Economic Newsletter for the New Millennium

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TAX PROPOSALS HERE, TAX PROPOSALS THERE, TAX PROPOSAL EVERYWHERE…BUT HOW DO WE ANALYZE THEM?

Soak the rich if can agree on who they are; 999 is the way to go; flat tax rate or bust; and on and on it goes. This current crop of tax proposals is not new. Huckabee, Forbes and others from previous elections, put forth similar ideas. Unfortunately, public finance theory explains very clearly that those persons and non-person entities initially and legally mandated to pay the tax are not necessarily the ultimate bearers of the tax burden. In public finance theory, the topic is referred to as the 'shifting of' and 'incidence of' taxes. "I did not know that," you say. Well sit back, have your aspirin or some such pain reliever at the ready, and fasten you intellectual seat belts. We are about to embark on a flight into the now you see it, now you don't land of the initial incidence, the shifting and final incidence, or where the burden finally rests, in the life of a tax.

Our example of the analysis of the effects of a tax will focus on the profits tax. Mass confusion exists over this tax as it does for most taxes. If you think that the firm legally mandated to pay a corporate tax (at the state or federal level) is necessarily the ultimate bearer of the entire profits tax, think again. If you think it is ultimately borne only by the rich fat cats, think again. That is why you were asked to have a pain killer at the ready.

One of the best minds of this past century in the area of public finance, the now deceased Richard A. Musgrave, a former professor of mine many years ago, would lament in his lectures and in his text book, *The Theory of Public Finance* (1959), that no matter what the law says, who actually ***is*** the ultimate bearer of all or part of the profits tax, can differ dramatically from one case to another. After going through a kind of verbal games theory of analysis, he concluded that one guess is probably as good as another and perhaps the assumption as to who on average bears the corporate profits tax would be one-third of the final burden resting on the buyers (higher prices), one-third on the equity capitalists (stockholders in the form of lower dividends), and one third on the other productive resources such as labor (reduced wages/compensation). Imagine that, labor ultimately bearing one-third of a corporate profits tax on the firm employing labor. If the firm's product is a consumer product, labor ends up ultimately another significant portion of the firm's profits when the worker purchases the product in question. But, but, but…you shout at me in a whining fashion, that your community organizer disagrees, to which I say join your organizer in city centers and add to the cacophonous din in the chaotic demonstrations.

Richard A. Musgrave - *THE INCIDENCE OF BUSINESS TAXATION*

THE AMERICAN UNIVERSITY LAW REVIEW [Vol. 29:331 1980]

http://www.wcl.american.edu/journal/lawrev/29/tipps.pdf?rd=1

Although I wanted to present these statistics by way of introduction, the analysis of the tax structure in terms of what share is borne by business is inappropriate. Businesses do not pay taxes, businesses do not become poor. The business owners become poor, the business employees get lower wages, or the business customers pay higher prices. Businesses are merely intermediaries to tax burden distribution. I am not saying that businesses are not powerful organizations with social and political influence. I am not saying that if there is a need for regulation, the shareholders should be regulated instead of the corporation. I am saying only that it is obvious that corporations and businesses, themselves, do not bear taxes to the same extent as owners, customers, and employees of the businesses. If one is interested in what happens to the distribution of the 'tax dollar, it is the distribution among people that should be examined, not the distribution between businesses and others. Thus, if one looks at *the shifting pattern, the question clearly is whether, as part of this changing pattern, the tax burden distribution has become more progressive or less progressive.*

The Reality

First of all, recall that the firm is simply the place where the transformation process of production occurs. The firm is not the debt (bondholders) or equity capitalist (Stockholders… being the owner of the firm and as such is self-employed as the equity capitalist). The firm is also not the entrepreneur who determines the output and input mix and negotiates the compensation to the other resources including labor. Neither is the firm the labor or land it employs. If this is understood, it would seem that the profits tax falls upon the owner or equity capitalist and not the firm employing the equity capital. But while this is so, it is only the initial incidence and nearly always not the final incidence (or burden) of this profits tax. The owners or equity capitalists do not bear the ultimate tax burden or at least not all of it. Most people are of the mindset that the owners of the firm bear all of the profits tax, but that is incorrect, or at least partly incorrect, depending upon how much of the burden can be passed forward to the buyer of the firm's product or backward to the other resources such as labor.

Also remember that we are well into the age of Institutional Capitalism. While there are a few privately owned firms with a narrow base of ownership, the capital stock of most of the large publicly traded firms are increasingly owned by financial institutions such as mutual funds, life insurance companies and pension funds. To the extent the profits tax falls upon the owners of firms, they fall upon the beneficiaries of pension funds, the owners of mutual fund shares such as the Vanguard family of mutual funds or stockholders in Buffett's Berkshire Hathaway, and policy holders of mutual life insurance companies and stockholders of the stock life insurance companies. Most of these are not the rich and the famous. They are very likely to be Jose the Plumber or Mary the financial analyst or Luke, the greeter at your local Wal-Mart or Costco outlet.

Depending upon the price elasticity of demand, some or all of the ultimate burden of the profits tax could be passed forward in the form of a higher prices to the buyers or backward to the other productive resources in the employ of the firm whose profits are being tax ed. The only general rule is that the more price inelastic is the demand for the firm's product, the more likely is a portion of the burden of the tax that will be passed on the buyer.

THE PRICE OF A COLLEGE EDUCATION:
a troubled pricing environment in academia

http://www.econnewsletter.com/73901/38201.html

Using college tuition (or total cost, as an example)

Economists have a name for this relationship between price, quantity demanded, and the effect on total revenue. It is called price elasticity of demand. If in response to a price or tuition rate increase, total tuition revenue increases, the price range in which the price change occurs is said to be relatively inelastic.

For further reading on Price Elasticity of Demand, be sure to read the following…

Definitions and Miscellaneous – Price Elasticity of Demand

http://econnewsletter.com/98601/98622.html

The degree to which a good or service is price (in)elastic is heavily dependent of the substitution effect. The substitution effect in turn depends upon the number of substitutes for the product of the firm whose profits are being taxed and the degree of substitutability of competing goods and services.

Similarly, the more price inelastic is the supply of the productive resource (labor, debt and equity capital, entrepreneurship, and land), the more of the final burden is passed backward to the productive resources employed by the firm in the transformation process of production.

Which of the productive resources and how much of the final burden will be borne by each of them differs in each case and may change over time. How much will be passed forward to the buyers and how much backward to the productive resources depends upon the price (in)elasticity of the demand for the product and the supply of each of the productive resources. This can change over time as the product and resource markets change.

One thing is certain, the firm, qua [as] firm, will not ultimately bear the final burden of the profits tax regardless of the legislative mandate as to who initially will pay the tax or be burdened with the initial incidence. Remember the firm is only the place where the transformation process of production occurs. Households from whence the productive resources originate, at least in a free market capitalistic system, as either the supplier of the productive resources or as consumer of the goods and services produced, ultimately bears the entire tax burden.

> **Again, from Richard A. Musgrave:**
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> ***Businesses do not pay taxes, businesses do not become poor. The business owners become poor, the business employees get lower wages, or the business customers pay higher prices. Businesses are merely intermediaries to tax burden distribution.***

For this reason the progressivity or regressivity of a profits tax cannot be determined despite the popular view that the rich bear the burden of the profits tax.

To reduce the need for the pain reliever you have had at the ready, in a later article on the web site we will analyze the much bantered about spending tax, sales and excise taxes are examples. Early in my graduate studies, I was in attendance at a lecture given by the British economist, Nicholas Kaldor http://en.wikipedia.org/wiki/Nicholas_Kaldor. Guess what it was about? A spendings tax (e. g., VAT – Value Added Tax) and this was fifty some years ago. At that time he was the leading authority on such a tax.

As Scripture (Ecclesiastes 1:9 http://www.usccb.org/bible/ecclesiastes/) tells us, "What has been, that will be; what has been done, that will be done. Nothing is new under the sun."