Analysis of the Effects of a Consumption Tax in Puerto Rico

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Many sectors of Puerto Rico's civil society have recently proposed replacing Puerto Rico's current income-tax system with a consumption tax, such as a retail sales tax or a European-style value-added tax.[1] There is a vast and varied literature on the issue of consumption taxes.[2] Our aim is not to repeat or summarize what others have already said in this field. Nor would it be appropriate at this early stage to review the technical issues concerning the mechanics and implementation of a consumption tax system in Puerto Rico.[3] Instead, we shall analyze a number of general points that have, for the most part, been overlooked by

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[1] There are two major types of consumption taxes: a retail sales tax and a value-added tax (VAT). Broadly defined, a sales tax is imposed on personal consumption expenditures at the point of sale in retail establishments; in contrast, a VAT is a tax that is imposed on all goods and services acquired for any purpose. A good discussion of the differences and similarities of both types of consumption taxes can be found in David F. Bradford, *What Are Consumption Taxes and Who Pays Them*, 39 TAX NOTES 383 (Apr. 18, 1988).

[2] For a small sampling of the leading articles in this field, see William D. Andrews, *A Consumption-Type Tax or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Robin Cooper Feldman, *Consumption Taxes and the Theory of General and Individual Taxation*, 21 VA. TAX REV. 1 (2002); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); Alan Schenk, *Choosing the Form of a Federal Value-Added Tax: Implications for State and Local Retail Sales Taxes*, 22 Cap. U. L. REV. 291 (1993); and George R. Zorow and Charles E. McLure, Jr., *Implementing Direct Consumption Taxes in Developing Countries*, 46 TAX L. REV. 404 (1991).

[3] The Puerto Rico House of Representatives recently approved a bipartisan resolution calling for the further study of the feasibility of a consumption tax proposal. *See* Resolución de Investigación Núm. 3035 of July 16, 2002. But the exact form a consumption tax would take in Puerto Rico (i.e. sales tax or VAT) remains to be specified.

others and that have a specific bearing on Puerto Rico's special situation and unique circumstances.

We begin by describing the origins of the current income-tax system in Puerto Rico to provide the reader some historical context to the current policy debate. Next, we shall analyze three distinct concerns with respect to the proposed adoption of a consumption tax in Puerto Rico. In part II of this paper, we shall consider what psychological effects the adoption of a consumption tax would have on taxpayers in Puerto Rico. Would the average Puerto Rico taxpayer perceive a consumption tax as fairer than the current income-tax system? We shall analyze in part III what effect a consumption tax might have on trade, investment, and savings in Puerto Rico. Would a consumption tax increase or reduce these economic activities? Last, in part IV, we shall discuss what effect, if any, a consumption tax would have on Puerto Rico's large underground economy.

I. Origins of Puerto Rico's Current Tax System

Eighteen ninety-eight is a pivotal year in Puerto Rico's history. This is the year the Island's destiny irreversibly changed from a crown colony of Spain to an "unincorporated territory" of the United States.[4] Though it may not seem obvious at first, Puerto Rico's tax system and the Puerto Rico-U.S. relationship are linked together.[5]

Puerto Rico's first income tax was authorized by Congress, not by the government of Puerto Rico.[6] The federal Revenue Act of 1913 (the 1913

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[4] Puerto Rico's status as an "unincorporated territory" of the United States was imposed (in our view, wrongly imposed) by judicial fiat in Downes v. Bidwell, 182 U.S. 244 (1901) (Brown, J., concurring) and Balzac v. Porto Rico, 258 U.S. 298 (1921). It is still an open question whether the adoption of the Commonwealth Constitution in 1952 changed Puerto Rico's neo-colonial status, since Downes and Balzac have not yet been overruled. For a fair and balanced discussion of Puerto Rico's current constitutional status, see T. Alexander Aleinikoff, *Puerto Rico and the Constitution: Conundrums and Prospects*, 11 CONST. COMM. 15 (1994).

[5] Ironically, Downes v. Bidwell was a tax case. The plaintiff in Downes was challenging the constitutionality of U.S. tariffs imposed on goods imported from Puerto Rico.

[6] Revenue Act of 1913, Pub. L. 16, § II, 38 Stat. 166 (1913). The top tax rate under the

Act) authorized the Island government to collect federal income taxes in Puerto Rico.[7] Although the 1913 Act was a national (U.S.) law, it provided a major source of revenue for the insular government. All the revenue generated in Puerto Rico under the 1913 Act was earmarked for the Island.[8] In its first year, the revenue yield in Puerto Rico under the 1913 Act was $50,000.[9]

The reader might ask, if Puerto Rico became part of the United States in 1898, why did Congress wait 15 years to impose an income tax on Puerto Rico? The short answer is the Sixteenth Amendment.[10] Prior to the ratification of the Sixteenth Amendment in 1913, the Supreme Court had held that Congress lacked the constitutional authority to impose a national income tax.[11]

Congress soon granted to Puerto Rico the authority to amend or modify the application of all federal tax laws in Puerto Rico under the War Revenue Act of 1917.[12] The Puerto Rico government soon thereafter enacted its first comprehensive tax code, the Income Tax Law of 1917.[13] Puerto Rico has relied on income taxes as its main source of revenue ever since.[14]

Today, the political relationship between Puerto Rico and the United States is set forth in the Puerto Rican-Federal Relations Act.[15] It is worth

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1913 Act was set at six percent (for persons with incomes in excess of $500,000 per year).

[7] *Id.* at 180 ("the administration and the collection of the taxes imposed in Porto Rico and the Philippine Islands shall be by the appropriate internal-revenue officers of those governments").

[8] *Id.* ("all revenues collected in Porto Rico and the Philippine Islands shall accrue intact to the general governments, thereof, respectively")

[9] *See* Suphan Andic & Ramón J. Cao García, *Reforma Contributiva en Puerto Rico*: *Estudio Técnico* 103 (1994).

[10] *See* U.S. CONST., AMEND. XVI: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

[11] *See* generally Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1 (1999).

[12] Pub. L. 50, § I, 40 Stat. 300, at 1088 (1917).

[13] P.R. Law No. 59 of Dec. 4, 1917.

[14] Puerto Rico also imposes excise taxes on certain goods produced or imported into the Island. Puerto Rico's internal revenue laws are codified at 13 L.P.R.A. §§ 161 et seq.

[15] *See* Pub. L. 36, 39 Stat. 961 (1917) (codified as amended at 48 U.S.C. §§ 731 et seq.).

noting that the Puerto Rican-Federal Relations Act confers to Puerto Rico a large measure of fiscal autonomy.[16] The Puerto Rico government has the express power to levy an income tax or a consumption tax in Puerto Rico.[17] Moreover, Puerto Rico-source income is generally exempt from federal income taxes.[18] Yet despite its fiscal autonomy, Puerto Rico continues to rely mostly on income taxes for generating revenue and has not experimented with an alternative tax system, such as a consumption tax.

II. Psychological Effects of a Consumption Tax

Few tax scholars have taken the time to analyze tax law from a psychological perspective or from the perspective of behavioral economics. Yet the way people perceive a tax system has real world implications that simply cannot be ignored by policymakers. There is a direct relationship between the way people perceive the fairness of a given tax system and the level of tax evasion and tax morale generally.[19]

More to the point, we conclude that a broad-based consumption tax would enjoy a major psychological advantage over the current income-tax system.[20] Even if an individual taxpayer winds up paying the same amount of *consumption* taxes as he does *income* taxes—that is, even if a taxpayer pays the same amount of taxes under either system—we predict the average taxpayer would perceive a consumption tax system to be fairer and more equitable than the current income-tax system. This conclusion has important implications for tax morale in Puerto Rico.

The Puerto Rican-Federal Relations Act is the basic law establishing the terms and conditions of the current political relationship between Puerto Rico and United States.

[16] The relevant provisions of the Puerto Rican-Federal Relations Act regarding the Island government's fiscal autonomy are codified at 48 U.S.C.A. §§ 734, 734a, 741, and 741a.

[17] *See* 48 U.S.C.A. § 741a (authorizing the Puerto Rico legislature to levy and collect taxes on all goods "as soon as the same are manufactured, sold, used, or brought into the island").

[18] *See* 26 U.S.C.A. § 933.

[19] *See*, e.g., Gebhard Kirchgaessner, *Moral Aspects of Taxation* (2001) (unpublished manuscript, on file with the Center for Economic Studies and Institute for Economic Research of the University of St. Gallen).

[20] We qualify our conclusion with the key word "broad-based." A consumption tax with a narrow base or one full of special exemptions, loopholes, and the like would suffer the same tax-morale problems as under the current income-tax system.

To explain this point, we must directly bring to bear the study of human psychology and behavioral economics.[21] Specifically, we must consider the way people perceive losses. When a person is confronted with a set of choices under uncertain conditions (such as whether to pay taxes or run the risk of tax evasion), he is likely to establish an arbitrary reference point in his mind to judge whether a particular result or outcome would constitute an actual loss of a vested right or merely a foregone gain of a prospect.[22]

Simply put, a vested right is something of value that already belongs to me; in contrast, a prospect is something of value that I might or might not obtain in the future.[23] From a psychological perspective, this is a critical distinction because people tend to regard the loss of a vested right as worse than passing up an equivalent (or even a greater) gain.[24] As a result, a person who is loss-averse would feel the loss of a psychologically vested right of a $X market value more strongly and more deeply than he would the loss of a prospect of identical (or even greater) market value.[25]

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[21] It is worth noting that Daniel Kahneman, a pioneer in behavioral economics, was one of the recipients of last year's Nobel Prize in economics. A concise and easy-to-read summary of Kahneman's ground-breaking work can be found in "All too human," The Economist, Oct. 12, 2002, at 74. *See* also Press Release: The Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel 2002, Oct. 9, 2002. This press release is available online at <www.nobel.se/economics/laureates/2002/press.html>.

[22] The leading article explaining this insight is Amos Tversky and Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. 5251 (1986). As mentioned in note 21 above, Mr. Kahneman was awarded the Nobel Prize in economics last year for his work in the field of behavioral economics (Mr. Tversky past away in 1996). *See* also Daniel Kahneman & Dale Miller, *Norm Theory: Comparing Reality To Its Alternatives*, 93 PSYCH. REV. 136 (1986); and Cass R. Sunstein et al., *Predictably Incoherent Judgments* (2001) (unpublished manuscript, on file with the University of Chicago Law School).

[23] In short, a person's psychological "reference point" constitutes a dividing line between vested "rights" and mere "prospects."

[24] A qualification is in order here. This holds true for people who are loss averse. In reality, though, most people tend to be loss averse.

[25] A good example of this is the debate over physical versus regulatory takings. For instance, a farmer would likely regard the outright expropriation of his crops (of $X market value) as more severe than a zoning law that deprived him of development rights

This insight into human psychology helps us to understand the way people perceive the fairness of a given tax system. Income taxes are generally perceived as unfair and too high because an income tax, by definition, is imposed on a person's earned income and thus the payment of income taxes is seen as the loss of a vested right (a large portion of one's personal income). Put another way, people perceive income taxes as a penalty for working. The average taxpayer feels that the state is taking away a portion of his income, for the more I work and the more money I make, the more income tax I am required to pay.[26]

Yet taxpayers perceive consumption taxes in a different light. The average taxpayer regards a tax on consumption—whether in the form of a sales tax or an added value tax—as the loss of a mere prospect, for the taxpayer pays no tax until the moment he makes a consumption choice.

For example, if I choose to buy a luxury car, say an expensive Jaguar convertible, rather than a cheap compact model, such as a Volkswagen Golf, I will pay a larger amount of tax on my purchase. It is true from an economic standpoint that I can also choose the amount of (taxable) income I earn relative to (non-taxable) leisure. For example, if I work in a high-income profession, say law or medicine, rather than a low-income profession, I will also pay a larger share of taxes. But this ignores the pivotal role of psychology in human perceptions.

From a psychological point of view, the result in the first example is perceived as fairer than the second because I, the taxpayer, decide which car to buy in the first place (and thus how much tax I am willing to pay). The purchase of the car is seen as a mere prospect. In contrast to a person's consumption decisions, people tend to regard their income as a

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with the same market value. *See*, e.g., Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 37-38 (1989).

[26] As we mentioned in note 24 above, this is true of persons who are loss averse. A risk-averse person might see things differently. He might say 'the more tax I pay the better' because he would perceive an increase in his tax liability as resulting from an increase in his income. In addition, some scholars have (wrongly, in our view) defended the income-tax system on other grounds. See, e.g., Mohinder Bhatia, "P.R.'s progressive individual income tax," The San Juan Star, Jan. 20, 2003, at 36 (arguing that Puerto Rico's income-tax system is "progressive" and encourages home ownership and college education).

vested right. Taxes on income are therefore perceived as a loss of a vested right rather than the loss of a mere prospect.

This analysis of people's perceptions has important implications for tax reform in Puerto Rico and, we dare say, the United States. Even if a consumption tax were revenue-neutral and have no effect on Puerto Rico's large underground economy, a broad-based consumption tax would enjoy a psychological advantage over the current income-tax system. Taxpayers would probably perceive a broad-based consumption tax as more equitable than the current income-tax system.[27]

III. Effect on Investment, Savings, and Trade Flows

The adoption of a consumption tax in substitution of the current income-tax system would have important effects on Puerto Rico's economy:

a) Investment

First and foremost, a consumption tax in place of the current income-tax system would convert Puerto Rico into an attractive tax haven for new outside investment.[28] The replacement of the current income-tax system with a direct or indirect consumption tax would have the immediate effect of imposing a zero tax on corporate profits. As a result, all other things being equal, foreign and U.S. investors might be expected to respond to this strong tax advantage by investing in the Puerto Rico economy.

It is worth noting that Puerto Rico has a long history of relying on domestic and U.S. tax incentives to promote investment on the Island. The federal Caribbean Basin Initiative (CBI) and the Tax Reform Enabling Act of 1994 are recent examples.[29] At present, however, Puerto

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[27] This assumes that any proposed consumption tax would be enacted in substitution of the current income-tax system. We understand that some of the proposals currently under discussion call for a mixed system, maintaining the current income-tax system, with lower tax rates. *See* "House looking to approve proposed tax reform," The San Juan Star, Dec. 18, 2002, at 32.

[28] In addition, a consumption tax would provide a substantial windfall to existing investments in Puerto Rico owned by non-Puerto Rico residents.

[29] The CBI program is codified at 28 U.S.C.A. § 936. The 1994 tax reform is codified at

Rico's economy appears to be stagnant. And with the phase out of Section 936, there are currently few federal tax incentives in place to promote investment in the Puerto Rico economy. Worse yet, any attempt by the Puerto Rico government to obtain new federal tax incentives for the Island will no doubt confront an uphill political battle given the current climate in Congress.[30] Accordingly, at this time a consumption tax may be the most politically-feasible measure for promoting new outside investment in the Puerto Rico economy.

Nevertheless, we must point out that Congress could adopt certain countermeasures to offset the investment distortions created by the adoption of a consumption tax in Puerto Rico.[31] The most likely response by Congress would be to adopt a residence approach to corporate income in order to reach Puerto Rico-source income earned by U.S. corporations and individuals.[32] Under a residence approach, U.S. corporations and individuals would be required to report and pay U.S. income tax on Puerto Rico-source income.[33]

b) Savings

A broad-based consumption tax, whatever form it takes, would provide a far greater incentive for saving than there exists under the current income-tax system. Under the current system, a Puerto Rico taxpayer must generally pay the same rate of income tax regardless of

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13 L.P.R.A. §§ 8001 et seq. For an excellent analysis of the 1994 tax reform law, *see* Alcides Ortiz-Ferrari, *Desarrollo Económico: Legislación de 1994 y el Nuevo Modelo Económico de 1994*, 64 REV. JUR. U.P.R. 309 (1995).

[30] *See*, e.g., Javier Maymí, "A dar la batalla por Sección 956," El Vocero, Oct. 11, 2002, at 16. This situation is further aggravated by the crude political reality that Puerto Rico lacks voting representation in both chambers of Congress.

[31] Since most outside investment in Puerto Rico is from the United States, we shall concentrate on how the United States (in particular, Congress) might respond to the adoption of a consumption tax in Puerto Rico.

[32] For example, both the United Kingdom and Japan use a residence approach to tax the worldwide income of U.K and Japanese firms and individuals.

[33] In theory, the Puerto Rico government could respond to such a defensive measure by Congress and restore the tax advantages offered by consumption tax by imposing a high withholding tax on Puerto Rico-source income remitted to non-resident corporations and individuals.

how much post-tax income he puts into his savings.[34] In contrast, under a consumption tax system taxpayers have a strong incentive to convert their income into savings since no taxes are paid on savings and since the interest payments generated by a person's savings are also tax-free.

This savings incentive is an inherent feature or advantage of a consumption tax system and is highly desirable from a social standpoint. For the principle effect of an increase in savings is a corresponding increase in a country's domestic capital stock, resulting in more domestic investment, employment gains, and economic growth.[35]

Moreover, one of the Puerto Rico economy's most endemic problems is the high rate of conspicuous consumption by Island residents. On average, Puerto Rico residents spend a higher fraction of their income on consumption than the residents of any of the fifty U.S. States do.[36] The adoption of a consumption tax promises to be an effective way of countering this problem.

c) Trade

In the abstract, a consumption tax should have a neutral effect on trade since such a tax would apply equally to both imports and domestic consumption goods.[37] Nevertheless, an imbalance in favor of imported goods may occur if consumers alter their purchasing behavior in favor of

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[34] For individual Puerto Rico taxpayers, the most important exception is the deduction for contributions to qualified individual retirement accounts (IRA's). This deduction, however, is currently capped at $3,000. *See* 13 L.P.R.A. § 8423(bb)(2) (Supp. 1999). IRA's are defined at 13 L.P.R.A. § 8569 (Supp. 1999).

[35] *See*, e.g., David Romer, *Advanced Macroeconomics* 17-22 (2002); Paul A. Samuelson, *Economics: The Original 1948 Edition* 265-77 (McGraw-Hill ed. 2002).

[36] *See*, e.g., Vladimir Rivera, *The Credit Channel* (2002) (unpublished manuscript, on file with the Economic Investigation Unit of the University of Puerto Rico).

[37] With respect to a value-added tax, its effect on trade will depend on whether the tax system adopts an origin or destination approach. Under the destination approach, export sales are excluded from the tax base while imports are included. A destination-type VAT would thus have a neutral effect on trade flows. Under the origin approach, however, purchases of imports are excluded from the tax base while export sales are included. As a result, an origin-type VAT may interfere with trade flows in the short run. See Peggy B. Musgrave, *Consumption Tax Proposals in an International Setting*, 54 TAX L. REV. 77, 93 (2000).

various forms of hard-to-detect cross-border shopping (such as mail-order and electronic sales) to reduce their consumption-tax burdens.[38] The problem is that, because of the large enforcement costs involved, electronic commerce and mail-order sales are inherently unobservable transactions. The aggregate effect of this form of tax evasion might even be to put Puerto Rico merchants at a disadvantage vis-à-vis out-of-state merchants.

In the absence of a specific consumption tax proposal, it is difficult to predict in the abstract to what extent Puerto Rico consumers will alter their purchasing behavior, that is, whether mail-order sales and electronic commerce would pose a serious threat to the tax system.[39] As a general matter, the higher the tax rate, the greater the incentive for engaging in cross-border transactions. Therefore, any proposal for tax reform in the direction of a consumption tax must take this potential problem into account, since mail-order sales and electronic commerce may erode the tax base and thus result in lower rates of revenue collection.

d) Consumption

Before we move on, we must perforce discuss what impact a consumption tax would be expected to have on *consumption*. The problem is that in the absence of a specific consumption tax proposal, the best we can do now is to outline some general points on how a consumption tax would act upon the Puerto Rico economy. Otherwise, any prediction on our part at this stage would be pure and idle speculation.[40]

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[38] To have some idea of the magnitude of this gap with respect to mail-order sales in the United States, estimates for 1994 indicate a mammoth interstate tax gap on mail order sales of $3.3 billion. *See* Advisory Committee of Intergovernmental Relations, Taxation of Interstate Mail Order Sales: 1994 Revenue Estimates (1994).

[39] We do not, however, expect a large increase in physical cross-border shopping because Puerto Rico is an island. It is safe to say that the potential tax evasion gains generated by such behavior would be more than offset by the travel and time costs involved, though this may not be true for small (i.e. easy to conceal) luxury goods, such as diamonds.

[40] As we mentioned in note 3 above, as of this writing there are no specific tax-reform bills under consideration by the Puerto Rico government.

At the macroeconomic level, we would expect a consumption tax to reduce aggregate demand because consumption is always the largest component of aggregate demand. Consumption, in turn, is a function of income.[41] Some of a person's income may be stashed away in savings, while the rest will be spent on consumption goods (including services, non-durable commodities, and consumer durables).[42] In reality, the net effect of a consumption tax on aggregate demand is uncertain and will depend on such critical variables as the rate and base structure of the tax. This is so because the immediate effect of a consumption tax will be to *increase* the amount of each taxpayer's disposable income.[43] With more income at his disposal, the taxpayer has more income to spend on consumption (and savings). As a result, the extra amount of income allocated to consumption may offset the reduction in aggregate demand caused by the imposition of the consumption tax.

A final caveat is in order. Economists refer to the rate at which consumption increases as income increases as the "marginal propensity to consume" (MPC).[44] MPC increases when the increase in income is seen as permanent. Accordingly, to the extent Puerto Rico taxpayers perceive the change to a consumption tax as a permanent move (that is, one that will be respected by whatever political party happens to be in power), then the higher the MPC will be.

IV. Effect on Puerto Rico's Underground Economy

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[41] Under an income-tax system, consumption is a function of disposable income, since some of a person's income is taxed away. A further refinement is that a person's disposable income may be augmented by government transfer payments. Accordingly, disposable income can be defined as the difference between income and *net taxes* (i.e. the difference between taxes and transfer payments).

[42] Note that the line between *consumption* and *saving* can be somewhat arbitrary: why is the purchase of a car classified as *consumption* and not *saving*? By the same token, why is the purchase of a house *saving* and not *consumption*?

[43] Of course, this statement assumes that the consumption tax is not imposed in addition to or on top of the current income-tax system but rather in replacement of it.

[44] MPC will always be between 0 and 1. People will spend *some* of any extra addition to their income on consumption (that is, they will not save all of it), but they will not spend *all* of the extra addition to their income on consumption (that is, they will save some of it).

What do a street-corner vendor, a criminal-defense lawyer, and a drug lord have in common? Although they are engaged in radically different activities, they all provide valuable goods and services to paying customers. Furthermore, to the extent they do not report some or all of the income they receive from their customers, they are also evading their share of tax liability. This sector of a nation's economy, where tax evasion is rampant, is often referred to as the "underground economy." Some commentators prefer the term "hidden," "informal," or "parallel" economy. However this term is defined, the problem is the same: tax evasion.

The size of Puerto Rico's underground economy is gigantic. According to the Puerto Rico Treasury Department, Puerto Rico's underground economy generates at least two billion dollars per annum, or no less than 17% of Puerto Rico's Gross Personal Income.[45]

These figures, if true, raise an intriguing question. Why is the underground economy in Puerto Rico so large? That is, why do so many citizens evade their duty to pay taxes? Either tax evasion has become a socially-acceptable norm in Puerto Rico or tax liability is simply so large that many otherwise law-abiding citizens feel compelled to evade taxes just to stay in business. For purposes of this essay, however, we shall limit ourselves to the following question: What effect would a consumption tax have on Puerto Rico's underground economy?

Everyone agrees that our current system of direct taxation of income produces inefficiencies that allow avoidance as well as evasion to flourish and everyone agrees that in order to reach into the underground economy, a more efficient auditing system must be implemented. But will a consumption tax in place of an income tax reduce Puerto Rico's underground economy? The simple answer is probably not.

The adoption of a consumption tax in place of the current income tax would provide new incentives and opportunities for tax avoidance and tax evasion. Consider the case of a drug lord, a doctor, or a street vendor, that is, of a person who under the current system evades taxes by failing to report his total income to the tax authorities.

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[45] Some estimates put the size of Puerto Rico's underground economy at between $10 billion to $20 billion. *See* "House looking to approve proposed tax reform," The San Juan Star, Dec. 18, 2002, at 32.

Let us take the easiest case first: the drug dealer. The income generated by black-market activities such as drug peddling and prostitution will not be captured under any tax system period. Simply put, the drug lord's incentive to evade both income taxes and consumption taxes is the same. By paying taxes, the drug lord would implicitly be recognizing the commission of a crime (such as prostitution or drug peddling) unless he goes to the trouble and expense of laundering the income generated by his illicit activities. Furthermore, most black-market activities are likely to be cash or barter transactions. Since these types of transactions leave no paper trail, they are hard to detect after the fact thus making it all the easier to evade taxation.[46]

Now take another example, far removed from the violent streets of the drug *puntos*, that of a doctor (or a criminal-defense lawyer) who under the current system does not report his cash transactions in his income-tax form. A consumption tax would in no way alter the doctor's tax-evading behavior. The incentives to evade are still the same. Under a consumption tax, the doctor will continue to evade taxes on his cash transactions because, just as before, he will not report the cash transactions to the authorities.[47] The only difference is that a consumption tax would increase the cost to patients of health care.

If we use an economic approach to analyze this example, we shall see that a consumption tax has the perverse and unintended effect of making tax-evading doctors better off and their patients worse off. Tax-evading doctors will simply add the cost of the tax to their fee,[48] and thus his cash patients will wind up paying more for the doctor's services than before. Patients who pay in cash will be forced to ration the number of visits to the doctor or to consume less of other goods to maintain the same number of doctor visits.

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[46] Even when a cash transaction, such as payment by check or credit card, leaves a paper trail, it is fair to say that the administrative costs of investigating the unreported cash transactions of a given taxpayer would be large.

[47] *See*, e.g., Mathews N. Murray, *Would Tax Evasion and Tax Avoidance Undermine a National Retail Sales Tax?*, 50 NAT'L TAX J. 167 (1997) [hereinafter Murray].

[48] This is assuming that the demand for the services of doctors is inelastic (i.e. that there are few or no substitutes for the services in question). To the extent the average patient prefers to consult with the same doctor (for example, his family doctor), this assumption would hold true.

Consider now the case of a humble and hard-working street vendor. In Puerto Rico, for example, there are merchants selling bottled-water, vegetables, newspapers, and other goodies at almost every major city intersection. Under the current system of direct taxation of income, a street vendor pays no (or little) income tax if he does not report (or if he underreports) his earned income from sales made at traffic lights or other remote locations. As with the black market, there is still no cost-effective auditing mechanism for detecting and sanctioning the vendor's tax evasion.

If we were to switch to a consumption tax (such as a sales tax or a value-added tax), it appears as if the vendor is now under the tax net, since his personal consumption would be subject to the consumption tax.[49] But the opposite is true, for our water-bottle seller would now enjoy several advantages over his competitors in fixed locations (such as supermarkets and convenience stores). First and foremost, the street vendor will simply transfer most (but not all) of the cost of the sales tax paid on his personal consumption to his customers.[50] Second, he has no fixed expenses or overhead, such as rent, utilities, etc.[51] and he pays no municipal taxes (i.e. *patentes municipales*) since he does not operate at a fixed address.[52]

Even when the street vendor is subject to tax on his personal spending (e.g. when he buys the bottled water at a discount store), the rise in post-tax prices on bottles of water sold at supermarkets and convenience stores confers a major advantage to the street vendor. Street vendors will raise the price of their bottled water to an amount greater than the sales tax, but less than the store price, and thus he will maintain an edge over stores. Accordingly, a consumption tax will not only result in no net increase in

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[49] *See* Murray, *supra* note 47, at 176-78.

[50] In reality, this assumption probably does not apply to bottled-water, since most bottled-water is of the same or similar quality. As we mentioned in note 48 above, a vendor will pass on to his customers the full cost of a consumption tax if there are few or no substitutes for the product or service in question.

[51] The street vendor also enjoys a comparative advantage over fixed locations since he can reach his potential customers directly at traffic stops and parks.

[52] The irony is that most street vendors *do* operate at the same locations. For example, the same street vendors tend operate at the same parks and street corners.

tax revenues for the state; it will also have the ironic effect of increasing the tax evader's income.[53]

Nevertheless, a consumption tax system may still have positive psychological effects that may result in a lower rate of tax evasion than under the current system. As we noted in part II of this essay, taxpayers will perceive the payment of consumption taxes as a loss of a mere prospect. Also, a consumption tax may create the perception or illusion among taxpayers that members of the underground economy are paying their fair share of taxes. If so, this perception may result in a higher rate of voluntary compliance of the marginal taxpayer.

We stress the words "may" and "might" because we suspect that the marginal tax payer (i.e. one who is deciding whether to pay or evade taxes) is perhaps not likely to be fooled by the perception that everyone is paying his fair share of taxes under a consumption tax system.

V. Conclusion

There are a host of complicated factors Puerto Rican tax scholars and policymakers must consider as we debate the merits of replacing the current income-tax system with a consumption tax. What type of consumption tax is best for the Island? How should the transition from the current system to the new system be achieved? Should any special goods or services be exempt from the consumption tax? And how high must the new tax rate be in order to achieve revenue neutrality?

There is an extensive literature on these questions. Rather than cover the same ground, we have chosen to commence our analysis by evaluating those aspects of a consumption tax that have received little attention by tax scholars and policymakers. We conclude that the adoption of a consumption tax in Puerto Rico would produce a number of tangible and intangible benefits, benefits that have been ignored or overlooked to date.

Adopting a consumption tax in place of an income tax involves many trade-offs. First, a consumption tax in place of the current system may not generate additional tax revenues and may involve additional administrative expenses, but we predict that people would perceive a broad-based consumption tax as more equitable than the current system.

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[53] *See* Murray, *supra* note 47, at 177.

Second, a consumption tax might increase cross-border shopping, but it would also have the potential positive effect of promoting savings and investment in the Island's economy. And third, though a consumption tax would probably not reduce the size Puerto Rico's underground economy, people might be more willing to pay their share of taxes if they perceive that everyone else is paying their fair share. These ample benefits suggest that any proposal for radical tax reform in Puerto Rico should be taken seriously. The consumption-tax debate should proceed forthwith.