Alcohol, Prohibition, and the Revenuers

BY DONALD J. BOUDREAUX

The standard account of America's experience with alcohol Prohibition centers on ideology. This account states that citizens were so infused with Progressive hubris that they set forth in 1919 on a futile quest to mandate morality by banning the manufacture and sale of liquor. But when they recognized that Prohibition was failing, Americans abandoned the "noble experiment."

The standard account contains grains of truth. Undoubtedly, many Americans during the Progressive era possessed a fervent faith in democratic government and a burning desire to "uplift" the lot of humankind. The temperance movement meshed with the Progressive spirit: use government to engineer better social outcomes—in this case, enforced sobriety. And there is no doubt that Prohibition not only failed to stop Americans from drinking, but also fueled organized crime.

But this account is simplistic. It overlooks the realities and complexities of political behavior, as well as important facts. The ideology of temperance played a role in staging Prohibition, but the raw logic of politics was the true director of this drama.

The central character was federal taxation. Specifically, the income tax proved a viable alternative to liquor taxation for raising revenue, making Prohibition politically possible. Despite decades-long agitation for Prohibition, Congress could not afford to sacrifice liquor-tax revenues until it discovered just how lucrative the income tax could be. That tax's revenue-raising prowess reduced the cost to Congress of voting for Prohibition. Fourteen years later, though, matters changed abruptly when the onset of the Great Depression severely slashed income-tax revenues.

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Before the modern personal income tax in 1913, Uncle Sam relied mainly on customs duties and liquor taxation. From 1870 through 1912 receipts from these two taxes alone accounted for more than two-thirds of federal revenues (and in many years accounted for more than 75 percent). Liquor taxes trailed only customs duties as the largest single source of revenue during the half-century preceding the modern income tax, with liquor taxes accounting for about a third of federal revenues.

Then came the income tax (implemented first in 1914) and, on its heels, America's entry into World War I. During the war federal revenues received through income taxation for the first time exceeded those from any other single source. Income taxes went from about 16 percent of the federal government's revenues in 1916 to double that proportion in 1917. By 1918 the income tax supplied nearly two-thirds of those revenues.

Income-tax revenues accelerated most dramatically in 1918, but the income tax had already demonstrated its prodigious revenue potential the year before. Receipts in 1919 were almost triple those of 1916. More important, Congress passed in October 1917—two months before it successfully proposed the Prohibition-enabling Eighteenth Amendment—the legislation that would yield 1918's enormous increase in income-tax receipts: the War Revenue Act of 1917. It raised more than $2.3 billion in 1918.

By fall of 1917 Congress saw the income tax as its chief source of revenue, reducing the cost of voting for Prohibition in December 1917. The lost liquor-tax revenues (beginning January 16, 1920) were trivial

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compared with the huge and rapidly growing revenues derived from the individual and corporate income taxes. The temperance movement's decades-long quest was seemingly brought to a triumphant conclusion.

Yet Prohibition's cost to Congress increased not long afterward, so the Eighteenth Amendment was repealed in 1933.

This conventional explanation for repeal—that Prohibition was widely defied—can't explain why Congress ended Prohibition after such a short trial run, particularly in light of the dearth of organized support for repeal during the 1920s. It's far more likely that Congress proposed the Twenty-First Amendment (to repeal the Eighteenth) in February 1933 not so much because it was a faithful agent of voters who recognized the futility of Prohibition, but because the politicians desperately wanted more revenue.

The Great Depression severely reduced individual and corporate incomes, and income-tax revenues correspondingly plunged beginning in 1931. By 1932 federal income-tax receipts fell by well over a third from their level in 1931 and to almost half their 1930 level. In 1933 fiscal matters got even worse, with income-tax receipts that year less than 40 percent of their 1930 level. The revenues in 1933 were the lowest since 1917. The income-tax stream that had swelled so promisingly during Woodrow Wilson's second presidential term was running dry.

A Search for Taxes

So Congress searched for another taxable activity. This search led the framers of the 1932 Democratic party platform to call for repeal of the Eighteenth Amendment in order "to provide therefrom a proper and needed revenue." Jouett Shouse, president of the Association Against the Prohibition Amendment and an influential figure in the Democratic Party, predicted that repeal of the Eighteenth Amendment would generate at least $1 billion in additional revenue. A prominent House leader in the fight for the Twenty-First Amendment admitted in 1934 that "if we [anti-Prohibitionists] had not had the opportunity of using that argument, that repeal meant needed revenue for our Government, we would not have had repeal for at least ten years."

And sure enough, Prohibition's repeal did indeed generate higher liquor-tax revenues. As a percentage of federal government revenues, liquor taxes jumped from 2 percent in 1933 to 9 percent in 1934 to 13 percent in 1936. Repeal did not fully compensate for lost income-tax revenues, nevertheless it promised a sizeable stream of additional revenue.

Congress had strong allies in this revenue-seeking cause. Among the interest groups that supported the Twenty-First Amendment was organized labor allied with wealthy industrialists (such as Pierre and Irénée du Pont). Labor leaders and the very wealthy hoped that higher liquor taxes would restrain or even reverse the expansion of income taxation.

The loss of revenues from the income tax made it less costly for Congress to satisfy these interest groups than just a few years earlier. Beginning in 1934 effective income-tax rates were cut for all taxpaying groups with net incomes of $20,000 ($300,000 in 2007 dollars) or less. Although the typical income earner paid no taxes on his income during the 1930s, a significant number of unionized workers took home incomes high enough to be liable for the tax. For example, the median unionized worker in the building trades earned more than $2,000 a year all during the 1930s (nearly $31,600 in 2007 dollars). Workers with annual incomes between $2,000 and $3,000 and a single exemption saw their effective income-tax rate fall from 2 percent in 1933 to 1.6 percent for the years 1934 through 1939.

On the whole, then, income-tax rates for persons owing federal income taxes fell for all but the very highest earners. So while the du Ponts and their peers failed to win lower income-tax rates for themselves as a consequence of Prohibition's repeal, the great majority of Americans who paid federal income taxes (including large numbers of politically potent unionized workers) had their income-tax burdens eased.

It is no coincidence that Congress first acted to repeal the Eighteenth Amendment only *after* the severe revenue-reduction shock administered by the Great Depression. Openly collecting taxes on freely traded liquor without repealing the Eighteenth Amendment and the Volstead Act would have too blatantly flouted the Constitution. So they were repealed.

As the cliché goes, money is the mother's milk of politics.