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A Brief History of Federal Taxation

The modern federal tax system is based on income taxation. This tax system, and the size and role of government it supports, is largely a creation of the New Deal and World War II. Although the U.S. Constitution granted Congress authority to levy many types of taxes, the first federal tax measure was a tariff bill, and the tariff remained the principal source of federal revenue until World War I.

Partisan conflicts over federal taxing power quickly emerged in the 1790s as Federalists proceeded to raise tariff rates and levy new excise taxes (notably an unpopular tax on whiskey) and direct taxes on land and property. Jeffersonian Republicans, in turn, denounced these "internal taxes" and the spending regime that they supported. As president, Thomas Jefferson proceeded to repeal internal taxes while pursuing balanced budgets and debt reduction exclusively through spending cuts. The War of 1812 then temporarily reinstated internal taxes, but tariffs and revenues from the sale of public lands largely funded the federal government for the next several decades. While tariff rates and protectionism continued to fuel partisan and sectional disputes over this period, federal budgets remained small and usually balanced.

The Civil War revived internal taxes and briefly introduced income taxes on individuals and businesses. With the growing federal budgets of the post–Civil War era, excise taxes remained in place, and protective tariffs became the focus of an escalating debate over fairness and economic distortions. Federal taxes and spending, however, remained relatively low. At the turn of the twentieth century, the federal budget was less than 3 percent of gross national product (GNP); state and local spending, by comparison, was nearly twice as high.[1]

[1] Dennis S. Ippolito, *Why Budgets Matter: Budget Policy and American Politics* (University Park: Pennsylvania State University Press, 2003), 84–85.

The constitutionality of the federal income tax was finally settled in 1913, and individual and corporate income taxes provided by far the largest share of federal revenues during World War I. These taxes remained in place at reduced levels during the 1920s, and the domestic policy initiatives of the New Deal and the enormous costs of World War II then completed the transition to the income-based federal tax system in place today. The development of federal tax policy, then, has been shaped by wars and also by competing visions of the size and role of government. The critical first step in that development, however, was the struggle to establish the federal government's power to tax.

Securing the Power to Tax

The Revolutionary War was fought by a national government that could not tax and had to resort to massive borrowing, paper currency, and even mass expropriation (impressment) of goods and services.[2] Once the war was over, the Confederation Congress was powerless to compel the states to raise revenues on its behalf and found itself unable to service the wartime debt or to fund an army or navy to protect the nation. Tax protests helped spark the movement toward independence, so the lack of a national revenue system during this period no doubt reflected widespread antitax sentiments. It can also be traced to colonial attitudes regarding "the authority to levy a tax, not over the tax itself."[3] The American colonies had, in fact, developed diverse systems of taxation that were far more important in terms of revenue than the taxes levied by England.[4] Because these taxes were imposed by the colonial governments, in particular by colonial legislative assemblies, they did not ordinarily raise the constitutional and representational issues that undermined the English government's efforts to tax the colonies.

Colonial Taxes

The taxes commonly used in the colonies affected property, goods, and people. Property taxes on land were levied, at one time or another, by most of the colonies, and "improvements, personal property, and inventories" were also taxed by several colonial governments.[5] Taxes on goods included excises (notably on domestic liquor), import duties (on rum, wine, finished goods, and slaves), and export duties (on commodities such as tobacco). Poll taxes were

[2] E. James Ferguson, *The Power of the Purse: A History of American Public Finance, 1776–1790* (Chapel Hill: University of North Carolina Press, 1961), 57–69.

[3] Steven A. Bank, Kirk J. Stark, and Joseph J. Thorndike, *War and Taxes* (Washington, D.C.: Urban Institute Press, 2008), 2.

[4] Glenn W. Fisher, *The Worst Tax? A History of the Property Tax in America* (Lawrence: University Press of Kansas, 1996), 12.

[5] Edwin J. Perkins, *The Economy of Colonial America* (New York: Columbia University Press, 1980), 125–126.

prevalent, in most cases with flat or graduated rates on adult males as well as slaves and servants.[6]

There were regional variations in the colonial tax system. The New England colonies "regularly used the property tax as a source of income and all accepted, at least nominally, the idea that taxation should be related to ability to pay."[7] Southern colonies relied on poll taxes and property taxes, but with considerably less concern for ability to pay. In the southern colonies, "men of landed and established wealth, who normally dominated the southern legislatures, erected a tax system that favored their interests."[8] Both direct and indirect taxes were found in the middle colonies.[9]

The New England colonies also used "faculty" taxes – precursors to the income tax – that applied to the earning capacity of various occupations or trades. These included special taxes on "merchants, moneylenders, artisans, lawyers, and others who did not live off the land."[10] In most cases, these levies were not directly applied to income but depended on the ability to earn. In Massachusetts, however, a specific tax rate was levied on incomes and profits from various business activities.[11]

While the types of taxes levied by the colonial governments were diverse, it is generally agreed that the overall level of taxation was relatively low. One study estimates that "British tax burdens were ten or more times heavier than those in the colonies."[12] In part, taxes were low because colonial governments provided few services beyond their administrative costs. County and town governments were usually responsible for whatever provision was made for the poor and were also called upon to help meet the expenses of locally organized militias.[13]

In addition, most of the cost for the military defense of the colonies was taken on by the English government. The French and Indian War, which lasted from 1756 to 1763, was the most expensive of the military campaigns fought on the North American mainland. England emerged from this war with undisputed control of Canada, Florida, and territory east of the Mississippi River, and with a very large wartime debt. The new taxes levied on the colonies by England, beginning with the Sugar Act of 1764 and the Stamp Act of 1765, were intended to defray some of these costs, but the response from the colonies was uniformly hostile. Boycotts of English goods, attacks on tax collectors, and a formal

6 Ibid., 126.
7 Fisher, *The Worst Tax?*, 15.
8 Ibid., 16.
9 Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon & Schuster, 1986), 364.
10 Fisher, *The Worst Tax?*, 4.
11 Perkins, *The Economy of Colonial America*, 127.
12 Alvin Rabushka, *Taxation in Colonial America* (Princeton: Princeton University Press, 2008), 867.
13 Davis Rich Dewey, *Financial History of the United States*, 6th ed. (New York: Longmans, Green, 1918), 8–9.

protest by the Stamp Act Congress that nine colonies organized in October 1765 led Parliament to repeal the Stamp Act the following year. Heavier import duties then were enacted, including the infamous tax on tea, and customs enforcement was strengthened as well. Thus, taxation continued to strain relations between the colonies and England until the Revolution.

The colonial period established some general views about taxation that would affect public finance for quite some time. The authority of colonial assemblies to levy taxes was widely accepted, but taxes were kept low by strictly limiting the types of expenditures for which the colonial governments were responsible. Colonial legislatures also resorted to borrowing, in the form of "bills of credit," to fund extraordinary expenses, such as war, and to promote commerce. The reliance on paper currency and borrowing, rather than taxation, to fund the Revolutionary War was a natural progression.[14] In addition, this legislative power of the purse was routinely used to prescribe "exactly what could and could not be done" with public funds.[15] While the administrative practices and capacities of the colonial governments were in many instances rudimentary, their understanding of the political importance of the taxing power was not.

Financing War without Taxes

The Continental Congress that operated as a "national government" until the Articles of Confederation were ratified in 1781 was never given the power to tax by the states, despite the repeated difficulties it encountered in financing a long and costly war. It first issued unsecured paper currency, with 2 million in Continental dollars printed in July 1775 and an additional 4 million by the end of the year.[16] The total climbed to $25 million in 1776, at which point this unsecured currency began to depreciate sharply in value. Congress had planned for the states to levy taxes in support of this currency, but the states were overwhelmed by their own wartime expenses and reluctant to impose heavier taxes. A requisition system that Congress adopted in November 1777 assigned financial quotas to each state, with an estimated $95 million apportioned over the next two years. Less than $13 million, however, was actually received and less than $1 million of this amount was in the form of specie payments.[17]

The Continental Congress also borrowed from domestic and foreign creditors. The first authorization for domestic loan certificates was issued in 1776. Foreign loans and subsidies began that same year, with an initial grant from

[14] James D. Savage, *Balanced Budgets and American Politics* (Ithaca: Cornell University Press, 1988), 65.
[15] Webber and Wildavsky, *A History of Taxation and Expenditure*, 365.
[16] Ferguson, *The Power of the Purse*, 26.
[17] Ibid., 33–34.

France.When the war ended in 1783, more than $6.3 million had been borrowed from France and nearly $1.5 million from Holland and Spain.[18]

The direction of wartime finance passed to the Articles of Confederation government in 1781. Like its Continental Congress predecessor, the Confederation Congress had no direct taxing power. Under Article VIII, expenses for the war and "all other expenses that shall be incurred for the common defence or general welfare, and allowed by the united states in congress assembled" were to be financed out of "a common treasury."[19] The mechanism for funding that treasury, however, depended on taxes "laid and levied" by the states. These taxes were to be apportioned among the states based on "the value of all land within each state," as well as buildings and improvements, but the states were then responsible for meeting their obligations.

The requisition system worked no more effectively under the Confederation government than it had previously. In an attempt to provide a more certain access to revenues, the Confederation Congress approved a national tariff in 1781 (an impost or import duty of 5 percent) that would be pledged to paying interest and principal on all wartime debt, foreign and domestic.[20] The states, however, rejected the constitutional change necessary to vest this power in Congress. A revised national tariff plan was submitted to the states in 1783, with stricter limits on its application and duration and with the further stipulation that state officials, rather than federal officers, would be responsible for its collection. It, too, failed to secure the unanimous agreement of the states required to amend the Articles. Federal taxes on land, poll taxes, and excises on liquor were also proposed, but none were approved by Congress.

The financial weaknesses of the Confederation government became even more glaring after the war ended in 1783. The wartime debt that the national government had incurred totaled nearly $40 million, while the states had an estimated $21 million in additional debt, most of which was directly or indirectly tied to wartime expenses.[21] For the national government debt, annual interest charges were estimated at almost $2 million, with roughly one-fifth of this amount needed to service foreign debt. Requisitions collected from the states had dwindled even further after 1783, so these obligations could not be met. In 1785, interest payments on the debt held by the French government were suspended, and a default on principal repayment occurred two years later. Private loans from Holland were rescheduled and interest continued to be paid, but principal repayment could not be postponed indefinitely, raising fears about another default.

[18] Dewey, *Financial History of the United States*, 47.
[19] Henry Steele Commager, ed., *Documents of American History*, 6th ed. (New York: Appleton-Century-Crofts, 1958), 113.
[20] Ferguson, *The Power of the Purse*, 117.
[21] Dewey, *Financial History of the United States*, 56.

As interest payments were delayed or suspended, the amount of outstanding debt increased. Between 1783 and 1789, arrears of interest on domestic debt totaled more than $8 million and arrears on foreign debt nearly $1.6 million.[22] The fiscal problems of the Confederation, and its political weakness, crippled its ability to maintain a military that could protect against external and internal threats. The Continental Army had been almost entirely disbanded after 1783, leaving a "pathetically small" force of 625 men.[23] Little could be done to enforce American territorial rights in disputes with England and Spain or to deal with frontier conflicts involving the Indian tribes. And without a navy, American commercial vessels had little protection against the Barbary pirates preying in the Mediterranean. When a rebellion broke out in western Massachusetts in 1786 over the state's tax and credit laws, Congress voted to raise troops and to collect requisitions from the states to support them.[24] Only one state, Virginia, complied. When the Massachusetts legislature refused to provide funds for a state militia, the governor and a group of bankers in Boston organized and privately funded a militia that ended Shays' Rebellion without any federal assistance. This episode had a "chilling effect on the thinking of prominent political leaders through the states [and] confirmed the widespread suspicion that the Confederacy was dangerously weak."[25] In 1787, Congress found itself "so destitute of funds and credit that it could neither pay its own civil officers nor borrow one penny from its own citizens."[26]

As the incapacities of the Confederation government deepened and apprehensions over foreign threats and internal disorder mounted, efforts to create a new national government gained widespread, if not universal, support. Led by such notables as George Washington, Alexander Hamilton, and James Madison, this movement persuaded a reluctant Congress to authorize the constitutional convention that met in Philadelphia in May 1787. Its stated purpose was to revise the Articles of Confederation through "alternations and amendments" that would "render them adequate to the preservation and support of the Union."[27] Shortly after the convention began, however, plans for a radically different national government began to take shape.

Taxation, Spending, and Borrowing

The deliberations of the Philadelphia Convention were concluded on September 15, 1787, and the proposed Constitution was submitted to Congress two days

[22] Ibid., 57.
[23] Bank, Stark, and Thorndike, *War and Taxes*, 5.
[24] Sheldon W. Pollack, *War, Revenue, and State Building* (Ithaca: Cornell University Press, 2009), 163.
[25] Ibid.
[26] Roger H. Brown, *Redeeming the Republic* (Baltimore: Johns Hopkins University Press, 1993), 27.
[27] Quoted in Pollack, *War, Revenue, and State Building*, 168.

later. On September 28, Congress approved a resolution submitting the Constitution to the states for ratification. The ratification debates that then took place revealed sharp divisions over the powers and structure of the new federal government. For its critics, the Constitution's transfer of power from the states to the federal government was unnecessary and even dangerous. The military was a major concern because the Constitution provided Congress with the authority "to raise and support Armies" and "to provide and maintain a Navy." Anti-Federalists were convinced that these provisions, and the power given to Congress over state militias, posed a serious threat to individual rights and liberties and, of course, to the states. The prospect of a federal standing army was particularly unsettling given the recent colonial experience.

Anti-Federalists also objected to the fiscal powers the Constitution conferred on Congress. The New York and Rhode Island statements of ratification, for example, included proposed constitutional amendments to restrict federal borrowing and debt by requiring two-thirds votes of the House and Senate.[28] Anti-Federalists also opposed the Constitution's prohibition on state-issued bills of credit and its related requirement for specie repayment of debt. The taxing power the federal government would exercise under the Constitution was especially troubling to those who wished to maintain the prerogatives the states had enjoyed under the Articles of Confederation. Their greatest concern was that the federal government would no longer be dependent on the states for revenue but rather would have an exclusive power over tariffs that would deprive the states of needed revenues. Finally, and "most abhorrent of all," the federal government would be able to levy "internal" taxes (such as excises) in addition to tariffs, or "external" taxes.[29]

That the Constitutional Convention would modify the requisition system was no great surprise. Edmund Randolph, who presented the Virginia Plan at the beginning of the Convention, explained that the Articles of Confederation had been drawn up when little was understood "of the science, of constitutions, and of confederacies."[30] As a result, the "inefficiency of requisitions was unknown – no commercial discord had arisen among any states . . . foreign debts had not become urgent – the havoc of paper money had not been foreseen." The competing New Jersey Plan, which envisioned only modest changes in the Articles of Confederation, nevertheless conceded the necessity for new revenue provisions. It authorized the Confederation Congress "to pass acts for raising a revenue" through tariffs and stamp taxes.[31] If additional revenues in the form of requisitions were needed, the New Jersey Plan provided that

[28] Savage, *Balanced Budgets and American Politics*, 83.
[29] Dewey, *Financial History of the United States*, 73.
[30] Max Farrand, ed., *The Records of the Federal Convention of 1787* (New Haven: Yale University Press, 1911), I–18.
[31] Commager, *Documents of American History*, 136.

Congress could apportion these among the states based on their population and "devise and pass acts" ensuring compliance.

When national tariffs had been proposed in 1781 and 1783, most states had been willing to amend the Articles of Confederation to authorize their use. The Constitutional Convention could have simply revived the tariff option but instead endorsed a comprehensive federal taxing power, completely eliminating the requisition system that had made the Confederation government dependent on the states. Thus, the language in Article I, Section 8 amounted to a sweeping change in the critical power of taxation:

> The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

The Constitution did place a restriction on "direct taxes" in Article I, Section 2, requiring that "Representatives and direct Taxes shall be apportioned among the several States, which may be included within this Union, according to their respective Numbers." During the colonial period, poll taxes and land taxes had been considered direct taxes, but the "precise meaning" of the term was not altogether clear when the Convention approved this language.[32] (The Supreme Court exploited this ambiguity in 1895, when it invalidated the federal income tax as a direct tax requiring apportionment. The Sixteenth Amendment in 1913 then removed the apportionment requirement for income taxes.)

The fiscal powers in Article I included broad grants of authority regarding borrowing and spending. No restriction was placed on federal deficits or debt, and both taxes and borrowing could be used to support spending. The spending power, in turn, extended to the "common Defence and general Welfare," the delegated powers assigned to Congress, and the "necessary and proper" clause that concludes Section 8.

The breadth of the federal government's power to tax, spend, and borrow was defended at length in Federalist Papers 30–36 by Alexander Hamilton. Hamilton had been one of the most ardent proponents of a strong national government at the Convention and was convinced that expansive and integrated fiscal powers were not only desirable but necessary. Federalist 30 contains Hamilton's classic statement that "Money is with propriety considered as the vital principle of the body politic; as that which sustains its life and motion and enables it to perform its most essential functions. A complete power to procure a regular and adequate supply of it . . . may be regarded as an indispensable ingredient in every constitution." For Hamilton, an "unfettered" power to tax and to borrow was needed so that the federal government could meet its foremost responsibility of defending the nation, but he argued that the

[32] Jack N. Rakove, *The Annotated U.S. Constitution and Declaration of Independence* (Cambridge: Harvard University Press, 2009), 110.

government's taxing power should be "requisite to the full accomplishment of the objects committed to its care and to the complete execution of the trusts for which it is responsible." Hamilton contended that this "indefinite power of taxation" should be "free from every other control, but a regard to the public good and to the sense of the people."

The Constitution had conferred on the federal government the broad powers to tax, spend, and borrow, so the checks on these powers were, as Hamilton understood, essentially political. Once the Constitution was ratified and the new government organized, the political contest over the actual size and role of the federal government began. As the nation's first Secretary of the Treasury, Hamilton set the initial course for federal financial policy, but he and his Federalist followers were challenged and ultimately defeated by a Republican Party that had very different views about taxation and the nation's finances.

Tariffs versus Internal Taxes

The fiscal history of the United States from the 1790s until the Civil War illustrates the important role that taxation played in national politics. The political majority for most of this era – the Jeffersonian Republicans, later the Democrats – was strongly opposed to internal taxes, especially excises. They had a correspondingly narrow view of federal spending, an intense commitment to balanced budgets, and an aversion to the accumulation of federal debt. The balanced-budget rule, as a prescription for limited government, thus became the operative principle for the federal government if not for the states. In addition, the legislative power of the purse, another Republican tenet, worked reasonably well during peacetime but was not well suited for emergencies, especially war.

The Federalist Vision

On September 2, 1789, Congress created the Department of the Treasury and assigned to its Secretary the responsibility for reporting to Congress on the administration of federal finances, including "plans for improving and managing the revenue and for support of the public credit."[33] Alexander Hamilton was appointed Secretary on September 11, and his first "Report Relative to a Provision for the Support of the Public Credit" was submitted to Congress on January 19, 1790. This report, which proposed that the federal government honor both its domestic and foreign debts at their original (or par) value and also assume the wartime debts contracted by the states, was extremely controversial. Hamilton's later proposals for a national bank and the use of tariffs and subsidies to promote domestic manufacturing and economic development further deepened the divisions with Thomas Jefferson and his followers in

[33] George T. Kurian, *A Historical Guide to the U.S. Government* (New York: Oxford University Press, 1998), 582.

Congress. Issues relating to taxation and debt became recurring themes in the struggle for political control between Hamilton's Federalists and Jefferson's Republicans during the 1790s.

The first national tariff was enacted shortly after Congress convened in 1789. The tariff act that became law on July 4, 1789, "provided for specific duties on over thirty kinds of commodities; for ad valorem rates, varying from 7½ to 15 per cent, on a few specified articles, and for a 5 per cent duty on all articles not enumerated."[34] At Hamilton's urging, tariffs were increased the following year, and another tariff increase in 1791 was approved, as was a new excise tax on distilled spirits and stills. Other "internal taxes" soon followed, including a tax on carriages in 1794. These new taxes were not popular. Protests against the excise tax on whiskey culminated in the Whiskey Rebellion in 1794, which required the intervention of federal troops. The carriage tax was challenged by the state of Virginia but upheld by the Supreme Court in 1796. According to the Court, the carriage tax was not a direct tax and did not require apportionment among the states.

The following year, Congress passed a tax on land (including houses and slaves) that fell under the Court's definition of a direct tax and was accordingly apportioned among the states. This tax was needed to help fund a naval buildup that began during the late 1790s. Prior to that, the American "navy" consisted of a small fleet of revenue-cutters – armed sailing ships that patrolled American waters and helped enforce revenue laws – that Hamilton had established in 1790.[35] In 1798, Congress also authorized a payroll tax on seamen's wages to finance their medical care in the Marine Hospital Service.

The sweeping program of federal taxation enacted under Hamilton and Oliver Wolcott, who succeeded him in 1795, quickly restored the credit of the United States. Revenue from tariffs and other taxes were dedicated to payments on the nearly $80 million in consolidated debt that the federal government held in 1790, and the funding and servicing of the debt became routine. Between 1789 and 1801, interest on the public debt accounted for almost one-half of federal spending (see Table 1.1). Beginning in 1792, however, spending for the Army and, later, the Navy rose sharply in response to military threats involving Indians, Algerine pirates, England, and France, and other noninterest expenditures grew as well, averaging more than $1.2 million annually by the late 1790s. The total federal budget more than doubled over this period from less than $4.3 million in 1789–1791 to nearly $10.8 million in 1800. Despite the tariffs and internal taxes enacted by the Federalists, there were several deficits during the 1790s and a modest increase in the total debt.

For Republicans, the Federalists' accumulation of deficits and debt had to be reversed, but Republicans were also committed to restricting the use of internal taxes. Hamilton had wanted to establish the federal government's authority

[34] Dewey, *Financial History of the United States*, 81.
[35] Kurian, *A Historical Guide to the U.S. Government*, 584.