

Chapter 4

Why Is There a Ratchet Effect? Evidence from Civil War Income Taxes



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Abstract The ratchet effect in public finance refers to the historical phenomena that the size of government increases during a crisis but does not return to its previous level when the crisis ends. The traditional explanation is that voters change their views on the appropriate size of government during the crisis. But change in taste is an explanation of last resort: it should not be accepted without examining alternatives. This paper looks Civil War taxes as an illuminating case of the ratchet effect. Both the observed political process and the resulting mix of taxes suggest that interest groups, not voters, led to the ratchet effect in this case. During the Civil War both tariffs and income taxes increased, but only the higher tariff stayed. This paper uses an analytical narrative to show that this was because the new interest groups only wanted the higher tariff and not the income tax.

4.1 Introduction

The ratchet effect is an empirical phenomenon related to the growth of government. It was discovered by Peacock and Wiseman (1961), who found that most government growth was associated with periods of crisis such as wars. They noticed that government expenditures as a percentage of GDP have an upward-sloping trend line, but also that growth of government increases during a crisis and does not return to its former level after the crisis passes. Higgs (1987, p. 50) found a similar result in the United States. Rasler and Thompson (1985) found that the ratchet effect holds internationally. To explain the ratchet effect, Peacock and Wiseman postulated that voters allow governments to raise taxes in order to pay for necessary crisis-related expenditures. When the crisis ends, voters' views of appropriate tax levels have changed. Voters then accept a larger government. Thus, their explanation relies on a change in voter ideas or preferences.

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As they put it, outside of crisis periods:

Notions about taxation are likely to be more influential than ideas about desirable increases in expenditure in deciding the size and rate of growth of the public sector. There may thus be a persistent divergence between the ideas about desirable public spending and ideas about the limits of taxation. This divergence may be narrowed by large-scale social disturbances, such as major wars. Such disturbances may create a displacement effect, shifting public revenues and expenditures to new levels (Peacock and Wiseman 1961, p. xxiv).

Taxation during the U.S. Civil War provides an interesting counter-example to Peacock and Wiseman's account. During the Civil War, government spending increased dramatically and exhibited a ratchet effect afterwards. After the war, however, the income tax was completely eliminated while the tariff was merely reduced. The traditional view of the ratchet effect would suggest that voters in the 1860s became accustomed to higher levels of taxation on both income and imported goods. Instead, I find that interest groups organized legislation that continued to increase the tariff rate throughout the Gilded Age while repealing the income tax. I make my case through an analytical narrative of the process that implemented, then removed, the Civil War-era income taxes.

4.2 The Ratchet Effect in the US Civil War

During a crisis, several things happen. The perceived benefits of various government expenditures change. What had been an effective policy equilibrium is no longer. The perception that a different policy equilibrium is more suited to dealing with the crisis provides an incentive to change the prevailing structure or combination of existing interest groups and the rules that protect them. Groups poised by chance to take advantage of the situation do so. They strengthen their position during the crisis and attempt to get key coveted positions after the crisis. Idiosyncrasies particular to the crisis encourage voters to insist on specific structural changes. But once the previous structure is broken, many of the rules that supported the previous structurally induced equilibrium are no longer in effect. Thus, the relative cost of moving to any new policy equilibrium decreases dramatically, particularly the cost of being at a larger level of government.

4.2.1 *The Crisis and Immediate Response*

Prior to the Civil War, internal federal taxes barely existed. Government played a small role in the economy. Tariffs and the sale of public lands provided most federal revenue. From 1817 to 1857, the federal government did not use the excise, stamp, income or property taxes (Smith 1914). The national debt was small. During most years the federal government ran a surplus. Even during the Mexican-American

War, the U.S. had no need for internal taxation. Occasional shortfalls in revenue were met by issuing Treasury notes.

When South Carolina attacked Fort Sumter on April 12, 1861, however, the need for revenue suddenly increased. Shortly afterward, Lincoln called for 75,000 new militiamen and summoned a special session of the Congress to meet on July 4. In order to fight the war, the Union needed to raise revenue and to borrow large sums of money. The size of the federal government increased dramatically during the war. As Holcombe (1999, p. 13) notes, “the magnitude of post-Civil War expenditures was at least double pre-war outlays.” Government receipts as a percentage of GDP stayed well above its antebellum rate even as the GDP was increasing (Johnston and Williamson 2003). But before an income tax could come into being, a variety of groups had to organize and find a new tax policy equilibrium. The actual process that brought about the increase in taxation provides important evidence that interest groups, not voters, were critical to the ratchet effect.

4.2.2 The Process of Forming a Coalition

Because the Southern states were no longer represented in Congress during the Civil War, the Republican Party had a large majority. However, this did not give Republican leadership *carte blanche*. The loyalty of the citizenry was suspect in several regions of the Union.¹ Implicitly understanding Olson’s (1965) theory of interest groups, the leadership retained power and preserved the Union by forming a winning coalition that could keep Border States from seceding, accommodate Copperheads—those Democrats who sympathized with the South, and raise money to fight the war.²

The Union leadership needed to keep three disparate groups within their coalition: the yeoman farmers who filled the Midwestern and Border states and provided many of the Union soldiers, the finance capitalists who lent the Union money, and the manufacturers who made up the strength of the Republican Party.³ Northern Democrats deliberately exploited the tax fairness question, turning taxation into what McPherson (1988, p. 442) calls the second most divisive issue in the North during the war. Many felt that it was a poor man’s fight and a rich man’s war. Working class people and farmers noted that tariffs raised the prices and profits on manufactured goods.

¹Tabarrok and Spector (1999) analyze the 1860 election and Lincoln’s popularity.

²During his tenure Lincoln carefully allowed certain issues to appear to be the work of Congress alone. These included increased tariffs and the national banking system. These issues were sectionally divisive, and Lincoln did not want them to break up his coalition. Copperheads were conciliatory Democrats.

³A fourth important group was the Radical Republicans, which overlapped the other three groups but the loyalty of the Radical Republicans was never questioned. Radicals were inelastic demanders of Republican leadership.

Border States were also sensitive to the tax issue. Lincoln was very keen to form a coalition with moderates and War Democrats, in part because he was worried about the possible secession of the Border States. To keep these states in the Union he needed at least to keep up the appearance that the burden of the war was being shared equitably. Equity was especially relevant because by the time the income tax finally passed on August 5, 1861, the North had already lost at Bull Run. The popularity of the war was temporarily waning (McPherson 1988, p. 348). This was exacerbated by the feeling that war might not be fought or financed in a manner fair to all.

Eventually most of the cost of the war would be paid with tariff revenue, but tariff revenue was coming in slowly in the middle of 1861.⁴ The loss of Southern tariff revenues and an initial disruption of commerce caused tariff revenues to fall dramatically. Tariff revenue fell from \$9,772,574 during the previous 3 months to \$5,515,552 during the next 3 months. Some Republicans advocated abandoning the gold standard immediately, but this met fierce opposition from hard-money interests. Congress discussed issuing treasury notes. This also met with opposition, and the government decided to issue bonds.

Bonds were difficult to sell, not only because the country was undergoing a massive civil war, but because many Southerners had already dumped their U.S. bonds in England and other European countries.⁵ Foreigners were similarly flooding the market with U.S. securities including national, state, and corporate debt (Bensel 1991, p. 249). As a result, demand for new U.S. bonds was low (Dewey 1903). Trying to borrow \$150 million, Secretary of the Treasury Salmon Chase went to New York City to meet personally with a group of bankers who might be persuaded to purchase or underwrite federal bonds (Bolles 1886, Vol. II, p. 21).⁶

Borrowing alone (without new taxes) could not raise sufficient funds, in part because financiers had to be convinced that future tax revenues would be large enough to ensure repayment of bond debt. Lenders were already wary. Thaddeus

⁴Secretary of the Treasury Salmon P. Chase proposed that uninhabited lands in the northwest and west could be sold, but such sales would not bring revenue to the Union for quite some time.

⁵Banks were also having difficulty selling bonds in part because of the Trent Affair. The Trent Affair occurred in Nov. 8, 1861 when the U.S.S. San Jacinto boarded the British mail carrier Trent and took two Confederate emissaries by force. Britain was understandably upset by the incident. The U.S. was forced to apologize and return the prisoners. Bondholders were afraid that if war with Great Britain broke out, the chances of the U.S. ever repaying debt would be dramatically reduced.

⁶There are several accounts of Chase's difficulty in selling the bonds, including Sharkey (1959). The Independent Treasury Act of August 1846, which stated that the Treasury could pay out and accept payment only in coin, proved a major impediment. Chase was able to get this law amended in August of 1861, but the delay made raising revenue quite difficult. Chase met with representatives of thirty-nine New York banks as well as representatives of Boston and Philadelphia banks. These bankers would later be an important interest group within the Republican Party. Chase focused on eastern banks because western banks lacked the resources to purchase or underwrite bonds in any great quantity (Dewey 1903).

Stevens (R-PA, 9th District), chair of the House Ways and Means Committee, declared in a debate on July 24, 1861:

The capitalists must be assured that we have laid taxes which we can enforce, and which we must pledge to them in payment of the loans, or we shall get no money. (Stevens 1997, p. 216)

With tariff revenue already apparently maxed out, attention turned to internal taxes. At the beginning of 1861, the government paid little attention to the income tax; taxes on property and on manufacturing appeared more promising. Federal property taxes could be piggybacked onto existing administrative state and local systems, providing an easy method for raising revenue.⁷ However, most members of Congress considered a property tax to be a “direct tax.” Article 1, Section 8 of the Constitution required the federal government to allocate a direct tax among the states based on population, not wealth or property values.⁸ Representatives from poorer states complained that their constituents would face a higher tax rate than constituents in richer states. Furthermore, there was concern that intangible property would not be taxed. Wealthy finance capitalists would pay little if any tax, while farmers who held all their wealth in real property would pay a high tax.

Representative Schuyler Colfax (R-IN) stated:

I cannot go home and tell my constituents that I voted for a bill that would allow a man, a millionaire, who has put his entire property into stock, to be exempt from taxation, while a farmer who lives by his side must pay a tax.⁹

Colfax was speaking directly of the difficulty in creating a winning coalition, or win-set in spatial-analytic terms. The Republican Congress would need to carefully construct a set of policies in order to keep all the disparate groups involved. Taxes needed to have some appearance of fairness, especially with respect to vertical equity. Colfax could tell his constituents that the crisis called for higher taxation and expenditures, but not that they should bear an unfair share of the burden. Property taxes were defeated, and the leadership looked for new taxes.

4.2.3 *The Civil War Income Tax of 1861*

The multifaceted tax bill that eventually passed through both houses in August 1861 was a compromise bill that, among other provisions, taxed income above \$800 per year at 2%. In order to encourage the purchase of government bonds, the income tax included the first loophole: the tax rate was reduced on income from government

⁷States collected direct taxes for the U.S. government in 1813, 1815, and 1816 (Smith 1914, pp. 24–25).

⁸*Congressional Globe*, 1st Sess., 37th Cong. 1861, p. 252.

⁹*Congressional Globe*, 1st Sess., 37th Cong. 1861, p. 306. Colfax would become Speaker of the House in 1863.

bonds. Congress had some notion of how an income tax would work because some states and municipalities in the U.S. used an income tax—including all the New England states, Boston, and Savannah (Kinsman 1903). In addition, both Congress and bondholders were aware of Britain's success with its income tax.¹⁰

Despite the fact that this was the first U.S. income tax, other parts of the tax bill—particularly changes in tariff rates—received much more attention.¹¹ The income tax was expected to bring in a mere \$5 million (Smith 1914). The changes in tariffs were expected to provide more revenue and to provide it more quickly.¹² Moreover, Congressmen from the manufacturing districts were quite eager to raise protective tariffs to levels that had been impossible while the Southerners—who cited high tariffs among the reasons for their secession—remained in Congress.

House leadership believed, however, that a low income tax rate was ideal. The tax only needed to generate enough revenue to convince finance capitalists that bonds would be repaid.¹³ The mere existence of a tax on the wealthy (even at a low rate) kept the masses happy, including voters in Border States, by providing some semblance of vertical equity (Stanley 1993). Manufacturing interests were happy with the low rate because it did not produce enough revenue to reduce support for tariffs. Nor did it outrage wealthy supporters. The income tax did not seriously impede the groups that put the Republicans in power.

Interestingly, the progressive nature of the income tax bill was not hotly debated. It was part of the issue of vertical equity. More importantly, the progressive tax was thought to bring in more money. That had been the case in Prussia's graduated income tax (Witte 1985; Brownlee 2003).

4.2.4 The Civil War Income Tax of 1862

Raising revenue in 1862 was contentious in Congress for several reasons. Civil War fighting had been much tougher than expected. Casualties at Shiloh alone exceeded

¹⁰Great Britain enacted the first income tax in 1798 under Pitt the Younger and abolished it in 1816. Sir Robert Peel instituted a second temporary income tax in 1842. However, due to the Crimean War it was not abolished as planned. The Confederacy also used the income tax both at the national and state level. For more on the history of income taxes, see Kinsman (1903) and Seligman (1895).

¹¹All writers on the subject note how little attention the income tax received at the time. Tariff schedules and property taxes account for much more of the debates for two reasons. First, tariff revenues would come in sooner. Second, representatives of organized manufacturing groups tended to hold leadership positions with agenda control. This is particularly true of the iron men.

¹²The rate on coffee received the most attention. Chase suggested that coffee and tea be removed from the free list and that the low tariff on sugar be raised.

¹³The finance capitalists were an organized group within the Republican Party. There are a variety of letters to both Houses from organized groups of finance capitalists. These can be accessed electronically at The Journal of Senate of the United States of America and *The Congressional Globe*. The interested reader can also look at Sharkey (1959, p. 250), Bensel (1991), McPherson (1988, p. 599), and Unger (1959).

the number of killed or wounded in all previous U.S. wars combined.¹⁴ After Shiloh, Union leadership realized that the Civil War would not be short; many more men and much more money would be needed. At the same time, citizens were losing confidence in the Union's ability to win the war. When the fighting first began, Union recruiting offices had more volunteers than they sought, but by 1862 recruits were tough to find.

The loss of confidence in Northern victory led to large financial losses for banks underwriting or holding U.S. bonds. On December 28th, 1861, the New York banks suspended specie payments. Other private banks followed suit immediately, and the federal government itself suspended specie payments on February 25, 1862 (Mitchell 1899; Bolles 1886, p. 68; Smith 1914; Friedman and Schwartz 1963). Unable to continue paying for goods and services in gold, the government turned to issuing irredeemable currency—Greenbacks.¹⁵ The Greenbacks were crucial to the ratcheting up of federal expenditures and eventually a contentious part of the Civil War income tax repeal. Without Greenbacks, the Union would not have been able to fight such an expensive war (Dewey 1903).

Lincoln and the Congressional leadership knew that lack of enthusiasm for the war would hurt the Republicans in midterm elections. Some effort went into making sure that soldiers from key states were kept out of battle. Republican army officers observed their soldiers while voting, and federal troops oversaw elections in Border States (Anderson and Tollison 1991). Those maneuvers were important, but a finance system that did not offend key groups of voters was also important.

While the war was originally popular in most of the North, in other Northern states the war waxed and waned in popularity, and in yet other parts of the North it remained unpopular throughout. Generally, Northerners strongly supported the war, but some groups felt that the Civil War would mostly benefit the rich. The poor bore the burden of tariffs that were both high and regressive (McPherson 1988, p. 448). The poor who could not pay a bond to exempt themselves from military service would bear the burden of military duty. Although many of Irish descent enlisted in the Union army, voters in heavily Irish areas tended to doubt the war. New York State, for example, generally supported the war, but New York City did not.¹⁶ New York State even had a serious anti-war candidate for governor.¹⁷

Using speeches by John Sherman (R-OH 13th District) and Justin Morrill (R-VT, 2nd District), Stanley (1993) argues that the poor in the industrial cities, Border States, and western agrarian states would have voted for taxes that were more

¹⁴On April 6 and 7, 1862 there were 23,746 estimated total casualties.

¹⁵Because they were expected to be (and were) eventually redeemed in gold, the greenbacks were technically a credit money and not a fiat money.

¹⁶Both New York City and Boston had draft riots.

¹⁷The anti-war movement was probably strongest in Ohio, but Ohio also contributed great numbers of soldiers. This appears to be one of the reasons that Senator John Sherman (R-OH, later Secretary of the Treasury) was such a staunch supporter of the income tax. Sherman felt that Ohio could do much for the Union if its people were staunchly behind it (Bensel 1991, p. 329; McPherson 1988, p. 560.)

progressive in nature, had they the option.¹⁸ Politicians like Sherman and Morrill well understood the constraints they faced in building a winning coalition. They had to raise money to have finance capitalists willing to lend money. However, simply raising tariffs had limited potential for revenue and would anger the populace while an income tax could anger powerful constituents.

Furthermore, the wealth disparity was growing among the various sections of the United States. New York and New England were not only much richer than the western agrarian states, but they also had better access to capital. This income disparity led to some discontent that endangered Republican stability unless a concession could be included in the tax legislation.

The general consensus among writers, economists, and Congressmen was that tariffs, excise taxes, and the manufacturing tax could all be shifted to final consumers. The general public felt, however, that neither the income tax nor the property tax could be shifted (Stanley 1993; Ricardo 1823). Incomes were highest in New York and New England. Voters in western and Border States thus strongly favored an income tax. They opposed a property tax because they held the majority of their wealth in property.

Poorer voters in Border and other agrarian states, who supported the Union only marginally, did not have to pay the income tax because their income was too low. They did bear higher tariffs, which doubled, and excises on alcohol and tobacco, which increased dramatically. They also bore a disproportionate share of the regressive federal excise taxes on items like matches and playing cards. The progressiveness of the income tax, by contrast, made it very popular in agrarian districts (Taussig 1931).

The New England states were politically complex. Abolitionist support was strong in these states. Textile mill owners, small businessmen, and farmers strongly supported the war as well. But insofar as the states were industrialized, they were beginning to have large immigrant constituencies. These constituencies tended to vote Democratic, and the Democrats tended to oppose the war. The Northeast sector of American society owned about 70% of the nation's wealth in 1860. Naturally, it provided the most critical tax base, remitting 75% of the revenues.

Wealthy Northern states would pay most of the income tax and the manufacturing tax.¹⁹ They also had relatively strong anti-slavery constituencies that comprised the bulk of the Radical Republicans (Bogue 1973). To some extent their Representatives were willing to accept an income tax in exchange for the end of slavery, even

¹⁸Stanley (1993) paints John Sherman as a centrist, but other writers including (McPherson 1988, p. 329 and 594) tell a story of Sherman as a staunch Republican. My view is that Sherman was a staunch Republican who was willing to make sacrifices to get the things he wanted. During the Civil War and Reconstruction about 75% of the Vermont vote went to the Republican Party. Congressmen like Morrill could certainly have taken very strong positions on a variety of issues, but as chair of the House Ways and Means Committee, Morrill was concerned about Republican fortunes in places beyond Vermont. At this time he was chair of the Subcommittee on Taxation.

¹⁹Luxuries were also taxed. These included gold plate, carriages valued over \$50, yachts, and pool tables (Smith 1914).

though protective tariffs were preferred. The strongest promoters of the Civil War income tax were propertied Republicans like Justin Morrill, John Sherman, and Thaddeus Stevens. These politicians passed the Civil War income tax because other issues were more important than their immediate financial interests. Furthermore, the constituents who would pay the income tax were also strong supporters of the Civil War.

The upper middle classes of the nation's commercial and industrial centers complied widely with the income tax (Brownlee 2003). According to Stanley (1993), and Paul (1954), 10% of all Union households had paid the income tax by the war's end. Households in the northeast comprised 15% of that total. The North raised 21% of its war revenue through taxation, as opposed to the South, which raised just 5% this way.

Of course, voting patterns had to do with immigration patterns and ethnicity as well as industrialization. Southerners settled much of the lower Midwest while New Englanders settled the upper Midwest. States such as Illinois and Indiana were thoroughly split. Pennsylvania had pockets of anti-war sentiment, although it often took the form of anti-draft sentiment and anti-employer sentiment—the strikes in Pennsylvania's coal producing regions are an example (McPherson 1988; Mitchell 1899; Bogue 1973).²⁰

With the defeat of the federal property tax in 1862, Congress increased income tax rates. The exemption decreased from \$800 to \$600, and all income between \$600 and \$10,000 was taxed at 3%. The rate on income over \$10,000 climbed to 5%.²¹ The 1862 bill was far more specific than the 1861 bill and established the Commissioner of Internal Revenue.²² Still, the 1862 bill left many of the specifics up to the Treasury department.

4.2.5 Civil War Income Tax of 1864

The 1862 bill included both 1862 and 1863 because Congressmen almost seemed too busy to worry about the income tax. The 1864 bill, however, was far more contentious than the earlier bills. The national debt was already an astounding \$1.8 billion, and the deficit was \$600 million. This time Congress bitterly debated the degree of progressiveness. Salmon Chase argued that tax revenues should be enhanced to avoid the expense of borrowing even more money: "It is hardly too much, perhaps hardly enough, . . . to say that every dollar raised [by taxation] for extraordinary expenditures or reduction of debt is worth two in the increased value

²⁰In the 1860 election, Pennsylvania sent 10 Democrats to Congress and 12 Republicans. Campbell of the 11th Congressional District (PA) was a Whig.

²¹The House Bill had a 7.5% tax on incomes over \$50,000, but this was removed in the joint conference.

²²George S. Boutwell was appointed the first Commissioner of Internal Revenue.

of national securities.”²³ Wealthy states were well aware by this time that they were paying the lion’s share of the tax. Massachusetts, with just over 6% of the North’s total population, paid more than 13% of the income tax. New York paid more than 34% of the tax. These states argued against a highly progressive bill.

Furthermore, Congress also began to include all sorts of exceptions and special provisions that favored farmers in the income tax bill. For example, rent was deductible. Real estate income was taxed only if the property was bought and sold in the same tax year. Eastern interests and Midwestern manufacturers were willing to have an income tax, but they fought such efforts to shift the burden in their direction.

The June 1864 bill had a \$600 exemption and taxed incomes between \$600 and \$5000 at 5%, income between \$5000 and \$10,000 was taxed at 7.5%, and income above \$10,000 was taxed at the maximum rate of 10%. Interestingly, a month later the income tax rate was increased by 5% for all income above \$600. Brownlee (2003, p. 34) estimates that by this time more than 10% of all Northern households paid the income tax and that in the northeast 15% of households paid the income tax. While tariffs and excises still provided the bulk of the tax revenue, income tax revenues were substantial by 1864. In 1866 the ratio of income tax to tariff revenue exceeded 40%. In 1865 and 1867, it exceeded 37%. In 1866 internal revenue collections reached \$310 million; they were not that high again until 1911.

4.3 Civil War Income Tax Repeal, or What Happens After the Crisis?

In the standard ratchet model, taxes decrease quickly after the crisis but never to their pre-crisis level. The Civil War income tax is a twist on this. In the Peacock and Wiseman-Higgs model, voters have become accustomed to the higher taxes such that when the crisis is over, taxes never revert to their pre-crisis level. But the model does not explain why the income tax is completely removed after the Civil War.²⁴ It may still be partly correct because tariffs and excise taxes ratcheted, but it does not explain the income tax pattern.

The Civil War income tax and its repeal are better explained by the changing positions of various groups within the Republican Party. Since the Republicans were so powerful, one might wonder why they slowly abandoned the income tax instead of repealing it outright at the end of the war. Why did it take until 1872 to completely remove the income tax? Ratner (1967) argues that because the power of business interests increased slowly during this period, it took some time for them and their Republican allies to repeal the income tax. The Republican interest groups

²³Report of the Secretary of the Treasury, 1863, p. 12. Originally found in Mitchell (1899). Chase also inflated the currency. Prior to the war, he was a hard money man. After the war he was again a hard money man, but during the war he was for inflation.

²⁴Neither Peacock and Wiseman nor Higgs mention any outright tax repeals.

that formed the coalition to fight the Civil War and to raise the income tax were also slowly dissolving. Within the Republican Party, one group wanted to abandon the income tax immediately, one wanted to keep it, and one wanted to keep it for a short time.

Immediately after the Civil War the Republican Party became an amalgamation of several disparate groups whose views changed over time. The financiers or finance capitalists who lent the Union money during the Civil War were one group.²⁵ They were comfortable with a temporary income tax. The second group was comprised of manufacturers who were so concerned with the manufactures tax and with the tariff schedule that they were willing to accept tariffs on the high side of the Laffer curve. They saw the income tax as a substitute for tariffs and wanted to abandon the income tax immediately.²⁶ Yeoman farmers of the Midwest formed a third constituent group, one that became more active later in the period of Reconstruction and the Progressive Era and wanted to keep the income tax. A final group within the party consisted not so much of constituents but rather Congressmen who had personal agendas. These were the Radical Republicans, who wanted to punish the South and provide funding for the Freedmen's Bureau.²⁷ This group lost its identity relatively quickly after the Civil War.

Bensel (1991, pp. 301, 331, and 372) argues that the Republican Party was only able to keep its coalition of interest groups because it distributed wealth from the South to the Midwest. It also facilitated cross subsidies that allowed it to take on relatively unpopular policies including the gold standard and to some extent high tariffs.²⁸ As I show, the economic theory of regulation provides a better analytical framework for understanding the changes in U.S. tax policy than Higgs' voters get used to the higher taxes model.

²⁵Banking interests are typically associated with New England and New York. These areas also represented traders opposed to the income tax because they were going to be paying it, yet favored the income tax because it might replace high tariffs, which weakened trade.

²⁶Paul (1954) offers a slightly different perspective, arguing that banking and manufacturing interests were the force behind the movement to repeal the income tax, while merchants and importers were in favor of keeping the income tax and lowering tariffs. He does not split the country into the same three groups that I use.

²⁷This is not to say that Radical Republicans' constituents were not also in favor of increased voting rights and punishing the South. However, it appears that during and immediately following the Civil War some Congressmen were elected who were more radical than the median voter in their districts.

²⁸In some western states, Republicans split off from the main party because of the party's stance on gold. In some eastern states, some Democrats split off from the main party because of its stance on silver.

4.3.1 *Manufacturers*

Manufacturing interests were opposed to the income tax in part because factory owners paid the income tax, but more so because they preferred strong protectionist tariffs.²⁹ But they agreed to continue to vote for the income tax in exchange for votes for more tariffs from financial districts, until it appeared that the U.S. bonds were going to be paid off in gold. Further, prices were falling for manufactured goods (Sharkey 1959, p. 85). New England textile firms benefited from lower cotton prices, but other manufacturers were hurting. This made manufacturers eager to end the income tax and to pay for all government expenditures with a tariff.

4.3.2 *Farmers*

Most farmers did not pay the income tax, and those who did received many deductions.³⁰ Western farmers had little reason to favor the tariff, because it meant they paid higher prices for goods. Farmers argued that high tariffs reduced foreign demand for U.S. grain while an income tax would not.³¹

Further, the mild income tax helped to keep the illusion of vertical equity and to encourage the resumption of the gold standard. John Sherman (R-OH), for example, felt that a tax system based solely on regressive consumption taxes exacerbated class tensions among voters. This is a simplification, of course. Corn farmers were stronger anti-tariff constituents because corn tended not to be an export crop. Farmers west of Chicago tended to be more interested in railroads than tax policy. Farmers in the Midwest strongly opposed specie resumption (Atkinson and Beard 1911; Unger 1959). Many within the Democratic Party felt that government bonds ought to be paid for with Greenbacks. Their slogan was, “the same currency for the bondholder and the plowholder” (Garner et al. 1906, p. 1411). Men, particularly farmers, feared they would have to repay their debts in dearer currency than that in which they had contracted.

To coax western states to stay within the Republican coalition, they were paid off with farm-friendly legislation. The payoff to western farming states also included war pensions. Although the eastern states received more pensions, the wage differential made them much more important in the West. Republicans also paid off western states with railroad construction schemes and river and harbor

²⁹Pennsylvania iron manufacturers were the most ardent advocates of this.

³⁰The most contentious deduction was the fact that farmers who “ate” their profits did not pay taxes on them.

³¹Western Republicans eventually left the party. Progressives and Populists from the West sided with the Democratic Party (Bensel 1991; Galloway and Wise 1976).

improvements.³² Southerners did not qualify for pensions, so this was a transfer from the tariff-paying South to the West. Congress made a protective tariff palatable to agrarian interests with the addition of a strong tariff on raw wool.³³ The Wool and Woolens Act of 1867 protected western farmers from British wool and to some extent wool from the Commonwealth countries (Taussig 1893).³⁴ Pennsylvania and Ohio were big wool producers, and their Congressmen pushed hard for the bill. Other farmers benefited as well, for many farmers throughout the United States kept a few sheep (Bensel 1991).³⁵

4.3.3 *Financial Interests*

Historian Richard Bensel (1991) notes that the war had a huge impact on U.S. financial markets. They were fundamentally altered by the Union's tax and credit policies.

The Union war mobilization probably fell most heavily upon the financial system, permanently changing both the internal organization of national capital markets and the relationship of the central state to finance capitalists (Bensel 1991, p. 238).

This group's preference for and against the income tax depended heavily on whether Greenbacks or gold would prevail. During the war British financial capital left U.S. markets, and there "emerged a distinctly American class of financiers" (Bensel 1991, p. 249).³⁶ Northeastern financial interests had the most complex interests, but, they were the major reason for the income tax's slow phase out instead

³²During the election of the Speaker of the House in 1859, John Farnsworth (R IL) argued that if a Southern Democrat was elected to the Speakership, "the committees shall be so stocked and constituted that the rivers and harbors of the West shall have no protection whatever." *Congressional Globe*, 36:1:230, December 23, 1859. 87.7% of Free State Congressmen voted for the Rivers and Harbors bill in 1860, while only 20% of slave state Congressmen did so (Bensel 1991, p. 70).

³³Democrats reminded Midwestern protectionists that other nations would match protectionism for protectionism. A tariff on wool would mean reduced markets for other agricultural products. For example, see the remarks made by Fernando Wood, Chairman of the Ways and Means Committee, on April 9, 1878.

³⁴It should be mentioned that after the Civil War the income tax was not raising tremendous amounts of money. It was not the main card that Republicans were playing but rather one small piece of their win set. However, until other matters were taken care of, it could not be removed completely.

³⁵In addition, a high tariff on lead appeased certain states that feared Mexican competition.

³⁶"When the Civil War ended the interests of finance capitalists and the American state were probably more closely linked than at any other point in the nineteenth century" (Bensel 1991, p. 238).

of an abrupt end. Financial interests favored a temporary income tax in order to get specie resumption specifically for bond repayment.³⁷

At the end of the Civil War, the United States owed \$2,755,764,000 and was using Greenbacks instead of gold (US Bureau of the Census 1976, p. 1118; Bolles 1886). Finance capitalists were primarily concerned with the return to the gold standard and the repayment of government bonds in gold.³⁸ Since the wartime boom ended in April 1865, financiers worried that a post-war recession would prevent the repayment of bonds in gold (Bolles 1886). The income tax, which they paid, was of secondary importance. Finance capitalists were willing to make sacrifices in order to fill federal reserves with gold and to hold off western pressure for soft money and easy credit.

Greenbacks were discounted heavily against gold lowering the value of bonds which might be repaid in Greenbacks. The discount also made international transactions more costly. All foreign transactions took place in gold while domestic transactions were carried out in Greenbacks. Hence Greenbacks provided both currency risk and transactions costs to anyone who wanted to trade in either foreign goods or foreign capital markets. As Friedman and Schwartz (1963, p. 26) note:

Dealers as well as others having extensive foreign transactions therefore found it convenient to maintain gold balances as well as greenback balances. To accommodate them, New York banks and perhaps others as well, had two types of deposit accounts: the usual deposits payable in greenbacks or their equivalent and special deposits payable in gold. The gold deposits were expressed in dollars' like the greenback deposits but that dollar meant a very different thing. It stood for the physical amount of gold that had corresponded to a dollar before the Civil War and was to again after 1879. During the period of suspension, this physical amount of gold was worth well over two dollars in greenbacks from mid 1864 to early 1865..

The financial class saw the Greenback discount as their foremost problem. They wanted to add gold to the federal reserves which made them favor quick recovery of cotton production and export. Anything that slowed gold accumulation was considered an anathema. Many in Congress hoped that as the economy grew, it would grow into the money supply and the Greenback discount disappeared. At that point the U.S. could resume using gold for currency with limited pain. When

³⁷The northeast includes not only finance capitalists but also manufacturers and international traders. Following Bensel (1991), at least some districts finance capitalists were extraordinarily strong. Furthermore, while international traders faced increased risk when they had to purchase their goods in gold but sell them for fiat money. While they could hedge their risk by buying options, they greatly preferred the gold standard. Moreover, chambers of commerce regularly lobbied the federal government for an end to the Greenback.

³⁸It might be argued that specie resumption was a payoff for the risky loans that finance capitalists took during the Civil War, but a more likely explanation points to their relative power. Mayer (1964) suggests a close association between Northeast financiers and a wide variety of Republican interests, including state parties in Ohio and Indiana. Mayer cites one Republican manager from Indiana who sent a letter to Jay Gould asking for \$10,000 in 1876 to spend getting Indiana to vote hard money and Republican. Mayer also cites the close association with financiers when it came to defeating the Greenback party in the Midwest (Mayer 1964, p. 199).

the business cycle downturn ended at the end of 1867, increased money demand lowered the Greenback discount (Sharkey 1959, pp. 107, 117).

The business cycle upturn also provided more reason to believe that the currency would be paid off. This provided increased impetus for Congressmen from the Northeast to vote to lower the income tax. By 1880 the federal debt had been cut from \$2.7 to \$2 billion. Per capita debt had been cut in half. Because of the finance capitalists, all proposals for increased taxes on government bonds were defeated in the 1860s.

Had it not been for a recession in 1872, the United States likely would have returned to gold shortly after the end of the income tax. As post-Civil War expenses wound down and the federal government slowly improved its chances of returning to gold, raising the exemption and reducing the tax rate lowered the income tax overall. The falling price of gold—from \$2.019 in 1865 to \$1.233 in 1870 to \$1.120 in 1872—allayed fears that there would never be specie resumption (Mitchell 1908, pp. 5–13). Once it looked like the U.S. would return to the gold standard, keeping taxes seemed much less important. Finance capitalists and associated bondholders no longer fought for an income tax, but manufacturing groups did fight.³⁹ Since financial interests were paying the income tax, they had reason to fight it after their primary concern was dealt with.

4.4 Interaction of the Three Groups

Because one group wanted an income tax, one did not, and the third group was ambivalent, a priori thinking would imply that a small income tax would result. This is especially true given John Sherman's feelings that a small income tax was stabilizing for the economy. However, the Northeast and the northern industrial belt held the most important positions within the Republican Party, and their interests dominated. Western interests were poorly represented, and they were paid off with a wool tariff and increasingly with Union pensions. Additionally, the South could be made to pay taxes through the tariff and the cotton excise, but virtually no Southerners had enough income to pay an income tax. The only Southern cities with substantial income tax receipts were Knoxville, TN, and New Orleans, LA.

When Andrew Johnson succeeded Lincoln, he was all but powerless. The defeated South was under military rule of the North and relatively powerless even after the Hayes-Tilden election. The Republican Congress held all the real power.⁴⁰ Republicans found that in many districts they could wave the bloody shirt, either

³⁹Kindahl argues that specie resumption would not have occurred if there hadn't been major deflation as a result of currency contraction and recessions.

⁴⁰The "American state and the Republican Party were essentially the same" from 1861 to 1877 (Bensel 1991, p. 3). At the end of the Civil War, the Republican Party leadership consisted mostly of wealthy Northeasterners (Bensel 1991).

figuratively or actually, and win the election. In contrast, the Democratic Party was both strongly associated with Southern disloyalty and split between soft money and hard money interests.⁴¹

On the expenditure side, Reconstruction was taking a major toll on the finances of the United States. Effectively over by 1871 with Hayes-Tilden, Reconstruction had been expensive, and transfer of all the debt into a tariff was impossible. The total number of armed forces was 150% of the pre-Civil War number. Federal military expenditures increased and veterans' benefits were increasing, although they had yet not reached the level they would in the 1880s.⁴² Congress also found other areas on which to spend money; for instance, it began financing four railroads across the continent. Thus, only after Reconstruction could manufacturing interests vote to get rid of the income tax.

4.5 Conclusion: Lessons From the Civil War Income Taxes

The secession of the South in effect broke the logjam behind which this (Northern Republican) agenda had languished in the years just prior to the Civil War and a major portion of state expansion was composed of policies that had been proposed and debated in the prewar period. (Bensel 1991, p. 2).

At the outset of the Civil War, Northern constituents could see a clear need for an increase in revenue. Northern voters were willing to accept higher taxation, but more importantly the traditional low-tariff proponents, Southerners, were absent from the debates. This allowed Union interest groups to form a winning coalition that existed in a very different part of the relevant policy space. Immediately after the war, Southerners and Copperhead Democrats were powerless. Farmers, manufacturers, and bankers struggled to find an appealing tax policy. This suggests that the traditional Peacock and Wiseman-Higgs theory of the ratchet does not hold. Changing taxpayer willingness is not the most important element in the ratchet. Rather, crises break up previous equilibria and give an advantage to certain groups when the crises end.

While the literature on the ratchet effect suggests that ratchets are voter driven, anecdotal and empirical works suggest that voters are just one of many interest groups. Voters in different areas certainly had different views. Simply positing that all voters change their ideology on the appropriate level of taxes is incorrect.

This case study has shown how a specific aspect of government growth can occur and how it need not be permanent at all. The ratchet effect only works when the interest group favoring the increase is either more powerful than those opposed to the growth of government or can successfully utilize the status quo bias. When

⁴¹Interestingly, the Republicans and Democrats switched their stances on strong currency during the Civil War.

⁴²By 1884 veterans benefits would account for 29% of all federal expenditures.

Rasler and Thompson (1985) looked at the ratchet effect, they found that a ratchet usually occurs but not always. This paper suggests that looking at the interest groups formed during the crisis is the best way to understand when a ratchet effect might occur.⁴³ The coalition of interest groups and the relative power of each matter greatly when studying the ratchet.

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⁴³Of course, the famous Spanish-American War telephone tax that lasted for one hundred years, but that is a different question. In 1898 the U.S. instituted a telephone tax to pay for the Spanish-American War. That tax was repealed in 1998. Since no organized constituent group opposed the small tax, it lasted. The Civil War income tax was small compared to some other taxes, but organized groups wanted it removed.

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