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Commentary

Title:

"Three Big Myths about the Income Tax"

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Ben Franklin once observed that nothing is as certain as death and taxes. He might have added a third point: It is also certain that politicians, who get to spend the tax revenue, will create myths to lull citizens into paying more in taxes than is necessary to sustain a free society. Let's analyze three of these myths, all of which threaten American prosperity.

First, the large revenue from the income tax is necessary to pay most of the costs of running our government.

Not true. For most of US history we have not had an income tax. The 16th amendment, which allowed a federal income tax, did not become law until 1913. Before 1913, we supported our government through taxes on imports, taxes on whiskey and tobacco, and by the sale of federal land. That was it! With that limited tax base, politicians had to spend money wisely.

In the fifty years before the 1913 income tax, the US became the strongest economic power in the world, a very wealthy nation, and a magnet for immigrants from Europe and elsewhere. With no income tax to stifle innovation, Americans invented the typewriter, the telephone, the adding machine, the computer, the car, and the airplane, among other inventions. As for federal revenue, the US, in the late 1800s, had 28 straight years of annual surpluses, and eliminated almost two-thirds of our national debt.

What about social services without an income tax? Was there any safety net? Before the income tax, people in need got help from churches and local charities. People helped people directly; almost no one depended on federal bureaucrats and welfare checks. Before 1913, various entrepreneurs and community leaders founded the Red Cross, the Salvation Army, humane societies, and orphanages across the country. People helped people, rather than politicians helping themselves by subsidizing voting blocs with other peoples' money. John D. Rockefeller, for example, the first billionaire in US history, gave about half of all of his wealth to charity. Steelmaker Andrew Carnegie used his wealth to help build thousands of libraries throughout America. Others, with less to spend, still gave generously. After the 1906 San Francisco earthquake, for example, Americans all over the country sent food and clothing to San Francisco, and the railroad operators collected these supplies in special box cars that were filled by citizens in town after town along the route to San Francisco. A limited government revealed an unlimited generosity of Americans toward Americans in distress.

Second, the income tax is the fairest tax to raise the necessary revenue to support the federal government.

Not true, again. The American Founders, for example, did not believe that. They avoided an income tax because they believed consumption taxes were more sensible and much fairer. The first US Secretary of Treasury, Alexander Hamilton, said in *Federalist Paper #21* that consumption taxes – levies on imports or on luxury goods – were the best way to raise revenue because "the amount to be contributed by each citizen will in a degree be at his own option, and can be regulated by an attention to his resources." Here Hamilton was thinking that people could choose to buy products locally, or they could pay a tax to buy imported British blankets and clocks, or maybe French wine.

Hamilton added: "If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great…This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them." A 50 percent tariff, for example, on imported British shirts, instead of a 10 percent tax, might actually mean less revenue for the government because more Americans would buy cheaper American clothing and avoid the tax. That, as Hamilton concluded, was “a complete barrier against any material oppression” and a “natural limitation” on government. Consumption taxes, then, were a paradox. You could do two seemingly contradictory things: Raise revenue and protect liberty as well.

Under the current income tax system, liberty is always precarious. We do not choose what taxes we pay by what we consume; politicians choose what taxes we pay depending on political conditions at the moment.

Third, the rich ought to pay proportionately much more income tax than everyone else.

Wrong again. The top 10 percent of income earners currently pay more than two-thirds of all federal income taxes collected. The progressive income tax already may be stifling American entrepreneurship and innovation. Furthermore, when taxes on income are excessive, rich people stop inventing and start looking for tax shelters, loopholes, foreign investments, and other ways to protect their wealth from confiscation. When they succeed, the whole economy suffers. The 14th amendment promises equal protection of the laws to all citizens, and if we discriminate against the rich, the door is open to pass laws discriminating against blacks, women, and old people.

The top rate of the original 1913 income tax was 7 percent; most people were exempt from paying any income tax. In the 1930s, however, during the Great Depression, President Franklin Roosevelt began taxing the rich at rates of 80, 90, and 94 percent on all income over $200,000. Not surprisingly, entrepreneurship slowed down and the Great Depression persisted. World War II reshaped the problem by enlarging the national debt to pay for military services needed to win the war. When the dust settled, rich people were using tax shelters to avoid the high taxes, and middle-class and poor Americans found themselves shouldering the bulk of income tax payments for the first time in US history. Cutting the 94 percent income tax rate on the rich after World War II opened up the country again for investment, and the US again began leading the world in innovations from fast food to Holiday Inns to Xerox copiers and into the computer age.

If the three myths described in this article can be widely recognized, America can use the liberty and the increased capital (from a smaller income tax) to maintain its leadership in worldwide economic development.