Tax History Museum: 1861-1865

The Civil War

The Civil War represented a watershed moment in the history of American taxation. The quick, limited engagement both sides confidently predicted soon proved a chimera. Instead, the exigencies of protracted, destructive warfare engulfing private property and civilian populations as well as commissioned combatants demanded innovations in government financing. While the outcome of the conflict may be attributed to any number of contingent factors, the varying fiscal strategies undertaken by the Union and Confederate governments undoubtedly influenced the capacity of both societies to sustain the war effort. North and South employed markedly different approaches. The North's proved more efficacious in the long run.

Confederate War Financing

The antebellum south enjoyed one of the lightest tax burdens of all contemporary civilized societies. Local or state governments assessed all obligations. By contrast, the hastily assembled Confederate government lacked the bureaucratic infrastructure to levy or collect internal taxes. Its citizens possessed neither a tradition of compliance nor a means to remit payment. Land and slaves comprised the bulk of southern capital; liquid forms of wealth like specie or paper currency were hard to come by in a predominantly agrarian region.

Efforts to raise war revenue through various methods of taxation proved ineffective. The Confederate Congress enacted a minor tariff in 1861, but it contributed only $3.5 million in four years. That same year, Congress implemented a small direct tax (0.5 percent) on real and personal property. But the government in Richmond was forced to rely on the individual states to collect the levy. Reprising the scenario played out during the Revolutionary War, most states did

not collect the tax at all, preferring to meet their quota by borrowing money or printing state notes to cover it.

A Confederate bond.

The Davis administration turned to loans to finance the initial bulk of war debts. Riding a wave of patriotic enthusiasm in 1861, the Treasury earned $15 million selling out their first bond issue. The second issue, however, consisting of $100 million in 8 percent yield bonds, sold slowly. Few southerners had the cash to purchase them, but in addition the year-end 12 percent inflation rate threatened to negate any promise of real financial return. It fell to investors to buy up the remainder of the 8 percent bonds, which they purchased with newly minted Confederate Treasury notes.

A $100 note issued by the Confederacy.

By necessity rather than choice, the South turned to the printing press to pay most of its bills. In its first year, the Confederate government derived 75 percent of its total revenue from Treasury notes, less than 25 percent from bonds (purchased, of course, with the notes), and under 2 percent from taxes. While the proportion of the latter two would increase slightly in later years, the foundation of Confederate war financing consisted of over $1.5 billion in paper dollars that began depreciating before the ink had a chance to dry. By refusing to establish the notes as compulsory legal tender, Treasury officials hoped to avoid undermining confidence in the currency. They preferred that the currency be backed by public confidence in the Confederacy's survival (notes were to be redeemable in specie at face value within two years of the end of the war).

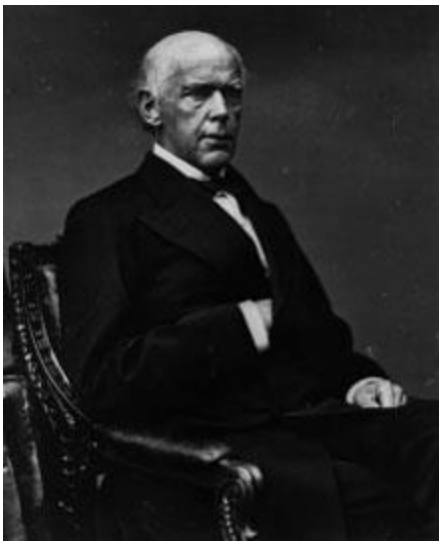
A $2 note issued by the state of Georgia.

This being the case, various state, county, and city notes also circulated widely, diluting the medium further; the fact that these poorly printed bills were easily counterfeited did not help matters. Ironically, the Confederate decision to turn to paper money in lieu of a system of internal taxation abetted the most odious, regressive form of de facto taxation southern society endured: runaway inflation, appearing in the wake of military reversals in 1862, and topping 9,000 percent by war's end.

By the spring of 1863, the crushing burden of inflation motivated Richmond to come up with an alternative to fiat money. In April, they followed the Union's lead and enacted comprehensive legislation that included a progressive income tax, an 8 percent levy on certain goods held for sale, excise, and license duties, and a 10 percent profits tax on wholesalers. These provisions also included a 10 percent tax-in-kind on agricultural products. The latter burdened yeoman more than the progressive income tax encumbered urban salaried workers, since laborers could remit depreciated currency to meet their obligations. Adding to the inequity, the law exempted some of the most lucrative property owned by wealthy planters their slaves from assessment. Lawmakers considered a tax on slaves to be a direct tax, constitutionally permissible only after an apportionment on the basis of population. Since the war precluded any opportunity to count heads, they concluded that no direct tax was possible. Accumulating war debts and heightened condemnation of a "rich man's war, poor man's fight" led to revision of the tax law in February 1864, which suspended the requirement for a census-based apportionment of direct taxes and imposed a 5 percent levy on land and slaves. These changes came too late, however, to have any sustained impact on the Confederate war effort.

Union War Financing

In addition to its developed industrial base, the North entered the war with several apparent institutional advantages, including an established Treasury and tariff structure. With the exodus of southern representatives, the Republican-dominated Congress ratcheted up tariff rates throughout the war, beginning in 1862 with the *Morill Tariff Act*, which reversed the downward trend instituted by the Democrats between 1846 and 1857. Subsequent tariff legislation, especially the 1864 act, raised rates further. Protective tariffs were politically popular among manufacturers, northern laborers, and even some commercial farmers. But Customs duties amounted to about $75 million annually, only nominally more, after adjusting for inflation, than the value of duties collected during the 1850s. Still, the high rate structure established in the Civil War would remain a hallmark of the post-war political economy of the Republican party.


Secretary of the Treasury Salmon P. Chase

Ideological reservations tempered some of the Treasury's supposed institutional advantages. Secretary of the Treasury Salmon Chase, like many northern policymakers, generally distrusted any form of exchange other than specie. They preferred to pay government debts by physically moving gold out of the Treasury instead of transferring funds from demand deposits via check. They also refused to utilize established private banks in New York, Boston, and Philadelphia as repositories for federal funds, further complicating financial transactions. Chase hoped to follow Albert Gallatin's model of financing the War of 1812, which (initially) emphasized borrowing over taxation. Ultimately, however, mounting debts, a shortage of specie, and the threat of inflation led the Union to adopt innovative plans for both borrowing and internal taxation.


Prominent financier Jay Cooke.

In contrast to the Confederacy, which relied on loans for about 35 percent of its war finances, the Union raised over 65 percent of its revenue this way. Having little personal experience, Chase turned to Philadelphia Banker Jay Cooke to administer the sale of war bonds. Although he expected banks and wealthy citizens to purchase most of them, Cooke employed a sophisticated propaganda campaign to market the bonds to the middling classes as well. Patriotic newspaper advertisements and an army of 2,500 agents persuaded almost one million northerners (about 25

percent of ordinary families) to invest in the war effort; bond sales topped $3 billion. In this way, Cooke previewed the techniques with which governments in the 20thcentury would fund modern wars.

In order for the bond program to be successful, the North needed an unrestricted currency supply for citizens to pay for them and a source of income to guarantee the interest. The Legal Tender Act filled the first requirement. Passed in February 1862, the act authorized the issue of $150 million in Treasury notes, known as Greenbacks. In contrast to Confederate paper, however, Congress required citizens, banks, and governments to accept Greenbacks as legal tender for public and private debts, except for interest on federal bonds and customs duties. This policy allowed buyers to purchase bonds with greenbacks while the interest accrued to them was paid in gold (funded, in part, by specie payments of customs duties). Investors enjoyed a bountiful windfall, since government securities purchased with depreciated currency were redeemed with gold valued at the prewar level. Taxpayers essentially made up the difference. Because most bonds were acquired by the wealthy or by financial institutions, the program concentrated investment capital in the hands of those likely to use it, much as Alexander Hamilton's debt plan had sought to do.


Documentary tax stamp (left) on deed to land, 1863.

The Union government's decision to implement a broad system of internal taxation not only insured a valuable source of income, but shielded the northern economy from the sort of ruinous inflation experienced by the South. Despite another $150 million Greenback issue, the overall northern inflation rate reached only 80 percent, comparable with the domestic rates during World Wars I and II. The *Internal Revenue Act of 1862*, enacted by Congress in July, 1862, soaked up much of the inflationary pressure produced by Greenbacks. It did so because the Act placed excise taxes on just about everything, including sin and luxury items like liquor, tobacco, playing cards, carriages, yachts, billiard tables, and jewelry. It taxed patent medicines and newspaper advertisements. It imposed license taxes on practically every profession or service except the clergy. It instituted stamp taxes, value added taxes on manufactured goods and processed meats, inheritance taxes, taxes on the gross receipts of corporations, banks, and insurance companies, as well as taxes on dividends or interest they paid to investors. To administer these excise taxes, along with the tariff system, the Internal Revenue Act also created a *Bureau of Internal Revenue*, whose first commissioner, George Boutwell, described it as "the largest Government department ever organized."

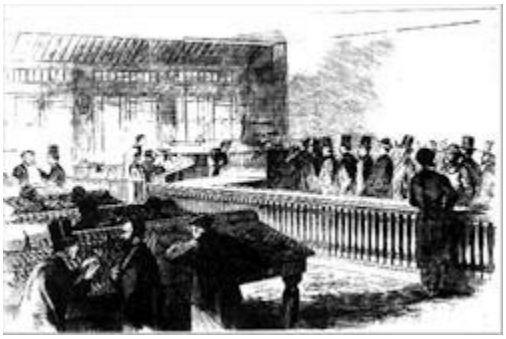

Office of the Collector of Internal Revenue,
FOURTH DISTRICT OF MARYLAND.
Frederick, Md. March 9th 1863
Received of
Dollars Cents
for Income Duty on
Return for the month of Jan 1863
Collector.

Receipt for Civil War excise tax on a Jersey wagon, 1863.

The majority of internal taxes and tariffs duties were regressive, consumption-oriented measures that affected lower income Americans more severely than higher-income Americans. In response, Republicans looked to reinforce the system's fairness by implementing a supplementary system of taxation that more accurately reflected taxpayers' "ability to pay." The income tax addressed this need.

The first federal income tax in American history actually preceded the Internal Revenue Act of 1862. Passed in August 1861, it had helped assure the financial community that the government would have a reliable source of income to pay the interest on war bonds. Initially, Salmon Chase and Thaddeus Stevens, Chairman of the House Ways and Means Committee, wanted to implement an emergency property tax similar to the one adopted during the War of 1812. This way, the government could adapt the administrative system that state and local governments had developed for their own property taxes. But legislators understood such a property tax as a direct tax. Article 1, Section 9 of the Constitution required the federal government to apportion the burden among states on the basis of population rather than property values. Emphasizing population over property value would actually render the tax quite regressive. Residents of lower-density western states, border states, and poor northeastern states stood to bear a greater burden than those of highly-populated urban states, despite the latter's valued real estate. Their representatives also complained that a property tax would not touch substantial "intangible" property like stocks, bonds, mortgages, or cash.

As an alternative, policy makers sought to follow the example of British Liberals, who had turned to income taxation in order to finance the Crimean War without heavy property taxation. Justin Morrill, (R-VT), Chairman of the Ways and Means Subcommittee on Taxation and the architect of the regressive tariff structure, introduced a proposal for the first federal income tax. Because it did not tax property directly, congressional leaders viewed the income tax as indirect, and thus immune from constitutional strictures.



Drawing of taxpayers lining up at a collector's office to pay the 1862 income tax.

The first income tax was moderately progressive and ungraduated, imposing a 3 percent tax on annual incomes over $800 that exempted most wage earners. These taxes were not even collected until 1862, making alternative financing schemes like the Legal Tender Act critical in the interim. The Internal Revenue Act of 1862 expanded the progressive nature of the earlier act while adding graduations: It exempted the first $600, imposed a 3 percent rate on incomes between $600 and $10,000, and a 5 percent rate on those over $10,000. The act exempted businesses worth less than $600 from value added and receipts taxes. Taxes were withheld from the salaries of government employees as well as from dividends paid to corporations (the same method of collection later employed during World War II). In addition, the "sin" excise taxes imposed in the 1862 act were designed to fall most heavily on products purchased by the affluent. Thaddeus Stevens lauded the progressivity of the tax system:

"While the rich and the thrifty will be obliged to contribute largely from the abundance of their means . . . no burdens have been imposed on the industrious laborer and mechanic . . . The food of the poor is untaxed; and no one will be affected by the provisions of this bill whose living depends solely on his manual labor."

Justin Morrill, chairman of the House Ways and Means Subcommittee on Taxation and crafter of the Union's Civil War tax and tariff legislation.

But the war grew increasingly costly (topping $2 million per day in its latter stages) and difficult to finance. The government’s ability to borrow fluctuated with battlefield fortunes. The Confederate navy harassed northern shipping, reducing customs receipts. And inevitable administrative problems reduced the expected receipts from income and excise tax collection.

In response, Congress approved two new laws in 1864 that increased tax rates and expanded the progressivity of income taxation. The first bill passed in June upped inheritance, excise, license, and gross receipts business taxes, along with stamp duties and ad valorem manufacturing taxes. The same act proceeded to assess incomes between $600 and $5,000 at 5 percent, those between $5,000 and $10,000 at 7.5 percent, and established a maximum rate of 10 percent. Despite protest by certain legislators regarding the unfairness of graduated rates, the 1864 act affirmed this method of taxing income according to "ability to pay." An emergency income tax bill passed

in July imposed an additional tax of 5 percent on all incomes in excess of $600, on top of the rates set by previous income tax bills. Congress had discovered that the income tax, in addition to its rhetorical value, also provided a flexible and lucrative source of revenue. Receipts increased from over $20 million in 1864 (when collections were made under the 1862 income tax) to almost $61 million in 1865 (when collections were made under the 1864 act and emergency supplement).

A Union "greenback," authorized by the Legal Tender Act of 1862; note portrait of Salmon P. Chase in left.

The affluent upper middle classes of the nation's commercial and industrial centers complied widely with the income tax. 10 percent of all Union households had paid some form of income tax by war's end; residents of the northeast comprised 15 percent of that total. In fact, the northeast, a sector of American society that owned 70 percent of the nation's wealth in 1860, provided the most critical tax base, remitting 75 percent of the revenues. In total, the North raised 21 percent of its war revenue through taxation, as opposed to the South, which raised just 5 percent this way.

Federal taxes were also instrumental in instituting a system of national banking during the war. The National Banking Acts of 1863 and 1864 imposed a system of "free banking" — banks established by general incorporation as opposed to specific charters — on a national level. State banks were granted national charters and allowed to issue national bank notes (these notes were separate from Greenbacks). One third of a national bank's capital had to consist of federal bonds, since the new national notes were to be backed by federal bonds. The National Banking Acts thus served as another means to induce bankers to purchase bonds. In an attempt to avoid increased regulation, however, many state banks declined to seek national charters. To remedy this problem, the 1864 act imposed a 10 percent tax on state bank notes to drive them out of existence. As a result of this tax, the number of national banks tripled by the war's end, while their purchase of U.S. bonds nearly quadrupled.