The Vital Role of the Accountant

Part One of Two Parts: Accounting in a Modern Market Economy

Modern industrial societies are made possible not simply by science and invention. They require powerful social institutions to serve as pillars supporting the platform on which research, development, and production scale economies are used to transform society. These institutions must be stable and maintained with integrity. Some are more obvious than others: a democratic — rather than hierarchical or authoritarian — culture so that individual genius and creativity can thrive; a safe banking and financial sector that allows savers and investors to join forces; and a rule of law that guarantees the property rights of those who would earn and save. Less heralded and sometimes ignored, yet among the most vital of these institutions, is a system of reliable income accounting.

Why has income accounting become so crucial an ingredient to economic growth and the functioning of the modern market economy? It isn’t simply a matter of individuals and firms keeping track of their money, so as to limit theft and fraud, although that function certainly is important. At an elementary level, however, good bookkeeping is sufficient to meet that goal. To determine how to allocate resources in the modern firm, however, an owner or manager has to know much more: which product is profitable and which is not; what parts of the firm are adding value on net and which are not; and which groups of workers are productive and which are not. Double-entry bookkeeping further enhances the ways that accounting can help answer these allocation questions by giving two different vantage points over what is happening, based on inflows and outflows, sources and uses, assets and liabilities.

Modern taxation was both born and made possible by the income accounting that began to take place in the modern, large corporation. In a sense, tax accounting is always an appendage to financial accounting. Too often economists, lawyers, and accountants talk as if competing theories over what to tax — income, imports, property, sales, and so forth — are the drivers in the development of tax policy. Sure, for instance, political disillusion with the tariff and its eventual theoretical castigation as an inferior revenue-raising mechanism was an important political development that led toward the establishment of income taxation as a major alternative source of revenues. But the tariff wasn’t a successful revenue-raiser for several millennia for nothing. It did not stand in opposition to most theorists’ notion of what might constitute a good tax until the income accounting made possible by the larger industrial organization came along.

In its own heyday, the tariff was among the most prevailing means of collecting taxes because it too could depend administratively on the more reliable financial accounting systems of its day. In this case, the “financial accounting” took place when ships were unloaded, bills of lading were produced, and buyer and seller (or their agents, including shippers) made sure what was being paid for was delivered. Kings, tyrants, and legislatures saw a chance to latch a tax system onto this important set of financial and commercial accounts, and to tax them in ways that were roughly proportionate to the amount being exchanged.

Notice that these tax systems, whether tariff or income tax, rely significantly on the competing self-interest of the private parties to make sure that the accounting system is accurate. If a merchant has ordered 500 pounds of tea and 100 pounds of sugar, he wants to be sure that he doesn’t get 400 pounds of tea and 50 pounds of sugar. Certainly there are many exceptions to be sure that he doesn’t get 400 pounds of tea and 50 pounds of sugar. Certainly there are many exceptions and collusion against the tax authorities is possible. But collusion is expensive and requires some illegal means of enforcement among the parties involved, since a mutual contract to cheat the government is usually not enforceable in a court of law. In effect, cheating is easier when there are fewer transactions or fewer numbers of people involved. In other, more complex cases (for example, with a larger ship delivering to many merchants), paying the tax was often a minor inconvenience relative to having no reliable system of accounting on which market participants could depend, or setting up a second set of accounts to report to the government.

So it is with the modern large organization and the income tax. Without good financial accounting of income, it could not survive. Its managers won’t know when it, or many of its various operations, become unprofitable. The organization’s shareholders won’t have much idea of its intrinsic value and at what price it should trade in the market. Its bondholders and bankers won’t know how risky it is to lend to it and at a minimum will demand a higher interest rate to compensate. Its executives won’t know which foreign operation is successful and which isn’t, or whether one type of research tends to pay off and another doesn’t.

The income and wage taxation of individuals is also largely dependent on this corporate (or large organization) financial accounting system. Again, the company wants to know what it pays people on net, and people want to know what they are receiving. It is doubtful even today that an income tax system could exist if
everyone were a sole proprietor and did her own bookkeeping. Lesser-developed countries, evolving through growth of a small entrepreneurial class, often have great trouble establishing an income tax and end up applying it only to a few large organizations. Even in the United States, purportedly with one of the most compliant populations, a very high rate of under-reporting, ranging roughly from 20 percent to 50 percent, applies to independent contractors, sole proprietors, and small partnerships who report mainly to themselves.

Next week: Some Implications