

## Whiskey, Margarine, and Newspapers: A Tale of Three Taxes

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A review of the history of sin taxes illustrates most if not all of the problems between the state and the taxpayer, problems not unique to sin taxes but rather found in taxes of all forms. These problems center around the state's use of its coercive powers against its own citizens. Today we tend to think of liberty arising from a private-property based market system, with a democratic form of government. Historically, liberty meant freedom from abusive taxes. The Greeks, for example, equated them with tyranny. Taxes destroy liberty not just as a result of the obvious taking of wealth, property, and income that they entail, but also from the abusive administrative systems often set up to collect them. For example the bureaucracy created by Rome to collect taxes in Asia Minor in the 1st century B. C. had the power to scourge and behead tax dodgers. Confronted with tax collectors imbued "with the arrogance of bureaucrats and the power of military executioners," it is not surprising that taxpayers soon lost the inclination to evade payment (Adams 1993, p. 86). Historically, death has not been an uncommon nonpayment penalty. It is of little wonder that the belief that "a man is only free if his name does not appear on a tax roll..." has been prevalent throughout history.<sup>1</sup> And, in fact, this belief explains much of the difficulty in studying the history of taxes. Often when taxpayers have been successful--either through rebellion or peaceful means--in inducing the state to eliminate a tax, they have also eliminated the tax rolls. At the conclusion of the Napoleonic wars, when the British Parliament voted to eliminate the income tax used to help finance the war, they not only abolished the hated tax, they also voted to destroy all records pertaining to it.<sup>2</sup>

### Introduction

This history of sin taxes aims to be neither chronological nor comprehensive, but rather will focus on selected historical episodes which clearly illustrate the issues raised by the taxing of sin. Sin taxes in modern economic terms are externality taxes, taxes designed to reduce behavior which is felt to be "harmful to society." Percival S. Menken, writing in the late 19th century, summed up the traditional position: "Civilization rests upon the basis of restraint, whether self-imposed or enjoined by the state. It advances only when each individual so acts within the sphere of personal liberty as not to impede or injure his neighbor in the exercise of individual rights. It necessitates the subjection of individual liberty to the welfare of the whole" (Menken 1891, p. 25). Discussing the regulation of liquor consumption by taxation as well as by prohibition, Menken continues: "[o]n this account, if it can be shown, that the unrestricted sale of liquors, tends to the disadvantage of the community, laws restricting such sale, even to the extent of destroying it, have their justification" (Menken, p. 25).

Of the four possible reactions to the imposition of a tax, according to Charles Adams, "three of them are bad: rebellion, flight to avoid tax and evasion" (Adams, p. 447). Another 19th-century commentator, summed up the reaction side of the sin tax issue this way:

The history to these taxes [on liquor] is connected with the habits, the morals and the health of the people; with smuggling and all the evil consequences to a nation that ensue from lawlessness, the idleness, the meanness and the ferocity which it engendered; with adulteration of so dire a kind as seriously to affect the health of the subjects; with our foreign and our domestic policy, as when... [taxes on drinks]...have, on occasion, proved the cause of serious disputes with foreign powers, have altered the course of trade, or have given rise to serious

riots at home--in short, with very much that is interesting from other points of view than a mere fiscal point (Dowell 1965, p. 47).

The quote illustrates the common reactions to sin taxes: smuggling by middle men or consumers, a very typical response that Canada, for example, is currently facing as a result of imposing high sin taxes on cigarettes; adulteration of a product by producers in such a way that taxes are reduced or no longer applicable; substitution by consumers of a similar nontaxed product.

A good illustration of substitution is the response to high taxes on whisky in the United States in the second half of the 19th century, when many people simply switched to beer, and others to opium and marijuana (Hu 1950, p. 40). One reason this is such a good example is that it shows how often the substitute product causes more problems than the original. As we will see, there are usually several margins for substitution or adjustment available to both consumers and producers when a sin tax is imposed, and these margins include legal as well as illegal options.

Finally, there is protest. Rebellion has been an historically important response to unpopular taxes including sin taxes, and the Whisky Rebellion is a classic example of this response.

Sin taxes, like all taxes and laws in general--even those passed with the best intentions--can obviously have undesirable consequences. Furthermore, externality, like beauty, is in the eye of the beholder, and often what the beholder really wants is not control of externality but special protection and privilege. In other words, sin taxes are often the result of less than honorable intentions. Governments have used sin taxes to suppress activities they find threatening. The knowledge tax, imposed on newspapers, books, pamphlets and other sources of information, was used to stifle criticism of the government itself, as well as any other idea or opinion found objectionable. Rent-seeking has also played a significant role in the sin tax story. In the last century the dairy industry lobbied for taxes on margarine so as to protect the "wholesomeness" of the food people were consuming.

The following history of sin taxes will examine the various motives for imposing the tax, the responses of consumers and producers to the taxes, as well as the effects of sin taxes on the underlying political constitution.

## **Taxes and Regulation of Alcoholic Beverages**

When the consumption of alcoholic beverages began appears to be lost in pre-history, yet attempts to regulate the consumption of alcohol have been chronicled for thousands of years. The inventor of rice wine was banished by the Chinese Emperor Yute in the year 2200 B.C. to check public drunkenness, and in 1122 B.C. grape wine was prohibited and laws ordering the destruction of all vines were proclaimed, though these measures were apparently not very successful. In Egypt, the pharaohs enacted laws against the consumption of wine, while in Greece and Rome there were laws passed curtailing alcohol abuse, again apparently to little effect. Governments have a long and undistinguished history of trying to cope with alcohol use among their citizens.

The identity of the first person to use distillation to make strong spirits is also uncertain. The process was refined in Europe in the 13th century by Arnould de Villeneuve, a Montpellierian alchemist, who called the result of his labor *aqua vita*, water of life. "Whisky", invented in Scotland, where they recently celebrated the 500th anniversary of its discovery, is a Gaelic word that originated as an abridged version of *aqua vita* (Dowell, p. 156).

During the English Civil War, the Long Parliament adopted the first excise taxes in that nation's history. Included were taxes on distilled spirits. Excise taxes were "the most hated of all European taxes. In England, liberty was equated with the absence of an excise tax..." (Adams, p. 254). The British antipathy towards excise taxes resulted from the obtrusive nature of the bureaucracy used to

collect the tax and from the observation that the excise destroyed the economies of nations. Later, in the 1720s, a cheap form of distilled spirits was introduced made with materials that paid little or no tariffs. This beverage, made with genevra, the juniper berry, was called geneva--gin. Soon cheap gin had increased spirit consumption among the lower classes to such an extent that tax legislation was proposed to halt the "increasing tide of drunkenness,...`tending to the destruction of the health of the people, enervating them, and rendering them unfit for useful labor and service'.... By intoxication the people were debauched in morals, and driven into all manner of vices and wickedness" (Dowell, p. 167). This sin tax, called the Act Against Geneva of 1727, resulted in the introduction of a new spirit not covered by the Act, termed "Parliament Brandy," which was unfortunately even more harmful than gin. The Act was repealed in 1733 and gin drinking came roaring back.

In 1736, England passed the Act Against Spirituous Liquors, covering all strong spirits. It imposed prohibitive taxes designed to curtail all consumption, but this law also failed because it was impossible to enforce, was wildly ignored, and was the cause of wide-scale social disruption and protest that led to its replacement with moderate taxes in 1743. In 1778, the principle purpose of taxes on spirits shifted to revenue raising --and high taxes to finance the fight against American independence led to widespread illicit distillation and smuggling (Dowell, p. 180).

Britain's experiences with sin taxes presage the American experiences with both taxes and prohibition. The American colonies early on restricted the consumption of alcohol with a combination of taxes, licenses and regulations. Massachusetts forbade the sale of "strong water" to Indians. Violations of the various laws and punishment for intoxication included confinement to the stocks, imprisonment, the lash, and fines.

An excise on distilled spirits was the first internal tax passed by the government of the new United States, on March 1, 1791. Americans inherited the British hatred for excise taxes, so it is no surprise when this one caused many problems and resulted in the infamous Whisky Rebellion. Though this tax was not specifically a sin tax since it was enacted to help pay the Revolutionary War debt, the problems caused by the consumption of spirits were felt to make the tax more palatable. Treasury Secretary Alexander Hamilton proposed the tax, arguing in part that it would have a desirable impact "from the standpoint of health and morals" (Hu, p. 13).

It is worth spending some time reviewing this episode because it not only illustrates the classic problems of excise taxes and sin taxes in particular, but also many of the problems we observe in modern confrontations between the coercive power of the state and the citizen, and some features unique to the birth of the nation, as well. In this episode we will find the establishment of federal authority; a harsh system of enforcement and collection; rent-seeking; big producers coming around to support the tax because they gain at the expense of small producers; differential impacts on the various states; evasion; and rebellion. This episode also confirms, almost 190 years ex ante the proposition advanced by Barzel (1976), that a per-unit excise tax discriminates in favor of higher quality output--a fact that led to some of the problems with the tax.

When the whisky tax bill was introduced in Congress in June 1790, opposition to it was heated. Southern representatives were especially antagonistic, arguing that while the "East" had beer and cider to fall back on, the South had no breweries or orchards. The bill was passed with the support of the middle and northern states (Hu, p. 14). The tax hit the farmers on the Western frontier especially hard, as they--especially those in Pennsylvania, Virginia and North Carolina--dealt with poor roads across the Alleghenies, and had found hauling grain to Eastern markets to be unprofitable. Whisky, on the other hand, was of greater value and lesser bulk and the farmers had been profitably transporting their grain in this form to markets in the East. Compounding the problem, the Constitution required that taxes be uniform, and at the time this constitutional restriction was taken seriously. Because the tax per gallon on

Western whisky was the same as that on the higher quality whisky distilled in the East which commanded twice the price,<sup>3</sup> the effect of tax was to reduce the price of Eastern whisky relative to that distilled in the West. Barzel makes the point that per-unit taxes cause a market substitution toward higher quality goods. This point is essentially the same as that made by Alchian and Allen (1983, p. 39) regarding shipping costs: When it costs the same per pound to ship high quality oranges to New York from California as it does to ship low quality oranges, the percentage of high quality oranges sold in New York will be greater than that sold in California. Similarly, the effect of a per-unit tax is to lower the relative price of the high quality commodity. This tax-induced change in relative prices inflamed the Western farmers but, as might be expected, the large Eastern distillers began to support the tax when they realized that it gave them a competitive edge.

So far we see that the whisky tax pitted the South and West against the middle and north-east states, as well as big producer against small--divisiveness fairly typical of most legislation. And here remember that Congress was bound by the constitutional constraint that taxes be geographically and otherwise uniform. Uniformity on one margin--a fixed per-unit tax, was not uniformity on other margins. The tax discriminated against the South and the West which lacked readily available substitutes and adversely affected small distillers who tended to produce whisky of lower quality than the larger producers in the East. Of course, an ad valorem tax assessed on the value of sales would be uniform per dollar of whisky sold, but it would tend to favor the Western producer relative to the Eastern. Moreover, any tax would still be biased against the consumers in the West and South who had fewer untaxed substitutes to turn to. This illustrates an important aspect of sin taxes as well as taxes in general. When there are several margins of adjustment available to the producers and consumers of a taxed commodity, and when the costs of adjustment are different for different producers and consumers, a tax that is uniform--i. e., imposes the same cost--on one margin will not be uniform on the others. Uniformity is virtually impossible in a complex world where there are several margins of adjustment.

Although the differential impact of the tax was galling, the administration of the tax was even more of a problem for farmers in Western Pennsylvania. Those caught evading the tax were required to appear in court in Philadelphia. This meant absence from home for a considerable time, heavy expense for witnesses and lawyers, and fines as high as \$250 which "confronted the great majority of distillers with what seemed almost certain ruin, seeing that farms and stills were worth from \$300 to \$500 at most.... It was, moreover, regarded a clear contravention of Anglo-Saxon liberties to take men to a great distance from their vicinage [i. e., neighborhood] for trial" (Hu, p. 20). These intrusions reinforced the usual complaints about the administration of excise taxes: revenue agents snooping around buildings and property, attempts to induce neighbor to spy on neighbor, and creation of a climate of fear, anger, and hostility among the citizens. A further aggravation was that currency was scarce in the region and whisky was used as a medium of exchange--but was not excepted as payment for taxes.

At a meeting in Pittsburgh, Albert Gallatin, later a United States Senator and Secretary of the Treasury under Jefferson, declared: "[a]ll taxes upon the articles of consumption, because of the power that must necessarily be vested in the officers who collect them, will in the end destroy the liberty of any people that permits them to be introduced" (Adams, p. 317). The prevailing sentiment was that the whisky tax was a betrayal of the Revolution.

During the rebellion itself several revenue collectors were tarred and feathered, and others were threatened with physical violence and destruction of their property. Distillers who complied with the law had their property destroyed and their stills shot full of holes by "Tom the tinker." At this point some attempt was made to ease the special burden of the law on those in the West by allowing cases to be tried in state courts, which eliminated the burden of trials in Philadelphia. But this was too little too late, and the violence continued.

Hamilton felt that "[a] government can never be said to be established, until some signal display has manifested its power of military coercion" (Hu, p. 29). He was confirming the proposition that the unique feature of government as an institution is that it claims the power to use coercion, and further, he felt that it was necessary to demonstrate that power to assert the authority of the new national government. The Whisky Rebellion gave Hamilton that opportunity. Troops were called out, and with President Washington initially at their head, started for western Pennsylvania. Confronted with an approaching force of nearly 13,000 men, the "Whiskey Rebels" dispersed before the army reached its destination and the Rebellion was over (Nash and Jeffrey, p. 247). The tax, however, remained unpopular and evasion was widespread, so after all this, it was not much of a revenue producer. Jefferson, though an Anglophobe, had the traditional Anglo-Saxon dislike of excise taxes, and when he was elected he vowed to work towards its repeal. The tax on distilled spirits, along with other excise taxes, was in fact repealed by an act passed in April 1802, and effective July 1, 1802.

Jefferson felt so strongly about the relationship between taxes and liberty that he suggested that there should be a rebellion every twenty years to keep government in check and he was not speaking in abstract. As Charles Adams points out there were almost a dozen rebellions during Jefferson's lifetime--six in the United States including the Revolution and the Whisky Rebellion, all to a greater or lesser extent tax revolts. "Jefferson justified tolerance for civic disorder and rebellion by referring to a Latin maxim,... 'Malo periculosam libertatem quam quietam servitutem' ('Rather a dangerous liberty than a peaceful servitude') (Adams, p. 321). In this light, the Second Amendment to the Constitution could be thought of as providing for a rather drastic early form of term limits if taxes became abusive.

Internal taxes were revived to finance the War of 1812, including once again a tax on distilled spirits. These taxes were repealed in 1817, and until the Civil War the federal government imposed no excise taxes on whisky. Nor were any other internal taxes levied during this period, the government relying entirely on tariffs for revenue.

Between 1817 and the Civil War, taxation and the regulation of alcoholic beverages were left to the states. During this period the temperance movement was founded and began gathering momentum. States used their taxing and licensing prerogatives to raise revenue and control the consumption of alcohol. The move toward prohibitory and local-option laws began in many states--issues which will be taken up in the next section.

The outbreak of the Civil War resulted in the enactment of a variety of federal taxes including a tax on income and an excise on distilled spirits which was imposed in July 1862. Taxes on spirits were increased rapidly and additional taxes were imposed at the manufacturing as well as at the wholesale and retail levels. At this time distilled alcohol had many uses other than as a beverage, including "burning fluid" (used for illumination), and in the manufacture of varnishes, patent medicines, and dyes, as well as for processing photographs. The manufacturers of these and other products were forced to switch to substitutes and many went out of business. For example, as a result of the tax the price of alcohol used as burning fluids went from \$.34 per gallon in 1861 to \$4.25 in 1865, pricing the product out of the market (Hu, p. 38). The effect on the use of distilled spirits as a beverage was not so dramatic. Apparently there was significant adulteration of whisky with nontaxed substances, and a significant amount of whisky produced that evaded the tax. The amount of whisky that was taxed decreased to a much greater extent than did consumption.

In 1868, taxes were reduced from \$2.00 per proof gallon to \$.50 per proof gallon and the use of spirits in manufacturing resumed,<sup>4</sup> with illegal distilling no longer being a problem. Taxes were increased from time to time between 1868 and the First World War. The event of note during this period, aside from the march towards the 18th Amendment, was the Whisky Ring, which was organized to evade taxes (Hu, Ch. 2).<sup>5</sup>

## **The Prohibition Movement**

Our examination of Prohibition will focus on its relationship to sin taxes and the similarity of responses generated by prohibition to those generated by taxation. From 1873 to 1915, revenue from taxes on alcoholic beverages exceeded revenue from all other internal sources combined, and for nineteen of those years these taxes provided more than three-fourths of the revenue from all internal sources (Manning 1949, p. 22). Giving up much of this revenue for the "noble experiment" would involve a hardship which in part reflects the intensity of feeling about the whole issue. Part of this revenue loss was made up by taxes from other sources including, initially, a relatively small contribution from the income tax.

The Temperance movement gained momentum in the early 1800s with initial emphasis on moral suasion to discourage drinking, an effort which proved substantially unsuccessful. As the century progressed various states adopted some form of alcohol prohibition, often including local option laws. Because communities found that since alcohol could easily be brought in from neighboring wet areas, there was a push for state-wide prohibition. Eventually many states abandoned this effort when it became evident that state-wide restrictions were no more successful than local-option, and that nation-wide prohibition was necessary to truly halt the abuse of alcohol (Hu, p. 49-50). Once again we find attempts to control the consumption of alcoholic beverages stymied by evasion involving smuggling from adjacent wet areas as well illegal production. For example, in 1852 Massachusetts enacted state-wide prohibition which remained in force until 1875. Massachusetts was the only state that attempted to collect statistics on establishments known to sell liquor--they (the ones they knew about) increased in Boston from 1,500 in 1854 to 1,516 in 1866 (the last year reported). But because arrests for public drunkenness increased in Boston from 6,983 to 15,542 over the same period, there must have been a significant number of hidden establishments (Menken, p. 47). Other states such as Kansas reported better success. However, the basic feeling at the time was that the system was not working very well. Dr. Dio Lewis, on a tour through several large cities in the Midwest where he was told that liquor was simply not available, saw drunken men lying in the street. In Iowa City, covered by prohibition, he saw "seventy-five to one hundred kegs of beer being delivered in a truck from a brewery... and concluded that prohibition was a wild theory" (Menken, p. 51).

The perception in the 19th century was that alcohol consumption led to a great deal of crime. Reports at the time attributed over half of all criminal arrests to intoxication. In Suffolk County, where Boston is situated, "it was shown that sixty per cent. of all sentences for crime in the Commonwealth during the last twenty years [prior to 1881] were distinctly rum offenses..." (Menken, p. 26). In Cleveland in 1887, 4,720 out of 8,588 arrests were attributed to intoxication (Menken, p. 26). In Philadelphia, in a single year 40,000 out of 45,000 arrests were claimed to be alcohol related (Menken, p. 27). These figures are undoubtedly exaggerated and, moreover, it is hard to say how many of those arrested were intoxicated but behaving harmlessly. The Suffolk County data, which are probably more accurate than most, reveal that 48 percent of those arrested for larceny or assault and battery were under the influence of liquor (Menken, p. 27). Once again it is impossible to say whether drink drove these individuals to crime or whether they would have been criminals in any case. The perception at the time, however, was that liquor was imposing an enormous cost on society. From today's perspective, alcohol consumption was generating negative externalities in the form of criminal behavior. It was this behavior that the 18th Amendment was designed to eliminate. In this, as we know, it was only partially successful--at a cost of the significant rise in criminal activity associated with the evasion of Prohibition.

It is not the purpose here to delve deeply into the history of the 18th Amendment or the Prohibition movement. Rather we want to look at those areas where the response to prohibition is

similar to that of taxes. Specifically, we saw that in the 1700s the British imposed a prohibitory tax on spirits and, as might be expected, the results were similar to those under the 18th Amendment. There was widespread evasion through smuggling and illegal production; even moderate taxes resulted in a significant amount of evasion.

**Table 3.1**  
**Average Yearly Consumption in Gallons per Capita**

Period	Spirits	Beer	Wine	Pure Alcohol
1911-14	1.47	20.53	0.59	1.69
1921-22	0.92	1.49	0.51	0.73
1927-30	1.62	6.27	0.98	1.14

The data in this table are reproduced from Hu (1950, p. 53), Table B. The data were originally collected by Clark Warburton.

Table 3.1 presents some of the results of a study of the economic impact of Prohibition (see Hu, 52-54).<sup>6</sup> The table shows the average yearly per capita consumption of alcoholic beverages for the pre-18th Amendment and pre-World War I period of 1911-14, the early Prohibition years of 1921-22, and the later Prohibition years of 1927-30. Several things stand out: First, there was a lag between the onset of Prohibition and the extensive establishment of alternative sources of supply; second, after allowing for this adjustment, the per capita consumption of total alcohol (in terms of pure alcohol) dropped by a third from 1.69 gallons in the 1911-14 period to 1.14 gallons in 1927-30; third, there was considerable substitution among the categories of alcoholic beverages.

That there is a considerable adjustment period between the imposition of a prohibitory law and the full development of illegal economic markets is not surprising. Jeffrey A. Miron and Jeffrey Zwiebel (1991) report similar results using more extensive data. They look not only at consumption but at the per capita incidence of cirrhosis, alcoholic deaths, and arrests for drunkenness and alcoholic psychosis, and all of the time series show a steep initial decline at the onset of Prohibition and then a steady increase (Miron and Zwiebel, p. 244-45). Further, they find that the reduction in alcohol consumption associated with Prohibition reflects increased economic costs--specifically, the higher costs borne by suppliers associated with evading detection, as well as the higher search costs borne by consumers trying to find sources of illegal supply and the higher costs associated with increases in the probability of being cheated. Possible reductions in consumption resulting from moral suasion emanating from the belief that alcohol consumption was immoral, or reductions as a result of respect for the law, were not evident (Miron and Zwiebel, p. 245). The reduced consumption of alcohol during Prohibition appears to be almost entirely the result of the increased economic costs associated with illegal production and consumption.

Prohibition, like taxes, induces substitutions along various margins. If the illegal supply is being smuggled from areas where the prohibited product is legal or where enforcement is lax, then prohibition should result in substitutions similar to per unit excise taxes or to a shipping cost. The risks of capture are essentially the same whether 50 pounds of high- quality, pure heroin or 50 pounds of low-quality impure heroin is smuggled into the United States. Since the penalties if one is caught (the costs) are essentially the same, prohibition should increase the purity or quality of the product smuggled into the country as apposed to what would be supplied if consumption were legal (ignoring the effects of tariffs on legal imports). On the other hand, if the product is produced domestically and if quality is associated with large-scale production or, as in the case of distilled spirits, a long period of aging, then prohibition should cause a reduction in the quality since the bigger the scale of an operation or the longer the production period, the greater the likelihood of arrest. Prohibition will also result in the sale of alcohol in

more concentrated forms for a given market value since greater bulk, other things equal, increases the likelihood of arrest. One is obviously more likely to be noticed hauling beer barrels, for example, than the much smaller containers of whisky containing the same quantity of pure alcohol. This observation in part explains the significant drop in beer consumption per capita shown in Table 3.1, relative to the slight increase in the consumption of spirits and wine from the pre-Prohibition period to the 1927-30 period. Wine falls between beer and distilled spirits in terms of alcohol concentration, but the direct application of the theory to wine consumption during Prohibition is complicated by the fact that sacramental wine and home production of wine were legal.

Outright prohibition, like prohibitory taxes and even more moderate taxation, leads to adjustments on several margins. Most obvious is a shift from legal to illegal consumption. Second is a reduction in overall consumption, which Miron and Zwiebel find in the case of the alcohol prohibition was almost entirely the result of the higher costs of consumption and production. Third, because prohibition has the same effect as a per unit tax or high transportation cost, there will be a shift toward products with less bulk and higher value. We would expect a shift away from bulky products like beer in favor of more concentrated distilled spirits. Further, since the production of higher quality whisky takes longer and is more capital intensive, and since both factors increase the possibility of observation and detection, we would expect in domestic production a shift toward lower quality, more easily concealable products. Together, the last two effects result in a shift toward more expensive, higher quality goods being smuggled into the dry area from regions where production is legal as well as a shift toward lower quality production in the restricted areas.

Two provisos must be added to this last set of observations: 1) If higher valued illegal production is as easily concealable as lower valued production, then due to the Alchian and Allen effect, we expect production in areas covered by prohibition to shift towards higher valued output; 2) Because those selling illegal goods face higher costs establishing a brand name (among other reasons, they are less likely to deal with repeat customers and more likely to leave the business as a result of arrest), they are more likely to behave opportunistically and cheat their customers by misleading them about the "quality" of the merchandise. They are more likely to sell a lower quality adulterated product which they represent as being of higher quality. Consumers will be aware of this behavior and it will be reflected in the prices they are willing to pay for illegal products. As predicted by the literature dealing with the market for lemons, which emerge when there is an asymmetric distribution of information between buyers and sellers about the quality of the product, the reactions of consumers will have the effect of shifting sales toward lower quality output. In other words, the sellers know the quality of the product they are selling, while the buyers, who cannot easily determine product quality at the point of sale, suspect the quality will be lower than represented by the seller and thus adjust the price they are willing to pay downward.

### **Post-Prohibition**

A major problem facing government upon the repeal of the 18th Amendment in 1933 was the vast illicit market in alcohol that was still in place. This illicit market, according to Hu, "was entrenched, organized, and efficient, with a smoothly operating system of production and distribution" (Hu, p. 64). The underground market was necessarily of prime concern in the establishment of post-Prohibition tax rates on alcoholic beverages: If tax rates were set too high, the illegal market would continue uninterrupted. Further, the state governments were experiencing budget problems and were looking at alcohol consumption as a source of revenue. These concerns dictated coordination between the states and the federal government so that combined tax rates would not be so high that the illicit market would continue to operate and adversely affect revenue collection. But because of the differential impact of the

proposed tax-sharing schemes on the distribution of revenue among the states, no coordinated effort was worked out.<sup>7</sup>

Some argued that Congress had an obligation to use the excise for sumptuary purposes and to impose a "high" tax rate to discourage drinking, while others recognized the futility of this approach which would simply maintain reliance on the illegal market and result in the collection of little revenue. Calculations were performed to estimate the maximum tax consistent with the elimination of bootlegging, based in part on the spread between the cost of the bootlegger and the cost of the legitimate producer. The tax rate consistent with this objective was between \$2.00 and \$2.20 a gallon. The sumptuary camp argued for taxes up to \$6.00 per gallon, which, by allowing the profitable operations of the bootleggers to continue, would not have achieved their purpose (Hu, p. 78). A bill with a tax rate of \$2.00 per gallon on distilled spirits was signed into law on January 11, 1934, a victory for those who recognized that taxpayers and markets adjust rationally to the taxes they confront.

### **The Oleomargarine Tax**

The federal tax on oleomargarine is of interest because it represents a case of Congress and the executive succumbing to pure rent seeking on the part of the dairy industry. Moreover, the acceptance of this tax by the Supreme Court represented a significant extension of the police powers of the federal government.

The Constitution reserved police powers for the states and the individual citizens. The whole regulatory edifice built by the federal government beginning in the latter part of the 19th century had to overcome this constitutional constraint. The government breached this barrier by way of its constitutional powers to tax, regulate interstate commerce, and regulate the mail. The Constitutional question raised by the oleomargarine tax was whether the federal government had the power to impose a tax which did not have the specific purpose of raising revenue (Lee 1973, Ch. 1). The excise tax on distilled spirits did not face this constitutional hurdle because its primary purpose was to raise revenue; officially the sumptuary aspects of the tax were of secondary importance. Use of federal taxing authority to regulate rather than merely raise revenue would significantly expand the police powers of the federal government based on the long recognized principle, reiterated by Justice Marshall,<sup>8</sup> that the power to tax is the power to destroy. This power to destroy is constrained when the primary reason for a tax is raising revenue, since destruction of a taxed activity eliminates all tax revenue. As the deliberation over tax rates following the repeal of Prohibition shows, a revenue-maximizing tax authority, has an incentive to assure the long-run survival of the activity which produces revenue. This objective requires tax rates that are moderate enough not to go beyond the peak of the Laffer Curve.<sup>9</sup>

The Industrial Revolution and modern chemistry wrought fundamental changes in the production of food. Increasing technological expertise in the latter part of the nineteenth century made possible the manufacture of table foods from ingredients hitherto unused for such purposes, such as cottonseed oil or animal fats, that closely resembled the genuine farm commodity. The manufacture of oleomargarine was an outstanding example of this trend (Lee, p. 12).

Oleomargarine, developed in France and introduced into the United States in 1874, was first manufactured by mixing skimmed milk with processed animal fat. With the addition of yellow dye oleomargarine resembled butter in appearance as well as food value, but was cheaper to manufacture. Coincidentally, technological progress in the dairy industry was increasing the supply of butter and driving down its price (Lee, p. 13). Caught in this vise of falling butter prices and rising competition

from a new product, the dairy industry's response was predictable: They appealed to government for protection from "unfair" competition from the upstart oleomargarine manufacturers. The dairy industry's early rent-seeking success came with the states, especially the dairy states. In the 1880s, most states passed legislation regulating the manufacture and sale of oleomargarine and/or levied taxes on it, while several states banned its sale entirely. Other states passed laws prohibiting manufacturers from adding yellow dye to the product, thereby make margarine less attractive. New Hampshire required the addition of an unappealing pink color (Lee, p. 15).

As with the control of alcohol, the dairy industry asserted that federal legislation was necessary to truly regulate the abuse and fraud perpetrated by the production and sale of margarine. Arguments used by the industry were that oleomargarine was unwholesome, that consumers were being defrauded because margarine was often mislabeled as butter, and that the use of yellow coloring was fraudulent and should be prohibited--or that at least, the manufacture and sale of margarine should be restricted in some way. Oleomargarine properly made was a "wholesome nutritious food," and occasional fraud in labeling or in the use of substandard ingredients could be dealt without driving the product off the market (Lee, p. 13-14). Furthermore, the dairy industry was not above adulterating butter with cheap ingredients and coloring their own product to make it more appealing (Lee, p. 17). The real issue was the competition the dairy industry faced from the cheaper substitute, and the industry went to great lengths to eliminate this competition. Finally, in 1886, the industry was successful in getting a law passed by Congress and signed by the president requiring the licensing of manufacturers, wholesalers, and retailers of oleomargarine (with annual fees of \$600, \$480, and \$48 respectively) and imposing a tax of two cents per pound. As a result of this legislation, the number of oleomargarine manufacturers dropped by more than a third (Lee, p. 22-23).

The federal law as well as several state laws were challenged in the courts. Since the tax was designed solely to inhibit an industry and not to raise revenue, it was argued that it entailed an unconstitutional usurping of police powers that the Constitution granted to the states. In a series of decisions the Supreme Court accepted this federal encroachment of the powers originally reserved for the states as well as some of the state laws that seemed to violate the due process clause by, for example, completely banning the industry (Lee, p. 23-27).

Rent seeking is, in effect, the hiring of the coercive power of the state by some private citizens to use against other citizens to give themselves some private advantage. This is one of the abuses that the Constitution was designed to prevent. As in many other cases, politicians and justices found ways around these constraints to allow the central government to grow ever more powerful.

With the door opened by the oleomargarine tax, over the next few years other industries demanded that the federal government provide them with protection from "unfair competition". Attempts were made by various producer groups to limit competition from such products as lard diluted with processed cottonseed oil, filled cheese, phosphorus matches, and various drugs. Not all of these and other attempts were successful. For example, a tax on adulterated lard failed not because of some higher principle but because two powerful special interests were on opposite sides--these were the cottonseed oil industry lobbied against the tax, and the cattle industry in favor of it. Taxes were, however, successfully used to eliminate from the market the filled cheese, phosphorus matches,<sup>10</sup> artificially colored oleomargarine, opium, and a number of other drugs.

As a result of shortages of dairy products caused by a combination of World War II and price controls, considerable consumer dissatisfaction with the laws regulating margarine (which by now was made with vegetable oil) developed.<sup>11</sup> Because of pressure by various consumer groups, margarine manufactures, the League of Women Voters, and to help gain the support of organized labor the Democrats promised to repeal the taxes on oleomargarine during the 1948 election campaign. This

promise was fulfilled, and the national taxes on margarine were repealed by a bill signed by President Truman in March 1950. (Lee, p. 58) As in the case of adulterated lard, the tax on margarine was not repealed because the federal government suddenly came to its senses and decided it had overstepped its constitutional authority. Rather, the shortages of the war years helped alter the balance of political power and, as a result, competing interest, along with "public opinion", could no longer be ignored. In the next section we will see an example of the use of a tax to constrain the formation of public opinion.

### **The Knowledge Tax**

Censorship is probably as old as human speech. Socrates for example, was condemned to death in ancient Greece for "blasphemy against the gods and because his teaching was impious" (Pinon 1960, p. 10). The invention of moveable type in the mid 15th-century brought increased demands on the censors from both the church and the crown. The knowledge tax in the form of a stamp tax on paper, pamphlets, books, and newspapers represents a considerable refinement in the censor's tools. This tax allowed the censor to focus with precision on the offending material and tax it out of existence. Gone were the difficult-to-enforce lists of banned books, executions for sedition or treason, and many other forms of punishment.

Censorship is a way for the church--when it enjoys a monopoly as did the Catholic church in the West prior to the Reformation--and the state to maintain their positions of authority. In the case of the state, censorship creates a barrier to entry by prohibiting the dissemination of competing ideas and criticism. The state uses censorship to protect the rents that accrue to it by virtue of its control of the levers of power--"the state" here meaning the individuals who are actually making decisions to protect their access to rents. These individuals include kings, majority parties in parliaments, presidents, prime ministers, and bureaucrats.

Taxes on knowledge were first implemented in England during Queen Anne's reign. The stated purpose of these taxes was to "check `false and scandalous libels' against Government and `the most horrid blasphemies against God and religion'." However, according to Collet's history of the knowledge tax, the actual reason for this initial tax--as well as duties on linen and soap --was to help finance the War of Spanish Succession (Collet 1899, p. 8). A tax was placed on legal documents, "on papers, pamphlets and advertisements, and required a stamp to be placed on every paper that [Parliament] chose to call a newspaper" (Collet, p. 8). Special dispensations were allowed for uses by the universities and the church and for certain other scholarly books. When first imposed in "1712 the tax was a halfpenney on half-a-sheet or less, and one penney on publications of more than half-a-sheet" (Pinon, p. 24). The press recognized the danger the knowledge tax represented to it and fought the tax from the very beginning.

During the reign of George III, hostility between government and the press grew. Rapid economic growth and technological change created conflicts when change disrupted the established order between employers and employees, in agriculture, and between social classes. Political corruption, in part resulting from the existence of rotten boroughs and the whole issue of electoral reform, also generated conflict between government and the press. In the 1760s, John Wilkes engaged in a heated print campaign against the government for freedom of the press and electoral rights. Wilkes' attacks led to demonstrations in the streets and provoked the resignation of the Prime Minister, Lord Brute. His successor, George Grenville, had Wilkes sentenced to the Tower and his papers confiscated. This sentence was overturned by the chief justice (Pinon, p. 21-22).

Another failure to suppress the press by force eventually turned Parliament to a more subtle means of censorship. Ancient privilege prevented the reporting of speeches made in Parliament. However, a Parliamentary speech delivered in 1770 by Lord Chatham which took to task government

officials for engaging in a system of "bribes and corruption...allowing them to wax fat at the expense of the State and of the Empire", was memorized and subsequently reported by Sir Philip Frances writing under the name Junius (Pinon, p. 23). The resulting uproar led George III to order that "a stop once and for all [be put] to the pretensions of the press" (Pinon, p. 23). Hostilities between the press and government continued to increase as Parliament attempted to use force to impose its will on the press. Once again demonstrations broke out; members of Parliament were struck by stones and potatoes thrown by an angry crowds, the Prime Minister's carriage was destroyed (Pinon, p. 23). The Crown and Parliament were forced to back down. These setbacks led to a change in tactics. When force failed to halt the growing threat to the rents controlled by the crown and Parliament they substituted the knowledge tax. Just as consumers of alcoholic beverages will substitute when confronted with a tax or prohibition, those in control of government will find (or attempt to find) another means to maintain control of rents associated with the coercive power of the state when the costs of using the current means increase.

Exacerbating the government's problem was the emerging symbiotic relationship between the press and public opinion. Beginning in the latter 18th century, technical progress and innovation were dramatically lowering the cost of printing. Simultaneously--and not coincidentally--public opinion was becoming important as a political force (Johnson 1991, ch. 6). Crucial to this formation of public opinion were the newspapers and, thus, the knowledge tax was used in an attempt to tame this growing monster when other means had failed. Antonio Pinon-Tiana summarizes the government's attack on the press as follows:

In 1756 the tax was increased by another halfpenny. In 1789 it went up to 2d. In 1792 it rose to two and a half pence. In 1804 to 3d., and in 1815 to 4d. less 20 per cent. As a consequence of this increase in taxes the London papers, *The Times* among them, were compelled to raise their prices to 7d. which necessarily reduced circulation to a few thousands, with the result that the press simply existed for the governing classes (Pinon, p. 24).

Not only was there a stamp duty on newspapers, but a levy on paper and advertising, and laws requiring the registration of printers and printing presses were also enacted.

In 1815, an act made sure for the first time that various provisions of the knowledge tax covered pamphlets and printed papers containing "observations on the news", and also required the posting of a bond before publishing a newspaper, pamphlet, or printed papers. Many of the modifications in the law were designed to extend coverage to forms of printed material that had been created to escape coverage of earlier provisions of the tax, or to extend coverage to new areas the government found troublesome, such as editorial "comments on the news" (Collet, p. 17). These actions indicate a fairly widespread legitimate attempt to avoid the tax by altering the format of printed material so that it would escape coverage or be taxed at a reduced rate. Outright tax evasion was also widespread. One provision adopted in 1815 specified substantial fines for street hawkers caught selling unstamped papers. The law also encouraged citizens' arrests by offering a reward of 20 shillings to anyone who apprehended such a tax evader (Collet, p. 13).

Taxing newspapers, however, was like stirring up a hornet's nest--with the predicted result that the press continuously campaigned against the taxes and argued for their repeal. There were also committees and societies organized to fight for the repeal of the taxes on knowledge. These efforts were finally successful. The tax on advertising revenue was repealed in 1853, the stamp duty in 1855, the paper duty in 1861, and the remaining provisions in 1865.

## Colonial Censorship

Early censorship in the American colonies followed the initial English model of suppression by brute force and was abandoned in the colonies between 1725 and 1730 (Pinon, p. 31). In 1765, Parliament extended the stamp duties that were already in place in England to the American colonies. The purpose of these taxes was to help defray Britain's cost of defending the colonies. Ironically, the "[tax] money was to be spent entirely in the colonies for their benefit and protection" (Adams, p. 293). The Stamp Act of 1765 required stamps on every colonial newspaper, pamphlet, legal document, pack of playing cards, and pair of dice.

Colonial newspapers declared war on the British.<sup>12</sup> There were riots in Boston directed against those associated with the stamp duty. Violent protests broke out in New York and Rhode Island. By late 1765, crowds were burning revenue collectors in effigy throughout the colonies and "convincing" them to resign their commissions (Nash and Jeffrey, 1986, p. 145). Here again, Parliament, by antagonizing newspapers, stirred a hornet's nest which this time helped lead to the loss of the American colonies.

## Conclusion

We have examined three different "sin" taxes: the whisky tax, the oleomargarine tax, and the tax on knowledge. These taxes are not only of historical significance, they illustrate the different reasons that can motivate government to impose a tax aside from the search for additional revenue. Examination of these tax episodes also reveals the various responses to taxes on the part of those who bear the tax burden. Finally each of these taxes played an important role in either the founding or the early formation of the United States.

Whisky taxes and the knowledge tax also exhibit the tendency of a tax to go from one primarily designed to raise revenue (though in both cases the sumptuary aspects of these taxes were used as selling points) to one designed to discourage consumption and production. Anti-consumption fervor then often leads to an increase in the tax to prohibitory levels and, finally, back down again--in the case of the whisky tax after Prohibition--to primarily a revenue tax. The oleomargarine tax was always a nonstarter as a generator of funds, never raising much more than 1 percent of total internal revenue and in most years significantly less than that; it was a tax solely designed to discourage the production and consumption of margarine.

Aside from revenue, the motives of the British, Colonial, and United States governments in imposing taxes on whisky and other alcoholic beverages has been to reduce the perceived harmful effects of their consumption. In the cases we have examined of both prohibitory taxes and outright prohibition at the national level, the combined political, economic, and social costs of prohibition led to their repeal and replacement by more moderate taxes.

In the nineteenth century the federal government instigated a regime of regulatory taxation with rent-seeking as its sole motivation. The oleomargarine tax best illustrates this governmental tax motive. The dairy industry, through its manipulation of the political process, was able to secure legislation that severely constrained the ability of the rival manufacturers of margarine to compete. Interestingly, this tax was only repealed when wartime shortages changed the political balance. Among other forces consumer anger over shortages of dairy products convinced the Democrats to favor repeal of the margarine tax to help the party during the 1948 election.

A third tax motive, illustrated by the knowledge tax, is found in the attempt by government to strengthen its own grip on governmental rents by handicapping the competition in the market for political ideas. These taxes were also eventually repealed, in part because they inflamed the very sources of

communication that carried the political competition. From the beginning, newspapers fiercely opposed the knowledge tax and were finally successful in obtaining its repeal.

Another major component of the history of sin taxes is evasion. High taxes always lead to evasion. Selective excise taxes are evaded by substitution into the production and consumption of legal but non-taxed--or more lightly taxed--alternatives, and by substitution to illegal underground transactions that avoid taxation entirely. As a result, attempts to reduce crime and other social problems caused, for example, by the consumption of whisky, led to a whole new set of criminal and social problems associated with illegal tax evasion. We also saw examples of how supposedly "uniform" taxes have non-uniform results. This is because products are multidimensional, resulting in substitution along one or more of several dimensions. In the case of the whisky tax of 1791, each proof-gallon of whisky bore the same per-unit tax, but the tax per dollar of sales was much higher on the lower quality "Western" whisky than on the higher quality whisky produced by the large distillers. This was one of the grievances that led to the Whisky Rebellion.

Finally, these episodes illustrate the important role taxes have played historically in shaping and, in fact, leading to the overthrow of the existing government. The whisky tax and subsequent rebellion was used by Hamilton to assert the power and authority of the central government. He felt that a show of force was necessary to demonstrate that the national government was a major player as a wielder of coercive power.

The constitutional issues raised by the oleomargarine tax resulted in a series of Supreme Court decisions that significantly enhanced the police power of the federal government. And perhaps most dramatically, resistance to the Colonial extension of the knowledge tax helped set in motion the American Revolution. This response, and the Whisky Rebellion, illustrate a very common historical response to taxes: open rebellion. Though this response has been seen less frequently in recent years, especially in the developed world, it remains to be seen whether rebellion as a response to taxes perceived to be unjust has passed forever into history.

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## Notes

<sup>1</sup> This is quoted by Charles Adams (1993, p. 140). The original quote is from a chronicler from the mid-1700's by the name of Grapperhaus.

<sup>2</sup> Adams (1993, p. 347) here and elsewhere presents many examples of the burning of tax records. Burning records was in fact very common historically. These records usually represented the only detailed account of the population, so their elimination made it more difficult to reinstate the tax at some future date.

<sup>3</sup> Hu (1950, Ch. 1) describes the relative impact of the whisky tax on the various geographic and economic interests. He also presents an account of the events associated with the Whisky Rebellion. Much of the sequence of events presented here is taken from his account.

<sup>4</sup> A proof gallon is a gallon of spirits that contains 50 percent alcohol. The tax is adjusted proportionally for spirits containing more or less than 50 percent alcohol.

<sup>5</sup> The Whisky Ring affair was one of the numerous scandals that rocked Grant's two terms as president. The scandal involved distillers bribing federal tax officials to avoid paying the excise tax. Grant's private secretary became involved in the scandal (Gruver, 1981, p. 429).

<sup>6</sup> The statistics presented in this section relating to alcohol consumption during Prohibition are "subject to considerable margin of error" (Hu, p. 54). The errors should not be so large as to affect the overall changes in the consumption patterns caused by Prohibition.

<sup>7</sup> The states had problems reaching an agreement over a unified state-federal tax policy because of problems in determining how to distribute the revenue among themselves. Some states were primarily consumers, such as New York, and some like Kentucky-- which was dry--were primarily producers. The suggested distribution formulas were either based on consumption or production, and no single formula could satisfy all the states (Hu, p. 66-68).

<sup>8</sup> *McCulloch v. Maryland*, 4 Wheaton 316 (1819).

<sup>9</sup> The Laffer Curve, named after the economist Arthur Laffer, illustrates the simple point that as the tax rate increases from zero, tax revenue will increase up to a point and then begin to decrease. To see why revenue eventually decreases, consider what would happen if income was taxed at a rate of 100 percent. No one would work (or at least report any income) and tax revenue would be zero. As the rate decreased from 100 percent, people would begin to earn income and tax revenue would increase. Revenue is maximized at some rate between zero and 100 percent.

<sup>10</sup> There was a considerable health hazard involved in the manufacture of phosphorus matches, causing many workers in the industry to die a grisly death. However, under proper conditions these matches could be manufactured safely.

<sup>11</sup> As a result of a tax on artificially colored margarine, if consumers wanted yellow margarine for purely aesthetic reasons they were forced to mix in the yellow dye at home. This obvious inconvenience annoyed consumers.

<sup>12</sup> See Schlesinger (1957) for a detailed account of this interesting episode.