THE THEORETICAL QUESTION

It has been argued that countries relying predominantly for their revenue on taxes eligible for border tax adjustments (that is to say indirect taxes on goods) have a balance of trade advantage over other countries, since the effect of border tax adjustments is to make exports cheaper and imports more expensive. It has been generally agreed that the existing system of border tax adjustments would be neutral only if taxes eligible for border adjustments were fully shifted into prices, while ineligible taxes were not shifted at all—that is to say that an increase in an indirect tax on an article would result in an equivalent increase in the price of the goods, while an increase in other taxes would have no effect at all on prices. For if a tax is fully reflected in the price of a home-produced article it appears justifiable to put an equivalent tax on a similar imported article and not put a tax on such an article which is to be exported.

If, on the other hand, the tax is not fully reflected in the price of the domestic article, it is arguable that to the extent that the tax is not shifted forward, an import equalisation tax has the effect of an additional customs duty and remission of the tax on exportation has the effect of an export subsidy. Despite this agreement on what would constitute a neutral system, there remain different opinions on whether or not the existing system is neutral.

The tax shifting controversy

The tax shifting controversy has centred on the relative degree of shifting of consumption taxes (which are eligible for border adjustment) on the one hand and profits taxes (which are ineligible for the border tax adjustment) on the other. According to classical theory, consumption taxes are treated as costs and fully reflected in prices. This conclusion has been challenged on the grounds that rising costs result in a fall in demand, and that to maximise total profits the seller will reduce his profit (i.e. bear part of the tax himself) on each individual article in order to prevent the total demand from falling too greatly.

The theoretical argument becomes more and more complicated because various reasons can be adduced for suggesting that such taxes are not fully shifted (e.g. government expenditure on transport, social security benefits, etc. out of revenue derived from the tax help to reduce business costs; the effective tax rate is less than the nominal rate because of tax-evasion, etc.), while other arguments can be suggested for believing that a rise in such taxes may lead to an even greater rise in prices than the rise in tax itself (e.g. the initial influence of an increase in indirect taxes on prices will involve wage increases which will increase costs, which will result in further price increases; sellers tend to take the opportunity of tax increases to put prices up additionally to cover other rising costs).

Further complications arise because shifting will vary from article to article depending upon their elasticity of supply and demand and according to the state of the economic and governments' monetary and pricing policies.

At first sight it might seem that this controversy could be settled by examining the facts. One is after all simply asking in general terms, if an article priced at 10 units is taxed an additional 2 units, will the new price be 11 or 11½ or 12 or 12½? While it is true that further factual enquiries may help to shed light on the question; there still would remain a great deal of interpretation to be done. For while it may be agreed that the object is to compare pre-tax prices with post-tax prices, it is not clear what period should be taken. In the very short term the full effects of the tax change may not have time to make themselves felt (e.g. the seller may begin by trying to pass the total increase to the buyer but later reduce his prices) while, in the longer term, factors totally unconnected or only remotely connected with the tax change may also affect prices.

The above simplified account suggests that the problem of the extent to which prices are affected by changes in consumption taxes is difficult to resolve. The question of the effect of business profits taxes on prices of goods is even more difficult, for the theoretical arguments in favour of a particular view of the shifting of these taxes are more abstract and the verification of the facts more complicated. Consequently it is not altogether surprising that some writers appear to think that an increase in profits tax will have no effect on the price of the goods produced by the taxpaying companies, while others think that the