Lessons on Tax Effects

There are several lessons to be learned from the Civil War history that inform our knowledge of the effect that Tariff’s had on the production of cotton in the South. Contemporary observers well described these economic phenomena but the lessons are little discussed in modern times where they would be valuable in application.

Inequality - The Inherent Evil of Tariffs

The first phenomenon is the greatest one. It is the fundamental cause of the war. It is the inherent evil of the tariff. That tax is necessarily unequal in its effect on the various economic interests. Because it is levied on imports, it falls most heavily on those who are economically dependent on international trade.

Because the tariff stifles trade in foreign imports, domestic producers favor it. They will organize politically if the prospects of gaining the power to raise the tax are within the realm of possibility. The vicious propaganda campaigns of the tariff men such as Lewis Tappan and Gerrit Smith in the decades prior to the war illustrates the evil incentives.

Because the pro-tariff men used anti-slavery as their political tool to limit the westward expansion tariff-resisting southern agriculture, the southern men found it necessary to counter that propaganda with pro-slavery propaganda. Southern slave owners like John Hartwell Cocke who were liberally inclined to work for the freedom of the slaves, found themselves stifled by the understandable southern reaction to the relentless anti-slavery propaganda from the tariff men. Actual southern liberalization was set back by desperate economic politics.

The lesson is clear. Don't allow the legislature to impose tariffs. Any constitution that permits tariffs is necessarily defective because it sets up the stage for strife.

Cascading Markups

A second lesson relates to the imposition of taxes on intermediate transactions in the chain of commerce. Taxes imposed on intermediate transactions are simply passed on to the next purchaser and so on down the chain. Each buyer who resells, however, must make a profit on the transactions or he cannot survive in business. The amount of the tax, therefore, gets marked up. Each buyer adds a percentage to the price, including the amount of the tax plus a percentage of it.

The markups on markups on markups of the tax accumulate and multiply down the chain of transactions, adding a great deal to the ultimate price. They are like fat in the arteries of commerce, stifling the flow.

William Winter Payne of Alabama gave an excellent exposition of cascading markups in a speech in Congress as the Whigs were preparing to pass their high-tariff bill of 1842. Payne was a cotton planter in Sumter County, Alabama, about 100 miles southwest of Birmingham. He served in Congress from 1841 to 1847.

Payne's example is noteworthy not only because of the example of cascading markups but because of the high actual level (100%) of the tax.

Payne's purpose was to illustrate the practical operation of the tariff. "I desire," he said, "the consumer of dutiable goods to see the amount he annually pays to the manufacturer." He presented tables, "showing the cost of dutiable goods under the rate of duty imposed by this bill; and also the cost of the same goods to the consumer, exclusive of the duty."

Payne gave the example of cotton fabric goods worth 6 cents per yard. The tariff law, however, required those goods to be taxed as if they were worth 20 cents per yard, the "minimum valuation." The tariff rate was 30% applied to the minimum valuation of 20 cents yielding a tax of 6 cents, an effective tax rate of 100%.

That was, said Payne, a "tax to the consumer of 180 per cent. upon the original cost." "[E]very man who consumes cotton goods, the original cost of which , exclusive of duty, is $1," he explained, "will under the operation of this bill, have to pay $2 80."

A. Imports goods worth $100.00

Duty to Government at 100 per cent. $100.00

Custom-house cost of said goods $200.00

Profit of importing merchant on said goods,

At 20 per cent. $ 40.00

B. the retail merchant, pays for said goods $240.00

Profit of B, at 50 per cent $120.00

Cost to Consumer $360.00

The following would be the cost of said goods exclusive of duty:

A. imports goods amounting to $100.00

Profits of A, at 20 per cent. 20.00

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B, the retail merchant, pays for said goods $120.00

Profit of B, at 50 per cent 60.00

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Cost to the consumer of said goods 180.00

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Difference of cost in favor of consumer 180.00

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Mr. Payne's examples show the wasteful multiplication of the tax burden when taxes are imposed upon intermediate transactions in the chain of commerce. The conclusion must be that taxes imposed on business are inefficient and that the tax, to be efficient, must be imposed at retail.

If the tax is imposed at retail, the tax must be uniform. In other words, a constitution must require that all transactions bear the same rate of tax with no exemptions. Otherwise, favored and disfavored groups will form and agitate to sway the law to their favor, to the disfavor of others.