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Incidence of Business-Profits Taxes

By GEORGE V. KRACHT

Since the year of 1916 the problem of the incidence of a general tax upon business profits has had a deep interest for industrial executives and public accountants. In constructing and interpreting graphic charts and comparative statements of operating results, computing goodwill or estimating the prospective earning power of a business on the basis of past results, the disposition of the high federal taxes paid becomes undeniably a troublesome question. Yet this question must certainly be answered in one way or the other before any satisfactory inferences can be drawn by executives from comparative data.

PROPOSED SOLUTIONS

Three more or less well-defined schools of thought on this perplexing problem exist. The first, carrying with it the unquestioned authority of Professor E. R. A. Seligman, maintains that profits taxes cannot be shifted; that all efforts on the part of taxed agencies to redistribute them over the community through the media of higher prices meet with an effectual resistance on the part of the consuming public; that the eventual result of these efforts is merely higher prices or nominal profits before taxes, but the same real profits, it being assumed, of course, that other factors influencing profits remain constant. Translated into ordinary accounting terms, this school holds that profits taxes represent distributions to the government as a partner in business enterprises.

A second school of thought contends with equal definiteness that all profits taxes are actually paid by the consumer; that the producer or distributor pays only that portion thereof which he would normally pay in his capacity of an ultimate consumer; and

that the diffusion of such taxes is accomplished through the means of a changing price level. In other words, it is contended that profits taxes constitute a cost of production.

A less arbitrary and perhaps more inconclusive stand is taken by still another set of writers. These latter hold that a partial redistribution of a business tax levy is generally accomplished, but that the ratio redistributed cannot be uniformly defined with any substantial accuracy. So far as the accountant or business man is concerned, the practical effect of the conclusions of this school is that the relation of income taxes to operating profits is a special matter to be considered in interpreting charts and statements, but one not capable of mathematically precise definition.

In the face of this wide divergence of opinion among experts, the layman is inclined to throw up his hands and fall back upon an attitude of agnosticism. Unfortunately, some working postulate on the subject is a matter of practical necessity. The accountant and the executive must arrive at a decision, whether they wish to or not, simply because they deal with questions which involve and demand a decision. I, therefore, make no apology for discussing this contentious problem in these pages, confessing, at the outset, my adherence to the theory last mentioned.

The Argument from Statistics

A set of facts and a basic theory of political economy are usually advanced by the "non-diffusion" advocates in support of their contentions. The set of facts is that during the past seven years prices have not varied concomitantly with the tax levies; that during the years of almost confiscatory taxes (1917 and 1918) commodity prices were lower than in subsequent periods; and that consequently no causal connection between the two series of phenomena can exist. But since taxes cannot get redistributed over a community except through the medium of a changing price level, it is concluded that taxes upon business profits cannot be shifted.

The argument would be convincing only if the reaction of prices to profits taxes must be direct and instantaneous. That assumption, as every producer of commodities knows, is invalid.

An abrupt increase in the rates at which profits taxes are levied creates a problem, which the business world solves gradually, hesitatingly and piecemeal. Even the monopolist is compelled to act slowly in the face of such a situation, to experiment and to revise his sales policies several times before he attains that nicety

of adjustment of price to market which insures him the maintenance, so far as is possible, of his status quo. How much more true is this of the tenuously connected groups of producers whose policies determine prices in competitive fields!

An extremely high tax levy does not pass through the industrial system with the rapidity of an electric current. The fabric of that system is made of adaptable but highly resistant material; its processes of accommodation are slow and involved; and the full effects of a sharp change in the environing influences surrounding the system do not become apparent until after a considerable period of time has elapsed. Consequently, the assumption that, since prices have not varied concomitantly with taxes during the past decade, the two phenomena are not causally connected may be passed by without further argument. It is unnecessary to point out that major inflating influences, other than taxes, at work during this period must be considered, if any valid inference from statistical data is to be drawn.

THE LAW OF PRICE

The economic law upon which is based the contention that profits taxes cannot be shifted offers greater difficulties.

Professor E. R. A. Seligman, the leading exponent of this school, presents it in the following words:

> But while there is only one price for exactly similar units of the same commodity in the market at any given time, there are, under conditions of competition, always differences in cost. . . . At any given time the normal price will tend to equal the highest cost of production. As long as the demand at any particular time is sufficient to take off the total supply of commodities produced at different costs, the price at which the whole supply will be sold tends to be fixed at the point of greatest cost. Inasmuch as the price is fixed at the cost of producing the most expensive portion of the supply that is actually sold, the difference between the lowest cost and the actual price—that is the difference between the cost of producing the article under the most disadvantageous circumstances and that of producing and bringing it to market under the more favorable conditions, constitutes the producers' surplus or profits. Profits are the result of the industrial process; they do not represent cost, but surplus over cost.

Consequently, Professor Seligman concludes:

> Under normal conditions, when there is neither a business boom nor a business depression, when there is neither a sellers' market nor a buyers' market, but just an ordinary normal average market, the producer will not even have an excuse for adding an income tax to the price. For, as we have pointed out above, prices will be fixed under normal conditions at the cost of production of the marginal competitor who pays no taxes; and he pays no taxes because he finds at the end of the year that he has made no profits. ("Can Income Taxes be Shifted?" *The National Income-Tax Magazine*, April, 1924.)

From such premises, Professor Seligman draws the definite inference that "taxes on business incomes cannot be passed on in the shape of higher prices. . . ."

The Marginal Producer

These premises constitute the basis upon which the structure of the political economy of the so-called classical school has been erected. With the fundamentals of the premises, we need here raise no quarrel. It is undoubtedly true that prices tend to coincide with the highest cost of production for the reason that industry is substantially competitive. Abnormally high profits in any field of activity attract new capital thereto; the first effect is an increased supply; and, as price is largely a function of supply and demand, the subsequent result is lower prices. The modus operandi of these economic forces should be manifest to every public accountant.

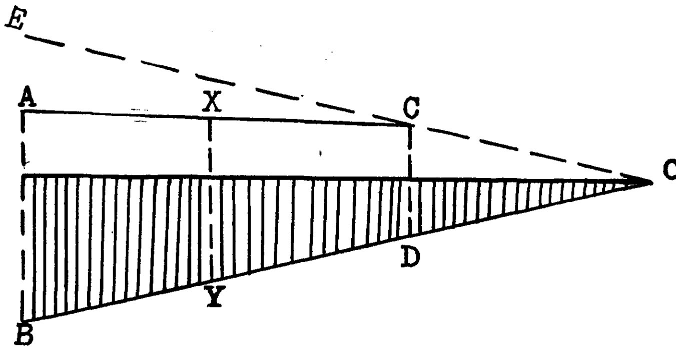
We must, however, quarrel with the assumption that this tendency of price to coincide with the point of greatest production is uniformly realized. If the industrial organization were a static condition, with a plenitude of capital, available labor supply and the other factors requisite to an instantaneous achievement of ends, the tendency in question might be largely realized.

But industry is certainly not static in character. It is rather an organism; a fluctuating balance of forces, some exclusive, others complementary. Capital and labor, production and consumption, supply and demand, inventive progress, growth of population and innumerable other forces enter into that unstable equilibrium which we call modern industry. Tendencies everywhere are opposed, deflected from their course or brought to a standstill at some intermediate point. We may say that such and such a force per se tends to produce certain definite effects; will produce such effects if unmodified; but that is quite different from the assertion that the effects in their entirety are fully realized.

In the present case, the nature of the opposition met by the tendency of competition to depress prices to the level of highest costs will readily occur to every public accountant. New fields of industry are continually opening up to capital through the creation of new wants; old fields are being constantly expanded through normal growth of population and invention; while both are influenced by the ever increasing productivity of labor.

As a result of these forces, even in the old established industries, the downward tendency of price is halted before it meets the rising cost of production. And when, through the progress of invention, the line describing cost of production in any particular field is depressed to a lower level, the margin between price and cost of production is temporarily still further increased.

The distinction between a cross-section of any special group of producers at any one time on our theory and that propounded by Prof. Seligman may be graphically illustrated by the following diagram:



In this diagram, the line AC represents the price level established largely by the workings of the law of supply and demand. BD reflects cost of production, increasing as it includes concerns producing at higher costs. The distance between AC and BD at any point (AB, XY, CD) measures profits to the producers located at such point on BD. The line EC is drawn to give effect to the consideration that if supply were decreased by moving the line CD towards AB, the price level (AC) would be raised. In actual commercial practice, this latter line would probably be broken; and the entire diagram must be taken as an illustration of a set of principles rather than a graphic representation of fact.

The shaded area represents Professor Seligman's extension of the theory outlined above. Inasmuch as he presumes a greater supply than have we, the price level would be lower; that is, it would normally be located at O, the point at which EC extended intersects the extension of line BD. The result is, of course, to reduce profits of all producers, although as stated, no attempt has

been made to fit the representation to any industry; and, consequently, the proportions shown are purely arbitrary.

Marginal Profits

It follows from the foregoing that the dominating fact with regard to industry is that the great bulk of production is conducted at a substantial profit. If it were not, the incentive to risk money for such purposes would disappear. And when any particular field of activity becomes exploited to the point where profits commensurate with risk cannot be secured, capital begins to flow in other directions.

Naturally producers make mistakes and frequently create conditions in some particular field which force the marginal producers to operate at a very narrow margin of profit. However, even here, the progress of invention, the growth of population and other factors quickly effect a readjustment.

In short, while it should be granted that prices tend to meet the point of highest cost, they never do so simply because the moving forces of industry interpose. In a static society the coincidence might conceivably be realized; although even in this case, it is difficult to see what incentive would be offered investors to tie up money in enterprises which cannot produce at a reasonable commercial profit. However, the point need not here concern us.

Revised Status of Problem

Granting that under normal conditions the producers at highest cost still earn reasonable profits, have we proved that the business taxes can be shifted? True enough, the motive to shift part of the taxes through the media of higher prices still exists. But can that motive be made effectual? And if it could on our assumption, why could it not equally be made effectual on the assumption outlined by Professor Seligman? The marginal producer, whether he feels the taxes or not, always has before him the motive to increase profits through prices, as have all other producers of commodities. If then, he does not increase them, it is because of the operation of laws which resist his desire so to do.

Consequently, it would appear that even though Professor Seligman's assumption that marginal producers generally earn no profit is untrue, still the situation is not a whit improved. The motive to earn higher profits through larger prices is present both

before and after a tax levy, and it is not clear just how the imposition of such a tax could render the motive effectual.

To make this clear, we are compelled to return for a moment to the forces that fix price. The essentials of the classical theory of supply and demand must, I think, be conceded. Price is largely a function of these two variables; the highest cost of production does not create or fix price; it merely conditions it.

Let us put this as simply as possible. At any given time, a certain quantity of any particular commodity can be sold at a given price. Usually, however, due to our long and complex process of production, supply precedes demand. Demand regulates future supply; the present is a definite quantity. This total existent supply can be sold only at a certain price, dependent upon the demand therefor. Consequently, price is said to result from the working of the law of supply and demand.

Now, if the price for any commodity remains, for a substantial period of time, farther above the highest cost of production than is the case with other commodities, capital will flow into that particular field, increase the supply and depress price. It will continue to flow in, however, only to the point where relative profits warrant. After that it will be attracted to other fields. If a mistake is made and the industry is expanded to the point where price equals or exceeds the highest cost of production, expansion will cease until demand catches up with supply. It will probably be clearer, therefore, if it be said that prices of commodities never for any long period fall below the point where they insure a reasonable profit to producers. This fact is clear to every accountant who has made even a superficial study of modern business.

Consequently, it would appear to make no difference whether marginal producers do or do not have to pay a tax on business profits. The point is whether producers affected by the tax can shift a portion thereof to other shoulders by means of higher prices. If they can, any producers not operating at a profit will gladly follow their example.

Immediate Effects of Levy

Price, as stated, is largely a function of supply and demand. Unit commercial profits are the difference between prices and cost of production. To shift taxes, therefore, producers must be able to increase prices and at the same time keep demand from falling

below the point where the higher unit profit is not eaten up by the lower number of units sold. What new elements does a tax on business profits introduce into the situation which enables them to do this?

For one thing it provides an additional motive for united action on the part of that dominant set of producers who operate on the whole at a reasonable profit. The coöperation in question may be largely unconscious; it may result, for the most part, from the partial suppression of the spirit of competition in the face of a common enemy. Imitation becomes a more powerful influence on that account; and as a result thereof a nicety of adjustment of supply to demand, not previously attained, is made possible.

This factor is worthy of further notice, for an examination of it discloses how widely divergent are the theories of the political economists from the facts as they are known to the public accountant. The effects of a tax on the profits of the monopolist offer the best entrée to our investigation.

Monopolists and Profits Taxes

The economists uniformly contend that the monopolist, at least, cannot shift profits taxes. The reasoning upon which their conclusion is based has been so clearly and tersely presented by Professor Seligman in the article previously mentioned that we cannot do better than to quote again from it.

Professor Seligman states:

> But if the tax is imposed upon his (the monopolist's) profits, it will not lead him to increase the price; for, if he could do this without cutting down his sales, he would have done it before the tax was imposed. What the consumer is willing to give is unaffected by what the producer is compelled to take. In the case of a tax on output the producer may find it to his interest to sell a little less at a higher price; because the less he sells, the smaller his tax: but in a tax on net profits his tax is reduced not by the falling off in output but by the falling off in profits; and if he increased the price he would suffer a double loss, namely in his lower profits as well as in the payment of the tax. He will therefore prefer to maintain his profits and pay the tax, that is he will not shift the tax to the consumer.

These statements would be erroneous even were the monopolist motivated in all his actions by a narrow self-interest. The producer who is wise enough to have gained control of the agencies manufacturing or fabricating any commodity knows full well the danger of leaving unsatisfied a large demand for his commodity which could be filled at a reasonable profit. Such action would not only imperil his commanding position by inviting either direct competition or competition through substitutes, but it would also

lay him open to attack by the legislative or other protective social agencies. Consequently, even though he possessed the insight into social forces necessary to the nice adjustment of price to profit which Professor Seligman assumes and even though he were able to maintain that adjustment in the face of a fluctuating demand, it would not always be to his interest to do so. The competition which obtains among commodities and the danger of adverse legislation or of arousing a strong public sentiment would always exist. The most that can be said is that the monopolist, who is guided always by self-interest, maintains prices at a point which permits the largest profits in a given situation; due regard being given to the danger of inviting competition or adverse public action. This point is usually the point at which all demand for the commodity at a price sufficiently higher than cost to insure a reasonable profit on investment can be satisfied. Possible competition is a factor as strong as actual and, in a certain sense, competition (i. e., commodity competition) always exists. The conclusions to be derived from these facts are important.

Before drawing them, however, the existence of other factors tending to depress monopoly prices to the point where they insure only a reasonable profit on investment should be noted. Probably every public accountant has had an opportunity at some time or other to study the development of a concern producing a patented article. If so, he knows that prices are first fixed experimentally at a figure which is substantially in excess of cost; that if consumers actively bid against one another, this price may be later increased, but otherwise will probably be maintained; that as production facilities are expanded, revisions of price downward are made when found advisable; but that the producer never attempts that endless experimentation with prices which would be necessary if the maximum of profits were to be secured. Habit, an influential force in industrial life, prevents, if nothing else. The market, of course, is studied with relation to cost and prices; policies are revised, etc. But the attainment of the maximum of immediate profits is uniformly prevented by the influence of habit and the difficulties which surround such attainment.

Monopoly Slack

Now, such being the case, it is apparent that some slack always exists which the monopolist can pick up when an additional motive to do so is supplied. How large this slack is, how much he

can increase prices without endangering his profits, depend upon evident factors—such as the extent of commodity competition to which he is subjected and the degree to which his policies have previously been influenced by motives other than the desire for a maximum of immediate profits (habit, the instinct to expand, the difficulties and effort of experimentation with prices, the fear of inviting competition of a direct or indirect nature, etc.).

The balance of this complex set of motives, manifesting itself in certain established price policies on the part of the monopolist, will obviously be disturbed by the sharp reduction in his profits. The fear of inviting competition will speak with less authority, if for no other reason than that such competition would be less likely to arise in the changed situation; while the disposition to move along the lines of least resistance (one of the most powerful motives in industrial life) will be transformed into an intense effort to maintain the status quo of the industry.

That this effort can be made effectual is apparent, even though we assume for the moment that results are accomplished at the expense of less fortunately situated producers of other commodities. Although economic laws condition his influence, the monopolist, at least, has the power to react advantageously upon the industrial situation. The margin allowed him may be narrow and sharply confined, but it is none the less real.

Competitive Industry and Profits Taxes

Of course, the obvious retort to all this is that the monopolist has merely succeeded in enriching himself out of the pockets of his fellow producers; that by raising his prices and thereby shifting all or part of his taxes, he has curtailed the market for other commodities; and that the producers of such commodities are now subjected to the double burden of taxes and declining sales and profits.

This would be true if the total demand for consumable commodities were a fixed factor—that is, to translate the thought into ordinary commercial language, if the consuming public has at any one time only so many dollars which it is willing to spend. Before going into this subject, let us assume for the moment that demand itself in terms of dollars is a variable affected by price. If that be the case, then not only may the monopolist be able to increase his real profits through higher prices, but so also may agencies producing under conditions of competition.

We have already examined the argument that this assumption is invalid, because if any set of producers were able to increase profits through the media of prices, they would have done so without the incentive furnished by the tax levy. Such a statement of the case assumes an adaptation of means to ends, of policies to profits, which the facts of industrial life do not warrant. The situation of the monopolist has been minutely examined; the situation of competitive industry is similar. If the latter agencies do not hold the positions of strategic importance occupied by the monopolists, they acquire equivalent advantages, in that the tax levy provides an incentive to temporary coöperation among them. While an increase in price on the part of one producer before the levy would scarcely have moved his competitors to imitate his example, the situation thereafter would be radically changed. In short, the attempt to shift taxes through higher prices would be almost universal.

Consumption and Profits Taxes

Now, the other side of the picture confirms the inferences which have been drawn from our examination of the producing agencies. This examination has led us to believe that no producer has fully exploited his market, or, in other words, has been earning the highest profits he can get, production factors remaining constant. But how can this statement be reconciled with the existence of a definite dollar demand? It would certainly seem that in a general price-raising movement, motivated only by a profits tax, some at least must suffer.

It would, if consumption were not also a variable, influenced by prices. To say that the producing world can increase its real profits through higher prices within certain undetermined limits is the same thing as to say that the consuming world can and will, if necessary, spend more dollars on consumable products. Let us examine this possibility.

Now, a cross-section of the consuming world, at any one time, would show a certain amount of income being disposed of to satisfy immediate wants, the balance being put away as savings. There has been attained what may be called temporary equilibrium of desires. Confronted by an increase in the prices paid for articles consumed, the consumer will readjust his wants to his decreased real income. Some will maintain their savings and cut down on immediate wants; others will decrease both; while at the

opposite extreme still others will, if necessary, use up past savings in the effort to maintain their previous standard of living.

If, therefore, a wide movement of prices upward is created by the producers, while some producers will suffer because of commodity competition, it may be generally stated that the consuming public will increase its price purchases. The increase may not be sufficient to absorb the same units produced at the higher prices, because of the curtailment of wants through motives of necessity or desire, but it will in all cases be substantial.

The effect on the profits of the various classes of producers will be various. Consumers who curtail their wants must readjust themselves to the new price situation and choose between them. Monopolists or favored industries, which have been strongly influenced in past policies by motives other than self-interest, will be relatively benefited; commodity competition may force producers of luxuries to operate on a lower margin of profit, relatively to their previous situation in the producing world. Nevertheless, taking the producing agencies as a unit, they do undoubtedly manage to shift part of the tax levy. How far each member thereof is successful depends upon factors, some of which have been suggested, all of which the public accountant should study in constructing and interpreting comparative statements.

A collateral effect of this process is obviously the decrease of capital which can be invested for productive purposes. The producer must be satisfied with lower profits, the consumer with lower savings. Consequently, due to the natural growth in population, the equation between supply and demand becomes further disturbed and the working of these economic forces confirms and stabilizes the new price level, and perhaps even raises it still more than it has been raised.

Even if the producer alone first bore the entire tax burden, the factors just mentioned would eventually shift part of it to the consumer. Since such levies produce increased motive to coöperation among competing producers and a motive on the part of the monopolist to exploit the market more thoroughly, the action of the producer will precede the action of supply and demand.

Where agricultural products (such as wheat or corn) are concerned, the influence of the producer on the market is, at the best, feeble. Such groups must, for the most part, await the appearance of rigidly caused effects before part of the tax can be transferred to other shoulders.

Specific Conclusions

The conclusions, important to the public accountant, then are:

1. That part of the taxes levied on business profits can be shifted.
2. That the extent of the shift, with relation to any particular producer or set of producers, depends upon the special factors surrounding each case.
3. That, in interpreting and constructing comparative statements, all such factors should be carefully studied for the purpose of disclosing the true effects of federal taxes on operating profits.
4. That, while such effects cannot be determined with mathematical precision, the general relations of operating profits to profits taxes can be described with substantial accuracy; and that a knowledge of such relations is necessary to a correct reading of comparative statements, involving years of abruptly changing tax rates.

The general principles outlined above should enable every public accountant to prosecute his investigation into their special application to any industry with profitable results.