1 Survey of Taxes on Consumption and Income, and Introduction to Value Added Tax

I. Introduction

The VAT has spread around the world more quickly than any other new tax in modern history.[1] According to Alan Tait, the value added tax "may be thought of as the Mata Hari of the tax world – many are tempted, many succumb, some tremble on the brink, while others leave only to return, eventually the attraction appears irresistible."[2] The extreme of a country that left, only to return, is Japan. It enacted a VAT in 1950, delayed its effective date for several years, repealed it in 1954, and then enacted a different version of VAT in 1988.[3]

This book covers value added tax and, in some parts, other consumption taxes in use or proposed in developing and developed countries. A valuable resource in electronic form that assists in locating tax legislation around the world is http://www.itdweb.com, developed jointly by the International Monetary Fund, the Organization for Economic Co-operation and Development, and the World Bank.

Tax on consumption generally refers to a tax on goods and services that are acquired by individuals for their personal use or satisfaction. It generally does not include goods and services that are physically used or incorporated by business in the production or distribution of goods or in the rendition of services (business inputs).

It is difficult for a business to operate internationally without considering the implications of sales tax or value added tax on international trade, whether or not the company's country of residence has a broad-based tax on consumption. For example, the United States does not have a sales tax or value added tax, except at the state and local levels of government. Nevertheless, a U.S. business operating in or shipping goods or transferring services to developed or developing countries with VATs must consider the VAT implications of exports to or imports from those countries.

[1] See Appendix A, listing the countries with VATs and sales taxes.

[2] Tait, Value Added Tax: International Practice and Problems 3 (IMF 1988) [hereinafter Tait, VAT].

[3] See Schenk, Japanese Consumption Tax: The Japanese Brand VAT, 42 *Tax Notes* 1625 (Mar. 27, 1989).

This book explores value added and other consumption tax principles from a comparative perspective in the hope that this scrutiny may lead to suggestions for improving existing VAT systems and designing new ones. We will discuss VAT systems in the member states of the European Union (EU), as well as examine the implications of the EU VAT directives on domestic law in the member states. We will explain major departures from the EU model in non-European countries (especially in New Zealand, Japan, and South Africa), and highlight the wide variety of consumption tax proposals in the United States, ranging from proposals to adopt a federal VAT as an additional revenue source to proposals to replace some or most existing federal taxes with some form of consumption tax. In a later chapter, we will discuss several of these U.S. proposals. None of the U.S. proposals has been subjected to serious congressional debate. Appendix B is a theoretical VAT Act for the Commonwealth of New Vatopia that can be used as a starting point for a country interested in adopting a VAT or revising an existing VAT. It is used in this book as a reference and a source to compare VAT rules in effect in a variety of countries.[4] This chapter provides background for the study of consumption taxation. It discusses direct and indirect taxes, and explores tax structures in developing and developed economies. The impetus for improvement in the taxation of goods and services is highlighted, and the basic concepts and terms used in the VAT literature are detailed.

II. Development of Taxes on Consumption – A Brief Review of History

Most early forms of taxation were levies on land[5] or on the produce from land. The following is only a thumbnail sketch of how the produce of land and goods have been the subject of taxation throughout recorded history. The tax on land in early civilizations was payable in kind with the produce from the land.[6] The tithe in Egyptian kingdoms was imposed as a proportion of agricultural produce.[7] In the days of the city-states of Athens and Rome, although there were taxes in the form of rents from state-owned land (including taxes on natural resources extracted from these lands), the rulers supplemented revenue from land with indirect taxes.[8] Customs duties were imposed at the ports and taxes were extracted at the markets for goods that arrived by land.[9] In the third century A.D., Diocletion imposed fees (or taxes) from the monopolies that he granted for the production and sales of goods.[10]

[4] This VAT is on the IMF website. See www.imf.org/external/np/leg. Go to Tax Law Drafting Samples: VAT.

[5] Land, as a representation of wealth, was a favorite subject of taxation because it was visible and the tax was collectible.

[6] C. Webber & A. Wildavsky, A History of Taxation and Expenditure in the Western World 44 (Simon & Schuster 1986). In the early civilizations of the Sumer city-states, tax payable in grain was transported to the ruler's storehouses. *Id.* at 43.

[7] *Id.* at 71.

[8] *Id.* at 107.

[9] *Id.*

[10] *Id.* at 112.

During the late thirteenth century, England imposed taxes on its wool exported by the Italian merchants who were granted the monopoly on this export. This "Ancient Custom," as it was known, later was expanded to cover all exports of goods from England.[11] In the late Middle Ages, in Italy and elsewhere, goods produced by artisans were taxed by taxing the guilds. The guilds raised the needed funds by taxing their members.[12]

The taxation of goods changed as firms were organized to produce goods and sell them through distributors to retailers. It became common, especially in Europe, to impose tax on business turnover (gross receipts). Thus, a cascading turnover tax was imposed every time that goods were transferred in the process of production and distribution to the final consumer. "Cascading taxes cannot be reclaimed by the purchaser, so that the tax component of the price of goods becomes larger and larger the more stages there are between producer and consumer – with obvious distortionary effects as between highly integrated enterprises and other enterprises."[13] For example, assume that a lumber mill sold lumber to a carpenter for a pretax price of $1,000. With a 1 percent turnover tax, the mill added $10 tax and charged a tax-inclusive price of $1,010. The carpenter fashioned the lumber into tables and sold the tables to a retailer. To its $5,010 pre-turnover-tax price (including the $10 tax on the lumber), the carpenter added $50 tax, for a tax-inclusive price of $5,060 (the numbers are rounded to dollars). The retailer sold the tables to consumers for a pretax price of $10,060. The retailer added $101 tax, for a tax-inclusive price of $10,161. The government collected total tax of $161 (10 + 50 + 101).

To take an extreme comparison, assume that the carpenter operated his own mill and sold his crafted tables directly to consumers. If there were no turnover tax on the mill's purchase of trees, and if the carpenter sold the tables to consumers for pretax prices of $10,000 (because he would not bear the $60 tax imposed by the multiple turnovers), the carpenter would add turnover tax of $100, for tax-inclusive prices totaling $10,100. This comparison made in Table 1.1 illustrates some of the deficiencies of the turnover tax – the cascading of taxes and the incentive to integrate a business vertically.

Businesses must pay turnover tax on all purchases, that is, on all business inputs. At each subsequent turnover of goods (i.e., sale), the taxes previously paid and the values previously taxed are again subjected to tax in a process often referred to as pyramiding or cascading, or just as "tax-on-a-tax." In the example just described, the carpenter charges $50 tax on his $5,010 sales price that includes the $10 tax buried in his $1,010 cost for the milled lumber (or, to put it differently, he collects a total of $60 of tax from the retailer, of which the $50 tax charged on the sale is paid to the government and $10 buried in the pre-tax $5,010 price is paid to his lumber supplier).

As indicated, the cascading tax element in retail sales is reduced if the carpenter vertically integrates his operations. The classic example of a vertically

[11] *Id*. at 197.

[12] *Id*. at 149.

[13] See Owens, *The Move to VAT*, 1996/2 Intertax [hereinafter Owens, The Move to VAT], p. 45.

Table 1.1. Turnover tax nonintegrated and vertically integrated business

	Nonintegrated	*Vertically integrated*
Mill sale to carpenter $1,000 × 1%	$10	
Carpenter sale to retailer $5,010 × 1%	50	
Retailer sale to consumers $10,060 × 1%	101	
Carpenter sales directly to consumers $10,000 × 1%		$100
Total tax imposed & collected	$161	$100

integrated American business was the Ford Motor Company's River Rouge complex (in Dearborn, Michigan) that processed the steel and glass and other parts for the cars that were assembled on its assembly line. A more recent example is the Benneton company that operates its own retail shops to sell the apparel that the company manufactures.

In Germany, Dr. Wilhelm von Siemens recognized the problems with turnover taxes and developed what he referred to as the "improved turnover tax" or "the refined turnover tax."[14] Adams discussed a value added concept in the United States in 1921.[15] The principle was to reduce the tax on sales by the tax already paid on business inputs in order to avoid the tax-on-a-tax effect and to remove the incentive to vertically integrate a business. The effect of this "improved" turnover tax for a nonintegrated series of businesses and a vertically integrated business is illustrated in Table 1.2.

This "improved" turnover tax is imposed and collected at each stage of the production and distribution of goods and services whenever there is a transaction, but the net tax liability represents only the tax on the value that has been added by the selling business at that stage. By granting a reduction in tax liability for the tax imposed on taxable purchases (the input tax credit), the tax base at each stage basically is limited to the value added by the employment of labor and capital. The various methods of calculating net VAT liability will be discussed in Chapter 2.

Before the widespread use of multistage VATs, some countries imposed single stage consumption taxes. Single stage taxes at the retail level still are used by almost all states in the United States and by several provinces in Canada (and formerly in Sweden). More commonly, a single stage tax is imposed at the manufacturer's (Canada formerly) or wholesaler's level (Australia before its GST).

[14] C. Sullivan, The Tax on Value Added, Col. U. Press 1965 [hereinafter Sullivan, Tax on Value Added], p. 12, citing Gerhard Colm, "Methods of Financing Unemployment Compensation," *Social Research*, II (May, 1935), 161.

[15] Sullivan, Tax on Value Added, *supra* note 14, at 41, citing Adams, "Fundamental Problems of Federal Income Taxation," *Quarterly Journal of Economics*, XXV (1921), 553. Adams referred to his proposal as a tax on "approximate net income" or "modified gross income," and recommended it to replace the direct personal income tax. *Id*.

Table 1.2. Improved turnover tax nonintegrated and vertically integrated business

	Nonintegrated	*Vertically integrated*
Mill sale to carpenter		
Taxable sale of \$1,000 × 1%	\$10	
Carpenter sale to retailer		
Taxable sale- \$5,000[16] × 1%	50	
Credit for tax on purchases	(10)	
Retailer sales to consumers		
Taxable sale- \$10,000[17] × 1%	100	
Credit for tax on purchases	(50)	
Carpenter sales directly to consumers		
Taxable sales- \$10,000 × 1%		\$100
Total tax imposed and collected	\$100	\$100

III. Direct and Indirect Taxes on an Income or Consumption Base

A. Direct and Indirect Taxes

Direct and indirect taxes can be imposed on an income base or consumption base. But what is the distinction between a direct and indirect tax?

Taxes customarily have been classified either as direct or indirect taxes. "A *direct tax* is one that is assessed upon the property, business or income of the individual who is to pay the tax. Conversely *indirect taxes* are taxes that are levied upon commodities before they reach the consumer who ultimately pay[s] the taxes as part of the market price of the commodity."[18] This distinction, based on the incidence of the tax, has been criticized because "modern economic theory" points out that income taxes (considered a direct tax) may be shifted.[19]

According to J. S. Mill's classic economic principles, the distinction between direct and indirect taxes relates to "whether the person who actually pays the money over to the tax collecting authority suffers a corresponding reduction in his income. If he does, then – in the traditional language – impact and incidence are on the same person and the tax is direct; if not and the burden is shifted and the real income of someone else is affected (i.e., impact and incidence are on different people) then the tax is indirect."[20]

[16] The price would be \$5,000 instead of \$5,010 because the carpenter recovers the \$10 tax on his taxable purchases.

[17] The sales prices would total \$10,000 instead of \$10,060 because the retailer would only be charged a pre-tax price of \$5,000 and he would recover the \$50 tax charged on the purchase of the tables.

[18] *The Guide to American Law*, vol. 10:25 (1984) (defined by Schenk).

[19] See, for example, V. Thuronyi, Comparative Tax Law, pp. 54–55 (Kluwer 2003).

[20] Walker, "The Direct-Indirect Tax Problem: Fifteen Years of Controversy," 10 *public Finance* 153, 154 (1955), citing J. S. Mill, Principles of Political Economy, Book V, ch. III.

In the field of international trade, an Annex to the World Trade Organization agreement defines "direct taxes" as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property" and "indirect taxes" as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges."[21]

The direct versus indirect tax distinction has legal significance in countries subject to the World Trade Organization rules.[22] Under the SCM Agreement,[23] which is Annex 1 to the WTO, a contracting party is restricted in its ability to grant subsidies to exports or to impose more burdensome taxes on imports than apply to domestic goods.[24]

According to the WTO rules, border tax adjustments for indirect taxes do not constitute subsidies of exports or disadvantages to imports.[25] This WTO direct–indirect tax distinction apparently does not depend on who bears

[21] Agreement on Subsidies and Countervailing Measures (SCM), Annex I (Illustrative List of Export Subsidies), item (e), footnote 58. The SCM is Annex 1A to the WTO. Item (e) treats as an export subsidy (t)he full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises, and footnote 58 to the term "direct taxes" includes the definitions in the text.

[22] This direct–indirect distinction has a special role in Canada. "In Canada, both the federal and provincial governments have the constitutional authority to levy sales taxes." N. Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics* 141 (Australian Tax Foundation 1993). The federal government has broad power to raise revenue with any mode or system of taxation, but the provincial governments are authorized to impose only direct taxes. Although a sales tax typically is considered an indirect tax, a 1943 Canadian Privy Council case held that a provincial retail sales tax was a direct tax for constitutional purposes. *Id.* at note 304. Professor Brooks quoted from the case: "when the purchase is made by an agent acting for his principal the tax nevertheless remains 'direct,' being paid by the agent for and on behalf of his principal who really bears it." *Atlantic Smoke Shops, Ltd. v. Conlon*, [1943] A.C. 550, at 551.

[23] The Agreement on Subsidies and Countervailing Measures [hereinafter SCM Agreement], supplementing GATT, Articles VI & XVI.

[24] The WTO, incorporating Article XVI of the original 1994 GATT agreement, provides: "(C)ontracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." Uruguay Round of Multilateral Trade Negotiations General Agreement on Tariffs and Trade, Apr. 15, 1994 [World Trade Organization, or WTO], encompasses, among other agreements, the General Agreement on Tariffs and Trade (GATT) 1994,. The quote is from GATT 1994, Ad Art. XVI(4). The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts (GATT Secretariat 1994) [hereinafter GATT], p. 509. If a contracting party grants or maintains any subsidy to increase exports or reduce imports, it is obligated to notify the other contracting parties "in writing of the extent and nature of the subsidization of the estimated effects . . . and of the circumstances making the subsidization necessary." *Id.* at Art. XVI.

[25] Whereas if "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)" is a subsidy under SCM, *supra* note 23, Article 1.1(a)(1)(ii), a footnote to that item provides that "the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."

the tax.[26] The prohibition against export subsidies may affect the border adjustability of some of the federal taxes proposed in the United States to replace or supplement the federal income taxes, especially proposals for a sales-subtraction VAT that allows a deduction for wages paid.[27]

In some countries, the imposition of a value added or other tax on consumption raise constitutional issues.[28] For example, the province of Alberta, Canada challenged the constitutionality of the Canadian Goods and Services Tax (GST), a European-style VAT.[29] The Canadian Supreme Court upheld the GST.[30] The Australian High Court struck down a tobacco franchise license fee imposed by a state because Parliament[31] had the exclusive power "to impose duties of customs and of excise, and to grant bounties on the production or export of goods. . . . " In that case, New South Wales imposed this tax on duty-free shops that sold retail tobacco to members of the public.[32] In contrast, the Federal Court of Australia upheld the constitutionality of the Australian GST.[33]

In the Philippines, the Supreme Court upheld against a constitutional attack, congressional changes in the VAT that included the grant of authority to the President to raise the VAT rate under special circumstances.[34] In some cases, the nation's constitution must be amended to give a level of government power to impose a tax previously the province of another level of government.[35]

26 It is not clear if the direct/indirect tax distinction applies to imports. See letter from Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Dept. of Treasury, to Senator Sam Nunn, February 1995.

27 See the discussion of these proposals in Chapter 14 *infra*.

28 In 2002, the Supreme Court of Papua New Guinea held that the national VAT was unconstitutional because it violated the Organic Law on Provincial and Local Level Governments that granted to the provinces exclusive power to levy sales taxes. *VAT Monitor*, Nov./Dec., 2002, p. 519. The national government apparently sought constitutional and legislative changes to address the constitutional challenge. The authors do not have information on the outcome.

29 Alberta claimed that the GST represented an unconstitutional attempt by the national government to interfere with Alberta's jurisdiction over property and civil rights under Head 3 of section 91 of the *Constitution Act, 1867*.

30 *Reference re Goods and Services Tax*, [1992] 2 W.W.R. 673; 2 Alta. L.R. (3d) 289; 138 N.R. 247; 2 S.C.R. 445, affirming in part and reversing in part [1991] 82 Alta. L.R. (2d) 289. The Court of Appeals of Alberta upheld the constitutionality of the tax, but "found that the federal government was required to reimburse suppliers for the costs of withholding and remitting GST, and that the obligation imposed on a province, as supplier, to collect and remit GST violated the *Constitution Act, 1867*." A. Schenk, Goods and Services Tax: The Canadian Approach to Value-Added Tax, p. 1, note 2 (1993). The Supreme Court reversed this part of the holding of the Alberta court.

31 The Australian Constitution, section 90.

32 *Ha and anor v State of New South Wales* & ors; *Walter Hammond & Associates v State of New South Wales & ors*, 189 CLR 465 (High Ct. Australia 1997).

33 O'*Meara v. Commissioner of Taxation*, [2003] FCA 217.

34 See Gutierrez, "Philippines' Arroyo Scores Victory in Supreme Court on VAT Measure," *BNA Daily Tax Report*, Sept. 2, 2005, p. G-2.

35 The Indian Constitution, Art. 268A was added in 2003 to empower the Union government to impose the Service Tax. See http://www.servicetax.gov.in/servicetax/overview/ovw.

The United States does not have a federal sales tax or VAT. Nevertheless, there have been academic discussions about the constitutionality of a federal VAT or other consumption-based tax to replace or supplement existing federal income and payroll taxes.[36] The issue under the U.S. Constitution is whether any proposed consumption tax is a "direct tax" that must be apportioned among the states on the basis of population.[37] There is no significant argument that a European, New Zealand, or Japanese VAT discussed in this book would constitute an unconstitutional direct tax if it were enacted by the United States Congress.[38] Even if some of the VAT, due to competitive pressures, were borne by the seller, the indirect VAT would not thereby be transformed into an unconstitutional direct tax.[39]

B. Income and Consumption Base for Tax

Thomas Hobbes, in his *Leviathan,* advocated consumption as an appropriate base for taxation. In his view, people should pay tax based on what they consume (withdraw from society's limited resources) rather than on what they earn in income (contribute to those resources through their labor). Both receive the protection from the government.[40]

Income and consumption can be viewed as different aspects of "consumption" in a broad sense. In this respect, income represents the potential power to consume and consumption represents the exercise of the power by consuming goods and services. An annual tax on individuals can be imposed on an income base (the hybrid income-consumption base is used to impose the individual income tax in the United States) or on a consumption base.

Consumption-based taxes can be imposed on or collected by business, its workers, and individuals.[41] If the tax is imposed on business, it can be measured by sales or by the value added by business firms at each stage of production and distribution. The tax (like the flat tax discussed later in this book) can be imposed both on business and its workers. Under this form of tax, the base for business is sales less both tax-paid purchases and tax-paid wages. The wage portion of the value added base then is taxed to the wage earners and reported on returns filed by them. If a consumption-based tax is imposed only on individuals, the tax base is income less savings.

[36] See discussion *infra* Chapter 14.

[37] U.S. Const., art. I, sec. 2, cl. 3, and art. I, sec. 9, cl. 4.

[38] For an in-depth discussion of this issue, see Johnson, "Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution," 7 William & Mary Bill of Rights Journal 1 (1998); Jensen, "The Apportionment of 'Direct Taxes': Are Consumption Taxes Constitutional?," 97 *Colum. L. Rev.* 2334 (1997) [hereinafter Jensen, Are Consumption Taxes Constitutional?].

[39] Jensen, Are Consumption Taxes Constitutional?, *supra* note 38, at 2405.

[40] "What reason is there, that he which laboureth much, and sparing the fruits of his labor, consumeth little, should be charged more, than he that living idlely, getteth little, and spendeth all he gets: Seeing that one hath no more protection from the commonwealth thatn the other?" T. Hobbes, Leviathan 184 (Dutton ed. 1914).

[41] See Toder, "Comments on Proposals for Fundamental Tax Reform," 66 *Tax Notes* 2003 (1995).

As discussed earlier, taxes can be classified as direct or indirect taxes. Direct taxes imposed on an income base include the familiar individual and corporate income tax and the payroll taxes. A direct tax like the income tax imposed on individuals can be imposed on a consumption base by removing returns to capital (such as interest, dividends, and capital gains) from the tax base.[42] For example, a personal expenditure tax was used briefly in India and Sri Lanka and was proposed in the United States in 1995.[43] Many forms of indirect taxes can be levied on a consumption base, including selective excise taxes, a turnover tax, a single stage sales tax (such as a manufacturer or a retail sales tax), or a multistage sales tax like a value added tax.[44]

Unlike the individual income tax imposed on an income or hybrid income-consumption base, consumption-based taxes imposed on transactions (like the VAT) cannot be tailored to individual circumstances. As a result, comparing the individual income tax with a European-style VAT, the individual income tax is more flexible as a tool to achieve progressive taxation.

This book does not discuss the politics of raising revenue with an income-based tax or a consumption-based tax, or both, but includes the following thoughts on the importance of considering spending as well as taxation as part of fiscal policy.

One complaint about a VAT is that it is a regressive tax – the tax represents a larger percentage of the income of a low-income household than a high-income household. One response to this argument comes from the noted economist John Kenneth Galbraith, who focuses not only on the incidence of the tax but the combined effect of the tax and how its revenue is spent:[45]

> The relation of the sales tax to the problem of social balance is admirably direct. The community is affluent in privately produced goods. It is poor in public services. The obvious solution is to tax the former to provide the latter – by making private goods more expensive, public goods are made more abundant. Motion pictures, electronic entertainment and cigarettes are made more costly so that schools can be more handsomely supported. We pay more for soap, detergents and vacuum cleaners in order that we may have cleaner cities and less occasion to use them. We have more expensive cars and gasoline so that we may have more agreeable highways and streets on which to drive them. Food being relatively cheap, we tax it in order to have better medical services and better health in which to enjoy it.

It is proper that a portion of the revenue obtained from a VAT be set aside for the design and implementation of the spending measures, whether they

[42] See Lessons of Tax Reform, at Box 2 on pp. 24–25 (World Bank 1991). On consumption tax, see the in-depth discussion in Fried, "Fairness and the Consumption Tax," 44 *Stanford L.Rev*. 961 (1992).

[43] See S.722, USA Tax Act of 1995, 104th Cong., 1st Sess., 141 *Cong. Rec.* S.5664 (Apr. 24, 1995).

[44] See discussion of Direct and Indirect Tax in Section IV.

[45] John Kenneth Galbraith, The Affluent Society 238 (4th ed. Houghton Mifflin Co. 1984).

be food stamps, subsidized rents, or other social welfare measures. Thus, to the extent that a value added tax increases prices of goods that poor people buy, it is proper for public policy to provide relief through public spending measures tailored to the needs of those targeted for relief. The best modern brief statement of this policy comes from the Fiscal Affairs Department of the International Monetary Fund:

> Fiscal policy – taxation and spending – is a government's most direct tool for redistributing income, in both the short and the long run. However, the effect of redistributive tax policies, especially in the face of globalization, has been small. Policymakers should focus on developing a broadly based, efficient, and easily administered tax system with moderate marginal rates. Although the primary goal of the tax system should be to promote efficiency, policymakers also need to consider how to distribute the burden of taxation so the system is seen as fair and just.
>
> The expenditure side of the budget offers better opportunities than the tax side for redistributing income. The link between income redistribution and social spending – especially spending on health and education, through which governments can influence the formation and distribution of human capital – is particularly strong, and public investment in the human capital of the poor can be an efficient way to reduce income inequality over the long run.[46]

Advocates of consumption-based taxes claim that income-based taxes discourage savings by double taxing it. Richard Goode disagrees:[47]

> Saving is an individual decision about the use of income that does not diminish the saver's capacity to bear taxation. Saving itself does not attract tax. What an income tax does strike is the additional economic resources that a saver gains by lending or investing. In this respect, the return on savings is treated exactly like wages or any other accretion to one's command over economic resources.[48]

> Goode concedes that consumption taxes encourage savings, "which is especially desirable in developing countries. Under a consumption tax, the net return that can be obtained on income that is saved and invested is higher (in relation to the amount of immediate consumption foregone) than it is under an income tax. With comparable tax rates, the difference is due solely to the fact that postponement of consumption also postpones payment of a consumption tax but does not postpone payment of an income tax."[49]

Figure 1.1 illustrates the income and product flows for income and consumption tax bases. Table 1.3 and its acccompanying notes show the

[46] Excerpt from "*Should Equity Be a Goal of Economic Policy*?" by staff of IMF's Fiscal Affairs Department, 35 Financial Development #3, Sept. 1998, p. 4.

[47] Goode was the first director of the IMF's Fiscal Affairs Department, serving from 1965–1981.

[48] R. Goode, Government Finance in Developing Countries (Brookings Instit. 1984) [hereinafter Goode, Government Finance in Developing Countries], pp. 141–142.

[49] *Id.* at 142.