"John Bull troubled with the Blue Devils." So read the caption on this 1799 cartoon. Britain, like other European nations, had enacted an income tax to pay for the war against Napoleon. It was a turning point: the "temporary" levy on income became permanent.

The Politics of Taxation

During the 1980s, taxes have been America's Number One domestic political issue. The decade began with Ronald Reagan slashing taxes. It ends with George Bush pledging "no new taxes" in the face of clamor over unprecedented U.S. peacetime budget deficits. More is involved than dollars and cents. Throughout history, debates over taxes have set off larger controversies not only over the *size* of government, but also over its purposes. In Europe, as Carolyn Webber notes below, new taxes imposed between the 13th and 18th centuries helped monarchs forge the modern nation and wage wars. U.S. and Western European taxes now finance the welfare state. Since early in this century, as W. Elliot Brownlee shows, Americans have opted for mild "soak the rich" levies to redistribute wealth. Today, as Congress ponders ways to close the budget gap, further "leveling" of incomes through taxation is out; pragmatic "revenue initiatives" are in. That shift may be the chief political legacy of the early 1980s.

PLUCKING THE GOOSE

by Carolyn Webber

The art of taxation, wrote Jean-Baptiste Colbert, an adviser to France's Louis XIV, "consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."

Over the centuries, each European government has found a different way to pluck the goose. Today, in Italy, where evading income taxes is practically a national pastime, the government relies heavily on automatic payroll deductions; in West Germany, bureaucrats calculate the amount of income tax each citizen owes at the end of the year, and the Germans dutifully pay up.

Until the 20th century, taxation had only two functions; to underwrite the day-to-day workings of government, and to finance warfare and standing armies—by far the greatest expense of government until recent times. During this century, especially since World War II, tax burdens have grown dramatically, and taxation has acquired two new uses: "stabilizing" domestic economies and redistributing income through the welfare state.

Whether they have been extracted by brute force, as they frequently were until recent centuries, or with the acquiescence of taxpayers, taxes have long been a lightning rod for conflict over the nature of society—who will pay? for what purposes? The answers keep changing. As England's Edmund Burke observed in 1774, "To tax and to please, no more than to love and be wise, is not given to men."

The first taxpayers probably were the people of ancient Mesopotamia, who, some 5,000 years ago, began making gifts of grain and livestock to temple priests, hoping to win the favor of the gods. In time, as priests became priest-kings and the temple bureaucracies expanded, the "gifts" became compulsory. By the mid-2nd millennium B.C., royal bureaucrats in Egypt and Mesopotamia were collecting taxes at regular intervals. Those too poor to pay in grain or livestock paid with their labor, erecting the Pyramids and other great monuments of antiquity.

In Egypt, as in most lands throughout history, the poor paid the taxes; the privileged classes were exempt. In Athens during the Golden Age of Pericles (mid-5th century B.C.), free citizens, rich or poor, were not subjected to the indignity of paying "direct" head or property levies. While everybody payed indirect taxes (e.g., customs duties and sales taxes) only prostitutes, resident foreigners, and other lowly sorts paid direct taxes. But, in an ancient version of "privatization," each wealthy Greek was expected to take his turn providing governmental services: outfitting a ship for the navy, erecting a temple, or sponsoring a public festival. These liturgies (from *liturgos*, or public service), like philanthropy nowadays, conferred honor upon the donor.

Later, during the Peloponnesian Wars (431–404 B.C.), Athens adopted a progressive tax on wealth called the *eisphora*. ("Progressive" taxes impose rates that increase with income or wealth. "Proportional" taxes, levied at a flat rate, force the wealthy to pay more than others, but less than they would under progressive rates.) Isocrates, an Athenian rhetorician, later complained that taxes on the rich "cause so much vexation that property owners lead a harder life than utter paupers."

When the Romans overthrew the Athenian empire in 197 B.C., they adopted the liturgies, which the Romans called *munera*. Along with the tributes paid by various conquered peoples, the *munera* allowed the Roman Senate to abolish land and personal taxes on Roman citizens in Italy in 167 B.C.

As Rome's bureaucracy and army grew, however, the emperors were compelled to reimpose taxes. Emperor Augustus assessed death duties and a sales tax in 6 A.D. (It was Augustus' comprehensive tax census of the Roman Empire, which required all subjects to return to their native cities, that brought Joseph and Mary to Bethlehem.) His successor, Tiberius, refused to raise taxes, declaring that "the subjects should be sheared but not shaved." Later emperors were not so restrained.

By the 4th century, the Roman Empire was disintegrating under the pressure of civil war, corruption, and barbarian invasions. Roman subjects were fleeing the cities of Gaul and Italy, seeking refuge as much from the desperate emperors' tax collectors as from the Goths and other barbarians. The refugees, along with impoverished farmers, offered their labor to powerful local landowners, surrendering their liberty for security. "These wretched people . . . seek exile . . . for the enemy is more lenient to them than the tax collector," alleged Salvian the Presbyter, an early Christian priest. The Romans "extort tribute from the poor . . . the weaker carry the load for the stronger." As the descendants of the Roman freeholders became tied to the land, medieval serfdom emerged.

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Collecting taxes the old-fashioned way. Hieroglyphics found on the tomb beneath this Egyptian carving (circa 2500 B.C.) read: "Seizing the town rulers for a reckoning."

By the late 8th century, when Viking invasions impelled landowners in parts of Western Europe to band together under the leadership of weak kings, regular taxes had long since vanished. Every king under the nascent feudal order was required to "live off his own"—the surplus produced by his scattered estates. According to historian Marc Bloch, medieval kings "positively killed themselves by travel." England's King Edward I logged 1,300 miles during one 14-month period during the late 13th century. As the king traveled from one estate to another, however, his vassals were obliged to extend hospitality, which, depending on the length of the royal visit, often amounted to a substantial de facto tax.

On special occasions—when his daughter married or his son was knighted—the king could also command a special *aid* from his vassals. They were also expected to supply troops for the king's army. But the king had no other taxing power and frequently lived hand to mouth.

When Europe's kings embarked on the Crusades during the 12th century, they suddenly needed cash to meet the expense of shipping their armies across the Mediterranean to the Holy Land. They asked their pious subjects to pay special *aids*; these were medieval Europe's first royal money taxes. Once their subjects had paid, the kings could ask again—and again.

Even at this early date, the emerging nations of Europe were embarking on different courses. In England, a council of noblemen, angered by the ever-increasing *aids*, forced King John I to sign a charter in 1215 limiting, among other things, his power to tax. "No . . . aid shall be imposed . . . except by the common council of our kingdom . . . and it shall be only a reasonable aid," declared the Magna Carta. In France, by contrast, kings were able to impose some money taxes (notably the *taille*, a head and property tax) while avoiding such permanent checks on their power: They simply exempted nobles (and the clergy) from most direct taxes, leaving peasants and merchants to bear the ever-increasing burden of supporting government. By the time of the Revolution, peasants and middle-class merchants in some areas of France were surrendering up to half of their income to Versailles.

An expanding economy, generating enough surplus for the state to skim, has always been essential to increasing revenues. Thus, it was the flourishing city-states of Renaissance Italy—Siena, Lucca, Prato, Florence, and several others—that ushered in modern taxation during the 13th and 14th centuries. Moreover, Siena and its sister cities were self-governing republics; with the notable ex-

ception of the United States, it generally has been easier to impose high taxes in lands where citizens give their consent. "In constitutional states," Montesquieu observed in 1748, "liberty is compensation for the heavy taxation; in despotic states the equivalent of liberty is light taxes."

Constantly at war with one another, and thus always in need of greater revenues, the city-states imposed sales and production taxes on "all but air and water"—clothing, salt, grain, bread, meat, wine, and all imports. In a few cases, the Italian communes invoked modern notions of fairness. Thus, the city fathers of 13th century Siena imposed a property tax on land and personal assets "so a greater equality will be maintained among the citizens." Anticipating the modern income tax, the Italian communes also tried, without much success, to tax the earnings of soldiers, city officials, and professional men.

"There is no art which one government sooner learns of another," Adam Smith noted five centuries later, "than that of draining money from the pockets of the people." Shrewdly assessing their subjects' tolerance, the kings of Europe imposed an increasing burden of new Italian-style taxes after the 15th century. The growing frequency and cost of war between the 15th and late 18th centuries kept up the pressure for more revenues. Money, observed Colbert, King Louis XIV's finance minister, "is the vital nerve of war."* Huge mercenary armies had replaced the tiny fighting forces of the Middle Ages: 100,000 to 200,000 men fought in the Thirty Years' War (1618–1648); 450,000 to 500,000 in the War of the Spanish Succession (1701–19). When Oliver Cromwell governed England (1653–1658), he kept its navy at sea for months on end to prevent the unpaid sailors from jumping ship.

"The post-1450 waging of war," writes historian Paul Kennedy, "was intimately connected with 'the birth of the nation-state'.... Most European countries witnessed a centralization of political and military authority . . . accompanied by increased powers and methods of state taxation, and carried out by a much more elaborate bureaucratic machinery than had existed when kings were supposed to 'live off their own' and national armies were provided by a feudal levy."

Throughout Europe, tax was piled upon tax. When mercantilist writers such as Antoyne de Monchretien in France and Thomas Mun in England argued (as do policymakers in Japan and Third World countries today) that protectionist tariffs fostered internal economic development, revenue-hungry leaders from England to Russia seized on the idea to justify new customs duties. After all, it was thought, the burden would fall upon foreigners, not citizens.

From the 17th century on, Europe's rulers also imposed a proliferating variety of indirect taxes on goods and services traded in domestic markets. Rich and poor alike paid taxes on food (sugar, spices, grains, meat, malt, vinegar) and drink (cocoa, wine, cider, beer, ale, coffee, and tea)—virtually everything, in fact, from coal and soap to the whalebone used in corsets. When Cromwell and the Puritans governed England, they seized the estates of nobles and imposed excise taxes on wigs, playing cards, and other luxury goods.

Despite such luxury taxes, indirect imposts burdened the poor far more than the rich. Yet, at the time, they were considered equitable. Making the case for a duty on

*Colbert said "money," not "taxes," because monarchs had several other ways to raise cash: plundering conquered lands, debasing the national currency, or borrowing from private financiers. England's Bishop Berkeley remarked during the 18th century that the government's ability to borrow from the public at large (up to 40 percent of what it spent), rather than from financiers, was "the principal advantage that England hath over France."

salt before Parliament in 1732, Prime Minister Sir Robert Walpole explained: "Every subject contributes something; if he be a poor man he contributes so small a trifle, it will hardly bear a name; if he be rich, he lives more luxuriously, and consequently contributes more." Moreover, the well-to-do, especially the nobility, could not escape the indirect levies.

By the late 18th century, many advisers to the crowned heads of Europe had begun to understand that the poor were greatly overburdened. Turgot, Louis XVI's finance minister during the 1770s, told his master: "The expenses of government, having for their object the interests of all, should be borne by every one, and the more a man enjoys the advantages of society, the more he ought to hold himself honoured in contributing to these expenses."

The French aristocracy disagreed; Turgot was sacked after only two years in office. Reform fared better elsewhere in Europe. In Catherine the Great's backward Russia, as in King Joseph II's Austria and Prussia under Frederick II, peasants were relieved of some feudal obligations and aristocrats were subjected to nominal taxation. Britain remained by far the most equity-minded state.

When the French Revolution broke out in the summer of 1789, an English country squire named Arthur Young was detained while traveling in rural France and accused of being a French nobleman in disguise. He saved his life by climbing the steps of a village inn and telling the peasants of England's fiscal equity:

> Gentlemen, we have a great number of taxes in England which you know nothing of in France.... Every window in a man's house pays, but if he has no more than six windows, he pays nothing. [The window tax was originated by the Romans.] A Seigneur with a great estate pays taxes on land and personal property but the little proprietor of a garden pays nothing. The rich pay taxes for their carriages, and their servants, and even for the liberty to kill their own partridges, but the poor farmer pays nothing of all this. And what is more, we have in England a tax paid by the rich for the relief of the poor.

During the French Revolution, radicals imposed both a window tax (which remained in effect until 1925) and a progressive income tax on the wealthy. Under Napoleon (1799–1815), France derived about one-third of its revenues from levies on income and wealth.

Just as the wars of 15th century Europe transformed the experiments of Italy's city-states into common practice, so the Napoleonic Wars led to the extension of the income tax. The wars disrupted foreign trade and drastically reduced customs revenues; treasury officials throughout Europe realized that new taxes would be needed. There were few alternatives. The Dutch imposed an income tax in 1797; England in 1798, Austria in 1799, the Duchy of Baden in 1808, and Russia in 1812. All were flat-rate taxes, levied on the well-to-do.

They were universally hated. The income tax, said one critic, was "hostile to every sense of freedom, revolting to . . . Englishmen, and repugnant to the British constitution." After Napoleon was exiled to St. Helena in 1815, England and the continental powers (including France) abolished their income taxes.

Ironically, it would be the English, not the heirs of revolutionary France, who would pioneer the modern income tax.

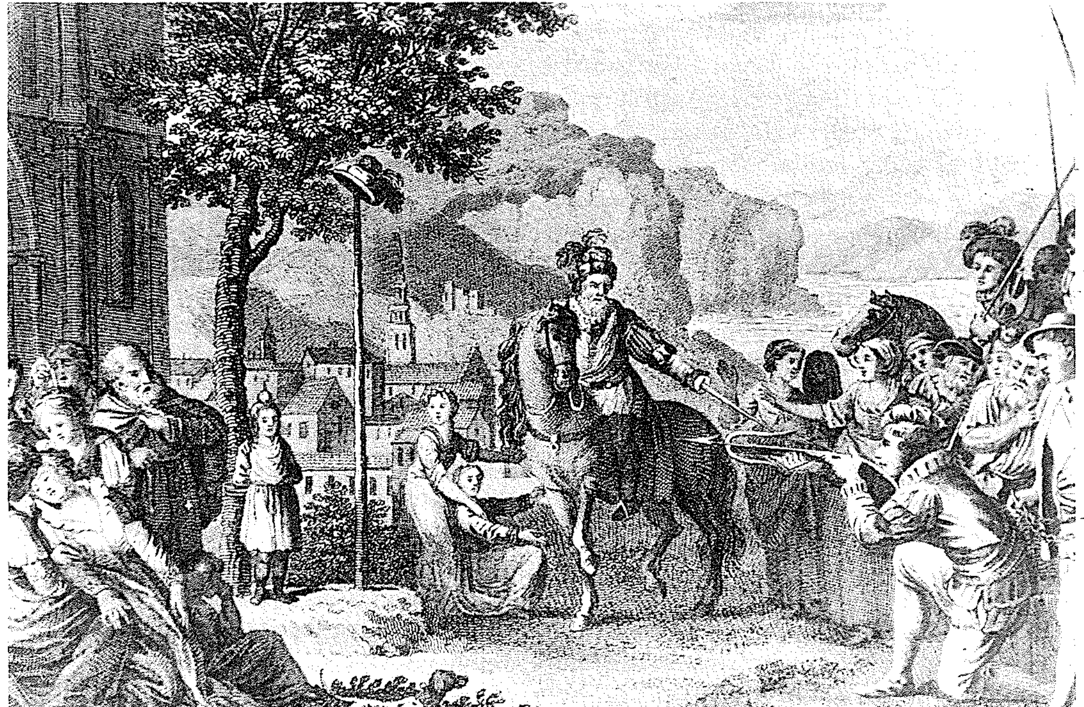
Britain was the dominant power of the era, thanks in no small part to the tax revenues provided by its robust economy. Yet,

the depressions of the 1820s and '30s brought home the evils of the early Industrial Revolution and stirred unrest in the new industrial cities of Manchester and Liverpool. Excise taxes on food and other necessities, along with the Corn Laws, which imposed import duties on wheat to protect the estates of Britain's landed aristocracy, deprived "famishing thousands" of their daily bread.

Out of this dire situation arose one of the most unusual political coalitions in history. After 1820, wealthy merchants and manufacturers joined workingmen's advocates, such as William Cobbett, in demanding the abolition of the Corn Laws and reduction of domestic excises. The workers wanted cheap food; their employers wanted free trade and economic growth. As one group of businessmen from the Anti-Corn Law League put it: "The great bulk of the people, the customers of each other, and of all the other classes, are becoming too poor to purchase, and thus they cease to consume and profits are destroyed." It was, in essence, much like the argument of today's supply-side economists: Lower taxes can improve economic performance.

Popular opinion slowly turned against protectionism. "The real question at issue," stated a report by a parliamentary Committee on Import Duties in 1840, "is, do we propose to serve the nation or particular individuals [i.e. agricultural interests]?"

When free trade advocate Robert Peel was elected prime minister in 1841, he needed a new tax to replace the revenues lost through tariff reduction. His solution: a "temporary" restoration of the Napoleonic War flat-rate income tax. The new manu-



In 1307, according to Swiss legend, William Tell was forced to shoot an apple from his son's head as a penalty for resisting the authority and taxes of Austria. Tell succeeded; his act of defiance sparked a rebellion, which ultimately led to Swiss independence.

facturers of Manchester and Liverpool were among its most fervent backers.

By the end of the century, a new European arms race (e.g., building steel "dreadnought" battleships), along with growing demands for new roads, sewers, and schools in the cities, compelled the Continent to follow Britain's lead.* (Until that time, governments claimed only 3 to 5 percent of gross national product.) By 1900, six European nations had adopted an income tax; three more followed between 1900 and 1910. (The United States did so in 1913.) The rates were very low by today's standards, between 2 and 6 percent, and the poor were exempt. At first, no one thought that more could be collected without causing grave economic damage.

But government expenses kept rising. Progressive taxation, a radical idea once rejected out of hand by mainstream politicians, began to seem both just and feasible. While industrialization raised living standards, it also created a whole new class of super-wealthy industrialists. Growing inequality between owners and workers prompted the leaders of Europe's new labor parties to seek "soak the rich" measures. Their arguments were strengthened by developments in academe. Economist F. Y. Edgeworth and others, citing the new concept of "marginal utility," argued that a $1 tax, for example, subtracted more from a poor man's "utility" than it did from a rich man's.

Britain's first graduated inheritance tax, adopted by a moderate Liberal government in 1894, made progressive taxation respectable. "Even without the pressure of immediate necessity," declared Home Secretary Sir William Harcourt, "it would be a mere act of financial justice to redress inequalities which have too long existed." France, Germany, and Italy adopted progressive income and inheritance taxes soon after the turn of the century. All did so to finance rearmament.

Britain also enacted, in 1908, the first progressive tax intended specifically to *redistribute* income. Needing a way to finance a new old age and sickness insurance scheme which would protect workers already too old to have made contributions to the plan, Prime Minister David Lloyd George, a Liberal, decided that the rich would pay. "I have got to rob somebody's hen roost," Lloyd George explained. "I am on the lookout which will be the easiest to get and where I shall be least punished, and where I shall get the most eggs."

By the beginning of World War I, most of the nations of Europe had adopted the same kinds of taxes, but chose to emphasize different ones. Britain relied heavily on the income tax. In France, direct taxes were still tainted by memories of the *ancien régime*'s abuses; sales taxes and other indirect levies supplied 50 to 60 percent of revenues as late as the 1920s. The Italians relied on direct taxes and on profits from government monopolies in industry and banking. And Germany's government, hampered by restrictions on direct taxation in its 1871 constitution, borrowed heavily during and after World War I. The resulting "hyperinflation" under the Weimar Republic left a legacy of aversion to deficit spending that still guides economic thinking in West Germany.

Germany had been the first nation (in 1871) to create a social insurance program—funded by employee payroll "contributions"—for the elderly and sick. In theory, every worker would pay for the benefits he later collected. (Unemployment insurance was added in 1927.) Britain, France, and Sweden followed the German example. The

*Added pressure came from the relatively new notion of the balanced budget. Until the 19th century, Europe's governments possessed neither unified national budgets nor the ability to forecast reliably the next year's outlays.

Great Depression of the 1930s began the transformation of these social *insurance* programs into social *welfare* programs. As the demand for benefits surpassed worker contributions (except the United States), the programs were increasingly paid for out of general tax revenues.

The Depression also spawned John Maynard Keynes' sweeping revision of economic thought, the *General Theory of Employment, Interest and Money* (1935).

The scale of unemployment during the 1930s convinced Keynes that the cause of the Depression was not, as mainstream economists then believed, excessive wages; it was deficient buying power throughout the economy. For Keynes, and for the economists and policymakers who built on his ideas after World War II, the solution was increased government intervention in the economy. The manipulation of taxes was one method (along with heavy spending on labor-intensive public works). By varying income tax rates and by using tax incentives to spur targeted industries, government would "fine tune" the economies of the West. Increasingly, raising revenue was only one tax goal among many.

Once again, however, each nation shaped its taxes in unique ways.

In Britain, as in the other nations of Western Europe, the very high tax rates imposed during World War II came down only slightly after the war, as political leaders rapidly expanded the welfare state. In Britain, Labor governments favored income redistribution; Conservative governments favored investment incentives. As the two parties alternated in power, each one modified, but did not eliminate its predecessor's changes, and the British tax code became a maze. "No one would design such a system on purpose," writes Anthony King, a British political scientist, "and nobody did."

Britain long ago surrendered its dubious pride of place as the heaviest taxer to Sweden. In 1976, Britons enjoyed the spectacle of Swedish filmmaker Ingmar Bergman fleeing to their country in search of a tax haven! In comparisons among nations, Sweden holds the world record, claiming half of its gross domestic product in taxes.

Surprisingly, corporate tax burdens are light in socialist Sweden—even by U.S. standards. (See charts, p. 84.) And many of the wealthy also escape heavy taxation. The reason: Sweden uses its tax code aggressively to encourage government-approved investments (e.g., in steelmaking or shipbuilding) that promote economic stability. Perhaps because it never experienced the sharp break with feudalism that most of Western Europe did, Sweden is the ultimate "nanny" state. Capital invested "properly" is taxed lightly; investments not deemed to be socially useful (e.g., yachts, private estates, jewelry) are taxed at confiscatory rates. Likewise, while Sweden claims much of its citizens' personal income, it gives much back. In the United States, many government benefits are means-tested; but 75 percent of all Swedes receive some sort of benefit—family allowances, tuition assistance, job training.

West Germany funds a large share of its social welfare outlays, as it did in Bismarck's time, through regressive payroll taxes. Like Sweden, it uses tax incentives to lower certain burdens on the wealthy. Capital gains on stocks and bonds, subject to a tax of up to 33 percent in the United States, are exempt in West Germany—as well as the Netherlands, Belgium, and Japan. (But the United States, virtually alone among Western nations, leaves gains from the sale of one's home, in most cases, untouched.)

In France, one of the most heavily taxed nations in Europe, successive governments after World War II clung to the tradition of

indirect taxation. France adopted a value added tax (VAT), a consumption tax on goods and services, in 1954, more than a decade before the rest of Europe. The French, like other people, have shaped the tax system to reflect their culture. Wine is taxed at a lower rate than mineral water or Coca Cola; a tax on yachts, horses, limousines, and other "signs of wealth" remains as a legacy of the Revolution. "The effect is that on the whole the rich in France are far more discreet than they are in most countries," notes historian Theodore Zeldin.

France has a steeply progressive income tax, but it is easy to evade—there is no compulsory withholding. To collect taxes, note Richard Rose and Guy Peters, officials in France (and Italy) "estimate what they think an individual earns, and wait for the person to accept the figure or bargain for a lower tax assessment. Like buyers and sellers in a used car transaction, tax collectors try to get as much as possible, and citizens to pay as little as possible."

Sweden, alone among European nations, purports to have almost no tax avoidance. The Finance Ministry audits each tax return. If discrepancies are discovered, the auditor consults a local tax board about the suspect's means. The state has a long reach: A small town of 20,000 souls may have 10 or 12 boards, so board members know taxpayers personally.

Long gone are the days when impoverished feudal monarchs traveled through their kingdoms importuning their subjects for revenue. Some economists today wonder whether Western Europe is approaching a ceiling on the taxes that can be extracted to support social welfare spending. Yet, with the exception of Denmark in 1973, no European nation has experienced a "tax revolt" since World War II. Only opinion polls and the growth of Western Europe's "underground" economies testify to popular discontent.

Western Europe has kept a watchful eye on Ronald Reagan's tax reform experiments in the United States. Our massive budget deficits have convinced European leaders not to embrace the supply side arguments used to justify Reagan's 1981 tax cuts. On the other hand, Reagan's 1986 reforms—which reduced individual income tax rates but closed many loophole-creating investment incentives—have attracted much interest and several imitators, notably Britain's Margaret Thatcher. Virtually every Western European nation, along with Japan, has taken at least some modest steps to lower tax rates and broaden the tax base (without lightening the total tax burden) to increase economic efficiency. "The tax reform movement is universal," writes Brookings' Joseph Pechman. Even in the Soviet Union, Gorbachev's proposal for a steep progressive income tax (peaking at 90 percent) on earnings in the infant private sector provoked such loud protests that it was dropped.

But taxes will remain high in Western Europe because Europeans want the security that generous government spending affords. Even in the United States, where the federal tax burden diminished slightly during the Reagan era (as a percentage of gross national product), federal *spending* rose slightly.

In most nations, at most times in history, the argument has been less over *how much* government should tax than *whom* it should tax. Over the millennia, tax burdens have shifted from the very poor to the middle class and the rich. Senator Russell B. Long (D-La.) once summed up the politics of taxation this way: "Don't tax you, don't tax me. Tax that fellow behind the tree."

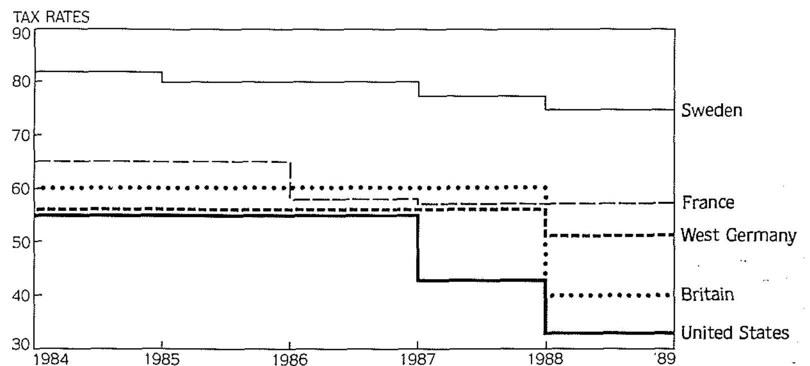
TAX BURDENS AND TAX SOURCES IN 10 NATIONS[1]

	Taxes as a Percentage of GDP	Tax Sources as a Percentage of Total Government Revenues					
		Personal Income	Corporate Income	Payroll	Consumption[2]	Property	Wealth[3]
Sweden	50.5	38.5	3.5	29.1	27.3	0.9	0.7
France	45.6	12.8	4.3	45.7	33.8	2.5	0.8
Netherlands	44.9	19.5	7.0	43.9	26.8	1.8	0.9
Britain	38.1	26.0	12.9	17.5	32.4	10.5	0.6
West Germany	37.7	28.7	6.1	36.5	26.3	1.1	1.3
Italy	34.7	27.4	9.5	35.3	27.7	NA	0.2
Canada	33.2	36.0	8.4	13.3	32.8	8.6	0.9
Australia	30.4	45.1	9.2	5.5	35.5	4.6	NA
United States	**29.2**	**35.7**	**7.1**	**29.4**	**17.9**	**9.1**	**0.8**
Japan	28.0	24.8	21.0	30.2	17.1	5.7	1.2

[1] National, state, and local taxes, 1985. [2] Includes sales, value-added, and excise taxes, tariffs, and miscellaneous levies. [3] Includes wealth taxes and estate, inheritance, and gift taxes.

The tax "mix" (above) varies even more from nation to nation than does the overall tax burden. The differences reflect cultural and political factors. For example, property taxes are heaviest in the United States, Britain, and Canada, where local government is strongest. Despite an international trend toward lower income tax rates (left), sharp differences remain: Sweden's top rate (75 percent) is almost twice Britain's. Tax rates on average factory workers (below) also vary greatly.

REDUCTIONS IN TOP PERSONAL INCOME TAX RATES, 1984–88



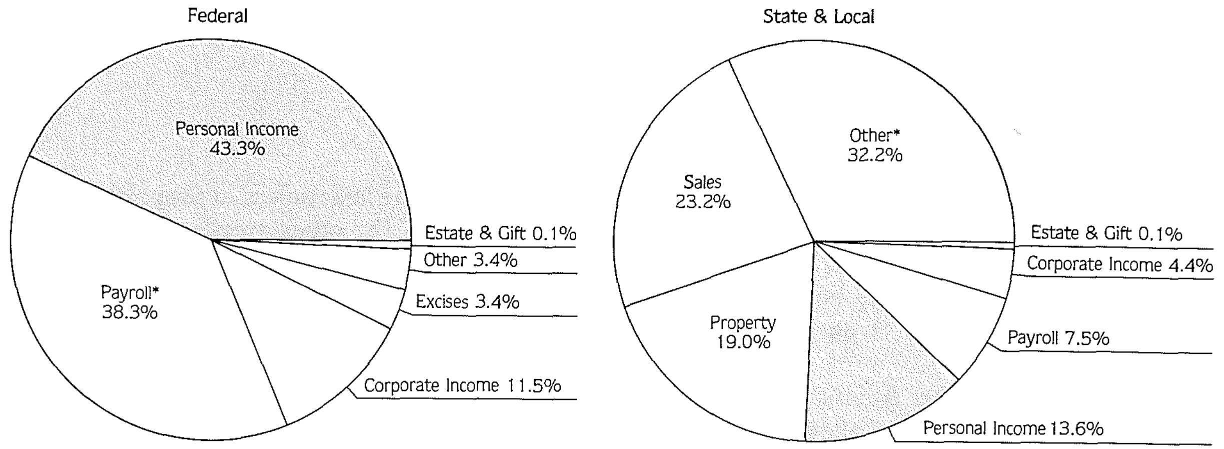
INCOME TAX RATES ON AVERAGE FACTORY WORKERS, 1986*
(As a percentage of gross earnings)

1) Sweden 34.5%
2) Australia 17.5%
3) Britain 17.4%
4) Italy 13.7%
5) United States 12.4%
6) Canada 11.0%
7) Netherlands 8.5%
8) West Germany 8.3%
9) Japan 3.1%
10) France 0%

*Reflects the impact of standard deductions.

Sources: Joseph Pechman, *World Tax Reform* and *Federal Tax Policy*; Organization for Economic Cooperation and Development; U.S. Department of Commerce, Bureau of Economic Analysis; District of Columbia, Department of Finance and Revenue.

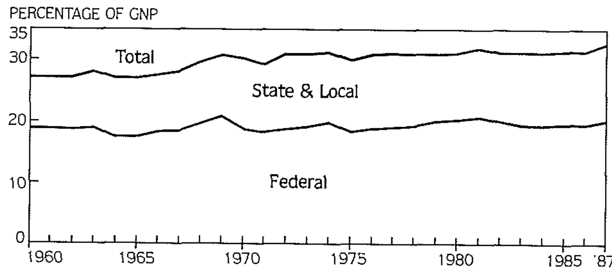
WHERE THE PUBLIC SECTOR'S MONEY COMES FROM:
Federal, State & Local Tax Revenues, 1987



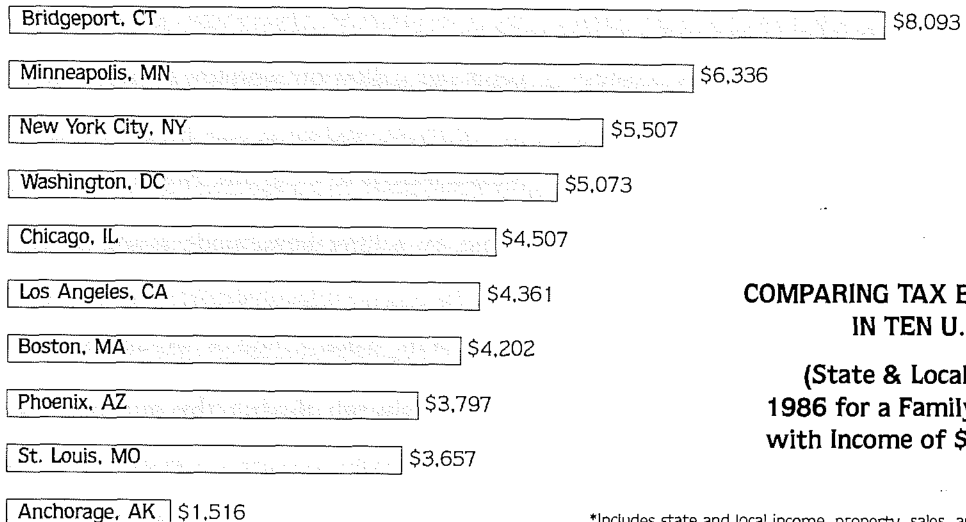
*Chiefly, Social Security contributions.

*Includes license and user fees.

THE GROWING U.S. TAX BURDEN, 1960–87
(Taxes as a percentage of gross national product)



A division of labor: Washington (above) relies mostly on income and payroll levies; the states and localities impose regressive sales taxes, property levies (in effect, wealth taxes), and various fees. Surprisingly, since 1960, the state and local tax bite has grown by 50 percent (to 12.2 percent of GNP), faster than has Washington's. As the chart below shows, large regional contrasts remain. In addition to the taxes shown, the family would pay about $10,000 to the IRS and $3,000 in Social Security contributions.



COMPARING TAX BURDENS IN TEN U.S. CITIES

(State & Local Taxes in 1986 for a Family of Four with Income of $50,000*)

*Includes state and local income, property, sales, and auto taxes.

THE AMERICAN WAY

by W. Elliot Brownlee

"This Destruction of the Tea is so bold, so daring, so firm, intrepid and inflexible, and it must have so important Consequences, and so lasting, that I can't but consider it as an Epocha in History."

So wrote John Adams in December 1773, on the morning after 150 men disguised as Indians tossed the cargo of three tea-laden British ships into Boston harbor. At times since then, the politics of taxation in America has seemed almost like a reprise of the Boston Tea Party.

More than the people of most nations, Americans generally have chosen to rely on the most painful forms of taxation (e.g., direct levies on property and income), keeping the tribute rendered "unto Caesar" at the forefront of public attention. Not only have Americans remained deeply unfriendly to the taxman, but our debates over taxation have been vehicles for defining larger conflicts—between regions and classes, and over the meaning of "equality," "fairness," and "justice."

The nation has, in effect, arrived at three successive sets of responses to these conflicts, fundamentally altering the federal tax system during two of the nation's greatest wars. Today, without a war but with a sizeable military budget, we may be on the verge of a fourth transformation.

The Republic's first tax "system" was the least controversial. The Framers of the Constitution, associating taxes with the abuses of monarchy, severely limited the taxing powers of the new national government. The Constitution specified (in Article 1, Section 9) that "No capitation or other direct tax shall be laid, unless in proportion to the census." In other words, "direct" taxes were to be apportioned among the states, with the most populous states bearing the largest burden. Thus, because it was virtually impossible to devise a formula to satisfy the Constitution, the new national government was effectively denied the power to impose property taxes, then the most common and productive levy.

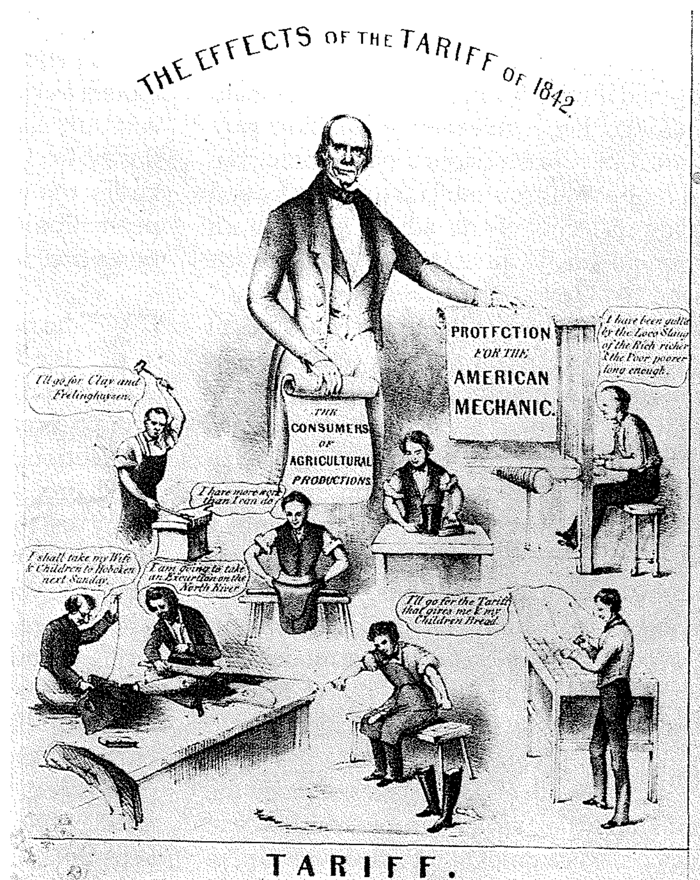
The remaining alternatives were "poll" (or head) taxes and "indirect" taxes, such as tariffs or excises. Poll taxes were out of the question: They had been intensely unpopular in colonial days. Excises were hated just as passionately. They discriminated against the producers whose commodities were taxed, and as Patrick Henry had argued in opposing the Constitution in 1787, they threatened liberty itself: "Suppose an excise man will demand leave to enter your cellar, or house, by virtue of his office; perhaps he may call on the militia to enable him to go."

Nevertheless, at the insistence of George Washington's Secretary of the Treasury, Alexander Hamilton, Congress in 1791 imposed a stiff excise of seven to 18 cents per gallon on whiskey. It was a first-class political blunder. The tax fell chiefly on the frontier farmers, from western Massachusetts to Ohio and North Carolina, who derived much of their meager cash income by selling homemade grain liquor. The first scattered acts of frontier tax resistance began to snowball into a dangerous movement. When a mob of 500 disgruntled farmers sacked the home of a federal agent near Pittsburgh during the summer of

1794, President Washington was forced to strap on his saber once again and muster some 15,000 militiamen to put down the "insurrection." The Whiskey Rebels disappeared; so, too, before long, did the whiskey excise.

Without much debate, Congress thereafter agreed to rely almost exclusively on tariffs, the only major revenue source left to it. This was the first American tax system: Because the U.S. government's needs were modest, tariffs generally could be kept low.

Import levies on certain goods, however, crept upwards, especially after the War of 1812 swelled the new government's budget. They continued to grow for a different reason: The budding manufacturers of textiles, clothing, boots, and shoes in New England and the Middle Atlantic states, represented chiefly by the Whig party, favored high protectionist tariff walls against imported European goods—the tariffs were so high that imports were restricted and customs revenues reduced. Northern merchants and Southern planters correctly perceived that they would bear the chief burden. South Carolina's John C. Calhoun protested that protectionism was "an immense tax on one portion of the community to put money into the pockets of another." The nation, he warned, was fracturing into a "taxeating" North and a "taxpaying" South.



High tariffs helped the workingman, according to a Whig cartoonist. At the time, Democrats rejected protectionism; today, the Democratic party is the center of protectionist sentiment.

When Congress imposed the "tariff of abominations" in 1828, Calhoun responded with his famous Nullification Doctrine, arguing that the states could void acts of Congress. And, in 1832, an angry South Carolina legislature finally barred federal customs agents from collecting duties within the state. As President Andrew Jackson dispatched reinforcements to the federal garrisons at Forts Sumter and Moultrie, the legislature summoned volunteers to protect the state from "invasion." A clash was averted only when the Whigs, led by Senator Henry Clay of Kentucky, agreed to tariff reductions.

From that point until the Civil War, Jackson's Democratic party dominated the government and kept tariffs low, and even trimmed them during the 1840s and 1850s.

However, when the Civil War broke out, Northern manufacturers got the high tariffs they had always wanted, as part of Abraham Lincoln's huge emergency taxation program. U.S. Commissioner of Revenue David Ames Wells summed up the new federal policy in terms of the advice given to an Irishman on his first visit to Donnybrook Fair: "Wherever you see a head, hit it." Wells' version was: "Wherever you find an article, a product, a trade, a profession, a sale, or a source of income, tax it!"

The Civil War levies included 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, and special taxes on corporations. And with surprisingly little controversy, Congress even imposed its first income tax—a moderately progressive levy on the well-to-do.* The necessities of war swept away all objections to the Lincoln program.

Virtually all of these taxes, except the tariffs and the "sin" taxes on whiskey and tobacco, were quickly repealed after Appomattox. The income tax, popular in rural areas (where few citizens were wealthy enough to be subject to it), survived until 1872. But, because Southern Democrats were virtually powerless, tariffs remained high. Until 1913, the average duty on imports rarely dropped below 40 percent and frequently ran closer to 50 percent. Business lobbyists won even stiffer rates on a few selected goods: iron, steel, cotton textiles, and certain woolens.

The stiff post–Civil War tariffs were not aimed, as earlier tariffs were, solely to raise revenue. Designed to shield American industry from foreign competition, the new tariffs represented a stunning victory for protectionism. They constituted the nation's first major tax overhaul.

The new tariffs were also a victory for the Republican party, which represented a powerful array of interest groups created by America's Industrial Revolution. Northern manufacturers enjoyed protection from European imports; many of their factory hands and other skilled workers believed protectionism kept U.S. wages high. Affluent Northerners who owned government bonds knew that tariff revenues supplied their interest payments. Governors and mayors throughout the North liked feeding from what became known as the "pork barrel"—Congress' annual Rivers and Harbors appropriation for local public works—which tariff revenues kept full. And the vast army of Civil War veterans received increasingly generous pensions from tariff collections.

But criticism of the protective tariffs mounted, particularly among farmers in the South and West and among middle-class consumers, who got little from protectionism except higher prices. By the 1880s, Washington had retired its Civil War debts, killed the income tax, and, in an era when peacetime federal outlays were low, was running embarrassing budget surpluses; it had no excuses left for high taxes. Still, the tariffs survived unscathed.

In 1887, President Grover Cleveland, the first Democrat elected to the White

*The nation's first income tax began in 1861 as a levy of 3 percent on incomes over $800; it was 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. At the time, $600 was roughly twice the average annual male income.

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House since James Buchanan (1857–61), stunned the nation when he broke with the protectionists and devoted his entire State of the Union speech to the tariff, blasting it as a "vicious, inequitable and illogical source of unnecessary taxation."

Opposition to the tariff grew as Big Business emerged during the 1880s and 1890s, and as a major economic depression enveloped the nation during the mid-1890s, sharpening a widespread sense of grievance over the growing inequality of wealth and worries over what appeared to be diminishing prospects for small businessmen, professionals, and skilled workmen. "Trusts, combinations, and monopolies," Cleveland and his allies charged, restricted economic opportunity and threatened republican political institutions, just as King George III had. And the protective tariff was the "mother of Trusts."

The Cleveland Democrats, true to their Jacksonian heritage, merely favored a return to low taxes and minimal government. Other foes of the tariff had more ambitious notions.

Henry George, a crusading California newspaperman, had proposed the "single tax" in 1879 in *Progress and Poverty*, a book read by millions of Americans. "Poverty," George wrote, "deepens as wealth increases, and wages are forced down while productive power grows, because land, which is the source of all wealth and the field of all labor, is monopolized." His idea was simple. Government would raise all of its revenue from just one source: It would tax away all the value of land that resulted from its *location*, as opposed to its "use value." In a single stroke, George believed that he could destroy monopolies, distribute wealth more evenly, make land speculation unprofitable and depressions impossible, and eliminate poverty.

The single tax, however, faced a Constitutional barrier: Article 1, Section 9. George and his followers thus promoted his plan at the state and local levels, where property taxes loomed large. After moving to New York City, George mounted a third party bid for the mayoralty in 1886, and finished a surprisingly strong second to Democrat Abram S. Hewitt, outpolling the GOP's Theodore Roosevelt.

Nevertheless, the single taxers never got very far. They faced overwhelming opposition from real estate interests and small property owners, including farmers, who feared that the reform would ruin their chances, however modest, to profit from their holdings.

Reviving the income tax held much greater promise. Farmers in the South and West backed it. So did many working- and middle-class Americans in the cities. Like the single taxers, advocates of income taxation argued that their tax would not touch the wages and salaries of ordinary people. Going beyond "ability to pay"—a long accepted idea—many of these advocates called for a *progressive* income tax that would recapture the "tribute of monopolists" and break up large concentrations of wealth.

During the depressed 1890s, rising farm protest increased the appeal of the income tax, and the Populist Party endorsed it in 1892. Senator William Jennings Bryan (D-Neb.), the charismatic orator, forced the inclusion of a modest income tax—a "flat" tax of 2 percent on incomes over $4,000—in the Wilson-Gorman Tariff of 1894. "The Democratic hen has hatched a Populist chicken at last," cackled the *New York Tribune*.

But the Supreme Court, in *Pollock v. Farmers' Loan and Trust Co.* (1895), ruled that the income tax violated Article 1, Section 9 of the Constitution. Concurring with the majority, Justice Stephen J. Field issued a telling warning: "The present assault on

A dip in tariff revenues during the late 1870s sparked a brief drive for a progressive U.S. income tax. Opponents quickly stifled the "communistic" idea.

capital," he declared, 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 Democrats did not give up. In Congress, Representative Cordell Hull of Tennessee (later Franklin Roosevelt's Secretary of State) denounced the tariff as an "infamous system of class legislation" that forced the workingman to pay most of the cost of government while "virtually exempting the Carnegies, the Vanderbilts, the Morgans and the Rockefellers with their aggregated billions of hoarded wealth."

In 1909, with the help of Western "progressive" Republicans, notably Senator Robert M. LaFollette of Wisconsin (and a surprise assist from President William Howard Taft, a conservative Republican), the Democrats finally won Congressional approval of the Sixteenth Amendment: "The Congress shall have power to lay and collect taxes on incomes, from whatever sources derived, without apportionment among the several states and without regard to any census or enumeration."

Within months of Woodrow Wilson's victory in the presidential election of 1912, the states had ratified the amendment. Popular enthusiasm for federal attacks on monopoly power was at its peak—Wilson's chief competitor in the three-cornered contest had been an equally ardent foe of the trusts, Theodore Roosevelt, running as a "Bull Moose" Progressive. (President Taft had finished a distant third.) Wilson had described his campaign as "a second struggle for emancipation," explaining that "if America is not to have free enterprise, then she can have freedom of no sort whatever."

The Progressive ferment produced such landmark reforms as the creation of the U.S. Department of Labor (1912), the Federal Reserve system (1913), the Federal Trade Commission (1914). By comparison, the first modern American income tax, contained in the Underwood Tariff of 1913, was something of an anti-climax. It set a "normal" rate of 1 percent on both individual and corporate incomes, and exempted married couples earning less than $4,001—

about six times the average American male's income at the time.* A graduated surtax began at 1 percent on incomes over $20,000, rising modestly to 6 percent on incomes over $500,000. The income tax was high enough to pay for tariff reform, but it would do next to nothing to redistribute the nation's wealth.

That equation changed dramatically when Europe went to war in the summer of 1914, disrupting foreign trade and shrinking U.S. tariff receipts. Washington would have to look elsewhere for tax dollars. In Congress, many powerful "anti-preparedness" legislators from the South and West, such as Representative Claude Kitchin (D-N.C.), chairman of the House Ways and Means Committee, also happened to be stout champions of tax reform. They would go along with a national defense buildup, for a price. "If the forces of big business are to plunge this country into a saturnalia of extravagance for war purposes in a time of peace," declared Representative Warren Worth Bailey in 1916, then "the forces of business should put up the money."

Republicans and conservative Democrats fought to spread the "preparedness" burden more broadly through such measures as a national sales tax. But, with the ratification of the Sixteenth Amendment, the people had spoken. As U.S. entry into World War I neared, the nation embraced its third major tax system: "soak-the-rich" income taxation.

The Revenue Act of 1916 boosted individual and corporate income tax rates (to a maximum of 10 percent), introduced federal estate taxation (at a progressive rate, rising to 5 percent on estates of more than $50,000), and imposed special taxes on war industries. In 1917, when America finally entered the European war, Congress passed "the most gigantic fiscal enactment in history" up to that time, according to economist Edwin R. A. Seligman. The top rate on individual incomes soared to 83 percent. A radical new progressive tax on corporate "excess profits"—defined essentially as anything more than an 8 percent annual rate of return on invested capital—shifted the burden of financing the war effort to industrial America. By 1918, businesses large and small were paying some $2.5 billion, more than 70 percent of all federal tax revenues.

To the dismay of Big Business, key Congressional Democrats, including Representative Kitchin of the Ways and Means Committee, clearly hoped to make permanent the wartime excess profits tax. Not until the next war would the battle between the corporations and liberal advocates of "soak-the-rich" taxation end.

At first, the nation retreated from "radical" taxation during the "return to normalcy" after World War I, just as it had after the Civil War. Under a succession of Republican presidents during the 1920s, Congress abolished the excess profits tax, lightened taxes on the rich, and created numerous tax "loopholes" for business, such as the oil depletion allowance.

The federal income tax, however, survived and became the chief source of federal revenues. Again, the tax found a surprising friend: Andrew Mellon, Secretary of the Treasury under Presidents Harding, Coolidge, and Hoover.

In many ways, the frail but determined Treasury boss of the 1920s, (the joke in Washington was that three presidents served under him) sounded like a Republican "supply side" economist of the 1980s. "When initiative is crippled by legislation or by a tax system which denies [the taxpayer] a right to receive a reasonable share

*This meant that a couple earning $4,000 paid no taxes. Today, a family earning $120,000 (six times the average male income) would pay about $24,000 to the I.R.S. after taking various deductions.

PUZZLING OVER TAX CUTS

George Bush's proposal to cut the maximum tax on capital gains from 33 percent to 15 percent has reopened an old and convoluted debate over the economic effects of tax cuts.

Few economists doubt that such a cut would stimulate investment. One question is: How much? The second question: Would a cut increase or reduce federal tax revenues?

Such questions, especially the second one, probably would not have been seriously considered today without the work during the 1970s of Arthur Laffer, the founder of modern "supply side" economics. Laffer said that certain tax cuts would ultimately boost economic activity and, hence, tax revenues.

The uncertainty over the Bush proposal exists, notes a 1988 study by the Congressional Budget Office (CBO), in part "because taxpayers have considerable discretion over whether and when to pay capital gains taxes." If taxes are high, people may delay selling stocks, bonds, and other assets, or even keep them to pass along to their heirs.

Arthur Laffer

After two reductions in capital gains taxes, in 1978 and 1981, revenues from the tax had more than doubled by 1985. The CBO suggests that this was largely the result of one-time "dumping" of long-held assets. But the Treasury Department believes that the cuts increased taxpayers' willingness to invest. As for revenues, the CBO estimates that the Bush proposal would cost the Internal Revenue Service $4–$8 billion annually (although "the possibility of a revenue gain cannot be entirely rejected"); a Treasury study predicts higher revenues.

Meanwhile, both sides await the results of the 1986 tax reforms, which increased the maximum capital gains tax (from 20 percent to 33 percent) to offset the reduction in top income tax rates. (Only the United States has raised capital gains taxes in recent years; in Japan and several Western European nations, capital gains are tax exempt.) Amid today's uncertain economic climate and large federal budget deficits, the results are not only matters of academic interest.

Still underway are assessments of President Reagan's 1981 income tax cuts. By 1986, contrary to the predictions of some "supply side" economists, Washington's revenues from income taxes had not gained the levels projected earlier under the old rates. But one group of Americans was paying more: those earning over $200,000. Moreover, the affluent were bearing a larger share of the income tax burden. The top one percent of taxpayers (with adjusted gross incomes of $100,000 or more) contributed 26.1 percent of revenues in 1986 versus 18.1 percent in 1981. The poorer half of the population (earning less than $25,000) paid 6.4 percent of the taxes, down from 7.5 percent in 1981.

"The rich are paying a larger share of income taxes because the rich are claiming a larger share of the income," argues the *New Republic*'s Michael Kinsley, among others. Indeed, Americans in the top five percent of the income distribution claimed 17 percent of all income in 1986, up from 15.4 percent in 1981, a 10 percent increase.

But Harvard's Lawrence Lindsey believes that the rich did not really get much richer. In part, these business executives, professionals, and entrepreneurs chose, in response to the 1981 tax cuts, to take more of their compensation in cash rather than tax-free fringe benefits such as company cars. Lindsey says that the tax cuts, which *were* larger proportionally for upper income groups, have also encouraged the affluent to work harder and invest more than other groups. That, he believes, has increased upward social mobility.

Before the Johnson era's 1964 tax cuts, the wealthiest two percent of Americans got more than 50 percent of their income from "unearned" dividends and interest—suggesting the dominance of "old money" families at the top. By 1983, the proportion of "unearned" income had dropped to about 19 percent for the wealthy, suggesting that most of the rich were no longer from "old money" families.

Supply siders like Lindsey, replies Kinsley, should admit that the Reagan-era tax cuts were intended to provide "more general prosperity at the cost of more inequality." Only one thing is certain: a new round of debate as data on the effects of the 1986 tax reforms slowly become available.

of his earnings," he warned in *Taxes: The People's Business* (1924), "then he will no longer exert himself and the country will be deprived of the energy on which its continued greatness depends." Yet, Mellon also persuaded corporations and the rich that they should not press for a national sales tax, which would shift much of the nation's tax burden back to the poor and middle class. By consenting to *some* progressive income taxation, he argued, they would prove their civic responsibility and defuse more radical attacks on capital.

The Mellon "recipe" remained popular during the flush years of the Jazz Age. But the Great Depression revived public resentments over private wealth and anxieties about the structure of opportunity in America.

President Franklin D. Roosevelt, like Wilson before him, believed in "soak-the-rich" taxation. At first, he held back. Alarmed by federal budget deficits, eager to win business support for early New Deal recovery programs, he supported new taxes that were regressive but could produce revenues immediately (e.g., whiskey and tobacco excises). He agreed to finance his new Social Security system (1935) with regressive payroll contributions as a way of encouraging Americans' sense of individual entitlement to the benefits, and thus fending off future conservative tax-cutters.

As the Depression wore on, however, popular discontent forced FDR's hand. In June 1935, responding to the "thunder on the Left," particularly Senator Huey Long's Share the Wealth movement,* the president finally unveiled a "soak-the-rich" tax program of his own. He called for a variety of corporate taxes, surtaxes that would raise the top income tax rate on individuals from 63 to 79 percent, and an inheritance tax. (A federal estate tax, levied on the estate itself, was already in effect. The inheritance tax was to be paid by *recipients* of bequests.) Echoing Woodrow Wilson, he explained 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."

Congress promptly gave FDR much of what he wanted. The next year, he focused his attention on business, asking Congress to replace the existing corporate income taxes with an "undistributed profits" tax, which would tax all profits which corporations did not pass on as dividends to their stockholders. Again, the rationale was Wilsonian. Roosevelt intended to reform corporate behavior. He was convinced that Big Business deliberately amassed undistributed profits to avoid taxation and used the money unwisely or unfairly. After Congress enacted a watered-down version of his proposal, FDR advertised it during his 1936 reelection campaign as a tax that "made it harder for big corporations to retain the huge undistributed profits with which they gobble up small business."

Roosevelt wanted to go further. But his politically disastrous "Court-packing" fight in 1937 and the recession of 1937–38 gave his foes the opportunity to counterattack.

The Depression, which had helped FDR persuade his countrymen of the need for heavier "soak-the-rich" taxation, now worked the other way. Prominent Democratic businessmen such as Bernard Baruch and Joseph P. Kennedy joined Republicans in charging that Roosevelt's taxes on

*At the core of the Share the Wealth Program were tax proposals which Long had begun to develop as early as 1916. In 1935, Long called for taxing away all family fortunes over $5 million and all family incomes above $1 million. With the revenue, Long promised to provide a "homestead" allowance and a guaranteed annual income to each needy family. Yet, one contemporary study indicated that even stiffer taxes than Long proposed would provide only a bit more than $400 per needy family.

business had triggered the recession by discouraging investment. Americans who had seen their hopes for a long overdue economic recovery suddenly dashed—especially professionals, small businessmen, prosperous farmers, and skilled workers—were ready to believe them. In 1938, a coalition of Republicans and conservative Democrats slashed the tax on undistributed profits. In 1939, Congress formally canceled New Deal tax reform by eliminating the tax—"one of the few New Deal innovations ever retracted by subsequent legislation," as economist Herbert Stein notes.

FDR had another chance after Pearl Harbor, when Washington needed quick infusions of cash to finance the war effort. In Britain, John Maynard Keynes was calling for "a plan conceived in a spirit of social justice, a plan which uses a time of general sacrifice, not as an excuse for postponing desirable reforms, but as an opportunity for moving further . . . toward reducing inequalities." Roosevelt agreed. In 1941, his Secretary of the Treasury, Henry M. Morgenthau, proposed taxing away all corporate profits above a 6 percent rate of return. Roosevelt went further. "In time of this grave national danger, when all excess income should go to win the war," he 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." (This is the equivalent of $200,000 in 1988 dollars.)

Congress was having none of it. The American middle class accepted the verdict of *Time*, which warned that Morgenthau's plan would put corporations in a "weakened financial position to feel the slump and unemployment that will come with the peace."

Only once thereafter did Roosevelt challenge Congress. In 1943, he vetoed a revenue act which, because of the phasing in of tax 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 overrode a presidential veto of a revenue act, dealing FDR a humiliating defeat.

Beginning in 1940, Congress, acting largely on its own, gradually transformed the income tax during the war years from a "class tax" to a "mass tax." It steadily lowered the personal exemption, "including in" more and more people. As time went on, clerks and salesmen and factory foremen joined wealthier Americans in the painful ritual of filling out 1040 forms every April. The number of taxpayers jumped from 3.9 million in 1939 to 42.6 million in 1945. Membership in the "community of taxpayers," two economists noted, "spread from the country club district down to the railroad tracks and then over the other side of the tracks."

Patriotic fervor eased popular acceptance of the "mass tax." (Songwriter Irving Berlin, commissioned by the Treasury Department, penned an ode: "You see those bombers in the sky/Rockefeller helped to build them/So did I.") Generous deductions (e.g., for interest on home mortgages) satisfied the middle class, while the steep progressivity of the tax attracted the support of lower-income taxpayers. And the introduction of payroll withholding in 1943 took much of the sting out of taxpaying. As former TV anchorman David Brinkley writes in his memoir of the war years, "Congress and the president learned, to their pleasure, what automobile salesmen had learned long before: that installment buyers could be induced to pay more because they looked not at the total debt but only at the monthly payments."

Despite the heavy burden it imposed on

the middle class, the World War II tax structure had a longevity that the World War I changes lacked. It survived without radical alteration until the 1980s.

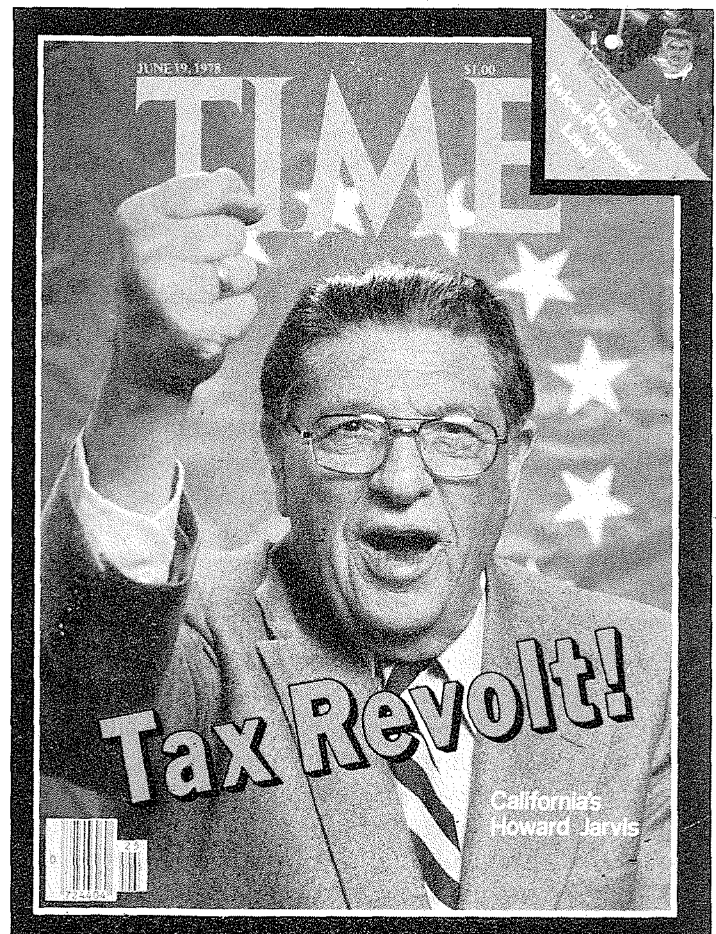
The Cold War (and the Great Society) helped keep taxes high. One reason that Woodrow Wilson's war taxes, like Lincoln's before them, were rolled back was simply that government outlays dropped sharply after the guns fell silent. Victory over the Axis powers, by contrast, brought no vast reductions. The need to maintain a large defense establishment to deter Soviet expansionism and, later, the growth of the welfare state, sustained Washington's appetite for revenue.

And the income tax was well suited to satisfying it. Not only did the progressive tax seem equitable to most Americans by the 1950s, but it was also a reliable money raiser.

Through the prosperous 1950s and 1960s, neither political party sought to alter the nation's basic tax formula. Instead, they busied themselves with refining and manipulating it. In theory steeply progressive, the tax code was filled with "loopholes." By the mid-1960s, Senator Warren Magnuson (D-Wa.) could observe: "The first nine pages of the Internal Revenue Code define income; the remaining 1,100 pages spin the web of exceptions and preferences." Gradually, the Democrats backed away from the Wilson-Roosevelt approach to soak-the-rich corporate taxation. Defending his 1964 tax cuts, President Lyndon Johnson sounded very much like Andrew Mellon, arguing that reductions in corporate and capital gains levies would boost investment and avert a recession.* Herbert Stein later called the 1964 measure "the great victory of conservative fiscal policy."

But the debate was not over. One of the advantages of the individual income tax, from Washington's point of view, was that

*The 1964 tax cuts, originally proposed by President John F. Kennedy, included a relatively small but symbolically significant $1.3 billion cut in corporate taxes. The top rate on personal income dropped from 91 to 70 percent; the bottom rate went from 20 to 14 percent.



California voters stunned the nation in June 1978 by passing Proposition 13, which cut local property taxes by 50 percent. The "tax revolt" spread, helping Ronald Reagan win the 1980 election.

moderate inflation yielded politically painless "hidden" tax increases by slowly pushing workers into higher tax brackets. "Bracket creep" worked reasonably well until the mid-1960s. Then, Lyndon Johnson, reluctant to choose between the Great Society and the Vietnam war, and unwilling to ask for higher levies to pay for both, embraced the deadly combination of easy money and deficit financing. It was a fateful decision. As inflation surged, reaching a then-unbelievable five percent in 1969, bracket creep became bracket leap. When the economy also began to sour, taxpayers grew restless. A new debate over the nation's tax system began.

During the 1970s, liberal tax specialists, such as Harvard's Stanley Surrey, exposed the extraordinary individual and corporate loopholes (e.g., the oil depletion allowance) that Congress had written into the tax code over the years, and coined the catchphrase "tax expenditures" to describe them. Along with economist Joseph Pechman, Surrey called for elimination of the massive "horizontal" inequities thus introduced into the system: Individuals with roughly the same income might pay vastly different taxes, depending on what tax loopholes they (or their accountants) were able to exploit. The richer the taxpayers, the bigger the loopholes they seemed to find.

The momentum for tax reform grew. But what kind of reform?

In an ironic accident of history and geography, the leading spokesman for liberal reform emerged from the South, the conservative champion from the North. In 1976, presidential candidate Jimmy Carter, of Georgia, calling the income tax system a "disgrace to the human race" and a "welfare program for the rich," vowed to overhaul the whole system and make it more progressive. Representative Jack Kemp (R-N.Y.) led a coterie of "supply side" conservatives who revived the arguments of Andrew Mellon, calling for tax cuts that would stimulate business investment and personal incentives to "work, save, and invest." In California and other states, meanwhile, "grassroots" conservatives led Proposition 13-style "tax revolts," seeking chiefly to reduce local property taxes.

Jimmy Carter got the first shot at reform, but found himself frustrated by Congress and ensnared in his own moralizing rhetoric over corporate deductions for "three martini lunches" and other petty matters. In 1978, the self-styled populist reluctantly put his signature to a federal revenue act that provided only minimal tax relief and simplification for the majority of Americans while it made generous cuts in capital gains and business taxes.

After Ronald Reagan embraced the supply side cause and vanquished Carter in the election of 1980, his new administration engineered passage of the Economic Recovery Tax Act of 1981, which contained the most dramatic tax cuts since the 1920s. The act sharply reduced income tax rates, accelerated corporate depreciation write-offs, lowered the tax rate on capital gains, and, significantly, ended "bracket creep" by indexing personal income tax rates to inflation. Summing up the liberal view of the "Reagan Revolution," Harvard's John Kenneth Galbraith wrote that the White House believed that "The poor need the incentive of lower benefits, while the rich require the incentive of lower taxes."

In 1984, newspaper headlines across the nation flashed the astonishing fact discovered by an obscure Washington tax analyst named Robert McIntyre: 128 large corporations had paid no income tax at all during some years after 1981. Among them were General Electric, Boeing, and Dow Chemical. That news, along with other flaws discovered in the 1981 law and the

THE NEW BALANCING ACT

"I am not going to raise taxes, period," said George Bush during the 1988 campaign. Nevertheless, politicians and academics have continued to debate new revenue proposals to cut the $140 billion Federal budget deficit. The yardstick is the effect of any new tax on economic growth; apart from Jesse Jackson, no leading Democrat has called for revival of 1930s "soak-the-rich" taxation.

Congress has been reluctant to reopen the Pandora's box of the income tax. But several tempting big-ticket "loopholes" remain in the Internal Revenue code. For example, by taxing employer-financed fringe benefits (e.g., health insurance), Washington could raise some $30 billion. Another possible target: Social Security payments, which are now already partly taxable when retired couples' annual income exceeds $32,000. Or Congress could simply increase existing personal and corporate income taxes. A five percent surcharge would produce $27 billion.

Increased "sin taxes" on alcohol and tobacco find much favor in Congress, in part because they would remain largely "invisible." Doubling excise taxes on alcohol would yield $4 billion in 1989; tripling levies on cigarettes (now 16 cents per pack) would produce about $6 billion. The many Democrats who advocate such increases, complains columnist Mark Shields, trample on "the revered Democratic tradition of basing taxes on progressivity." Excise taxes, he notes, take a bigger proportional bite out of the incomes of the poor than of the affluent.

Various taxes on energy—an oil import fee, increased gasoline taxes—would also be regressive. Yet, they would presumably encourage conservation, thereby lessening American reliance on imported oil. A 15-cent per gallon gasoline tax, favored in 1988 by Representative Dan Rostenkowski (D-Ill.), chairman of the tax-writing House Ways and Means Committee, would yield $15 billion.

But many Democrats draw the line at comprehensive consumption taxes, especially the European-style value added tax (VAT) backed by a number of economists. By penalizing consumption, a VAT would "help raise the dangerously low U.S. savings rate," says business consultant Charls Walker. A one percent VAT imposed on all goods and services would produce $20 billion. Its regressive impact could be partially offset by giving rebates to lower-income families. That is not enough for many Democrats. Governor Michael Dukakis, who blocked Jesse Jackson's attempt to insert a "soak-the-rich" tax plank in the 1988 party platform, said that a VAT would "soak the middle class." Dukakis may not have the last word. Nevertheless, while promoting U.S. economic health is now the paramount concern, "fairness" clearly remains an important political test for any new tax.

growing budget deficit, convinced Capitol Hill Republicans and Democrats alike that the system was in crisis. It was an opportunity for reform unlike any since the two world wars.

This time, however, the initiative lay with a conservative Republican administration seeking, in part, to further reduce taxes on the well-to-do. Yet, there were major differences between 1986 and the Mellon tax cuts of the 1920s.

The Reagan administration was more interested in improving economic incentives for entrepreneurs than in protecting

Big Business: It was willing to accept a shift of more than $100 billion in taxes from individuals to corporations. Second, Democrats, notably House Ways and Means Committee Chairman Dan Rostenkowski, were needed as co-authors of any reform bill. And, following a strategy devised by Senator Bill Bradley (D-N.J.), leading Democrats abandoned their traditional insistence on "soaking the rich." In return, they won increases in the personal exemption and the standard deduction, which took millions of the nation's poorest families off the tax rolls; they also won the elimination of important loopholes and "tax expenditures" favoring middle- and upper-income groups.*

In return, the Democrats agreed to a compression of the rate structure, drastic cuts in the top individual income tax rates (from 50 to 33 percent), and a drop in the corporate rate (from 48 percent to 34 percent). In effect, Democrats compromised their traditional emphasis on "vertical" equity in order to create a more uniform, more "horizontally" equitable income tax.

Because of the still enormous federal budget deficits, however, the United States probably has not seen the last of major tax reform during this century. In fact, we may be slowly approaching a fourth sea change in American tax policy.

If Democrats and Republicans in Washington stick to the bipartisan formula of 1986, they may choose to resolve the budget crisis by coupling tax increases with further changes designed to improve "horizontal" equity. Of any new levy, the most radical would be a national value added tax (VAT), on the Western European model. (Under a VAT, each business at every stage of production is liable for a tax on what it sells, but each receives a refund on the tax it paid to its suppliers.) Such taxes are "fair" in that they tax everyone with the same consumption levels at the same rate. And, by promoting saving and investment rather than consumption, they probably would spur economic growth.

A new VAT might please both conservatives (by averting increases in progressive income taxes) and liberals (by broadening the tax base for future expansion of domestic programs). The United States would have a new tax system based on a combination of a mildly progressive, relatively comprehensive income tax and the first major federal taxation of consumption since the demise of the tariff system. If this is the route Congress eventually takes, we may be on the verge of renouncing intermittent century-long efforts to use the federal tax system to pursue the Populist and Progressive vision of achieving "social justice" through redistributing the wealth.

*Removed were the consumer-interest and sales tax deductions, "passive-loss" tax shelters, preferential rates on long-term capital gains, and the investment tax credit for corporations. Some fears over the effects of such changes proved to be exaggerated. For example, taxpayers who do not itemize their deductions lost the ability to "write off" charitable contributions, arousing concern among charitable organizations. Yet donations by individuals rose substantially (though not as much as they might have without the tax change), climbing from $66 billion in 1985 to $77 billion in 1987.

THE POLITICS OF TAXATION

Looking back on the growth of Britain's national debt through the 18th and 19th centuries, Thomas B. Macaulay wrote in his grand *History of England* (1861) that "at every stage in the growth of that debt the nation has set up the same cry of anguish and despair.

"Like Addison's valetudinarian, who contrived to whimper that he was dying of consumption till he became so fat that he was shamed into silence, [Britain] went on complaining that she was sunk in poverty till her wealth . . . made her complaints ridiculous."

Macaulay is quoted by Jude Wanniski in **The Way the World Works** (Simon & Schuster, rev. ed., 1983), an ambitious "supply side" reinterpretation of history in terms of taxation and economic principles.

"What made the Industrial Revolution and the Pax Britannica possible," Wanniski argues, with an eye on contemporary American politics, "was the audacity of the British Parliament," which ignored the experts' dire warnings about the growing national debt in 1815, after the defeat of Napoleon, and proceeded to reduce tariffs and eliminate the wartime income tax.

Such bold judgments are rare in today's scholarly histories of taxation, which tend to focus on relatively narrow sub-topics. But much of this literature is summarized in **The Rise and Fall of the Great Powers** (Random, 1987), by Yale's Paul Kennedy. He contends that the fate of nations, from Ming China to the United States today, has depended in part on their ability to marshal resources through taxation, borrowing, and other means. But he suggests that how money is raised is less important than how it is spent: Britain became a great power after 1815, Kennedy believes, partly because it devoted only two to three percent of its gross national product to the military (versus seven percent in the United States today).

Taxes frequently involve a tradeoff between promoting social equity and fostering economic efficiency. Wanniski and Kennedy represent, in different ways, a resurgence of academic concern over the economic effects of taxation. During most of the 20th century, according to Sidney Ratner's highly readable chronicle of **American Taxation** (Norton, 1942), Americans have been most interested in equity—finding ways to use the tax code to shift burdens to the rich and redistribute income. In Ratner's view, the politics of taxation in the United States can be summarized as a constant struggle between "vested interests" and the forces of "democracy."

Taking the story through the early Reagan years, John F. Witte contends in **The Politics and Development of the Federal Income Tax** (Univ. of Wisc., 1985) that efforts to redistribute income through the tax code during this century have largely failed. Because Congress has tried to "satisfy the demands of diverse groups, to meet the political needs of decision-makers, and . . . to correct, adjust, and fine-tune the system, the income tax as a fundamental and ostensibly equitable means of raising revenue has been slowly but continuously eroded." Writing in 1985, he saw "absolutely nothing" in U.S. history to suggest that any kind of major overhaul of the tax system was possible.

As journalists Jeffrey H. Birnbaum and Alan S. Murray observe in **Showdown at Gucci Gulch** (Random, 1987), a lively account of the on-again, off-again course of 1986 federal tax reform, Witte was almost right.

Since then, U.S. tax cuts and rising discontent abroad over heavy tax burdens have sparked changes in Britain and other countries. Joseph Pechman's **World Tax Reform** (Brookings, 1988) and **Comparative Tax Systems** (Tax Analysts, 1987) are useful but already partly outdated overviews. The World Bank's **World Development Report 1988** (Oxford, 1988) examines tax trends in the poorer nations of the world.

Looking ahead in **Tax Policy in the 21st Century** (Wiley, 1988), Herbert Stein, paraphrasing Benjamin Franklin, notes that his fellow economists around the world see only two sure prospects: death and (higher) taxes.