

Federal taxation in America

*A short history
Second edition*



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Introduction: Taxation and national emergencies

Since the late 1970s, radical reform of the federal tax system has been a matter of serious discussion. And that discussion has prompted important changes in the tax system. Of particular note were the reforms that President Ronald Reagan engineered. These amounted to the most significant changes in federal tax policy in peacetime since the New Deal of President Franklin Roosevelt. The so-called Reagan Revolution, however, did not abandon the income tax that had been crafted during World War II. Indeed, the Reagan administration actually increased the capacity of the income tax for raising revenue. But in the 1990s, other powerful conservatives, led by Newt Gingrich and the congressional architects of the “Contract with America,” began calling for eradicating the income tax and replacing it with either a national tax on consumption or a “flat tax.” In 2002, president George W. Bush joined those voices by proposing a broad tax on consumption that would take the place of the progressive income tax. In 2003, in response, Congress enacted tax cuts that may have initiated the shift of federal finance toward a system of consumption taxation.

As part I of this book suggests, there would be nothing extraordinary about the emergence of a new tax regime—that is to

say, a system of taxation with its own characteristic tax base, rate structure, administrative apparatus, and social purpose. The United States has had five such regimes since the founding of the republic. There would be nothing new, either, about such a shift beginning gradually. For example, the adoption of a tax regime based on income taxation had its origins in a long period of political agitation and legislative experimentation. Even the 1913 ratification of the Sixteenth Amendment to the Constitution, which provided a constitutional basis for income taxation, and the adoption of income-tax legislation in that same year, did not produce a dramatic change. The income tax was a highly tentative experiment until 1916, when America prepared to enter World War I and settled on it as the primary means of raising taxes for the war.

What would be without precedent, however, is a decisive shift to a new tax regime in the absence of a national crisis or emergency. The moments of sweeping change in tax regimes have come invariably during the nation's great emergencies—the constitutional crisis of the 1780s, the three major wars, and the Great Depression. Thus, on the one hand, the history of American taxation is not encouraging for reformers who would seek a new regime in periods of political stability, peace, and prosperity. On the other hand, history suggests that American political leaders have been creative and resourceful, capable of embracing drastic changes in the federal tax system if the right political and economic circumstances converge. Further, the meaning of “crisis” is, to a large extent, in the eye of the beholder. Many conservatives, for example, believe that the nation is experiencing a long-term crisis of confidence in government that compels a reconstruction of public institutions, including instruments of taxation. Perhaps the tax cuts that the Bush administration engineered in 2001, 2002, and 2003 will turn out to be the first steps in the adoption of a new tax regime.

The need to understand the sources of this conservative reconstruction, its potential significance, and the likelihood of it

succeeding were very much on my mind as I revised the first edition of this book. Consequently, in this second edition, I have significantly expanded the coverage of the past twenty-five years. To do this, I have added part II, in which I seek to connect contemporary tax issues, and especially the prospects for fundamental tax reform in the twenty-first century, with the earlier history of tax regimes in America.

The core of this book, however, remains part I. It seeks to explore the association between the growth of government since the early republic and the history of federal taxation. The association has been close, just as conservative critics of the federal tax system have perhaps suspected. Part I examines the political, economic, and intellectual underpinnings of American tax regimes to help explain the enormous growth of the federal government, which, like the development of taxation, has hinged on the nation's great crises.

The history discussed in part I turns on the government's need for vast new revenues to meet national emergencies. These crises invariably forced political leaders to reexamine thoroughly the nation's financial options. In so doing, those leaders faced issues that went far beyond the financial problem of meeting demands to increase government spending. The great crises—each of which involved the meaning or survival of the nation—stimulated debate over national values. At the same time, each of the great crises intensified ideological and distributional divisions within American society. Because wars required the sacrifice of lives as well as treasure, they were especially powerful stimulants of social division. The resulting political conflicts often centered on issues of taxation; tax politics was always an important vehicle for the expression of both national values and the underlying social and ideological conflicts that the emergencies only intensified.

Within the economic and social turbulence of each crisis, the political leaders in the executive and legislative branches of the

federal government struggled to establish coherent tax policies. On the whole, the crisis conditions strengthened the power of these leaders, and the tax systems they implemented further enhanced their influence. Political leaders mobilized party government and administrative techniques, including professional expertise, to expand the capacity and productivity of the federal tax system. To be sure, there was always tension between executive and legislative leaders over tax policy, and both the president and Congress had to address the demands of local interests. But during the Civil War and World War I, the common partisan loyalties and shared social values of the nation's political leaders largely overcame the pressures that tended to fragment American government. Consequently, during those two emergencies, the nation's political leadership created tax regimes with a high degree of coherence and intention.

Tension between the executive and the legislative branches intensified during the 1920s and once again during the late 1930s. The demands of local interests on the federal government also increased during these same periods. Consequently, the administration of Franklin D. Roosevelt found it more difficult to shape the new tax regimes demanded by national emergencies than had the administrations of Abraham Lincoln during the Civil War and Woodrow Wilson during World War I. But appeals to party loyalty worked to Roosevelt's advantage, and he proved resilient in forging coalitions both inside and outside the federal government. As a result, the two tax regimes produced by the New Deal and World War II bore the imprint of his administration more than that of Congress, and the imprint of a national interest more than that of local interests.

Within the conflicted politics of each of the emergencies, the leaders of the federal government worked to persuade Americans to accept new taxes. During wartime, the architects of national mobilization made taxation part of larger strategies of persuading

Americans to accept sacrifice. In the Civil War and each of the two world wars, they crafted new tax programs designed both to implement sacrifice and to convince the mass of taxpayers that their sacrifices were fair. In the process, the new tax systems acquired the symbolic function of expressing the goals of the federal government. The high-tariff system of the Civil War, for example, came to represent the federal government's commitment to create a powerful national market and to protect capitalists and workers within that market.

To help make the case for fairness, the nation's political leaders experimented with progressive income taxes during the Civil War and then introduced them on a grand scale during the two world wars. The adoption of progressive taxes during those two wars took into account and exploited powerful impulses, stimulated by the forces of democracy and industrialization, for a restructuring of American society. As a consequence, both wars produced major advances in the cause of progressive taxation at the same time that they broadened the social and financial base for funding warfare and other purposes of the federal government.

During World War I, progressive impulses were so strong that the framers of tax policy launched major initiatives that were designed to tax capital and to democratize production and finance. The most radical initiatives—most notably, the rigorous taxation of corporate excess profits—did not survive the postwar reaction of the 1920s, but they continued to influence tax policy until World War II, when the requirements of unprecedented mobilization and the fear of postwar depression led the framers of progressive tax measures to focus on the taxation of the much larger base of salaries and wages, rather than that of rents, interest, and profits.

The tax regimes of the two world wars did not produce a social revolution. But they did establish tax policy that was far more progressively redistributive than it had been before World War I, and they did establish a responsibility for the federal government

to redistribute income according to ideals of social justice. These regimes became a powerful expression of the democratic ideals of the nation.

The social tensions—tensions of class and section—created by industrialization might have led the nation eventually to adopt progressive income taxation even in the absence of war. But historical contingency played a powerful role. The wartime mobilizations and the fact that both mobilizations were managed by the leadership of the Democratic Party—which was more strongly committed to progressive income taxes and more opposed to regressive taxes on consumption than the Republican Party—accelerated the process. In addition, by contributing to the resolution of wartime social crises, the emergency-driven tax policies acquired a legitimacy and cultural force that sustained them well after the emergencies were over.

The opportunity to establish new taxes provided policy architects with openings to modernize the tax system, in the sense of adapting it to new economic and organizational conditions and thereby making it a more efficient producer of revenue. No process of “modernization” closely dictated the selection of options. But in each crisis, policymakers discovered that the organizational maturing of industrial society had created a new menu of feasible options. For example, because of the prior development of financial accounting for the management of large corporations and the collection of Social Security payroll taxes, during World War II the federal government was able to establish a broad-based income tax—one that reached wages and salaries as well as the income from capital. Exploiting the new tax options during each emergency provided a structure and an administrative apparatus that allowed the federal government to capitalize effectively on postcrisis economic expansion.

By creating instruments of taxation that had acquired an independent legitimacy and were administratively more robust, each

crisis opened up new opportunities for proponents of expanded government programs to advance their interests after the emergency was over. Postwar leaders were able to forge new expenditure programs—both direct and indirect—without incurring the political costs associated with raising taxes or introducing new ones. The popularity of the expenditure programs, in turn, reinforced the popularity of the tax system behind the programs. Thus, the crisis-born enhancement of tax capability contributed to the much-discussed “upward ratchet” effect that emergencies had on government spending.

Each new tax regime drew political strength from the fact that it increased not only the federal government’s size but also its centralization. The relative growth of federal taxation was most rapid during the five national emergencies. To some extent, the expansion of federal taxation undercut the tax base of state government. But the federal government offset this and won state and local support for its tax regimes by assuming part of the burden of financing public services from states and localities after the crisis, and by finding ways to expedite the levying and collecting of state and local taxes. In the process, the federal government often also contributed to the centralization of taxation *within* states.

Indirect expenditure programs were particularly important to the political survival of new tax regimes after national emergencies. These indirect programs, which are now known as “tax expenditures,” were networks of privileges—deductions, exemptions, and credits—within the tax code. They resulted from the resurgence of local interests after the emergencies. These programs reduced tax bases and often made rate structures less progressive. But they left intact the fundamental intent of the emergency tax regimes. In fact, they provided significant political protection to the new regimes.

The survival of each emergency-born tax system in the post-crisis era lent the nation’s tax system an increasingly layered, or

diversified, quality. Each new regime preserved important elements of its predecessor—elements that had survived earlier postcrisis political tests. Thus the World War II system contained not only the features that lent it distinction but also those that it had inherited from the Civil War, World War I, and Great Depression regimes.

In the absence of a new national emergency, the systems of the early republic, the Civil War, World War I, and the New Deal might have survived much longer. Each of them produced adequate revenues to fund expansive postcrisis programs. Each of the systems faced substantial criticism, but in each instance political leaders developed successful strategies, including compromises on tax policy, for preserving the regime. Nonetheless, each tax system proved inadequate—both politically and economically—to meet the fiscal demands of a subsequent national emergency, and each gave way to a new system.

In the absence of a new national emergency, the World War II tax regime remains in place today. To be sure, during the 1980s, the federal government embarked on significant tax reform. But ironically enough, the reforms, which were part of the “Reagan Revolution,” turned out to strengthen the World War II tax regime. Reagan’s successors, George H. W. Bush and Bill Clinton, did not advance the reforms, but they also—largely through tax increases—enhanced the fiscal capacity of the World War II regime.

President George W. Bush, however, has launched a program that purports to have begun comprehensive reform of the nation’s fiscal system, including taxation. His approach has been incremental, and his accomplishments are as yet limited, but his ambition is sizable and he may be able to carry his program further. For President Bush to have a chance of finishing this job, however, the nation may have first to pass through an episode of extreme fiscal stress. Such an episode could materialize if the Bush tax cuts turn out to have made the tax system inadequate to meet the economic challenges facing the nation during the twenty-first century. But the outcome

of such a crisis may disappoint conservative forces. The new regime might turn out to be rather different from the kind of regime the Bush administration would favor. The history of federal taxation in America may provide some guidance regarding the likely nature of a new tax regime.