

From Tariffs to Taxes

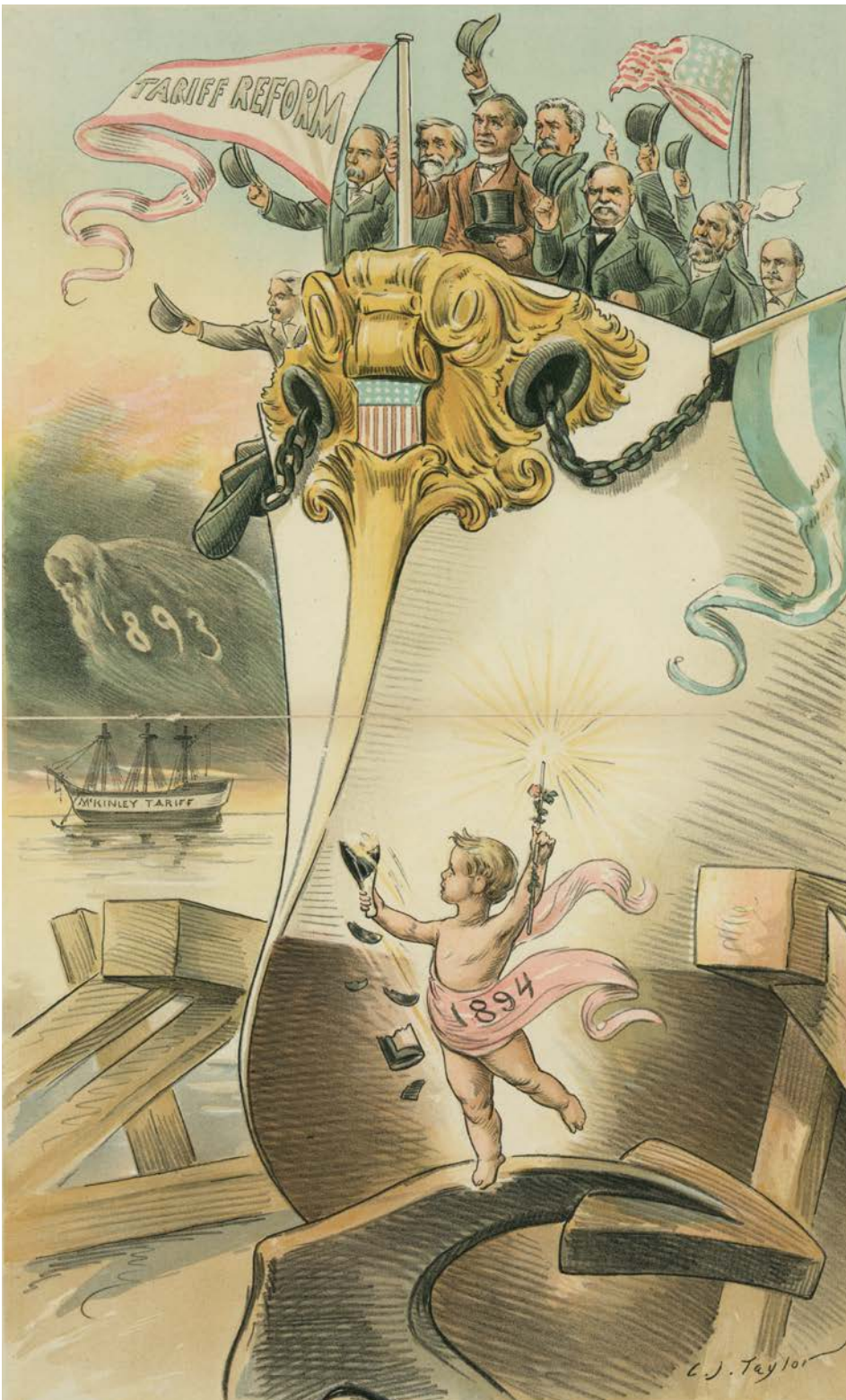
By Michael A. Martorelli

FROM 1888 TO 1913, the arguments for and against tariffs and income taxes were as heated as any in the country's history. The decision to shift from using tariffs as the major source of federal revenue to depending instead on income taxes occupied two generations of lawmakers. Achieving that goal required the intervention of the Supreme Court and the passage of an amendment to the US Constitution.

The Tariff Act of 1789 was the first major piece of legislation passed by the members of the first US Congress. Given their negative experiences with British taxation, it's no surprise those legislators turned to tariffs as the prime source of the new country's revenue. Taxing imported goods at an average rate of about 15% did indeed raise the prices of those products to American consumers. But doing so also established a pricing umbrella that gave nascent manufacturing industries an economic subsidy as they began to establish themselves. The legitimacy of using tariffs to finance the government was not especially controversial. But while the validity of tariffs was not seriously challenged, they were never universally popular. Indeed, throughout the next 100 years there was rarely an extended period of time when the details over the amount of the tariff and the range of goods on which that levy was imposed were not the subject of strenuous arguments among government officials and the general population. Even while waging those arguments, however, successive administrations of both political parties were able to maintain a certain level of protectionist tariffs through periods of both peace and war, as well as prosperity and panic.

The tariffs that were generating about \$50 million annually (80–90% of all federal receipts) in the late 1850s proved woefully inadequate to finance the Union's \$3.2 billion cost of prosecuting the Civil War. In 1861, Treasury Secretary Salmon Chase persuaded Congress to establish the nation's first income tax in order to bolster the Union's finances. During the four years of fighting, Congress approved new

1893 *Puck* cartoon titled "Launched at Last—Good Luck to Her!" showing a cherub labeled "1894" smashing a bottle of champagne as he launches a large ship under the banner "Tariff Reform" with Grover Cleveland and members of his cabinet standing on the bow waving their hats.



levels for both tariffs and the income tax. The federal government borrowed more than \$2.6 billion to finance the war; it generated another \$360 million from income taxes and \$300 million from tariffs.

The income tax expired in 1872. Federal fiscal policy returned to what had been considered normal in the antebellum era. From 1875 to 1890, tariffs consistently accounted for well over half of federal receipts. Meanwhile, total federal spending declined steadily, leading to the generation of sizable budget surpluses throughout the 1870s and 1880s and the eventual calls for substantial tariff reform, i.e. reductions.

In December 1887, Democratic President Grover Cleveland sparked what congressmen themselves called “The Great Tariff Debate of 1888” by devoting much of his Annual Message to tariffs. It was a blistering attack on the overall level of tariffs, the inequitable nature of the levies imposed on various imported products and the damage that high tariffs did to the financial health of consumers and farmers. The Democratic majority on the House Ways and Means Committee spent the next year crafting a bill that would reduce the average tariff by almost 30%.

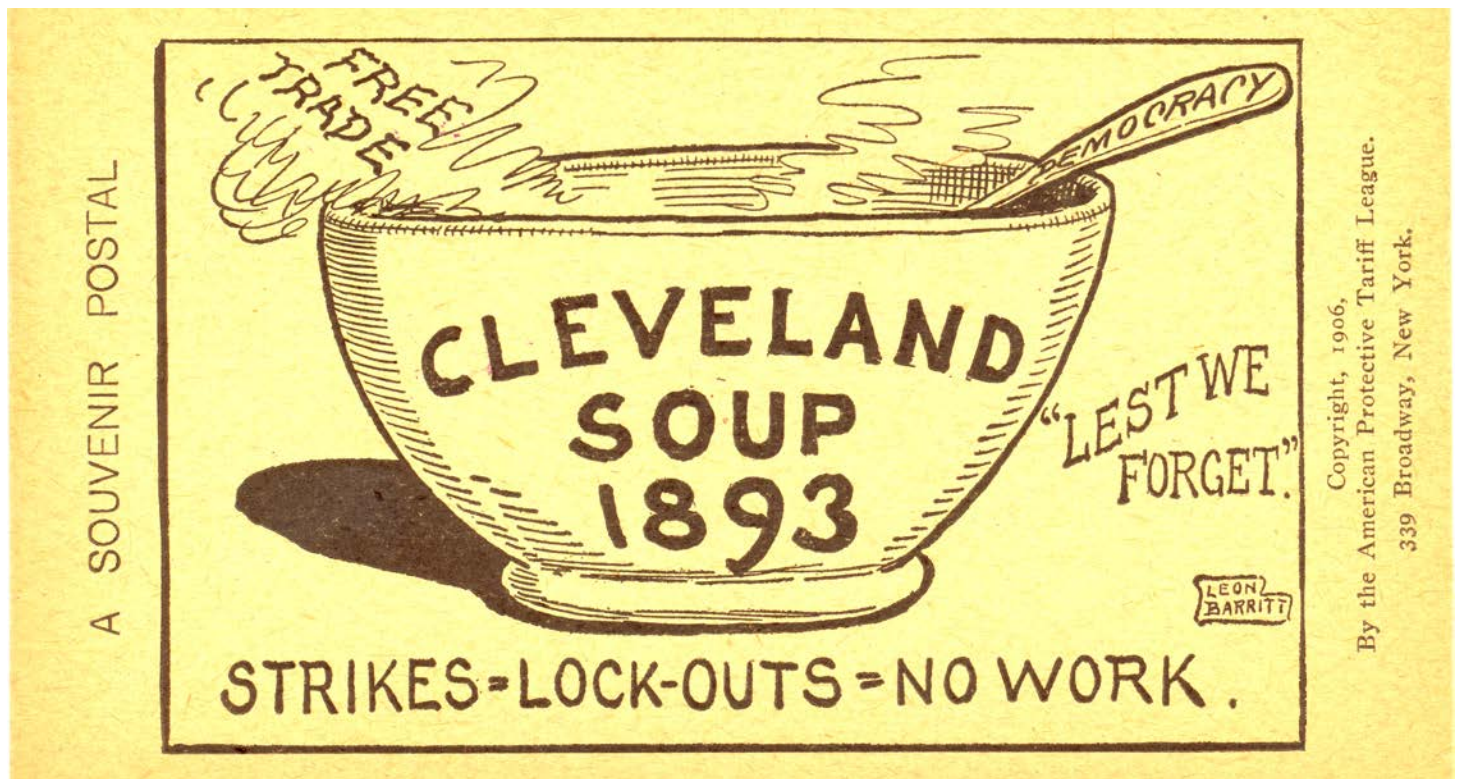
The Republican-controlled Senate Finance Committee proposed a different bill that would actually raise most tariffs. The debate that raged in Congress throughout 1888 reflected the two political parties’ worldviews that tariffs were either essential to the protection of American manufacturers against foreign competition (Republican) or harmful to most consumers and farmers forced to pay higher prices for manufactured goods (Democratic).

The political deadlock seemed to be broken by the election of 1888 that saw Republicans win both the presidency and the control of both houses of Congress. But the victors misinterpreted Americans’ feelings about the need for high tariffs. Benjamin Harrison actually lost the popular vote to incumbent Grover Cleveland; but the Republican became the 23rd President by winning a majority of votes in the Electoral College. From his position as the new chairman of the House Ways and Means Committee, Congressman William McKinley shepherded through Congress what became known as the McKinley Tariff Act of 1890; that bill raised the average duty on imports by about 45%.

The next two elections proved that the Republicans had overplayed their hand.

In November 1890, Democrats won back control of the House and gained seats in the Senate; in 1892, Cleveland re-claimed the presidency and Democrats re-gained control of both houses of Congress. Predictably, key legislators in the House and Senate crafted the Wilson-Gorman Tariff Act, which lowered tariffs to their pre-1890 levels and which President Cleveland signed in August 1894. The lingering effects of the Panic of 1893 were instrumental in making the election of 1896 yet another realigning one in which Republicans took control of the presidency and both houses of Congress. Party leaders devoted their time to again addressing the tariff issue; by July 1897, President William McKinley was ready to sign the Dingley Act and, thereby, raise tariffs back towards their 1890 levels.

After winning re-election in 1900, the protectionist-minded McKinley found himself challenging the long-held Republican idea that American industry benefitted from the existence of a high wall of protective tariffs. Companies of all sizes were increasing their efforts to market their products to customers throughout Europe, South America and Asia. The President came to realize that high levels of tariffs



1906 postcard for the American Protective Tariff League showing a bowl labeled “Cleveland Soup, 1893.” The words “free trade” and “lest we forget” appear to the left and right of the bowl, a spoon “democracy” rests inside the bowl. The image references the Panic of 1893 and President Grover Cleveland’s inaction at reforming the tariff laws.



1894 print shows a St. Bernard rescue dog with a blanket labeled “Tariff Reform” strapped to its back and a small barrel labeled “The Wilson Tariff Bill” under its chin, next to a man labeled “Labor” caught in snow drifts labeled “McKinley Tariff”; nearby, Grover Cleveland, as a monk with a hand to his ear, responds to the dog’s bark. At the top of a hill, in the background, is the US Capitol.

Library of Congress

were impeding those efforts. In order to enable more international trade, he suggested in a speech in September 1901 the need for a series of joint agreements among nations to reduce tariffs and eliminate unnecessary trade barriers. But he never got the chance to take concrete steps to pursue that idea since he was assassinated the very next day. For most of the next seven years, the very activist President Theodore Roosevelt gave lip service to the idea of at least semi-free trade and supported selected reciprocity agreements. However, he did very little to address the tariff question in any fundamental manner.

Immediately upon taking office in March 1909, Roosevelt’s chosen successor, William Howard Taft, called Congress into special session to address what he believed was another necessary effort at tariff revision. Taft held the traditional Republican view that high tariffs were necessary to protect the interests of the nation’s manufacturers. But he also acknowledged that the need for high rates was steadily declining as those manufacturers continued to improve their own efficiencies of production and distribution. The

President was content to let congressional leaders develop the details of the much-needed tariff revision. However, his sporadic comments during the five months it took those men to develop a bill only served to confuse the supporters of both protectionism and free trade. In August, President Taft signed the Payne-Aldrich Tariff Act, a compromise bill that lowered 650 tariff rates, raised 220 others and left 1,150 unchanged. It proved unsatisfactory to a large number of reform-minded Republicans and was a major reason why many of them deserted the party in the election of 1910. That intra-party split enabled Democrats to gain control of the House and make inroads into the Republican majority in the Senate. Two years later, Democrats again benefitted from the split between Republican conservatives and progressives. Democrat Woodrow Wilson entered the White House in March 1913 with majorities in both houses of Congress. In October, he signed the Underwood-Simmons Act that lowered the general tariff level again—this time to one not seen in more than 75 years.

As noted earlier, the income tax that

had been levied during the Civil War years expired in 1872. During the next decade, congressmen representing the Greenback movement and Labor Reform party made more than a dozen attempts to revive that tax.

They were repeatedly rebuffed by representatives from the industrial Northeast. Throughout the 1880s, a growing number of labor leaders, agrarian associations and social reformers became increasingly aware of the role that high tariffs and high excise taxes were playing in exacerbating the unequal distribution of wealth in America. By the dawn of the new decade, they began to realize that a progressive income tax represented the most effective way to dissolve the apparent link between high tariffs and the monopoly powers enjoyed by the country’s business elite. Imposing an income tax during a time of peace and prosperity still posed a challenge. But the changing times helped accelerate the desire for such a tax.

The Panic of 1893 saw an unprecedented number of bank closings and corporate failures, as well as record increases in unemployment and personal

bankruptcies. It provided an excellent backdrop for the emerging consortium of the disaffected groups noted above to push their congressional representatives to impose a progressive income tax on the wealthy. In addition to reducing tariffs, the Wilson-Gorman Act of August 1894 introduced a 2% federal tax on individual income. Members of both the Populist and Democratic parties supported the reduction in tariffs and the concomitant establishment of a graduated income tax with a relatively high exemption. Taking these actions would not disrupt the level of federal revenue but would shift the balance of revenue-producers from the poor to the rich. The validity of that argument was never tested. In April 1895, the Supreme Court declared the tax to be an unapportioned direct one that violated several clauses of the US Constitution.

This particular version of an income tax might have died, but the idea for one certainly did not. Its supporters believed the Supreme Court had been mistaken in its ruling. Moreover, they saw the personal income tax as not only an economic tool to address some fiscal imbalances, but an ethical and moral way to raise government revenue while limiting the growing concentration of wealth. In the 1896 campaign for the presidency, the Democratic standard-bearer William Jennings Bryan supported an income tax aimed primarily at the wealthiest Americans to replace the tariffs and excise taxes that were paid largely by the poorest citizens. Even after his defeat, the party leaders continued to push for an income tax. In 1898, House Democrats' proposal for an income tax of 3% on annual incomes over \$2,000 was soundly defeated.

In the midst of the emerging debate over the income tax, the federal government began to report increasingly larger deficits in each year from 1897 to 1899, even with the Dingley tariffs at historically high levels. Restraining federal spending was difficult, largely due to the need to fund programs such as the expansion of the Navy and increases in veterans' pension benefits. In the first several years of the 20th century, members of the Republican party's growing progressive wing came to appreciate the need to consider new sources of revenue. Another financial panic in 1907 brought reduced economic

activity, more corporate bankruptcies, high unemployment and new strains on the federal budget. By 1909, congressional progressives had become sufficiently powerful to add an income tax rider to an early version of the Payne-Aldrich Tariff Act.

On separate occasions since winning the White House, President Taft had voiced both support for and opposition to an income tax. He did not want to see another challenge to the Supreme Court over such a fundamental change in federal policy. Instead, he believed Congress should pass a constitutional amendment authorizing a tax on individuals' income before actually imposing such a levy. Even while wrangling over what was to become the Payne-Aldrich Tariff Act noted earlier, in July 1909, Congress sent to the states this language for a proposed 16th Amendment: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Taft persuaded the conference committee crafting the final version of the tariff bill to replace the provision for an income tax on everyone with one taxing only the income of corporations. As noted earlier, he signed Payne-Aldrich in August.

When the 16th Amendment was proposed, conservative lawmakers in Congress doubted it would be ratified by the required number of 36 of the country's 48 states. Many failed to recognize the public's dissatisfaction with the complex and always-changing system of tariffs. Farmers in the South and West, and Progressives and Populists in other areas agreed with the traditional Democratic argument that tariffs unfairly taxed the poor and drove up prices for all consumers. President Theodore Roosevelt and his progressive Republican followers supported the amendment. Legislators representing manufacturers, bankers and others involved in the country's expanding foreign trade recognized its role in supporting reductions in tariffs and other trade barriers. And government officials of both parties saw the tax as a way to insure the greater level of federal revenue they believed would be necessary to respond satisfactorily to the growing militarism of Germany and Japan. All three candidates for President in 1912

supported the amendment. It was no surprise when Delaware acted in February 1913 to become the 36th state to vote for its ratification.

With that amendment now approved, Congress used a provision of the aforementioned Underwood-Simmons Act of October 1913 to impose a progressive individual income tax at rates ranging from 1% to 7%. Tax revenue started to flow to the individual US Treasury within the year.

Tariffs generated 95% of the US government's revenue in 1790. During the next 120 years, they rarely dipped below 60% of federal receipts. In 1915, following the passage of the 16th Amendment, tariffs contributed only 30% of those receipts. During the subsequent 102 years they declined steadily as important sources of revenue; tariffs now account for less than 2% of all the funds the government receives. Meanwhile, the personal and corporate income taxes formally proposed in 1909 have recently been contributing more than 55% of revenue. The so-called "payroll tax" used to fund the Social Security and Medicare programs established in 1933 and 1965, respectively, provide another 35%. But that, as they say, is another story. \$

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