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Original Intent and the Income Tax*

Today's federal income tax system bears little resemblance to the one imposed in 1913. The original personal income tax system was simple, the tax rates were relatively moderate, and, because the exemption level was relatively high, only a small percentage of Americans paid any tax. The system has since become much more burdensome because more revenue is needed to finance vastly increased government spending. Today, the income tax is a major impediment to entrepreneurship and economic growth.

Entrepreneurs drive the economy. By creating and investing in new businesses, ideas, and innovations, the entrepreneur ensures economic renewal and growth. Unfortunately, the federal government has an economically unhealthy habit of throwing obstacles in the path of entrepreneurs, such as burdensome regulations and inflationary monetary policies. Perhaps the most formidable government barrier, though, is the income tax.

Today's federal income tax system is punitive, complicated, inefficient, intrusive, and impedes entrepreneurship, investment, economic growth, and job creation. Interestingly, however, when initially imposed, the income tax, despite its progressive rates, appeared rather straightforward and not all that burdensome—almost benign. Of course, appearances can be deceiving.

There were, of course, warnings about the dangers of a progressive tax structure. But people supported the income tax because it was originally meant to impose only very low tax rates on only the highest incomes. Proponents argued that the 16th amendment to the U.S. Constitution would force the so-called "robber barons" to pay taxes. It was not supposed to provide a mechanism for Washington to reach into most Americans' pockets.

Figures 1 and 2 illustrate this point. Figure 1 shows the personal income tax structure as initially imposed in 1913, while figure 2 indicates what this tax system would look like in 1994 dollars.

Original Tax Rates

The original income tax was obviously not meant to be paid by most citizens, nor were rates high enough to significantly undermine the spirit of enterprise. For example, under this system single taxpayers today would pay no tax on any earnings up to almost $45,000 and married couples on earnings up to almost $60,000. A one percent tax rate would be in effect on incomes up to about $300,000. The top rate of 7 percent would not take hold until earnings hit almost $7.5 million.

As for the corporate income tax, it was imposed in 1909 at a rate of one percent and included a $5,000 exemption. Again, translated into 1994 dollars, companies would face the one percent rate with an exemption of $81,967.

Alas, people attracted to the income tax through appeals to envy soon discovered that envy knows no boundaries and never makes for good economic policy. Government rather quickly transformed the income tax from a light tax on high incomes to a heavy tax on almost all incomes.

This very different income tax than originally intended then acted as high-octane fuel for the growth of government spending. Between 1913 and 1994, inflation-adjusted federal government expenditures increased by 13,592 percent! Over this same period, personal and corporate income taxes grew from 7 percent of total federal revenues and 0.1 percent of the economy, to more than 54 percent of total federal revenues and over 10 percent of U.S. GDP.

The income tax also proved to be an economically dangerous levy, raising the costs of working, saving, investing, and risk-taking, thereby restraining economic growth. From 1870 to 1913—between the Civil War income tax and the post-16th Amendment income tax—the U.S. economy expanded by over 435 percent in real terms, or by an average rate of more than 10 percent per year—

Figure 1

1913 Personal Income Tax System

Tax Rate	*Income Level*
1%	up to $20,000
2%	$20,000-$50,000
3%	$50,000-$75,000
4%	%75,000-$100,000
5%	$100,000-$250,000
6%	$250,000-$500,000
7%	0ver $500,000

(A $3,000 exemption for single filers and $4,000 for a married couple.)

Figure 2

1913 Personal Income Tax System in 1994 Dollars

Tax Rate	*Income Level*
1%	up to $298,507
2%	$298,507-$746,269
3%	$746,269-$1,119,403
4%	$1,119,403-$1,492,537
5%	$1,492,537-$3,731,343
6%	$3,731,343-$7,462,687
7%	0ver $7,462,687

(A $44,776 exemption for single filers and $59,701 for a married couple.)

* This article, by Raymond J. Keating, is reprinted from the February 1996 issue of The Freeman, a monthly publication of the Foundation for Economic Education, Inc., 30 South Broadway, Irvington-on-Hudson NY 10533. Mr. Keating is chief economist with the Washington, D.C.-based Small Business Survival Foundation.

with no inflation. Alas, as we now look toward the twenty-first century, America's economic vitality in an increasingly competitive world economy is suspect.

The implications are clear: surely we must downsize government, deregulate our economy, and ensure sound money. Perhaps most important, though, we should replace our current tax system with a low, flat income tax. Or better yet, we should put an end to what has turned out to be one of the biggest impediments to entrepreneurship and growth in America this century—the income tax. The resulting entrepreneurial boom might surprise even the most wild-eyed optimists and launch the U.S. economy into the twenty-first century. ❑

The inflation-adjusted dollar amounts in Figure 2 refer to 1994 dollars. Since 1994, the general price level, as measured by the Consumer Price Index, has increased another 5.9 percent. The figures below indicate what the original system would look like in 1996 dollars:

1913 Personal Income Tax System in 1996 Dollars

Tax Rate	*Income Level*
1%	up to $316,031
2%	$316,031-$790,078
3%	$790,078-$1,185,117
4%	$1,185,117-$1,580,156
5%	$1,580,156-$3,950,390
6%	$3,950,390-$7,900,780
7%	0ver $7,900,780

(A $47,405 exemption for single filers and $63,206 for a married couple.)

BUSINESS-CYCLE CONDITIONS

The leading indicators strengthened this month, and all but one of the coincident indicators reached a new high. For the first time since February 1995, the Federal Reserve raised interest rates in a preemptive strike against price inflation. It is not yet clear what effect the rate increase might have on interest-rate sensitive sectors such as housing and durable goods. Still, the economy continues to grow, and further expansion is expected in the months ahead.

There were four new highs among the primary leading indicators in this month's appraisal of business-cycle conditions. The *M2 money supply*, *new orders for consumer goods and materials*, the *ratio of manufacturing and trade sales to inventories*, and the *index of 500 common stock prices* all reached new highs for the cycle. (Stock prices and all dollar-denominated series are reported in constant dollars).

Stock prices decreased in recent weeks on the news that the Federal Reserve was raising interest rates. Thus, it may seem surprising that our index of stock prices reached a new high. There is a reason. March is the latest month for which we have complete monthly data. Although the decline began in March, it continued well into April, and we will not have April data until the end of the month. In addition, when looking for cyclical trends in this series we use a 2-month moving average of the base data in order to smooth out irregular and often insignificant fluctuations in the monthly data. The latest figure thus is the average of February and March base data. Despite the decline in the March base data, constant-dollar stock prices still were higher in March than they were in January, thus the moving average reached a new high.

It may turn out that the recent drop in stock prices is only a temporary interrruption of the series' cyclically upward trend. If the base series is higher in April than it was in February, the 2-month moving average will hit another new high. On the other hand, if the base series remains below its February peak, the moving average will decline. Although the recent evidence for April suggests that the market is perhaps bouncing back, it remains to be seen whether our series, which is based on the S&P 500, will recover sufficiently to reach a new high next month.

The *average workweek in manufactur-*

ing also is appraised as clearly expanding. The base series increased in April above 42 hours per week for the first time since January 1995. *Initial claims for state unemployment insurance* (inverted) also is clearly expanding.

The 3-month percent *change in sensitive materials prices* has been increasing for seven months now. However, the increases have been erratic and the series is well below its peak for the cycle. It remains appraised as probably expanding. On the other hand, *vendor performance*, the percent of purchasing managers reporting slower deliveries from their suppliers, was upgraded this month to probably expanding. For months the cyclical trend of this series was in doubt. However, this month's increase brought the series to a 20-month new high, which was judged sufficient to warrant upgrading its appraisal.

The cyclical status of *contracts and orders for plant and equipment* was downgraded this month. After years of steady increases the series began to decline early last year, but it was not clear whether the series was cylically contracting, and it was downgraded to probably expanding. Around the middle of 1996 the series began to recover some of its earlier decline, but it has since flattened out. Its cyclical status is now indeterminate.

There is no apparent trend in *new housing permits*. This series had been appraised as probably contracting, but the increases of the past 3 months have raised further doubt about the series' cyclical trend. Housing is one of the most interest-rate sensitive sectors of the economy. It is not yet clear what impact the latest rate increase, and possible subsequent increases, will have on the housing market. If the rate increases are small, the impact probably would be limited.

The *M1 money supply* continues to contract from its 1994 cyclical peak. The *3-month percent change in consumer debt* also has been decreasing for many months. Despite the latest uptick in the data, the series remains appraised as clearly contracting.

Overall, 80 percent (8 out of 10) of the leading indicators with an apparent cyclical trend are expanding. Last month the figure was 73 percent. The cylical score also increased this month. The score, AIER's purely arithmetical assessment of the twelve leading indicators, rose to 78 from a revised score of 73. Last month's score was initially reported as 69, but revisions to the data resulted in a higher revised score. Unlike the cyclical score, the percentage of leaders expanding is never revised, and reflects our assessment of the leading indicators in a particular month based on the data available at that time. The increase in both the percentage of leaders expanding and the cyclical score indicates that the economy will continue to expand at least into the summer.

During the next several months, however, it is possible that there will be another interest rate hike. This could happen as early as late May when the Federal Reserve's Federal Open Market Committee (FOMC) meets again. Often when the FOMC switches its stance on monetary policy it does so in incremental steps. For instance, prior to February 1995, the FOMC raised interest rates seven consecutive times. These rate hikes had a significant impact on the housing market and the durable goods industries. Then, in July 1995, the FOMC lowered rates by a quarter point, and lowered them again in December 1995 and January 1996. The recent quarter-point increase may be only a one-time shot, or it might be the first step toward laddering rates higher.

All but one of the six primary roughly coincident indicators are at new highs, and all six are clearly expanding. *Personal income in manufacturing* was the only coincider not to reach a new high. The prior two months it reached new highs, but this month the series decreased slightly. Still, the monthly base data for personal income in manufacturing increased.

Nonagricultural payroll employment increased by 175,000 new jobs in March. So far, 465,000 net new jobs have been created since the beginning of the year. The *index of industrial production* surged 0.9 percent this month to 119.6. Capacity utilization, which is not one of our statistical indicators but is a coincident indicator of business activity, also rose this month to 84.1 percent. Recently, economists have questioned the usefulness of capacity utilization as a predictor of price inflation, but many would still regard 84.1 percent capacity utilization as a warning flag of developing business-cycle related price pressures.

Manufacturing and trade sales, *civilian employment as a percentage of the working-age population*, and *gross domestic product* all continue to expand as well. Overall 100 percent (6 out of 6) of the roughly coincident indicators with apparent cyclical trends are expanding.

Among the six primary lagging indicators, the *average duration of unemployment* (inverted) and *manufacturing and trade inventories* reached new highs.

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Dec.	*Jan.*	*Feb.*	*Mar.*	***Primary Leading Indicators***	*Feb.*	*Mar.*	*Apr.*
-[r]	-	-		M1 money supply	-	-	-
+	+	+		M2 money supply	+	+	+
-	+	+		Change in sensitive materials prices	+	+?	+?
-	+	+		New orders for consumer goods	+?	+?	+
-	+	-		Contracts and orders for plant and equipment	+?	+?	?
+	-	+		Index of new housing permits	-?	-?	?
-[r]	+			Ratio of manufacturing and trade sales to inventories	+	+	+
nc	-	+	+	Vendor performance	?	?	+?
+	+	+	-	Index of common stock prices (constant purchasing power)	+	+	+
+	-	+	+	Average workweek in manufacturing	+	+	+
-	+	+		Initial claims for unemployment insurance (inverted)	+?	+?	+
+	+	+		Change in consumer debt	-	-	-
				Percentage expanding cyclically	73	73	80
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+[r]	+	+	Index of industrial production	+	+	+
+	-	+		Personal income in manufacturing	+	+	+
-	+			Manufacturing and trade sales	+	+	+
+	+	-	+	Civilian employment to population ratio	+	+	+
+				Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	100	100	100
				Primary Lagging Indicators			
+	-	nc	+	Average duration of unemployment (inverted)	+	+	+
-	+			Manufacturing and trade inventories	+	+	+
+	+[r]	-		Commercial and industrial loans	?	?	?
-	+	-		Ratio of consumer debt to personal income	?	?	?
+	+	+		Change in labor cost per unit of output, manufacturing	-?	-?	?
+	-	-	+	Composite of short-term interest rates	?	?	?
nc No change.	[r] Revised.			*Percentage expanding cyclically*	67	67	100

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

Chart 1
Percentage of AIER Leaders Expanding

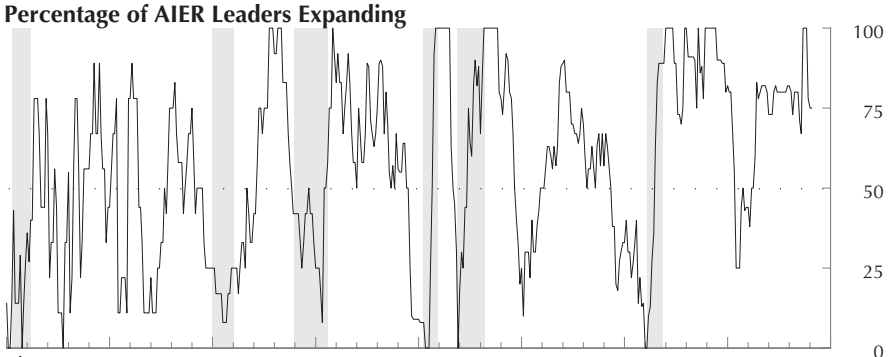


Chart 2
Cyclical Score of AIER Leaders

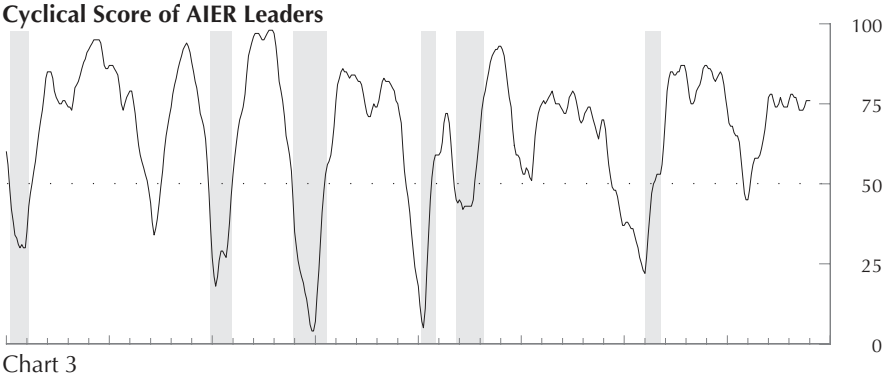
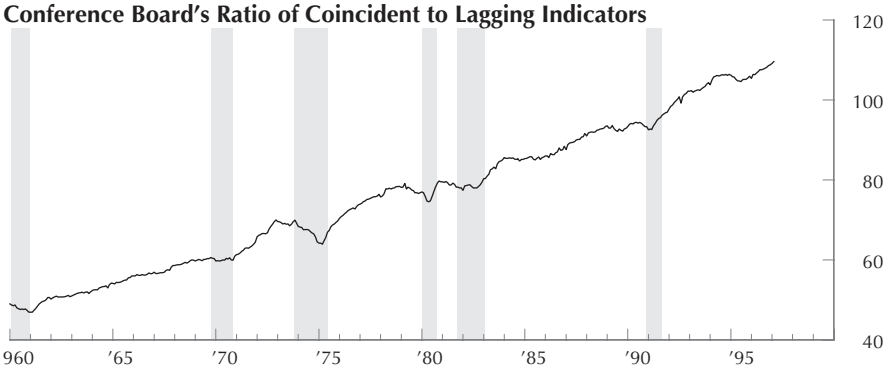


Chart 3
Conference Board's Ratio of Coincident to Lagging Indicators



At 15.7 weeks, the duration of unemployment is still atypically long for an expansion that is now over 6 years old.

There are no apparent cyclical trends in the remaining four lagging indicators. For several months it appeared that the *percent change from a year earlier in manufacturing labor cost per unit of output* was probably contracting. However, the series has fluctuated slightly above or below zero for most of the expansion, and after several months in negative territory, the series is now above zero again. It was previously appraised as probably contracting, but after the latest increases we are unable to discern any cyclical trend in the series.

Federal Reserve policymakers reportedly are watching the labor market like a hawk for signs of rising labor costs. They apparently are concerned that as people begin to feel more job security, something they may not have felt for most of the expansion, they are going to begin demanding bigger wage increases. The increase in our labor cost series above the zero level — indicating that unit labor costs increased over the past 12 months — could indeed be a sign that this is starting to happen in the manufacturing sector. However, given the small size of the increase, more data are required to warrant that assertion.

Commercial and industrial loans decreased slightly, but not enough to reveal any cyclical trend. The same applies to the *ratio of consumer debt to personal income*. Both series are cyclically indeterminate. The *composite of short-term interest rates*, the average of 1-month dealer-placed commercial paper and 3-month top-rated bankers acceptances, increased this month to 5.47. Due to the timing of the Federal Reserve's increase in interest rates, this series does not yet reflect the full impact of the rate increase. The monthly figure we report is the average of week's-end closing rates, and since the Fed raised rates on March 25, only one week's worth of data (for the week ending March 28) reflects the quarter-point increase in the federal funds rate. It is very likely that the composite of short-term rates will be even higher next month when all of April's data are available. For now, the series remains cyclically indeterminate.

Overall, 100 percent (2 out of 2) of the primary lagging indicators with apparent cyclical trends are expanding. With only two series having apparent trends, the laggers may not be as strong as the percentage of lagging indicators might suggest. At times like this, it is especially useful to look at other relevant evidence measuring the strength of the laggers and thus the potential for bottlenecks in the economy. One useful series is the ratio of the Conference Board's composite leading index to its composite lagging index. (The Conference Board now publishes much of the economic data previously maintained by the Commerce Department.) Many of the individual economic series included in these composite indexes are the same as those included in AIER's statistical indicators. A decrease in the ratio of coinciders to laggers historically signalled developing bottlenecks and recession. As the accompanying chart shows, at the present time there are no such indications. Although this series has given false signals in the past, most recently in 1995, it has seldom failed to signal a recession. (The 1990-91 recession was a notable exception.) The continued increases in this ratio in recent months lend further support to the main indication from our own leading series — that of continued expansion into at least the third quarter of 1997. ❑

PRICE OF GOLD

	1995	*1996*	*—— 1997 ——*	
	Apr. 27	*Apr. 25*	*Apr. 17*	*Apr. 24*
Final fixing in London	$386.35	$393.30	$340.40	$340.90

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