

UC Berkeley

Working Papers

Title

Taxation for a strong and virtuous republic : a bicentennial retrospective

Permalink

<https://escholarship.org/uc/item/6d98k7b6>

Author

Brownlee, W. Elliot

Publication Date

1990

A1458
no. 90-14

5/8/90

TAXATION FOR A STRONG AND VIRTUOUS REPUBLIC:
A BICENTENNIAL RETROSPECTIVE

by

W. Elliott Brownlee
Department of History
University of California, Santa Barbara

Working Paper 90-14 ✓

**INSTITUTE OF GOVERNMENTAL
STUDIES LIBRARY**

MAY 3 1990

UNIVERSITY OF CALIFORNIA



UNIVERSITY OF CALIFORNIA AT BERKELEY

TAXATION FOR A STRONG AND VIRTUOUS REPUBLIC:
A BICENTENNIAL RETROSPECTIVE

by

W. Elliott Brownlee

Bicentennial Lecture, Treasury Historical Association

October 26, 1989

Working Paper 90-14

c 1989

W. Elliott Brownlee
ALL RIGHTS RESERVED

Working Papers published by the Institute of Governmental Studies provide quick dissemination of draft reports and papers, preliminary analyses, and papers with a limited audience. The objective is to assist authors in refining their ideas by circulating research results and to stimulate discussion about public policy. Working Papers are reproduced unedited directly from the author's pages.

In 1989 the rush of historical anniversaries in the West and the tumultuous events in the East have converged to elicit overblown pronouncements on the record of liberal democracy in the United States, and elsewhere. Tonight, at the risk of adding to the rhetorical excesses, I would like to take advantage of the bicentennial anniversary of the Treasury to comment on a central aspect of that record--the history of the way in which we Americans, through the federal government, have taxed ourselves.

Some scholar-critics present a very gloomy view of our present fiscal condition. They tell us that our tax system is in a condition of pluralist "grid-lock." It is, they say, paralyzed by grinding, selfish competition among interest groups--a competition that has resulted in a crippling combination of unfairness, economic inefficiency, and revenue deficiency.¹ Such criticism has been grist for the mill of critics who bemoan America's national weakness. The criticism has enabled them to explain that putative weakness partly in terms of the pluralism of tax politics and American resistance to tax paying. To such critics, the words "Read My Lips! No New Taxes!" demonstrate the depth and effectiveness of that resistance.²

The gloomy critics, however, may underestimate the long-term significance of the Tax Reform Act of 1986. Even if the reform package is modified to include preferential taxation of capital gains, the 1986 act will have thrust us toward the goals of a

broader-based, more equitable, and economically more efficient income tax.³ As the late Joseph Pechman suggested last summer, the 1986 reform act may have so strengthened the base for income taxation that, a very modest increase in rates, perhaps as little as three percentage points across the board, could raise as much as \$100 billion by the early 1990s.⁴ Pechman's forecast, however, assumed that the reform act would have long-term political viability--an assumption cast in some doubt by the current debate over capital gains taxation. Let me pose the question: Does the history of taxation raise the same doubt about the viability of the 1986 reforms? More generally, does our tax history contain more seeds of optimism than the prophets of stagnation and gridlock have discovered? In any event, perhaps by examining that history we can define more realistically the alternatives actually available for securing the fiscal underpinnings of our republic.

The nation's past contains much evidence to support the view that we are a society of tax resisters, immersed in the narrow search for private gain. It is quite true that in large numbers, we have evaded taxes, exploited the tax codes for loop-holes, migrated to low-tax havens, and sought political parties and candidates committed to reducing taxes. At times we have favored direct taxation--taxation of property and income---to make certain that taxation hurts and retards the growth of government. Some of this resistance to taxation has its basis in the ideas of

"modern liberal" thought--ideas that as early as the American Revolution emphasized individualism, celebrated the pursuit of private self-interest and financial gain, and regarded with suspicion governmental initiatives that might impede profit-maximizing.

But we have another side to our history--one that has its intellectual roots in the same era of the Revolution and formation of the Constitution. Even then, "modern liberalism" did not hold sway, unopposed or unqualified. Historians now agree that the central language of the Revolution contained not only Lockean liberalism, with its emphasis on private rights, but also a "classical republicanism," or a "civic humanism," that stressed communal responsibilities. These ideas focused on the need to foster public virtue, the threat of corruption to public order, and the dangers of commercialism. The Founding Fathers (and even Adam Smith) held these ideas of classical republicanism in tension with those of modern liberalism.⁵

Commitments to civic humanism has led to pressure for higher taxes. For example, the ideal of a harmonious republic of citizens equal before the law has created demands for taxes to destroy islands of special privilege, and taxes to insure that all Americans were able to assume the privileges and responsibilities of citizenship. Also, civic humanism embraced the notion that taxpaying was one of the normal obligations of a

citizenry bound together by ties of affection and respect. At the local level, and later at the federal level, civic humanism reinforced the use of direct taxation--property and income taxes--by asserting the equity of those taxes as well as hostility to big government. Civic humanism, in fact, emphasized the responsibilities of wealth to support government and public order. Civic humanism, embracing enlightened self-interest, included the criterion of "ability to pay" in evaluating taxation. Adam Smith, for example, in his first canon of taxation declared that "the subjects of every state ought to contribute toward the support of the government, as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." For that matter, even Alexander Hamilton, in Federalist No. 36, advocated heavy taxation of the luxury of the rich, declaring that, "Happy it is when the interest which the government has in the preservation of its own power, coincides with a proper distribution of the public burdens, and tends to guard the least wealthy part of the community from oppression."

The ethics of citizenship also had another implication: that Americans would display a capacity for political and social learning. I would argue that American tax policy, even during episodes of great contention, has been influenced by pragmatic people who demonstrated that they could learn from experience, rise above narrow self-interest, and change their minds. The

recent, dismal criticism of the American process of taxation has failed to recognize important occasions when American legislators and bureaucrats have separated taxation from short-run, short-sighted economic interests and applied social learning--learning about the interests of others and the community at large--and consequently modulated their own demands.

The nation's first tax system was shaped heavily, of course, by the Constitution. An element restricting federal taxation was Article I, Section 9, which specified that "No capitation or other direct tax shall be laid, unless in proportion to the census...." With this provision, the founders of the republic limited the power of the national government to impose property taxes.⁶ This limitation was not a victory for modern liberalism so much as for civic humanism. The limitation reflected the fact that the framers of the Constitution thought about taxation in the context of the corruption of Parliament and the monarchy, and worried about the potential for similar abuse by the new federal government. The limitation also reflected the fear of factionalism that James Madison expressed in Federalist No. 10. He saw "the most common and durable source of factions" as "the various and unequal distribution of property," and he worried that the issue of taxation, more than any other, created an opportunity and temptation for "a predominant party to trample on the rules of justice."

Moreover, the intent of the Constitutional limitation was not to deny the new republic the resources it needed. Indeed, a central hope of the supporters of the Constitution was that the new central government, in contrast with the government of the Articles of Confederation, would have the taxing power that was required for a strong and meaningful nation. Indeed, the Constitution left the way open for the new federal government to impose "indirect" taxes such as tariffs.⁷ Tariffs could work. When they were kept low, they won popularity. Such tariffs were highly productive of revenue, were inexpensive to collect, were widely diffused yet thought possible to avoid through prudent living, and were useful in economic diplomacy.

Moderate tariffs, in fact, provided the new republic with the revenues to build a vigorous nation--to assume the States' debts, to wage war against Native American societies and against France, Great Britain, and Mexico, to fund the Louisiana Purchase and programs of public works, and to support the routine but important economic business of distributing the public lands and of managing the national customs union. The new fiscal system worked until the Civil War, even during the 1840s and 1850s, when the Democratic party dominated the federal government and consistently reduced tariffs. In addition, moderate tariffs allowed the leaders of the early republic to limit the political divisiveness of taxation, just as the Founding Fathers had hoped. Aspiring to create a unified and just republic, they prevented

tax issues from themselves arousing the disruptive forces of factionalism.

The leaders of the early republic also succeeded in establishing a tax system that was fair in the sense of not creating or reinforcing major islands of special privilege. But, as the industrial revolution gathered momentum and increased both the social and the private rates of return on accumulations of capital, even republican idealists often called for a program of encouraging capitalism by expanding privileges, particularly in the corporate sphere. Some joined in the formation of what might be called a business class. Loosening their ties to civic humanism, they supported Alexander Hamilton's proposition that the state should give active and positive reinforcement to private investors. They coalesced in the leadership of the Whig party, and embraced the program known as Henry Clay's American System. This program which included a call for high protective tariffs. Consequently, the Whigs threatened to disrupt the tax system of the early republic.

The Whig proposals would have had little long-term effect on American tax policy, however, had not slavery and the sectional crisis created an opportunity for the new business class to broaden its message and, through the agency of the Republican party, to dominate the federal government. The Civil War itself clinched the party's hold on the federal government for more than

a generation. Consequently, and ironically, the Republicans were able to turn taxation into the promoter of big government and of party rule.

The search for a harmonious republic was difficult during the era of industrialization. Citizens struggled to adapt eighteenth-century institutions to industrial reality. But their changes in tax policy would have been minimal in that period had it not been for the Civil War, and the two other total wars that followed in the twentieth century. The total wars that consumed American lives, energies, and resources on a great scale from the 1860s through the 1940s exposed the tensions inherent in the republic's ideals. The political system adapted to these tensions while responding to the national emergencies. Consequently the fundamental character of the federal tax system changed three times, once during each major war. Each transformation conditioned Americans to accept higher taxes--a kind of upward-ratchet effect on government spending. But the wars often intensified, rather than resolved, the ideological and distributional issues at stake in tax politics. During the long era of total war and national crisis, conflict over taxation became severely turbulent. Its outcome became difficult for political actors to predict. Taxation appeared to be up for grabs. For that reason, it became even more hotly contested.

The Civil War, the nation's first modern war in the sense of

a war with enormous, capital-intensive requirements, demanded an ambitious and unprecedented program of emergency taxation. In the chaos of that first total war, Republicans experimented with a vast array of taxes, including an income tax and excises on virtually all items of consumption.⁸ The American public endured the taxation as a necessary evil but, after the war, the Republican governments kept the "sin" taxes on whiskey and tobacco and, even more important, the wartime tariffs. These high tariffs averaged well over 40 percent of the value of imports, and formed the core of what was a new fiscal system.⁹

The postwar high-tariff system was the centerpiece, in turn, of an ambitious new program of national economic policy and economic nation-building. The great increase in tariffs was also a stunning victory for economic nationalism and protectionism--one forgotten a century later during heated tirades against Japanese trade policy. The introduction of high tariffs initiated a process of making tax protection, tax incentives, and tax subsidies important elements in the nation's political economy. Manufacturers welcomed the high-tariff system because it allowed them to build national marketing organizations free of worries about disruptions caused by European competitors. The high tariffs provided benefits not so much to the "infant industries" favored by Adam Smith as to giant American corporations that were integrating vertically and gaining a long-term advantage over European competitors who were restricted to smaller markets.

Tariffs also seemed to benefit workers who feared competition from lower-wage labor in Europe, Latin America, and Asia. Finally, the tariff funded new transfer-payment programs and public works. Republican governments used tariffs to fund the nation's first major system of social insurance--an ambitious program of pensions and disability benefits for Union veterans. As the pensions grew increasingly generous during the 1870s and 1880s, they became a central element in the strength of the Republican party. In addition, community leaders throughout the North liked feeding from what became known as the "pork barrel"--the annual Rivers and Harbors bill that the tariff revenues funded. Even with all the new spending, by the 1880s, the federal government had retired its Civil War debts and had begun to accumulate an embarrassing surplus.¹⁰

The Democratic party challenged Republican power with a biting critique of the tariff--a critique based not so much on modern doctrines, including nineteenth-century liberalism, as on the civic humanism of the American Revolution and the early republic. Democrats harnessed their assaults on the tariff to a more general attack on special privilege, on monopoly power, and on public corruption. President Grover Cleveland, focusing on the modern corporations that were emerging during the 1880s, indicted the system of high tariffs for spawning the "trusts, combinations, and monopolies"--organized expressions of public corruption and special privilege that were built, he charged, "upon

undue exactions from the masses of our people." Tariff reformers like Cleveland harkened back to the values of the Revolutionary era and charged that companies like Standard Oil, working with its Republican retainers, threatened the republic just as had King George and his colonial agents.

The Republicans had, in fact, invited such attacks. In retrospect, it is fair to say that the Republican economic program had destroyed the plans of the Founding Fathers for fostering social harmony, and finessing the raw class conflict that debates over tax policy could arouse. The Republicans had not only opened up such issues but also moved taxation onto the political center stage, where it remained for nearly a century. Institutional development is often irreversible and "path-dependent." This turned out to be the case for national taxation.

When federal coffers were full, tariff reformers were reluctant to propose any new taxes but, during the depressed 1890s, enthusiasm grew for a new tax, one that would replace tariffs--the progressive income tax. Central to its appeal was the argument of its promoters, based on principles of civic humanism, that the tax would reallocate fiscal burdens according to "ability to pay." What was truly radical about the progressive income tax, and new in the industrial era, was the goal of basing the entire tax system on expropriation of the largest incomes and corporate profits. Income tax champions, like the supporters of

Henry George's "single-tax," argued that their tax would not touch the wages and salaries of ordinary people but would, instead, attack the unearned profits and rents of monopolists. Thus, they firmly believed that the income tax could itself contribute to an assault on monopoly power.

During the 1890s, depression conditions and rising farm protest increased the popularity of the income tax. In 1892, the Populist party endorsed it. In 1894, the Democratic Senator from Nebraska, William Jennings Bryan, working with the Populists, forced the inclusion of a modest income tax in the Wilson-Gorman Tariff. The new tax might have calmed protest but the Constitution came into play in 1895, when the Supreme Court, in Pollock v. Farmers' Loan and Trust Co., ruled that the income tax violated Article I, Section 9. Justice Stephen J. Field warned that "the present assault on capital" would be "the stepping stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich; a war constantly growing in intensity and bitterness."

The Supreme Court's decision failed to halt the income tax movement. Democratic party leaders such as Bryan intensified their fight. They added income taxation to tariff reform as a central party cause. Their efforts kept tax reform before the American public, and achieved a breakthrough finally in 1909, when Congress approved and sent to the states the Sixteenth

Amendment. Ratification prevailed in 1913, carried forward by the presidential election of 1912, in which popular enthusiasm for federal policies designed to attack monopoly power reached an all-time high. Following Woodrow Wilson's election to the presidency, Congress coupled tariff reform with the adoption of another modestly progressive income tax.

If World War I had not intervened, it is possible that even Wilson's progressive administration would have been slow to expand the income tax system. No overwhelming force of economic logic or structure lay behind the tax. The tariff, especially when lowered, would have been productive. Even the supporters of income taxation were uncertain how the income tax would work or, for that matter, how income should be measured. But, as it turned out, the financial demands of total war, set in the context of redistributive politics, produced yet another tax system, the nation's third.

By 1916, president Wilson and Secretary of the Treasury William G. McAdoo concluded that the nation faced resource requirements of unprecedented magnitude. Their problem was that the disruption of international trade had ruined the tariff as a source of new tax revenues. Their alternatives were national sales taxes and/or income taxes. Wilson and McAdoo, in the single most important decision in the financial history of the war, and perhaps the century, chose to cooperate with a powerful group of

insurgent Democrats. These Democrats not only opposed preparedness but also had ideals of social justice that led them to champion highly progressive taxation. Led by Congressman Claude Kitchin of North Carolina, who chaired the House Ways and Means Committee and served as majority leader of the House, they carried forward nineteenth-century antimonopoly, redistributionist traditions. In the group were a significant number of single-taxers. Through taxation, they all hoped to attack concentrations of wealth, special privilege, and public corruption. The group held enough power to insist that if preparedness, and later the war effort, were to move forward, it would do so on their financial terms. "If the forces of big business are to plunge this country into a saturnalia of extravagance for war purposes. . . ," declared one Democratic Congressman, then "the forces of business should put up the money."¹¹

Wilson's decision as to how to finance the war was partisan. Wilson regarded the tax program as essential for his party to maintain control of the federal government. Wilson feared that, without an aggressive anti-business posture, he would bitterly divide the Democratic party, spoil opportunities for attracting Republican progressives to his party, and destroy his strong partnership with congressional Democrats. But the decision involved more than partisanship. The leaders of the Wilson administration themselves embraced taxation as an important means to achieve social justice through a restructuring of the economy

according to the humanistic ideals of the early republic. Wilson and McAdoo, along with Louis Brandeis and Colonel Edward M. House, believed that taxation should discipline corporations--especially a "money trust"--in order to promote a more competitive economic order and a more humane social order.

The Democratic progressives forced the wartime debate over taxation to focus on the most fundamental and sensitive of economic 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 an economic predator, which tax policy could and should tame. In this debate, the proponents of high progressive taxation were the clear victors. The outcome was that the nation embraced its third major tax system: "soak-the-rich" income taxation.

Thus, during the second period of crisis, one in which the pressure of fighting a modern war coincided with powerful demands to break the hold of corporate privilege, Woodrow Wilson and the Democratic party turned Republican fiscal policy on its head. The Democrats embraced a tax policy that they claimed, just as the Republicans had for their tariff system, would sustain a powerful state and economic prosperity. But the new tax policy would assault, rather than protect, the privileges associated with corporate wealth. The Democrats, when they had their chance to

rule, did not roll back taxes. Instead, they advanced their own statist program for accelerating industrialization, one based on strikingly different assumptions about the sources of prosperity.

The Democratic program, implemented in the Revenue Acts of 1916 and 1917, transformed the experimental income tax into the foremost instrument of federal taxation; it introduced federal estate taxation; it imposed the first significant taxation of corporate profits and personal incomes, but rejected a mass-based income tax--one falling most heavily on wages and salaries; last but not least, it adopted the concept of taxing corporate "excess-profits."

In contrast with Britain, which taxed "war-profits" of corporations with a tax on the excess of wartime over peacetime profits, the United States imposed a graduated tax on all business profits above a "normal" rate of return. Only Canada, among the other belligerents, employed the excess-profits base. By 1918, U.S. corporations were paying over \$2.5 billion in excess-profits taxes per year--more than half of all federal taxes, which in turn amounted to more than one-third of all federal wartime revenues, a share that was the highest among all the belligerent nations.

The decision to place excess-profits taxation at the center of wartime finance, and to make excess-profits taxation a

permanent part of the revenue system, outraged business leaders. The nation's foremost investment bankers and corporations became the most vigorous tax resisters. The resulting conflict between advocates of "soak-the-rich" taxation and business leaders would flare for more than twenty years.

Business leaders preferred financing the war through borrowing and a mix of "war-profits" taxation, a mass-based relatively flat personal income tax, and a variety of consumption taxes.¹² In response to corporate criticism, the Wilson administration relied on its professional economists, led by Thomas S. Adams of Yale University, to develop the "administrative discretion" that they believed could "recognize normal rates of profit for different classes of business" and thus protect the economic engine of warfare. Cooperating with this technocratic initiative, Congress created an Excess Profits Advisory Board. This meant that, for the first time, Congress extended a high degree of discretion to the Treasury in interpreting tax law. The Board institutionalized a process of learning in which experts within the Treasury interacted continuously with corporate taxpayers.

The Excess Profits Board was just one element in Wilson's effort to use "statist" or administrative means, rather than "market" mechanisms, for converting capital to the conduct of the war.¹³ The implications of the new democratic statism for the

Treasury were profound. The complex and ambitious program of wartime finance required a vast expansion of its administrative capacity. For example, the Bureau of Internal Revenue increased in size from 4,000 to almost 16,000 employees during the war, and underwent reorganization along multifunctional lines. Supervising the Treasury was an exceptionally capable team assembled by Secretary McAdoo. Lacking an adequate civil service presence, McAdoo fashioned within the Treasury what political scientist Hugh Heclo has called an "informal political technocracy," or a "loose grouping of people where the lines of policy, politics, and administration merge in a complex jumble of bodies." This was an early example--certainly the first in the Treasury--of what would become a typical expression of America's unique form of a "higher civil service."¹⁴ A Treasury team--led by Assistant Secretary Russell C. Leffingwell, Commissioner of Internal Revenue Daniel C. Roper, and principal tax adviser Thomas C. Adams--forged an organization that was not only vigorously independent but also powerful because of its linkages with Congress, elements of the business community, other federal agencies, the Democratic party, and public finance professionals. Under McAdoo's leadership, this team kept the Treasury remarkably independent, free of domination by competing centers of power within the federal government, or by groups outside the government. By 1918 the initiative for analyzing and drafting tax legislation had shifted from Congress to the Treasury.

The unique combination of redistributational and significant "state-building" components in the Treasury's financial program constituted, however, a strategic, long-term threat to the nation's corporations. Most severely threatened were the largest corporate hierarchies who believed their financial autonomy to be in jeopardy. Indeed, no other single issue aroused corporate hostility to the Wilson administration as much as the financing of the war.

Corporate leaders found their opening in 1918, after Wilson and McAdoo had decided that the war effort, if it extended into the next year, 1919, would require greatly increased revenues. Wilson and McAdoo proposed doubling federal taxes in fiscal 1919 by, among other means, requiring corporations to pay 80% of the higher of their "excess-profits" or "war-profits." Wilson, however, had to make his case for dramatic tax increases during the election year of 1918. Republicans blamed the wartime financial program for inflation and economic distress, delayed consideration of the new tax bill until after the November elections, gained control of Congress in those elections, and set the stage for the 1920 presidential elections and the "return to normalcy." In 1920, an economic depression--the nation's sharpest ever--guaranteed a decisive Republican victory. 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 and create a new party system.

After recovery from the wrenching inflation and depression of the immediate post-war period, the Republican Secretary of the Treasury, Andrew Mellon, adopted a new strategy for his party: seeking financial policies that would protect the investment system yet still mediate class conflict. On the one hand, he expanded the attack on the most redistributive parts of the wartime tax system. The Revenue Act of 1921 abolished the excess-profits tax, made the individual income tax much less progressive, and installed many devices favoring capital, such as the preferential taxation of capital gains. On the other hand, in one of those moments shaped by enlightened self-interest, Mellon took the advice of economists serving as Treasury tax advisors and protected income taxation against the threat of a national sales tax. Mellon persuaded corporations and the wealthiest individuals to accept, instead, some progressive income taxation. This approach would, Mellon told them, demonstrate their civic responsibility and defuse radical attacks on capital. "Soak-the-rich" remained but only at reduced rates, with major loopholes, and without its sharp anti-corporate edge. Mellon's strategy was what might be described as a "corporate liberalism," in contrast to McAdoo's "democratic statism."

Mellon had kept enough of the Wilsonian program to demonstrate his commitment to the principle of "ability to pay." At the same time, however, Mellon had created privileged enclaves

within the tax code. Thus, the cumulative effect of the swift creation of a massive income tax and the equally swift Mellon modifications was the establishment of an income tax that failed tests of economic efficiency. It displayed the inconsistencies in concept and definition that have ever since plagued economists and reformers seeking economic neutrality in taxation.

Mellon's sophisticated strategy faced a challenge when the Great Depression and Franklin Roosevelt's New Deal finally enabled the Democratic party to establish a long-term period of control over the federal government. Roosevelt believed deeply in "soak-the-rich" taxation. If it had been possible, he would have immediately resumed Wilson's effort to shift the tax burden to the wealthiest individuals and corporations. But Roosevelt was worried by depression conditions, and he was wary of business power and the continuing appeal of Mellon's liberalism. Roosevelt moved slowly. For example, he supported regressive Social Security payroll taxes as a way of encouraging people to think of Social Security as an insurance system in which their "premiums" established investments which had to be protected. His goal was to protect New Deal reforms like Social Security from a conservative, tax-cutting counter-revolution.

As the Great Depression wore on, popular pressure for more radical measures grew. In June of 1935, Roosevelt responded to the "Thunder on the Left," particularly Huey Long's "Share the

Wealth" movement, by finally launching a tax reform program--one designed to restore the Wilsonian system. He intended to close loopholes for the wealthy, increase progressivity, and reform corporate behavior. Roosevelt declared that accumulations of wealth meant "great and undesirable concentration of control in relatively few individuals over the employment and welfare of many, many others."

In 1936, Roosevelt announced the centerpiece of his tax reform program--the replacement of the existing corporate income tax with an undistributed profits tax. The new tax would apply only to those profits which corporations did not distribute to their stockholders, and it would be graduated according to the proportion of profits that were undistributed. Roosevelt was convinced that corporations deliberately retained profits to avoid the taxation of dividends under the individual income tax. Further, he believed that large corporations had the power to retain greater shares of surpluses than did small companies, that those surpluses gave large corporations an unfair competitive advantage by reducing their need to borrow new capital, and that large corporations often re-invested their surpluses unwisely. Congress passed the tax, although in modest form, and in the 1936 campaign, Roosevelt advertised it as one that "made it harder for big corporations to retain the huge undistributed profits with which they gobble up small business."

Roosevelt, now growing more enthusiastic about ambitious tax reform, wished 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. But these plans, more than any dimension of the New Deal, aroused the hostility of large corporations. They, quite correctly, viewed Roosevelt's tax program as a threat to their control over capital resources and their latitude for financial planning. There is no evidence of a "strike of capital," but business did seize the political opening created by Roosevelt's unsuccessful court fight in 1937 and the recession of 1937-38. Conservative Democrats in Congress, remembering well the defeats of 1918 and 1920, broke with the president. They supported the argument that tax cuts were necessary to restore business confidence. In 1938 New Deal tax reform ended when a coalition of Republicans and conservative Democrats pushed through Congress a measure that reduced to insignificance the tax on undistributed profits and discarded the graduated corporate income tax.¹⁵

Roosevelt revived his tax reform ambitions during World War II. Like Wilson and McAdoo, he and Secretary of the Treasury Morgenthau preferred to finance the war with taxes that bore heavily on business and upper-income groups. In 1941, Morgenthau proposed taxing away 100% of all corporate profits above a 6 percent rate of return. Roosevelt went so far as to propose, in April of 1942, that "in time of this grave national danger, when

all excess income should go to win the war, no American citizen ought to have a net income, after he has paid his taxes, of more than \$25,000."

Radical war-tax proposals such as these faced two major political obstacles. One was the opposition from a diverse group of military planners, foreign-policy strategists, financial leaders, and economists. Throughout the turbulence of the 1920s and 1930s, they had marshalled the economic lessons of World War I, and its aftermath, for use in the event of another major war. This group of experts, for the sake of mobilizing even greater resources with less inflation, vigorously promoted mass-based income taxation and heavy reliance on market mechanisms in mobilizing capital.¹⁶

The second obstacle was, in sharp contrast with Wilson's war, powerful Congressional opposition. Without any real choice, Roosevelt challenged Congress only once, in 1944. He vetoed a revenue act which, because of the phasing-in of withholding, forgave an entire year's tax liability. Noting that the lion's share of the benefits of forgiveness went to the wealthy, Roosevelt called the bill "not a tax bill but a tax relief bill, providing relief not for the needy but for the greedy." For the first time in history, Congress over-rode a presidential veto of a revenue act, and dealt Roosevelt a humiliating defeat.

In 1940, Congress instituted "mass-based" income taxation-- an income tax with low personal exemptions. Because of the low exemptions, income tax revenues began to flow from the taxation of wages and salaries, rather than of profits, dividends, interest, and rental income. Consequently, the number of income-tax paying individuals grew from 3.9 million in 1939 to 42.6 million in 1945, and federal income-tax collections leaped from \$2.2 billion to \$35.1 billion. Membership in the community of taxpayers, as two economists put it, had "spread from the country club district down to the railroad tracks and then over the other side of the tracks."

Congress supported the "mass-based" revenue system partly because of the wide popularity of the war effort. Once the new taxes were in place, the administration persuaded the millions of new tax payers that paying their taxes was a fine way for them to express their patriotism. Withholding and a variety of deductions favoring the middle-classes eased acceptance of the tax. Moreover, middle-class taxpayers preferred the mass-based income tax to a national sales tax, which corporate leaders at times promoted. Further, fear of a renewed depression led to public tolerance of taxation that was favorable to the corporations and corporate privilege. The American middle-class accepted the verdict of Time magazine which denounced Morgenthau's excess profits plan with the warning that it would put corporations in a "weakened financial position to meet the slump and unemployment

that will come with the peace." However naive this may have seemed to radical New Dealers, it was an expression of a commitment to the pursuit of enlightened self-interest. Finally, and in the same spirit, many New Deal legislators accepted the deepening of the income tax as the most effective means of insuring a flow of resources to support programs of social justice. Mass-based income taxation essentially ended the conflict that had begun during World War I between business and progressive advocates of "soak-the-rich" income taxation.

Mass-based income taxation, of course, turned out to be the basis of our fourth, and current tax regime. The World War II system has survived because the nation entered an era of unprecedented prosperity, national homogenization, and military competition. As part of the process, the two major parties, for the first time since the early nineteenth century, reached agreement on the essential elements of a tax system. Important differences have remained between the two parties, but both promote taxpaying as a normal obligation of citizenship; both support a federal tax system featuring a progressive income tax and a regressive payroll tax; both favor protecting the independence of corporate financial structures; both support the use of tax policy in the cause of economic stabilization; and both have sought an elastic source of revenue for national defense. Consequently, as Americans' identification with political parties has declined, the role of tax issues in party competition has

also declined. The war, the threat of renewed depression, and the prosperity that followed created an opportunity for the Republican Party to finish the job it had begun during the 1920s of taking both the partisan sting and the redistributive threat out of taxation. At the same time, in the face of wartime and post-war prosperity, the Democratic party largely abandoned taxation as an instrument to mobilize class interests. While presidents Kennedy and Johnson continued to support tax reforms such as the taxation of capital gains at death, they also advocated tax cuts and did so with language that was reminiscent of Andrew Mellon's.

Tax reform gathered momentum again during the 1970s when the ideals of the early republic won support in diverse quarters. Conservatives focused on high, inflation-driven rates ("bracket-creep") while liberal tax experts exposed the inequities resulting from burying extraordinary special privileges--"tax expenditures"--in the tax code. Both conservatives and liberals criticized the tax system for producing economic inefficiencies and distortions. Conservatives won the first victories with more Mellon-style, "supply-side" cuts in the early 1980s. But, meanwhile, supported by Treasury staff, both the Reagan administration and Congressional Democrats began scouting the income tax system to find areas requiring structural reform. They edged into a competitive scramble to occupy the high ground of equity-driven tax reform.

The result--the Tax Reform Act of 1986--was, like the tax reforms of the 1920s, initiated by Republicans seeking to reduce the taxes on wealth. But there were three major political differences. First, the Republican administration in 1986 was more interested in improving economic incentives for entrepreneurship than in protecting corporate bureaucracies.¹⁷ Second, the 1986 act was written with substantial Democratic participation. Third, the Democratic leadership in Congress abandoned its traditional reform posture of enhancing the progressive rate structure of the income tax in favor of rectifying some of its horizontal inequities. In effect, Democrats compromised their traditional approach to "ability to pay" in order to create a more uniform--a more "horizontally" equitable--income tax.

It can be argued that, as a result of the bipartisan effort, the Tax Reform Act of 1986 advanced a process of restoring to federal taxation the sense of balance sought by the founders of the republic. The act represented a major step in the elimination of tax-based privilege, while reaffirming the duties of citizenship. It preserved progressivity and "ability to pay" while promoting uniformity and economic efficiency. It meant a strengthening of the tax system in the face of a growing national fiscal crisis.

In conclusion, let me submit that the apparent unwillingness

of the American people to accept higher taxes does not point to deficiencies in either the American character or the political order. The history of taxation suggests, instead, that Americans have been willing to tax heavily when they have a sense of national emergency and when they believe their taxes to be fair. This history indicates that if we wish to strengthen the republic during the 1990s, we should build on the political and economic strategies embraced by the Tax Reform Act of 1986, rather than move away from them. If we build on the act, rather than dismantle it, perhaps we can come full circle in our tax policy, returning to a system that more closely corresponds to the ideals of 1789--one that is widely accepted as fair, and that has capacity for supporting a republic that is strong in both the public and private realms. However, we should remember that moments of equilibrium in tax policy have always proved elusive, and that self-indulgent quests for private gain and narrow partisanship have often provoked destabilizing counter-attacks. And waiting in the wings today are value-added taxes, simplified alternative taxes, expenditure taxes, and some bad old taxes. At the most critical junctures in American history, taxation has always seemed to be up for grabs. Why should it be any different in the 1990s?

1. See, for example, John Witte, The Politics and Development of the Federal Income Tax (Madison: The University of Wisconsin, 1985).
2. See Paul Kennedy, The Rise and Fall of the Great Powers: Economic and Military Conflict from 1500 to 2000 (New York: Random House, 1988), especially pp. 434, 527, and 534-535, and David Calleo, Beyond American Hegemony, The Future of the Western Alliance (New York: Basic Books, 1987), pp. 109-113 and 126.
3. I regard the major provisions of the act as (1) a shift of more than \$100 billion in taxes from individuals to corporations as part of the reform package; (2) an increase the personal exemption and the standard deduction, thereby taking millions of the nation's poorest families off the income tax rolls; (3) the eliminated of important "tax expenditures" (consumer-interest and sales tax deduction, passive-loss tax shelters, preferential taxation of long-term capital gains, and the investment tax credit for corporations) favoring the wealthy; (4) compression of the rate structure, and drastic cuts in the top individual income tax rates and in the corporate rate (from 48% to 34%). To date, the best account of the politics of the act is 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).
4. Joseph Pechman, "More Tax Reform," The Wilson Quarterly XIII (Summer 1989), 141-142.
5. A useful 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, 1979), 116-131. On Adam Smith, see Donald Winch, Adam Smith's Politics, An Essay in Historiographic Revision (Cambridge, Eng.: Cambridge University, 1978).
6. They believed that local control was necessary for the equitable operation of the property tax, and that the federal government might abuse the tax to attack certain categories of property (such as slaves), to favor town dwellers over farmers, or to punish a particular section of the country.
7. Excises were also possible but the seemed to single out unfairly particular classes of producers. President Washington's and Secretary Hamilton's excise tax on whiskey touched off the Whiskey Rebellion of 1794. Washington had to raise 15,000 troops to discourage the Pennsylvania farmers who had protested, waiving

banners denouncing tyranny and proclaiming "Liberty, Equality, and Fraternity." Subsequently, the Federalists abandoned efforts to raise excise taxes, and the Jefferson administration abolished all of them.

8. The numerous levies included internal excise taxes on virtually all consumer goods, license taxes on every profession except the ministry, stamp taxes on legal documents, a federal property tax, an inheritance tax, special taxes on corporations, and a tariff which imposed duties that were almost half the total value of all imports, and a general income tax. The income tax began in 1861 as a levy of 3 percent on incomes over \$800, then increased in 1862 to a tax of 3 percent on incomes from \$600 to \$10,000 and 5 percent on those above \$10,000, and increased again in 1864 to rates of 5 and 10 percent. (\$600 was a middle-class income, probably more than twice the average annual income of adult males at the time.)

9. The highest tariffs were imposed on manufactured goods, particularly on metals and metal products, cotton textiles, and certain woolen goods; on many of these items the rate of tax was as high as 100 percent.

10. Also supporting tariffs were bond holders of the Union government. The tariffs provided the revenues to repay them, and did so without substantially increasing their tax burden. Supportive as well were American bankers interested in facilitating the flow of European capital to America. They appreciated how the tariff paid off the public debt to Europeans and helped conserve foreign exchange.

11. The Congressman was Warren Worth Bailey, a single-taxer from Pennsylvania. For a discussion of Bailey's role and, more generally, of the sources of the Revenue Act of 1916, see W. Elliot Brownlee, "Wilson and Financing the Modern State: The Revenue Act of 1916," Proceedings of the American Philosophical Society 129 (1985), 173-210.

12. In agreement were many prominent professional economists. Led by Edwin R.A. Seligman of Columbia University, they advocated consumption taxes and mass-based income taxes, arguing that they would fight inflation and promote investment. For the economists, resistance to "excess-profits" taxation provided them with an opportunity to continue their effort, begun during the 1880s and 1890s, to win the confidence of the business community by attacking extreme policies of redistribution and by championing "scientific" reform programs as against the radical proposals made by "amateur" economists. The debate over excess-profits taxation marked the first time large numbers professional economists engaged in the discussion of national fiscal policy. 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 Supple, eds., The State and Economic Knowledge: The American and British Experience (Cambridge, England: Cambridge University Press, forthcoming 1990).

13. For analysis of the Wilson administration's full program of war finance, including borrowing, see W. Elliot Brownlee, "Social Learning and Political Investigation in the Financing of World War I," in Michael J. Lacey and Mary O. Furner, eds., The State and Social Investigation, forthcoming.

14. Hugh Heclo, "The State and America's Higher Civil Service," Paper delivered at Wilson Center Conference on the Role of the State in Recent American History, October 23-24, 1982.

15. Roosevelt, respecting the strength of the opposition, decided not to veto the unpalatable bill. Instead, he allowed the Revenue Act of 1938 to become law without his signature and denounced the Act as the "abandonment of a important principle of American taxation"--taxation according to ability to pay. In 1939, Congress eradicated the undistributed profits tax and formally cancelled New Deal tax reform.

16. Their contributions to the international arrangements that structured the post-World War II economy (the Marshall Plan, the Bretton Woods agreements, etc.) are well known. Unknown and previously undocumented, however, is their crucial contribution to the American strategy for financing World War II.

17. Assistant Secretary of the Treasury Richard Darman described this as "tax populism." See Robert G. Darman, "Populist Force Behind Tax Reform Suggests Future Culture Shifts," Financier, X (December, 1986), 23-32, and "Beyond Tax Populism," Society, 24 (September/October, 1987), 35-38.

IGS Working Papers

(\$2.50 each plus tax)

1990

- 90-15 Thermidor In Land Use Control?, Paul van Seters
90-14 Taxation For a Strong and Virguus Republic: A Bicentennial Retrospective W. Elliott Brownlee
90-13 How the Cases You Choose Affect the Answers You Get: Selection Bias in Comparative Politics, Barbara Geddes
90-12 Counterfactuals and Hypothesis Testing in Political Science, James D. Fearon
90-11 Pat Crashes The Party: Reform, Republicans, and Robertson, Duane M. Oldfield
90-10 The Acquisition of Partisanship by Latinos and Asian-Americans: Immigrants and Native-Born Citizens, Bruce E. Cain, D. Roderick Kiewiet, Carole J. Uhlaner
90-9 New Perspective on the Comparative Method, David Collier
90-8 California Agency Reconnaissance Project: Teaching Public Administration Through Field Research, Todd R. La Porte and David Hadwiger
90-7 Earthquake Safety For New Structures: A Comprehensive Approach, Stanley Scott
90-6 Government Policies And Higher Education: a Comparison of Britain and the United States 1960 to 1860, Sheldon Rothblatt and Martin Trow
90-5 Dominance and Attention: Images of Leaders in German, French, and American TV News, Roger D. Masters Siegfried Frey, and Gary Bente
90-4 Nonverbal Behavior and Leadership: Emotion and Cognition in Political Information Processing, Roger D. Masters and Denis G. Sullivan
90-3 The Dredging Dilemma: How Not to Balance Economic Development and Environmental Protection, Robert A. Kagan
90-2 Turning Conflict Into Cooperation: Organizational Designs for Community Response in Disaster, Louise K. Comfort
90-1 The Effect of Campaign Spending, Turnout, and Dropoff on Local Ballot Measure Outcomes and The Initiative and California's Slow Growth Movement, David Hadwiger

1989

- 89-27 On Campaign Finance Reform: The Root of All Evil is Deeply Rooted, Daniel Hays Lowenstein
89-26 Toward A Dispersed Electrical System: Challenges to the Grid, Jane Summerton and Ted K. Bradshaw
89-25 Top Bureaucrats and the Distribution of Influence in Reagan's Executive Branch, Steven D. Stehr
89-24 Designing an Emergency Information System: The Pittsburgh Experience, Louise K. Comfort
89-23 Learning From Risk: Organizational Interaction Following the Armenian Earthquakes, Louise K. Comfort
89-22 The Elusiveness of Rural Development Theory and Practice: Domestic and Third World Perspectives Joined, Ted K. Bradshaw
89-21 Saints and Cardinals in Appropriations Subcommittees: Academic Pork Barreling and Distributive Politics in an Era of Redistributive Budgeting, James D. Savage
89-20 The Case for Experiential Knowledge, Gene I. Rochlin
89-19 Choice vs. Control: Increasing Organizational Effectiveness in Interdependent Environments, Louise K. Comfort and Keun Namkoong
89-18 Bingo! An Untapped Revenue for California Cities, William B. Rumford, Jr. and Randy H. Hamilton

89-17 The Research on Higher Education Program: An Appreciation of Eskil Bjorklund, Martin Trow

89-16 Santa Cruz County Planning Issues: Papers on Planning, Housing And Forestry, Edward J. Blakely and Ted K. Bradshaw

89-15 Why Pretend One Size Fits All: An Examination of Management Issues That Concern Small Federal Agencies, Randy H. Hamilton

89-14 Music of the Squares a Lifetime of Study of Public Administration, Herbert Kaufman

89-13 Technology and the Future: Issues Before the Bush Administration, Edward Wenk, Jr.

89-12 How Much Does Law Matter? Labor Relations in Rotterdam and U.S. Ports, Robert A. Kagan

89-11 Party, State and Ideology in the U.S. House of Representatives, 1967-76, K. G. Armstrong

89-10 Ernst Fraenkel Lecture, Free University of Berlin the American Election of 1988: Outcome, Process and Aftermath, Nelson W. Polsby

89-9 The Ambiguous Status of Science and Technology in Australia, Anthony Pecotich and Kelvin Willoughby

89-8 1992, European Integration and *The Times*, David Morgan

89-7 American Higher Education: "Exceptional" or Just Different?, Martin Trow

89-6 American Higher Education: Past, Present and Future, Martin Trow

89-5 The Distribution of Academic Earmarks in the Federal Government's Appropriations Bills, FY 1980-1989, James Savage

89-4 London 2001, Peter Hall

89-3 The University of London: An American Perspective, Eugene C. Lee, Frank M. Bowen

89-2 Ukiah, 1904: A Modest Footnote to the History of the Council-Manager Form of Municipal Government in the United States, Randy H. Hamilton

89-1 American Identity and the Politics of Ethnic Change, Jack Citrin, Beth Reingold, Donald P. Green

1988

88-27 Locality and Custom: Non-aboriginal Claims to Customary Usufructuary Rights as a Source of Rural Protest, Louise Fortmann

88-26 Bruce Keith's Almanac: Patterns of Voting in California, Bruce Keith

88-25 Cold Turkeys and Task Force: Pursuing High Reliability in California's Central Valley, Todd R. La Porte and Ted Lasher

88-24 Environmental Ethics in California, Carolyn Merchant

88-23 Crisis as Opportunity: Designing Networks of Organizational Action in Disaster Environments, Louise K. Comfort

88-22 The Logic of Uncertainty: Interorganizational Coordination in International Disaster Assistance, Louise K. Comfort

88-21 Information Networks in International Disaster Assistance, Louise K. Comfort

88-20 The Decay of Federal Theory, S. Rufus Davis

88-19 Inside Japan's Leviathan Decision-making in the Government Bureaucracy Brian Woodall and Nobuhiro Hiwatari

88-18 Technology and Adaptive Hierarchy: Formal and Informal Organization for Flight Operations in the U.S. Navy, Gene I. Rochlin and Energy Resources Group

88-17 **From Crisis to Community: The 1988 Oil Spill in the Pittsburgh Metropolitan Region**, Louise Comfort, Joel Abrams, John Camillus and Edmund Ricci et al.

88-16 **The Arrogance of Optimism**, Martin Landau, Donald Chisholm

88-15 **American Democracy in World Perspective and What to Do About It**, Nelson W. Polsby

88-14 **Modernization of the U.S. Senate**, Nelson W. Polsby

88-13 **The Iowa Caucuses in a Front-loaded System: A Few Historical Lessons**, Nelson W. Polsby

88-12 **The Reagan Presidency After Seven Years**, Eugene C. Lee (moderator)

88-11 **The United States Air Traffic System: Increasing Reliability in the Midst of Rapid Growth**, Todd La Porte

88-10 **Issues in Rural and Small Development, Case Study: Watsonville, Santa Cruz County California**, Trish Ramos, Lakshmi Srinivas, Miriam Chion, Ana Lopez, Harry Hecht, Chris Broughton, Robert Murray

88-9 **White Reactions to Black Candidates: When Does Race Matter?**, Jack Citrin, Donald Philip Green, David O. Sears

88-8 **Are Chicanos Assimilating?**, Jorge Chapa

88-7 **California Agency Reconnaissance Project Reports**, Todd R. La Porte, David Hadwiger, Steven Stehr

88-6 **Do You Have To Be Crazy To Do This Job? Causes and Consequences of Job Satisfaction Among Local Legislators**, Edward L. Lascher Jr.

88-5 **American All-mail Balloting: A Summation of a Decade's Experience**, Randy H. Hamilton

88-4 **Corporate Campaign Spending and Initiative Outcomes in California**, Tom E. Thomas

88-3 **Research Applications: Perspectives on the California Seismic Safety Commission**, Stanley Scott

88-2 **Earthquake Engineering and Public Policy: Key Strategies for Seismic Policy**, Stanley Scott

88-1 **What Do Decision Models Tell Us About Information Use?**, Evert A. Lindquist

1987

87-7 **The Politics of the AIDS Vaccine or How the California Legislature Searched for the Magic Bullet—And Wound Up Squabbling With the Trial Lawyers, the Budget-Cutters, and the Alzheimer's Establishment**, David L. Kirp and Hugh Maher

87-6 **The Reagan Presidency After Six Years**, Eugene C. Lee (moderator)

87-5 **A Critical Theory of Community**, Dennis J. Coyle

87-4 **The Reluctant Revival of Landowner Rights**, Dennis J. Coyle

87-3 **Informal Pluralism and LDP Guidance—Examination of Japan's Protectionism of Raw Silk Importation**, John Q. Zhao

87-2 **Towards a Typology of New Subnational Governmental Actors in International Relations**, Ivo D. Duchacek

87-1 **The Rocky Road to Privatization**, Lyle C. Fitch

SEND ORDER TO:
Institute of Governmental Studies
102 Moses Hall
University of California
Berkeley, CA 94720
(415) 642-5537

**PLEASE PRE-PAY ALL ORDERS
UNDER \$30:** checks payable to The
Regents of the University of
California.
SALES TAX: California residents add
sales tax.
HANDLING AND SHIPPING: add
20% of sales price. Allow 4 weeks for
delivery.

Please add my name to the *PAR* mailing list (free). _____
TITLE _____ **QUANTITY/COST** _____

SUBTOTAL _____
SALES TAX _____
HANDLING (20%) _____
TOTAL _____

NAME _____
ADDRESS _____

CITY _____ **STATE** _____ **ZIP** _____

U.C. BERKELEY LIBRARIES



C098094840