Journal of Accountancy

Volume 32 | Issue 2 Article 1

8-1921

Fallacies of the Sales Tax

Walter A. Staub

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 32 AUGUST, 1921 No. 2

Fallacies of the Sales Tax

By WALTER A. STAUB

Solomon truly said "There is no new thing under the sun," and so the sales tax which has been very ardently advocated for enactment in the United States is found on examination to embody a principle of taxation which was in use many centuries ago and which the best thought on the subject of taxation has long since discredited. As Professor Seligman well said in the course of the long and exhaustive study of the taxation problem made during the past fall and winter by the tax committee of the National Industrial Conference Board:

> The sales tax is not a novel tax. . . . The Romans had it, not to speak of the Egyptians, and the Babylonians. . . . With only two exceptions, it has been abolished everywhere and has not been reintroduced in any first-class country—and those two exceptions are Germany, which reintroduced it in 1919, and France, which, as has been said, introduced it in 1920. Now before we consider the experiences with this tax, it must be remembered that we can learn little one way or another, either for or against it, from Mexico or Cuba or the Philippines, or Canada, all of which are countries of insignificant economic proportions, where we do not find the real kind of sales tax that we have been discussing. . . . *

FOUR PROPOSITIONS

There has unfortunately been a great deal of loose thinking on the subject of a sales tax and many business men have been carried away with the alluring prospect of a tax which would (a) raise a large amount of revenue for the federal government; (b) impose no burden on business because it would invariably

*Special Report Number 17, page 72.

and in full amount be passed on to the consumer; and (c) be spread out so thin that it would impose no appreciable burden on the consumer. It will perhaps be helpful to state briefly a few cardinal propositions.

1. No tax which is expected to raise from $1,000,000,000 to $6,000,000,000, or even more, in one year (the estimates vary between those figures) can be a "trifling tax." It is bound to be felt by someone.

2. A tax is not necessarily light because expressed in a low rate. A tax of 1 per cent. on the *gross* sales may not infrequently amount to 40 or 50 per cent. of the *net* profit from the sale. If a sale results in no profit, or even a loss, and the tax must nevertheless be paid, 1 per cent. may prove a crushing burden.

3. If a sales tax cannot be passed on to the consumer, it becomes a tax on gross earnings and far outdoes in injustice the crudest income or profits tax.

4. If a sales tax is passed on it becomes a tax on consumption (needs) instead of being imposed according to ability to pay (income).

LURE OF A LOW RATE

Perhaps nothing has been more responsible for the apparent favor with which many business men greeted the proposal for a uniform tax of 1 per cent. on all sales than the low rate. The pioneers of the present movement for such a tax were, whether they were themselves aware of it or not, psychologists of no mean order when they selected a base for the tax which would permit of naming a rate as low as 1 per cent. After having to struggle during recent years with taxes expressed in rates running as high in one year as 80 per cent. (on net profits, not on sales), the slogan "a tax of only 1 per cent." made a strong appeal to the American business man. If he did give thought to the vital difference between imposing the tax on gross business instead of on net profit, he was told that in any event the tax would all be passed on to his customers.

Now it needs to be realized that what matters in the final analysis is not the number of tax-doses but the aggregate of the doses. The individual rain drop is trifling in size and force, but when there are enough drops they produce a cloud-burst. So with the sales tax, the rate in which the tax is expressed is in one sense quite immaterial. The important questions are (a) what amount is to be raised by the tax; (b) what will be the effect if the tax is passed on to the consumer; and (c) what will be the result if the tax cannot be passed on?

PRODUCTIVITY OF SALES TAX

As to the first of these questions, the tremendous variation in the estimates of the productivity of a 1 per cent. sales tax raises grave doubt of its desirability as a governmental fiscal measure. Estimates of the amount it will produce range all the way from $1,000,000,000 to $6,000,000,000, and some extravagant estimates run even higher. Much has been said of the unreliability of incomes or profits as a basis for taxation, yet it is a question whether even the excess-profits tax—were it to be retained, which does not seem likely—would be much more difficult to estimate as to productivity for a year in advance than has proven to be the case with the sales tax which was enacted in France last year. Advocates of a sales tax in the United States made much last fall of the imposition of such a tax in France during the preceding summer. They make but little reference to it now, doubtless for the following reasons:

(a) The tax has proven to be extremely unpopular. This is quite contrary to the assurances given us that a sales tax is spread out so thinly over the consumers that none will feel it appreciably and, therefore, it will be readily accepted.

(b) The tax actually collected has always fallen far short of the budget estimates of the amount to be raised therefrom and has, in fact, been steadily decreasing; the latest reports indicate that in recent months less than 40 per cent.* of the estimated revenue to be received from the sales tax in those months was actually collected. This again is contrary to what we have been told is one of the most desirable features of a sales tax, viz., its extreme dependability as a revenue producer.

The argument for the dependability of the sales tax as a revenue producer was based on the premise that gross sales continue undiminished through a period of depression to a greater degree than is the case with profits. That profits decrease at a somewhat faster pace than the falling off in gross business is doubtless true, but that this offers insuperable difficulties in fore-

*A Paris dispatch in the *New York Herald* of May 29, 1921, stated that "February's receipts amounted to only one-third the estimates."

casting revenue from income taxes as compared with estimating the productivity of sales taxes is not true. In Great Britain the income tax has been the leading factor in the national budget for over half a century and through periods of varying prosperity and depression. The annual forecasts of the revenue to be derived from that source have been much more dependable than the forecasts of the revenue to be derived from the sales tax in France. Further, who are better able to pay taxes, those whose income is cut off entirely—and it is estimated that at the present time 5,000,000 wage earners in the United States are unemployed—or those whose incomes continue during a period of depression even though in reduced measure?

PASSING ON THE TAX

The proponents of a general-sales tax frankly advocate the passing on of the tax to the consumer, in fact, this expected passing on is claimed as one of the leading virtues of the tax. This is a most astounding situation. Practically all schools of economists have considered the ideal tax one which, when fairly imposed, could not be passed on but would be actually borne by those on whom imposed. In the past the effort has invariably been made to explain that a given tax was not passed on. For example, a favorite claim of some protectionists was that the foreigner really bore the tariff duties imposed on imports and that the cost of such goods was, therefore, no greater to the consumer than it would have been had no duties been imposed.

If the tax is invariably passed on, and if it is insufficient in amount to be burdensome to the consumer, why not simplify the tax still further—and simplicity is another virtue claimed for the sales tax—by imposing it directly on the consumer, say, on a poll-tax basis? This would eliminate the making of millions of monthly reports of sales; it would absolutely obviate any possible pyramiding of the tax; it would remove any incentive to find ways of doing business, such as leasing or consignment arrangements, which might technically avoid the imposition of sales tax; it would prevent any possible advantage in favor of the multiple process concern against the single process business; and it would with a vengeance bring home to those classes having only a low income the realization that they were actually paying a tax to the federal government and had a personal interest in its conduct—another virtue claimed for taxes which will fall not only on those having an income exceeding the $1,000 and $2,000 exemptions under the present income-tax law but also on those whose incomes fall short of those amounts.

Merely to state the proposal for such a tax, i. e., on a per-capita basis, is sufficient to show its impracticability as well as its unfairness. It would have as little chance of getting through congress as an icicle would have of getting through a hot summer's day. A per-capita tax of say $15 (assuming that the amount of tax to be raised is only $1,500,000), or of even only $10, for each man, woman and child in the country doesn't sound like very much to pay for the blessings enjoyed in America in these times as compared with the conditions under which a majority of the people in Europe are living at the present time. Surely that sounds like a small enough annual contribution from each inhabitant of the United States toward the fund out of which our national expenses are paid and by which the financial burden resulting from the war is carried. Yet we know that to levy such a tax would be unfair, inadvisable and probably impossible.

To require a workingman, whose wages are substantially all required to pay for the maintenance of his family in moderate comfort, to pay anywhere from $50 to $100 (assuming his family to consist of five persons) as an annual national poll tax would, especially in the present disturbed state of affairs, be the most foolish thing this country could do. As Professor Seligman says of the sales tax:

> Under our present system where the income tax is expected to yield about one and a quarter billions, and the excess-profits tax about a billion dollars, the other taxes, most of which rest upon consumption, already aggregate about a billion. The proposition now is to take off one of those three chief categories—the tax on excess profits—and remove the burden from profits or wealth or income, and put it on the other or consumption side. This would, in my opinion, unduly shift the balance and bring us too near the position formerly occupied by all the aristocracies of old, and still reflected in some of the European countries.
>
> Why is it that England and America show their democracy, their real democracy, so much more than countries in the difficult position of Italy, or France, or Germany? There you will find throughout the war, and even now, the great mass of taxes imposed upon the consumption of the common man; whereas in England

> and in the United States, during the Great War, as over against our experiences in the Civil War, the great majority of taxes are raised from wealth; that is, from those who can afford to pay, rather than from the consumption of the necessaries and comforts of life.
>
> We measure wealth to-day in terms of income; that is, in terms of net income, in terms of social income; and those who are compelled to spend their entire income cannot afford to pay as well as those who do not have to spend all their income.*

What essential difference is there between such a poll tax and a general-sales or turnover tax? If invariably passed on, the sales tax must eventually converge on and be borne by the consumer's purchases. Thus, in a broad way, the tax would spread out on a per-capita basis. It is true that the wealthy would pay a little more per capita than the poor but just as the wealth of the very rich, if distributed ratably among the rest of the country's population, would increase but little the per-capita wealth of the ordinary workingman, so the larger expenditures of the wealthy would reduce but little (relatively) the per-capita living expenses of the working classes from the per-capita average of all classes. Also, some expenditures of the rich—such as wages of servants which form a material part of their living expenditures—would not be subject to the sales tax, whereas practically all a workingman pays for the maintenance of his family would be subject to the tax.

David F. Houston, formerly secretary of the treasury, recently said:

> A sales tax would be no substitute for an excess-profits tax. The excess-profits tax falls on corporations. The sales taxes would, without much question, be paid by consumers. If it is proposed to abolish all profits taxes, and to raise the revenue needed through sales taxes, then we should run into this equally great difficulty, that whereas now about 21 per cent. of our federal taxes are consumption taxes, then perhaps 50 per cent. would be consumption taxes. No student of taxation could or would defend making consumption the basis for such a percentage of our federal revenues. Consumption is not a sound basis for such a mass of revenues. Consumption does not measure ability to pay, and to raise the amount of taxes by a sales tax which a repeal of all profits taxes would imply, would throw us into an absolutely obnoxious and indefensible scheme of federal taxation.

*National Industrial Conference Board, Special Report No. 17.

IF THE TAX IS NOT PASSED ON

Viewing the question from another angle, what would be the results if the tax cannot be passed on to the consumer in its entirety? The answer is that the sales tax would then become a tax on gross earnings. A tax on gross earnings would far outdo in injustice and in unfair incidence any injustices which admittedly have been suffered in individual cases from the imposition of our crude war and excess-profits taxes. During 1918, a year of widespread business prosperity, the equal of which for volume of profits earned we are not likely to see soon again, one-third of the corporations of the country either earned no profit whatever or sustained an actual loss. Doubtless some of these were inactive corporations not doing business but on the other hand there were other corporations reporting profits which were but small in amount. It is clear that a considerable number of active corporations earned little or no profits.

If it is so simple a matter to pass on a sales tax, it should likewise be easy to pass on the full cost of goods manufactured or purchased for resale and the expense incident to the business. And yet apparently a considerable number of the business corporations of the country cannot, or for some reason do not, pass on all their costs or expenses. Why not? The answer is that cost alone does not determine what the purchaser can in turn secure when selling an article. Demand and supply play a large part in fixing the price. Sales-tax advocates are beginning to concede that in a falling market it may not be possible to pass on the sales tax and that in a rising market the loading of profit, due to the removal of competitive restrictions, may far outrun the amount of the sales tax which should theoretically be passed on.

In Mr. B. S. Orcutt's article on the *Overturn Sales Tax on Commodities,* which appeared in almost identical form in the *Wall Street Journal* and THE JOURNAL OF ACCOUNTANCY, he attempts to meet this point by providing for the charging of the 1 per cent. sales tax as a separate item at the foot of the seller's invoice. It is to be pointed out, however, that when this tax (which is to be paid to the government by the seller) is paid by the purchaser as an addition to purchase cost, he does not in turn specifically re-charge it to his customer. This tax is merged in or lost in the cost of his goods and the tax which he adds to the resale must be paid to the government and does not recoup him for the tax which he paid upon buying the goods for resale or for use in manufacturing. This process repeats time after time from the original purchase of raw materials through the various steps up to the final sale to the ultimate consumer.

It is also to be pointed out that neither the Smoot nor Mott sales-tax bills which have been introduced at the present session of congress call for the specific addition of sales tax as a separate item on the seller's invoice. Further, when the goods get down to the retailer, assuming that the 1 per cent. tax is to be charged specifically to the consumer, some very practical difficulties arise. Shall a full cent be added to articles selling for less than a dollar, so that on a single pound of sugar, say, selling for seven cents, a tax of one cent, or about 14 per cent., shall be collected? On an article selling for $1.10 is the tax to be two cents or almost 2 per cent.? If so, is the retailer to keep for himself the tax collected in excess of 1 per cent. on his aggregate sales? If not, he would have to keep a record of tax collected on each sale and thus the vaunted simplicity of the sales tax—the merchant simply sending the government a cheque each month for one per cent. on his total sales—would disappear.

On the other hand, if the retailer absorbs the tax as some sales-tax advocates graciously permit him to do, the tax becomes a tax on his gross earnings—instead of on his profits from such earnings—with all the unfairness and discrimination of a gross-earnings tax.

In a primer gotten out by one of the sales-tax propaganda organizations an illustration is worked out purporting to show the amount of sales tax resting on each loaf of bread with the results that it would be 1/6 cent per loaf. The naïve suggestion is then made that this tax, being so small, the baker may absorb it instead of passing it on to the consumer. Just why the baker should be selected for the doubtful distinction of absorbing the sales tax passed on by the farmer and miller is not explained.

Even assuming that the tax, no more and no less, is passed on through one stage after another of the processes of manufacture and distribution, is it not clear that the multiple-process concern would be given a considerable advantage at the expense of the single-process concern? Many sales-tax advocates in effect answer that the single-process concerns have thus far managed to exist in spite of the advantages possessed by multiple-process concerns and may therefore be expected to survive the added differential against them imposed by a turnover-sales tax. Does this sound just? Should a handicap be still further increased by tax measures?

On the general proposition of whether or not a sales tax could or would invariably be passed on, the following statement contained in a *New York Times* editorial (February 5, 1921) is typical of the loose thinking so prevalent on this subject:

> A flagrant instance of the vicious character of the tax imposed upon corporations in this country is disclosed in the annual statement of Montgomery, Ward & Co. of Chicago. With net sales in 1920 amounting to $101,745,270, the company shows losses of $7,855,278, including depreciation. Yet during this year of loss the federal government took from the company $860,326 in taxes upon business of the year 1919.

Had a 1 per cent. sales tax been in effect in 1920, the company would have had to pay $1,017,452.70 in sales taxes instead of only $860,326 in profits and income taxes on the profitable business of the preceding year. Also, the sales tax would have had to be paid regardless of whether a profit or loss was sustained on the sales of $101,745,270, whereas profits and income taxes are payable only if a profit is realized on the sales.

Again, if the sales tax could so certainly be passed on to the company's customers, why wasn't the loss of $7,855,278 passed on, not to speak of charging some profit? The answer is that the same economic influences which caused the company to lose money on its 1920 business would also have probably caused it to forego the passing on of the sales tax to its customers.

SUMMING UP

Limitations of space do not permit of discussing all the details and minor phases of the question. Suffice it to sum up by stating that whether the sales tax is actually passed on to the consumer or whether it is absorbed by the producer or merchant (on whom it would in the first instance be imposed), it is an inequitable and unwise tax.

If actually passed on to the consumer in every case—the possibility of which may well be questioned—the effect is to distribute a large part of the tax burden of the country not according to ability to pay (income) but according to needs (consumption). In other words, it lays a tax on expenditures instead of on the profit derived therefrom by the recipients of such expenditures.

If, however, the sales tax is not passed on to the consumer—and even the proponents of the tax admit that under certain conditions the tax may not be passed on—it would become a tax on gross earnings instead of on net income. This would be jumping from a relatively comfortable frying pan into a mighty hot fire. In place of a business having to pay profits or income taxes only if a profit has actually been earned, the sales tax would have to be paid, even if the year's business had resulted in a loss.

REDUCE GOVERNMENTAL EXPENSES

One further thought should perhaps be expressed and that is in answer to the query as to what tax is to be substituted for the excess-profits tax—assuming that the latter is to be repealed—if the sales tax is not acceptable. In the writer's opinion, there should be no substitute. Instead of looking for one, business men ought to unite in making it unmistakably plain to congress that it is high time the government cut its garment according to the available cloth. During the past twelve months there has been a tremendous change in business conditions and business men generally have had to revise their budgets and to cut their expenses to the bone. Why should only the federal government, which is as it were an overhead expense of the combined taxpayers of the nation, be exempt from the necessity of restricting its expenditures to figures which are in reasonable proportion to the present income of the nation's taxpayers? More insistence on such a course would tend toward a much better and more effective solution of our present difficulties of national finance than does the advocacy of such a dangerous, unsafe and—judging by past experience—discredited tax measure as a general-sales or turnover tax.