

The Journal of the American Taxation Association

A Publication of the American Taxation
Association Section of the American
Accounting Association

MAIN ARTICLES

Taxable Income and Firm Risk

Dan S. Dhaliwal, Hye Seung (Grace) Lee, Morton Pincus, and Logan
B. Steele

Material Weaknesses in Tax-Related Internal Controls and Last Chance Earnings Management

Cristi A. Gleason, Morton Pincus, and Sonja Olhoft Rego

Income Statement Reporting Discretion Allowed by FIN 48: Interest and Penalty Expense Classification

John L. Abernathy, Brooke Beyer, Andrew D. Gross, and Eric T.
Rapley

An Examination of Reputational Costs and Tax Avoidance: Evidence from Firms with Valuable Consumer Brands

Chelsea Rae Austin and Ryan J. Wilson



**American
Accounting
Association**
American Taxation
Association

The Journal of the American Taxation Association

Association

V.39 N.1 2017

The Journal of the American **Taxation** Spring 2017

Association

Volume 39

Number 1

Main Articles

Taxable Income and Firm Risk Dan S. Dhaliwal, Hye Seung (Grace) Lee, Morton Pincus, and Logan B. Steele	1
Material Weaknesses in Tax-Related Internal Controls and Last Chance Earnings Management Cristi A. Gleason, Morton Pincus, and Sonja Olhoft Rego	25
Income Statement Reporting Discretion Allowed by FIN 48: Interest and Penalty Expense Classification John L. Abernathy, Brooke Beyer, Andrew D. Gross, and Eric T. Rapley	45
An Examination of Reputational Costs and Tax Avoidance: Evidence from Firms with Valuable Consumer Brands Chelsea Rae Austin and Ryan J. Wilson	67
Summaries of Papers in This Issue	95

Book Review

AJAY K. MEHROTRA, <i>Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation</i> Sheldon D. Pollack	99
---	----

Book Reviews

In each issue, *JATA* publishes reviews of textbooks and other books of interest to tax scholars. All book reviews are solicited by the Associate Editor. However, if you know of a book that you would like reviewed, or if you are interested in reviewing a book, please contact the Associate Editor.

The Associate Editor is:

Jay A. Soled

Department of Accounting and Information Systems
Rutgers University
1 Washington Park
Newark, New Jersey 07102
Phone: (973) 353-1727
Fax: (973) 375-1283
Email: jaysoled@andromeda.rutgers.edu

AJAY K. MEHROTRA, *Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation, 1877–1929* (New York, NY: Cambridge University Press, 2013, xvi–429, \$90).

Following the Civil War, the American state emerged as a unique political institution. The Union government had possessed the largest standing army in the world during the military conflict, but after the cessation of hostilities much of it was disbanded, along with a good deal of the state apparatus built during the war. The national income tax enacted during the first years of the conflict was drastically reduced after the war and then allowed to expire in 1872 as the national government returned to its traditional nineteenth-century sources of revenue: excise taxes, revenue from the occasional sale of public lands, and custom duties. The bulk of that revenue was derived from the system of high protective tariffs crafted by Republicans during the war and maintained in the decades that followed. As Frank Taussig put it in his classic study of nineteenth-century Republican tax policy, the retention of the high wartime tariff rates “brought about gradually a feeling that such a system was a good thing in itself, and desirable as a permanent policy” (Taussig 1894, 194). With increased international trade and commerce in the decades following the Civil War, the protective tariffs raised enormous revenue for the national government. From the end of the Civil War until the First World War, anywhere from 30 percent to 60 percent of federal receipts were derived from customs duties.¹

As revenue from the tariff alone exceeded annual federal expenditures, the national government enjoyed the luxury of budget surpluses in every fiscal year from 1866 to 1893. This potent combination of limited government and revenue from high protective tariffs left the national government in a highly favorable financial position. This led Henry George, the eclectic economist, to quip in 1883 that “the great question before Congress is what to do with the surplus” (George 1911, 168). The response of successive Republican Congresses to the “problem” of annual surpluses “was to authorize greater and greater largess for the Civil War veterans and their (ever more distant) relatives” (Higgs 1987, 97). From 1880 to 1910, the national government devoted more than a quarter of its expenditures to paying pensions to veterans of the Union cause. At the peak of the program in 1893, there were 966,012 pensioners (most located in the North), and the national government spent a whopping

Published Online: February 2017

¹ U.S. Bureau of the Census, *Historical Statistics of the United States*, series Y 352–357 (“Federal Government Receipts—Administrative Budget: 1789–1939”), Part 2, 1106.

41.5 percent of its total receipts on pension benefits (Skocpol 1993, 114). Much of the rest was devoted to servicing the Union war debt and funding internal improvements.

If this system of public finance based on high protective tariffs was fruitful, then it also was politically provocative. While economists did not yet have the tools to trace the distributional effect of the tariff with precision, its impact was evident. This system of indirect taxation was highly regressive and uneven in its impact on different regions and economic sectors. High tariffs largely benefited manufacturing interests and the “moneyed” men in the Northeast, while urban workers and farmers in the South and West generally bore the burden of the impost. The latter also carried much of the burden of state and local property taxation. The party system reflected these cleavages and regional disparities as manufacturers and the wealthy were represented by the Old Guard in the Republican Party, while opponents of the tariff gravitated toward the Democrats, the Populist Party, and a wide array of radical third parties hostile to established tariff and fiscal policy. Tariff reform along with opposition to hard currency emerged as the central themes of Grover Cleveland’s presidential campaign in 1884. Yet despite numerous Democrat initiatives for tariff reform, successive Republican Congresses actually managed to *increase* tariff rates in the decades that followed—reaching historic heights by the turn of the twentieth century. These Republican successes aroused even greater social unrest and political opposition to the *ancien régime*.

The backlash against Republican tariff policy eventually provoked a concerted political response that would have profound consequences. Democrats joined by Progressives in the Republican Party enacted the short-lived but highly symbolic income tax of 1894—a flat tax of 2 percent on personal income in excess of \$4,000. One year later, the Supreme Court ended the nation’s second experiment with a national income tax when it held the impost unconstitutional as an unapportioned direct tax in the infamous case of *Pollock v. Farmers’ Loan & Trust Co.* (1895).² But the setback was temporary. As Ajay Mehrotra puts it in *Making the Modern American Fiscal State: Law, Politics, and the Rise of Progressive Taxation, 1877–1929*, “rather than spelling the end of the progressive tax reform movement, the Court’s decision [in *Pollock*] became a rallying cry that empowered and galvanized revenue reformers” (p. 411). Later, in the midst of an internecine split within the Republican Party between the Old Guard and “insurgent” Progressives, Congress approved a resolution in 1909 for a constitutional amendment authorizing an unapportioned national income tax. In the wake of Woodrow Wilson’s stunning and unexpected electoral victory in 1912, the requisite number of states ratified the Sixteenth Amendment in 1913. Soon after, a Democrat-controlled Congress enacted a minor income tax in October 1913 as part of major tax reform legislation, the Underwood-Simmons Tariff Act of 1913. This was a tax of 1 percent on income between \$3,000 and \$20,000, with a graduated surtax that reached 6 percent on income in excess of \$500,000. That said, the new income tax was largely symbolic as the nation still relied on the tariff for most of its revenue.

But the adoption of the income tax in 1913 had profound consequences. A great burst of governmental spending came with America’s entry into the First World War, increasing pressure on policymakers to secure additional revenue for the war effort. Out of necessity, Congress expanded the income tax, which quickly replaced the tariff as the principal source of revenue of the national government. (It remains so today.) This marked the culmination of a long political struggle to restructure the fiscal foundation of the American state, transitioning the nation from a system of public finance based on regressive protective tariffs to one based on progressive income taxation. The intellectual roots and origins of the political and social movements that fostered this restructuring of our system of public finance is the subject of *Making the Modern American Fiscal State*. Here, Mehrotra illuminates the role that ideas and academics played in the campaign against the old fiscal order of regressive taxation.

The tariff generated political and social discontent; academics played an important role in giving focus and direction to that discontent. “Reacting to this social unrest and to the growing inequalities of the time, a new school of American political economists began to challenge the prevailing assumptions about the so-called ‘natural’ relations among state, society, and economy” (p. 410). The impetus for reform gave rise to radical third parties that pushed the Democrats further to the left. The populists in the Democrat Party expressed their opposition to hard currency and high protective tariffs in symbolic language. Think of the imagery in William Jennings Bryan’s famous “Cross of Gold” speech to the 1896 Democratic National Convention in Chicago that secured for him the presidential nomination. The image of the American farmer and urban worker being crucified on a cross of gold by the moneyed men of the Northeast was powerful but lacked detail and content. That would be supplied by a group of American economists who crafted the language to give voice and content to the populist impulse for fiscal reform—just as economist Thomas Piketty has for the nebulous grievances of the Occupy Wall Street movement. These activist academics applied the tools of the new discipline of economics to questions of taxation and fiscal policy. In so doing, they are central figures in Mehrotra’s narrative—scholars such as Richard Ely at the University of Wisconsin and Henry Carter Adams at the University of Michigan. But most prominent and influential among these “visionaries of the new fiscal order” was Edwin R. A. Seligman, a professor of political economy at Columbia University.

² *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429 (1895), *aff’d on reh’g*, 158 U.S. 601 (1895).

Seligman is a familiar figure to students of American taxation, who still read his masterful history of American taxation—revised in 1914 to include a chapter on the politics behind the adoption of the Sixteenth Amendment and the recently enacted federal income tax (Seligman 1914). Seligman graduated from Columbia University and then studied in Germany before returning in 1882 to Columbia, where he earned a law degree and a doctorate before accepting a teaching position. In this capacity, he trained a generation of economists in fiscal and tax policy—including his prize student, Robert Murray Haig. Seligman was a founder and president of the American Economic Association and also an editor and contributor to the *Political Science Quarterly*. In this influential journal, Seligman advanced the case for progressive income taxation and promoted the new science of public finance (Seligman 1893, 1894). But Seligman was more than just a disinterested, cloistered academic on the Morningside Heights campus. Mehrotra shows that he was also an active and influential player in the political debate over tariff reform and income taxation. Congressional leaders would study his popular and professional writings on taxation in draft even before publication. Senators William Borah and Cordell Hall, perhaps the most learned legislators on matters of public finance, would quote from Seligman’s treatise on the floor of the Senate during the critical debates over the new constitutional amendment and the enactment of the income tax of 1913, while Oscar Underwood did the same during the debate in the House (pp. 277–278, 282, 288). Mehrotra makes a convincing case that, more than any other individual, Seligman shaped the new vision of the American fiscal state, urging Congress to use its power of taxation to promote a “well regulated” and just society.

Perhaps the most interesting aspect of the new vision of public finance propagated by these tax reformers was the notion of “fiscal citizenship.” Seligman and other reform-minded economists rejected the “classical benefits” theory of taxation holding that citizens paid taxes in exchange for such benefits as protection. Central to the notion of fiscal citizenship was the claim that policymakers should reallocate the burden of taxation “across both class and geographical regions, promoting a new social democratic sense of citizenship” (p. 8). At the same time, the citizenry would need to be educated and encouraged to accept the notion that citizens pay taxes based on their “ability to pay.” Seligman carried this vision of fiscal citizenship to the extreme, holding that: “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” (Seligman 1895, 72). As Mehrotra notes, Seligman “went well beyond traditional social contract rationales” and classical liberal political thought to develop his concept of the taxpayer’s “faculty” to support an organic state (p. 113). Adams and Ely expressed similar sentiments, albeit in less dramatic fashion. They were right to reject the fiction of a social contract in which taxes are the *quid pro quo* for protection, but arguably, they succumbed to some watered-down Hegelian notion of the state. No doubt, conservatives (then and today) will recoil at Seligman’s alien vision of fiscal citizenship.

In Mehrotra’s account of the birth of the modern American fiscal state, a second group of actors are credited with playing an instrumental role in institutionalizing the new fiscal order. These included prominent Wall Street lawyers who served in the U.S. Treasury Department during and after the First World War. As dedicated Progressives, these professionals supported the income tax and were responsible for actually implementing the new tax regime. As Mehrotra aptly puts it, these Treasury lawyers were the “bricklayers of the modern fiscal polity” (p. 33). While pro-business Republicans returned to power following the war, the income tax was not dismantled as it had been after the Civil War. During his long tenure as Secretary of the Treasury during the 1920s, Andrew Mellon enlisted a cadre of professional staff and tax experts to work in the Treasury Department. Mehrotra credits Mellon with fending off attempts to use his department as a dumping ground for patronage appointments. Ever since, Treasury has played an important (albeit increasingly diminished) role as defender of the integrity of the federal tax system against partisan politics and pork barrel tax legislation. Mellon also played an important role in blocking attempts by Old Guard conservatives to repeal the income tax following the First World War. While Mellon championed rate reduction (“tax normalcy”) that brought down the top marginal rate from 77 percent to 25 percent, he opposed repealing the income tax altogether. As a consequence, conservative attempts in the 1920s to replace the income tax with a national sales tax failed. In an interesting aside, Mehrotra observes that the ironic result of the defeat of efforts to replace the income tax with a national sales tax may well have doomed attempts decades later to bring a Value Added Tax (or VAT) to the United States. Ninety years later, the United States remains wedded to the revenue from the income tax and is still without a VAT.

Ajay Mehrotra has given us a powerful account of the transformation of the American system of taxation. The critical role played by economists such as Edwin Seligman and lawyers in the Treasury Department is a central element of that story. But for all the sound and fury of the populist and progressive movements, they gave us no more than a modest income tax of 1 percent—albeit with a surtax for a handful of super-wealthy individuals. Even with major tariff reduction, the income tax still contributed only a minor share (16 percent) of the revenue of the national government in 1916.³ Was this really such a great success for the reform movement for progressive income taxation? Historian Robert Stanley has convincingly argued that “centrist” political leaders in both parties were willing to accept a minor income tax to deflect and deflate more radical demands

³ Computations based on figures from U.S. Bureau of the Census, *Historical Statistics of the United States*, series Y 352–357 (“Federal Government Receipts—Administrative Budget: 1789 to 1939”), Part 2, 1106.

from populist and radical agrarian parties for truly significant wealth redistribution (Stanley 1993). In the end, Democrats and Republicans alike were willing to accept a mildly progressive income tax because they understood that it would never effect any significant redistribution of wealth.

If the progressive campaign for fiscal reform generated only a minor income tax, then what was responsible for transforming the federal income tax into the major source of revenue it is today, capable of financing an activist American state along with its powerful military? The answer is that income tax was transformed by the First World War. With the outbreak of the European conflict, international trade declined, and with that, revenue from customs duties declined. When America entered the war, demand for revenue to support the military campaign increased enormously. Along with public borrowing, the income tax emerged as the prime source of that revenue. Policymakers quickly learned that minor changes to the income tax could produce dramatic increases in revenue. In successive legislation, the personal exemption was lowered while marginal tax rates were increased. During the height of the war in 1918, the top marginal rate reached 77 percent on income in excess of \$1 million, and revenue from the wartime income tax and excess profits tax supplied fully 63.1 percent of federal receipts. In that same year, revenue from the tariff and all other excise taxes declined to just 28.7 percent of federal receipts.⁴ During the war, the income tax emerged as the main tool of revenue extraction for the American state. This was not an historical aberration.

In describing the rise and development of the state in early modern Europe, Charles Tilly famously wrote: “War made the state, and the state made war” (Tilly 1975, 42). An addendum to that adage is: To wage war, a state needs a stable and fruitful source of revenue. As such, war-making and revenue extraction went together in the history of European state development. As Tilly would later put it: “European states generally moved toward a system of collecting taxes in money, paying for coercive means with the money thus collected, and using some of the coercive means to further the collection of taxes” (Tilly 1990, 84). Much the same intricate relationship between state building and revenue extraction was experienced during the formative years of state development in the United States. The first national income tax was enacted during the fiscal crisis occasioned by the Civil War. During the war, policymakers quickly abandoned the flat 3 percent rate enacted in 1861 in favor of a progressive rate structure that reached 10 percent on income in excess of \$25,000 by the end of the war. The income tax of 1913 was a minor impost of 1 percent (with a surtax of 6 percent) when enacted but was transformed by revenue pressures experienced during the First World War that pushed the top rate to 77 percent. While rates were reduced during the period of retrenchment of the 1920s, the nation again turned to the income tax (and public borrowing) to finance the Second World War. At that time, the top marginal tax rate reached 93 percent. Those historic wartime rates were retained during the Cold War to finance the powerful military of the post-war American state.

Mehrotra is familiar with both the notion that the income tax was the “centrist” response to more radical pressures for the redistribution of wealth, as well as the argument that the most significant periods of expansion of the revenue powers of the state have occurred during sustained periods of war. Indeed, he acknowledges the power of these arguments. The virtue of Mehrotra’s study is to reconcile these perspectives. If centrist political leaders accepted a mildly progressive income tax to forestall more radical attacks on the existing order, then they certainly were pushed in that direction by Progressives and reform-minded economists such as Seligman. The progressive income tax was not a high priority item on the platforms of the radical third parties. It ended up on the political agenda and enshrined in the Constitution only due to the efforts of Progressive reformers—and once the income tax was in place, it was the obvious alternative for policymakers searching for more revenue to finance the war. The story of income taxation in the United States spans more than just the period from 1877 to 1929, but as Mehrotra teaches us in *Making the Modern American Fiscal State*, this is when Progressive reformers first succeeded in undermining the old fiscal order and thereafter in building the foundation for the modern American fiscal state. It is a most interesting story.

SHELDON D. POLLACK

Professor of Law and Legal Studies

University of Delaware

REFERENCES

- George, H. 1911. *The Complete Works of Henry George: Social Problems*. Garden City, NY: Doubleday, Page & Company.
- Higgs, R. 1987. *Crisis and Leviathan: Critical Episodes in the Growth of American Government*. New York, NY: Oxford University Press.
- Seligman, E. R. A. 1893. The theory of progressive taxation. *Political Science Quarterly* 8 (2): 220. doi:10.2307/2139643

⁴ Computations based on figures from U.S. Bureau of the Census, *Historical Statistics of the United States*, series Y 352–357 (“Federal Government Receipts—Administrative Budget: 1789 to 1939”), Part 2, 1106.

- Seligman, E. R. A. 1894. The income tax. *Political Science Quarterly* 9 (4): 610. doi:10.2307/2139851
- Seligman, E. R. A. 1895. *Essays in Taxation*. New York, NY: Macmillan.
- Seligman, E. R. A. 1914. *The Income Tax: A Study of the History, Theory, and Practice of Income Taxation at Home and Abroad*. 2nd edition. New York, NY: Macmillan.
- Skocpol, T. 1993. America's first social security system: The expansion of benefits for Civil War veterans. *Political Science Quarterly* 108 (1): 85. doi:10.2307/2152487
- Stanley, R. 1993. *Dimensions of Law in the Service of Order: Origins of the Federal Income Tax, 1861–1913*. New York, NY: Oxford University Press.
- Taussig, F. W. 1894. *The Tariff History of the United States: A Series of Essays*. New York, NY: G. P. Putnam's Sons.
- Tilly, C. 1975. Reflections on the history of European state-making. In *The Formation of National States in Western Europe*, edited by Charles Tilly, 3–83. Princeton, NJ: Princeton University Press.
- Tilly, C. 1990. *Coercion, Capital, and European States: AD 990–1990*. Cambridge, MA: B. Blackwell.