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Historical Perspective on U.S. Tax Policy Toward the Rich

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HISTORICAL PERSPECTIVE ON U.S. TAX POLICY TOWARD THE RICH

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for

"Does Atlas Shrug? The Economic Consequences of Taxing the Rich"

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The goal of taxing America's richest citizens has made the nation's tax system unique.[1] In the twentieth century, to tax the rich, the federal government adopted sharply progressive personal and corporate income rates, a highly progressive system of estate and gift taxation, and an income tax that has generally taxed capital income at higher rates than "earned" income. However, the federal tax code has also embraced a wide variety of "tax expenditures," many of which served to reduce the progressivity of the American tax system. The resulting complexity, joined with the highly progressive rate structure, form the two most distinctive features of American taxation. Uncovering the meaning of these features requires an exploration of the history of taxation, and especially the taxation of the rich, from the origins of the new republic during the late eighteenth century.[2]

Since the time of the constitutional crisis in which the republic took shape, American governments have taxed the rich not only to raise revenue but also to foster internal social order. Historians of American taxation generally agree on this point. They agree as well on the importance of the symbolism of taxation

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[1]In this essay, when I refer to "the rich," I follow Joel Slemrod's suggestion of focusing on "households whose income is in the top 1 percent of all household . . . units." See Slemrod, "On the high-income Laffer curve," in Slemrod, ed., Tax Progressivity and Income Inequality (Cambridge, Eng.: Cambridge University Press, 1994), 179.

[2]For a provocative discussion of international comparisons, see Sven Steinmo, Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State (New Haven: Yale University, 1993), 35-40.

of the rich--that is, on the historic imperative felt by American governments to tax the rich at rates that appear to equal or surpass those applied to individuals and families of lesser means.

Historians disagree widely, however, on the purposes underlying this symbolism, and on the intimately related question of how serious America's political leaders have been in making the reality of the tax code reflect the progressive symbolism.

Some historians view the taxation of the rich, including the introduction of progressive income taxation, as nothing more than empty rhetoric. One such historian, Robert Stanley, describes the early history of the federal income tax (from the Civil War through 1913) as an expression of capitalist desire "to preserve imbalances in the structure of wealth and opportunity, rather than to ameliorate or abolish them, by strengthening the status quo against the more radical attacks on that structure by the political left and right." Consistent with Stanley's history of the income tax is Mark Leff's history of New Deal tax reform. He argues that Franklin D. Roosevelt looked only for cosmetic tax reform and was never willing to confront capitalist power by undertaking a serious program of income and wealth redistribution through taxation. Thus Stanley and Leff regard income-tax initiatives before World War II as hollow, almost entirely symbolic efforts designed by the protectors of capitalism to appease the forces of democracy.[3]

I take a very different point of view. My study locates the symbolism that led to "progressive" taxation deep in the nation's republican traditions. The central concern for promoting civic virtue among the republic's citizens had a powerful impact on republican traditions on the taxation of the rich as well as on the formation of new tax regimes. I argue that American republicanism was concerned with far more than the preservation of capitalism, and that for two centuries republicanism has been the most important determinant of American taxation of the rich. And, I suggest that republicanism has brought about substantial taxation of the nation's richest citizens, especially during great national emergencies, which spawned America's distinctive tax regimes. During the last two hundred years, Americans have taxed the wealthy at high levels, despite the social value they have attached to the accumulation of private capital, and despite their reluctance to throw up governmental barriers to the individual "pursuit of happiness."[4]

This paper is devoted largely to understanding the ideals of

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[3]Robert Stanley, Dimensions of Law in the Service of Order: Origins of the Federal Income Tax, 1861-1913 (New York: Oxford University Press, 1993), viii-ix; and Mark Leff, The Limits of Symbolic Reform: The New Deal and Taxation (New York: Cambridge University Press, 1984).

[4]By a "tax regime" I mean a system of taxation with its own characteristic tax bases, rate structures, administrative apparatus, and social intentions. For a survey of the history of taxation organized around the tax regimes created during national emergencies, see W. Elliot Brownlee, Federal Taxation in America: A Short History (Cambridge, Eng.: Cambridge University and the Woodrow Wilson Center, 1996).

American architects of tax policy, and how those architects have acted upon their ideals, balancing expectations of republican virtue with a desire to use instruments of taxation in a practical way to achieve a wide range of social goals, only one of which was the advancement of capitalism. The paper also reflects upon the reactions of the rich to progressive policies that singled them out for heavy taxation. From World War I through World War II, when progressive assaults were most ambitious and threatening, the rich generally reacted not by shrugging and going "on strike," as Ayn Rand proposed. Instead, they stayed in both economic and political marketplaces and struggled to turn back the assaults. By the late 1940s they had largely succeeded in removing the redistributional fangs from the movement for progressive taxation.[5]

I

During the constitutional crisis of the late eighteenth-century, Americans began to wrestle with the problem of how to tax the richest members of society. In these formative years, governments--federal, state, and local--saw the question of how to tax the rich as part of the central social issue of determining the exact role that privilege ought to have in a republic.

Amid the formation of the early republic, Americans came to understand their society as a res publica, or a commonwealth.

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[5]Ayn Rand, Atlas Shrugged (New York: Random House, 1957). See n. 68, below.

Government's central responsibility was, in the words of Oscar and Mary Handlin, "to protect and advance the common wealth." Stated somewhat differently, the political language advanced by the constitutional crisis of the American Revolution embraced an idealism that went far beyond a Lockean liberalism, with its emphasis on private rights. The idealism of the Revolution also asserted a classical republicanism, or a civic humanism, which stressed communal responsibilities. These ideas trumpeted, on the one hand, the need to foster public virtue and, on the other, the threat of corruption and commercialism to public order. The founders, and even Adam Smith, held these ideas of classical republicanism in tension with those of liberalism.[6]

In implementing republican ideals, governments treated privilege with skepticism. They granted privileges to individuals or groups in limited and well-defined forms, and then only when such privileges would clearly advance the collective interest of the commonwealth. And, the governments of the new republic

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[6]See Oscar and Mary F. Handlin, The Wealth of the American People: A History of American Affluence (New York: McGraw-Hill, 1975), 59, for the quotation, and 57-81 for a useful overview of the history of government in the new republic. An excellent introduction to the modern intellectual history of the Revolutionary era is found in the essays in Jack P. Greene, ed., The American Revolution: Its Character and Limits (New York: New York University Press, 1987). For important suggestions as to the long-run influence of civic humanism, see Dorothy Ross, "The Liberal Tradition Revisited and the Republican Tradition Addressed," in John Higham and Paul K. Conkin, eds., New Directions in American Intellectual History (Baltimore: The Johns Hopkins University Press, 1979), 116-31. On Adam Smith as a civic humanist, see Donald Winch, Adam Smith's Politics: An Essay in Historiographic Revision (Cambridge, England: Cambridge University Press, 1978).

established special taxes on recipients of privilege, such as individuals who received corporate charters by special legislation. But, as such special grants of privilege became more limited and the grants themselves less common, legislatures often reduced or abolished the special taxes. Similarly, state governments grew reluctant to use taxation as a means for granting privilege. Instead, they increasingly used taxation to affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a republican citizenry.

The ideal of a harmonious republic of citizens equal before the law embraced the notion that taxpaying was one of the normal obligations of a citizenry bound together in a republic by ties of affection and respect. This communal thinking went further, emphasizing the direct relationship between wealth and the responsibility to support government and public order. It embraced enlightened self-interest and included "ability to pay" as a criterion in determining patterns of taxation. It was in that spirit that Adam Smith declared, in his first canon of taxation in The Wealth of Nations, that "the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities."[7]

American governments shared Smith's enthusiasm for "ability to pay" and, along with Smith, regarded the property tax--in

[7]Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (New York: The Modern Library, 1937), 777.

particular, the taxation of property according to its value--as the tax which offered the greatest potential for taxing according to "ability to pay." They were aware, as was Smith, that the rich of their day spent more of their income on housing than did the poor and that a flat, ad valorem property levy was therefore progressive. Smith was cautious in advancing the desirability of progressive taxation, but he wrote that "It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in proportion."[8]

Even in the colonial period, property taxation was the mainstay of local government, and after 1775 state governments employed it extensively. Then, the democratic forces unleashed by the American Revolution fueled movements to reform state taxation by expanding property taxation. These movements focused on abandoning deeply unpopular poll taxes and shifting taxes to wealth as measured by the value of property holdings. The explicit goal of the expansion of property taxation was the enhancement of the commonwealth, and the practical import was to increase the taxes on all citizens with property and subject the wealthiest citizens to the highest rates of increase.

The accomplishments of these reform movements varied widely

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[8]The quotation is also from Adam Smith, Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, 794. For discussion of Smith's point, see Harold M. Groves, Tax Philosophers: Two Hundred Years of Thought in Great Britain and the United States, edited by Donald J. Curran (Madison: University of Wisconsin, 1974), 19-20.

across the new states. But support continued to grow, even during the hard deflation of the 1780s. Proponents of tax reform worried that the new national government might preempt the use of property taxation by state and local governments. Consequently, in the new constitution, through Article I, Section 9, they severely limited the national government's ability to levy property taxes. The clause specified: "No capitation, or other direct tax shall be laid, unless in proportion to the census."[9]

The restriction imposed by Article I, Section 9, along with the requirement imposed by Article I, Section 8 that "all duties, imposts, and excises shall be uniform throughout the United States," reflected not only enthusiasm for state and local property taxation but also the fact that American republicans thought about taxation in the context of the corruption of the British Parliament and the monarchy. They sought to prevent similar abuse by the new federal government. The federal government, they feared, could become too far removed from the people or captured by a powerful faction. The consequence might be abuses of power in taxation. They saw the property tax, in particular, as well-suited to the purposes of discriminatory federal taxation. The national government might single out particular regions or groups and then apply discriminatory taxes to their property holdings. The framers who were associated with

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[9]The complicated story of tax reform during the American Revolution is ably told by Robert A. Becker, Revolution, Reform, and the Politics of American Taxation, 1763-1783 (Baton Rouge: Louisiana State University Press, 1980).

a particular industry or section of the country often worried that the federal government might identify their industry or section as one that deserved higher property taxation. Slaveowners, for example, worried about federal property taxation that would single out slave property. Representatives of rural districts worried about taxation that might favor town dwellers over farmers. An example of such taxation was the taxation of property holdings on the basis of their acreage rather than their value. Urban commercial interests worried about the reverse--federal taxation of property holdings on the basis of their value.

Such fears, in turn, fueled the fear of factionalism that James Madison, perhaps the new republic's foremost civic humanist, expressed in Federalist No. 10. He predicted that "the most common and durable source of factions" would be "the various and unequal distribution of property." He concluded that the issue of taxation, more than any other, created an opportunity and temptation for "a predominant party" in the new government "to trample on the rules of justice." Madison regarded the large scale of the republic as the fundamental protection against factionalism, but he valued Article I, Section 9 for the way in which it provided additional security.

The Constitution restrained the federal government from undertaking experiments in class-based taxation aimed at the rich. Until the Civil War, the federal government depended primarily on revenues from regressive tariffs and rarely singled out wealthy individuals through taxation. There were exceptions to the general pattern. Hamilton experimented with excises on goods and services consumed almost exclusively by the affluent. These taxes included a kind of luxury tax on carriages, a stamp tax on legal transactions, and a tax on snuff. But the taxes were never important revenue raisers, and Hamilton supported them not so much to tax the rich as to exercise the constitutional powers of the federal government without arousing the kind of democratic opposition represented by the Whiskey Rebellion. Similarly, in 1798, the Federalists adopted a progressive property tax to help finance the naval buildup against France. Under this tax legislation, Congress assigned revenue goals to the states on the basis of population but required that each state, in raising its share of revenue, tax houses at rates that increased as the value of the houses increased.

None of the Federalist experiments with progressive taxes worked well. Moreover, these taxes contributed to Federalist political defeats in 1798 and 1800. Subsequently, in 1802, the Jefferson administration, despite its more democratic proclivities, led in the abolition of all excise and direct taxation by the federal government.

As the federal government removed itself from the realm of direct taxation, state and local governments forged ahead in developing revenue systems that relied on property taxes. Most dramatic was the use of property taxation by state governments. Two fundamental forces--the democratization of politics and the industrialization of the economy--accelerated the property-tax movement. Jacksonian Democracy, with its successful assault on the property qualifications for voting, and the Industrial Revolution gathered force during the 1820s and 1830s. At the same time, Jacksonian reformers extended the scope of property taxation, trying to tax new and rapidly growing forms of wealth.

By the Civil War, in most states reformers had created the elements of a general property tax designed to reach all property--intangible (personal property such as cash, credits, notes, stocks, bonds, and mortgages) as well as tangible property (tools, equipment, and furnishings, as well as real estate). Some states simply expanded the statutory definitions of what constituted property for tax purposes. Other states added to their constitutions provisions for uniformity (requiring that properties of equal value be taxed at the same rate) and for universality (requiring that all property be taxed). For example, Ohio's 1851 constitution provided that "Laws shall be passed taxing by a uniform rule all moneys, credits, investments in bonds, stocks, joint-stock companies or otherwise; and also all real and personal property, according to its true value in money." (Article 12, Section 2) Ohio had launched general property-tax reform as early as 1825 and had garnered sustained increases in taxes on personal property. But, in only two years, the state, empowered by its 1851 constitution, doubled its assessment of personal property--to about two-thirds the value of real property. In the same two-year period, state and local tax collections each nearly doubled.

By the 1860s, in much of the nation, property taxation had become the dominant source of state and local revenues, and the movement for general property taxation had significantly increased the relative contribution of the wealthiest Americans to government. As a consequence of the apparent success of property taxation for meeting state and local revenue needs, state and local political leaders became increasingly vigilant in watching for possible federal incursions into their property-tax base. This vigilance helped keep the taxation of the rich almost exclusively a matter for state and local government.[10]

II

The Civil War crisis compelled the federal government to

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[10]For overviews of the antebellum reform movement for general property taxation, see Sumner Benson, "A History of the General Property Tax," in George C. S. Benson, et al. The American Property Tax: Its History, Administration, and Economic Impact (Claremont, California: Claremont Men's College, 1965), 31-52, and Richard T. Ely, Taxation in American States and Cities (New York: Thomas Y. Crowell, 1888), 131-45. On Ohio's property-tax experience, see Ely, 146-59, and 456. The major exceptions in the increasing reliance by state governments on property taxation were in the South, where the waxing movement to protect slavery increasingly shielded slaves from state taxation. In North Carolina, for example, during the 1840s and 1850s the state government relied on investment income from banks and railroads and on borrowing to reduce its reliance on property taxes. See Richard Sylla, "Long-Term Trends in State and Local Finance: Sources and Uses of Funds in North Carolina, 1800-1977," in Stanley L. Engerman and Robert E. Gallman, Long-Term Factors in American Economic Growth, National Bureau of Economic Research, Studies in Income and Wealth, Volume 51 (Chicago: The University of Chicago, 1986), 832-35. Another valuable study for understanding nineteenth-century public finance at the state level is Peter Wallenstein, From Slave South to New South: Public Policy in Nineteenth-Century Georgia (Chapel Hill: The University of North Carolina Press, 1987).

reconsider taxing the rich. The very first taxes the Civil War administration of Abraham Lincoln imposed were regressive consumption taxes--high tariffs and excises on an enormous range of consumer goods and services. But Republican leaders worried that new, regressive taxes could undermine confidence in the Republican Party and the war effort, particularly in western and border states. Consequently, they looked for a supplementary tax that bore a closer relationship to "ability to pay" than did the tariffs and excises. The goals of such a tax would be to raise additional revenue, thus easing inflationary pressures, to convince taxpayers that the wartime fiscal system was fair, and to persuade the public that it was embarked on more than a "rich-man's war and a poor man's fight."

The Republican leadership had very few options. The rudimentary accounting methods followed by homes, farms, and businesses meant that the most practical method to raise huge amounts of revenue quickly was the one they had already chosen: taxing goods at the point of importation or sale. Even this approach required the swift development of a large administrative apparatus for the collection of excises.

Less practical, but perhaps feasible, was coopting the administrative systems that state and local governments had developed for property taxation. Secretary of the Treasury Salmon P. Chase and Thaddeus Stevens, chair of the House Ways and Means Committee, favored this approach at first, and they proposed an emergency property tax modeled after one adopted during the War of 1812. But virtually everyone regarded a property tax as a "direct" tax, and therefore restricted by Article I, Section 8, of the Constitution. Members of Congress from western states (including the Great Lakes states), border states, and poorer northeastern states complained that the constitutional requirement, which compelled the allocation of a property tax among the states on the basis of population rather than property values, would mean a higher rate of taxation on property in their states. They also complained that the tax, as initially drafted, would not tax the rich. It would focus on real estate and would not reach real estate improvements and "intangibles" such as stocks, bonds, mortgages, and cash. Congressman Schuyler Colfax of Indiana declared, "I cannot go home and tell my constituents that I voted for a bill that would allow a man, a millionaire, who has put his entire property into stock, to be exempt from taxation, while a farmer who lives by his side must pay a tax."

In response to the complaints, the leadership took note of how the British Liberals had used income taxation in financing the Crimean War as a substitute for heavier taxation of property. Justin S. Morrill of Vermont, who chaired the Ways and Means Subcommittee on Taxation and was a staunch proponent of high tariffs, introduced a proposal for a new and very different tax--the first federal tax levied against personal income. Congressional leaders viewed the tax as an indirect tax because it did not directly tax property values.[11]

The first income tax of the Civil War was ungraduated, imposing a basic rate of 3 percent on incomes above a personal exemption of $800. (The federal government had no scientific way to measure personal income, but Congress came surprisingly close to setting the exemption close to average annual family income, which was about $900 in 1870.[12]) Amendments in subsequent war years reduced the exemption and introduced graduation. In 1865, the tax imposed a 5 percent rate on incomes between $600 and $5,000 and 10 percent on incomes over $5,000. The rates seem may seem low by twentieth-century standards, but they imposed significantly higher taxes on the wealthy--perhaps twice as high--than the wealthy were used to paying under the general property tax. And, this was the first time that the federal government had

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[11]The most informative scholarship detailing the development of income-tax legislation between the Civil War and World War I remains Roy G. Blakey and Gladys C. Blakey, The Federal Income Tax (London: Longmans, Green, 1940), 1-103; Sidney Ratner, American Taxation: Its History as a Social Force in Democracy (New York: Norton, 1942), 13-340; and Edwin R. A. Seligman, The Income Tax: A Study of the History, Theory, and Practice of Income Taxation at Home and Abroad (New York: Macmillan, 1914). Robert Stanley has revised this scholarship, emphasizing the conservative forces behind the development of the federal income tax through 1913. In explaining the adoption of the first federal income tax, he emphasizes the Republican desire to provide political protection for the consumption-based tax regime. See Robert Stanley, Dimensions of Law in the Service of Order: Origins of the Federal Income Tax, 1861-1913.

[12]Bureau of the Census, Historical Statistics of the United States, Colonial Times to 1970 (Washington, D.C.: G.P.O., 1975), 41 and 240.

discriminated among taxpayers by virtue of their income.[13]

The tax reached well into the affluent upper-middle classes of the nation's commercial and industrial centers. By the end of the war, more than 10 percent of all Union households were paying an income tax, and the rate of taxpaying probably reached 15 percent in the northeastern states, where the federal government collected three-fourths of its income-tax revenues. These households probably constituted roughly the slice of society that economic historians have estimated as owning 70 percent or more of the nation's wealth in 1860. By the end of the war, most of the richest one percent of the nation's families--as measured by their Civil War tax returns--paid income taxes at the marginal rate of 10 percent.[14]

The administrative machinery created by the Commissioner of Internal Revenue relied heavily on the cooperation of taxpayers.

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[13]On the point that propertied New Yorkers paid substantially higher income taxes than property taxes, see Seligman, The Income Tax, 473-75.

[14]The estimates of the percentages of Union households paying income taxes are based on the well-known data on taxpayers developed by the Commissioner of Internal Revenue for 1866. By contrast with my emphasis, Robert Stanley, citing a figure of only 1.3 percent of the American people paying income taxes, claims that the tax did not reach the middle class. Stanley seriously understates the social reach of the income tax by including the Confederate population and by using "people" rather than taxpaying households for his denominator. See Robert Stanley, Dimensions of Law in the Service of Order, 39-40 and 263-64. On estimates regarding the distribution of income and wealth, 1790-1860, see W. Elliot Brownlee, Dynamics of Ascent: A History of the American Economy (New York: Alfred A. Knopf, 1979), 134-36. On the distribution of taxpayers by income groups, see U.S. Government, Annual Report of the Commissioner of Internal Revenue for the Year 1872 (Washington, D.C.: U.S G.P.O, 1873), vi.

Compliance was high, at least during the war, because of patriotic support for the Union cause, and because of the partial enactment of British "stoppage at the source," meaning collection at the source or the withholding of taxes by corporations and others who make payments of income. The Commissioner of Internal Revenue lacked the administrative capacity to obtain earnings reports or collect taxes from farms and small businesses, where most Americans earned their income. But the law did require corporations--railroads, banks, and insurance companies, primarily--to collect taxes on dividends and interest, forms of income that constituted a large share of the income of the affluent citizens Congress wanted to tax. Also, the law required agencies of the federal government to collect taxes on salaries, which grew substantially during the wartime mobilization.

The Civil War decade was probably the high-water mark in nineteenth-century America for the taxation of the rich. After the war, the tax rates paid by wealthy citizens almost certainly declined, by virtually any measure, and did so at every level of government.

After the Civil War, Republican Congresses responded to the complaints of the affluent citizens who had accepted the income tax only as an emergency measure. In fact, little organized political support had emerged for permanent income taxation, and only a minority of the party's congressional leadership thought about the tax as a shield to protect regressive tariffs. Fewer still actually liked the distributional effects of the tax.

Republican leaders found eradicating the income tax relatively easy to do because, during the late 1860s and early 1870s, they were phasing out most of the excise taxes, which the general public resented in peacetime and blamed for postwar increases in the cost of living. Beginning in 1867, the Republican leadership increased the income tax exemptions and lowered the rates. In 1870, Congress--mistakenly fearing a deficit--extended the tax, but then allowed it to expire in 1872.

III

Introduction of the general property tax had offered the promise of taxing all wealth at the same rate, and taxing rich families, who received more of their income from personal property, at progressive rates. But, after the Civil War, in most urban areas, that egalitarian promise vanished. The swiftly growing desire of city governments to build modern infrastructure (parks, schools, hospitals, transit systems, waterworks, and sewers) drove up tax rates to levels wealthy urbanites were unwilling to pay. They responded by underreporting the value of their intangible personal property (e.g., cash, credits, notes, stocks, bonds, and mortgages), and urban governments lacked administrative machinery that was adequate to expose and assess such property. State governments, meanwhile, were at the mercy of local governments in the assessment of property values for state property taxation. Consequently, state and local governments began to abandon general property taxation and to develop in its place a property tax that was less burdensome on the wealthy: the modern property tax, with its standardized assessment practices and its focus on real estate.[15]

The easing of the relative tax burden on the rich, especially during the hard depression of the mid-1890s, stimulated Populists in the West and the South, and champions of Henry George's "single tax," who were scattered throughout urban America, to promote social justice through tax reform. The Populists championed a progressive tax on the profits of corporations and the incomes of the wealthy, and single taxers often supported it at the federal level while they sought radical reform of the property tax at the state and local levels.[16]

The Populist and the single tax movements each harkened back to classical republicanism by highlighting the responsibility of government to punish and discourage special privilege. Central to the appeal of a highly progressive income tax during the 1890s was the claim that the tax would reallocate fiscal burdens according to both "ability to pay" and the distribution of government benefits in the form of special privilege. The tax, therefore, would help restore a virtuous republic free of

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[15]On the complex difficulties with the general property tax, see Clifton K. Yearley, The Money Machines: The Breakdown and Reform of Governmental and Party Finance in the North, 1860-1920 (Albany: State University of New York Press, 1970), 3-95 and 137-65.

[16]Traditional "progressive" scholarship placed a great deal of emphasis on the importance of such grass-roots pressure by farmers in shaping the inception of the federal income tax. See, for example, Elmer Ellis, "Public Opinion and the Income Tax, 1860-1900," Mississippi Valley Historical Review 27 (September 1940): 225-42; and Sidney Ratner, American Taxation: Its History as a Social Force in Democracy, passim.

concentrations of economic power. Part of the attack focused on the protective tariff, which tax reformers claimed had become in itself a source of special privilege, encouraging the growth of corporate monopolies.

The reform rhetoric was, in a fundamental sense, conservative; it directed attention to the values of the early republic. What was potentially radical about the movement for progressive income taxation was its content: the goal of raising the government's revenues primarily or even entirely from the largest incomes and corporate profits. The radical advocates for income taxation regarded such incomes and profits as the consequence of monopoly power and unfair advantages. They argued that their tax would not touch the wages and salaries of ordinary people but would, instead, attack unearned profits and incomes. The tax would, its proponents claimed, redress the wealth and power maldistribution that was responsible for the evils of industrialization. Those who believed they had faced expropriation now wanted to do the expropriating.

Thus, support for a radical progressive income tax had far more to do with the search for social justice in an industrializing nation than with the quest for an elastic source of revenue. The progressive income tax became an integral part of democratic statism--a radical program of invoking instruments of government power to create a more democratic social order by redistributing wealth. Democratic statism represented a new kind of liberalism, an adaptation to industrial conditions of classic nineteenth-century liberalism and of the commonwealth tradition of early republicanism, which had included a distrust of commerce. Democratic statists like the Populists and the single taxers regarded themselves as applying the ideals of the American Revolution to the new conditions of industrial society. Although the strategy remained one of liberating individual energies by providing a social order of abundant opportunity, the tactics had changed. To these new liberals, the state had become a necessary instrument and ally, not an enemy. They designed their tax program to restructure the machinery for distributing income and wealth.[17]

The new grass-roots pressure changed the politics of federal taxation. During the Civil War, the Republican leadership had exercised a great deal of discretion in crafting the income tax. To be sure, they had developed the tax in anticipation of sectional and class resistance to a federal property tax. But they had designed the tax without any group's insistence that they do so. And, after the war, they set their own timetable for its demise. In contrast, when Congress began to reconsider income taxation during the early 1890s, it did so primarily in response to popular pressure. Moreover, Congress then faced numerous proposals for a high degree of progression, and the proposers'

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[17]For a discussion of the meaning of democratic statism and its relationship to progressive income taxation, see W. Elliot Brownlee, "Economists and the Formation of the Modern Tax System in the United States: The World War I Crisis," in Mary O. Furner and Barry E. Supple, eds., The State and Economic Knowledge: The American and British Experience (Cambridge, England: Cambridge University Press, 1990), 401-35.

arguments had a sharp, radical edge.

The pressures for progressive tax reform from western and southern Populists became strong enough to force a shift in the position of the leaders of the Democratic Party. A contributing factor was the decline of foreign trade and tariff revenues during the depression of 1893-97. This enabled the Democrats to embrace a proposal for a new tax while still calling for the shrinkage of swollen Republican programs of public works, pensions, and military expenditures. Democrats took control of both houses of Congress in 1893, and its leaders in the House from the South and the West, including Benton McMillin of Tennessee, who chaired the Ways and Means Subcommittee on Internal Revenue, enacted an income tax in 1894 as part of the Wilson-Gorman Tariff. They sensed an opportunity to use tax issues for a major realignment of the two political parties along sectional and class lines, and they debated the income tax with unprecedented agrarian ferocity.[18]

Hostility from northeastern Democrats, as well as the opposition of most Republicans (including leaders like Senators John Sherman of Ohio and Justin Morrill of Vermont, who had supported the Civil War income tax), limited the progressivity of

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[18]On the realignment strategy, see Charles V. Stewart, "The Federal Income Tax and the Realignment of the 1890s," in Bruce A. Campbell and Richard J. Trilling, Realignment in American Politics: Toward a Theory (Austin: University of Texas Press, 1980), 263-87. Stewart also describes the way in which political parties, in building consensus, moderated the content and rhetorical tone of income-tax proposals after 1896. See Stewart, "The Formation of Tax Policy in America, 1893-1913" (Ph.D. dissertation, University of North Carolina at Chapel Hill, 1974).

the tax. Within both parties, leaders recalled how effective the Civil War income tax had been in reaching the incomes of the nation's wealthy families. Congress reproduced many of the technical features of the Civil War income tax and set a somewhat lower rate on incomes (2 percent). But Congress introduced several changes that reflected rising popular enthusiasm for taxing the rich. Congress established a much higher personal exemption ($4,000), thus focusing the tax more directly on very wealthy individuals. Congress also defined as taxable income any personal property acquired by gift or inheritance. Finally, Congress applied the 2 percent tax to the income of business corporations (defined as revenues above operating expenses, including interest on indebtedness). This tax embodied the assumption that the federal government ought to tax corporations according to a "benefit" theory of taxation as well as the principle of "ability to pay." Americans had begun to regard corporate taxation as an especially important vehicle for both the taxation of the rich and assaulting special privilege.[19]

The 1894 tax was short lived. In 1895 the Supreme Court, in <u>Pollock v. Farmers' Loan and Trust Co.</u>, declared that the income tax of the Wilson-Gorman Tariff was unconstitutional. The <u>Pollock</u> decision raised a significant institutional barrier to progressive taxation, but it also stimulated popular support for

[19]Nearly a century later, average Americans still favored levying additional taxes on corporations. See Steven M. Sheffrin, "Perceptions of Fairness in the Crucible of Tax Policy," in Joel Slemrod, ed., <u>Tax Progressivity and Income Inequality</u>, 321-324.

income taxation. Populists and Democrats from the South and the West now attacked the Court and found that their audiences responded enthusiastically. Democrats began to introduce constitutional amendments that would permit income taxation, and in 1896 the Democratic Party formally endorsed income taxation. This was the first time a major party had done so.[20]

The Democrats, however, went down to a decisive defeat in 1896, and the victorious Republicans felt no urgency in adopting progressive tax reform, especially when economic recovery took hold during the late 1890s. By the time Republicans had to face the problem of financing the Spanish-American War, they had recovered the power to neutralize the Democratic thrust for income taxation. Republicans were willing to accept, however, a progressive but modest tax on estates. That tax, which Congress repealed in 1902, help finance not only the Spanish-American War but also the suppression of the Huks and the intervention in the

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[20]Modern scholarship has modified an older "progressive" interpretation of the Pollock decision as a conspiratorial act of judicial fiat. For that view, see Robert G. McCloskey, The American Supreme Court (Chicago: The University of Chicago Press, 1960), 140-41 and Sidney Ratner, Taxation and Democracy in America, 193-214, among others. The best current discussion of the role of the Court is Robert Stanley, Dimensions of Law in the Service of Order: Origins of the Federal Income Tax, 1861-1913, 136-75. Stanley argues that the Court was engaged in a kind of Jacksonian attack on the dominant role of Congress in "statist capitalism." Consistent with his interpretation is Morton Horwitz's argument that the Pollock decision was a logical culmination of a process that established an "anti-redistributive principle" as "part of the very essence of the constitutional law of a neutral state." See Morton J. Horwitz, The Transformation of American Law, 1870-1960: The Crisis of Legal Orthodoxy (New York: Oxford University Press, 1992), 19-27.

Boxer Rebellion.[21]

During the first decade of the new century, support for income taxation resumed its growth. The gains were most marked across rural America but especially strong in the Midwest and the West. Republican leaders like Robert M. La Follette of Wisconsin discovered that income taxation was one of those reform issues that attracted and held voters to the alignment the party had crafted in 1896. Presidents Theodore Roosevelt and William Howard Taft both recognized this support and made vague gestures on behalf of a graduated income tax (in 1906 and 1908, respectively). But popular backing for income taxation grew too in the urban Northeast. There, both Republican and Democratic leaders found that the tax had begun to appeal to their constituents.

An important new element in the growing support for federal income taxation was the formation of an urban-rural alignment of middle-class citizens who favored state and local tax reform. The economic depression of the 1890s, followed by accelerating demands for services from state and local governments, accentuated the flaws in general property taxation. Both farmers and middle-class property owners in towns and cities resented how their tax burdens grew as a consequence of the inability of local

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[21]For suggestions of the influence on tax policy of what political scientists call "critical elections" (like 1896), see Susan B. Hansen, The Politics of Taxation: Revenue without Representation (New York: Praeger, 1983). On the estate tax enacted during the Spanish-American war, see Sidney Ratner, American Taxation: Its History as a Social Force in Democracy, 234-250.

and state governments to use general property taxation to reach intangible personal property. And these groups became interested in the adoption of new taxes, such as income, inheritance, and corporate taxes. Small property owners, both rural and urban, assumed that they would not have to pay the new taxes, and that those new taxes would replace state property taxes. In effect, the proponents of the new taxes believed that they would help restore the progressiveness lost in the administrative collapse of the Jacksonian general property tax under industrial conditions. Richard T. Ely, the economist who most vigorously championed reform of state general property taxation, captured the essence of the new reform program. In the 1880s, he wrote that "some way must be contrived to make owners of . . . new kinds of property, <u>who include most of our wealthiest citizens</u> [emphasis mine], pay their due share of taxes." His solution was for states to adopt the income tax, "the fairest tax every devised."[22]

But states were very slow to adopt the new, alternative taxes. No state enacted a modern income tax until 1911, when

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[22]Richard T. Ely, <u>Taxation in American States and Cities</u>, 140 and 288. For discussions of the urban interest groups that developed a taste for tax reform, See David P. Thelen, <u>The New Citizenship: Origins of Progressivism in Wisconsin, 1885-1900</u> (Columbia: University of Missouri Press, 1972), 202-22; Clifton K. Yearley, <u>The Money Machines: The Breakdown and Reform of Governmental and Party Finance in the North, 1860-1920</u>, 193-250; John D. Buenker, <u>Urban Liberalism and Progressive Reform</u> (New York: W.W. Norton, 1973), especially 103-17; and Morton Keller, <u>Regulating a New Economy: Public Policy and Economic Change in America, 1900-1933</u> (Cambridge: Harvard University Press, 1990), 208-15.

Wisconsin did so. The Wisconsin tax pioneers finessed administrative problems by collecting most of the revenues from corporations, which faced a stringently administered 6 percent tax on their profits. Manufacturers accounted for about two-thirds of the corporate burden. But the tax may well have slowed the pace of industrial investment in Wisconsin by increasing the cost of capital to Wisconsin manufacturers significantly above the levels faced by their competitors located elsewhere in the Great Lakes states.

Political leaders in the other Great Lakes states, and industrial states elsewhere regarded the damage of industry in Wisconsin as a cautionary tale. Massachusetts and New York did not adopt income taxes until they faced the fiscal problems imposed by World War I, and until they were confident that they could build the administrative machinery required to assess and collect a tax based primarily on individual incomes rather than corporate profits. Most industrial states did not enact income taxes until the revenue crisis created by the Great Depression.[23]

Nonetheless, the debates prompted by the Wisconsin experience promoted widespread interest in all measures, including adoption of income taxes, that might rebalance the equity of the tax system. In addition, the sluggish progress of

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[23]W. Elliot Brownlee, Progressivism and Economic Growth: The Wisconsin Income Tax, 1911-1929 (Port Washington, N.Y.: Kennikat Press, 1974) and "Income Taxation and Capital Formation in Wisconsin, 1911-1929," Explorations in Economic History, 8 (September, 1970), 77-102.

income taxation at the state level increasingly convinced middle-class citizens that it would be desirable to enact the tax at the federal level.

During the ferment over tax issues at the state and local levels, some defenders of the wealthiest property owners joined the movement for federal income taxation. They concluded that the tax might help take the wind out of the sails of more radical tax measures at the state and local levels. The most influential among these conservatives was a group of urban economists and attorneys who were tax experts. Economists Edwin R. A. Seligman of Columbia University and Charles J. Bullock of Harvard University led them in promoting income taxation, on the one hand, and in moderating the rhetoric used to justify the tax, on the other. As early as 1894 Seligman had argued that the point of the tax was to "round out the existing tax system in the direction of greater justice." Such language helped shift the discourse over taxation from a focus on the salvation of industrial America to an emphasis on a moderate redistribution of the tax burden.[24]

Conservative support for moderate income taxation might be described as expressing a kind of "corporate liberalism," or "progressive capitalism." More generally, this vision, developing in tension with democratic statism, influenced not only the development of income taxation but also the ideas of the so-

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[24]Edwin R. A. Seligman, "The Income Tax," Political Science Quarterly (1894): 610.

called progressive movement. Reformers of this more conservative persuasion wanted to bring a greater degree of order to industrial society and to strengthen national institutions, just as did the democratic statists. But, in contrast with democratic statists, "progressive capitalists" or "corporate liberals" admired the efficiency of the modern corporation. Government regulation, including taxation, was desirable only if it served to protect the investment system.[25]

By 1909, there were enough insurgent Republicans in Congress who supported a graduated income tax to force action. A diverse group of representatives and senators from both parties supported the immediate enactment of such a tax. Congressman Cordell Hull, a first-term Democrat who represented the same Tennessee district as had Benton McMillin, noted changes in the composition of the Supreme Court and found it "inconceivable" that the nation "had a Constitution that would shelter the chief portion of the wealth of the country from the only effective method of reaching it for its fair share of taxes."[26]

A bipartisan group hammered out a proposal, but they had to limit the progressiveness of the tax in order to generate enough support in Congress. Senator Nelson Aldrich, the chair of the

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[25]Exemplary discussions of corporate liberalism are Mary Furner, "Knowing Capitalism: Public Investigation and the Labor Question in the Long Progressive Era," in Supple, The State and Economic Knowledge, 241-86, and Martin J. Sklar, The Corporate Reconstruction of American Capitalism, 1890-1916 (Cambridge, England: Cambridge University Press, 1988).

[26]Cordell Hull, The Memoirs of Cordell Hull, Volume 1 (New York: Macmillan, 1948), 49.

Senate Finance Committee, proved resourceful in both preserving Republican Party union and blunting the thrust toward income taxation. He worked closely with President Taft to persuade the insurgents to accept a modest tax, described as "a special excise tax," of 2 percent on corporate incomes. He also worked to submit the Sixteenth Amendment, legalizing a federal income tax, to the states for ratification. Aldrich and the northeastern Republicans recognized the growing popular support for income taxation but hoped that the measure would fail.

Ratification prevailed in 1913, much to the surprise and consternation of standpat conservatives. The process of ratification succeeded in part because of two sets of political campaigns.[27]

One set consisted of revivals of the single-tax movement. Beginning in 1909, soap magnate Joseph Fels, who had converted to Henry George's faith in the single tax, began to finance campaigns for constitutional reforms permitting classification of property for the purpose of taxation (and thus high rates of taxation on the "site value" of land) and local option in taxation. Although the campaigns won no significant electoral victories except one in Oregon in 1910, they awakened the interest of the urban middle class in using the income tax to redistribute wealth, and further popularized Henry George's ideal of allocating taxes according to the distribution of special

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[27]The standard source on the ratification movement is John D. Buenker, The Income Tax and the Progressive Era (New York: Garland, 1985).

privilege. The campaigns also convinced more wealthy property owners that they needed moderate reform as a defensive measure, and their support was important to the crucial victory of ratification in New York in 1911.[28]

The second set of political campaigns were those of the presidential candidates in the election of 1912. As a consequence of the campaigns of Woodrow Wilson, Theodore Roosevelt, and Eugene Debs, popular enthusiasm for federal attacks on monopoly power reached an all-time high. Many Americans entertained vague ideas that federal income taxation would provide a means either for assaulting monopoly power or recouping some of its ill-gotten gains for the benefit of the republic.

In 1913, bipartisan support for income taxation was broad, and the Democrats controlled Congress. Nonetheless, the income tax measure they enacted was modest. To some extent this was because the leaders of both parties were cautious and wanted to maximize support for income taxation within the Northeast, where they feared the tax would be unpopular, and thus maintain party unity. To a greater extent it was because the nation's political leaders, as well as the general public, were unsure of how much redistribution they wanted the new tax instrument to accomplish. Woodrow Wilson urged caution on Furnifold M. Simmons, chair of the Senate Finance Committee. "Individual judgments will

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[28]On Joseph Fels's campaigns see Arthur P. Dudden, Joseph Fels and the Single-Tax Movement (Philadelphia: Temple University Press, 1971), 199-245, and Arthur N. Young, The Single Tax Movement in the United States (Princeton, N.J.: Princeton University Press, 1916), 163-83.

naturally differ," Wilson wrote, "with regard to the burden it is fair to lay upon incomes which run above the usual levels."[29] Moreover, the supporters of income taxation were themselves uncertain how income ought to be defined or how the income tax would work administratively.

Finally, in 1913 virtually none of the income-tax proponents within the government believed that the income tax would become a major, let alone the dominant, permanent source of revenue within the consumption-based federal tax system. Certainly the advocates of income taxation who were hostile to the protective tariff hoped that the tax would help reduce tariffs. But they doubted that the new revenues would be substantial. And the idea that the tax would enable the federal government to grow significantly was far from the minds of the drafters of the 1913 legislation.

To be sure, Congressman Hull, who was the primary author of the 1913 legislation, wanted to make certain that the federal government would have access to the income tax in wartime; he believed that the federal government could make the tax, as an emergency measure, even more productive than it had been during the Civil War. But for Hull, as well as for the other income-tax enthusiasts, the revenue goals of the tax were far less important than the desire to use the tax to advance economic justice.[30]

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[29]Woodrow Wilson to Furnifold M. Simmons, September 4, 1913, in Arthur S. Link, ed., The Papers of Woodrow Wilson, vol. 28 (Princeton: Princeton University Press, 1978), 254.

[30]Jordan A. Schwartz has cited Cordell Hull's emergency-revenue argument in claiming that "anticipation of war made the income tax a war tax." See Schwartz, The New Dealers: Power Politics in the

Consequently, the Underwood-Simmons Tariff Act of 1913 was less progressive and less ambitious in its revenue goals than the Civil War legislation or even the legislation of 1894. The new tax established the "normal" rate of 1 percent on both individual and corporate incomes, with a high exemption ($3,000 for single taxpayers) that excused virtually all middle-class Americans from the tax. The tax also established a graduated surtax up to 6 percent on personal income. The wealthiest one percent of American families paid marginal rates ranging between one and 7 percent--rates that were substantially lower than those they had faced during the Civil War. The act also exempted dividends up to $20,000 from the personal income tax. Thus, the act attempted a partial integration of corporate and personal taxes, limiting the

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Age of Roosevelt (New York: Alfred A. Knopf, 1993), 14. There is no evidence, however, that Hull expected war in 1910, when he made the cited comment, and there is much evidence that Hull was then primarily interested in a redistribution of tax burden. For Hull's own description of his important role in federal tax reform before World War I, see Cordell Hull, The Memoirs of Cordell Hull, 45-74. Between 1894 and 1913, when champions of income taxation referred to the possible need to levy it in wartime, they were usually buttressing their legal arguments for the constitutionality of the federal tax. See, for example, the dissenting opinion of Justice John Marshall Harlan in Pollock v. Farmers' Loan and Trust Company, 158 U.S. 601, 15 S.Ct. 673, 39 L.Ed. 1108 (1895) and Edwin R. A. Seligman, "The Proposed Sixteenth Amendment to the Constitution," in Seligman, The Income Tax, 627-28. (Seligman first published this part of the essay in 1910). Historians have only rarely claimed that the architects of the Sixteenth Amendment or the 1913 legislation expected the tax to produce major additions to federal revenue. The leading examples are Ben Baack and Edward J. Ray, who claim that the passage of the 1913 income tax "signaled voters that the federal government had the wherewithal to provide something for everybody." See Baack and Ray, "The Political Economy of the Origin and Development of the Federal Income Tax," in Robert Higgs, ed., Emergence of the Modern Political Economy: Research in Economic History, Supplement 4 (Greenwich, Conn.: JAI Press, 1985), 121-38.

double taxation of corporate earnings to the portion of those earnings received as dividends by the richest Americans.

In the first several years of the income tax, only about 2 percent of American households paid taxes. Meanwhile, the tariff and the taxation of tobacco and alcohol remained the most productive sources of revenue. The tariff, in fact, became even more productive because the 1913 reduction of tariff rates by the Wilson administration stimulated trade and increased revenues. If it had not been for World War I mobilization, the major consequence of the passage of the income tax in 1913 might have been the protection of the regime of consumption taxation inherited from the Civil War.

As it turned out, the great wars of the twentieth century made all the difference. Income taxation, especially of the "soak-the-rich" variety, enacted during World War I caused the role of income tax revenues to grow swiftly between 1913 and the 1920s. (See Table 1.) Because the Great Depression shrank the

Table 1
DISTRIBUTION OF REVENUES BY TYPE OF TAX

Date	Income Taxes	Sales Taxes	Property Taxes	Misc	All
1902	0%	37.5%	51.4%	11.1	100%
1913	1.5	29.5	58.7	10.3	100
1927	24.3	16.5	50.0	9.2	100
1932	14.5	18.6	56.2	10.7	100
1936	15.8	32.0	38.7	14.2	100
1940	19.4	32.4	34.9	13.3	100
1950	54.1	25.4	14.4	6.1	100
1960	58.2	21.6	14.5	5.7	100
1970	59.2	20.9	14.6	5.3	100
1980	63.4	19.5	11.9	5.2	100
1983	59.3	20.4	13.4	6.9	100
1990	56.7	21.1	11.6	10.6	100

Source: Department of the Treasury, Office of State and Local Finance, Federal-State-Local Relations (September 1985), 47-49; Department of Commerce, Survey of Current Business, 72 (March 1992), 10.

income tax base, the relative importance of income tax revenues declined during the 1930s. But those revenues soared during World War II and then continued to grow, although at a reduced rate, until the 1980s. The heavy reliance on income taxation that resulted distinguished the tax system of the United States from that of most industrial nations. Even by the late 1980s, the United States relied more heavily on income taxation than the other major industrial nations, except for Canada and Japan, which employed a highly productive corporate income tax. (See

Table 2.) In contrast, the other industrial nations, with the

Table 2
CONTRIBUTIONS OF VARIOUS TAXES TO TOTAL TAX REVENUES, 1987

	Personal Income Tax	Corporate Income Tax	Goods and Services Taxes
United States	36.2%	8.1	16.7
Canada	38.7	8.0	29.8
France	12.7	5.2	29.3
Germany	29.0	5.0	25.4
Japan	24.0	22.9	12.9
Netherlands	19.7	7.7	26.0
Sweden	37.2	4.1	24.1
Switzerland	34.0	6.2	19.1
United Kingdom	26.6	10.6	31.4

Source: OECD Statistics on the Member Countries in Figures, Supplement to the OECD Observer No. 164 (Paris: OECD, June/July 1990).

exception of Japan, made far greater use of sales taxes, particularly national value-added taxes.

IV

Between 1913 and American entry into World War I in 1917, the forces of industrialization pressed the federal government and the states to play a greater role in humanizing the conditions of industrial life. Following the enactment of the 1913 income tax there was a decided increase in the concentration of incomes earned by the best-paid individuals. In fact, during these years, the concentration of income reached its zenith in the United States. Workers, small farmers, and small businessmen enjoyed significant income gains in the expansive economy of 1915 and 1916, but they could observe the far more dramatic gains of the very wealthy.[31] Redistributional energies acquired a special edge and focused increasingly on using the tax system on behalf of redistribution.

In addition, during these years, the organization of financial and managerial capitalism matured through the blossoming of corporations that were multidivisional, hierarchical, and national in scope.[32] Middle and lower-class Americans intensified their interest in curbing monopoly power through taxation and, in particular, through national-level taxation that could effectively reach the income and assets of large corporations. At the same time, the development of modern corporations and of sophisticated financial intermediaries created much of the organizational capability necessary for assessing and collecting direct taxes on the incomes of corporations and wealthy individuals.

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[31]On the increasing concentration of incomes between 1913 and 1916, see Jeffrey G. Williamson and Peter H. Lindert, American Inequality: A Macroeconomic History (New York: Academic Press, 1980), 81-82. Williamson and Lindert identify 1916 as the year of peak income concentration in American history. They attribute the 1913-16 wave not to monopoly power, however, but to sharply rising food prices.

[32]Alfred D. Chandler, Jr., finds that the modern integration of American industry was complete by World War I. "By the second decade of the century," Chandler concludes, "the shakedown period following the merger movement was over." The result was that "modern business enterprises dominated major American industries, and most of these same firms continued to dominate their industries for decades." See Chandler, The Visible Hand (Cambridge: Harvard University Press, 1977), 345.

To maintain social order--even if the war and its stresses had not intervened--the federal government had to play a major, and expanding, role of mediation between a variety of social groups and the new corporations. But, without the intervention of the United States in World War I and the management of that intervention by the leadership of the Democratic Party, the federal government would have been slow to adopt income taxation, and federal taxation would have developed with a much greater reliance on the taxation of consumption.[33]

The war effort made mediation on behalf of social order more difficult for the federal government because it had to acquire the resources for a massively expensive war effort. This meant that, in the mobilization for the war, the administration could not escape addressing the raw distributional issue of how the huge costs of war would be allocated, or "who should pay." The Democratic administration of Woodrow Wilson concluded that the issue created political and social opportunities rather than problems. The result was the creation of a democratic-statist tax regime. That regime, with its highly progressive tax rates and its tax base consisting of the incomes of corporations and wealthy individuals, provided the core of wartime finance.

The tax-reform process began in 1916 when President Wilson and Secretary of the Treasury William G. McAdoo made the single most important financial decision of the war. In arranging

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[33]For an appreciation of the impact of World War I on the nature of the income tax, see Bruce Bartlett, "The Futility of Raising Tax Rates," Policy Analysis 192 (April 8, 1993), 9-10.

wartime financing, they chose to collaborate with a group of insurgent, largely Southern Congressional Democrats who harbored populist hostilities to Northeastern capitalists. Led by Congressman Claude Kitchin of North Carolina, who chaired the House Ways and Means Committee, the insurgent Democrats attacked concentrations of wealth, special privilege, and public corruption. Kitchin exploited the influence of the Ways and Means Committee. The Democratic insurgents were able to insist that if military preparedness, and later the war effort, were to move forward, they would do so only on the financial terms of the insurgents. They embraced taxation as an important means to achieve social justice according to the humanistic ideals of the early republic. Highly progressive taxation then became a major element of the Wilson administration's program for steering between socialism and unmediated capitalism.[34]

The war provided an opportunity for Democratic progressives

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[34]Some political-science scholarship has stressed the crippling effect of post-Civil War Southern sectionalism, and the associated hostility toward the federal government, on the development of a modern state. But this scholarship does not discuss progressive federal income taxation, which this sectionalism (expressed in the careers of Claude Kitchin and Cordell Hull) promoted. See Richard Bensel, Sectionalism and American Political Development, 1880-1980 (Wisconsin: University of Wisconsin Press, 1984); Bensel, Yankee Leviathan; and Jill Quadrango, The Transformation of Old Age Security: Class and Politics in the American Welfare State (Chicago: The University of Chicago Press, 1988). Historians are well aware of the general significance of the many Southerners who were in the Wilson administration or among his supporters in Congress, but no one has systematically examined their ideas on government. The best analyses are Arthur S. Link, "The South and the 'New Freedom': An Interpretation," The American Scholar XX (1950-1951): 314-24; and George B. Tindall, The Emergence of the New South, 1913-1945 (Baton Rouge: Louisiana State University Press, 1967), 1-60.

to focus the debate over taxation on one of the most fundamental and sensitive social issues in modern America: What stake does society have in corporate profits? More specifically, the question became one of whether the modern corporation was the central engine of productivity, which tax policy should reinforce, or whether it was an economic predator, which tax policy could and should tame. The outcome of the debate was that the nation embraced a new tax system: "soak-the-rich" income taxation.[35]

Thus, during the period of crisis, one in which the pressure of fighting a modern war coincided with powerful demands to break the hold of corporate privilege, Wilson and the Democratic Party turned Republican fiscal policy on its head. They embraced a tax policy that they claimed--just as the Republicans had claimed for their tariff system--would sustain a powerful state and economic prosperity. But the new tax policy of the Democrats was one that assaulted, rather than protected, the privileges associated with corporate wealth.[36]

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[35]By World War I, the description of highly progressive taxation as "soak-the-rich" taxation was common in both America and England. The term had emerged in United States in the late 1890s, accompanied by the introduction of a new meaning of soak: "to impose upon by an extortionate charge or price." J.A. Simpson and E.S.C. Weiner, The Oxford English Dictionary (Oxford: Clarendon, 1989), 892-893. See, also, Eric Partridge, A Dictionary of Slang and Unconventional English, Paul Beale, ed. (London: Routledge and Kegan Paul, 1984), 1108 and Harold Wentworth and Stuart Berg Flexner, Dictionary of American Slang (New York: Crowell, 1967), 498-499.

[36]A contrasting view of the importance of redistributional impulses is John Witte's. In explaining the crucial Revenue Act of 1916, he stresses the "dictates of war" and asserts that "there is

The Democratic tax program, implemented in the Revenue Act of 1916 and the wartime revenue acts that followed, transformed the experimental, rather tentative income tax into the foremost instrument of federal taxation. The Revenue Act of 1916 imposed the first significant tax on personal incomes, doubled (to 2 percent) the tax on corporate incomes, and introduced an excess profits tax of 12.5 percent on munitions makers. It rejected a broadly based personal income tax--one falling most heavily on wages and salaries--and focused on the taxation of the wealthiest families. Among the provisions of the 1916 legislation was the elimination of the personal exemption for dividends. Thus, the act deliberately introduced the double taxation of corporate earnings distributed as dividends. In effect, the 1916 legislation embraced the concept of using the corporate and personal income taxes as two different means of taxing the rich. The architects of the Revenue Act of 1916 intended to implement on the one hand, through the personal income tax, an "ability to pay" philosophy and, on the other hand, through corporate taxation, a "benefit" theory of taxation. The Democratic tax program of 1916 also introduced federal estate taxation. Estates larger than $50,000 paid a progressive tax that increased from a minimum of one percent to a maximum of 10 percent (on estates

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little evidence of an independent interest in redistributing income through the tax system." See John Witte, The Politics and Development of the Federal Income Tax (Madison: The University of Wisconsin Press, 1985), 81-2.

over $5 million).[37]

In 1918, only about 15 percent of American families had to pay personal income taxes, and the tax payments of the wealthiest one percent of American families accounted for about 80 percent of the revenues from the personal income tax. In 1918, even without taking into account the incidence of the corporate income tax on the rich, this wealthiest one percent paid marginal tax rates that ranged from 15 to 77 percent, and effective rates that averaged 15 percent, having increased from 3 percent in 1916.[38] (See Table 3.) Similarly, the richest Americans accounted for almost all of the estate taxes paid. Wartime legislation raised the maximum estate tax rates to 25 percent (on estates larger than $10 million) but did not lower the exemption or increase the minimum tax rate. Consequently, only slightly more than one

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[37]W. Elliot Brownlee, "Wilson and Financing the Modern State: The Revenue Act of 1916," Proceedings of the American Philosophical Society 129 (1985): 173-210. On the sympathy of leading figures in the Wilson administration for benefit approaches to taxation, see W. Elliot Brownlee, "Social Investigation and Political Learning in the Financing of World War I," in Michael J. Lacey and Mary O. Furner, eds. The State and Social Investigation in Britain and the United States (Cambridge, Eng.: Cambridge University and the Woodrow Wilson Center, 1993), 335-337.

[38]Because they ignore the incidence of corporate income taxation on the rich, these estimates seriously understate the effective rates. Richard Kasten et al. estimated that in 1980, for example, the corporate income tax might have increased the effective rate of all federal taxes on the top one percent of households from 28.7 percent (assuming that all of the corporate tax fell on labor income) to 34.9 percent (assuming that all of the corporate tax fell on capital income). See, Richard Kasten, Frank Sammartino, and Eric Toder, "Trends in Federal Tax Progressivity, 1980-1993," in Slemrod, ed., Tax Progressivity and Income Inequality, 21.

percent of decedents paid any estate taxes.[39]

Table 3
PERSONAL INCOME TAX RATES ON RICHEST ONE PERCENT OF HOUSEHOLDS, 1916-1929[40]

YEAR	MARGINAL RATES	EFFECTIVE RATES[41]
1916	2 to 12%	3.0%
1917	5 to 67	9.2
1918	13 to 77	15.0
1919	9 to 73	13.1
1920	11 to 73	15.8
1921	9 to 73	9.9
1922	9 to 58	9.8
1923	9 to 58	7.8
1924	10 to 46	9.3
1925	10 to 25	7.5
1926	6 to 25	7.4
1927	6 to 25	7.8
1928	6 to 25	8.9
1929	5 to 25	8.1

Finally, the Democratic program of finance embraced the concept of taxing corporate "excess profits." The Revenue Act of

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[39]For the percentages of decedents who were over 25 years of age and whose estates paid estate taxes, 1922-1977, see Carole Shammas _et al._, _Inheritance in America: From Colonial Times to the Present_ (New Brunswick: Rutgers University, 1987), 128-129.

[40]Bureau of Internal Revenue, U.S. Department of the Treasury, _Statistics of Income_ (Washington, D.C.: U.S. G.P.O; Bureau of the Census, U.S. Department of Commerce, _Historical Statistics of the United States: Colonial Times to 1970_, 41-43. The richest one percent of households in a given year is taken as the aggregation of the highest-income taxpayers equalling one percent of the households in the nation.

[41]Effective rates are the average percentages of taxable income paid in income taxes by the richest one percent of households.

1917 increased the tax on corporate incomes to 6 percent and expanded the excess-profits tax on munitions makers to a graduated tax on all business profits above a "normal" rate of return. The rates of taxation were graduated progressively by rates of return on invested capital. In 1917, the tax rates ranged from 20 percent on profits over the "normal" rate of return to 60 percent on profits earned by more than a 33 percent rate of return. The Revenue Act of 1918 doubled the basic corporate income tax, to 12 percent and further increased excess-profits taxation. The act reduced the number of tax rates from six to two but increased the lowest rate to 30 percent and the top rate to 65 percent (on profits earned by more than a 20 percent rate of return). The excess-profits tax accounted for about two-thirds of all federal tax revenues during World War I and added to the tax burden that the personal income tax imposed on the rich. Only the United States and Canada among the belligerents taxed excess-profits in this way, and only the United States placed excess-profits taxation at the center of wartime finance. The designers of the new corporate taxes assumed that corporations would not be able to pass them on to others. Because progressives assumed that corporations were already maximizing profits, having pushed prices as high as possible and kept wages as low as possible, they concluded that corporations would have to pay their taxes out of those profits.[42]

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[42]Excess-profits taxation turned out to be responsible for most of the tax revenues raised by the federal government during the war. Taxes accounted for a larger share of total revenues in the

The new public finance regime included vast expansion of the administrative state. The complex and ambitious program of taxing and borrowing required a vast expansion of the Treasury's administrative capacity. A major arm of the Treasury was the Bureau of Internal Revenue (BIR), the forerunner to the Internal Revenue Service, whose personnel increased from 4,000 to 15,800 between 1913 and 1920 and which underwent a reorganization along multifunctional lines, with clear specifications of responsibilities and chains of command. One of the most demanding chores of the bureau was the administration of the excess-profits tax. In the process of interpreting, selling, explaining, and assessing the new business tax, the Treasury created a modern staff of experts--accountants, lawyers, and economists. Much of this bureaucracy also implemented the new individual income tax by processing the huge volume of information on individual taxpayers. This flow of information resulted from an "information at the source" provision in the Revenue Act of 1916, which required corporations to report on salaries, dividends, and interest payments. In short, the Treasury built a class of

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United States than in any of the other belligerent nations, despite the fact that by the end of 1918 the daily average of war expenditures in the United States was almost double that in Great Britain and far greater than that in any other combatant nation. The most careful accounting of American war costs remains Edwin R. A. Seligman, Essays in Taxation (New York: Macmillan, 1921), 748-82. The assumptions of progressives about the shifting and incidence of taxes on corporate profits are remarkably similar to those made fifty years later by neo-classical analysts. For an influential example of the latter, see Dale W. Jorgenson, "Anticipations and Investment Behavior," in James S. Duesenberry, ed., The Brookings Quarterly Econometric Model of the United States (Chicago: Rand McNally, 1965), 35-94.

mediators--defining themselves as experts--whose task was to reconcile the goals of the corporation and affluent individuals with the needs of the state. But under Secretary of the Treasury McAdoo's leadership, the Treasury undertook far more than a "broker-state" balancing of contesting interest groups; it enhanced the power of the state to advance economic justice and the war.

The income tax with excess-profits taxation at its core enraged business leaders--for good reason. Redistributional taxation, along with the wartime strengthening of the Treasury, posed a long-term strategic threat to the nation's corporations. Those most severely threatened were the largest corporations, which believed their financial autonomy to be in jeopardy. In addition, the new tax system empowered the federal government, as never before, to implement egalitarian ideals. No other single issue aroused as much hostility to the Wilson administration among corporate leaders and America's richest families as did the financing of the war. Even Wilson's long-time supporters within the business community, among them Bernard Baruch, Jacob Schiff, and Clarence Dodge, bitterly attacked his tax program within the administration and often quietly supported Republican critics. The conflict between advocates of democratic-statist, soak-the-rich taxation on the one hand and business leaders on the other hand would rage for more than two decades.

Despite the damage to business confidence, the Wilson administration and congressional Democratic leaders paid almost no attention to the complaints of Baruch and other business critics. The Democratic leaders did so in part because they shared Kitchin's ideal of using taxation to restructure the economy according to nineteenth-century liberal ideals. They presumed that the largest corporations exercised inordinate control over wealth and that a "money trust" dominated the allocation of capital. For Wilson and McAdoo, the tax program, with its promise to tax monopoly power and break monopoly's hold on America's entrepreneurial energy, seemed to constitute an attractive new dimension to Wilson's "New Freedom" approach to the "emancipation of business." Thus, wartime public finance was based on the taxation of assets that democratic statists regarded as ill-gotten and socially hurtful, comparable to the rents from land monopolies that Henry George and his followers had wanted to tax. In fact, both Wilson and McAdoo entertained explicit single-tax ideas as they developed their tax-reform program.[43]

Party government also played a crucial role in the decision of the Wilson administration to go after the rich and the corporations. Wilson and McAdoo knew they could have easily

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[43]Wilson, however, had far greater suspicion of the administrative state than did McAdoo. In 1916, because of that suspicion, Wilson may well have been attracted to using taxation, rather than administrative regulation, to tackle "the monopoly problem." As the war wore on, and as he was unable to resist the growing influence of business within the wartime bureaucracy, Wilson became even more attracted to the anti-monopoly potential of excess-profits taxation. But no scholar has fully explored the linkages between Wilson's approach to the taxation of business and his overall relations with business. The best study of Wilson and business during the war is Robert D. Cuff, The War Industries Board: Business-Government Relations during World War I (Baltimore: The Johns Hopkins University Press, 1973).

engineered passage of a much less progressive tax system--one relying more heavily on consumption taxes and taxation of middle-class incomes--in cooperation with Republicans and a minority of conservative Democrats. They were confident in their ability to administer such broad-based taxes effectively. But they regarded mass-based taxation as a betrayal of the principles of their party. After all, the Democratic Party had strong traditions of representing the disadvantaged, of hostility to a strong central government as the instrument of special privilege, of opposition to the taxation of consumption, and of support for policies designed to widen access to economic opportunity. A failure to adopt a highly progressive and "reconstructive" tax program would have had serious political consequences for Wilson and McAdoo. They would have bitterly divided their party. They would have spoiled their opportunities for attracting Republican progressives to their party. And they would have destroyed their strong partnership with congressional Democrats--a partnership that both leaders regarded as necessary for the effective advancement of national administration.[44]

As the war neared its end, corporate leaders and Republicans mounted an effective counterattack against democratic statism. They found an opening in 1918 when President Wilson tried to make a case for doubling taxes. In the congressional elections, the

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[44]For a discussion of the sustained hostility toward special privilege within the Democratic Party, see Robert E. Kelley, The Transatlantic Persuasion:The Liberal-Democratic Mind in the Age of Gladstone (New York: Alfred A. Knopf, 1969).

Republicans used vigorous antitax, antigovernment campaigns throughout the nation, and anti-Southern campaigns in the West. There they argued that Claude Kitchin and the Southerners in the Wilson administration had imposed discriminatory taxation on the rest of the nation. The appeals worked; Republicans gained control of Congress. Then, in 1920, they rode to a presidential victory during the postwar economic depression. At the conclusion of the war, the Democratic Party of Woodrow Wilson had failed to do what the Republican Party of Abraham Lincoln had done--establish long-term control of the federal government through a party realignment.

V

The Republicans who assumed control of both the presidency and the Congress in 1921 saw tax reform as a means to roll back democratic statism. Under the leadership of Secretary of the Treasury Andrew Mellon, one of the wealthiest men in America, the Republicans blocked new soak-the-rich legislation and attacked the most redistributional parts of the wartime tax system.[45]

In the process, the Republicans granted substantial tax reductions to corporations and the rich--the nation's wealthiest

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[45]In 1924, Andrew Mellon paid more income tax ($1.9 million) than all but three other Americans. (Those three were John D. Rockefeller, Jr., Henry Ford, and Edsel Ford.) Mellon was a relative newcomer to the ranks of the nation's super-rich. Only a decade earlier, he (and the Fords, as well) had not been counted among the nation's wealthiest 50 citizens. Stanley Lebergott, The American Economy: Income, Wealth and Want (Princeton: Princeton University 1976), 169-171. For a discussion of the largest income tax payers in 1923 and 1924, as made public by a provision in the Revenue Act of 1923, see Albert W. Atwood, The Mind of the Millionaire (New York; Harper & Brothers, 1926), 253-256.

individuals. In 1921 they abolished the excess-profits tax, dashing Claude Kitchin's hopes that the tax would become permanent. In addition, they made the nominal rate structure of the personal income tax less progressive. The primary goal was to make that tax be less burdensome on the rich. In 1921, the Republicans cut the top marginal rate on the rich by one-third, reducing it from 73 to 58 percent. They reduced it further in 1926 and 1928 so that in 1928 the top marginal rate fell to 25 percent. (See Table 3.) Finally, Republicans attacked the estate tax. They were unable to eradicate it, as Andrew Mellon had hoped to do, but 1926 they did succeed in reducing the top rate from 25 to 20 percent and increasing the exemption from $50,000 to $100,000. As a consequence, by 1928 the percentage of decedents paying federal estate taxes had shrunk by half, to about half of one percent.[46]

At the same time, the Republicans busied themselves opening new loopholes. Beginning in 1921, in response to intense lobbying, they installed a wide range of special tax exemptions and deductions, which the highly progressive rate structure of the income tax made valuable to wealthy taxpayers. The Revenue Act of 1921 introduced the preferential taxation of capital gains at a rate of 12.5% for assets held longer than two years. (This rate held until 1934.) That act also introduced a variety of deductions, such as oil- and gas-depletion allowances, that

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[46]Carole Shammas et al., Inheritance in America: From Colonial Times to the Present, 128.

favored particular industries. The effect of these provisions on the taxation of the rich was to cut their effective rates nearly in half. By 1923, the effective rate on the richest one percent of American families had fallen to less than 8 percent, and it remained at this general level through the rest of the decade. It would have fallen even further if the economic growth of the 1920s had not pushed the less-rich households within the top 1 percent into higher tax-brackets. (See Table 3.)

Andrew Mellon hoped that the program of slashing taxes would not only benefit the rich but encourage them to invest at higher rates and thereby enhance productivity and growth.[47] In fact, on one occasion, Mellon's interest in promoting growth led him to try to close off a loophole in the tax code. The loophole was the complete or partial exemption from personal income taxation of interest payments from the government bonds issued during four wartime Liberty Loans and the postwar Victory Loan. Mellon proposed a constitutional amendment removing the tax-deductibility of all government securities. He was concerned that the deductibility encouraged wealthy taxpayers to invest in tax-exempt government bonds, thereby drawing capital away from investments that would be more stimulative of economic growth. Congress, however, received great pressure from the beneficiaries of this loophole, and did not follow Mellon's recommendation.[48]

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[48] For the significance of the progrowth arguments of Andrew Mellon, see Ronald Frederick King, "From Redistributive to Hegemonic Logic: The Transformation of American Tax Politics, 1894-

Along with the regime of highly progressive taxes created by World War I came enhanced power for the tax-writing committees of Congress. During the 1920s, legislators on these committees discovered how much influence they wielded through the incremental, relatively invisible consideration of valuable loopholes. Although they did not use the term, the legislators had discovered the political appeal of "tax expenditures." They could establish what amounted to new expenditure programs by creating pockets of privilege within the tax code. In turn, they won or maintained the support of powerful, wealthy groups or individuals while avoiding the political costs associated with raising taxes. Just like the system of protective tariffs before it, the federal income tax had become an instrument to advance special privilege.

To exert and reinforce their new power, the committees won approval in the Revenue Act of 1926 for creating the Joint Committee on Internal Revenue Taxation (JCIRT), which would become the Joint Committee on Taxation (JCT) in 1976. Congress originally charged the JCIRT with investigating avenues to simplify the law and with improving its administration, and the

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1963," Politics and Society 12 (No. 1, 1983): 1-52, and Money, Time & Politics: Investment Tax Subsidies in American Democracy (New Haven: Yale University Press, 1993), 104-11. King argues that Mellon invoked a "hegemonic tax logic" that was finally victorious in the Kennedy-Johnson tax cuts of 1964. No one has ever demonstrated that the Mellon tax cuts stimulated economic growth, but two economists have argued persuasively that the post-war lowering of the marginal rates at the top reduced tax avoidance through the purchase of tax-exempt securities. See Gene Smiley and Richard H. Keehn, "Federal Personal Income Policy in the 1920s," The Journal of Economic History 55 (June 1995): 285-303.

professional staff of the JCIRT did increase the technical capabilities of the tax-writing committees. But the JCIRT immediately became primarily a vehicle for enhancing the influence of the senior members of the tax-writing committees.[49]

The Republicans were tempted to go even further in their tax reforms. But Secretary Mellon moderated the reactionary assault by leading a struggle within the Republican Party to protect income taxation from those who wanted to replace it with a national sales tax. Mellon helped persuade corporations and the wealthiest individuals to accept some progressive taxation and the principle of "ability to pay." This approach would, Mellon told them, demonstrate their civic responsibility and defuse radical attacks on capital by recognizing the popular support that soak-the-rich taxation had gathered. Thus, while shrinking the state, Republican leaders took care to preserve progressive estate and personal income taxes. Also, Republican leaders supported retaining the basic corporation income tax; they held it at the World War I rate of about 12 percent. Mellon went so far as to advocate providing a greater reduction in taxes on "earned" than on "unearned" income, and the Revenue Act of 1924 included such a provision. "The fairness of taxing more lightly incomes from wages, salaries, or from investments is beyond

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[49]On the formation of the JCIRT see Roy G. Blakey and Gladys C. Blakey, The Federal Income Tax, 542-43 and 546-48. See also Donald R. Kennon and Rebecca M. Rogers, The Committee on Ways and Means: A Bicentennial History, 1789-1989 (Washington, D.C.: Government Printing Office, 1989), 330-3 and Thomas J. Reese, The Politics of Taxation (Westport, Connecticut: Quorum Books, 1980), 61-88.

question," Mellon asserted. He explained, "In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it; in the other, the source of income continues; the income may be disposed of during a man's life and it descends to his heirs." Thus, Mellon helped to preserve a revenue system that, even it its weakened form, advanced social justice.[50]

Mellon's strategy was what might be described as the pursuit of enlightened self-interest--as corporate liberalism, in contrast with Woodrow Wilson's democratic statism. Mellon received crucial support for his approach from the tax-writing committees of Congress. They wanted to preserve the political influence they found they could exert under a progressive system of income taxation.

At the same time, Mellon attempted to strengthen the Treasury by transforming it into a "nonpartisan" agency. In his book of 1924, <u>Taxation: The People's Business</u> (written largely by his expert assistant secretaries), he explained, "tax revision should never be made the football either of partisan or class politics but should be worked out by those who have made a careful study of the subject in its larger aspects and are prepared to recommend the course which, in the end, will prove for the country's best interest."[51]

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[50]Andrew W. Mellon, <u>Taxation: The People's Business</u> (New York: Macmillan, 1924), 56-7.

[51]Andrew W. Mellon, <u>Taxation: The People's Business</u>, 10-11.

Mellon was interested in more than scientific policymaking. His main goal was to insulate the Treasury from pressure from Democratic Congresses. He wanted to ensure that the Treasury operated within the confines of conservative assumptions about the state and corporate power, and within a political framework that advanced the Republican Party. Consequently, when Mellon approached tax cutting during the postwar reconversion and downsizing of government, he rejected the advice of Yale economist Thomas S. Adams, who was the primary tax adviser in the Mellon Treasury.

If the federal government was to dismantle its wartime system of taxation, Adams believed, it should take the opportunity to replace the system with an economically efficient income tax or a progressive spendings tax, one that would tax "unnecessary or surplus consumption." Adams began to despair of income taxation, concluding that it contained "incurable inequalities and inconsistencies" and had "reached a condition of inequality the gravity of which could scarcely be exaggerated." He advocated eliminating the excess-profits tax and reducing the rate of progression, but he urged avoiding the kind of special deductions introduced by Mellon. In addition, Adams favored the integration of corporate and individual income taxation. Rather than follow Adams's lead, Mellon chose to recommend tax cutting that created privileged groups and industries while providing protection to Republican administrations and Congresses against the charge that they favored the abolition of progressive taxation.[52]

The Republican administrations and Congresses of the 1920s had shifted ground within the World War I tax regime. Soak-the-rich remained, but only at reduced rates containing major loopholes and with its sharp anticorporate edge dulled. As a consequence of the path-dependent nature of the development of the tax regime initiated by American involvement in World War I, the income tax conveyed very mixed messages about the nature of wealth and civic responsibility in America. Without the wartime crisis, the growth of the federal government almost certainly would have been slower and dependent upon some combination of tariff revenues, sales taxes, and low-rate taxation of personal and corporate incomes or spending. That system might have been just as riddled with inconsistencies, departures from horizontal equity, and theoretical confusion as was the highly progressive tax system that emerged during and after the World War I crisis. But, in contrast with the system that probably would have emerged from a more incremental process, the system for financing World War I involved a substantial raising of the stakes of conflict over tax policy. Along with highly progressive taxation came opportunities both for undertaking massive assaults on wealth and corporate power and for carving out lucrative enclaves of special privilege within the tax code. These high stakes helped keep

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[52]For a discussion of Adams's analysis, see Brownlee, "Economists and the Formation of the Modern Tax System in the United States: The World War I Crisis," in Mary O. Furner and Barry E. Supple, eds., The State and Economic Knowledge: The American and British Experience, 430-31.

taxation at the center stage of politics through the Great Depression and World War II.

VI

The New Deal of Franklin D. Roosevelt introduced a new tax regime that once again focused attention on the rich. Roosevelt personally favored soak-the-rich taxation and recognized the large constituency that the Depression had created for the sort of tax reform--redistributional and anticorporate--undertaken by the Wilson administration. But Roosevelt moved slowly against the rich.

One reason for his delay was the repeal of Prohibition, which produced significant increases in federal revenue. Another reason was the Revenue Act of 1932, signed into law by President Herbert Hoover. That act had already produced a sharp increase in the rates of personal income taxation. In fact, the act represented a resumption of soak-the-rich taxation. It raised the top marginal rate from 25 percent to 63 percent and thus nearly restored it to World War I levels. In addition, the act of 1932 dramatically increased estate taxes by cutting the exemption in half (down to $50,000) and more than doubling the maximum rate (to 45 percent). In 1934, as a consequence of the 1932 act, some economic recovery in 1933-34, and loop-hole closing in the Revenue Act of 1934, the effective income tax rate on the rich rose to about 11 percent, which was higher than at any time during the years of Republican "normalcy." (See Table 4.)[53]

Table 4
PERSONAL INCOME TAX RATES ON RICHEST ONE PERCENT OF HOUSEHOLDS, 1930-1940[54]

YEAR	MARGINAL RATES	EFFECTIVE RATES
1930	6 to 25%	6.6%
1931	3 to 25	3.4
1932	8 to 63	6.8
1933	8 to 63	8.1
1934	5 to 63	10.7
1935	9 to 63	11.3
1936	10 to 79	16.4
1937	10 to 79	15.7
1938	10 to 79	14.8
1939	10 to 79	15.1
1940	14 to 79	21.6

Another reason Roosevelt moved slowly was his fear, which a

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[53]Among the Congressional efforts at loop-hole closing was a request that the Treasury establish systematic procedures for corporations to calculate their depreciation deductions. The Treasury responded by requiring straight-line depreciation for income-producing property. See William T. Hogan, Depreciation Policies and Resultant Problems (New York: Fordham University, 1967), 7-8. See, also, n. 70, below. The 1934 act retained the preferential taxation of capital gains, but increased the tax rate and made it progressive. For example, the act taxed gains from assets held between 2 and 5 years at 60 percent of the personal tax rates, or at marginal rates that ranged between 3 percent and 36 percent, rather than the previous flat rate of 12.5 percent. See Roy G. Blakey and Gladys C. Blakey, The Federal Income Tax, 586-588. This approach to taxing capital gains remained in place through World War II, although the Revenue Act of 1938 cut the percentage of long-term capital gains subject to personal income taxation from 60 to 50. See Bureau of Internal Revenue, Statistics of Income for 1946, Part I (Washington, D.C.: G.P.O.), 50-56 and 420-423.

[54]See Table 1 for the source of the data.

Democratic Congress shared, that a democratic-statist tax policy, if accompanied by a failure of economic recovery, would arouse business opposition and pave the way for a conservative counterattack on the New Deal. The Democrats remembered well how the economic troubles of 1918-20 had fuelled the Republican backlash against Wilson. Also important in slowing the pace of tax reform was the institutional legacy of twelve years of Republican leadership at the Department of Treasury. The Treasury staff that Roosevelt inherited was unenthusiastic about undertaking the work of devising new progressive taxes. Roosevelt's long-term secretary of the Treasury, Henry Morgenthau, Jr., did not assume office until January 1934, and his immediate deputies needed about six months to rebuild a capability within the department for advancing democratic-statist reform.

In 1935 Roosevelt decided that political and economic conditions favored a resumption of a democratic-statist tax policy. Most important, the growing "Thunder on the Left," particularly Huey Long's "Share Our Wealth" movement, opened the way for vigorous redistributional taxation designed to remedy flaws in the nation's economic structure.[55]

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[55]Roosevelt was as interested in the substance as in the symbols of "soak-the-rich" tax reform. But, for a very different view of Roosevelt's tax program than the one presented here, see the work of historian Mark Leff, who argues that Franklin D. Roosevelt looked only for symbolic victories in tax reform. Mark H. Leff, The Limits of Symbolic Reform: The New Deal and Taxation. For a critique of Leff, see W. Elliot Brownlee, "Taxation as an X-ray," Reviews in American History 14 (March, 1986): 121-6. The following account of the making of tax policy within the Roosevelt

Morgenthau's staff now contained a group of law professors, including General Counsel Herman Oliphant and Roswell Magill. Magill, a tax expert from Columbia University, directed a comprehensive survey of the federal tax system in preparation for a reform initiative. The monetary economist Jacob Viner also advised Morgenthau on tax issues, and Carl S. Shoup, Roy Blough, and Lawrence H. Seltzer--all economists who specialized in public finance--worked closely with Magill. Central to their efforts was an intensified effort to study the distributional effects of taxation at all levels of government.[56]

At the end of the summer of 1934, Magill and his colleagues

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administration through World War II draws on John Morton Blum, From the Morgenthau Diaries: Years of Crisis, 1928-1938 (Boston: Houghton Mifflin, 1959), 297-337, 439-51; From the Morgenthau Diaries: Years of Urgency, 1938-1941 (Boston: Houghton Mifflin, 1965), 22-30, 278-318; and From the Morgenthau Diaries: Years of War, 1941-1945 (Boston, Houghton Mifflin, 1967), 33-78. Blum's work still stands as the best general treatment of this subject. Also valuable is Roy G. Blakey and Gladys C. Blakey, The Federal Income Tax, 301-577, and Randolph Paul, Taxation in the United States (Boston: Little, Brown, 1954), 168-406. See as well Walter K. Lambert, "New Deal Revenue Acts: The Politics of Taxation" (PhD dissertation, University of Texas, Austin, 1970), for excellent details on the relationship between the Roosevelt administration and Congress. Lambert found no evidence that Roosevelt favored a radical distribution of tax burdens, but he did find a deep ethical commitment to the principle of "ability to pay."

[56]The most important study of tax incidence undertaken during the 1930s was the unpublished analysis of economist Louis Shere. See "The Burden of Taxation," unpublished memorandum, U.S. Department of the Treasury, Division of Research and Taxation, 1934. For an excellent survey of the modern measurement of tax burden in the United States, see B. K. Atrostic and James R. Nunns, "Measuring Tax Burden: A Historical Perspective," in Ernest R. Berndt and Jack E. Triplett, eds., Fifty Years of Economic Measurement: The Jubilee of the Conference on Research in Income and Wealth, National Bureau of Economic Research Studies in Income and Wealth, Volume 54 (Chicago: The University of Chicago Press, 1990), 343-408.

in the Treasury had presented Morgenthau with recommendations designed to raise new revenues and attack concentrations of wealth; in December, Morgenthau had forwarded the proposals to the White House. In developing a tax proposal for Congress, Roosevelt drew assistance from his close adviser Felix Frankfurter, who had been urging the president to use the taxing power to attack bigness in business. Roosevelt and Frankfurter used the Treasury recommendations to craft an ambitious program of radical tax reform, which Roosevelt presented to Congress in June. He told Secretary of the Interior Harold Ickes that the speech was "the best thing he had done as President."[57]

Roosevelt proposed a graduated tax on corporations to check the growth of monopoly, a tax on the dividends that holding companies received from corporations they controlled, surtaxes to raise the maximum income-tax rate on individuals from 63 to 79 percent, and an inheritance tax, to be imposed in addition to federal estate taxation. In his message to Congress, he explained that accumulations of wealth meant "great and undesirable concentration of control in relatively few individuals over the employment and welfare of many, many others." Moreover, "whether it be wealth achieved through the cooperation of the entire

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[57]On the significance of Frankfurter's interest in this tax legislation, see Ellis Hawley, The New Deal and the Problem of Monopoly: Study in Economic Ambivalence (Princeton: Princeton University Press, 1966), 344-59. Hawley, however, concludes that the Revenue Acts of 1935 and 1936 were "relatively innocuous" (359). Harold Ickes's discussion of the 1935 tax measure is in the June 19, 1935 entry in his diaries, the Harold L. Ickes Papers, Library of Congress.

community or riches gained by speculation--in either case the ownership of such wealth or riches represents a great public interest and a great ability to pay." But Roosevelt's goal was not a simplistic redistribution of wealth and power. Later that year, he explained to a newspaper publisher that his purpose was "not to destroy wealth, but to create a broader range of opportunity, to restrain the growth of unwholesome and sterile accumulations and to lay the burdens of Government where they can best be carried." Thus, he justified his tax-reform program in terms of both its inherent equity and its ability to liberate the energies of individuals and small corporations, thereby advancing recovery.[58]

During his 1935 initiatives, and throughout the peacetime New Deal, Roosevelt was able to count on the support of Doughton, who served as chair of the House Ways and Means Committee from 1933 until 1947. (Counting a second term, from 1949 to 1953, he was the longest serving chair of the committee in its history.) Doughton's support was often decisive in Congress, where Senator Pat Harrison of Mississippi, chair of the Senate Finance Committee, and other conservative southern Democrats often opposed New Deal tax reform. Doughton at times had his doubts about the more sophisticated New Deal tax proposals and resisted large tax increases of any kind. He complained privately in 1935, "we have had too many theories in key places under this

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[58]For the Roosevelt quotations, see Arthur M. Schlesinger, Jr., The Age of Roosevelt: The Politics of Upheaval (Boston: Houghton Mifflin, 1960), 328, and Lambert, 259-60.

administration." But he believed in the justice of shifting the distribution of taxes away from the "poor, weak, and humble," who--he was certain--paid a higher percentage of their incomes in taxes than did the wealthy. And, ever since he had begun his service in Congress in 1911, he had put party loyalty and the need to establish a record of Democratic leadership first.[59]

Led by Doughton, Congress gave Roosevelt much of the tax reform he wanted. The Revenue Act of 1935, joined with economic recovery, pushed households into higher tax-brackets and raised effective rates on the rich by nearly fifty percent. In 1936, the effective rate paid by the rich increased to 16.4 percent, higher than during any year of World War I, and, in fact, the highest level it had ever reached. It remained roughly at that level until 1940, when economic recovery pushed enough taxpayers into higher marginal rates to increase the effective rate even further, to more than 20 percent. (See Table 4.) The Revenue Act of 1935 also pushed up the maximum rate of estate taxation to 70 percent. By 1938 this change, along with the 1932 amendments to the estate tax, returned the share of decedents paying federal estate taxes to the level (1.2 percent) that had been reached in 1925, and raised the average tax per estate (in constant dollars)

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[59]For suggestions as to the significance to the early New Deal of Doughton in particular and southern Congressmen in general, see George B. Tindall, The Emergence of the New South, 607-13. Pat Harrison was less energetic and effective than Doughton, but he was able to kill Roosevelt's proposal for the taxation of inheritances in 1935. The Doughton quotations are from Lambert, "New Deal Revenue Acts," 297 and 226.

to more than triple the level of 1925.[60]

Roosevelt believed that the Revenue Act of 1935 would generate enough revenue so that he would not have to request any further tax increases until after the presidential election of 1936. But in early 1936, the Supreme Court invalidated the processing tax of the Agricultural Adjustment Act, and Congress overrode Roosevelt's veto of a bonus bill for World War I veterans. Both events threatened a substantial increase in the federal deficit.

In response, Morgenthau recommended an undistributed profits tax, a measure that Roosevelt had previously ignored as a major revenue-raiser. Morgenthau's proposal was to eliminate the tax on corporate income along with the minor taxes on capital stock and corporate excess-profits and replace them all with a tax on retained earnings--the profits that corporations did not distribute to their stockholders.[61] The new tax would be graduated according to the proportion of the profits that were

[60]Carole Shammas _et al._, _Inheritance in America: From Colonial Times to the Present_, 128.

[61]In 1933, to help finance public works, the National Industrial Recovery Act had included, as a modest experimental measure, a temporary set of taxes on capital stock and excess profits. The key tax was a levy of one-tenth of one percent on the declared value of a company's stock. As an incentive for full valuation of stock, the act also included a tax of 5 percent on all corporate profits over 12.5 percent of declared value. See Ellis Hawley, _The New Deal and the Problem of Monopoly: A Study in Economic Ambivalence_, 31, and Malcolm H. Bryan, "The Excess Profits Tax," September 20, 1934, in Department of Treasury, Office of Tax Analysis, National Archives, Washington, D.C.

undistributed.[62]

Morgenthau and his Treasury staff held the view that the measure would fight tax avoidance. Corporations, they were convinced, deliberately retained profits to avoid the taxation of dividends under the personal income tax. They noted that the Revenue Act of 1932 had restored the marginal rates of taxation on the wealthiest one percent of the nation's families almost to World War I levels. And, they believed that an undistributed profits tax was necessary to make these rates effective.[63]

Further, the Treasury believed that the measure would fight the concentration of corporate power. They were convinced that the largest corporations had the power to retain shares of surpluses greater than those retained by small companies. The surpluses, they were certain, gave large corporations an unfair competitive advantage by reducing the need to borrow new capital. Moreover, the Treasury claimed that the tax would promote recovery. Oliphant and Morgenthau believed that large corporations saved excessively or reinvested their surpluses unwisely. The undistributed-profits tax would provide a powerful

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[62]Magill's team of experts had discovered this idea when digging into the Treasury archives for inspiration. They had discovered a 1919 proposal by Treasury advisor Thomas S. Adams for an undistributed-profits tax, which he had favored as a replacement for excess-profits taxation. For evidence of Adams's influence, see Louis Shere, assistant Secretary of the Treasury, to Robert M. Haig, March 6, 1936, Robert Murray Haig Papers, Butler Library, Columbia University.

[63]See Department of the Treasury, Office of Tax Analysis, "Tax Revision Studies, 1937. Volume IV: Undistributed Profits Tax," National Archives.

increases in the higher brackets, "taxing surpluses in corporation treasuries, and fear of further increases," Ickes commented in his diary, had made "a bitter enemy out of practically everyone" among the "very rich."[64]

The threat to the rich from new legislation was all the more acute because Morgenthau and Roosevelt vigorously prosecuted tax evaders and tried to close loopholes used by tax avoiders. They launched their most spectacular crusade in 1934, when the Treasury prosecuted its former secretary, Andrew Mellon, for tax evasion. The Treasury claimed Mellon owed more than $3 million in back taxes and penalties. They chose Mellon as their special target because he seemed to represent the power of financial capitalism, its ability to shape national policy in its interest, the transmogrification of the tax system into an agency of special privilege, and the abuses of Republican government during the 1920s. Morgenthau told the government prosecutor, "I consider that Mr. Mellon is not on trial but Democracy and the privileged rich and I want to see who will win."

Mellon won in court; a grand jury refused to indict, and in 1937 the Board of Tax Appeals (BTA) found him innocent of tax evasion. But Mellon lost the public-relations battle. The BTA also said he had made errors that happened to be in his favor and added that he owed $400,000 in back taxes. The BTA went further, using the Mellon case to publicize the loopholes in the tax code.

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[64]See July 27, 1936 entry in the Harold Ickes Diaries, Ickes Papers.

incentive for such corporations to distribute their profits to their shareholders. Those shareholders, in turn, as Oliphant and Federal Reserve Board chairman Marriner Eccles stressed, would spend some portion of their dividends and thus stimulate the economy.

Roosevelt endorsed the undistributed-profits tax in a message to Congress in March and received support, in principle, from the Ways and Means Committee. But the administration faced the hostility of the Senate Finance Committee and its staffs, which feared revenue loss and preferred retaining the existing corporate income taxes while adding a small, flat tax on undistributed earnings. In June 1936 Congress passed a graduated tax on undistributed profits, despite heavy business lobbying against Roosevelt's proposal and intense wrangling over widely divergent revenue estimates. Morgenthau personally intervened in the negotiations between the House and the Senate and had much to do with the outcome. Because of Senate objections, the graduation was less severe than the Treasury had proposed, but Congress retained the basic corporate income tax. The new tax had five steps, rising from 7 percent to a maximum of 27 percent, on undistributed earnings.

The new corporate tax posed the greatest threat to the autonomy of corporate finance since the passage of the excess-profits tax during World War I. In July, Secretary of the Interior Ickes talked privately with Harry F. Guggenheim and concluded, "the fundamental policy issue today is taxation." The

The commissioner of the BIR pointed out that as secretary of the Treasury, Mellon had solicited from the Bureau "a memorandum setting forth the various ways by which an individual may legally avoid tax." It turned out that Mellon had used five of the ten methods detailed in the memorandum, as well as some others that he had devised on his own.

In spring 1937, the outcome of the Mellon case, coupled with a $600 million shortfall in tax revenues--a deficit that Treasury analysts blamed on tax avoidance--led Morgenthau and Roosevelt to seek remedial legislation. At the same time that the Treasury systematically investigated tax avoidance, Roosevelt won the support of the chairs of the tax-writing committees for creating the Joint Committee on Tax Evasion and Avoidance (JCTEA), with power to acquire the names of tax avoiders from the Treasury. With staff assistance from Thurman Arnold, whom the Treasury borrowed from the Department of Justice, Treasury witnesses inventoried loopholes and, under the pressure of Congressional questioning, identified sixty-seven "large, wealthy taxpayers" who had used the device of incorporation to reduce their taxes. The press zeroed in on Alfred P. Sloan, the president of General Motors, who had incorporated his yacht. Sloan explained, "While no one should desire to avoid payment of his share [of taxes] . . . neither should anyone be expected to pay more than is lawfully required."[65]

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[65]For the Sloan quotation, see John Morton Blum, From the Morgenthau Diaries: Years of Crisis, 1928-1938, 335.

Until the investigation by the JCTEA, the public had only rarely had access to information about individual income tax returns. Virtually the only period had been between 1923 and 1926, when Congressional progressives like George Norris and Robert LaFollette had succeeded in making public information the taxes paid by the nation's wealthiest taxpayers. In 1937, before the creation of the JCTEA, Roosevelt wanted to call out the identities of very wealthy individuals who avoided taxes through loopholes. Morgenthau tried to convince him that this might be illegal, but he nonetheless provided his boss with names and data. When he settled on the idea of establishing the JCTEA, Roosevelt finally gave up the idea of using his office to publicize data from the tax returns of the rich. Nonetheless, he passed on some information to administration figures Jim Farley and Homer Cummings, perhaps hoping that they would leak them to the press.[66]

The disclosures by the Joint Committee persuaded Congress to pass, unanimously, the Revenue Act of 1937. The measure increased taxation of personal holding companies, limited deductions for corporate yachts and country estates, restricted deductions for losses from sales or exchanges of property, reduced incentives for the creation of multiple trusts, and eliminated favors for nonresident taxpayers.

The economic recovery, which had cut the rate of

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[66]On this episode, see John Morton Blum, From the Morgenthau Diaries: Years of Crisis, 1928-1938, 327-337.

unemployment in half by 1937, encouraged Roosevelt to plan an even more intense reform program in 1938. He intended to increase the undistributed-profits tax, to establish a graduated tax on capital gains, and to tax the income from federal, state, and local bonds.

These ambitious plans, more than any other dimension of the New Deal, aroused fear and hostility on the part of large corporations. They correctly viewed Roosevelt's tax program as a threat to their profits, their control over capital, and their latitude for financial planning. The tax program, along with other New Deal measures, may well have contributed significantly to the exceptionally low level of private investment during the 1930s, and even, by depressing business expectations, to the severity of the Recession of 1937-38. Antimonopolist New Dealers like Harold Ickes went so far as to charge that capitalists had conspired and gone "on strike" in response to New Deal taxes.[67] There is no evidence of such a conspiracy, but the possibility may have inspired Ayn Rand, in her novel Atlas Shrugged, to embed at its core a strike of capital--a "moratorium on brains"--

[67]On the causes of the Recession of 1937-38, see Kenneth D. Roose, The Economics of Recession and Revival: An Interpretation of 1937-38 (New Haven: Yale University, 1954), especially 10-12 and 209-216, where Roose discusses the effects of the undistributed profits tax. Schumpeter also stressed the role of that tax. See Joseph A. Schumpeter, Business Cycles (New York: McGraw-Hill, 1939), 1038-1040. On the conspiracy charges, see Mark Leff, The Limits of Symbolic Reform: The New Deal and Taxation, 212-213.

against oppressive statism.[68]

In Atlas Shrugged, the conspirators withdrew from society into a capitalist Shangri-la, "The Utopia of Greed." In the real world of the late 1930s, however, business leaders did what American business leaders had generally done when they felt threatened by tax initiatives that were radical and popular. They entered the political arena and searched for support outside the business community. In 1938, they found Roosevelt vulnerable, weakened by two major errors: reinforcing the recession of 1937-38 and opening in 1937 the disastrous fight to restructure the Supreme Court. Conservative Democrats, led by Bernard Baruch and Joseph P. Kennedy, broke with the president and argued that tax cuts were necessary to restore business confidence. They agreed with Senator Pat Harrison, who declared in December 1937 that Roosevelt's tax program had "retarded progress and contributed to the unemployment situation."[69]

In 1938, a coalition of Republicans and conservative Democrats, working through the tax-writing committees, took advantage of Roosevelt's mistakes to try to block further New

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[68]The novel did not appear in print until 1957, but Ayn Rand began writing it at least a decade earlier and she formulated her political assessment of the New Deal during the late 1930s. She saw the political issues of the 1930s in stark, black-and-white terms. In 1940, for example, she plunged vigorously into Wendell Wilkie's presidential campaign but wound up condemning him for "abandoning his moral stand for capitalism." See Barbara Branden, The Passion of Ayn Rand (Garden City: Doubleday, 1986), 158-231, and Ayn Rand, Atlas Shrugged.

[69]For the Harrison quotation, see Lambert, "New Deal Revenue Acts," 422.

Deal tax reforms. Roosevelt fought back, denouncing at a Jackson Day dinner the businessmen "who will fight to the last ditch to retain such autocratic control over the industry and finances of the country as they now possess." But conservative Democrats had gathered enough strength to push through Congress, over the opposition of Ways and Means Chair Robert Doughton, a measure that gutted the tax on undistributed profits and discarded the graduated corporate income tax. Roosevelt, respecting the strength of the opposition, decided not to veto the bill. Instead, he allowed the Revenue Act of 1938 to become law without his signature and denounced it as the "abandonment of an important principle of American taxation"--taxation according to ability to pay. In 1939, Congress wiped out the undistributed-profits tax.

Roosevelt's defeats in 1938 and 1939 signaled a reassertion of congressional power over the shape of revenue legislation. From that time until the end of World War II, the tax-writing committees of Congress carefully maintained their control over the initiation of tax policy. The influence of Morgenthau and his Treasury advisers had waned; they were able to influence Congress decisively only when Roosevelt was able to mobilize public opinion.

The New Deal's most radical program of tax reform ended in the late 1930s, but Roosevelt and Congress had already ushered in a new tax regime, which featured a strengthened soak-the-rich component. And Roosevelt's program of reform of income taxation had conditioned Americans to expect that any significant tax increases would take place through increasing taxes on the rich and on corporations. To Roosevelt and some of his advisers, it seemed that intervention in another world war--an intervention managed once again by a Democratic administration--would be the occasion for renewed victories for democratic statism.

VII

World War II, like the great national emergencies before it, created opportunities for public-finance reforms that had clear social intent and organizational coherence. As had been the case during World War I and the Great Depression, decisive presidential leadership contributed significantly to the creation of a new tax regime. Motivated by a concern for social justice as well as by the threat to the nation's security, the wartime administration of President Franklin D. Roosevelt shaped the new tax regime and then used the media to persuade Americans to accept it. The new regime proved even more resilient after the war than the World War I regime had been during the 1920s. In fact, ever since, the World War II tax system has remained at the core of federal finance.

President Roosevelt and Secretary of the Treasury Morgenthau began to prepare for financing mobilization as early as 1939. Like Wilson and McAdoo in 1916-17, they set out to finance a large fraction of the costs of war with taxation and to use taxes that bore heavily on corporations and upper-income groups. Roosevelt focused more on the issue of tax structure than on the level of taxation. He talked widely about the need for excess-profits taxation; in the summer of 1940 he proposed such a tax, to be steeply graduated, on both individuals and corporations. Roosevelt, the Treasury, the Ways and Means Committee, and Senate liberals such as Robert M. La Follette, Jr., favored a World War I-style tax on profits above a minimum rate of return. Pat Harrison and other conservative Democrats, however, opposed this. In the Second Revenue Act of 1940, passed in October, they established a graduated tax on excess profits, reaching a maximum of 50 percent, but provided a generous credit based on prewar profits. Secretary of the Interior Ickes complained that this was "abandoning advanced New Deal ground with a vengeance," but Roosevelt decided not to challenge the power of Congress by accusing it of having sold out to big business.[70]

In 1941, following the passage of the Lend-Lease Act, the Roosevelt administration faced growing inflationary pressures. In response to those pressures, as well as to the need for new revenues, Roosevelt and Morgenthau decided to support reducing the exemptions from personal income as a way to restrain consumption. But they did not abandon reform. Morgenthau proposed taxing away all corporate profits above a 6 percent rate of return, as well as increasing surtaxes on personal income, and increasing the base for gift and estate taxes. Roosevelt made it

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[70]In June, Roosevelt had favored a graduated tax on all profits in excess of 4 percent. Harold Ickes Diaries, June 9, 1940 and August 10, 1940, Harold Ickes Papers, Library of Congress.

clear he favored a massive elimination of personal income-tax deductions by switching to the taxation of gross income. But in the Revenue Act of 1941 Congress once again rejected most of the reform measures. The act's major provisions consisted of lower exemptions and higher tax rates on upper-middle-class families.

After Pearl Harbor, Morgenthau and Roosevelt resumed their bid for public support of redistributional tax reform. "In time of this grave national danger, when all excess income should go to win the war," Roosevelt told a joint session of Congress in 1942, "no American citizen ought to have a net income, after he has paid his taxes, of more than $25,000."

Roosevelt, however, faced stiff opposition from strategic planners who believed that only a mass-based system of taxation would both adequately fund the war and mitigate economic strains, and from congressional Democrats who feared that a redistributional tax program would weaken the post-war economy. Morgenthau complained that his opponents had forgotten about the "people in the lower one-third." He noted, "I can get all my New Dealers in the bathtub now."[71]

In the summer of 1942, Morgenthau, on the recommendation of Randolph Paul and Roy Blough, tried to bridge the gap between the administration and Congress by proposing the adoption of a sharply graduated spendings tax designed to raise large revenues

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[71]John Morton Blum, From the Morgenthau Diaries: Years of War, 1941-1945, 35.

and restrain consumption while increasing progressiveness.[72]

Adoption of such a tax would have been by far the most radical departure in American tax policy since 1916. But the tax-writing committees regarded this proposal as too radical economically and too threatening to the influence they enjoyed as gatekeepers for the complex exemptions and deductions in the income tax. Roosevelt recognized the power of the committees, and regarded the spendings tax as a bargaining tool for defeating a general sales tax and for making the income tax more progressive. The president decided not to support Morgenthau, explaining to him that "I always have to have a couple of whipping boys."[73]

In October, Congress finally agreed to a few progressive concessions and settled on the income tax as the centerpiece of war finance. One of the concessions was increasing the rate of excess-profits taxation to 90 percent, but Congress rejected the

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[72]As noted above, immediately in the wake of World War I, Treasury advisor Thomas S. Adams had suggested a spendings tax. Subsequently, economist Irving Fisher's advocacy of the tax had kept the idea before his profession. See Irving Fisher and Herbert W. Fisher, Constructive Income Taxation (New York: Harper, 1942).

[73]John Morton Blum, From the Morgenthau Diaries: Years of War, 1941-1945, 48. A series of memoranda drafted in the Treasury's Division of Tax Research describe the proposed tax. See, for example, "Proposal for a "Consumption Expenditure Tax," memorandum dated July 9, 1942, Office of Tax Analysis, Department of the Treasury, National Archives. William Vickrey, a Ph.D. student of Irving Fisher's, served in the Division of Tax Research and may have been the author of this memorandum. See n. 70, above. For an analysis of Vickrey's views on a spendings tax, see Harold M. Groves, Tax Philosophers: Two Hundred Years of Thought in Great Britain and the United States, 110-113. The best survey of the development of Vickrey's views on taxation is Richard Arnott, et al., eds., Public Economics: Selected Papers by William Vickrey (Cambridge, Eng.: Cambridge University Press, 1994), 99-185.

World War I method of determining excess-profits, made the tax explicitly a temporary measure, and taxed only incorporated businesses. The committees also protected major loopholes favoring the wealthy and provided less than half the revenues that Roosevelt had requested.

The Revenue Act of 1942 represented agreement between Congress and Roosevelt on what became the core of a new tax regime--a personal income tax that was both broadly based and progressive. The act made major reductions in personal exemptions, establishing the means for the federal government to acquire huge revenues from the taxation of middle-class wages and salaries. At the same time, a the imposition of a surtax that was graduated from 13 percent on the first $2,000 to 82 percent on taxable income over $200,000 raised the marginal rates of taxation on personal incomes higher than at any other time in the history of the income tax in America.

The highly progressive income tax, coupled with the defeat of general sales taxation, was the major payoff from Roosevelt's earlier tax-reform campaigns, which had established widespread expectations that any significant new taxes would be progressive. At the same time, Roosevelt and many New Deal legislators hoped to be able to distribute much of the new revenues in progressive fashion. They believed that a mass-based income tax would be the best way to ensure a permanent flow of revenues to support federal programs of social justice.

Roosevelt continued his fight to make the income tax even more progressive, to tax corporations more heavily, and to shift revenue raising from borrowing to taxation, but he suffered two major defeats in 1943. The first was over the introduction of withholding. Roosevelt and the Treasury wanted taxpayers, after the introduction of withholding, to pay both their 1942 and their 1943 obligations during the calendar year 1943. Roosevelt told the chair of the Ways and Means Committee, "I cannot acquiesce in the elimination of a whole year's tax burden on the upper income groups during a war period when I must call for an increase in taxes . . . from the mass of people." But Beardsley Ruml, chairman of the New York Federal Reserve Bank and treasurer of R. H. Macy and Company, led a radio and press campaign that persuaded Congress to adopted the Ruml plan in the Current Tax Payment Act of 1943.

The second defeat for Roosevelt's wartime tax program occurred in the Revenue Act of 1943. In that legislation Congress provided for only modest tax increases ($2.3 billion versus the $10.5 billion requested by the Treasury) while creating a host of new tax favors for business, especially the mining, timber, and steel industries. Roosevelt denounced the bill as "not a tax bill but a tax relief bill, providing relief not for the needy but for the greedy." He vetoed the bill, but for the first time in history, Congress overrode a presidential veto of a revenue act. Alben Barkley, the Democratic majority leader in the Senate, described Roosevelt's veto message as a "calculated and deliberate assault upon the legislative integrity of every member of Congress." Secretary of the Interior Harold Ickes hoped that Roosevelt would go "to the people with his case against the Congress" for enacting "a vicious bill designed to protect the rich at the expense of the poor." But the humiliating defeat convinced Roosevelt that he had to accept the structure of the income taxation without further complaint.[74]

Despite the focus on the development of mass-based income taxation and the Congressional defeats of Roosevelt's efforts to make the new income tax system more progressive, the wartime legislation did increase dramatically the rates of taxation of America's rich through the personal income tax. Wartime revenue acts increased the marginal rates of taxation to levels ranging from 50 to over 90 percent throughout the war. The substantially higher marginal rates, coupled with wartime inflation, produced effective rates that, from 1942 through 1945, were more than forty percent, or roughly twice the effective rate achieved in 1940. In 1944 the effective rate on the rich reached an all-time high of nearly sixty percent, or almost four times the highest level achieved during World War I. (See Table 5.) The rates were high enough so that, even with the broad base of taxation, in 1945 the richest one percent of households produced 32 percent of the revenue yield of the personal income tax.[75]

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[74]Diaries of Harold Ickes, February 26, 1944, Ickes Papers.

[75]Bureau of Internal Revenue, U.S. Department of the Treasury, Statistics of Income for 1945, Part I (Washington, D.C.: G.P.O., 1951), 71.

Table 5
PERSONAL INCOME TAX RATES ON RICHEST ONE PERCENT OF HOUSEHOLDS, 1940-1946[76]

YEAR	MARGINAL RATES	EFFECTIVE RATES
1940	14 to 79%	21.6
1941	29 to 81	30.1
1942	42 to 88	43.6
1943	46 to 88	43.9
1944	50 to 94	58.6
1945	50 to 94	42.1
1946	47 to 91	37.6

Roosevelt's defeats in 1943 essentially ended the conflict, which had begun during World War I, between business and progressive advocates over soak-the-rich income taxation. The winning of World War II and a postwar surge of economic prosperity, which followed so closely on the heels of the Great Depression, all helped produce a popular, bipartisan consensus of support for sustaining the basic policy shifts, including the adoption of mass-based income taxation, undertaken during the Roosevelt administration. In the realm of tax policy, the World War II emergency institutionalized a new tax regime. It had three elements: (1) a progressive but mass-based income taxation for general revenues; (2) a flat-rate tax on corporate income, also for general revenues; and (3) a regressive payroll tax for social insurance.

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[76]See Table 1 for the source of the data.

VIII

After World War II some important differences between the two major political parties remained, but both parties insisted on maintaining the central characteristics of the World War II revenue system and eschewing both progressive assaults on corporate financial structures and the regressive taxation of consumption. For the first time since the early nineteenth century, the two political parties agreed on the essential elements of the nation's fiscal policy.

The general decline of partisanship after World War II no doubt contributed to the convergence of the two parties on fiscal policy. The convergence on tax policy involved acceptance by the Republican Party of levels of taxation of large incomes and corporate profits that were substantially higher than before World War II. These were levels that the rich and the business community had regarded as unconscionable at the time World War II ended. In the immediate post-war years, Republicans accepted marginal rates of personal income taxation on the rich that were as high as during World War II. (See Table 6.) The postwar tax on corporate incomes reached a peak of 52 percent, which held until 1964; thereafter, until 1986, it was usually either 46 percent or 48 percent.

Table 6
PERSONAL INCOME TAX RATES ON RICHEST ONE PERCENT OF HOUSEHOLDS, 1952-1988 (selected years)[77]

YEAR	MARGINAL RATES	EFFECTIVE RATES
1952		32.2%
1961	38 to 91%	
1963		24.6
1967		26.3
1969	46 to 77	
1972		26.1
1974	45 to 70	
1977		27.8
1979	59 to 70	
1981		28.9
1984	45 to 50	
1986		22.1
1988	28	

The convergence of the two parties, however, was more the product of a shift in direction by the Democratic Party. In the postwar era, Democrats largely abandoned taxation as an instrument to mobilize class interests. During the 1950s, the Democratic Congressional leadership accepted revisions of the

[77]Jon Bakija and Eugene Steuerle, "Individual Income Taxation since 1948," National Tax Journal, 44 (December, 1991), 474-475, for the marginal rates; Joseph Pechman, Tax Reform: The Rich and the Poor (Washington, D.C.: Brookings, 1989), 22, for the effective rates. Pechman, who relied on Treasury Department, Statistics of Income data, found consistently higher effective income tax rates than did Richard Kasten et al., who relied on Congressional Budget Office data. See Richard Kasten, Frank Sammartino, and Eric Toder, "Trends in Federal Tax Progressivity, 1980-1993," in Joel Slemrod, ed., Tax Progressivity and Income Inequality, 18.

personal income tax that reduced the effective rates of taxation on the rich to roughly 25 percent. Such rates were high by pre-World War II standards, but about half of the peak rates of effective taxation during the war. Although Presidents John F. Kennedy and Lyndon B. Johnson continued to support tax reforms, such as the taxation of capital gains at death, they also advocated a variety of tax cuts and did so by hawking the "supply-side" benefits much as Andrew Mellon had done during the 1920s. In 1964, Congress responded to Johnson's call for a tax cut "to increase our national income and Federal revenues" by slashing taxes in the face of large deficits. The Council of Economic Advisers, also committed to "growthmanship," actively supported the 1964 cuts, which reduced capital-gains taxes and allowed more generous depreciation allowances. Most liberals regarded the 1964 tax cuts as a victory for aggressive countercyclical stimulation of demand; they also embraced a conservative supply-side rationale for the cuts, particularly those that reduced the marginal rates on the rich. (See Table 6.)

In effect, Democrats assisted the Republican Party in finishing the job it had begun during the 1920s: taking both the partisan sting and the redistributional threat out of taxation. The shift in the tax policy favored by the Democratic Party was part of its more general shift--one begun after 1937, accelerated during World War II, and completed in the Kennedy-Johnson era--away from democratic statism and toward corporate liberalism. This line of thinking had expanded its intellectual ambit, and its political potency, by incorporating Keynesian countercyclical policies. Presidents Kennedy and Johnson invoked Keynesian ideas as part of a strategy for winning business support for their tax-reform program.[78]

Democrats and Republicans generally reached agreement as well over the need for support of effective income-tax administration, and kept issues surrounding tax administration out of politics. During the presidency of Harry Truman, both Democratic and Republican leaders saw withholding as crucial to the success of the income tax. Both parties supported ensuring adequate funding for the Bureau of Internal Revenue, including its efforts to punish employers who refused to withhold taxes.

The Truman administration shifted enforcement emphasis from the tax dodges of established fortunes to the "tax chiseling" of those who had profited during wartime and the period of prosperity following the war. In a 1947 Collier's article, Undersecretary of the Treasury A. L. M. Wiggins described how the BIR had sent 128 revenue agents to a farming community in

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[78]The scholarly literature on the Kennedy-Johnson tax programs has become impressive in depth and scope. See, for example, Ronald King, Money, Time & Politics: Investment Tax Subsidies in American Democracy, 151-319; Cathie Jo Martin, Shifting the Burden: The Struggle Over Growth and Corporate Taxation (Chicago: University of Chicago Press, 1991); Martin, "American Business and the Taxing State: Alliances for Growth in the Postwar Period," in W. Elliot Brownlee, ed., Funding the Modern American State, 1941-1995: The Rise and Fall of the Era of Easy Finance, 354-407; Herbert Stein, The Fiscal Revolution in America (Chicago: University of Chicago, 1969), 372-453; John F. Witte, The Politics and Development of the Federal Income Tax, 155-75; and Julian Zelizer, "Learning the Ways and Means: Wilbur Mills and a Fiscal Community, 1954-1964," in W. Elliot Brownlee, ed., Funding the Modern American State, 290-353.

Minnesota to examine bank accounts, store accounts, government payments, crop yields, and the records of grain and cattle buyers. Wiggins reported that the BIR had collected over $5 million in additional taxes and penalties from farmers in that community. The Treasury and the BIR did not reveal that, although they were increasing the efforts to audit individuals, efforts such as the Minnesota investigation were unusual. They wanted those tax dodgers who were, in Commissioner of Internal Revenue George Schoeneman's words, "a tragic group of otherwise respectable individuals" to fear apprehension and punishment.

To that end, Wiggins and Schoeneman exaggerated the efficiency of the BIR. In 1949, Schoeneman told the readers of American Magazine that "You see, it's almost impossible to deceive our investigators, because most of them are generally familiar with every type of dodge ever attempted, and if they run across what appears to be a new one, they can look into the files and find it's been tried before." The Treasury that had used propaganda to stress patriotic values during World War II used the mass media to deliver its threats during the postwar era. Fear of the Bureau of Internal Revenue (renamed the Internal Revenue Service in 1953), combined with the political popularity of the individual income tax, led to what was, by worldwide standards, an unusually high level of taxpayer compliance.[79]

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[79]A. L. M. Wiggins, "They Can't Fool the Internal Revenue Man," Collier's, September 1947; George Schoeneman, "Tax Cheaters Beware!" American Magazine, February 1949. On the wartime propaganda and the postwar enforcement efforts, see Carolyn C. Jones, "Mass-Based Income Taxation: Creating a Taxpaying Culture,

The bipartisan consensus on taxation ushered in an era of buoyant public finance that lasted until the 1980s. Usually well removed from the contested turf of partisan politics, the tax policies and political actions that produced the era were nearly invisible. Persistent inflation, as well as economic growth, helped to extend the life of the World War II tax regime. Inflation, which was most intense in the late 1940s and then during the period from the late 1960s throughout the 1970s, produced larger revenues through "bracket creep," or the push of increasing numbers of families into higher tax brackets faster than their real incomes increased.[80] In effect, the structure of income-tax rates became substantially more progressive. Although the Kennedy-Johnson tax cuts had reduced marginal rates of personal income taxation of the rich, and these rates remained relatively stable until the 1980s, the effective rates of taxation paid by the rich edged up during the 1970s. The rates

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1940-1952," in W. Elliot Brownlee, ed., Funding the Modern American State. We do not have a scholarly history of the Internal Revenue Service and the BIR, but for a very useful reference work, see Shelley L. Davis, IRS Historical Fact Book: A Chronology, 1646-1992 (Washington, D.C.: U.S. Department of the Treasury, Internal Revenue Service, 1992).

[80]Because of unanticipated inflation, the revenue system proved to be far more elastic after World War II than experts had predicted. Economists at the CED, for example, had believed that after the war, federal tax receipts as a share of gross domestic product would fall from the wartime peak of 22 percent to somewhere between 10 and 15 percent. In fact, the tax share of national product dipped below 15 percent only briefly, in 1950. By 1952 it was approaching 20 percent and ever since has remained close to, or slightly above, 20 percent. Herbert Stein provided the author with the information regarding the CED estimates at the end of World War II. Stein to Brownlee, June 20, 1994.

reached nearly 30 percent, or roughly those that had prevailed immediately before and after World War II. (See Tables 5 and 6.) Meanwhile, the corporate income tax, with a flat rate and hence no bracket creep, became a less dynamic source of revenue. In 1950, individual and corporate income-tax revenues were roughly equal; by 1980, individual income-tax revenues were nearly four times as large as corporate.[81]

The inflation-driven increases in revenues permitted new "tax expenditures"--special preferences offered under the tax code in the form of exclusions, deductions, and credits. Tax expenditures had accompanied the introduction and expansion of mass-based income taxation during the 1940s and 1950s. Some of these benefitted broad categories of middle-class Americans.[82] Others, like the introduction of accelerated depreciation in 1954, favored the wealthy.[83] During the 1960s and 1970s, tax

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[81]For a summary of the operation of postwar individual income tax, including the trends in progressiveness, see Jon Bakija and Eugene Steuerle, "Individual Income Taxation since 1948," 451-75.

[82]After World War II, and the ebbing of patriotism as a factor in income-tax compliance, Congress relied increasingly on tax expenditures and other measures--including the introduction of the income-splitting joint return for husbands and wives and the acceptance of community-property status--to enhance the legitimacy of the new tax regime. However, a deduction that had been in the tax code since 1913--the deduction for mortgage interest--was the most expensive of the tax expenditures. On the joint return and community-property status, see Carolyn D. Jones, "Mass-Based Income Taxation: Creating a Taxpaying Culture, 1940-1952," in W. Elliot Brownlee, ed., Funding the Modern American State.

[83]For a discussion of how accelerated depreciation for income-producing structures helped turn real-estate development in a rewarding tax shelter and may have contributed to an explosion in shopping center construction, see Thomas W. Hanchett, "U.S. Tax Policy and the Shopping-Center Boom of the 1950s and 1960s," The

expenditures became even more popular, and both old and new forms grew relative to conventional expenditures. Politicians became attracted to tax expenditures as a way to accomplish social goals, including reducing the tax burden on the rich. In other words, many Democratic and Republican members of Congress found self-serving political benefits in hiding tax programs from public scrutiny. Also contributing to the movement were taxpaying groups that aggressively sought preferential treatment within the tax code in order to offset the effects of bracket creep. In turn, the taxpayers and legislators who benefitted from the tax expenditures developed a vested interest in increasing the complexity of the process of tax legislation.[84]

The decline of inflation during the 1970s, along the weakening productivity that had ensued, undermined the fiscal capacity of the progressive, mass-based income tax, but it was the tax reforms undertaken during the administration of Ronald Reagan that ended the "era of easy finance" and significantly reduced the taxation of the rich. The Economic Recovery Tax Act of 1981 (ERTA) indexed tax rates for inflation and slashed the marginal rates on the rich. The Tax Reform Act of 1986 broadened the base of income taxation, and may have thereby restored some progressivity to the federal income tax system as a whole, but the measure reduced further the marginal rates of taxation on the

American Historical Review, 101 (October, 1996), 1082-1110.

[84]The leading analysis of the bureaucratic complexity of making tax policy, especially within Congress, during the 1960s and 1970s is Thomas J. Reese, The Politics of Taxation.

rich and confirmed ERTA's reductions in the effective rates paid by the rich.[85]

IX

The ten years or so since the Tax Reform Act of 1986 have been disappointing to reformers who hoped to see further broadening of the income-tax base or further reductions in the taxation of the rich. The administrations of both George Bush and Bill Clinton resumed an interest in enlarging tax expenditures, and the Clinton administration has focused on increasing taxes on the wealthy while offering tax-cuts to the middle-class. Meanwhile, proposals for a "flat tax" or a national sales tax have made little headway through the thicket of pluralistic government.

The lack of reform along the lines pioneered in 1986 is hardly surprising, however, when placed within the long history of American taxation. The nation has never embraced a new tax regime outside of a national emergency. And, when America has launched a new regime, it has always sought to middle-class support by including far more "vertical equity" than the current flat-tax or national sales tax proposals provide. The lesson of virtually every major episode of regime creation is that

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[85]For excellent histories of the Tax Reform Act of 1986, see Jeffrey H. Birnbaum and Alan S. Murray, Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform (New York: Random House, 1987); Timothy J. Conlan, Margaret T. Wrightson, and David R. Beam, Taxing Choices: The Politics of Tax Reform (Washington, D.C.: Congressional Quarterly Press, 1990); and C. Eugene Steuerle, The Tax Decade (Washington, D.C.: The Urban Institute Press, 1992), 71-162.

reformers must honor American ideals of republicanism. They therefore must seek an increase in progressiveness at the same time as they strive to stimulate investment, productivity, and economic growth.