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# History of Taxation in the United States

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“Human history becomes more and more a race between education and catastrophe.” H. G. WELLS, *The Outline of History*, Ch. 15.

One has a job of selection when he tries to compress three centuries of American taxation into less than an hour of spoken summary. He has to omit much that he would like to say. He cannot afford the luxury of indecision about what is most important. He has to resist the temptation to give space to interesting and dramatic incidents which would crowd out more significant parts of a kaleidoscopic story. I am afraid that it is even necessary to make the courageous decision to be dull. But as I proceed with the task, I shall be curious, as perhaps you will be also, to see what I select out of a vast aggregate story as deserving of mention in a compact summary which requires that I cover nearly fifteen years in every two minutes of speaking.

You know the better part of the story. In the beginning our Colonial forefathers—who, Justice Cardozo once said, “knew more about ways of taxing than some of their descendants seem to be willing to concede.”<sup>1</sup>—resorted to a faculty tax which has been called the ancestor of the modern income tax. At an early critical date in American history a group of the ablest of our forefathers, gathered at a convention, drafted a Constitution which with two amendments—one of which should have been unnecessary—has served the tax needs of the country ever

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since. Somewhat later Jefferson's administration abolished the elaborate system of excises set up by the Federalists and turned to the tariff as a source of revenue. This form of taxation was popular in the industrial North and was distasteful to the agricultural South, which was not interested in protecting manufacturing and agreed to tariffs just to get revenue. Moreover, the South was opposed to any policy which would increase the economic preponderance of the North. The tariff became inadequate as a source of revenue almost at the beginning of the War Between the States, and the country had a brief flirtation with progressive income and death taxation, which was constitutional in those days,<sup>2</sup> even though the permissive Sixteenth Amendment was required to enable Congress to do in the Twentieth Century what it had been permitted to do in 1861. "Normalcy" revisited the country quickly after the War, as it did after World War I, and Congress returned to the tariff as a revenue producer. It was a sufficient source of revenue for many years.

The Nineteenth Century ended on a note of turmoil and confusion. A highly articulate social and economic discontent with hard times in rural areas brought a populist chicken into the House in 1894, the year in which a disheartened Cleveland allowed the Wilson Tariff bill to become law without his signature. The income tax imposed by this bill carried the modest flat rate of two percent, but this was enough to arouse to fever pitch the anxieties of financial leaders in the eastern industrial states. Four of these states—New York, Pennsylvania, Massachusetts and New Jersey—had supplied four-fifths of the income tax collected in 1873, the eloquent Choate argued in the Supreme Court, and the "communist" march of income taxation would go on to dangerous destinations if Congress was "untrammelled and uncontrollable." This grim, hard warning was too much for a majority of the Supreme Court which after two long arguments held that the Federal government lacked the power to tax the instrumentalities of the states, which made a tax on the income from state bonds unconstitutional, and also that the entire 1894 Act was invalid because it was a direct tax upon real and personal property.<sup>3</sup>

But neither the arguments of leaders of the bar nor the susceptibility of an unreconstituted Supreme Court, nor any form of economic or fiscal isolationism, could permanently stay the powerful march of events in the rest of a fluid world. In other places than America the idea of income taxation was taking possession of unsuspecting electorates. In 1793 France had adopted a general income tax as a sporadic war measure. The British, led by Pitt, followed in 1799 with an income tax which was joyfully abolished in 1816 at the end of the Napoleonic

wars. These were war taxes. But peacetime acts came to other countries in the middle of the Nineteenth Century, and our own country succumbed in the War Between the States. By the end of the Century the "socialist" procession included Australia, New Zealand, Japan, Prussia and the Netherlands. In Britain a peacetime income tax came to dinner in England at the invitation of Sir Robert Peel in 1842, and never went home, even though Gladstone regarded it as a most unwelcome guest and longed for the "enviable lot" of abolishing the tax. Our own heretical Theodore Roosevelt echoed voices speaking from a distant wilderness in the early part of the Twentieth Century in favor of graduated income and inheritance taxation, and a little later the unheroic Taft, in a burst of campaign oratory, predicted that the country would some day resort to the income tax as a revenue measure. Much fat was soon in a consuming fire. In 1909 Congress passed an income tax on corporations which an ingenious Supreme Court sustained as an indirect excise tax.<sup>4</sup> In 1913 Taft's harmless 1909 gesture in favor of a constitutional amendment permitting a tax on incomes "from whatever source derived" turned into reality when Wyoming became the 36th ratifying state. Almost immediately a radical named Cordell Hull and some energetic Senators from the West and South accomplished the enactment of our first modern income tax.<sup>5</sup> The inevitable had quickly come to pass, speeded by the strenuous efforts of its friends.

The Sixteenth Amendment came none too soon. In 1909 Elihu Root had wanted his country "to have all the powers that any country in the world has to summon every dollar of the public wealth to its support if ever the time of sore need comes upon it." That hour came more quickly than even the far-sighted Root could have imagined. Early in April 1917, President Wilson, who in 1915 had said that "there is such a thing as a man being too proud to fight" and "such a thing as a nation being so right that it does not need to convince others by force that it is right," asked Congress to declare war on Germany. Taxes quickly entered a losing race with events. Deficits in millions became deficits in billions. The income tax soon became the "center and sheet anchor" of the American financial system. Excess profits taxation joined a growing list of public enemies, and World War I tax rates reached a high of seventy-seven percent for individuals and 80 percent for corporations. The real triumph of Mr. Choate's argument in the Pollock case was this fulfillment of his prophecy.

"The universal element in the soul of man" burnt dimly in the years following World War I. Reaction from the exertions, the strain, and the suffering came almost immediately. The people elected a genial poker-playing President who did not believe that a tax law could

repeal the "inexorable laws of nature." The next President believed that the prosperity of the lower and middle classes depended upon the good fortune and light taxes of the rich, and that "if we are to adopt socialism (which he identified with the use of income and death taxes to shift part of the burden of taxation from the poor to the rich) it should be presented to the people . . . as socialism and not under the guise of a law to collect revenue." For a time the economy raced ahead; in fact, the country went on a financial spree. But, before leaders in high places knew what was happening, the sun was sinking in a cloudy western sky. The storm arrived in the midst of forbidding calm. In the fall of 1929 the deluge descended upon an unbelieving people. Twelve years of tax reduction, budget balancing, and a decade of speculative debauch were at an end. Fear stalked a weary land from which a puzzled President had only recently promised that poverty would soon be forever abolished. A golden age had collapsed, and the people turned for leadership to another unorthodox Roosevelt. This one began a long career in the Presidency and an extended period of contact with taxation by telling the people that the only thing they had to fear was fear itself—"nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance."

Retreat soon ceased, but advance was uncomfortably slow at first. Taxes climbed faster than prosperity and employment. Change with its long arm, its disturbing touch, its decree of things not yet manifest, was everywhere in surcharged air, and what was left of wealth was sorrowful and afraid. Newness acquired a new prevalence and scope and acceleration so that the years of our own lives began to measure not some small growth, or rearrangement or moderation of what we learned in childhood, but a great upheaval. The tree of government was bending to a sinister blast so that capital would not be broken. But reform reared a head that seemed ugly, and new brands of taxation found favor on Capitol Hill. In 1935 President Roosevelt suggested a tax upon inheritances "which bless neither those who bequeath nor those who receive," and Congress responded with increased estate tax rates. In 1936 the undistributed profits tax burst upon a startled business world to survive for only three years of hectic existence. In 1937 a revived Treasury Department, unreconciled as had been a former administration to tax avoidance deluxe, suggested stern measures for its prevention. An exciting decade ended with two opinions which proved that even a Supreme Court could change its mood. The opinion in one of these cases upheld the imposition of a Federal tax on salary of employees of the Port of New York Authority.<sup>6</sup> In the other case the opinion sustained the levy of a Federal excise tax upon admission to

State University football games.<sup>7</sup> These two opinions, together with another opinion handed down in 1939,<sup>8</sup> sustaining the constitutionality of a tax on the compensation of Federal judges taking office after June 6, 1932, indicated a disconcerting capacity in the Supreme Court for "self-correction,"<sup>9</sup> and suggested that the way was open under the Constitution for the taxation of interest on State and municipal securities.<sup>10</sup>

Nor were things quiet on the Potomac of economics. An English Economist named Keynes, who had acquired great wealth and was later to acquire a title, joined intellectual forces with an American banker named Eccles, who was also being unfaithful to his wealthy class, to preach strange doctrines of a compensatory economy. To these prophets of a new economic deal, and to many who followed in their rapidly moving footsteps, debts were the other side of investment and not in themselves sinful. Nor was saving an unadulterated virtue. The forces of supply and demand would not, as the classical economists thought, necessarily keep the economy at the full employment level. The interest rate was not a perfect mechanism which assured that demand for investment goods would always be forthcoming in an amount sufficient to utilize all resources not being used for meeting consumer demand. Investment sometimes needed the encouragement of governmental action; Government was an indispensable partner of business rather than a patron. Perhaps worst of all in some quarters, the new philosophy called for a tax system which would counteract tendencies toward a disproportionately fast rise in saving and promote tendencies to enlarge consumption to keep it in step with rises in productive capacity.

This was a persuasive rationalization of a progressive tax system which imposed a heavier burden upon high bracket incomes that are largely saved than upon low bracket incomes that are largely spent. It is hardly surprising that the higher incomes did not feel like taking these new heresies lying down. Opposition became fervent and almost religious; a national deficit became a criminal act; and a depression was preferable to profligate government spending. Protest took the form of vilification; in the vocabulary of most select clubs those who wished to experiment their way toward a distributed prosperity were at the mildest socialists. But the voters at least thought that they knew better, and the ultimate victory in modified form of many of the Keynesian doctrines illustrated the truth of Keynes' observation that "the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas—it is ideas, not vested interests, which are dangerous for good and evil," and rule the world. For Keynes commanded

the future from his study more than Napoleon from his throne. Many of his ideas triumphed in a cruel ideological battle, and have by this time translated themselves into action.

The people eventually learned that the government may by the proper use of public funds create a condition of full employment. And this new learning has become irreversible; the moving finger has written; and all our piety and wit cannot lure it back "to cancel half a line," nor all our tears "wash out a word of it." A finally obedient Congress embodied this "most important advance in human knowledge in modern times" in the Employment Act of 1946. Walter Lippman, who made this evaluation, added the grim warning: "Heaven help the administration which refuses to apply this knowledge in the postwar world."

There have been few necessities for applying this new knowledge since it was first painfully gained in the Thirties. A series of startling events intervened to supplement a rapid process of education by trial and error. German troops marched into Poland in September 1939, and—in the vivid metaphor of a Chinese statesman—the sky was suddenly "black with the wings of chickens coming home to roost." The inevitable quickly followed. Early on a Sunday morning in December 1941, a Japanese air squadron descended from the blue of the Hawaiian skies to cripple the American Navy. Government spending—a sinister threat in time of peace—was no longer a matter of choice in time of war. Enemy nations had forced prosperity upon a country which had searched long and vainly for a way out of the most dismal depression of all time.

The next decade changed the pace and scale of fiscal history. Experience taught an incredulous people that an internal debt of \$275 billion does not wreck a prosperous nation. In one year the Federal budget rose to more than twice the amount of the national income of the depression year 1933, and to even more than the national income of the halcyon year 1929. Unemployment all but disappeared. The anemic purchasing power of the Thirties became an eager giant ready to devour much more than the country's suddenly busy industrial plant could produce. Goods, not buyers, were lacking; a sellers' market replaced a buyers' market of more than a decade. A country grown weary of deflation had more inflation than it wanted. The new objective was to find means of production to win the war and at the same time supply goods for the constantly increasing civilian spending power created by war activities. The war had two fronts.<sup>11</sup>

World War II years brought new meanings and values and magnitudes to taxation. It was out of all question to pay completely for the

war as we went. That would have wrecked the production effort, so essential to winning the war. The home front problem was inflation with danger potentials almost as great and as evil as war itself. A combination of direct controls—such as price and wage control, allocations of scarce materials, rationing, and regulation of consumer credit—went into partnership with taxation, and an unprecedented pattern of saving, to control inflation. There was some inflation, as you know, but military victory in the war abroad finally came to a country unravaged by inflation at home. Something else came too,—a realization on the part of many people (1) that a nation can thrive under a staggering burden of taxation, and (2) that taxation is one of the most valuable instruments of economic control the world has ever known. No longer would taxes be merely the exactions of a greedy government that spends and spends and spends, or even a government that fails to spend enough; no longer would taxes be for revenue only; thenceforth, the power to tax, in association with other governmental powers, would be a power to fulfill a better destiny for the American people.

Taxation would not have achieved increased value as an instrument of social and economic control during World War II but for another development. In the estimate of Professors Surrey and Warren, it “changed its morning coat for overalls.” Switching their metaphors, and making their point doubly clear, Surrey and Warren added that the income tax spread from the country club group district down to the railroad tracks and then over to the other side of the tracks. The figures support this conclusion. The Civil War income tax affected only a top group of about 1 percent of the population. The high exemption levels of the World War I income tax saved from the impact of the income tax more than 100 million out of a total population of 106 million. The 1942 Act with its Victory tax put more than 50 million taxpayers on the rolls. It had become impossible to save the low incomes as well as the high incomes from a heavy tax burden and at the same time raise the revenue required to make the expenditures the Government would have to make for many years to come. The alternative of taxing the higher personal incomes had been nearly exhausted. Moreover, a tax limited to the high incomes would not have the impact upon the economy implicit in a tax with a broad base and low exemptions.

Postwar years furnished proof of the truth of Holmes’ aphorism that a page of history is worth a volume of logic.<sup>12</sup> Logic told the economists, almost to the man, and many others who had known little but depression in their adult lives, that there would be grave problems of adjustment to postwar deflation. Congress, in fear of a business col-

lapse, rushed to repeal the ungainly excess profits tax. But instead of collapsing, business boomed after the war, and inflation continued to be a grave problem.

Altogether, the history of American taxation teaches a paradoxical lesson. Theoretically, high taxes should have an adverse effect upon the economy, since every tax is an impediment to action the taxpayer might otherwise take if he did not have to pay the tax.<sup>13</sup> But the historical record of the last 30 years should cultivate some distrust of strict logic in fiscal matters. In this instance its exactness has proved to be completely delusive.

My friend, Will Davis, has wisely said: "You can never argue about a fact; you can simply be ignorant of a fact." Let me briefly summarize the economic record of the last 35 years:

(1) After a period of low taxation in the Twenties the national income fell from a high of \$80 billion in 1929 to a low of \$40 billion in 1932. Unemployment rose to a high of 13 million.

(2) In the subsequent period of increasing taxes the American economy moved forward to the prosperity we are now enjoying. After adjustment for price changes the per capita income of the average American after taxes increased forty-two percent; farm income increased about fifty percent. Unemployment all but disappeared.

(3) In the record prosperous year 1953 taxes were virtually at World War II levels. Indeed, the combined corporate normal and surtaxes are even now at a level twelve points higher than the level they reached during World War II.

(4) In a period of high taxation we have established a Social Security program which provides a substantial cushion against the hazards of old age, dependency and unemployment. There has been a sensational increase in savings represented by bank deposits, U. S. savings bonds and life insurance.

These and many other statistics at least suggest the idea, dramatically expressed by Alvin Hansen, that we have "an Alice-in-Wonderland kind of economy in which the more we spend for defense, the more we have left for investment and consumption." And the historical record proves, I think, that American capitalism is not a house of cards which a slight gust of wind can blow away, but rather a tough institution which has taken a good deal of punishment in its stride, and which can continue to absorb heavy taxes if unavoidable international pressures so require.

The record of the American people as individuals is equal to the record of their corporations. They have demonstrated a willingness to



pay taxes that is almost unique in world history. No one yet knows the limit of their endurance or the boundaries of their capacity to make payment for a civilized society.<sup>14</sup> That a people so numerous, so scattered, and so individualistic annually assess themselves with a highly burdensome tax liability seems to me, as it once seemed to Mr. Justice Jackson, "a reassuring sign of stability and vitality of our system of self-government."<sup>15</sup>

Now as I come to the end of my allotted time, I suppose that I should turn from history to the present and the future. The value of history is not intrinsic; it is but a prologue to the future. Its virtue is that it provides perspective for those who must try to solve the many imponderable riddles presented by the tax and fiscal issues of the present time, and those which an intensely indeterminate future will bring to a country which has an appointed rendezvous with destiny. Is it possible to appraise in realistic terms the product of all the fabulous industry and ingenuity that has contributed to the making of our existing tax system?

The Man from Mars might assert that Congress and the Treasury and the Courts had had time over a period of forty years to make our Federal tax structure almost perfect. That the system is full of defects needs no demonstration. And yet I cannot suppress a feeling of wonder that our tax system is as good as it is when I remember how it came into being. It consists in large part of a series of extemporized responses to the immediate emergencies of war and depression. To a marked degree it is the product of snap judgment. Rarely, until recently, have we tried to use taxes to shape events. Cause and effect have been the other way around. Our taxes have been the result of our times when our times should have been the result of our taxes. We have imposed taxes without realization of their economic and social consequences when we should have imposed taxes carefully designed to bring the economic and social consequences we desired. In different words but not a different sense, to a large degree our taxes have been mere revenue-raising devices lacking the dignity and utility that derives from more comprehensive and far-reaching purposes.

In recent years history has taught us that taxes can do much more than raise revenue for a passive government which performs the few restricted functions which occupied the American government of the Nineteenth Century. We have learned that taxes can be part of a plan to prevent inflation and instruments in a campaign against deflation. We know now that they can serve as a prophylactic agent against undue concentration of wealth, and that they can function as a distributor of the cost of special benefits, as do Social Security taxes. As a result the place of taxation and fiscal policy in the economic and social fabric

of the country has altogether changed from the lowly station it occupied in the days before the Sixteenth Amendment gave a new green light to Congress. In short, we have listened to the message of tax history and the astonishing events of the Twentieth Century—that taxes can thwart the growth of the kind of America we desire, or help to make that America.

In addition, our tax system seems remarkable from the standpoint of the ponderous machinery of Congressional committees, hearings, debates, and administrative and judicial interpretation that constitute the Federal taxing process. I believe that we have a better tax system than we have any right to expect from such an inefficient process. I know that the system is unduly complicated. But taken in its entirety, it is a fair and equitable system. It is not as progressive as it pretends to be,<sup>16</sup> but its emphasis is not wholly divorced from the principle of ability to pay. The recent shift away from taxes upon consumption, which by their very nature bear heavily upon the low income groups, to taxes upon individual income and corporate profits results in a more reasonable distribution of the burden caused by the vast expenditure the Soviets are now forcing upon this country. As a consequence, the tax system in its present form is serving its great purpose without great dislocation of the personal lives of most Americans and without unduly hurting business or destroying the incentives of the free enterprise system.

The principal danger faced by our tax system, as I visualize our eclectic future, lurks in the mystery that surrounds the subject of taxation. Its history should not be the dull, esoteric story that has often been told; no aspect of American history has so deeply affected the ordinary daily living of most Americans. Many fiscal decisions have been more important to the country's development than the outcome of some wars. Many things done on Capitol Hill have been more critical than many battles. The whole fiscal story is inextricably entwined with the remarkable development of the country; it is part of the texture of America. For the future taxation presents an area of critical decision which may determine, for better or worse, the answer to the question whether the great experiment initiated by our forefathers shall succeed or fail. More than anything else, I think that our tax system needs a more diffused knowledge in and among the American people of its content and policy implications. We know too much for one man, or even a few men, to know much. It is imperative that American citizens understand how taxation works; how the tax revenue is extracted from the economy; from whom it is being extracted; and what portion of the total is being paid by different groups in the country. The democratic

process requires intelligent discussion of taxation at the grass roots level as a basis for many critical political decisions to be made in the future if we are to progress toward increased prosperity and a better life for all Americans.

Let me end with an apparent, but I do not think a real, contradiction. In taxation policy must embrace several viewpoints and blend many considerations. Thoughts about taxation must run in the manner of the thought of John LaFarge's friend, Okakura, "as a stream runs through grass, hidden perhaps but always there;" and we will often feel uncertain in what direction the stream is flowing. This kind of thought is unsatisfactory to the longing for certainty and repose that lures many human minds into an acceptance of delusively exact answers put forward by theorists who sometimes disguise the difficulties of a problem by sweeping all the chessmen off the table. That kind of approach will only obstruct the solution of the novel and imponderable tax problems we face in these anxious times. "They do things better with logarithms" was the wail that escaped the bewildered Cardozo when he contemplated the finished product of the best that was in him by way of the analysis of some of the legal problems he tried to solve. But there is no push-button solution of the economic problems of this complex, troubled period. There seldom is to any of the real problems of life. These economic problems are different from problems in algebra or geometry or trigonometry. The science of taxation is a poor, inexact science with many pressures and shades of contradiction. The most honest opinions will often differ widely, and we must all find our ways as best we can with a fallible and groping wisdom through tangles of imperfectly understood situations, past conflicts of values that cannot be wholly resolved, to answers which have to do. In the end we may have to wager our salvation upon a process of judgment we cannot articulate in full detail.

In the meantime, we need to be beware of the heathen that would beguile us to their temples, and the sirens with their songs. Rules of thumb "are a lazy man's expedient for ridding himself of the trouble of thinking and deciding."<sup>17</sup> Experience is a better teacher than theory, but theory is indispensable too. There is an unending interplay between fiscal policy and a constantly reshaping society. The perpetually changing economic problems of modern life call for a flexible attitude which looks analytically at the past, realistically at the present, and hopefully toward the future with the knowledge that there must be constant adaptation to the new necessities of an expanding economy.

It is a little more than three centuries since the colony of new Plymouth, Massachusetts, passed a short vague statute which taxed its few

inhabitants "according to their estates or faculties, that is, according to goods lands improved faculties and Personal abilities." It is not yet a year since the Congress of the United States passed a long, intensely specific, statute of 984 pages revising in wholesale fashion the internal revenue laws of the United States. What the Congresses of later days will do no man can tell; perhaps some day some Congress will better succeed in the task of making tax law "simpler and surer." But it is safe to guess that for too much law more law will have to be the cure, and that we are even now, after so much traveling, only at the end of the beginning of a long journey. Neither you in this audience, nor I on this platform, will be present at the beginning of the end of the journey. But, as long as strength survives, we can, at least, travel hopefully, which may, as Robert Louis Stevenson once suggested in another context, be better than to arrive.