. If the equivalence is instead based on the amount of after-tax investment, then the assumption is not necessary. *See infra* notes 63–64.

[63] To illustrate this point, consider a taxpayer's investment of $100 in year 1 for which a deduction would be allowed under the cash flow consumption tax model.

Suppose that the taxpayer's tax rate is 30% and the item will generate the cumulative amount of $200 in year 3, which will be withdrawn for consumption and therefore taxable. As a result, a post-tax investment of $70 (the result of a pre-tax investment of $100 for which a deduction is allowed) will result in pre-tax income of $200, which when withdrawn and taxed will amount to post-tax income of $140 ($200 – $60 (tax)). Under these facts, the taxpayer's net after-tax profit is $70 ($140 (post-tax return) – $70 (post-tax investment)) and rate of profit for the relevant years is 100%.

Similarly, if no deduction were allowed for the investment, but the resulting income was exempted from tax, as under the yield exemption model, then under these same assumptions, the taxpayer's rate of profit will be the same as the foregoing illustration. Specifically, the $100 nondeductible expenditure represents a post-tax investment of $100. In year 3, it generates the cumulative amount of $200, which is exempt from tax. Under these facts, the taxpayer's net after-tax profit is $100 and rate of profit for the relevant years is 100%.

In these two examples, the taxpayer's rate of profit is the same, namely 100%. Further, the taxpayer in the first example could duplicate the second taxpayer's amount of profit by investing the after-tax contribution amount of $100 instead of only $70. For example, suppose the taxpayer invested $142.86 before tax and therefore $100 ($142.86 – $42.86 (tax)) after tax to generate $285.72 before tax, representing a $200 after-tax amount ($285.72 – $85.72 (tax)), and $100 after-tax profit from the $100 after-tax amount invested. The taxpayer's rate of profit remains at 100% and his after-tax profit amount is $100 ($200 – $100).

This equivalence can be demonstrated mathematically as follows: Let C equal the after-tax contribution amount (so that $C/(1 - t)$ represents the before tax equivalent amount), r equal the rate of return and t equal the tax rate (assumed to be constant). The yield exemption savings at the end of the period will be represented by $C(1 + r)$. Under the consumed income model, the after-tax savings would be computed as follows: After-tax savings = $(C/(1 - t))(1 + r)(1 - t)$, which is the before-tax contribution $C/(1 - t)$, multiplied by one plus the rate of return $(1 + r)$, multiplied by the percentage remaining after a tax of t is imposed on the entire account upon distribution $(1 - t)$. This simplifies to $C(1 + r)$ and demonstrates the equivalence.

The above comparison is illustrated in the following table:

however, that returns to capital exceed the uniform assumed "risk free" rate of return under the above assumptions and the taxpayer under the consumed income method can not increase her after-tax investment by the amount of tax savings resulting from expensing the investment in order to take advantage of that return, yield exemption provides a greater benefit to capital than immediate expensing as under the consumed income method.[64]

The basic equivalence described above, however, facilitates comparison of the methods. The differences between the effects of

---

TABLE I. COMPARISON OF CASH FLOW CONSUMED INCOME TREATMENT WITH YIELD EXEMPTION TREATMENT

	Contri-bution	Taxes Due During Investment Period	Amount in Account,Including Earnings, at End of Period	Taxes Due at End of Period	Amount Remaining After Tax	After-Tax Profit
Cash Flow Treatment	142.86*	0	285.72	85.72**	200	100
Yield Exemption Treatment	100	0	200	0	200	100

* Represents $100 after effect of deduction: $142.86 (1 – 0.30) = $100
** $285.72 * 30% = $85.72

The above equivalence demonstrates the Treasury Department's statement that "permitting the capital cost of an asset to be expensed has the effect of exempting the income from ownership of the asset from taxation." U.S. DEP'T OF THE TREASURY, STUDY ON TAX DEPRECIATION POLICY OPTIONS, 116 CONG. REC. 25685 (daily ed. July 23, 1970). This theoretical equivalence is sometimes referred to as the Cary Brown theorem. *See* Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 103 TAX NOTES 91, 99 (Apr. 5, 2004).

The first illustration, under the cash flow consumed income model, is the method followed under the traditional IRA. The second illustration, under the yield exemption model, is the method followed under the Roth IRA. The above comparison shows them to be identical in effect.

[64] *See* Gentry & Hubbard, *supra* note 28, at 7–9. This potential effect is eliminated in the example *supra* note 63, when the taxpayer is able to "scale up" her investment without suffering a reduction in the rate of return on the investment. That is, she is able to invest the same "after-tax" amount, $100, in both instances, thereby assuring that she would receive the equivalent rate of return on the tax savings that she receives on the investment itself (condition (3) in the text). *See supra* note 62 and accompanying text. The inability to scale up when making investments generating supernormal returns, however, creates the caveat to the theoretical equivalence that is set forth in the text.

the methods are important in dealing with the transition from the current income tax to a form of consumption tax.

As noted above, the yield exemption consumption tax alternative appears to be a variation of the income tax model. The variance from the income tax is that it permits the returns from investments to be exempt from tax.

It has been argued that a yield exemption tax should be viewed as a wage tax, and therefore something different than a consumption tax.[65] Although the yield exemption tax has a close resemblance to a wage tax, this view ignores the business income component of the yield exemption tax, which necessarily taxes the return on capital devoted to business uses supplied as equity (to the extent that interest on business debt remains deductible, it is not included in the business income tax base) as well as windfall gains.[66] Thus, whereas it resembles a wage tax, it necessarily diverges from it (indeed has a broader base) largely because of the practical inability to separate (and exempt) the return from capital invested in the business from the return from personal services devoted to the business. Conversely, it also diverges from a wage tax (has a narrower base), because it effectively exempts from the tax base the return from personal services devoted to selecting and monitoring investments.

The yield exemption tax leaves existing wealth free from the erosion that afflicts the other forms of consumption tax. Unlike the VAT systems, it should not cause price levels to increase and so should not erode the purchasing power of existing wealth. Also, unlike the consumed income tax, yield on capital would not be subject to tax even if spent on consumption. Accordingly, a shift to yield exemption would actually increase the value of existing capital, because existing wealth would produce tax-free earnings, whereas under the income tax those earnings were partly or wholly subject to

[65] Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax,* 88 HARV. L. REV. 931, 938 (1975). Professor Warren viewed a wage tax and a yield exemption tax as equivalent if (1) all wealth is traceable to original savings out of wages plus simple investment income and the two are capable of being separated, so that one can be taxed while the other is not and (2) a single tax rate is applied to all earnings or all consumption expenditures, indefinitely. William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren,* 88 HARV. L. REV. 947, 953 (1975).

[66] Andrews, *supra* note 65, at 953–54. Professor Andrews pointed out that neither of Professor Warren's required conditions could realistically be met in fact, for numerous reasons including the impossibility of separating wages from investment income derived from the return on services devoted to finding the investment and wages from business income derived from capital used in the business. *Id.* at 954.

tax.[67] This effect would be somewhat moderated from a shift from the current U.S. income tax, because it already contains many yield exemption features. But, for example, a reduction in the capital gains and dividend tax rate from 15% to zero would have a positive effect on returns to capital and therefore the value of capital, even though the effect would not be as dramatic as it would be if the current tax system were a pure income tax.

More significant, however, is that a shift away from the current tax law's partial yield exemption approach to one of the other consumption tax models would magnify the adverse impact of the change on existing wealth. Further, every additional yield exemption provision inserted into the tax law makes the transition even more difficult.

III. MACROECONOMIC ADJUSTMENTS: COMPARISON AMONG CONSUMPTION TAX METHODS

As a baseline, assume first that there is a transition to the first three systems of consumption tax in a fully and instantaneously adjusting marketplace for capital, products, and labor. In real terms, the burden of the consumption taxes would fall on the consumers (although some of the burden would be shared by producers and sellers) and would result in a loss of real purchasing power of consumption goods and services for existing wealth. In the direct tax situation of the consumed income tax, it would occur in large part, because consumption purchases bore the tax. In the indirect tax situation of the VAT systems and RST, it would occur in large part, because product prices would increase. Simply put, after the change, existing wealth will have to be spent on goods that will carry an additional cost equal to the consumption tax on the goods, imposed either directly through a consumed income tax or indirectly through a VAT or RST, less any resulting price decrease brought about through market forces.

On the other hand, freedom from any future tax on capital under any form of consumption tax could increase the value of capital not spent on consumption (i.e., invested capital), because it will grow tax-free and therefore faster than under an income tax regime. The CBO and other economic analysts point out that this effect could offset the reduction in whole or in part and indeed could exceed the reduction for some people under all forms of consumption tax, if they can

[67] *See* Goldberg, *The U.S. Consumption Tax*, *supra* note 1, at 25.

accumulate wealth and defer consumption sufficiently.[68]

Even in a perfectly adjustable economy — free from long-term commitments like bonds, leases, and labor agreements — with no transition relief, some forms of capital will be disadvantaged relative to other capital. Under either a direct tax or indirect tax, the value of business assets would decline relative to cash,[69] because the basis of existing business assets could no longer be used to reduce the tax imposed on the seller of products. In contrast, cash used to purchase new business assets would permit full expensing and thereby receive more favorable treatment than existing capital. Moreover, the reduced value of business assets will be reflected in the value of equity (and potentially debt) interests in the businesses owning those assets. These effects will result under all of the forms of consumption tax other than yield exemption and the choice among them will be irrelevant as to their ultimate consequences to existing wealth, absent transition relief.[70]

The imposition of those consumption taxes, however, would launch a series of likely adjustments to price levels, debt, and other asset values and interest rates, all dependent on Federal Reserve reaction. The ultimate effects of these adjustments and Federal Reserve action will be the same regardless of the form of the foregoing consumption tax that is chosen, in an economy in which all prices, interest rates, and wages are fully and instantaneously adjustable, because the economic incidence of the taxing methods is the same.[71] They differ in their legal incidence.[72]

If there were no instantaneous adjustments, however, then the legal incidence of the tax would affect the transition period during which adjustments are made by all parties — i.e., consumers, producers, wage earners, business owners, etc. — and could have an effect that lasts beyond that period. To understand the magnitude of the effect of the choice of consumption tax on these factors, assume

[68] *See* Sarkar & Zodrow, *supra* note 28, at 362; *see also* Gentry & Hubbard, *supra* note 28, at 10–11. The possibility that the adoption of a consumption tax will increase national savings and, therefore, ultimately productivity and GDP, is beyond the scope of this Article.

[69] *See* Sarkar & Zodrow, *supra* note 28, at 363. This conclusion assumes that the Federal Reserve's reaction to the new tax is not so over-accommodative that it substantially reduces the purchasing power of cash.

[70] *See* McNulty, *supra* note 25, at 2127 (noting the impact on existing wealth in shifting to a transactional consumption or expenditure tax).

[71] *See* Goldberg, *E-Tax*, *supra* note 1, at 11–13.

[72] *See id.*

that a consumption tax in the form of a VAT were instituted in an otherwise no-tax economy. In this hypothetical, a new burden on capital used for consumption would be imposed on consumed income equal to the rate of tax multiplied by the amount of consumption. Thus the effective cost to the consumer of all goods purchased for consumption (relative to other uses of wealth) might increase by the amount of the tax imposed on that consumption (or in the case of a consumed income tax, the portion of income that is not saved). For example, if there were a 20% VAT imposed, the cost of consuming could increase by as much as 20%.[73]

The effect of the adoption of a VAT on existing wealth would be less than the VAT rate to the extent that the VAT replaced the existing corporate or business income tax.[74] But the effect on the value of business assets resulting from the disappearance of basis in those business assets[75] would be the same as it would have been under

[73] Of course, as with the imposition of any tax, classical analysis predicts that it is possible that prices might fall somewhat so that the cost of consumption would not increase by the full 20%, because the increase in the cost of consumption would dampen demand for consumption goods. In that event, consumers and producers would share the effect of the tax. Exactly what that sharing ratio would be (i.e., how much prices of consumption goods would decrease) would vary among particular goods, depending upon the elasticities of demand for those goods. But, on balance, one would expect some downward price adjustments and, therefore, some offset to the consumer's effective cost increases. Basic microeconomic theory suggests that an increase in price for a particular product reduces demand for that product, assuming some degree of elasticity of demand. HAL R. VARIAN, INTERMEDIATE MICROECONOMICS: A MODERN APPROACH 103–07 (4th ed. 1996). Because an increase in the tax rate for a good effectively increases the price of that good, it follows that demand would decrease according to the elasticity of demand for that good, thus exerting downward pressure on the price of the good. *Id. See generally* Goldberg, E-Tax, *supra* note 1, at 14.

[74] Economists generally agree that the economic incidence of a business or corporate tax falls on consumers, because businesses pass the tax to the consumers in the form of higher prices. Mark D. Urbanski, *U.S. Corporate Taxes — The Status Quo Is Not an Option*, 19 TEMP. INT'L & COMP. L.J. 219, 233 (2005). Therefore, if a VAT replaced the business tax, consumers would pay prices equal to the amount of the VAT rate less the rate of the pre-existing business tax.

[75] Under a VAT, businesses are allowed to expense the costs of capital goods and inventory, making it unnecessary to record or track basis. J. Clifton Fleming, Jr., *Scoping Out the Uncertain Simplification (Complication?) Effects of VATs, BATs and Consumed Income Taxes*, 2 FLA. TAX REV. 390, 393–94 (1995). While this feature of the VAT system is attractive on simplicity grounds, the elimination of basis for business assets would substantially reduce business wealth in the absence of transition rules. For this reason, many proponents of fundamental tax reform advocate the imposition of transition rules that would alleviate the harsh effects of the transfer.

the situation where there had previously been a no-tax economy, because a VAT results in a one-time tax on pre-existing basis.[76]

Where prices are not fully and instantaneously adjustable because some wealth is held in forms subject to long-term commitments, however, the adjustments are more complicated. Some forms of wealth would thereby be protected, but some forms of wealth would be devalued disproportionately. Adjustments for fixed contractual obligations and other commitments (such as bonds with fixed interest rates and long maturities, leases, and labor contracts or arrangements fixed by custom or expectation) may not be made quickly and indeed may be obstructed by these obligations and commitments.

The macroeconomic effects on particular investments that are fixed by long-term commitments could vary with the form of consumption tax enacted. Further, any monetary policy response to the tax change would affect these consequences as well. Manipulation of the money supply would affect nominal prices.[77] For example, if the money supply were held constant at the time of the shift to a 20% rate VAT, then price increases would be restrained and theoretically, with the appropriate money supply adjustments, could be eliminated. That would leave money and dollar-denominated financial assets, such as bonds, unaffected as to principal. But, under the classical economic model, one would expect interest rates to increase substantially as a result of the non-expansionary money supply policy choice,[78] having the effect of devaluing outstanding fixed-interest debt instruments, particularly those with long-term maturities. These increases would be tempered by the fact that interest income would not be taxed, augmenting real return, and interest expense would not be deductible, increasing the real cost of borrowed money. The net impact on bond values cannot be predicted *a priori*. Further, to the extent that debtors are affected, creditors will be equally affected but

Bradford, *supra* note 40 (advocating transition rules allowing companies to immediately deduct their basis at the time of the transition).

[76] Bradford, *supra* note 40, at 20.

[77] Monetary policy involves government manipulation of the money supply through a variety of instruments, including open market operations, changes in reserve requirements, or discount window lending. ANDREW B. ABEL & BEN S. BERNANKE, MACROECONOMICS 534, 536 (4th ed. 2001). It is generally accepted that tightening the money supply slows down the pace of economic activities, thus slowing inflation and causing prices to fall. *Id.* at 540–44.

[78] *Id.*; *see also* Alfred C. Aman Jr., *Bargaining for Justice: An Examination of the Use and Limits of Conditions by the Federal Reserve Board*, 74 IOWA L. REV. 837, 845 (1989) (noting that tightening the money supply via open market transactions or increasing reserve requirements would result in an increase in interest rates).

in the opposite direction, although many creditors were tax exempt under the income tax (e.g., pension funds, charitable organizations), so that they would obtain no additional advantage from the new exemption for interest.

The net effect of these adjustments on fixed income assets such as bonds, certain stocks and property subject to long-term leases, and other assets that are interest sensitive, would depend upon the nature and extent of Federal Reserve action. The effect on values of these kinds of assets would depend on whether the loss from the reduced consumption purchasing power of the bond (either by virtue of general price level increases or interest rate increases) would be offset by the increased value of the bonds resulting from their freedom from tax on the interest income they generate. If the former exceeded the latter, then they would suffer devaluation relative to newly issued financial or other investment assets whose rate of return (whether in the form of interest rate, dividend yield, or rent rate) would reflect the restrained money supply and resulting higher rate of return.[79]

Moreover, if the debtor is an entity, any change in value of the debt will be reflected in the value of the ownership interest of the entity. Thus, if a corporation had issued long-term fixed interest bonds and contemporaneously with the enactment of a VAT, the Federal Reserve does not expand the money supply to accommodate the VAT (thereby eliminating price level increases), any increase or decrease in the value of the corporation's bond obligations would be reflected in the value of the corporation's stock. Similarly, the value of equities could decline, because the value of their existing depreciable or saleable assets would be reduced as explained earlier. On the other hand, corporate dividends and capital gains would no longer be taxable to shareholders, so the value of equities, freed from the existing double tax burden applicable to C corporations, could actually increase.[80]

Thus, a VAT would be expected to reduce the value of assets in general and therefore reduce existing wealth of some asset owners, with the effects on particular assets dependent on what other adjustments are made by the government and the market reaction to those adjustments and other conditions. The existence of pre-existing

[79] It is generally accepted that increases in market rates cause the fair value of fixed-rate assets to fall, because the income streams they produce fall below what the market demands. THE FED. RESERVE BANK OF ST. LOUIS, INSIGHTS FOR BANK DIRECTORS: ASSET AND LIABILITY COMMITTEE, http://www.stlouisfed.org/col/director/alco/joinmeeting_sourcesofmarketrisk.htm (last visited Jan. 15, 2007).

[80] *See* Gentry & Hubbard, *supra* note 28, at 39–42.

legal obligations and commitments will affect parties differently during the transition period, because such obligations are generally not adjusted for changes in currency valuation, market interest rates, and prices.[81] Predicting the effect of a shift in the tax system on any particular assets, however, is fraught with uncertainty, because the Federal Reserve's monetary response would not be predictable.

The macro-economic effects of VAT systems do differ in one important respect from those of direct consumption taxes like the consumed income tax or the two-tier consumption taxes (as they apply to wage income). That difference involves price changes and results from the phenomenon of "wage stickiness." Under a VAT, prices of consumption goods would rise to reflect inclusion of the VAT and presumably an accommodative monetary expansion on the part of the Federal Reserve.[82] If the Federal Reserve is not accommodative, then prices would not increase and the adjustment required would apply pressure to reduce wage rates to reflect their freedom from tax. Wage rates may be prevented from being adjusted downward, however, due to the general principle of "wage stickiness."[83] Wage stickiness may result from union or employment contracts, or simply wage-earner unwillingness to accept a reduced nominal wage rate for psychological reasons, even though the workers' real wage (adjusted for the purchasing power of money) would not be reduced.[84] As a result, it is expected that the Federal Reserve would choose to be accommodative to avoid increased unemployment and the economy would experience resulting price increases.[85]

In contrast, no such issue would afflict the two-tier or the consumed income forms of consumption tax in any significant way.[86] That is because under both of those consumption taxes wages would continue to bear the tax.[87] Further, under the two-tier form wage expenditures would continue to be deductible (or give rise to VAT credits as under the E-Tax), while under a pure consumed income tax there would be no separate business component.

---

[81] Effects will also vary among similarly situated taxpayers, because, as Gentry and Hubbard have observed, "households are likely to differ in their portfolio choices." *Id.* at 14.

[82] CBO STUDY, *supra* note 2, at 65.

[83] *Id.*

[84] *Id.* at 65–66.

[85] *Id.*

[86] *Id.*

[87] *Id.*

Under a hybrid consumed income tax/VAT such as the USA Tax proposal, however, one would experience a likely one-time price increase because of the VAT business component from which wages would not be deductible. Thus, price increases would be more likely to occur under a VAT and a hybrid consumed income/VAT proposed tax than under the two-tier or pure consumed income consumption tax proposals.

Thus, the choice of the method of imposing a consumption tax is not irrelevant to the participants in the economy and, as suggested above, some of the adjustment can be affected and obstacles to adjustment overcome through manipulation of the money supply. Nevertheless, the uncertainty about particular assets in an economy with pre-existing commitments does not belie the general conclusion that aggregate wealth existing at the time of the changeover will suffer a reduction in consumption purchasing power.

In contrast to the other consumption tax proposals, a movement from a pure income tax to a yield exemption consumption tax would not create difficult transition issues for capital (other than capital currently enjoying a tax-free yield under the income tax). That is because existing wealth would not suffer reduced purchasing power by reason of the change. Rather, the value of existing wealth, on which tax has already been paid, would likely be enhanced, because it would enjoy the advantage of future tax-free yield. For example, long-term fixed income investments like bonds should increase in value under a yield exemption model, because the interest to which they are entitled would be tax-free. Also, stocks on which dividends and capital gains from sale would be tax-free would also be expected to increase in value. But, these effects could be tempered by an increased amount of investment attracted by the lure of tax-free yields and the effect of the shift in taxing regimes on the underlying companies that have issued the stocks or bonds. Presumably, their labor costs would increase by virtue of the higher taxes that would have to be borne by workers, who would demand higher wages. Also, one would expect higher taxes to be borne by the business firms themselves to make up for the revenue shortfall resulting from the change.

In addition, some particular forms of assets would be disadvantaged by the change. They would be assets that already enjoy income tax exemptions, such as municipal bonds. This exemption explains the current spread between the taxable yield on corporate bonds and the lower tax-free yield on municipal bonds. With all investment assets enjoying the attribute of tax-free yield, one would expect the market value of municipal bonds to decline. Owner occupied housing may also fall into this category. The obstacle presented by this phenomenon is discussed in Part V.[88]

Finally, to the extent that the current federal income tax is in part a yield exemption system, conversion to a pure yield exemption system would not have the magnitude of consequences as would a conversion from a pure income tax. Nevertheless, one would expect some of the wealth enhancement consequences described above to result.

IV. TRANSITION TO ALTERNATIVE METHODS OF CONSUMPTION TAX AND TRANSITION RELIEF FOR EXISTING WEALTH

The most important difference between a consumption tax and an income tax is that a consumption tax does not tax the return from savings and investment, whereas an income tax does.[89] As explained above, consumption taxes accomplish this by (1) allowing a deduction for saving and investment, as in the case of a consumed income tax, (2) taxing only amounts spent on consumption, as in the case of a VAT, or (3) directly exempting investment income from tax, as in the case of the yield exemption tax. This difference is independent of the method chosen to tax consumption. Moreover, as demonstrated above, all forms of consumption tax would tax wages[90] and all forms of consumption tax other than the yield exemption form would tax existing wealth in addition to wages.[91]

Transition rules that exempt old wealth from tax would convert any proposed consumption tax into a wage tax.[92] This is the case regardless of whether the tax under consideration is a consumed income tax, a VAT, or a two-tier consumption tax.

The method of consumption tax, in addition, can affect the ease with which transition rules can be crafted to lessen the impact of the shift on existing wealth. Indeed, transition relief that has the

[88] *See infra* Part V.

[89] Alan J. Auerbach & Kevin A. Hassett, *Introduction*, *in* TOWARD FUNDAMENTAL TAX REFORM 1, 5 (Alan J. Auerbach & Kevin A. Hassett eds., 2005).

[90] Gravelle, *supra* note 24, at 1521; *see also* Gentry & Hubbard, *supra* note 28, at 11–12.

[91] *See* Gravelle, *supra* note 24, at 1521.

[92] *Id.*; *see also* SLEMROD & BAKIJA, *supra* note 33, at 175 ("[T]he more transition relief that is provided to existing assets in the switch to any consumption tax, the more it becomes like a wage tax."). *But see supra* notes 65–66 and accompanying text (drawing a distinction between a yield exemption tax and a wage tax). Also note that a yield exemption tax needs no transition rules to exempt old wealth.

appearance of being justified and that can be given without undue administrative difficulty differs markedly among the forms of consumption tax.

A. Transition Relief for Existing Wealth Under a Consumed Income Tax

Under a consumed income tax, the tax on consumption is accomplished by imposing a tax on income (as broadly defined) that is consumed and not saved.[93] The effect of the shift to a consumed income tax from an income tax would be most pronounced with regard to dispositions of capital.[94] For example, absent transition relief, the entire proceeds of a sale of property by a taxpayer — whether investment property, business property, or inventory — would be subject to tax without offset by the basis that the taxpayer had in the property. Such a result effectively reduces the purchasing power of that old capital, because it is again subjected to tax even though it was originally purchased with after-tax money. Of course, to the extent the original cost had been deducted through depreciation or the value of the property represented untaxed appreciation, the effect described above would not be present. The undepreciated cost of a taxpayer's property, however, would be erased forever, absent transition relief.

The same effect would be obtained for withdrawals from savings accounts that are spent on consumption. Even though one might view these accounts as cash, they present the same problem as the basis in investment assets and therefore the resolution of the problem should be the same. Subjecting these accounts to tax upon withdrawal effectively reduces their purchasing power to an amount below the face amount or nominal account balance. This latter effect would present significant compliance issues with regard to hidden cash at time of enactment, which may make transition to this system without liberal transition relief a practical impossibility.[95]

---

[93] David F. Bradford, *What Are Consumption Taxes and Who Pays Them?*, 39 TAX NOTES 383, 384 (Apr. 18, 1988).

[94] McNulty, *supra* note 25, at 2128 (noting that without transition relief, the shift to a consumption tax would disadvantage existing holders of wealth).

[95] *See* Joseph Bankman, *The Engler-Knoll Consumption Tax Proposal: What Transition Rule Does Fairness (or Politics) Require?*, 56 SMU L. REV 83, 96 (2003) ("[U]nder a cash flow tax, the basis of all savings is zero, and the entire amount of dissaving is subject to tax. A cash flow tax thus increases the incentive to hide asset sales and creates an incentive to hide savings withdrawals.").

Transition relief is easily prescribed under a consumed income tax with regard to unrecovered basis and existing cash and bank accounts. It could involve reducing the taxable proceeds of sale by the basis of the property or, with regard to depreciable property, allowing continued depreciation of the basis. Similarly, taxpayers could be permitted tax-free withdrawals from cash balance savings accounts existing at the time of enactment. Those transition rules, however, would reduce the post-enactment tax collections substantially and would force higher tax rates to be imposed on the smaller base to meet revenue needs. As such, they would magnify the impact of the new tax on the cost of consumption and thereby devalue the remainder of a taxpayer's existing wealth, consisting of the previously untaxed appreciation of assets. However, as described above, this upward adjustment in tax rates would impact producers and factors of production as well. Higher tax rates would also increase the tax burden on wages.

The consumed income model has the appearance of being more worthy of transition relief than either the VAT or two-tier consumption tax. This is because the consumed income model bears a closer resemblance to the income tax on individuals than either form of VAT system or two-tier tax. The resemblance occurs largely because it is imposed on the individual directly, like the income tax. As a result, relief from the adverse impact of the shift on previously taxed existing wealth seems more justifiable as an avoidance of unfair double taxation.

Further, transition relief can be more easily accomplished administratively, because the mechanisms exist in a recognizable and acceptable form to accomplish it. For example, as explained earlier, sales of property and withdrawals of cash from existing accounts will only be impacted when spent on personal consumption, absent transition relief. But, at that time the property and accounts will suffer the devaluation discussed earlier, because only the after-tax amount will be available to be spent for consumption goods and services. Transition relief can be accomplished by continuing to use the basis concept of the income tax. Thus, a taxpayer who dissaves by selling assets and consumes the proceeds could be subjected to tax only on the proceeds, reduced by the basis in the asset. Under an income tax mindset, this type of transition relief appears justified, because basis represents expenditure with amounts on which tax has already been paid and therefore should not again be subject to tax. Similarly, savings accounts should also be viewed as having basis that includes all previously taxed principal and interest under this type of transition relief. In contrast, unrealized appreciation has never been taxed and therefore would not be entitled to transition relief. In this manner, only amounts that have already been subjected to the income tax would be protected from being subjected to the consumption tax that replaced the income tax.

The transition relief described above would convert the tax largely into a wage tax, but also a tax on unrealized appreciation and other items like deferred compensation that had not been taxed under the income tax. In the case of items that do not present the case of double taxed amounts, such as unrealized appreciation or the receipt of tax deferred income from qualified or other plans, it is unlikely that a serious argument could be made that transition relief should be available. Clearly, if no income tax has ever been collected, then transition rules are unwarranted.

B. Transition Relief for Existing Wealth Under a VAT or RST

As discussed above, the same effect on existing wealth would occur under an indirect tax in the form of a subtraction method VAT, credit invoice VAT, or RST as under a consumed income tax. In these cases, the seller would internalize the added tax in setting its prices. The resulting higher prices would devalue the amount of consumption that could be purchased with existing wealth. Further, existing business assets with basis would be devalued as well relative to newly purchased equivalent business property; this devaluation would be reflected in the value of equity interests in the affected businesses relative to equivalent newly created businesses.

As is the case with a cash flow consumed income tax, transition rules could reduce the impact of a shift on existing wealth. It is much more difficult, however, to create transition rules that are directly applicable to the consumer in a subtraction VAT than in a consumed income tax. Rather, transition rules under a VAT are typically suggested to apply at the producer level with regard to the costs of existing assets used in or purchased for production.[96]

Transition relief could ameliorate the adverse effect of these forms of consumption tax on existing wealth. In the case of a subtraction VAT, however, the phenomenon of double taxation at the

[96] *See generally* Joseph Isenbergh, *The End of Income Taxation*, 45 TAX L. REV. 283 (1990). In theory, one could provide transition protection for existing wealth by having the government subsidize spending from existing wealth. The specter of the government writing checks to private individuals in proportion to their existing wealth that is spent on consumption, however, is difficult to imagine.

individual level does not have the appearance of being unfair. Individuals who have existing wealth in the form of cash or unrecovered basis in property will not again bear the legal incidence of tax on sale. Accordingly, basis in property is treated just like unrealized appreciation in the property, but neither gives rise to gain as such. That is because the legal incidence of a VAT is on the seller. Thus only the very sophisticated would clamor for transition rules with regard to unrecovered basis in investment assets or savings, even though there would indeed be double taxation of these amounts.

At the business level, however, where the legal incidence of the tax is placed, businesses would perceive as unfair a tax on sales, offset by new purchases but not by undepreciated basis in existing assets. Cash spent on equipment or inventory, for example, would give rise to a deduction, but existing basis in the equipment or inventory would not be useable to offset sales. This divergence in treatment when viewed with an income tax mindset appears inconsistent and unfair, because it appears that basis has disappeared. As a result, any proposal to shift to a subtraction VAT is generally accompanied by a discussion of transition rules, which would permit businesses to use their bases in existing assets to offset the amount of value added upon which the VAT is imposed. Allowing a deduction or depreciation of any remaining basis in trade or business property or allowing a deduction for sales of inventory existing at the time of transition could accomplish this.

A credit invoice method point of sale VAT raises the same issues as a subtraction VAT and the solution to any perceived problem would also operate similarly, but with credits instead of deductions. Transition relief could treat remaining basis as a phantom purchase at the time of transition upon which a VAT was charged. The phantom VAT could be used as a credit against the VAT on the sale of the finished product. An RST also involves these issues, but isolates them to the retail level. Accordingly, the retailer could expect the same kind of transition relief, if any, that would have been forthcoming under a credit VAT.

Under any of the methods of permitting transition relief under an indirect tax, the one-time wealth effect on businesses and their owners of the consumption tax imposition would be moderated. A one-time expected price increase resulting from the enactment, however, would nevertheless occur, assuming accommodative monetary policy to avoid unemployment brought on by wage stickiness.[97] Moreover,

[97] *See* McNulty, *supra* note 25, at 2179, n.269 (noting that adoption of the VAT

transition relief as described above would decrease revenues from the new tax and thereby require higher tax rates than would be necessary absent that transition relief.[98] Those higher rates would magnify the effects of the tax on consumption price levels and thereby reduce old wealth, whose values were particularly sensitive and vulnerable to price level increases.[99]

C. Transition Relief Under Two-Tier Consumption Tax Proposals

Adjustments at the consumer/wage earner level should be relatively easy under the two-tier consumption tax proposals. This is because the two-tier proposals are essentially VAT systems, modified to allow a deduction or credit to businesses for wages paid, thereby shifting the legal incidence of the portion of the VAT imposed on wages to the wage earner. As such, the transition to the new tax would be easy, because the changes in tax collection mechanics would be minor. Indeed, most wage earners would pay a tax very similar to the tax paid under the income tax, although this tax would be simplified, because it would include only wage income in the tax base. Thus wage earners' after-tax income would not be much different than under the income tax, depending upon which two-tier proposal was adopted and which tax rates were chosen.

At the business tax level, however, the same VAT transition issues would arise with regard to unrecovered basis. As a result, the same possible transition relief as discussed earlier would have to be considered.

D. Transition Relief for Existing Wealth Under Yield Exemption Tax

In contrast to the other forms of consumption tax, one would expect that a shift from an income tax to a yield exemption consumption tax would advantage existing wealth, as discussed earlier. It would therefore find favor among those who already possess wealth and live off investment income. Retired people and older workers would tend to fall into this category. From a transition relief viewpoint, this result seems fair with regard to existing cash and savings and investments in which a taxpayer has a basis, because tax

---

would likely cause a one-time price increase equal to the rate of the tax unless the tax were moderated by transitional relief).

[98] Jane G. Gravelle, *The Distributional Effects of Fundamental Tax Revisions*, 33 SAN DIEGO L. REV. 1419, 1456 (1996).

[99] *See generally id.*

has already been paid on these amounts when earned. The bonus to yield exemption arises from taxpayers who own appreciated assets. These taxpayers have enjoyed tax deferral under the income tax regime on unrealized appreciation, and will never be taxed on those amounts. The effective forgiveness of past-deferred tax gives yield exemption a retroactive effect and a bonus to property owners that varies with the amount of their built-up appreciation in their property.

Similarly, beneficiaries of deferred income under qualified plans or other plans could also escape tax on those investments, unless these deferred income amounts were viewed instead as earnings from services subject to tax or become the subject of adverse transition rules subjecting them to tax. Either of these alternatives appears both fair and likely. Indeed, the contrast between yield exemption and the other consumption tax models can best be illustrated and explained by reference to the treatment of distributions from a qualified retirement plan. Absent a transition rule to the taxpayer's detriment, distributions from qualified retirement plans would also go untaxed under a yield exemption system, even though earned under the income tax regime and never subjected to tax previously. Under all of the other consumption tax models, in contrast, distributions received would be taxed if spent on personal consumption at the very least. It is also possible that Congress would insist that they be subjected to tax when received under a special rule that would apply the repealed income tax to them, as might be done under yield exemption as well.

Presumably, as indicated above, budget shortfalls from the adoption of a pure yield exemption tax would be made up by wage earners and business owners (other than shareholders of C corporations), who would continue to be taxed on their wage and business income. These taxpayers could experience an increase in their tax burdens. They would tend to be younger and middle aged workers who have not yet entered into their high savings years.

E. Comparison of Effects of Transition Relief

An important observation about the contrast between the yield exemption model and the other consumption tax models can be made at this point. The difference in the consequences to wealth between a yield exemption consumption tax and other methods of consumption tax is not mandated by the choice, but rather lies in the transition to it.

For example, wealth created after the effective date following enactment would have essentially similar treatment under all of the methods. Under a consumed income tax, a taxpayer could avoid tax on that wealth by saving it. Similarly, under a VAT, a taxpayer could avoid the tax by not spending it on consumption goods or services. Finally, under a yield exemption tax, the taxpayer would avoid tax on any earnings from the newly created wealth, which is an essentially equivalent treatment.[100]

On the other hand, under the likely forms of enactment (in their pure forms) and absent transition relief, existing wealth will not share equivalent treatment. Under a cash flow consumed income consumption tax, existing wealth in the form of property — when converted to cash — will become subject to tax on its full value. Thus, under a consumed income tax, wealth owners will lose the benefit of their basis upon which they have already paid tax. Further, absent transition relief, they would also lose the benefit of unrealized appreciation of property upon sale if they consume the proceeds. Moreover, even with the likely transition relief of being permitted to avoid tax on existing basis, the unrealized appreciation will still be subject to tax.

Similarly, a VAT would also subject the entire value of a business property to tax when sold. Absent transition relief, previous expenditures to the extent capitalized and as yet undepreciated will also be subject to tax, because they will not offset sales proceeds of the business. Further, the purchasing power for consumption goods and services of individuals' wealth will be devalued by the imposition of the tax. Businesses may receive transition relief with regard to their previously taxed basis, but it is unlikely that any transition relief will be forthcoming to those whose wealth has been devalued by the VAT generally.

The more favorable treatment of existing wealth under a yield exemption consumption tax, however, is not dependent on transition relief. Indeed, because there is already a yield exemption component part of the existing income tax, any transition deviation from the yield exemption method would be to limit its benefits, a very different dynamic than transition relief. Absent such transition deviation, appreciation that has occurred in the past would escape taxation, in the same manner as would future appreciation. Existing wealth that was created but not taxed under the income tax regime will never be taxed, unless Congress acts to affirmatively tax it through a mark-to-market approach to transition upon enactment, a very unlikely event. Failure to tax this amount could be viewed as favoring existing wealth

[100] See *supra* note 63 (comparing the consumed income model with the yield exemption model using a numerical example).

over future accumulations. It would shift the burden of funding government onto future wage earners and businesses by means of higher tax rates compared to what would be the case if the appreciation that had escaped tax could be captured in the tax base.

V. IMPLICATIONS OF THE ANALYSIS ON THE CHOICE OF CONSUMPTION TAX

As explained above, the selection of the form of consumption tax is as important as the decision to adopt a consumption tax. That is because the effect on existing wealth can be quite different among the alternative consumption tax regimes, particularly during the transition period, depending upon the transition relief that is enacted. While there is disagreement as to the magnitude of the differing effects on old wealth that would result from the adoption of the various of consumption tax alternatives and likely transition rules that would be enacted, there should be agreement that yield exemption will be kinder to existing wealth than either form of VAT, RST, or a consumed income tax. Both theory and practical political analysis support the view that it will be far kinder.

The implications of the foregoing conclusions are immense. They include class warfare and intergenerational issues; the adverse effect on activities that currently enjoy tax advantages; the likely fight over transition relief; grandfather rules and phase-ins, with their consequential higher tax rates to make up for the resulting revenue shortfall; and, importantly, the recognition that there is a substantial impediment to reaching what may be the most efficient tax system. These will be discussed in turn.

A. Class and Intergenerational Warfare

Class warfare is generally defined in terms of wealth, but could also be defined in terms of income or consumption spending, which may or may not draw different dividing lines than wealth. With regard to the choice of consumption tax, wealth would seem to be the most likely source of division. As explained earlier, the consumed income and VAT consumption taxes disadvantage wealth. They should therefore reduce wealth differences, because they disadvantage existing wealth by reducing its purchasing power of consumption goods and services.[101] Yield exemption, on the other

[101] Interestingly, since wealth and high income are closely associated, they also result in greater progressivity than yield exemption. Gentry & Hubbard, *supra* note

hand, advantages existing wealth and therefore likely enhances wealth differences.

Wealth itself, however, would not be the only cause of division. Earning power from labor would also be a divide. Those who have the ability to earn money from their work, which would not be taxed unless spent under a consumed income regime, VAT, or two-tier consumption tax regime, might view the benefit of tax-free income as outweighing the detriment of eroded wealth that can be spent on consumption. Retired people or those living off invested capital, on the other hand, likely would view these forms of consumption tax with hostility. Indeed, they would be more likely to sense the unfairness of double taxing savings amounts on which income tax had already been paid,[102] unless extensive transition relief for existing wealth accompanied the change.[103]

Social security recipients, who, in a sense, are living off accumulated wealth in the form of a government promise of their social security pensions, which can be valued in present value terms, may be most hostile, because they have the smallest cushion to the change. Adjustments might have to be made in social security benefit payments similar to the indexing of social security payments with the wage index. As one can see, a shift to these forms of consumption tax without a lengthy transition would face a difficult political battle.

In contrast, the battle would be quite different if the consumption tax that was adopted were a yield exemption form. In that case, the wealthy and retirees would have little reason to object to the shift, and the complaining parties would be those taxpayers who were required to make up the revenue shortfall through higher taxes on wage or business income. The potential harm to those people would be speculative, depending upon future legislative measures to raise

28, at 24–26.

[102] *See id.* at 10–11. However, Gentry and Hubbard also note that if corporate stock prices increase because of the elimination of the tax on corporate dividends and capital gains, the elderly are likely to also benefit disproportionately because of their disproportionately large share of ownership of those assets. *Id.* at 17. On the other hand, they would be net losers from the resultant devaluation of tax exempt bonds, of which as a class they own a disproportionately large amount. *Id.* at 18.

[103] *See* Sarkar & Zodrow, *supra* note 28, at 372 (noting the importance of transition relief for existing wealth on the welfare of the elderly: *see also* M. Kevin McGee, *Alternative Transitions to a Consumption Tax*, 42 NAT'L TAX J. 155, 155–56 (1989) (observing a likely dramatic and inequitable welfare loss to the elderly from a shift to a VAT, which could be ameliorated by employing a "personal expenditure tax" — a consumed income tax with a transition relief exclusion for existing wealth by permitting that wealth yield exemption treatment).

revenue. Among taxpayers and Congressmen, hope and self-delusion about tax increases can generally be relied upon to obfuscate any otherwise foreseeable future tax increases, notwithstanding Ricardo's assertion that expected future tax will be taken into account by current taxpayers.[104]

B. Effect on Tax-Advantaged Activities

A shift from the current income tax to a consumption tax in any of the various forms would also affect certain currently tax-advantaged activities. This could occur through the elimination of the advantage, such as by the effective elimination of any charitable contribution tax benefit to an individual under a VAT, because the legal incidence of the VAT is on businesses and not individual taxpayers. It could also occur by virtue of the leveling of the playing field under a consumption tax, such as by eliminating the tax advantage of life insurance under a yield exemption tax, because all investments would enjoy the advantage of inside build-up, now reserved for life insurance company products. Similarly, traditional retirement savings special benefits would be eliminated under a consumed income tax, under which all savings enjoy a deduction. If special incentives were desired for certain activities, they could be tailored to the type of tax involved. But, presumably, one reason for the adoption of a new taxing system would be to eliminate all or most of this special treatment.

The elimination of special treatment of certain investments could have an effect on the value of those investments. Owner occupied housing is perhaps the most important example. The shift from an income tax to a consumption tax could involve a reduction in the value of home prices resulting from the effective elimination of the tax subsidy of deductible home mortgage interest. Home ownership already enjoys the tax benefits of non-taxability of imputed income from the use of the home and excludability from income of all or most of the gain on the sale of the home (for most taxpayers);[105] these

[104] DAVID RICARDO, ON THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION ch. 29 (John Murray ed., 3d ed. 1821). Ricardo's assertion (known as "Ricardian Equivalence") posits that consumers characterize government borrowing as a future tax liability.

[105] Section 121, which contains qualification requirements, limits the scope, in general, to a home used by the taxpayer as her principal residence for two to five years prior to the sale and limits the benefit to $250,000 of excludible gain for a single individual and $500,000 of excludible gain for a married couple. I.R.C. § 121(a)–(b).

would continue (or even be enhanced) under a yield exemption tax system or current legislative iterations of the other consumption tax methods. Under all consumption tax methods, however, tax benefits for home mortgage interest, such as a deduction under a consumed income tax or exclusion from VAT, would not be allowed, unless the subsidy was somehow retained. This phenomenon would create downward pressure on home prices, unless interest rates declined correspondingly.[106]

Robert Hall has suggested that the subsidy could be retained under his two-tier "Flat Tax," by designating existing mortgages eligible for transition relief, which would entail continuing to allow a deduction for interest but requiring the lender to continue to include the interest in income. Post-enactment mortgages also could continue this treatment or, alternatively, neither permit a deduction nor require inclusion, in which event they would carry a lower interest rate.[107] Any replacement tax system would have to deal with the destabilizing effect to many people of a change that could reduce the value, or increase the carrying cost, of this investment.

Most of the proposals in the political arena have retained or created special rules for home mortgage interest. This demonstrates that regardless of the system chosen to replace the current income tax, transition rules are possible to protect the politically untouchable, but at the cost of retaining the current tax system's inefficiencies.

C. The Fight Over Transition

Wholesale transition to a VAT or consumed income tax would be destabilizing and perceived as unfair, regardless of the form in which it is implemented — consumed income tax VAT, or two-tier consumption tax. Those who have paid tax on previous earnings, but will be required to pay tax again when their after-tax saved earnings are spent on consumption, will view the result as unfair double taxation. They will perceive it as unfair that recently purchased assets

[106] See Sarkar & Zodrow, *supra* note 28 at 362, who discuss this likely effect in the context of a consumed income tax, because it would change the relative prices of assets that are now receiving disparate treatment under the income tax. *But see* Gentry & Hubbard, *supra* note 28, at 43–45 (suggesting that other factors such as lower interest rates could cause house prices to increase or would blunt any decrease, so that no simple conclusions are possible).

[107] Robert E. Hall, *Guidelines for Tax Reform: The Simple, Progressive Value-Added Consumption Tax*, *in* TOWARD FUNDAMENTAL TAX REFORM 70, 78–79 (Alan J. Auerbach & Kevin A. Hassett eds., 2005).

or cash will fare no better under the replacement system than appreciated assets or deferred retirement plan distributions, on which no tax has previously been imposed.

These objections can be dealt with through transition and grandfather rules. As explained earlier, previously taxed income in the form of basis in property can be allowed as a deduction or be treated as depreciable under a subtraction method VAT or can give rise to a phantom credit under a credit invoice VAT. Similarly, under a consumed income tax, basis can be allowed to offset amount realized in computing gross income, from which savings can then be deducted in arriving at the consumed income tax base. Arguably, anti-abuse rules would also be required in this latter situation to ensure that wealthy taxpayers are not able to turn over all of their investments to achieve a deduction for all of their bases in their assets, which would not be available if they had simply retained those assets.

In addition, announcing a shift to a consumption tax could stop transactions during the hiatus between the announcement and the effective date. For example, if a subtraction VAT were announced, to be effective at a future time, prospective purchasers could defer their purchases until the VAT became effective, so as not to lose the benefit of their basis in the purchased goods. Waiting would entitle the purchaser to an immediate deduction.

Of course, in some cases the disadvantage to the buyer in purchasing before the effective date would be offset by the advantage to the seller of that timing, allowing the seller to offset gain by the basis in the item sold. In those cases, impending law change would largely cause a reduction in price to the buyer to take account of the effects on buyer and seller. But, one would also expect the impending change to retard production in situations in which there is no seller offset to the buyer's disadvantage of purchasing before the effective date. Moreover, both parties would have to take into account the risk of non-enactment in the period between the proposal of the change and enactment.

Similarly, transactions that are crossing the transom when the enactment becomes effective not only raise issues of equity and wealth destruction, but also invite harmful speculation by prospective purchasers, who will make purchase decisions based on tax considerations instead of business needs. Permutations include the treatment of contracts for sale of goods or services for which prices are set, which are entered into under the income tax regime but performed under the VAT regime; the treatment of construction projects begun before the effective date but completed after; and similar long-running transactions. These kinds of transaction issues, however, are not different from changes occurring within the income tax as a matter of course on what has become a regular basis, at a time when similar types of long-running transactions are in progress. These transition issues in and of themselves should not present an insurmountable impediment to a shift. In that sense, they pale in comparison to the more important wealth reduction impact of any shift to a VAT, consumed income, or two-tier consumption tax, which could make such a shift difficult from a political point of view. They do, however, augment the obstacles to change that are already present and therefore need to be confronted.

On the flip side, excluding previously untaxed qualified retirement plan distributions from the tax base in any of these alternative systems would cause those systems to be retroactive in effect, because they would not attempt to tax income that was actually earned under the replaced income tax regime. As such, the consumption tax regime would seem to be unduly favorable to those individuals. A similar argument can be made with regard to unrealized appreciation, which perhaps should be taxable upon conversion to the new system, although the literature does not appear to deal with this latter possibility.

Any transition relief will necessarily result in higher tax rates under the substitute system than would be needed in the absence of such relief in order to compensate for the revenue lost from not taxing capital. Disincentives resulting from high tax rates would be magnified as a result and new investment could be adversely affected. On the other hand, instituting a consumption tax system (other than a yield exemption system) without transition relief would reduce individual wealth available for consumption, as discussed earlier, but may thereby create additional incentives to work and save in order to restore that wealth.

One solution to the transition problem resulting from a shift to a consumption tax that is not a yield exemption system is gradual change. A direct or indirect consumption tax could be phased in over several years, accompanied by a promise of upwardly adjusting social security benefits tied, as they are today, to a wage index, but also to the increased tax-inclusive cost of goods, as would likely be the case under a VAT. This gradual approach would be taken at the cost of greater complexity.[108]

Further, retirees who are beneficiaries of taxable pensions or

[108] Sarkar & Zodrow, *supra* note 28, at 367.

401(k) and similar defined contribution retirement accounts could be assuaged by allowing those account payments to be received at reduced income tax rates or even tax-free, because they would bear the consumption tax when spent. But, this transition relief may over-compensate those who perceive a disadvantage from the change to the extent that they can continue to accumulate in this tax advantaged way and defer consumption.

Ultimately, there will be a stock of existing wealth that has been accumulated on an after income tax basis that will bear the burden of the shift. To the extent that certain types of wealth are carved out from the burden-bearing wealth through special transition rules, existing wealth that does not fall into a favored category will have to absorb an even greater burden if revenue shortfalls are to be avoided. As Sarkar and Zodrow point out, gains and losses from the transition will be essentially "arbitrary and capricious," and therefore inequitable to the extent that the existing tax has been in effect for a long time; thus current "windfall losses" are not merely reversing previous "windfall gains," and the tax reform that is enacted is largely unexpected, so that it is not already reflected in asset prices.[109] Moreover, this perception is likely to be magnified, in their view, if gains from reform are widely distributed but losses are highly concentrated.[110] It seems unlikely that any mix of transition relief, grandfather rules, and phase-ins can satisfy all constituencies, and the results of the political battles may very well not yield an objectively determined best solution.

D. Recent and Proposed Income Tax Changes as an Impediment to Change

One can discuss fundamental tax reform in academic and aspirational terms, but ultimately, the process of tax reform is a political process. Those who perceive themselves as losers in the change will act to block the change. When the losers are wealthy, the political power they can exercise will likely be out of proportion to their numbers. When they are retirees or soon-to-be retirees, who are well organized, they are also apt to have political power greater than their numbers. These forces combined provide a formidable force for the proponents of change to overcome. Gradual change and transition relief will likely be required to overcome these forces.

[109] *Id.* at 359.

[110] *Id*. at 360.

The magnitude of these forces will likely be greater than they were twenty years ago during the last attempt at genuine tax reform in 1986. Since that time, many full or partial yield exemption provisions have been added to the Code to create a truly hybrid tax system. Moving from a yield exemption system which, from a pure income tax perspective, unduly favors existing wealth, to one that punishes it, presents a step that may now be too great to make by legislative fiat. Transition relief may be inescapable if the attempt to make the step, indeed the leap, has a realistic chance of success.

Thus, it is tempting to approach fundamental tax reform in terms of income tax versus consumption tax and the resulting winners and losers from any such shift. That narrow focus, however, misses the real struggle and particularly misperceives the interests that have grown around the yield exemption elements of the current tax, such as the non-taxation of unrealized appreciation, special tax rates for dividends and capital gains, and Roth-type retirement or savings benefits both currently in the law and proposed. Indeed, wealthy consumption tax advocates may prefer a yield exemption hybrid to a direct or indirect pure consumption tax; as a result, they could oppose such a shift in the interests of the status quo, as expanded by Retirement Savings Accounts (RSA) and Lifetime Savings Accounts (LSA) recently proposed by the Bush Administration.[111]

VI. CONCLUSION AND PROSPECTS FOR CHANGE

Transition to a consumption tax (other than yield exemption) may require a gradual approach, both as a matter of equity, perceived and real, and practicality. Accordingly, as a conceptual matter, transition would have to be accomplished through interim steps. For example, one could speculate about a transition to a two-tier credit invoice VAT, modified by an allowance of a deduction for wages while taxing those wages to workers (the E Tax discussed earlier), with scheduled annual increases over five to seven years. As the new tax is phased in, the income tax would be adjusted downward simultaneously by reducing the tax rates on individual income (other than wages) and on businesses across the board by the same number of percentage points by which the VAT is increased. The phase-out would create a zero

[111] *See* Goldberg, *The U.S. Consumption Tax*, *supra* note 1, at 14–15 n.70 ("The Bush Treasury Proposal would have both simplified and expanded individual retirement arrangements by replacing traditional, Roth, and nondeductible IRAs with Retirement Savings Accounts (RSAs) and would have permitted other kinds of tax advantaged savings through Lifetime Savings Accounts (LSAs).").

bracket amount in the income tax (other than for wages) and for businesses that would be enlarged as the years passed and the VAT was fully phased in. In effect, this latter change would, during the five to seven year transition period, permit taxpayers to adjust to the gradual wealth destruction effect of the VAT. Ultimately, after the phase-in period has been completed, there would be a two-tier consumption tax in the form of the E Tax and the adverse effect on those living off existing wealth would have occurred gradually. The pain, however, would be spread over more and younger people.

A gradual approach could be devised in similar fashion to apply to the cash flow consumed income form of consumption tax, other VAT systems, and the combinations and variations of these forms such as the USA Tax, the Flat Tax, and the X Tax, respectively.

The forces of reform, however, may be working against any shift to a consumption tax (other than yield exemption) even with transition relief in the form of gradual phase-in. As the income tax gradually becomes a yield exemption wage and business tax, existing wealth owners may view the consumption tax battle as having already been won without cost and without the need to make compromises. Possessors of existing wealth may be reluctant to support an alternative consumption tax system that would erode the consumption purchasing power of some of their wealth. Reform in other consumption tax directions may then be elusive, because it would lack the group that would be its natural supporters.

On the other hand, income tax defenders who have less wealth may see a consumed income or VAT consumption tax as the lesser of evils and indeed a positive reform from a wage tax, which the income tax is inextricably approaching. That is because the enactment of a consumed income tax and consumption VAT in effect imposes a one-time implicit tax on existing wealth (which is equivalent to a tax on the present value of the future income stream from capital[112]) and thereby makes the consumption tax progressive (or at least less regressive) in income tax terms. As a result, a VAT or two-tier consumption tax may have a larger constituency than it would have had ten or twenty years ago, when the tax system was more of an income tax than it has since become and particularly than where it appears to be headed.

[112] David Shakow & Reed Shuldiner, *Symposium on Wealth Taxes Part II: A Comprehensive Wealth Tax*, 53 TAX L. REV. 499, 513, 525 (2000).

APPENDIX

The effect of a consumed income tax on existing wealth can be illustrated by using a simple numerical example. Assume two sellers, Manufacturer M, who manufactures widgets and sells them at wholesale for $56, and Retailer R, who buys them from M and resells them at retail to the ultimate consumer, C, for $80. Assume also that those are the only sales that M and R engage in during the year. M pays wages of $40 to Employee W. R pays no wages. In addition, assume that sellers can pass any cost or tax increase to their customers and no party is able to pass any cost or tax increase back to factors of production. Further, assume that the imposition of taxes has no effect on demand or supply of any products or labor, so that the full amount of the tax must be internalized by the taxpayer upon whom the legal incidence of the tax is imposed, which will be reflected in its prices to customers. Also, assume that wages in terms of dollars (i.e., nominal wages), can never decline as a result of tax changes or any other economic changes (the assumption of "wage stickiness") and that the money supply is allowed to increase just enough to reflect higher costs, so that the policies under discussion are not affected by either inflationary or deflationary biases. Initially, assume that all of C's wealth is held in the form of cash. (The analysis will ignore the effects on the economy from any imposition of the new tax, as in Example 1, or any overall tax reduction that could result from the shift to a consumption tax using the same tax rate, as in Example 2. It will also ignore any business level income tax in order to simplify the numerical analysis).

Example 1. Consider first the enactment of a consumed income tax at the tax inclusive rate of 20% in an otherwise tax-free economy. Upon C's purchase of R's product for $80, C would be subject to a tax equal to $20 (20% * $100). This would be the case even if the entire $100 were derived from C's savings. Thus, C's wealth would have suffered a devaluation of 20% in that what used to be purchasable for $80 of wealth would now exhaust $100 of wealth. The new consumed income tax would have effectively caused a $20 diminution in C's wealth.

The effect of a subtraction method VAT, credit VAT, and retail sales tax on existing wealth can be illustrated by the above numerical example also. Assume the enactment of a subtraction method VAT at a tax inclusive rate of 20%. Under the simplifying assumptions stated above, the price charged by R will increase by $20, so that R will sell its product for $100 instead of $80. 80% of the price, or $80, will be retained by R and 20%, or $20 will be paid by R and its suppliers in tax. In particular, M. who previously was willing to sell its product for $56 will build its tax of $14 (20% * ($56 + $14)) into its price to R. R, in turn, who previously was willing to sell its product for $80 when it purchased it at wholesale for $56, will now sell it for $100. R will pay M $70, retain its profit of $24, and build in its tax on that profit of $6. The $6 tax (20% * ($100 – $70)) will be paid out of the $30 spread, leaving the $24 profit intact. Under that scenario, C will have to pay $100 for goods that he could have formerly purchased for $80. Thus, C's wealth would have suffered diminution of $20 and a devaluation of 20% ($100 – $80). A credit VAT and RST will operate in the same manner. This is the same effect on wealth as under the consumed income tax, but via a different mechanism.

Finally, the enactment of a two-tier consumption tax, in which both business and labor are subject to a flat tax-inclusive 20% tax, will affect prices in the same manner as other forms of VAT and the RST, with yet a slightly different mechanism. The full 20% tax will be imposed directly on W. Thus, W will incur a tax of $10 (20% * ($40 + $10), which he will pass on to his employer under the assumptions of the example by demanding a wage increase from $40 to $50. M's business tax will be computed by subtracting $50 from its wholesale selling price of $70. This $70 builds W's passed-though $10 tax into M's wholesale price, which becomes $66 instead of $56, and includes M's own tax of $4 (20% * ($70 – $50)). Thus, the resulting tax to M will be $4 instead of $14, as under a pure subtraction VAT. Together, W and M will pay combined tax of $14, the same as under a pure subtraction VAT.

R will incur a tax of $6, computed as (20% * ($100 – $70), and will sell its product for $100. In essence, R's retail price to C adds the aggregate taxes of W ($10) and M ($4), which are embedded in M's wholesale price to R, and R ($6), and R's pre-tax price of $80. Again, the net effect of the two-tier tax would be to increase price levels by the tax to $100. It would thereby devalue C's wealth by that amount. It now costs C $100 to purchase what used to cost $80, representing a 20% devaluation of wealth (($100 – $80)/100). Table 1 sets forth these results.

TABLE I. IMPOSITION OF CONSUMPTION TAX ON A TAX-FREE ECONOMY

Method of tax	Beginning wealth	Tax imposed upon use for consumption	Consumable wealth after direct tax on C	Price increase	Reduction in consumable wealth after direct tax and price adjustment
Consumed income	100	20	80	0	20
Subtraction method VAT (credit VAT)	100	0	100	20	20
Two-tier tax	100	0	100	20	20

Example 2. Consider now the effects on existing wealth if the various forms of consumption tax replaced an individual income tax instead of being imposed on a tax-free economy as in the previous examples. Assume the former tax inclusive income tax rate is also 20% and that W earns a gross amount of $50, so that his net after-tax earnings is $40. Under a consumed income tax, the wealth reduction effect would be exactly the same as in the previous example. Wealth shifted to consumption would now be subject to the 20% tax. C would exhaust $100 of wealth to purchase R's product, which previously cost him $80. He would thereby suffer reduced purchasing power of $20 and his wealth would be devalued by 20%.

Similarly, under a VAT, the cost of goods would increase by the amount of the tax (keeping with the assumption in the example of taxes being passed forward to customers). W, who previously earned $50, and therefore $40 after tax, before the replacement of the income tax, would now have the entire $50 available to spend on consumption, a $10 increase in nominal spending capacity. Consumption products, however, would now cost $112 instead of $80. That is because M would continue to earn its previous profit of $16 by selling its product at a wholesale price of $82 out of which it would pay W's wages of $50 and its VAT of $16. R would continue to earn its $24 net amount after tax, but would have to pay out of its $112 sales proceeds (1) $82 to M and (2) $6 of VAT, for total payments by R of $88. Thus, the effective increase in wages would be reflected in the product price paid by C, which would increase from $100 to $112.

Existing wealth, therefore, would have suffered a loss in nominal purchasing power of $32. What previously cost $80 would now cost

$112, thereby devaluing existing wealth. However, $12 of the $32 price increase experienced by C will be the result of a one-time inflationary effect. That is, the cost increase resulting purely from the imposition of the tax will be $20 and the $12 portion of the increase reflects the increased cost of labor, which would not bear any tax directly, but would not suffer any reduction because of the phenomenon of wage stickiness that was assumed. This occurs because the tax on labor was paid by the employers without reducing the overall cost of the labor.

In a fully adjustable economy (without wage stickiness), it would be expected that the elimination of the income tax would cause wages to decline to $40 from $50, allowing the "after-tax" wage amount to remain the same. Our basic assumption of wage-stickiness, however, precluded this from occurring. As indicated in the previous set of examples, a credit VAT and RST would have this same effect.

The two-tier consumption tax, however, permits an easier adjustment for the economy. By imposing the legal incidence of the portion of the VAT attributable to wages on W instead of M, the two-tier consumption tax permits the wage-earner, W, to be unaffected by the shift from income tax to a consumption tax. That is because W's after-tax wage income will be $40 both under the income tax and the replacement consumption tax. But, M's VAT will be $4 (20% * ($70 – $50)) instead of $14 (20% * $70) as under a pure VAT. The aggregate tax on W and M will remain at $14, which will be passed through to R. R will bear a tax cost of $6 as before and will resell its product for $100, which will include the original $80 plus $20 in aggregate "new" taxes. Table 2 sets forth these results.

TABLE II. IMPOSITION OF CONSUMPTION TAX AS A REPLACEMENT FOR AN INDIVIDUAL INCOME TAX

Method of tax	Beginning wealth	Tax imposed upon use for consumption	Consumable wealth after direct tax on C	Price increase	Reduction in consumable wealth after direct tax and price adjustment
Consumed income	100	20	80	0	20
Subtraction method VAT (credit VAT)	100	0	100	32	32
Two-tier tax	100	0	100	20	20

Thus, C's cash endowment, which will be spent on consumption, will be devalued to a lesser extent under the two-tier tax than under a VAT or RST, because the devaluation will not reflect any general one-time inflationary price increase resulting from W's effective relief from income tax responsibility, which will be borne by M and passed along ultimately to C in addition to other taxes.