Government Greed (Book Review)

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The father of the modern American state was a pipe-puffing executive at R.H. Macy & Co. named Beardsley Ruml." Thus opens Amity Shlaes' new book, The Greedy Hand. Shlaes is an editor at The Wall Street Journal, where she writes many excellent unsigned editorials about the absurdities, inefficiencies, and injustices of taxes. Her book shows, often dramatically, how the tax apparatus "pervades, dampens and makes knots of our lives" in our roles as workers, shoppers, investors, spouses, and parents. She discusses income taxes, Social Security taxes, sales taxes, property taxes, and estate taxes--in short, all the major taxes except the tax on corporate income. Along the way, she dispenses valuable nuggets of information about the tax system: its origins, its rationale, and some of its most twisted features.

Take tax withholding, whereby employers deduct from our gross pay an estimate of the federal and state income taxes we owe. Before 1943, there was no withholding; people just paid their annual taxes every March 15. But President Franklin Roosevelt and Congress dramatically increased tax rates in 1942, months after America entered World War II, and the new rates hit tens of millions of Americans who had never before paid federal income taxes. That, Shlaes writes, is when the "class tax" became a "mass tax."

There was one little problem. A Gallup poll showed that only 5 million of the 34 million people subject to the tax were saving to make their annual payment in March 1943. As March 15 approached, Treasury Secretary Henry Morgenthau fretted, "Suppose we have to go out and arrest five million people?"

Enter Beardsley Ruml, chairman of the Federal Reserve Bank of New York and an adviser to the president. While treasurer at Macy's, Ruml had noticed that customers didn't like big bills, preferring to pay in installments. So he proposed that employers deduct estimated taxes from workers' paychecks. The government accepted his proposal and added a sweetener: Taxpayers were granted amnesty on 75 percent of the lower of their 1942 and 1943 liabilities. So was born withholding, which Shlaes calls "the most ambitious bait-and-switch plan in America's history."

Withholding, writes Shlaes, is what allows the government to be so big. She has a point. It's hard to imagine someone earning, say, $50,000 and accepting this much government if, instead of paying $500 out of each month's paycheck, he had to pony up $6,000 in one lump sum just for federal income taxes.

One minor villain in the withholding episode, incidentally, was Nobel laureate Milton Friedman, at the time a 30-year-old Treasury Department economist. Friedman now agrees that withholding set the stage for today's big government: In Two Lucky People, the memoir he co-authored with his wife, Rose, he candidly states that he "was helping to develop machinery that would make possible a government that I would come to criticize severely as too large, too intrusive, too destructive of freedom."

Shlaes also writes thoughtfully about the Social Security tax. "For younger people," she notes, "the central tax is not income tax, it is FICA, which looms on their paycheck stubs like a Tyrannosaurus rex. To them Social Security is a job tax, indeed the job tax, the major tax fact of the first decade of their career life" (emphasis in original).

Shlaes quotes from a pamphlet published in 1936 by the newly formed Social Security Board. After explaining that employer and employee would each pay three cents of every dollar of the employee's earnings, up to $3,000, the pamphlet stated, "That is the most you will ever have to pay." Of course, this was utterly false. As Shlaes points out, the Social Security and Medicare taxes for each are now 7.65 percent for employer and employee on income up to about $70,000. The Social Security part alone is 5.3 percent for each.

The pamphlet also stated that "the check will come to you as your right." Unfortunately, though Shlaes quotes this statement, she doesn't challenge it. Yet in the 1960 case Flemming v. Nestor, the Supreme Court found that Social Security is not a legal right. Either of the board's two falsehoods, if made by a private pension fund, would have subjected it to a lawsuit.

Because the vast majority of FICA revenue goes to current recipients of benefits,

many critics of Social Security, including me, have likened it to a Ponzi scheme. According to Shlaes, Larry Dewitt--the Social Security Administration's official historian--actually devoted part of the SSA's Web page to distinguishing one from the other. (The SSA, Dewitt informs me, has since removed his analysis.) Dewitt explained that Charles Ponzi lured investors with promises of 50 percent returns on foreign postal coupons. In fact, investors were being paid their returns out of the inflows from later investors. Ponzi's scam, in short, was a pyramid scheme.

So far, that sounds a lot like Social Security. The difference, argued Dewitt, is that Ponzi's swindle was a geometric progression that "works only so long as there is an ever-increasing number of new investors coming into the scheme." Social Security, by contrast, is a simple arithmetic progression that "is sustainable forever, provided that the number of new people entering the system maintains a rough balance with the number of people collecting from the system."

Hmm. As Shlaes points out, demography and the economy have not cooperated with Dewitt's plan. Moreover, even the system's planners knew, as early as the 1950s, that without big tax increases or benefit cuts the baby boom would bankrupt the system. So, by Dewitt's own definition, Social Security is a Ponzi scheme. Shlaes' book does a real service in bringing the moral and intellectual bankruptcy of this Social Security apologist out into the open.

Shlaes also notes that the earnings penalty for Social Security beneficiaries under age 70 imposes a huge tax on incremental dollars earned by the youngest and most- able seniors. In 1996, 65-to-69-year-olds who earned more than $11,520 a year lost one dollar in benefits for every three dollars earned, a marginal tax rate of 33 percent. Americans aged 62 to 64 lost one dollar in benefits for every two dollars earned, a whopping 50 percent marginal tax rate. And that's before counting regular income taxes.

Moreover, Shlaes notes, for elderly people over a certain income level, 85 percent of their Social Security benefits are subject to income taxation. In fact, as I showed in an article in Fortune (March 4, 1996), when you put all these taxes together, the marginal tax rate on dollars earned from working is often more than 80 percent and could be more than 103 percent. "The overall effect," writes Shlaes, "is to send

a clear message: `Don't work.'"

The earnings penalty was imposed when Social Security began, because FDR's brain trust thought that the Depression was caused by "too much labor." "So they intentionally idled seniors," Shlaes writes.

Shlaes also shows how our graduated income tax system, in which marginal rates rise with income, imposes an often large penalty when two earners get married. She leads off with a story of two blue-collar workers in Indiana named Darryl Pierce and Sharon Mallory. "They duly did what many couples in America now do when they consider a serious question like matrimony," she writes. "They went to their accountant." The swing in their tax liability, they learned, would be $3,700 a year.

Shlaes' story of how the marriage penalty developed over about 50 years is detailed and well worth reading. She sums up the quandary as follows: "You could have progressivity [higher tax rates on higher incomes], you could have low rates for the second earner, and you could have a tax arrangement that buttressed the traditional family. But you could not have all three. When you treated married women who worked as individuals, you gave them and their husbands a tax advantage over traditional couples--at least as long as there was progressivity. And when you buttressed the tax supports for married couples with a stay-at-home wife while retaining progressivity, you punished couples with working wives." Because President Clinton and most Democrats opposed reducing "progressivity" and social conservatives in the Republican Party wanted to help "the family," the mid-1990s, by default, became an era of loophole writing.

My major disappointment with the book, incidentally, is with Shlaes' failure to challenge the word "progressivity." Shlaes seems not to have learned the lesson taught by George Orwell and Thomas Szasz: Words affect the way we think about things. "Progressivity" sounds, well, so progressive. It's not.

To her credit, Shlaes attacks the idea of higher tax rates for higher-income people. She quotes George Harrison's 1966 song "Taxman," written shortly after the Beatles' success put them into Britain's highest tax bracket. Shlaes doesn't mention it, but the top British tax rate on "earned" income at the time was 83 percent, and the top rate on income from dividends and interest was 98 percent. The Beatles were shocked to be paying such taxes; thus the song, which, she notes, makes specific references to the tax collectors, Prime Minister Wilson and Prime Minister-to-be Heath. (Margaret Thatcher later cut the top rates to 40 percent.)

As Shlaes writes, "We are all Beatles now." Even those of us who are modestly successful--earning, say, $80,000 in a high-tax state like New York or California--are paying marginal tax rates somewhere between 40 percent and 50 percent. The stated purpose of "progressive" taxation, writes Shlaes, is to tax the rich. But high marginal tax rates, she notes, aren't really taxes on the wealthy; they're taxes on becoming wealthy.

Shlaes, by the way, buys into the idea that super-rich people such as Leona Helmsley don't pay taxes. This is false: Even if Helmsley was guilty of defrauding the government from 1983 to 1985--and economist Paul Craig Roberts has presented powerful evidence suggesting that Helmsley's accountants, not she, were the actual frauds ("Leona May be Guilty, but Not as Charged," Wall Street Journal, April 9, 1992)--the Helmsleys paid $53.7 million in federal taxes on adjusted gross income of $103.6 million, rather than the $55.4 million the government claimed they owed. In other words, the feds are very successful at taxing the rich, too.

The only chapter I found unpersuasive is "Baby Taxes." In it, Shlaes shows how burdensome the government's tax and regulatory requirements are for those who hire nannies. That's presumably why President Clinton's first choice for attorney general, Zoe Baird, paid an immigrant off the books for providing day care.

So far, so good. Then Shlaes cites a statistic: Even after all the publicity about Baird, the IRS recently reported that only one in 13 taxpayers who owe "nanny taxes" actually pays them. This upsets Shlaes. I sympathize with her, because I too value honesty and hate the fact that, as Will Rogers once put it, taxes have made more liars than golf.

But there's another way to look at this. There was a saying in the late 19th century West: "A man who won't cheat a railroad ain't honest." At the time, the

government gave many railroads special privileges. Cheating them--breaking the oppressive law of the day--became the moral thing to do. The same principle applies today. How many teenage babysitters or newspaper delivery boys do you know who pay taxes on their income? I had both jobs as a kid and would have been shocked had someone told me I was legally liable for taxes.

One of the ways the most oppressive laws get changed, as Milton Friedman wrote in the mid-1960s, is for people to ignore and break them. So only one in 13 people actually pays the nanny tax? That may be one of the most hopeful statistics in this book.