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The Intellectual Foundations of the Modern American Fiscal State

Ajay K. Mehrotra
Indiana University Maurer School of Law, amehrotr@indiana.edu

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At the turn of the twentieth century, the U.S. system of public finance underwent a dramatic structural transformation. The late-nineteenth-century system of indirect national taxes – associated mainly with the highly partisan tariff and regressive excise taxes on alcohol and tobacco – was eclipsed in the early twentieth century by a professionally administered, graduated income tax that soon accounted for more than half of all federal tax revenue. This seismic shift toward direct and progressive taxation marked the emergence of a new fiscal polity, one guided not simply by the functional need for revenue, but by social concerns about justice, fairness, and the equitable distribution of fiscal obligations.

The intellectual debates and political struggles that took place a century ago inform our current discussions about "fundamental" tax reform. In recent years, American scholars, policy analysts, and lawmakers have decried the failings of the present U.S. tax system. At the same time, commentators have identified how the recent rise in inequality has signaled the arrival of a new Gilded Age in the United States. In an attempt to confront this increasing concentration of wealth and power, some present-day reformers have vowed to make profound changes to our existing progressive income and wealth-transfer taxes. A century ago, during a similar period of rising inequality, serious structural reform was not only envisioned but also achieved, and we would do well to recall the social and economic conditions, as well as the political will, that made that fundamental fiscal reform possible.

In the early twentieth century, the modern American fiscal state turned to direct and graduated taxes to reallocate the economic responsibilities of financing an emerging regulatory and administrative, social-welfare state. But the reformers who sought to usher in a new fiscal order intended to use tax laws and policies for much more: to redefine the meaning of modern citizenship; to facilitate a fundamental change in existing political arrangements; and, perhaps most important, to help underwrite the expansion of the American liberal state. To do all of this, tax activists understood that they needed to lay an intellectual foundation in support of direct and progressive taxation.

Among the critical reformers, a particular group of academic experts played a pivotal role in reconfiguring the meaning and implications of taxation. In a subtle, though significant, move, these economic and political theorists helped to supplant the prevailing "benefits theory" of taxation, and its attendant vision of the state as a passive protector of private property, with a more equitable principle of taxation based on one's "faculty" or "ability to pay," which demanded a more active role of the positive state. Led by the likes of Richard T. Ely, Henry Carter Adams, and Edwin R. A. Seligman, these German-trained, professional political economists helped dismantle the nineteenth-century orthodox theories of laissez-faire and promoted the adoption of new, more effective and egalitarian forms of taxation and state action.

The thinkers who led the movement for direct and graduated taxation emerged from similar backgrounds and experiences. Many were reared in the deeply religious environment of Northeastern evangelical Protestantism, and even those who distanced themselves from organized religion channeled their theological and ethical inclinations into their academic work and public advocacy.[1] German training and experience, moreover, bolstered their moral orientation. They, like many other aspiring American scholars, turned to German universities and mentors for their professional training in the social sciences, learning firsthand from some of the leading figures of the German historical school of economics about how historical and institutional development affected the so-called "natural" laws of political economy. And as part of their education outside the classroom, they learned about the promise and perils of the modern European social-welfare state.[2]

These scholars returned to the United States troubled by the excesses of late-nineteenth-century American industrial capitalism. The labor unrest and class conflict that resulted from the modern forces of mass migration, rapid industrialization, and uneven economic growth fortified the economists' reformist tendencies. Although they realized that they could not graft European social democracy onto American political culture, the progressive political economists sought to link the highbrow theories of the academy with the material world of the working masses.[3] They did this, in part, by challenging the prevailing system of political and economic thought and providing a new conceptual foundation for new forms of taxation. Eschewing timeless universalisms, these academic theorists believed that economic relations were embedded in a larger social and institutional matrix, one constituted mainly by law and legal processes. Thus many of the leading progressive political economists were eager to use law and legal institutions to exercise the "ethical agency" of state power. In this way, many of these thinkers were part of what legal historians have identified as the "First Great Law & Economics Movement."[4]

The intellectual movement for progressive taxation, guided by the new generation of professional economists, was part of a much larger transformation in American social thought at the turn of the century, often referred to as a "revolt against formalism." Shifting the justification for taxation from the benefits theory to the ability-to-pay principle delegitimized past standards of rigid economic thought and facilitated new ways of thinking about the social processes of modern life. This consequential transition profoundly affected the development of American liberalism, turning it away from its classical emphasis on negative individual liberties and toward a new focus on collective, positive rights.[5]

For many of the progressive political economists, benefits theory and the ability-to-pay principle were contending doctrines with fundamentally different underlying social and political theories. The benefits doctrine stood for the outmoded proposition, in the progressives' view, that taxation was justified as a price paid for goods and services provided by government in exchange for tax payments. Under the benefits theory, individuals paid taxes to ensure that the neutral and limited state could provide citizens with physical and financial security, not only from each other, but from the public powers of the state. The Michigan jurist and treatise writer, Thomas M. Cooley, typified this line of thought. "The citizen and the property owner owes to the government the duty to pay taxes," Cooley proclaimed, so "that the government may be enabled to perform its functions, and he is supposed to receive his proper and full compensation in the protection which the government affords to his life, liberty and property, and in the increase to the value of his possessions by the use to which the money contributed is applied."[6] Citizens, in essence, traded tax payments solely for the benefits that they received from the state.

The benefits theory equated taxes with commercial transactions. Members of a polity had no social obligations or civic duties beyond the *quid pro quo* of paying taxes and receiving governmental protection. If taxation was one of the most commonly and consistently experienced relationships between Americans and their government, benefit theory appeared to limit that important relationship – and the civic identity that emerged from it – to the cash nexus. Fiscal citizenship itself was reduced to a commodity.

In criticizing the benefits principle, the progressive political economists emphasized its anachronistic implications. Challenging Cooley directly, Richard Ely claimed that taxes could not be justified based on "the old fiction of reciprocity." Ely was careful in explaining that taxes were "not exchanges" or "payments" for public goods and services. "The sovereign power demands contributions from citizens regardless of the value of any services which it may perform for the citizen," wrote Ely in his 1888 tax treatise.[7]

As students of the German historical school of economics, progressive thinkers like Ely applied a thoroughgoing historicism to their analysis of contemporary American political economy and tax policy. Thus, Henry Carter Adams boldly derided classical benefits theory for ignoring how "the modern State ... assumes duties far beyond the primitive functions of protection to life and property." Although such a "quid pro quo theory of taxation may have served fairly well under conceptions of governmental activity held in the early part of the century," Adams argued in 1898, "it must be regarded at present as somewhat antiquated."[8]

Edwin Seligman, the leading authority on progressive taxation, condemned the social theory underpinning the benefits principle in even starker terms. Like Ely and Adams, Seligman maintained that the benefits doctrine was based, at its core, on an obsolete conception of citizenship:

> It is now generally agreed that we pay taxes not because the state protects us, or because we get any benefits from the state, but simply because the state is a part of us.... In a civilized society the

> state is as necessary to the individual as the air he breathes; unless he reverts to stateless savagery and anarchy he cannot live beyond its confines. . . . To say that he supports the state only because it benefits him is a narrow and selfish doctrine. We pay taxes not because we get benefits from the state, but because it is as much our duty to support the state as to support ourselves or our family; because, in short, the state is an integral part of us.[9]

Simply put, the progressive economists used taxation as a means to renegotiate the social contract between citizens and their state. Instead of relying on abstract economic relations based on market transactions to justify taxation, they turned to social relations and the interdependent reality of modern social and political life to explain the need for direct and graduated taxes.

The progressive theorists' unified disdain for the benefits principle did not translate, however, into a single universal vision of the ability-to-pay doctrine. Adams, who believed in distinguishing between the theoretical justification for taxation and the "lawyer's point of view," relied on what he referred to as a "contributory theory of a tax." Progressive taxation was justified under such a theory because it embodied the ethical duty of social unity that citizens of a polity owed to each other and to the larger commonwealth. Unlike the prevailing "purchase theory" or benefit theory of tax, which emphasized a solitary, atomistic, and consumerist relationship between the citizen-taxpayer and the state, Adams argued that a contributory theory was based on "solidarity of social interest." For him, a "sense of organic unity and of interdependence, and consciousness of common rights and common duties, go along with the idea of contribution."[10]

Ely pushed further in emphasizing the link between social solidarity and taxation. Quoting approvingly from a Massachusetts Tax Commission report, he wrote: "All the enjoyments which a man can receive from his property come from his connection with society. Cut off from all social relations a man's wealth would be useless to him. In fact, there could be no such thing as wealth without society."[11] Seligman took a slightly different approach. Although he agreed that the social interdependence occasioned by modern industrialism had displaced the logic of autonomous individualism, he maintained that the triumph of the ability-to-pay principle was the culmination of a long and gradual historical process driven mainly by class dynamics. "Amid the clashing of divergent interests and the endeavor of each social class to roll off the burden of taxation on some other class, we discern the slow and laborious growth of standards of justice in taxation, and the attempt on the part of the community as a whole to realize this justice," proclaimed Seligman. "The history of finance, in other words, shows the evolution of the principle of faculty or ability to pay – the principle that each individual should be held to help the state in proportion to his ability to help himself."[12]

To be sure, the practical application of the ability-to-pay principle had its limits. Accurately measuring a citizen's ability to pay taxes was a controversial issue that remained rather elusive – then and now.[13] But the progressive economists contended that their primary, pragmatic tax reform objective was not to recommend an unassailable fiscal system based on the principle of ability to pay. Rather, they aimed to demonstrate the theoretical limitations inherent in the benefits principle. That is not to say that they thought the benefits principle had no place in tax-policy discussions; their goal instead was to make more explicit the political and social theory implicit in the dueling tax notions and, in the process, create support for a reform movement. In this sense, the political economists, like other progressive activists, used the language of ethical duties and the idiom of social solidarity "less to clarify a political philosophy than to build a political constituency."[14]

Creating a social and political movement for tax reform also meant reaching an audience beyond the academy. The progressive economists thus realized that the power of their ideas alone was often not enough to change the laws and institutions that undergirded the American fiscal system. They needed to take a more active role in the political and policy-making process by participating as consultants and part-time tax commissioners, and by capturing the attention of lawmakers.

Just as the economists and other social scientists were promoting their ideas, the American political system itself was undergoing a profound transformation. The nineteenth-century political structure of "courts and parties" was giving way to a more fractured and pluralistic system of American statecraft. The rise of a more competitive political process and greater reliance on expert administration challenged the traditional control of party politics and patronage.[15] By linking a graduated income tax to tariff reform, tax activists were able to help move fiscal policy away from party politics and toward administrative expertise. With this shift, reform-minded economic experts joined organizations like the National Tax Association, the leading professional association of public finance experts, and other civic groups to provide an outlet for their ideas.

To make their ideas palatable for the public, the progressive economists needed to navigate between the two prevailing political positions on taxation. In leading the conceptual campaign for progressive tax reform, they needed to defend their ideas against economic and political conservatives who wanted to maintain the status quo, and against the seemingly radical populist calls for a more dramatically redistributive fiscal system.

Political conservatives, wedded to a classical, night-watchman view of the state, equated the move to graduated income and wealth-transfer taxes with creeping socialism. The conservative critic David A. Wells, for instance, contended that, except in the case of war financing, there was no place in a free republic for any form of graduated taxes based on the ability to pay. Although Wells, the former commissioner of Internal Revenue during the Civil War, was well aware of the importance of using taxes to fund an army and build a nation, he, like many old-guard commentators, opposed progressive taxation adamantly. "Any government, whatever name it may assume, is a despotism, and commits acts of flagrant spoliation," declared Wells, "if it grants exemptions or exacts a greater or lesser rate of tax from one man than from another." Arguing that graduated taxes of any sort were a form of emasculating charity, Wells concluded that "equality and manhood, therefore, demand and require uniformity of burden in whatever is the subject of taxation."[16] The progressive economists observed firsthand, often to their personal and professional detriment, the overwhelming power that critics like Wells held, particularly in delineating the bounds of academic freedom.

Conservative hostility to progressive tax reform, however, spread beyond social commentators and the academy and into legal institutions of power. The U.S. Supreme Court, in a rather surprising decision for contemporaries, struck down as unconstitutional the 1894 income tax, the first peace-time measure of its kind. In his concurring opinion, Justice Stephen J. Field illustrated the anxiety with which elites viewed the progressive tax movement. "The present assault on capital is but the beginning," wrote Field. "It will be but 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."[17]

Addressing these conservative opponents, the progressive economists sought to demonstrate that support for graduated taxes could be compatible with traditional American notions of equality and fairness. This required first showing that critics had erroneously assumed that "progressive taxation necessarily implies socialism and confiscation." Citing David Wells's writings explicitly, Seligman claimed, "[I]t is quite possible to repudiate absolutely the socialistic theory of taxation and yet at the same time advocate progression."[18]

To do so, Seligman and his like-minded colleagues turned to marginal utility analysis, an increasingly popular economic concept in the European and American academy at the time. A variant of neoclassical economics, marginalism held that the value of a commodity was based upon the subjective worth, or utility, a consumer ascribed to it. This value, in turn, depended upon how much of the commodity the consumer already had. Each additional, or marginal, unit of a commodity, including money, was believed to be of lesser value than the previous unit.[19] The progressive tax theorists used the notion of the diminishing marginal utility of money to contend that progressive taxation, in fact, entailed an equality of sacrifice among taxpayers. "Strict equality of sacrifice in the sense of relatively proportional diminution of burden," wrote Seligman, "thus involves progressive taxation."[20]

The use of marginalism to decouple graduated taxation from state socialism may have persuaded some critics. But the reform-minded economists faced a more amorphous, though equally formidable, kind of opposition from the political left, where the populist attraction to Henry George's single-tax theory distracted important constituencies away from the progressive tax reform movement. In defusing this opposition, the tax theorists attempted to debunk the amateur economic analysis conducted by George and his disciples and to unmask the "ultra conservative" social theory that underpinned George's call for a single-tax on land.

In his enormously popular 1879 book, *Progress and Poverty*, and in other writings, Henry George advocated for a levy only on increases in land value – a single-tax on what George referred to as the "unearned increment" of appreciated land. George's idea quickly captured the imagination of contemporary social movements. As early as 1885, Richard Ely observed that "tens of thousands of laborers have read *Progress and Poverty*, who have never before looked between the two covers of an economic book."[21]

Henry George and the single-tax appealed to a variety of grassroots, populist groups as an attack on land speculators and monopolists. Yet as the progressive economists noted, the single-tax in particular and George's political philosophy in general were premised on a conservative, if not reactionary, view of individualism. George argued that the fruits of individual labor belonged to the individual and the state had very little role to play in economic or social matters beyond levying a single-tax on land. At its core, George's single-tax appeared to be a narrow application of the benefits principle: landowners owed a duty to the state because it was the state that protected the private property rights of landowners.

The tax experts not only ridiculed George as an "unscientific" amateur, they also denounced the single-tax as an infeasible solution to the many ills of modern industrialism. At the 1890 American Social Science Association's conference dedicated to the single-tax, Seligman joined other professional political economists in berating George's "schemes" as "repugnant to our moral sense and repellant to our logic." Similarly, Ely depicted George as "an ultra conservative, for he does not believe in taxes at all, but holds them to be robbery. . . . The truth is, there is in modern society no such individual production as Mr. George assumes. What have I produced alone and unaided? Nothing."[22] In sum, nearly all professional tax experts loathed George's single-tax as a hopelessly reactionary panacea.

If the progressive economists did not take George's analysis of taxation seriously, they were compelled to contend with other forces on the political left advocating for a more radically redistributive fiscal system. American socialists, pointing to the experience of European nations, called for steeply graduated taxes on income and wealth as a means to confront the growing disparity of wealth and opportunity that accompanied industrial capitalism. The progressive tax reformers responded that American political culture posed serious institutional constraints on the adoption of European-style social democracy in the United States. Even Seligman, who discredited benefits theory because it elided the social connections between citizens and their state, recoiled at the implications of radically redistributive tax laws and policies:

> From the principle that the state may modify its strict fiscal policy by considerations of general utility, to the principle that it is the duty of the state to redress all inequalities of fortune among its private citizens, is a long and dangerous step. It would land us not only in socialism, but practically in communism.[23]

By operating between the two opposing political camps – between the conservative critics who equated graduated taxes with socialism and the populist reformers who advanced a seemingly more radical form of taxation – tax reformers sought to demonstrate that progressive taxation was, in fact, an assault on privilege and concentrations of wealth that did not amount to a move toward state socialism. This was no easy task. It required the progressive tax theorists to stake out a fragile intermediary position that subsequently afforded lawmakers and policy analysts an opportunity to make the existing system of public finance more transparent and fair, without threatening the fundamental prerogatives of American political culture.

The Supreme Court's decision striking down the 1894 tax law gave reformers an opportunity to forge their intermediary position. Although the decision was a formidable institutional obstacle, it did not mark the end of the progressive tax reform movement; instead, it galvanized tax activists to seek a constitutional amendment nullifying the Court's holding. Ratification of the Sixteenth Amendment was a long and arduous process, and the progressive economists played a key role in convincing state legislators of the amendment's popular appeal. In 1913, soon after the amendment's final ratification, the federal government adopted the country's first permanent progressive income tax. With relatively high exemption levels and moderately graduated rates, this tax law initially affected only a small fraction of the U.S. population and raised little revenue. But the law led the way in the rise of a new fiscal order.[24]

Ultimately, the moderate theoretical and political position taken by the progressive tax experts influenced lawmakers. As Congressman Cordell Hull (D-Tennessee), one of the chief architects of the 1913 law, explained: "I have no disposition to tax wealth unnecessarily or unjustly, but I do believe that the wealth of the country should bear its just share of the burden of taxation and that it should not be permitted to shirk that duty."[25] For reformers and lawmakers, then, progressive taxation implied that wealth in an industrial society was a social product, and that the distribution of social obligations ought to bear some resemblance to the distribution of social rewards.

Despite modest beginnings, the federal government soon vigorously employed its newfound fiscal powers. In response to World War I, the government established a series of revenue laws that dramatically expanded the scale and scope of the national tax system. The sheer demand for wartime revenue was certainly an important determinant of this fiscal revolution, but the progressive theorists' concerns about social justice and the distributional impact of American tax laws were equally significant. Building on the progressive economists' conceptual foundation, U.S. Treasury Department officials, many of whom were lawyers, sought to highlight the importance of fiscal citizenship to the financing of the war. These lawyers-turned-government administrators attempted to ensure that the physical sacrifices made by those who fought the war were matched by fiscal sacrifices from the affluent, who often benefited from the robust war economy. The astronomically high marginal and effective income tax rates, and the enactment of an inheritance tax and innovative levies on wartime business profits, illustrated that a new "soak-the-rich" form of taxation was taking shape. Indeed, by the end of the war levies on income and profits had come to dominate federal revenues.[26]

Although the World War I tax system was scaled back as part of the general retrenchment of the 1920s, the Progressive Era foundation of the graduated income tax remained remarkably resilient, and thus provided subsequent reformers with a conceptual base upon which to build. Another world war would trigger the second major transformation in twentieth-century American tax policy, replacing the existing "class tax" with a "mass tax" that reached a broad swath of middle-class wage earners.[27] But by the end of the 1920s, the intellectual, emotional, and cultural spade work had been accomplished; the foundations of a new fiscal polity were firmly established.

The new fiscal order that emerged at the turn of the century was by no means a radical system of wealth redistribution, nor was it merely a conservative bulwark against more dramatic reform. Instead, the modern American fiscal state that emerged in the early twentieth century dramatically altered the distribution of fiscal burdens along the lines of both class and region. In the process, this new polity fundamentally reconstituted the meaning of modern citizenship, the existing regime of American statecraft, and the range of possibilities for robust government action. This transformation was, ultimately, a qualified success. Although it did not go as far as some social democratic reformers had envisioned, this new fiscal polity laid the foundation for and held the promise of a new, more progressive American state.

ENDNOTES

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14 Daniel T. Rodgers, "In Search of Progressivism," *Reviews in American History* 4 (1982): 122.

15 Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities, 1877–1920* (Cambridge: Cambridge University Press, 1982); Richard L. McCormick, *The Party Period and Public Policy: American Politics from the Age of Jackson to the Progressive Era* (New York: Oxford University Press, 1986).

16 David A. Wells, "The Communism of a Discriminating Income Tax," *North American Review* 130 (1880): 328–329, 260. Ironically, while Wells was linking tax equality and uniformity with masculinity, early suffragettes were already using their status as taxpayers to fight for full citizenship. See Carolyn Jones, "Dollars and Selves: Women's Tax Criticism and Resistance in the 1870s," *University of Illinois Law Review*, 1994: 265–310; Linda Kerber, *No Constitutional Right To Be Ladies: Women and the Obligations of Citizenship* (New York: Hill and Wang, 1998).

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18 Seligman, *Theory of Progressive Taxation*, 222.

19 On the rise of marginalism, see "Symposium, Papers on the Marginal Revolution in Economics," *History of Political Economy* 4 (1972); Mark Blaug, *Economic Theory in Retrospect* (Cambridge: Cambridge University Press, 1997).

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