

# How The Income Tax Became A Tax On Labor

**Clifford Cobb and Jonathan Rowe**  
**Redefining Progress, San Francisco, CA**

In the first decade of the century, controversy over taxes gripped England. Winston Churchill articulated a novel guiding principle: “Formerly the only question of the tax gatherer was, ‘How much have you got?’” Churchill said. “Now we also ask, ‘How did you get it?’”

**“Formerly the only question of the tax gatherer was, ‘How much have you got?’” Churchill said. “Now we also ask, ‘How did you get it?’”**

A tax system should reinforce the fundamental moral connection between contribution and reward, said Churchill. Did you earn your income through enterprise and toil, or at least by providing capital for these? Or did you reap where you did not sow—garnering profits from what nature, rather than you yourself, had created? “Was the income gained by supplying the capital which industry needs, or merely by denying, except at an extortionate price, the land which industry requires?” The issue wasn’t capital versus labor, as Marxists had it. Rather it was capital and labor versus something else—unearned gain that arose from the mere ownership of land and natural resources.

In 1909, with Churchill’s strong support, the British Parliament enacted a special tax on gains from land.

In the U.S. Congress the need to finance America’s entry into the First World War spurred a similar debate. Significant support for what might be called the Churchill view did much to shape the new income tax that eventually emerged. In concept, the tax would spare the earnings of the working person and productive entrepreneur, and fall on unearned gains that arose from land and resources or the exercise of monopoly power in all its subtle forms.

## **The Inversion of the Income Tax**

That was almost a century ago. Since then, the original vision has been turned upside down. The income tax has come to fall almost entirely upon the workers and entrepreneurs it was intended to spare. In 1918, some 85% of American households paid no income tax at all, and almost 80% of federal income tax revenue came from the top one-half of one-percent of households. Very little of the burden fell on work. By 1990, almost three-quarters of federal tax revenues came from work.

**Nurses and janitors are paying twice the rate that millionaires paid in the version of the tax that Congress first enacted, in payroll taxes alone.**

The payroll tax ostensibly financing Social Security has become a monument to this inversion. It falls exclusively on the wages and salaries of working people up to a cap, and comprises some 35% of federal revenues—and more than half of the federal taxes that the average American pays. The payroll tax rate today is double—yes, double—the top income tax rate in 1913. Nurses and janitors are paying twice the rate that millionaires paid in the version of the tax that Congress first enacted, in payroll taxes alone. Then there's the corporate income tax, which back in the 1920s yielded almost a third of federal revenues. Today corporations pay just a little over one-ninth. A surprisingly large share of corporate income derives from real estate and resources, which comprised over 40% of the total assets of almost a third of the Fortune 500 companies in 1990. So the decline of the corporate tax is part of the inversion of the income tax generally.

The economic impact is perverse. The work tax system penalizes the human qualities the nation most needs to encourage—ingenuity, intelligence, constructive endeavor of all kinds. It promotes the waste of natural resources, and speculative gain—in real estate for example—that produces no new real wealth. The work-tax system especially burdens those who struggle hardest to make ends meet. Yet mainstream debate barely notes this fundamental perversity. For all the partisan polemics and chest-thumping about “radical reform” there is little disagreement on this basic point: the federal tax burden should fall mainly on work.

The various “flat tax” proposals, for example, would fall almost entirely on work. (When you exempt non-work income at the personal level, as these would do, you are left with a work tax by a different name.) Among the flurry of reform plans in recent years, only one even begins to address the work tax load—the plan offered by Senator Pete Dominici and former Senator Sam Nunn, which includes a credit for payroll taxes. If you've even heard of Nunn-Dominici, you are more attentive than most.

The tax reform commission chaired by Jack Kemp in 1995 floated the possibility of payroll tax relief. But the idea was conspicuously absent from the Dole-Kemp campaign, and this was not surprising. Mention the payroll tax, and voters would have realized that the Republican proposal for a 15% tax cut was actually more like 6% for a median household, once those payroll taxes are figured in.

**The quiet drift into a work tax system...helps explain why the Democrats have lost their grip on working class voters.**

The quiet drift into a work tax system has subtly shifted the politics of the Postwar years. It helps explain why the Democrats have lost their grip on working class voters. The original Democratic coalition was a producer coalition, farmers and laborers in particular. The underlying moral drama aimed upwards rather than downwards. The villains weren't welfare queens, but rather those who heap burdens upon producers through financial manipulation or monopoly control, or the speculative holding of large tracts of land or good water supplies. The income tax thus affirmed a belief in both the work ethic and productive enterprise.

As postwar prosperity lifted American workers into the middle class, they may have responded less to the class politics of the New Deal. But they still believed fervently in the value of hard work, and in rewards proportional to effort. The work tax system violated those basic values, and engendered a view of Democrats as the party of entitlement and therapy rather than of honest effort and due reward.

Republicans certainly share the blame; and to be sure, Democrats have resisted such things as capital gains breaks for nonproductive investment, which would shift the burden to work even more. But as the Congressional majority for most of the Postwar years, the Democrats have created “precisely the kind of revenue system that business groups had sought in 1916,” as W. Elliot Brownlee, a historian at the University of California at Santa Barbara, has put it.

Few voters like the current system. But Congress is so divided on the issue that leaders dismiss the possibility of fundamental changes in the near future. So how did the nation get into the work tax trap? The way in may offer clues to the way out.

The early advocates of the income tax did not rigidly adhere to the concept of “progressivity” that has become a liberal fetish. (That is, higher tax rates for higher levels of income.) Still less did they share the Right-wing supply-side enthusiasm for profit above all. Rather, they wanted a system that rewarded work and the creation of real wealth, as opposed to paper profit and speculative gain.

The early vision combined the entrepreneurial enthusiasm of the supply-siders with the concern for social justice that moves the best of liberal thought. Applied today, these insights could promote economic justice and prosperity, together with a healthy environment.

## Early History of Income Taxes

The first income tax in modern history was essentially aimed at land. The year was 1799 and England faced invasion from revolutionary France. The treasury was running dry; and the aristocracy had used its sway in parliament to keep land taxes to a pittance. In desperation, William Pitt, the Chancellor of the Exchequer, came up with another way to skin the cat—an income tax. The tax affected mainly income from property, which meant that landowners paid most of it, along with factory owners and a few urban professionals. (Government employees also paid, because their jobs were deemed so secure as to be a form of property.)

**Starting with the Civil War, the income tax was the part of the tax system that the very rich paid, to balance off the excises and tariffs and the draft which fell heavily on the masses.**

That British model set the basic pattern for the next century and a half, in America at least. Starting with the Civil War, the income tax was the part of the tax system that the very rich paid, to balance off the excises and tariffs and the draft which fell heavily on the masses. It was primarily a way to pay for wars. The Civil War version actually started in Congress as a land tax, and evolved later into a tax on incomes.

The vast majority of Americans—some 98%—were untouched; and over half the revenue came from New York, Pennsylvania, and Massachusetts, the industrial states which benefited most from the tariff. (Had Lincoln simply pushed an income tax in the first place, instead of raising the tariff and antagonizing the South, it is conceivable that he could have averted the Civil War. As it happened, both North and South enacted income taxes to fight one another.)

Under pressure from industrial state Republicans, Congress repealed the Civil War tax in 1871 after paying off the war debt. The federal government's main revenue source was now the tariff, which got as high as 45%; some accused the Republicans of enlarging the government to justify such high rates. The system provoked growing resentment among rural populists and urban reformers; and finally, in 1894, following a financial panic, Democrats managed to attach a small 2% income tax to a tariff bill. The Supreme Court struck it down a year later because it was not apportioned among the states according to population, as the Constitution arguably required. In 1909, largely to delay another income tax measure, the Republican Congress passed the 16th Amendment which removed this restriction. The states ratified it, and that set the stage for the debates over how to pay for WWI.

These debates raised basic economic questions in a way rarely heard today. In the last decades of the nineteenth century, America's traditional producer ethos was coming unglued. Giant corporations like Standard Oil and the railroads seemed to reap gains far beyond their deserving; the old face-to-face business culture of Main Street was yielding to the amorality of a corporatized market. Novelists and muckrakers portrayed the new economy in unflattering detail, and intellectuals analyzed it with foreboding. Thorsten Veblen argued that the corporate system was wasteful to its core, the privileged recipient of what he called a "run of free income."

### **Influence of American Economist Henry George in the Development of the US Income Tax**

**Henry George's views on taxation strongly influenced both Winston Churchill and many income tax advocates in the U.S. Congress.**

The formative income tax debates grew out of this rich brew. Especially important was the work of Henry George, the journalist and self-taught economist who crystallized the issue for the masses. His influence was enormous. His 1879 classic "Progress and Poverty" sold more than two million copies world-wide. Henry George's views on taxation strongly influenced both Winston Churchill and many income tax advocates in the U.S. Congress.

To simplify greatly, George analyzed the basic economic elements of land and natural resources in terms of earned versus unearned gain. The former came from work and enterprise and capital formation through saving and investing, while the latter was "value created by the whole community" and appeared as a rise in land values. (Political machination could also play a part, as illustrated in the movie "Chinatown.") John Stuart Mill had observed that landowners "get rich in their sleep." Mill called such gains "unearned increment" because they arise from mere ownership without any contribution or improvement to that which is owned. (Development and extraction, by contrast, are productive endeavors that deserve reward.) George picked up and amplified Mill's argument.

The question was not just moral but economic as well. Rising land prices, for example inflict a heavy burden upon those who do produce: when entrepreneurs pay more for land, there's less left over to construct the factory and build the business. If taxes should fall on anything, George said, it is these unearned gains. Producers pay for land anyway, and the only question is where the money goes. If it goes to the public treasury then taxes on work could be reduced, and wages would effectively rise. The

Georgist drama did not pit the heroic worker against the sordid capitalist, but rather producers generally against the passive owners and monopolists who rode their backs. "Well may the community...let the laborer have the full return of his labor, and the capitalist the full return of his capital," he wrote. Removing the tax burden from them, and shifting it to unearned increment, would "lift the whole enormous weight of taxation from productive industry."

That argument touched a deep growing anxiety at a time when the frontier was closing and the gap between the very rich and everyone else was getting larger than ever. Even farmers, the archetypal landowners, embraced George as defense against the hated railroads and corporate encroachment on the family farm. Not surprisingly, these views seeped into national politics, and played a prominent role in the debates over the original income tax. Republicans and Conservative Democrats favored consumption taxes, in the form of tariffs and excises. If not that, they wanted a broad-based income tax that fell everyone, the better to dampen enthusiasm for government and its activities.

**...the coalition that congealed behind the tax- farmers, labor, and outright Georgists- "believed that income taxation should reach only those incomes earned by monopoly power; the incomes of workers and the profits of firms in competitive sectors like agriculture should be exempt."**

The populist reformers, by contrast, thought that ordinary Americans had paid enough in excises and tariffs. Rep. Dan V. Stephens of Nebraska was speaking for many when he said that new revenues should come from the "surplus wealth of the nation that has already been collected into private hands in abnormal proportions." The idea of "surplus" or "unearned" wealth was a leitmotif in the debates. As Professor Brownlee has observed, the coalition that congealed behind the tax- farmers, labor, and outright Georgists- "believed that income taxation should reach only those incomes earned by monopoly power; the incomes of workers and the profits of firms in competitive sectors like agriculture should be exempt."

The military build-up reinforced this view. Many in Congress felt that the war would benefit most the same interests that had gouged the American people, and that these interests should pay for it. "The luxury of a large standing army and a great navy," declared Congressman Warren Worth Bailey, a newspaper publisher and Georgist from Johnstown, Pennsylvania, should be "supported by those whose interests demand that kind of army and navy." Bailey introduced a "Supertax" of 5% on all incomes over \$20,000 to pay for naval construction. He also proposed an inheritance tax on "swollen fortunes."

Bailey was one of the swing block in the House that pulled President Wilson's income tax proposal in this populist direction. The version enacted in 1913 started at 1% for incomes over \$3,000 (\$36,000 in today's dollars), and rose to a top rate of 6% for those over \$500,000. Less than 1% of citizens had to pay. By 1917, tax rates on the wealthy were ten times higher than in 1913. There was also a special tax on arms dealers. ("Jingoes should pay for jingoism," Congressman Bailey said.) Wilson's Treasury Secretary went so far as to require that annual increases in property values be reported as taxable

income, thus aiming the income tax still further in the direction of unearned gains. The Supreme Court struck down this rule in 1920 because Congress had not specifically authorized it, but the main pattern of the World War I finance remained.

When the war ended, the U.S. tax system came about as close to the producer-populist ideals as it ever would. Some eighty percent of personal and corporate income tax revenues came from the top one percent or so. Eighty-five percent of households paid no federal income tax at all, and there was a widespread feeling that this was right. Henry Ford took out full page newspaper ads proclaiming it "wise and just" to compel the very wealthy to "bear a fair share of the load which has hitherto rested all too heavily on the backs of the poor."

This was the income tax that the early advocates intended, and the basic pattern continued through the Coolidge-Hoover years of the '20s. To be sure, the Republicans softened the blow at the top by cutting the top rate from 77% to 24%; they also cut corporate rates by three-quarters. Yet that patron saint of the supply-siders, Treasury Secretary Andrew Mellon, also pushed a special break for earned income. "The fairness of taxing more lightly income from wages, salaries, [than] from investment is beyond question," Mellon said in his book *Taxation: The People's Business*. "Surely we can afford to make a distinction between people whose only capital is their mental and physical energy and the people whose income is derived from investments." (By contrast, today's supply-siders want to exempt income from investments and make working people bear the load.)

## **The New Deal and the Payroll Tax**

Through the 1920s, only about a third of the federal tax burden fell on working people, mainly in the form of excises. Over 60% of federal revenues came from individual and corporate income taxes, over 75% of which came from the richest 1% of the public.

The New Deal changed all that. Roosevelt initiated a great expansion of social programs; no less important was the way he paid for them. FDR didn't start out as a tax reformer; but under pressure from populists like Huey Long he embraced measures that caused dyspepsia among the very wealthy. He revived the estate and gift taxes, and imposed a special tax on undistributed profits to stop the use of corporations as personal tax shelters. He raised income tax rates at the top. But these were minor sources of revenue, and affected relatively few people. Much more significant, he increased taxes on the middle class, beginning with his decision to finance the social security system with a payroll tax.

Contrary to common impression today, this was not a foregone conclusion. Key advisors didn't like the approach, including Rexford Tugwell, the White House Brain Truster, and Frances Perkins, the Secretary of Labor. In her memoir, Ms. Perkins recalls the warning of then-Senator Hugo Black of Alabama. "The burden on small employers and the poorest paid workers would be too great to allow of the gradual expansion of the coverage and benefits," Black had said, "unless the tax resources of the whole United States were involved from the beginning." Others were concerned about the injustice: with a payroll tax, those who make money from investments would not pay a fair share.

**“With those taxes in there,” FDR said, “no damn politician can ever scrap my social security program.” The political instinct was astute; but the fact remained that for the very first time, the federal government was dipping directly into the paychecks of ordinary Americans.**

But FDR was adamant. He genuinely believed that people should pay for what they get (which is why he insisted that the rich pay their share too.) He also knew that Congress was not likely to pass a social security bill that had the faintest aroma of welfare; and future administrations wouldn't dare tamper with a system that people felt they had paid for, like retirement insurance, out of their own pay checks. “With those taxes in there,” FDR said, “no damn politician can ever scrap my social security program.” The political instinct was astute; but the fact remained that for the very first time, the federal government was dipping directly into the paychecks of ordinary Americans.

## **World War II—The Income Tax Becomes a Mass Tax**

During the Second World War, the federal government dipped even deeper. Once again, FDR spouted proposals to make the wealthy share the load; he even proposed to limit incomes to \$25,000 a year. But once again such moves were largely symbolic. The needs of war finance were massive; and Congress looked towards the middle class. So finally, to pay for a mass war, Roosevelt turned to a mass tax. There was resistance to a second bite out of the paychecks of working Americans. “Social security taxes are the only taxes which can properly be deducted directly from payrolls,” the American Federation of Labor told Congress. But in the end, the headline in the New York Times on March 4th, 1942 told the story: “Taxes Doubled on Lower Incomes in Treasury Plan: No Earned Income Credit” it said.

The result was a radical shift in the tax burden—downward. The top rate did go to 94% for incomes over \$2,000,000. But Congress also cut in half the exemption level for low-income Americans, which meant that families making \$600 a year—\$6,300 in today's dollars—were paying federal income taxes for the first time. By 1948 close to ten times as many Americans were paying federal income taxes as a decade earlier.

The logic was disturbing, for Democrats in particular. War finance was not the only exigency driving the new taxes on working people. Equally important was the desire to stop home-front inflation. War production had created a sudden surge of prosperity, but consumer products were in short supply. Too much money chasing too few products—it was a classic recipe for runaway prices. Since there couldn't be more products, there'd have to be less money; and war bonds could sop up only so much. As a New York Times editorial put it, “taxation must be broad enough and stiff enough to siphon off a large part of this excess purchasing power from every one. It must take back a sizable amount of the great rise in income that has gone to these two groups, the farmer and the wage and salary earners.”

Let those words linger in your mind. They define the agenda behind the wartime tax system that soon became the Postwar norm. Working people had too much money, and the tax system would have to take

it away. After the war, many forces helped keep the system in place. Some believed that war spending had cured the Depression—which would return if the Federal government now shut the spigot. There were new social programs to pay for, and, soon, the Cold War to keep defense factories churning. The new whizzes of the Democratic policy councils, the Keynesian economists, saw the broad new income tax as a lever to macro-manage the economy.

## **The Postwar Period—the Labor Burden Grows**

Congress repealed the excess profits tax and waged the Cold War without it. Now the jingoes were off the hook, and working men and women paid instead. Rates were nominally very high at the top—some 92% in 1953. But loopholes made effective rates much less; and the appearance of high top rates tended to blind liberal democrats to the growing burden lower down.

In war, Americans could accept such burdens. Their leader insisted on shared sacrifice. He even refused to call it sacrifice. It was a “privilege,” FDR said, to contribute to the fight for the democratic ideal; and therefore the shared national burden should be called an “equality of privilege.” But in the postwar consumer culture, people grew less inclined to regard their contributions to the federal government as a “privilege.” Yet they remained subject to a tax system premised on a need to keep the average Josephine and Joe from spending too much.

To liberal minds, the progressive rate structure was supposed to pull the sting for working people. Instead, it became the sting, as inflation kept pushing working people into tax brackets originally intended for the upper-middleclasses. As early as 1952, a worker making \$8,000 (about \$46,000 in today’s dollars) paid about the same effective rate as a millionaire twenty-five years before. Work itself now bore over half of the federal burden relative to corporate profits and investment gains.

Starting in the 1950’s, as Hugo Black and others had foreseen, the payroll tax began to explode. When first enacted in 1937 it was only 2% of wages and salaries. By 1960 the rate had tripled to 6%; and by the time Ronald Reagan took office, it had more than doubled again, to 12.3%. (In 1917, that income tax rate had applied to people making today’s equivalent of \$500,000.)

**In 1996 the payroll tax stood at 15.3%, split between employers and employees, which is more than the effective income tax rate paid by all but the richest 5% of US taxpayers. A family of four today making \$40,000 pays almost twice as much in payroll taxes as income taxes.**

In 1996 the payroll tax stood at 15.3%, split between employers and employees, which is more than the effective income tax rate paid by all but the richest 5% of US taxpayers. A family of four today making \$40,000 pays almost twice as much in payroll taxes as income taxes. In other words, both major parts of the federal tax system—income taxes and payroll taxes—now fall largely on the same thing; and the fastest-growing part falls exclusively on that one thing—work.

The shift to a work tax has profound political implications. As federal taxes crept into their paychecks, working Americans began to drift from the Democratic party. Back in the Wilson Administration, Mortimer Schiff, an investment banker with Kuhn, Loeb, and Co., worried aloud about the “popularity of the [income] tax among the great mass of our people through their escaping this form of taxation.” That’s no longer a worry. The Democrats, who largely engineered the current tax system, have reaped what they sowed.

## **Tax Reform, Yesterday and Today**

The challenges of the populist reformers resonate as much today as one hundred years ago. The speculative excesses of recent decades—from leveraged buy-outs to the Savings and Loan fiasco—demand tax reform to encourage productive, job-creating gain. The threats of pollution in its many forms, the waste of oil and other resources, the costs of suburban sprawl—demand policies to encourage wiser and more efficient use of land and other natural resources.

As it happens, that’s pretty much what the Kennedy Administration tried in the early 1960s, though few realized it at the time (including probably JFK himself.) Walter Heller, the chairman of Kennedy’s Council of Economic Advisors, had earned his Ph.D. at the University of Wisconsin under Harold Groves, an economist of the Georgist school. Heller’s proposals for encouraging new investment—accelerated depreciation and the investment tax credit—harkened back to the ideas of the early reformers for distinguishing productive new investment from, say, gains generated from land or resource holdings. (Under the Kennedy approach the latter were still subject to corporate rates which remained fairly high.) The system was far from perfect; for example, there were still big loopholes for oil depletion. Still, on the basic question of work and enterprise versus natural resources, the Kennedy approach stepped in the right direction.

More recently, however, the federal tax system has moved the other way, towards a notion of “neutrality” between all forms of income. The Tax Reform Act of 1986, for example, has received widespread praise.

It reduced complexity and lowered rates somewhat, which was good. But treating all forms of economic activity the same makes sense only if all activity is of equal economic and social value, which it is not.

## **The “Tax-Neutrality” Trap**

**...the popularity of Henry George and other progressive reformers frightened the nation’s financial elite. They responded by underwriting a new economic orthodoxy that erased the nasty distinction between “earned” and “unearned” income.**

“Tax neutrality” may seem an innocent confusion, but historically it was no accident. As Professor Mason Gaffney of the University of California at Riverside recounts in his recent book, *The Corruption of Economics*, the popularity of Henry George and other progressive reformers frightened the nation’s financial elite. They responded by underwriting a new economic orthodoxy that erased the nasty distinction between “earned” and “unearned” income. The benefactors of numerous American universities founded around that time—such as Leland Stanford, J.P. Morgan (Columbia), John D. Rockefeller (University of Chicago) and Ezra Cornell—had made their fortunes in land and natural resources, including railroads built on land grants. They deliberately recruited economics departments that would put the troublesome “land question” to rest.

The new departments espoused the “neoclassical” economic doctrines that conveniently reduced the world to just two “factors” of production, labor and capital. Land and natural resources were quietly slipped into the latter, bestowing a protective halo on the land speculator and resource royalist. These became providers of productive “capital,” on equal moral plane with the risk-taking entrepreneur, and deserving of benefits (albeit sometimes different ones) of the tax laws. When people like Jack Kemp talk about “capital gains” today, they conjure up images of new factories and high-paying jobs. But Professor James Poterba of MIT has found that only about 1% of such gains flow from real venture capital. The rest comes from such things as antiques, fine art, and existing stock certificates; and much of the latter represent disguised land and resources. Corporations hold some 75% of the real estate assets in the US, so increases in stock value often reflect underlying increases in real estate values, not job-creating capital.

The blinders of neoclassical orthodoxy obscure such crucial distinctions. Yet if one listens closely, echoes linger from the older debate. When Democrats try to restrict capital gains tax breaks to job-producing new investment they harken back to the old concern over productive versus unproductive gain. The issue even strikes a residual chord among supply-siders, the more honest ones at least. In his best-selling *Wealth and Poverty* (whose title is a tip of the hat to George’s *Progress and Poverty*), George Gilder distinguishes productive and unproductive gain. When increasing numbers spend their money on “relatively nonreproducible objects” such as land and works of art, he writes, “the economy is reoriented away from productive enterprise.”

Jack Kemp makes the connection to taxes, local ones at least. In his book, *The American Renaissance*, Kemp proposes a shift in local property taxes to “fall more heavily on land, rather than, as at present, penalizing property improvements.” Kemp’s prose is circumspect; he prefers to talk about what shouldn’t be taxed rather than what should. But the thought is pure George; and makes good sense. To the extent that cities shift part of the property tax burden from structures to land—as do some cities in Pennsylvania and elsewhere—they lower the penalty, in the form of higher assessments, for people who improve their property. The shift encourages development closer to urban centers and mass-transit nodes, because higher land taxes prod more intense use of central land where land values are highest. Thus it reduces sprawl.

Supply-siders like Kemp ought to see that the same logic applies to the income tax—and would have difficulty not seeing it but for the shell game that hides unearned land income under productive capital income. If the property tax should fall more heavily on land, for example, than on productive endeavor, so too should the income tax. If the property tax shouldn’t “penalize” property improvements, then neither should the income tax penalize the labor that creates those improvements. The answer, in other words, is not the “flat tax”, which as currently proposed is a disguised work tax. (Whether the income tax has a single flat rate is a separate question from what it taxes in the first place.) Nor is the answer

the liberal Holy Grail of steeply progressive rates applied to all income. If a tax ideal ignores Churchill's query about the sources of income, it discards the moral and economic vision that animated the original income tax debates, and leaves little more than sterile arithmetic.

## **Reform to Return to the Original Income Tax**

We must reexamine the federal tax system from the standpoint of productive versus unproductive gain. We should seek to tax not wealth-creating enterprise and labor, but the fruits of financial manipulation or monopoly power, or the unearned gain people derive when we license their use of natural resources like the broadcast spectrum. This raises some tricky issues, as does any approach to taxation. But the broad outlines are clear enough.

We could begin with capital gains, that perennial Republican issue. As described, conventional thinking lumps together two entirely different things: real capital (such as factories and machinery) on the one hand, and land and natural resources on the other. Any new tax breaks for capital gains should be limited to job-creating new investment such as venture capital; there's no reason to increase the deficit to reward gains that create no new jobs or wealth. (That includes sales of antiques, jewelry, fine arts and the like.) By the same token, many provisions in the current law reward the reshuffling of existing assets with no gain to anyone except the owner. For example, property owners can sell buildings back and forth and deduct "depreciation" from taxes over and over.

Then we could eliminate special tax breaks for land and other natural resources. Such breaks serve no economic function; the land will still be there, with tax break or without. Intrepid political souls could attack the array of subsidies for home ownership for the well-to-do, from mortgage interest deductions to the exemption of capital gains at death. Some two-thirds of the benefit of the mortgage interest deduction goes to the richest 10%, which means most federal housing subsidies go to those who need them least. Then we'd stop the giveaway of national assets such as mining rights on federal lands, and the broadcast spectrum. Once granted, broadcast licenses can be sold for billions of dollars; it's as though the government printed that money and just handed it to broadcasters.

We can also stop giving away another precious common resource: the atmosphere. Individuals and corporations currently use it as a dump for pollution, for free. Polluters should pay, just as they would pay for dumping trash at a landfill. Pollution fees would help curb pollution in the most efficient possible way—by giving companies powerful cost incentives.

Measures such as these would let us dramatically cut the work tax load. Those just outlined could raise over a quarter of the amount the payroll tax now provides. Americans would keep more of the fruits of their own toil, and pay taxes more in accordance with the costs they impose upon others, including future generations. Instead of rewarding those who passively profit from ownership of natural resources, the system would reward the inventors and entrepreneurs who find ways to use natural resources less. In Churchill's phrase, the tax system would promote "a constant relation between acquired wealth and useful service previously rendered."