Book Review

Ajay K. Mehrotra, *Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation, 1877-1929*, Cambridge: Cambridge University Press, 2013, pp. 432, $78.

Reviewed by Steven A. Bank

Ajay Mehrotra is a leader of a new generation of tax historians and a pioneer in the field of fiscal sociology. Befitting his richly interdisciplinary training and acculturation, Mehrotra's work is not merely a history of the tax laws, but an almost anthropological peek at the development of the nation's fiscal architecture. Although others have written about the origins of the income tax from a variety of disciplinary perspectives,[1] few are able to weave together the law, politics, sociology, and economics in the way he does.

In *Making the Modern American Fiscal State*, all of the best qualities of Mehrotra's work are on display. The book is careful, nuanced, informative, and comprehensive, painting a detailed picture of how the revenue system was radically remade over this period from a system based upon the necessity to consume to a system based upon the ability to pay. In the early nineteenth-century federal revenue system, which Mehrotra calls the Old Fiscal Order, America relied primarily upon regressive tariffs or customs duties to fund expenses at the national level. These were consumption taxes levied on products and goods imported into the country.

As with consumption taxes generally, such as the modern retail sales tax levied by states and municipalities, tariffs were regressive in the sense that they disproportionately burdened those of modest means. Rather than being borne by foreign importers, tariffs were largely passed on to consumers in the form of higher prices. Although there were some luxury goods that were purchased primarily by wealthier customers, most customs duties were on staples that everyone bought directly or indirectly in other products, and consumption was distributed fairly evenly among economic groups. This meant that even if

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1. *See, e.g.*, W. Elliot Brownlee, Federal Taxation in America: A Short History (2004) (economic history), Richard J. Joseph, The Origins of the American Income Tax: The Revenue Act of 1894 and Its Aftermath (2004) (law); John F. Witte, The Politics and Development of the Federal Income Tax (1985) (political science).

everyone consumed roughly the same amount of a product and bore roughly the same nominal amount of the additional cost attributable to the customs duties, the percentage of a wealthy person's income taken by such additional cost was far less than the percentage of a poorer person's income.

What compounded the regressivity of the tariff beyond that of a mere consumption tax is that tariffs effectively benefited wealthy domestic producers at the expense of consumers, the bulk of whom were decidedly lower on the socio-economic scale. In part, this was because the tariffs often were designed not to raise revenue, but rather to protect growing domestic industries against the competition from foreign imports. In theory, the protection did not have to drastically affect the price borne by consumers. The differential between domestic products and foreign imports as a result of the tariff simply should have driven consumers to buy the domestic products. That would have enriched domestic producers, which may have raised questions about the distribution of government power and largesse, but without seriously burdening consumers except perhaps as to choice and quality of the product purchased. In reality, though, tariffs enabled domestic producers to raise their prices to a point just below the tariff-driven rise in price for the comparable imported products. This meant that tariffs facilitated a windfall for domestic producers who were generally on the higher end of the income distribution, while levying a cost on consumers that was disproportionately felt by those who were of modest means. Moreover, as Mehrotra describes, opponents charged that tariffs exacerbated this regressive effect by removing competition and thereby facilitating "economic collusion and the concentration of corporate power in the form of trusts and other monopolies" (50). So, in the industries where tariffs offered protection to domestic concerns, the resulting drop in competition may have permitted those domestic manufacturers and producers to ultimately raise their prices even beyond that originally occasioned by the tariff.

Although Mehrotra is not the first to observe the revenue system's shift away from the reliance on regressive tariff taxes toward more progressive income taxes, he provides a much richer picture of how it occurred. He describes how this transformation took place not just through legislative enactments, but also through academic discourse. As befitting someone steeped in the Elliot Brownlee tradition of economic history, Mehrotra devotes ample time to profiling the pioneering public finance economists whom he credits for this progressive transformation in academic theory, including Henry Carter Adams, Richard T. Ely, and Edwin R.A. Seligman (97-120). Perhaps his greatest contribution is in the book's detailed description of the centralization of fiscal authority and the concomitant development of the administrative apparatus to operate the new system (293-348).

One might be tempted, however, in the wake of Thomas Piketty's tome *Capital in the Twenty-First Century*,[2] to ask whether the transformation Mehrotra describes actually accomplished very much. Piketty did find a reduction in inequality between 1910 and 1950 that roughly parallels the growth in the progressive income tax that Mehrotra describes, but he similarly observed a "resurgence of inequality after 1980 . . . due largely to the political shifts of the past several decades, especially in regards to taxation and finance."[3] The implication is that while Mehrotra may have described a transformative period in American finance, it was one that was rolled back in the latter half of the twentieth century. This is something that Mehrotra foreshadows in his description of the post-World War I period, when the rise of Republican fiscal policy under Treasury Secretary Andrew Mellon led to a rapid and drastic decline in the high graduated rates that had been enacted during the war (396-404).

Moreover, some observers of taxation during this period question whether the reduction in inequality during the first half of the century had much to do at all with the introduction of the income tax. Piketty attributed it primarily to the First and Second World Wars and the policies adopted in association with the war effort and subsequent recovery.[4] The advent of a system of pension payments for Civil War veterans has been described as similarly important to the creation of a social welfare state,[5] although it is fair to conclude that its stability was at least partly attributable to the revenue from income taxation.

Others have gone further in dismissing the progressive origins of the income tax. Political scientist Robert Stanley, writing about the income tax's beginnings during the Civil War and continuing through the ratification of the Sixteenth Amendment and the adoption of the first modern income tax,[6] described the tax as counterrevolutionary. According to Stanley, "income taxation was invoked to forestall dissent against the course of centrism during times of economic crisis."[7] As Stanley pointed out, the income tax did little to redistribute wealth. The income tax levied a one percent normal charge and up to a six percent surcharge.[8] This was a far cry from the rates advocated by progressives at the time the first post-Sixteenth Amendment income tax was adopted in 1913, with Representative Ira Copley's proposal for a top surtax rate

2. Thomas Piketty, Capital in the Twenty-First Century (Arthur Goldhammer, trans. 2014).

3. *Id.* at 20.

4. *Id.* at 20, 396-98.

5. Steven R. Weisman, The Great Tax Wars 176 (2002).

6. Robert Stanley, Dimensions of Law in the Service of Order: Origins of the Federal Income Tax, 1861-1913 (1993).

7. *Id.* at 13.

8. 38 Stat. 166 (1913); *see also* Sidney Ratner, Taxation and Democracy in America 333-6 (1980).

of sixty-eight percent falling on deaf ears.[9] Moreover, the thresholds for the adopted rates were quite limited, with the normal rate applying to individual incomes in excess of $3000 and the top rate applying only when incomes exceeded $20,000.[10] This was at a time when the mean adult male income was estimated to be $578,[11] making the income tax essentially inapplicable to the vast majority of the population and the top rates applicable to an exceedingly small circle of people. Three-tenths of one percent of the population had to pay the tax in 1916, which amounted to a mere one percent of the workforce.[12] Furthermore, the income tax revenues constituted only 11.5 percent of federal revenues in 1915, which was more of a reflection of the decline of tariff revenues due to the onset of World War I in Europe than a higher burden for the upper class.[13] From Stanley's perspective, all the income tax did was to acquiesce the masses that might have otherwise seized the opportunity presented by economic instability to revolt as they did against czarist Russia.

In *Making the Modern American Fiscal State*, Mehrotra responds to Stanley and other New Left legal historians by focusing on the permanent shift in the base of taxation ushered in during this period. Mehrotra maintained that "[t]he dramatic shift from a regressive, hidden, disaggregated, and politicized tax system to a graduated, transparent, and centrally and professionally administered one was a tremendous achievement" (27). The stability of the new fiscal order developed incrementally through accretion rather than dramatically through a particular court decision or legislative enactment, but it was no less permanent. According to Mehrotra, "[t]his transformation may not have gone as far as some dissent activists, theorists, and legislators had hoped, but it ultimately laid the foundation for a revolution in American fiscal relations. The idea that this was purely a palace revolution . . . provides only a partial accounting of a considerably more complex and consequential historical moment" (27). Mehrotra might have extended his study through World War II, when the tax fully assumed its place as the most important source of federal revenues,[14] to better make his point, but he does convincingly establish that the income tax became entrenched by 1929.

Although Stanley's revisionism likely goes too far in rejecting the progressive nature of the move to income taxation, what may be lost in Mehrotra's defense of the momentous nature of the transformation is the extent to which the progressivism involved in the shift was more contextual, political, and contingent than the rhetoric might suggest. There were certainly those who envisioned a radically redistributive type of progressive taxation,

9. 50 Cong. Rec. 1246 (1913) (statement of Rep. Copley); Ratner, *supra* note 8 at 328, n. 15.

10. 38 Stat. 166, 167 (1913); Stanley, *supra* note 6 at 249-50.

11. Stanley, *supra* note 6, at 249.

12. *Id.* at 250.

13. *Id.*

14. Steven A. Bank, Kirk J. Stark & Joseph J. Thorndike, War and Taxes 84 (2008).

but they weren't exactly the winners in this debate. Arguably, the winning theory of income taxation was one that is hardly ever discussed today and is not mentioned in *Making the Modern American Fiscal State*—one Edwin Seligman called in 1908 the "special compensatory theory."[15] This was distinguished from the general compensatory theory, which posited that the income tax was necessary to offset "the inequalities consecrated by custom and by law" whereby "the legal conditions of society naturally favor the rich."[16] Under the special compensatory theory, the revenue system is viewed as a whole and one form of taxation is made progressive to make up for the regressive effects of another specific form of taxation. According to Seligman, the income tax and other similar direct taxes are "designed to act as an engine of reparation" against the regressivity of the customs duties and excise taxes.[17] "In order to attain equal treatment," Seligman wrote, "regressive indirect taxes," must be counterbalanced by the progressive direct tax."[18]

It's not that Mehrotra ignores this part of the story. For example, he explains that in 1894 "[income] tax advocates . . . reminded their opponents that the proposed income tax was merely a supplement to a larger tariff regime, and that national taxation was just one part of a broader fiscal order that included many forms of regressive taxat[ion]." (128). But Mehrotra characterizes this as a mere political compromise that served as a weigh station on the road to the true progressivity of an income-centric tax system, rather than being a part of the design itself. Instead, it may be better understood as a view that the base and the rates of an income tax could ratchet up or down based on the makeup of the remainder of the system. Indeed, during the debates over the first post-Sixteenth Amendment income tax bill in 1913, Senator John Sharp Williams, the leader of the Democratic caucus, argued that "when the good day comes—the golden day—when there will be no taxes upon consumption at all . . . and no import duties at all except countervailing duties to offset them… [then] everybody will pay in proportion to his income," which, in effect meant a flat rate.[19] The transformation Mehrotra describes was important and it was progressive (in no small part due to the advance of fiscal citizenship that is one of the book's themes), but it was not necessarily designed to lead to progressive income taxation in the sense of steeply graduated marginal rates.

Perhaps this is why the "retrenchment" Mehrotra describes in the 1920s was less a retreat from the principles of progressivity and more a reflection of the return to the mean for income taxation in its service as a mild counterbalance to the continued presence of regressive features, including, in more modern times, the regressivity arising from the unequal distribution of tax evasion opportunities and from the wage taxes that disproportionately burden the

15. Edwin R.A. Seligman, Progressive Taxation in Theory and Practice 146 (1908).

16. *Id.* at 144 (quoting French writer Nicolas Villiaumé).

17. *Id.* at 146.

18. *Id.*

19. 50 Cong. Rec. 3841 (1913) (statement of Sen. Williams).

lower and middle classes. In many respects, the fundamentally moderate or even conservative underpinnings of the original income tax continues to describe the tax laws and frustrate reformers, including those who see Piketty's description of the rise of inequality as a clarion call for new forms of wealth taxation. Nevertheless, the fundamental point driven home by Mehrotra's *Making the Modern American Fiscal State* is that the brilliance of the federal revenue system is its ability to accommodate more progressive reforms, even if the political will may not currently exist to adopt them.