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.

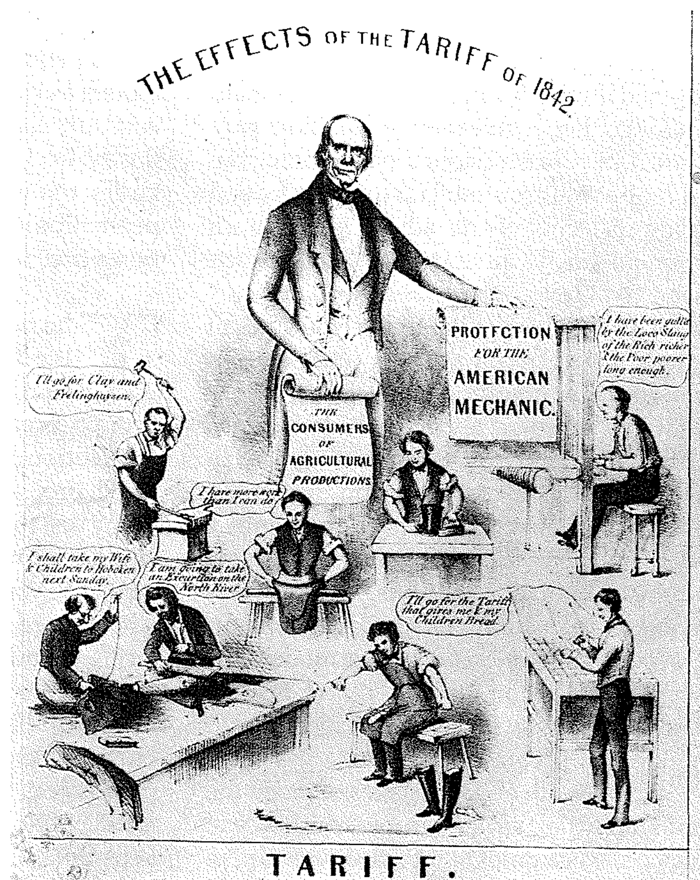
The remaining alternatives were "poll" (or head) taxes and "indirect" taxes, such as tariffs or excises. Poll taxes were out of the question: They had been intensely unpopular in colonial days. Excises were hated just as passionately. They discriminated against the producers whose commodities were taxed, 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.

***W. Elliot Brownlee**, 47, a former Wilson Center Fellow, is professor of history at the University of California at Santa Barbara. Born in La Crosse, Wisconsin, he received a B.A. from Harvard (1963) and a Ph.D. from the University of Wisconsin, Madison (1969). He is the co-author of* America's History *(1987) and author of* Dynamics of Ascent: A History of the American Economy *(1988). He is currently at work on a history of taxation in America.* *Copyright © 1989 by W. Elliot Brownlee.*

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.

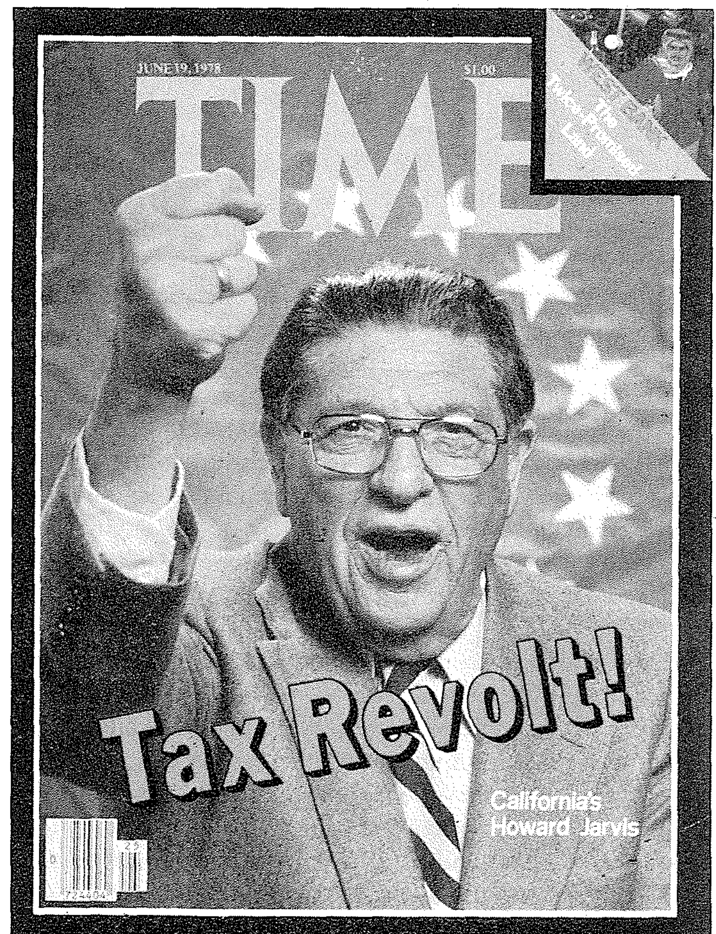
The Cold War (and the Great Society) helped keep taxes high. One reason that Woodrow Wilson's war taxes, like Lincoln's before them, were rolled back was simply that government outlays dropped sharply after the guns fell silent. Victory over the Axis powers, by contrast, brought no vast reductions. The 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.