

A NARRATIVE ANALYSIS OF INTERWAR TAX CHANGES

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ABSTRACT

This paper presents a detailed account of federal personal income tax legislation in the United States from 1918 to 1941. It uses primary sources to identify every legislative action that significantly affected the income tax over this period, and to determine the motivation, nature, and revenue effects of the actions. The paper also discusses legislation that made important changes in corporate and payroll taxes. The results of the analysis can be used as a starting point for studies of the effects of changes in taxes in this period.

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Understanding the microeconomic and macroeconomic effects of income taxation is a major concern of policymakers and economists. As a result, evidence from settings where there are large variations in tax policy is potentially very valuable. The interwar United States is one such setting. Changes in personal income tax rates were common, frequent, and variable in their specifics; capital gains taxation varied enormously in structure and severity; there were frequent, major changes in the corporate income tax; and the first national payroll taxes were introduced. Thus, this period is a potentially valuable laboratory for investigating a wide range of questions concerning the effects of taxes.

A necessary first step in using this laboratory is knowing what the tax changes in this period were. This paper therefore presents an account of federal income tax legislation in the United States from 1918 to 1941, with a focus on the personal income tax. We use primary sources—notably presidential speeches and messages, Congressional documents, and the *Annual Report of the Secretary of the Treasury on the State of Finances*—to identify every legislative action that significantly affected the income tax over this period. We then use the information in those sources to determine the motivation behind each tax change, the nature of the change, and its expected revenue effects. We also discuss the motivation, nature, and revenue effects of legislation that made important changes in corporate and payroll taxes. Thus, the paper extends the analysis in Romer and Romer (2009) to the interwar era.

The main purpose of our analysis is to provide a starting point for studies of the effects of interwar tax changes. For example, in Romer and Romer (2011), we build on the analysis here to investigate the incentive effects of changes in marginal income tax rates.

Another purpose is to provide information about the nature of U.S. tax policy. One finding of this study is that the motivations of interwar policymakers were very different from those of their postwar counterparts. Most tax changes were tied to spending changes. There were major tax increases to pay for the higher military spending in World War I and in the build-up to World War II; the repeated tax cuts of the 1920s were all related to reductions in spending; and the introduction of the payroll tax in 1936 was done as part of the introduction of Social Security. The idea of raising taxes to restrain an overheated

economy or cutting them to stimulate a weak economy was largely unheard of, even under Franklin Roosevelt. Indeed, the one tax change that was motivated by cyclical conditions was the major *procyclical* tax increase enacted in 1932: policymakers raised taxes because the weak economy had lowered revenues and created a large budget deficit. The desire to reduce the budget deficit also played a role in some of the smaller tax increases in the 1930s, as did considerations of fairness and efficiency.

A second finding is that the nature of the interwar tax system was very different from today's. Total income tax revenues were small relative to the economy; the income tax fell almost exclusively on the very wealthy; marginal tax rates were often very high; and the tax code was relatively simple. As we argue in Romer and Romer (2011), one implication of the small scale of the tax system and the close link between changes in taxes and changes in spending is that the aggregate demand effects of interwar tax legislation were almost surely small. On the other hand, the large and heterogeneous changes in marginal rates mean that the incentive effects were potentially large.

Table 1 lists all acts affecting personal income taxes in the period 1918–1941. It shows the estimated revenue effects of each act and the impact on the top marginal rate, and provides a summary of the major features of the act. The remainder of the paper is a detailed discussion of each act.

Table 1
Interwar Tax Legislation

Act (Date Enacted)	Revenue Estimate	Change in Top Marginal Rate (Percentage Points)	Nature of Tax Change
Revenue Act of 1918 (2/24/19)	+\$1,608 million +2.05% of GDP	+10 (1918) −4 (1919)	Raised normal tax rates in 1918 and then lowered partially in 1919; raised surtax rates; introduced war-profits tax
Revenue Act of 1921 (11/23/21)	−\$835 million −1.14% of GDP	−15	Reduced surtax rates; changed treatment of capital gains
Revenue Act of 1924 (6/2/24)	−\$341 million −0.39% of GDP	−14.5 (1923) +2.5 (1924)	Reduced both normal and surtax rates by roughly 25 percent
Revenue Act of 1926 (2/26/26)	−\$326 million −0.34% of GDP	−21	Reduced surtax rates roughly in half; large increase in personal exemption
Revenue Act of 1928 (5/29/28)	−\$233 million −0.24% of GDP	0	Increased earned-income credit; primarily changed corporate income tax
Joint Resolution No. 133 (12/16/29)	−\$160 million −0.15% of GDP	−1 (1929) +1 (1930)	Temporarily reduced the normal personal income tax and the corporate income tax by 1 point
Revenue Act of 1932 (6/6/32)	+\$1,121 million +1.91% of GDP	+38	Raised normal and surtax rates; surtax rates doubled at most income levels; raised corporate income tax and excise taxes
Revenue Act of 1934 (5/10/34)	+\$258 million +0.39% of GDP	0	Rearranged normal and surtax rates; changed treatment of capital gains; closed loopholes
Revenue Act of 1935 (8/30/35)	+\$270 million +0.37% of GDP	+16	Raised surtax rates on incomes over \$50,000; raised estate tax; established graduated corporate income tax
Revenue Act of 1936 (6/22/36)	+\$620 million +0.74% of GDP	0	No change in personal tax rates; subjected dividends to normal tax; large change in corporate tax, including graduated tax on undistributed profits

Table 1 (Continued)
Interwar Tax Legislation

Act (Date Enacted)	Revenue Estimate	Change in Top Marginal Rate (Percentage Points)	Nature of Tax Change
Revenue Act of 1937 (8/26/37)	Trivial	0	Raised surtax on undistributed net income of personal holding companies; closed loopholes
Revenue Act of 1938 (5/28/38)	Trivial	0	Changed treatment of capital gains so tax depended on how long asset was held; largely eliminated undistributed profits tax; made other fundamental changes in corporate income tax
Revenue Act of 1939 (6/29/39)	Trivial	0	Extended a number of existing excise taxes; made revenue-neutral changes to corporate income tax
Revenue Act of 1940 (6/25/40)	+\$1,004 million +0.99% of GDP	+7.9	Lowered personal exemption; raised surtax rates on incomes between \$6,000 and \$100,000; temporary “defense tax” equal to 10 percent of all regular taxes
2 nd Revenue Act of 1940 (10/8/40)	+\$700 million +0.69% of GDP	0	Raised corporate income tax rates; introduced new graduated excess profits tax on corporations
Revenue Act of 1941 (9/20/41)	+\$3,500 million +2.76% of GDP	-5.9	Raised surtax rates dramatically except at very top; subjected all income levels to surtax; reduced personal exemption

Revenue Act of 1918

Enacted: February 24, 1919

The motivation for the Revenue Act of 1918 was to raise revenue to cover the additional expenditures related to World War I. President Wilson addressed a joint session of Congress on May 27, 1918 to ask members “to prolong your session long enough to provide more adequate resources for the Treasury for the conduct of the war” (speech reproduced in “Hearings before the Committee on Ways and Means, House of Representatives, on the Proposed Revenue Act of 1918, Part I: Income, Excess Profits, and Estate Taxes, June 7 to July 17 and August 5, 14, and 15, 1918, p. 5). Wilson argued that “Additional revenues must manifestly be provided for. It would be a most unsound policy to raise too large a proportion of them by loan” (p. 5). Wilson also emphasized that “We can not in fairness wait until the end of the fiscal year is at hand to apprise our people of the taxes they must pay on their earnings of the present calendar year, whose accountings and expenditures will then be closed” (p. 5). However, this ended up to be exactly what happened. The act was not passed until February 1919 and raised taxes retroactively in 1918.

Secretary of the Treasury William McAdoo followed up on Wilson’s speech with a letter to the chairman of the Ways and Means Committee on June 5, 1918 with a detailed recommendation. McAdoo estimated that expenditures for the 1919 fiscal year (July 1, 1918 to June 30, 1919) would be roughly \$24 billion, approximately twice what they were in the previous year (letter also reproduced in “Hearings before the Committee on Ways and Means, House of Representatives,” p. 9). He argued that failing to raise taxes to pay for some of the increase “would be a surrender to the policy of high interest rates and inflation, with all of the evil consequences which would flow inevitably therefrom, and which would ... bring ultimate disaster to the country” (p. 9). McAdoo specified \$8 billion, or one-third of total expenditures, as the amount of revenue that should be raised in fiscal year 1919. He also made numerous recommendations about the form of the tax increase. In particular, he supported imposing a war-profits tax in addition to the existing excess-profits tax, an increase in the normal tax on unearned income, and “heavy taxation ... upon all luxuries” (p. 12).

The Ways and Means Committee produced a bill by September that followed fairly closely McAdoo’s suggestions. One aspect of the bill that was common at the time was that it was designed to replace existing revenue laws and stand on its own. The Ways and Means Committee report on the bill states: “Your committee has endeavored to wipe out all inequalities in the operation of existing law and recommends the repeal of the major portions of the revenue acts of 1916 and 1917 in order that the existing internal-revenue laws so far as deemed practicable will be in one act and therefore more readily accessible to the taxpayer” (“Revenue Bill of 1918,” 65th Congress, 2^d Session, House of Representatives Report No. 767, 9/3/18, p. 2).

The Senate did not take up the bill until the lame-duck session in December 1918. By this time, two events had changed conditions appreciably. One was the introduction of Prohibition, which reduced expected beverage tax revenue by more than \$1 billion per year. The second was the abrupt end of World War I in November 1918. According to the Senate Finance Committee report, “Taxes which can be easily borne amid the feverish activity and patriotic fervor of war times, are neither so welcome nor so easily sustained amid the uncertainties, the depreciating inventories, and the falling markets which are apt to mark the approach of peace” (“Revenue Bill of 1918,” 65th Congress, 3^d Session, Senate Report No. 617, 12/6/18, p. 2). Because expenditures in fiscal year 1919 were now likely to be only \$18 billion, the Secretary of the Treasury recommended and the Senate Finance Committee endorsed a bill that raised \$6 billion in revenue (p. 2).

According to a table in the Senate report, the existing law would raise \$4.370 billion in fiscal year 1919, whereas the proposed law would raise \$5.978 billion, or an increase of \$1.608 billion (p. 3). The Senate

Finance Committee recommended that the war-profits tax be largely eliminated in 1919, the excess-profits tax rates be reduced substantially, and the normal tax on personal and corporate incomes be reduced by one-third. The report estimated “that these changes would reduce the revenue for 1920 as compared with 1919 by approximately \$1,400,000,000” (p. 3). Thus, the Senate version contained a large net tax increase in fiscal year 1919 (calendar year 1918), and a near-return to previous tax levels in fiscal year 1920 (calendar year 1919). The final act was very similar to the Senate version. An academic article from June 1919 gives revenue estimates for the act very similar to those in the Senate report (Roy G. Blakey and Gladys C. Blakey, “The Revenue Act of 1918,” *American Economic Review*, 9 (June 1919): 213-243, p. 216).

As described, the Revenue Act of 1918 was a large, retroactive tax increase affecting primarily calendar year 1918. However, while the revenue effects were largely felt in fiscal year 1919, it had more long-lasting effects on income tax rates. The normal tax rate on the first \$4000 of income was raised from 2 percent in 1917 to 6 percent in 1918 and then to 4 percent in 1919 and after. The normal tax on incomes above \$4000 was raised from 4 percent in 1917 to 12 percent in 1918 and 8 percent in 1919 and after. The surtax rates were also raised for 1918 and all subsequent years. The top surtax rate only increased from 63 percent in 1917 to 65 percent in 1918, but the rates rose much more quickly with income under the Revenue Act of 1918. For example, the surtax rate on net incomes between \$50,000 and \$52,000 rose from 12 percent in 1917 to 24 percent in 1918. In general, for incomes between \$50,000 and \$150,000, surtax rates were roughly double under the Revenue Act of 1918.

Corporate income tax rates were also raised. The rate rose from a top value of 4 percent of net income in 1917 to 12 percent in 1918 and 10 percent in 1919 and subsequent years (“Revenue Bill of 1918: An Analysis of the Bill (H.R. 12863) to Provide Revenue, and for Other Purposes,” 65th Congress, 3^d Session, Senate Document No. 391, February 13, 1919, p. 5).

The act included a war-profits tax in 1918 equal to 80 percent of the excess of net income of the corporation over its prewar profits (with an adjustment for additional capital invested). There was also an increase in the excess-profits tax. In 1917, tax rates ranged from 20 to 60 percent of net income in excess of various fractions of invested capital. In the 1918 law, cutoffs income levels were lowered and rates were raised. The rate was 30 percent of net income in excess of 8 percent of invested capital (and not in excess of 20 percent of invested capital), plus 65 percent of net income in excess of 20 percent of invested capital. Corporations paid whichever of the war-profits and excess-profits tax was larger. The war-profits tax was essentially eliminated for 1919, and the excess-profits tax rates were reduced from 30 and 65 percent to 20 and 40 percent in 1919 (see 1930 *Statistics of Income*, pp. 322-324, for a summary of the rates in various years).

Finally, the Revenue Act of 1918 included a wide array of other tax changes. It lowered the estate tax slightly, raised taxes on tobacco products, and raised excise taxes on automobiles, jewelry, phonographs, and a number of other luxury goods. It also included a tax of 10 percent on the net profits of any business which employed children under a certain age.

Revenue Act of 1921

Enacted: November 23, 1921

The tax cut contained in the Revenue Act of 1921 was unquestionably tied to the reduction in spending following World War I. According to the 1921 Treasury *Annual Report*, government spending had fallen not only because of the end of hostilities, but also because of the introduction of an explicit budget process and the creation of the Bureau of the Budget (p. 1). The mindset of policymakers was very clear that tax reductions could only occur if spending declined; deficit-inducing tax cuts were not

contemplated.

The link between spending declines and tax declines is very clear in the size of the final tax cut. The 1921 *Treasury Annual Report* states that because of new lower estimates of expenditure for fiscal years 1922 and 1923, the Treasury tax proposal was changed to eliminate some tax increases that had been thought necessary to keep the budget in balance (p. 6). Treasury Secretary Mellon's statement on August 13, 1921 took as given that the fundamental requirement for a tax bill was that it "raise the needed revenue within reasonable certainty" (*Treasury Annual Report*, Exhibit 72, p. 372). Likewise, President Harding echoed this same view in his First Annual Message. In discussing policy in the future, he stated: "By your sustainment of the rigid economies already inaugurated, with hoped-for extension of these economies and added efficiencies in administration, I believe further reductions may be enacted" (12/6/21, p. 2).

The role of the reduction in spending is also evident in the Senate Finance Committee report on the bill. It stated: "The revenue bill which your committee recommends is designed to produce enough revenue to meet without borrowing all ordinary expenditure, ... but not enough to create a current surplus and thus encourage unnecessary spending" ("Internal Revenue Bill of 1921," 67th Congress, 1st Session, Senate Report No. 275, September 1921, p. 1). The committee appears to have felt not only that it was appropriate that taxes fall when spending declines, but also that reducing taxes encouraged government economy (or discouraged profligate spending).

While the reduction in spending was the proximate cause (or a necessary condition) for tax reduction, the form of the tax cut certainly reflected beliefs about incentives. The 1921 *Treasury Annual Report* had an extensive discussion of the dangers of high surtax rates. One argument was that "the higher surtax rates are rapidly ceasing to be productive of revenue," because they provided strong incentives for tax avoidance (p. 14). In particular, "[t]here is no doubt that a large and steadily increasing amount of money formerly invested in productive industry is now going into tax-exempt securities" (p. 14). The 1921 *Report* also argued that high surtax rates were discouraging saving and capital formation, and that this was very bad for future growth and standards of living. More generally, it worried that "[a]nother serious effect of these high tax rates is the destruction of incentive—the drying up of the activities of individuals in trade operations—with consequent lessening of business transactions, the slowing down of production, and ultimately a loss of revenue to the Government" (p. 16). There can be no question that the nature of the tax cut had a very strong philosophical component.

The Senate report on the bill did not give much information on the reason for the form of the tax reduction. The one thing that it did emphasize was the motivation for eliminating the excess profits tax. It said: "The repeal of this tax is recommended because of its inequalities and difficulty of administration and because of the manner in which it discriminates against corporations with small invested capital" (Senate Report No. 275, p. 21).

The size of the tax reduction was substantial. The 1921 *Treasury Annual Report* said it reduced revenues by \$835 million relative to existing law during the first full fiscal year it was in operation, which was 1923 (p.10). This accords with President Harding's description of it as a "billion dollar reduction" (First Annual Message, 12/6/21, p. 2).

The Revenue Act of 1921 changed taxes along a number of dimensions. Most obviously, it reduced surtax rates (while leaving the normal tax unchanged). For incomes up to \$100,000, the act reduced surtax rates by just 1 percentage point. But on higher incomes, the reduction was more substantial. The top surtax rate was reduced from 65 percent to 50 percent. The Revenue Act of 1921 also greatly affected the tax treatment of capital gains. Rather than being taxed at the surtax rate, taxpayers were allowed to pay the lower of the surtax rate or 12½ percent (the surtax rate hit 13 percent at

taxable incomes of \$30,000). Various excise taxes were also eliminated by the act. The excess profits tax, which had been introduced during the war, was eliminated, but a flat 2½ percentage points was added to the corporation income tax. The tax changes all took effect on January 1, 1922.

Revenue Act of 1924

Enacted June 2, 1924

The fundamental motivation for the Revenue Act of 1924 was a belief in the virtue of limited government. President Coolidge and his Secretary of the Treasury Andrew Mellon spoke eloquently of the dangers of high taxation. For example, in his Address at the Meeting of the Business Organization of the Government in June 1924, Coolidge said: “any oppression laid upon the people by excessive taxation, any disregard of their right to hold and enjoy the property which they have rightfully acquired, would be fatal to freedom” (6/30/24, p. 1).

Like virtually all the tax changes in the interwar period, this tax change was tied to spending changes. The notion of a tax cut without a budget surplus or a reduction in spending was simply not contemplated. Coolidge was an ardent proponent of reducing spending *so* taxes could be reduced. In December 1923, for example, Coolidge discussed the fact that spending had been reduced substantially. He went on to say: “It is possible, in consequence, to make a large reduction in the taxes of the people, which is the sole object of all curtailment” (First Annual Message, 12/6/23, p. 3). Likewise, in his June 1924 address, he stated: “this fight for economy had but one purpose; that its benefits would accrue to the whole people through reduction in taxes” (6/30/24, p. 2). The 1924 Treasury *Annual Report* stated: “As a result of this reduction in expenditures [since 1920] two revenue relief measures were made possible, the revenue act of 1921 and the revenue act of 1924” (p. 2).

The Ways and Means Committee report on the bill also made it clear that the current budget surplus was a driving force behind the tax cut. It quoted a letter from the Secretary of the Treasury that said surpluses of over \$300 million a year were anticipated for the next four or five years. The report then said: “These figures indicate beyond any question that present taxes are yielding more revenue than the needs of government demand. Tax reduction is therefore imperative” (“The Revenue Bill of 1924,” 68th Congress, 1st Session, House of Representatives Report No. 179, 2/11/24, p. 1). The committee urged “the reduction of taxes to the full extent justified by the Treasury surplus” (p. 1).

The Treasury proposal for the bill included a much larger reduction in top marginal rates than the act ultimately included. There can be no doubt that the form of the tax cut proposed was motivated by a belief that high marginal rates distorted incentives. The administration felt that high wartime rates were gradually generating less revenue as people responded to the incentives they provided for tax evasion (1923 Treasury *Annual Report*, pp. 4-5). In a letter to the chairman of the Ways and Means Committee on November 10, 1923, Secretary of the Treasury Andrew Mellon spelled out these arguments. He said:

The high rates put pressure on taxpayers to reduce their taxable income, tend to destroy individual initiative and enterprise, and seriously impede the development of productive business. Taxpayers subject to the higher rates can not afford, for example, to invest in American railroads or industries or embark upon new enterprises in the face of taxes that will tax 50 per cent or more of any return that may be realized. These taxpayers are withdrawing their capital from productive business and investing it instead in tax-exempt securities and adopting other lawful methods of avoiding the realization of taxable income (1923 Treasury *Annual Report*, p. 8).

The administration was sufficiently concerned about the distortion of incentives regarding tax-exempt

securities that, in addition to reducing marginal tax rates, it proposed a constitutional amendment abolishing the right of states and municipalities to issue such securities. President Coolidge endorsed Mellon's supply-side views in his First Annual Message. He said: "a revision of the surtaxes will not only provide additional money for capital investment, thus stimulating industry and employing more but will not greatly reduce the revenue from that source, and may in the future actually increase it" (12/6/23, p. 3).

The Ways and Means Committee report also emphasized the importance of tax reform. In addition to tax reduction, it sought to "simplify the law, so far as possible, and endeavor to close the gaps which now give opportunity to evade its provisions" (House of Representatives Report No. 179, p. 1). In justifying the reduction in marginal rates, the report quoted at length from Mellon's November letter and statements from two former Secretaries of the Treasury. The report showed less commitment to the extreme reduction in top rates that the Treasury proposed. It said: "In making his recommendations, the purpose of the Secretary was obviously to fix the maximum surtax rates ... at the point of maximum productivity. It is, of course, impossible accurately to determine at what rate of tax this point is reached, but it seems to be generally conceded that a 50 per cent surtax has a constantly increasing effect in creating evasions, and that it is inadvisable for other reasons" (p. 5). This less than full commitment to the 25 percent top rate may explain why the ultimate reduction was only to 40 percent. The House report also contained a lengthy discussion of the reason for the proposed reduction of the tax on earned income. The basic argument was one of fairness. It stated: "The taxpayer who receives salaries, wages, and other earned income must each year save and set aside a portion of his income in order to protect him in case of sickness and in his old age, and in order to provide for his family upon his death. On the other hand, the person whose income is derived from investments already has his capital and is relieved of the necessity of saving to establish it" (p. 5).

Coolidge and Mellon were unhappy with the final form of the bill. The 1924 *Treasury Annual Report* stated that the President "viewed the bill as a measure of temporary relief but not a genuine tax reform" (p. 4; see also Statement by President Coolidge Concerning the Revenue Bill of 1924, Exhibit 56, 1924 *Treasury Annual Report*, pp. 264-267). They were concerned that the reduction in marginal rates was not sufficient to limit efforts at tax evasion (1924 *Treasury Annual Report*, pp. 3-6).

The revenue effects of the bill were not expected to be large. However, revenue estimates for this time period are highly inexact, and it is unclear how policymakers were treating the potential growth effects of the bill. The most concrete estimates are for the Treasury's initial proposal. The 1923 *Treasury Annual Report* said the plan would cut revenues by \$323 million (p. 10). The House report said that in a full year of operative, the form of the bill that it proposed would result in a net revenue loss of \$341,440,000 (House of Representatives Report No. 179, p. 2).

The Revenue Act of 1924 changed taxes in a number of ways. It reduced normal tax rates from 4 to 8 percent to 2 to 6 percent, and lowered surtax rates by approximately 25 percent at most income levels (20 percent at the very top). The top surtax rate was reduced from 50 percent to 40 percent. The new rates applied to income earned in 1924. In addition, the tax from the surtax for 1923 was reduced retroactively by 25 percent. The Revenue Act of 1924 continued the wartime estate tax and added a gift tax as a means of stemming avoidance. It also established a credit of 25 percent of the normal tax on earned income up to \$10,000.

Revenue Act of 1926

Enacted February 26, 1926

In proposing and passing the Revenue Act of 1926, President Coolidge emphasized the need for

tax reform over the need for tax reduction. The groundwork for this action was laid in Coolidge's signing statement on the Revenue Act of 1924. He stated: "The bill as passed provides a certain amount of tax reduction. ... But it is not only lacking in tax reform, it actually adds some undesirable features to the present law" (1924 Treasury *Annual Report*, Exhibit 56, p. 264). Among the key reforms that Coolidge and Mellon wanted were a reduction in high surtax rates and a repeal of the estate tax (1924 Treasury *Annual Report*, p. 4).

The Coolidge administration gave many justifications for these reforms. One argument was the practical one that high tax rates make efforts at avoidance inevitable (1924 Treasury *Annual Report*, p. 6; see also, p. 264). Mellon went even further in his statement before the Ways and Means Committee of the House on October 19, 1925. He stated: "it is important to bear in mind the distinction between a reduction of taxes which reforms the tax system and a reduction in taxes which simply reduces revenue. It has been the experience of the Treasury that every time there has been a material reduction in surtaxes it has stimulated business and brought about an increase in taxable income which has made up a great part, if not all, of the loss in revenue" (1925 Treasury *Annual Report*, Exhibit 87, p. 350). Coolidge also stressed the positive revenue effects of lower rates (see, for example, Second Annual Message, 12/3/24, p. 2).

In addition to the revenue argument, Coolidge made much broader claims about the supply-side benefits of lowering marginal rates. His Third Annual Message, given just shortly before the act was passed, gave an impassioned listing of these benefits:

All these economic results are being sought not to benefit the rich, but to benefit the people. They are for the purpose of encouraging industry in order that employment may be plentiful. They seek to make business good in order that wages may be good They seek to lay the foundation which, through increased production, may give the people a more bountiful supply of the necessities of life (12/8/25, p. 3).

In his Second Annual Message on December 3, 1924, he made the flip side of this argument, saying that the severe postwar recession "resulted in no small measure from the prohibitive taxes which were then levied on all productive effort" (p. 1).

Coolidge also added a moral argument to his belief in lower tax rates. His Inaugural Address, for example, said: "I am opposed to extremely high rates, because they produce little or no revenue, because they are bad for the country, and, finally, because they are wrong" (3/4/25, p. 4). He added: "Under this republic the rewards of industry belong to those who earn them" (p. 4).

As with the earlier tax cuts, Coolidge stressed the need to reduce government expenditure before taxes could be cut. In essence, the tax cut was to be a balanced-budget measure. Mellon made this argument very clearly in his testimony to Congress. He said: "The first matter which must be considered in any revenue bill is how much revenue the Government requires" (1925 Treasury *Annual Report*, Exhibit 87, p. 346). He continued: "I think, however, that the surplus in 1927, ... would be between \$250,000,000 and \$300,000,000. This, it seems to me, is a figure which it is safe to take as the amount by which taxes can now be permanently reduced" (p. 347). Coolidge made similar arguments repeatedly. For example, in his Address at a Meeting of the Business Organization of the Government, he said: "The object sought is not merely a cutting down of public expenditures. That is only the means. Tax reduction is the end" (6/22/25, p. 1).

The Ways and Means Committee Report ("The Revenue Bill of 1926," 69th Congress, 1st Session, House of Representatives Report No. 1, 12/7/25) stressed the existence of a surplus as the main justification for the cut. It said: "It was estimated that under the revenue law then in force that the fiscal

year 1925 would produce a surplus of \$250,000,000; the fiscal year 1926, over \$200,000,000; and the fiscal year 1927, about \$300,000,000. Such being the case, it was obvious that our Federal taxes ought to be reduced” (p. 1). It went on to say: “the committee, having first determined the total amount of reduction in revenues which could properly be made, proceeded to apportion the benefits of such reduction ... as far as possible, to so distribute them as to bring the maximum good to all of our people” (p. 2).

The expected revenue effects of the action were fairly modest. The 1927 Treasury *Annual Report* said that the bill was expected to reduce tax revenues by \$46 million by cutting the normal tax, \$98 million by cutting the surtax rates, and \$42 million by increasing the personal exemption, for a total of \$186 million (p. 44). This is slightly less than the \$250 to \$300 million that Mellon said taxes could be cut. Coolidge said in a speech on June 21, 1926 that the bill also reduced wartime excise taxes by \$275 million (Address at the Eleventh Regular Meeting of the Business Organization of the Government, p. 4). Including this would increase the total to \$461 million. This sum is somewhat higher than the Ways and Means Committee estimate that “[f]or the calendar year 1926 the reduction in revenues is estimated at \$325,736,000” (House Report No. 1, p. 2). The tax reductions were made retroactive to January 1925.

The Revenue Act of 1926 had a number of key features. The most extreme was a dramatic reduction in surtax rates on personal income. The top rate was reduced from 40 percent to 20 percent. Rates at all but very low income levels were roughly cut in half. The normal tax rate was also reduced (from a top rate of 6 percent to a top rate of 5 percent). The personal exemption was raised by 50 percent, which substantially increased the number of people paying no federal income tax (1927 Treasury *Annual Report*, p. 10). The bill also removed the capital stock tax on corporations, and partially replaced it by raising the corporate income tax rate by 1 percentage point (from 12½ percent to 13½ percent).

Revenue Act of 1928

Enacted May 29, 1928

The Revenue Act of 1928 was a relatively minor tax action that primarily reduced the corporate income tax. It also made small adjustments to the personal income tax and certain excise taxes.

The proximate motivation for the tax reduction appears to have been current and prospective budget surpluses. For example, the Ways and Means Committee report on the bill began the general discussion saying: “We are again in the happy position of having a surplus of revenue in the Treasury which is being applied on the national debt, but which enables us to reduce taxation” (“The Revenue Bill of 1928,” 70th Congress, 1st Session, House of Representatives Report No. 2, 12/7/27, p. 1). This sentiment was echoed by Treasury Secretary Mellon’s statement before the committee. He stated: “The factor which definitely determines the extent to which we may reduce taxes is the 1929 surplus” (“Revenue Revision 1927-28,” Interim, 69th-70th Congresses, Hearings before the Committee on Ways and Means, House of Representatives, October 31 to November 10, 1927, p. 6). Likewise, Undersecretary of the Treasury Mills stated on November 11, 1927: “For the fourth time in seven years the state of Federal finances is such as to permit a substantial reduction of taxes” (1928 Treasury *Annual Report*, Exhibit 26, p. 278).

President Coolidge made many statements in 1927 and 1928 to the effect that the state of the budget was the crucial determinant of tax legislation. In June 1927, he stressed the importance of considering extended budget forecasts: “In considering the possibility of tax reduction, we must keep in mind that our revenue laws can not be written from the standpoint of a single year, but must be expected to yield adequate revenue over a period of years” (Address at the Thirteenth Regular Meeting of the Business Organization of the Government, Washington D.C., 6/10/27, p. 2). In December 1927, he said:

“The immediate fruit of economy and the retirement of the public debt is tax reduction.” Coolidge was explicit that budget balance was not negotiable, saying: “We must keep our budget balanced for each year” (both quotations, Fifth Annual Message, 12/6/27, p. 1). In 1928, Coolidge stated: “This Nation is committed irrevocably to balancing the Budget. Nothing short of a national emergency can trespass upon that commitment” (Address at the Fifteenth Regular Meeting of the Business Organization of the Government, 6/11/28, p. 3). This same view was expressed by the Ways and Means Committee report, which stated: “The majority of the committee are opposed to any plan that would produce a deficit” (House of Representatives Report No. 2, p. 2).

Shortly after passage of the Revenue Act of 1928, Coolidge reiterated the view expressed previously that his administration was reducing spending *so* that it could reduce taxes. He said: “We have approached the tax question from the angle of requiring no more from the people than necessary efficiently to operate the Government. The effort has been to reduce the cost of Government so as to make room for tax reduction” (Address at the Fifteenth Regular Meeting of the Business Organization of the Government, 6/11/28, p. 2). However, in this case, it is also clear that unexpectedly large revenues played a role in causing the budget surplus driving the tax cut. In his statement to the Ways and Means Committee, Secretary Mellon stated: “The Treasury Department has always contended that lower rates would be more productive than the very high rates which prevailed [before the Revenue Act of 1926], but neither the Treasury Department nor the Congress had anticipated such an immediate increase, an increase which was, of course, greatly accelerated by the rising tide of prosperity” (“Revenue Revision 1927-28,” Interim, 69th-70th Congresses, Hearings before the Committee on Ways and Means, House of Representatives, October 31-November 10, 1927, p. 3).

In his statement, Mellon suggested that budget surpluses of about \$250 million were likely to continue. Taking into account possible spending increases from new legislation, he concluded: “The Treasury believes that tax reduction should not in any event be in excess of approximately \$225,000,000” (Hearings, October 31-November 10, 1927, p. 7). The 1928 Treasury *Annual Report* suggested that the effect of the 1928 act (at a given level of income) was a reduction in tax revenues of \$222 million (p. 34). This is slightly lower than the Ways and Means Committee estimate of a reduction of \$232,735,000 (House of Representatives Report No. 2, p. 2).

President Coolidge said the proposed tax changes “would give us a much better balanced system of taxation” (Fifth Annual Message, 12/6/27, p. 1). The key component was a reduction in the corporate income tax rate. Secretary Mellon suggested that such a reduction in corporate taxes was necessary for both fairness and efficiency. He said:

Corporations last received relief from taxation in the revenue act of 1921, which repealed the excess-profits tax, and even then the income tax rate was increased. Since that time, while other classes of taxpayers have benefited either by the repeal of war taxes or the sharp reduction of war-time rates, corporations have continued to bear a heavy burden. The time has come to revise the corporation tax rates downward. Business conducted under the corporate form is to-day overtaxed as compared with individual business enterprises and partnerships, a condition which spells particular hardship to the small corporations with a limited net income and to the stockholder of limited means (Hearings, October 31-November 10, 1927, p. 8).

Undersecretary Mills, in his speech in November 1927, also stressed the unfairness of taxing corporate income more highly than other types of income. He said: “There is no logic or justice in such a discrimination” (1928 Treasury *Annual Report*, Exhibit 26, p. 281). Similar arguments were made by the Ways and Means Committee (see House of Representatives Report No. 2, pp. 3-4).

The key feature of the Revenue Act of 1928 was a reduction in the corporate income tax rate from 13½ to 12 percent. It also raised the specific credit from \$2000 to \$3000. The original proposal included a reduction in individual surtax rates for incomes in the middle range of taxable incomes (see Mellon's statement, Hearings, October 31-November 10, 1927, p. 7). However, this change did not make it into the final law. The only change in individual income taxes was an increase in the limit on which the earned income credit could be taken from \$20,000 to \$30,000. A proposal to abolish the estate tax also did not make it into the final bill.

Joint Resolution of Congress No. 133

Enacted December 16, 1929

Joint Resolution No. 133 was a fairly small, explicitly temporary tax cut passed at the end of 1929. Like the Revenue Act of 1928, it appears to have been motivated by the existence of a modest, largely unintended budget surplus. The 1929 *Treasury Annual Report* said that it expected a surplus of \$226 million in fiscal year 1930 and \$123 million in fiscal year 1931. It continued: "The Treasury Department believes, therefore, that the taxpayers should receive the benefit of any prospective surplus in the form of tax reduction" (p. 22). The 1930 *Annual Report* was equally explicit about the link to the surplus, and added that the surplus was not the result of government intentions. It said: "It was then apparent that the tax yield at 1928 rates would be more than sufficient for budget requirements in the fiscal year 1930.... This was due primarily to the increase in incomes of both corporations and individuals during the years immediately preceding, especially in the calendar year 1928. Accordingly, provision was made to reduce by 1 per cent the normal rates on individual income and the rate on corporation income applicable to incomes reported for the calendar year 1929" (p. 4).

President Hoover, in his Annual Budget Message to the Congress, Fiscal Year 1931, repeated the same view. He said: "With an estimated surplus ... it is felt that some measure of reduction in taxes is justified" (12/4/29, p. 10). He also added the argument that there were possible efficiency gains from cutting taxes. He stated: "Such reduction gives the taxpayer correspondingly more for his own use and thus increases the capital available for general business" (p. 10).

The tax cut was made explicitly temporary because the Treasury was unsure that the surpluses would continue. The 1929 *Treasury Annual Report* said: "the problem of estimating future revenue is attended by extraordinary difficulties at the present time due to the existence of a number of factors the effect of which it is almost impossible to foresee" (p. 23). Chief among these factors was an unusual surge in both income and capital gains in 1928, and a possible recession beginning in 1929. The 1930 *Treasury Annual Report* said that the 1929 tax cut "is the first instance in which income tax rates have been reduced for a single calendar year in order to relieve individuals and corporations from taxes when a surplus of receipts was anticipated without assurance that this surplus would continue for more than one year" (p. 2). Though an explicitly countercyclical motivation was not mentioned, the 1930 *Annual Report* pointed out that "During the calendar year 1930 the income tax reduction afforded relief to both individuals and corporations during a period of unfavorable business developments" (p. 2).

The Ways and Means Committee report on the bill seconded both the idea that the existing surplus was the key motive for tax reduction, and the notion that budget uncertainty was the reason for making the cut temporary. It said: "Because of the unusual conditions, your committee believes that the estimated surplus for 1930 and 1931 does not permit a permanent tax reduction. Nevertheless, it is convinced that the benefits of the probable surpluses should be passed on to the taxpayers" ("Tax Relief for 1929," 71st Congress, 2^d Session, House of Representatives Report No. 24, 12/4/29, p. 2).

The key motivation given for the particular form that the tax cut took was a desire to spread the

cut broadly. The 1929 Treasury *Annual Report* said the cut in both the normal tax rate and the corporate income tax rate “distributes the benefits as widely as possible and while giving all income taxpayers some measure of relief favors those of moderate incomes” (p. 25). It particularly stressed that since few people paid the income tax, but many held stocks and received dividends, “the way to give the greatest Federal tax relief to the greatest numbers is through a reduction of the corporation rate” (p. 25). It also pointed out that “under our system of graduated surtaxes the reduction of the normal rate is relatively of greater benefit to those with small or moderate incomes” (p. 25).

The Congressional report on the bill made similar arguments for the form the tax reduction took. It stated: “the relief should be granted to the greatest extent consistent with sound Government finance and to the greatest possible number of taxpayers” (House of Representatives Report No. 24, p. 3). It also presented calculations suggesting “the present corporation rate of 12 per cent is out of line with the rates imposed upon individuals,” and said: “It can hardly be denied that the way to give the greatest Federal tax relief to the greatest number is through a reduction of the corporation rate” (both quotations, p. 3).

The estimated revenue effects were relatively small. The 1929 Treasury *Annual Report* gave the effect in calendar year 1930 as \$160 million (p. 24). This estimate is repeated in the 1930 *Report* (p. 4) and the Ways and Means Committee report (House of Representatives Report No. 24, p. 1). The 1930 Treasury *Annual Report* indicated that \$90 million of this reduction came from the cut in the corporate rate and \$70 million from the reduction in the individual income tax rate (p. 4). The lower rates only applied to 1929 taxes, which were paid in early 1930.

As described above, the tax action took the form of reducing both the normal income tax and the corporate income tax rates by 1 percentage point. The normal tax rate, which varied from 1½, 3, and 5 percent depending on income, was reduced to ½, 2, and 4 percent; the corporate income tax rate was reduced from 12 percent to 11 percent.

Revenue Act of 1932

Enacted June 6, 1932

The Revenue Act of 1932 contained a very large tax increase. The sole purpose of the tax increase was to close the budget deficit caused by the reduction in revenues (and the much smaller increase in expenditures) brought about by the Great Depression. The 1932 Treasury *Annual Report* contained a thorough discussion of the decline in revenues caused by the Depression. It pointed out that with a highly progressive tax system, as the United States still had despite the large tax cuts of the 1920s, tax revenues decline even more rapidly than income (p. 9). At the time the bill was being considered by Congress, the projected federal deficit for fiscal year 1933 was more than \$1,700 million (1932 Treasury *Annual Report*, Exhibit 23, p. 259). These estimated deficits are mentioned in the first page of the Ways and Means Committee report on the bill (“The Revenue Bill of 1932,” 72nd Congress, 1st Session, House of Representatives Report No. 708, 3/8/32, p. 1).

To some degree, policymakers acted as if it was obvious that eliminating a budget deficit was justification enough for the substantial tax increase. For example, Ogden Mills, who became Treasury Secretary under Hoover, said in December 1931: “over a period of years, revenues must be equal to expenditures. Deficiency for a time may be inevitable, but the principle of a balanced Budget must never be abandoned, and when emergency conditions upset the balance, every effort must be made to restore it at the earliest possible opportunity” (1932 Treasury *Annual Report*, Exhibit 22, p. 256). Likewise, the 1932 Treasury *Annual Report* described the purpose of the tax increase as “to provide additional revenue to meet the emergency situation” (p. 13).

Both Treasury Secretary Mills and President Hoover, however, went somewhat further. Hoover, in his December 1931 Annual Budget Message said: “We can not maintain public confidence nor stability of the Federal Government without undertaking some temporary tax increases” (12/9/31, p. 2). He reiterated these motivations in his short Statement on Signing the Revenue Act of 1932, saying: “the bill will effect the great major purpose of assurance to the country and the world of the determination of the American people to maintain their finances and their currency on a sound basis” (6/6/32, p. 1).

Mills placed particular emphasis on the credit crisis facing the country. After saying that the decline in bank credit was a key impediment to recovery, he emphasized that “our private credit structure is inextricably bound to the credit of the United States Government” (1932 Treasury *Annual Report*, Exhibit 23, p. 259). Like Hoover, Mills also mentioned a link between a balanced budget and currency stability. He said: “Our currency rests predominantly upon the credit of the United States. Impair that credit and every dollar you handle will be tainted with suspicion” (p. 259).

The Ways and Means Committee report made many similar arguments about why budget balance was important. It stated: “any failure to balance the Budget for 1933 showing as it would a continuing failure in the face of known conditions to meet current expenditures out of current receipts would evidence such a lack of sound business methods in the conduct of our national finances as to cause a loss of confidence and apprehension as to the future” (House of Representatives Report No. 708, p. 4). It continued: “Our commercial credit system is inextricably tied up with the credit of the Federal Government, and anything that shakes public confidence in that credit necessarily affects the entire commercial credit system upon which business development and expansion are dependent” (p. 5).

In contrast to the 1920s, policymakers were not terribly worried about the incentive effects of the tax increase. The administration’s proposal involved essentially reenacting the Revenue Act of 1924. Hoover stated that this plan “has the great advantage that the Government is equipped by experience with similar legislation for its systematic and economical collection” (Annual Budget Message to the Congress, Fiscal Year 1933, 12/9/31, p. 2). The one thing that Secretary Mills emphasized repeatedly was the need to make the tax increase more broadly based. He said that raising taxes only at the top of the income distribution simply would not raise adequate revenue (1932 Treasury *Annual Report*, Exhibit 24, p. 264). Congress expressed slightly more concern about the incentive effects of high marginal income tax rates when it said: “these increases in the rates, particularly on the higher incomes, reaching, as they do in the proposed bill, a maximum of 46 per cent, equal if they do not exceed the point of diminishing return. No more revenue can be obtained out of a tax on large incomes” (House of Representatives Report No. 708, p. 7).

The 1932 Treasury *Annual Report* called the Revenue Act of 1932 “one of the largest increases in taxes ever imposed by the Federal Government in peace times” (p. 21). It also said that “In a year in which the enactment of any new revenue measure presented grave difficulties, the placing on the statute books of an act so substantial in scope was an impressive achievement” (pp. 21-22). When the law was enacted, it was estimated to yield a revenue increase of \$1,118.5 million for fiscal year 1933 (1932 Treasury *Annual Report*, p. 21). The Ways and Means Committee report gave the slightly larger revenue estimate for fiscal year 1933 of \$1,121 million (House of Representatives Report No. 708, p. 5).

The tax increase had many components. It raised the normal tax from 1½ to 5 percent to 4 to 8 percent. It roughly doubled surtax rates at most income levels; the top marginal rate rose from 20 percent to 55 percent. The law also eliminated the earned income credit and reduced the personal exemption substantially. The act permanently increased the corporate income tax from 12 percent to 13¾ percent, and added a temporary extra ¾ percent tax for 1932 and 1933. While the changes in the individual and corporate income taxes were substantial, the majority of the revenue effects were due to a vast increase in excise taxes. The most notable of these was an across-the-board tax of 2¼ percent on all manufactured

articles.

National Industrial Recovery Act

Enacted June 16, 1933

The National Industrial Recovery Act was an extremely complex and wide-ranging piece of legislation. While modern analysis has focused largely on the anti-competitive practices and labor provisions contained in the resulting industry codes, a very large part of the act centered on public works spending. Title II of the act authorized appropriations of \$3,300 million for public works and construction projects. The act provided for additional taxes to meet the service charges on the funds borrowed for this additional spending.

The Roosevelt administration believed strongly that regular recurring expenditures should be covered by regular, recurring revenues. But, it viewed the Depression as a national emergency, much like a war, that warranted increased borrowing. For example, Director of the Budget Lewis Douglas testified at a hearing on the NIRA:

Recurring items of expenditure should be met out of recurring revenue. ... But just as during the war there were emergency expenditures which had to be made, so now there are emergency expenditures which have to be made—expenditures of a nonrecurring and extraordinary nature. ... We propose to undertake this public works program, under which the Government will have to borrow a very substantial sum of money—\$3,300,000,000 (“National Industrial Recovery,” 73rd Congress, 1st Session, Hearings Before the Committee on Ways and Means, House of Representatives, No. 1, May 18, 1933, p. 29).

Likewise, in his Fireside Chat on the Recovery Program, Roosevelt talked of bringing regular expenses within our revenues. He then said: “It may seem inconsistent for a government to cut down its regular expenses and at the same time to borrow and to spend billions for an emergency. But it is not inconsistent because a large portion of the emergency money has been paid out in the form of sound loans which will be repaid to the Treasury over a period of years” (7/24/33, p. 1).

The tax increases included in the NIRA were designed merely to cover the interest and amortization on the debt incurred to pay for the increased spending. In his Message to Congress Recommending Enactment of the National Industrial Recovery Act, Roosevelt stated: “In carrying out this program it is imperative that the credit of the United States Government be protected and preserved. This means that at the same time we are making these vast emergency expenditures there must be provided sufficient revenue to pay interest and amortization on the cost and that the revenues so provided must be adequate and certain rather than inadequate and speculative” (5/17/33, p. 1). This view that the tax increases were designed “to meet service charges on the funds borrowed for construction of public works” was seconded by the 1933 Treasury *Annual Report* (p. 18). Thus, in a fundamental sense, this act included a spending-driven tax increase, but the tax increase was only a tiny fraction of the spending increase.

The revenue raised by the tax increases was extremely modest. The President’s Message to Congress said: “at least \$220,000,000 of additional revenue will be required to service the contemplated borrowings of the Government” (5/17/33, p. 1). The 1933 Treasury *Annual Report* estimated that the NIRA taxes would yield \$153.7 million in fiscal year 1934 (p. 22).

The NIRA included a number of tax changes. It imposed a capital stock tax of \$1 per \$1000 of

the declared value of a corporation's capital stock, where firms were allowed to set their declared value however they liked. To give firms better incentives, the capital stock tax was paired with an excess profits tax of 5 percent of net income in excess of 12½ percent of the corporation's declared value. The act also imposed a tax of 5 percent on dividends received, and extended the manufacturers' excise tax from the Revenue Act of 1932 for one year. It increased the tax on gasoline from 1 cent to 1½ cents per gallon. All of the new taxes took effect immediately.

The NIRA called for the new taxes to end when one of two conditions was met: at the close of the first fiscal year when receipts were greater than expenditures, or when the 18th amendment (Prohibition) was repealed. The 18th amendment was in fact repealed December 5, 1933. In keeping with the law, the dividend tax was repealed and the gas tax reverted to 1 cent after December 31, 1933. The capital stock tax was only to apply to the year ending June 30, 1933, and the excess profits tax was not to apply to any taxable year after June 30, 1934. However, the Revenue Act of 1934, approved May 10, 1934, reimposed both the capital stock and excess profits taxes.

Revenue Act of 1934

Enacted May 10, 1934

The Revenue Act of 1934 included a modest tax increase and a number of tax reforms. According to the Ways and Means Committee report on the bill, "The primary purpose of the bill is to increase revenue by preventing tax avoidance" ("The Revenue Bill of 1934," 73^d Congress, 2^d Session, House of Representatives Report No. 704, 2/12/34, p. 1). Thus, the bill had two motivations: reducing tax evasion and closing the budget deficit.

The interest in reducing tax avoidance certainly continued a theme common in the 1920s. However, whereas the Coolidge administration emphasized reducing tax rates as the key to reducing evasion, the Roosevelt administration and the Democratic Congress emphasized closing loopholes and raising some rates. One sign of the concern about evasion was that "A subcommittee of your Committee on Ways and Means has been engaged in studying tax avoidance and the means of preventing such avoidance since last June" (House of Representatives Report No. 704, p. 1). Many of the changes included in the bill were described by the Committee report as preventing evasion. For example, it discussed "the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme [in which] an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed" (p. 11). The Revenue Act of 1934 made such a scheme less attractive by imposing a 35 percent tax on the undistributed adjusted net income of such personal holding companies.

Roosevelt's speeches in 1934 barely mentioned the proposed act. However, he expressed concern about tax evasion in other contexts. At a press conference in March 1934, Roosevelt discussed the Justice Department's "proceedings against Mellon and others on tax evasion" (Excerpts from the Press Conference, 3/14/34, p. 3). Roosevelt stressed that "There are several hundred cases in exactly the same category" (p. 3). This concern about tax avoidance among the rich is a theme Roosevelt returned to in this discussion of other revenue actions in the mid- and late 1930s.

The Ways and Means Committee expressed substantial concern about the deficit. The report discussed the "vital need of the Government for the additional revenue which should be produced by this bill" (House of Representatives Report No. 704, p. 2). It also said: "Your committee is of the opinion that it is of the utmost importance to reduce the deficits estimated for the fiscal years 1934 and 1935 as much as possible and to attain the goal of a balanced Budget in 1936" (p. 4).

The Roosevelt administration appears to have been somewhat more sanguine about the deficit. In his Fireside Chat (Recovery Program), Roosevelt stressed the importance of “preserving and strengthening the credit of the United States Government,” which had been damaged by the fact that “For years the Government had not lived within its income” (7/24/33, p. 1). However, Roosevelt adopted a largely “cyclically-adjusted” view of the deficit. The same Fireside Chat said: “The immediate task was to bring our regular expenses within our revenues. That has been done” (p. 1). The 1934 Annual Budget Message defined roughly two-thirds of all federal expenditures as “emergency” (1/3/34, p. 1). Likewise, the 1935 Annual Budget Message spoke of “a Budget for the fiscal year 1936, which balances except for expenditures to give work to the unemployed” (1/3/35, p. 3). Thus, it seems unlikely that deficit reduction was a key motivation for the bill from the administration’s side.

The revenue estimates for the Revenue Act of 1934 are moderate. The Ways and Means Committee report gave an estimate of \$258 million (House of Representatives Report No. 704, p. 4). Of this number, roughly one-third was due to non-legislated changes in the administration of depreciation allowances urged by the Congress and adopted by the Treasury. Changes in the tax-rate structure accounted for \$28 million of the additional revenues; changes in the treatment of capital gains accounted for another \$35 million; and the new treatment of personal holding companies accounted for \$25 million (p. 4). These numbers are somewhat larger than those given in other sources. For example, the 1934 Treasury *Annual Report* said changes in the rate structure and capital gains provisions of the Revenue Act of 1934 increased revenues by \$26 million in fiscal year 1935 (p. 24). The President’s 1934 Annual Budget Message suggested a possible revenue impact of the proposed law of \$150 million (1/13/34, p. 4).

As the previous discussion has suggested, the Revenue Act of 1934 made many changes in the tax law. On rates, it changed the normal income tax from a two-tier tax (with rates of 4 and 8 per cent) to a single tax of 4 percent. It compensated for this reduction in the normal tax by raising surtax rates. The top surtax rate rose from 55 to 59 percent. Tax revenues were raised by lowering the exemption for dividends. The act partially reinstated the earned income credit, which had been eliminated by the Revenue Act of 1932.

The act included a very large change in the treatment of capital gains. Under existing law, capital gains were taxed at a maximum rate of 12½ percent. The new law subjected capital gains to the sum of the normal and surtax rates (which could be as high as 63 percent). However, the fraction of the capital gain that was taxed varied with how long the asset had been held. The act also raised the estate tax substantially, and imposed a new tax on personal holding companies.

Though not officially part of the act, an important administrative change urged by Congress and adopted by the Treasury raised corporate tax payments. The new depreciation guidelines reduced substantially the amount of deductions that were allowed. They also greatly changed the burden of proof required by justifying such deductions.

Social Security Act

Enacted August 14, 1935

The Social Security Act instituted a wide range of social insurance programs. In addition to the well-known old-age assistance, it also included aid to dependent children, public health initiatives, and a program of federally supported unemployment compensation. To pay for these programs, new taxes were placed on both workers and employers.

The motivation for the new spending programs was, in Roosevelt’s words, “to provide sound and adequate protection against the vicissitudes of modern life” (Fireside Chat, 6/28/34, p. 3). Congress

described the act as “a more comprehensive and constructive attack on insecurity,” and said “[t]he bill is designed to aid the States in taking care of the dependent members of their population, and to make a beginning in the development of measures which will reduce dependency in the future” (“The Social Security Bill,” 74th Congress, 1st Session, House of Representatives Report No. 615, 4/5/35, p. 3).

The motivation for the tax increases was clearly to pay for the new spending. The clearest evidence for this is that the tax increases were legislated in the same bill setting up the spending programs. Roosevelt was also explicit that the new Social Security System should be self-financing. In his Message to Congress on Social Security, he said: “the system adopted, except for the money necessary to initiate it, should be self-sustaining in the sense that funds for the payment of insurance benefits should not come from the proceeds of general taxation” (1/17/35, p. 1). Likewise, Congress emphasized that the bill “seeks to reduce dependency and to encourage thrift and self-support” (House of Representatives Report No. 615, p. 16). The Congressional report also said, “Practically no objections have been made to the imposition of the taxes levied in this bill,” and went on to say that such a self-financing social insurance system could ultimately lower the burden of relief on all taxpayers (p. 16).

Just shortly after passage of the Social Security Act, a similar measure was passed for workers in the railroad industry. This program focused almost exclusively on old-age assistance. The act, entitled the Carriers Taxing Act of 1935, was approved August 29, 1935. The program was obviously much smaller than the Social Security program, but was fundamentally similar in structure and motivation. In particular, the tax was designed to pay for the promised pension benefits. The act was replaced by the Carriers Taxing Act of 1937.

The revenue effects of the Social Security taxes were modest because the tax rates were low and coverage was incomplete. The President’s Annual Budget Message on January 7, 1937 said that the first full year of tax collection under the Social Security Act would result in revenue of \$774.8 million in fiscal year 1938 (p. 4). These numbers match fairly well with the retrospective numbers given in the 1940 Treasury *Annual Report*. The *Annual Report* said that Social Security revenues were \$253 million in fiscal year 1937 (p. 15). It then said that employment taxes increased \$502 million in fiscal year 1938, suggesting a total value of \$755 million in the first full fiscal year (p. 16). Both of these revenue estimates are noticeably smaller than those given in the Ways and Means Committee report on the bill. That report said that Title VIII of the bill (the taxing provisions related to old-age assistance and social programs) would raise \$560.2 million in fiscal year 1938 and Title IX (the taxing provisions related to unemployment compensation) would raise \$501.0 million (House of Representatives Report No. 615, p. 15). In general, the report’s estimates for Title VIII are quite close to the retrospective numbers, but the Title IX numbers are dramatically higher.

Revenue estimates for the Carriers Taxing Act of 1937 are more difficult to find. The President’s 1938 Annual Budget Message said that it had been expected that the taxes on carriers and their employees would produce revenues of \$134,552,000 in fiscal year 1937. However, litigation delayed collection, so only \$345,088 was collected (1/3/38, p. 3).

The Social Security Act imposed three taxes. One was a tax on individuals of 1 percent on wages up to \$3000. The second was an equivalent tax on employers on wages paid (again up to \$3000). Both of these tax rates were supposed to rise ½ percentage point every three years, reaching a maximum of 3 percent after December 31, 1948. However, the Social Security Amendments of 1939, approved August 10, 1939, prevented the first ½ percent increase that was to have applied in calendar years 1940, 1941, and 1942. The third tax was a tax on total wages paid by employers with 8 or more employees for unemployment compensation. The rate was 1 percent in 1936, 2 percent in 1937, and 3 percent in 1938 and after.

The Carriers Taxing Act of 1935 put a tax on employees of 3½ percent of compensation received up to \$300 per month. Like the Social Security Act, it put an equivalent tax on employers. These rates were lowered by the Carriers Taxing Act of 1937. The new rate was set at 2¾ percent on compensation up to \$300 per month for both employees and employers. The rate was to increase ¼ of a percentage point every three years until it reached 3¾ percent after December 31, 1948. (This act also refunded all taxes paid under the 1937 act for compensation paid prior to January 1, 1937.)

The income taxes under both the Social Security Act and the Carriers Taxing Act of 1937 took effect on January 1, 1937. The unemployment compensation tax on large employers included in the Social Security Act took effect January 1, 1936.

Revenue Act of 1935

Enacted August 30, 1935

The Revenue Act of 1935 was a modest tax increase motivated largely by notions of fairness. Unlike earlier tax changes, budget balance paid a relatively minor role. According to the January 3, 1935 Annual Budget Message, the deficit at the end of fiscal year 1934 was nearly \$4 billion. The Roosevelt administration clearly viewed economic conditions as a temporary emergency that warranted such large budget deficits. The Budget Message said:

[U]nemployment is still large. The States and local units now provide a smaller proportionate share of relief than a year ago and the Federal Government is therefore called upon to continue to aid in this necessary work.

For this reason it is evident that we have not yet reached a point at which a complete balance of the Budget can be obtained. I am, however, submitting to the Congress a Budget for the fiscal year 1936, which balances except for expenditures to give work to the unemployed (p. 3).

Such expenditures for relief and recovery were projected to be approximately \$4 billion in fiscal year 1936. In his Annual Budget Message in January 1936, Roosevelt was even more pro-deficit. He said: “Our policy is succeeding. The figures prove it. Secure in the knowledge that steadily decreasing deficits will turn in time into steadily increasing surpluses, and that it is the deficit of today which is making possible the surplus of tomorrow, let us pursue the course that we have mapped” (1/3/36, p. 2).

In his Message to Congress on Tax Revision, Roosevelt never mentioned raising revenue as a motivation for the proposed changes. In testimony to the House Ways and Means Committee, Secretary of the Treasury Henry Morgenthau mentioned balancing the budget, but only in the vaguest terms (“Proposed Taxation of Individual and Corporate Incomes, Inheritances, and Gifts,” 74th Congress, 1st Session, Hearings before the Committee on Ways and Means, House of Representatives, July 8, 9, 10, 11, 12, 13, 1935, p. 5). He was pushed on this point by Representative Knutson, who said: “I would say that the Secretary’s position seems to be that this is a revenue measure, and the President’s position seems to be that this is a share-the-wealth program” (p. 12).

Roosevelt’s Message to Congress on Tax Revision centered on the fairness argument for the proposed changes. He proposed increasing the tax on inheritances and gifts because: “The transmission from generation to generation of vast fortunes by will, inheritance, or gift is not consistent with the ideals and sentiments of the American people” (6/19/35, p. 1). He also proposed raising tax rates on higher incomes saying:

Social unrest and a deepening sense of unfairness are dangers to our national life which we must minimize by rigorous methods. People know that vast personal incomes come not only through the effort or ability or luck of those who receive them, but also because of the opportunities for advantage which Government itself contributes. Therefore, the duty rests upon the Government to restrict such incomes by very high taxes (p. 2).

Even the proposed changes in the corporate income tax centered on equity. Roosevelt said: "It seems only equitable, therefore, to adjust our tax system in accordance with economic capacity, advantage and fact. The smaller corporations should not carry burdens beyond their powers; the vast concentrations of capital should be ready to carry burdens commensurate with their powers and their advantages" (p. 3). Secretary Morgenthau also emphasized the fairness motivation in his testimony to Congress. He said:

These proposed taxes rest on the principle of ability to pay. They are devised to draw an accumulation of wealth and income which, for the most part, have been derived from Nation-wide activities. In consequence, their enactment should constitute an important step forward in reshaping our tax structure along sounder and fairer lines (Hearings, July 8, 9, 10, 11, 12, 13, 1935, p. 5).

The Ways and Means Committee report on the bill made it clear that Congress was largely just following the President's suggestions. It stated: "It is hoped that the enactment of these titles into law will remedy some of the defects of our present tax system, will provide substantial revenue, and will carry out the major policies recommended by the President in his message" ("The Revenue Bill of 1935," 74th Congress, 1st Session, House of Representatives Report No. 1681, 7/30/35, p. 4). One sign that the Democratic majority may have agreed with the President's motivation is that it revised the excess profits tax on corporations to be sharply progressive and higher than existing law on all but the lowest profit level. The report stated: "This tax was not specifically mentioned by the President, but your committee feels it is in line with his general policy to tax those with the ability to pay whether they be individuals or corporations" (p. 7).

The "Views of the Minority" included in the report suggested that "the Democratic members of the committee were not only indifferent, but actually hostile to his [the President's] proposals" (House of Representatives Report No. 1681, p. 18). In their view, "That the bill now comes before the House with their approval is further evidence of the fact that the majority are not guided by their convictions but by the orders they receive from the White House" (p. 18). The minority was also quite cynical about why the President proposed the tax changes just six months after saying he did not feel it advisable to raise taxes. They said: "The fact is that the President's tax message came at a time when the administration's popularity and prestige were rapidly on the decline, and it served to divert public attention from the criticisms which were being leveled at the President and his policies. It doubtless had a secondary purpose of undermining the increasing political strength of the two chief exponents of the 'share the wealth' and 'soak the rich' philosophy by making a bid for the support of their large army of followers" (p. 17).

The revenue estimates provided by Secretary Morgenthau for the initial proposed changes had a huge range. He said the revenue increase could range between \$118 million and \$901.5 million (Hearings, July 8, 9, 10, 11, 12, 13, 1935, p. 6). The 1935 Treasury *Annual Report* gave an estimate of \$222 million for fiscal year 1937 (pp. 39-40). This number is also given in the President's Annual Budget Message (1/3/36, p. 1), which suggests it may be somewhat low because "collections in the fiscal year 1937 from income taxes and the estate tax only partially reflect the Revenue Act of 1935" (p. 6). The Ways and Means Committee report gave an estimate for the revenue increase of \$270 million in "a full year of operation, under present improving business conditions." Of this total, \$45 million was from

the increased surtaxes, \$15 million was from the graduated corporation tax, \$100 million was from the increase in the excess-profits tax, and \$110 million was from the inheritance and gift taxes (House of Representatives Report No. 1681, p. 4).

The Revenue Act of 1935 contained a number of provisions. It raised the surtax on incomes over \$50,000. While surtax rates rose just a point or two at incomes around \$50,000, the surtax rate at \$100,000 rose 6 percentage points, and that on incomes over \$1 million rose between 14 and 16 percentage points. The act also raised the estate tax substantially. The specific exemption was lowered from \$50,000 to \$40,000, and rates were doubled at low levels. The top estate tax was raised from 60 to 70 percent.

The act also made numerous changes to the corporate income tax. For example, it replaced the existing flat corporate income tax of 13¾ percent with a graduated tax of 12½ to 15 percent, based on net income. It also included an increase in the excess profits tax (re-introduced by the National Industrial Recovery Act of 1933).

The estate tax provisions were in effect beginning on August 30, 1935. The personal and corporate income tax provisions were scheduled to take effect on January 1, 1936. However, they were superseded by the Revenue Act of 1936, which set the same tax rates (but made some other changes as well). As a result, no personal or corporate income tax returns were actually filed under the Revenue Act of 1935.

Revenue Act of 1936

Enacted June 22, 1936

As discussed in the description of the Revenue Act of 1935, the Revenue Act of 1936 was a closely related measure. It made no changes to the surtax rates or estate tax rates included in the Revenue Act of 1935. But, because of its timing, it is the tax bill under which returns were first filed using those higher rates. The main tax changes included in the Revenue Act of 1936 affected the corporate income tax. It lowered the graduated normal corporate income tax slightly, and then added on a scale of surtaxes on undistributed profits, graduated from 7 to 27 percent.

The proximate motivation for the bill appears to have been a desire to restore progress toward budget balance following two events. One was a Supreme Court decision invalidating taxes collected under the Agricultural Adjustment Act and the Bituminous Coal Act. The other was the passage of the Adjusted Compensation Payment Act (the Bonus Bill), which greatly accelerated a promised bonus payment to veterans. According to the President's Supplemental Budget Message to Congress, these two events threatened the "clear-cut and sound policy" of making progress toward reducing the deficit. He therefore declared: "it is incumbent upon us to make good to the Federal Treasury both the loss of revenue caused by the Supreme Court decision and the increase in expenses caused by the Adjusted Compensation Payment Act" (3/3/36, p. 1). The President estimated that \$620 million per year of new permanent taxes were necessary; "five hundred million dollars of this amount represents substitute taxes in place of the old processing taxes, and that only one hundred and twenty million dollars represents new taxes not hitherto levied" (p. 1). The President's message also indicated that another \$517 million of additional revenues was needed for temporary purposes, but these revenues could be spread over two or three years (p. 2). The motivation of replacing lost revenue and covering the amortized cost of the veterans' bonus was reiterated in the President's Annual Budget Message in January 1937 (1/7/37, p. 3).

While budget balance was the proximate motivation for the act, notions of fairness clearly played a key role in determining the form the tax increase took. In his March 3rd message, Roosevelt described

an undistributed profits tax as “a form of tax which would accomplish an important tax reform, remove two major inequalities in our tax system, and stop ‘leaks’ in present surtaxes” (3/3/36, p. 1). He also said: “the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners” (p. 1). In a campaign appearance following passage of the bill, he said: “the undistributed profits tax, is merely an extension of the individual income tax law and a plugging-up of the loopholes in it, loopholes which could be used only by men of very large incomes” (Address at Worcester, Mass., 10/21/36, p. 3). In another campaign speech, Roosevelt said the tax was part of the fight against monopolies because it made it “harder for big corporations to retain the huge undistributed profits with which they gobble up small business” (Address at Boston, Mass, 10/21/36, p. 2).

As with other tax actions in the mid-1930s, Congress largely parroted the President’s motivation. The Ways and Means Committee report on the bill said: “The need for such a bill was called to the attention of the Congress by the President” (“The Revenue Bill of 1936,” 74th Congress, 2^d Session, House of Representatives Report No. 2475, 4/21/36, p. 1). After reprinting the President’s message, the report said: “The President requests the Congress to raise 620 million dollars of additional revenue annually ... [and] suggests some form of undistributed profits tax. Your committee recognizes the fact that the greatest defect in our present system of taxation lies in the fact that surtaxes on individuals are avoided by impounding income in corporate surpluses” (p. 3). It then went on to detail the major purposes of the undistributed profits tax, citing, in addition to preventing tax avoidance, the removal of inequities between different forms of business organization and between large and small shareholders (p. 3).

The estimates of the expected revenue effects are fairly consistent. The Ways and Means Committee report said the undistributed profits tax would “produce an average of at least 620 million dollars in additional revenue annually” (House of Representatives Report No. 2475, p. 4). This was despite the fact that the plan eliminated some other taxes affecting corporations. Indeed, one way that Congress raised an additional \$173 million of temporary revenues was to continue the capital stock tax at one-half the previous rate for one last year. The President’s Statement on the Summation of the 1937 Budget said that it would produce annual revenue of \$652 million at current business conditions (9/2/36, p. 1).

As described above, the key tax changes brought about by the act were those affecting corporations. Under previous law, the corporate income tax rate was slightly graduated, from 12½ percent to 15 percent. There was an excess profits tax of 6 percent of net income in excess of 10 percent of the declared value of the capital stock and 12 percent of net income in excess of 15 percent of declared value. The new law eliminated the excess profits tax. It set a normal tax on corporate net income graduated from 8 to 15 percent. It then imposed a tax on undistributed net income graduated from 7 to 27 percent. The new corporate tax took effect after December 31, 1935. As a result, it superseded the changes in the corporate tax included in the Revenue Act of 1935 before any taxes were paid under that law. The Revenue Act of 1936 included a one-time tax on unjust enrichment. The idea was that some sales had occurred under the assumption that the excise taxes declared unconstitutional would be continued. As a result, firms may have already passed along the tax, and so received a windfall from the Supreme Court’s decision (see 1936 Treasury *Annual Report*, pp. 29-32, for a description of the acts provisions).

The Revenue Act of 1936 had no effect on individual normal or surtax rates; it merely recodified the rates contained in the Revenue Act of 1935. The most notable change it made in the individual income tax was to subject dividends to the normal tax.

Revenue Act of 1937

Enacted August 26, 1937

The Revenue Act of 1937 was a fairly minor action taken to prevent certain methods of tax avoidance and evasion. It had no effect on tax rates.

The impetus for the act came from the President and the Department of the Treasury. On June 1, 1937, Roosevelt sent a message to Congress, the centerpiece of which was a letter from Treasury Secretary Henry Morgenthau. Morgenthau stated that lower-than-expected revenues led the Treasury to investigate individual income tax returns. The preliminary investigation found several devices being used by high-income people to avoid taxes. Among them were personal holding companies being set up in places such as the Bahamas and Panama; domestic personal holding companies; incorporating yachts and country estates; and creation of multiple trusts for relatives and dependents. Roosevelt concluded that: “it seems to me that the first duty of the Congress is to empower the Government to stop these evil practices, and that legislation to this end should not be confused with legislation to revise tax schedules” (Message to Congress on Tax Evasion Prevention, 6/1/37, p. 6).

Congress embraced the President’s call to action. According to the Ways and Means Committee report on the bill, the special Joint Committee on Tax Evasion and Avoidance was formed on June 11, 1937 (“The Revenue Bill of 1937,” 75th Congress, 1st Session, House of Representatives Report No. 1546, 8/13/37, p. 1). The joint committee concluded that “legislation should be enacted in regard to the following subjects, with respect to which it has been shown that certain serious loopholes exist” (p. 2). It also urged that “legislation along the lines recommended be enacted at the earliest possible moment in order to protect the revenue, and in order that all may bear their fair share of the tax burden” (quoted in House of Representatives Report No. 1546, p. 2). The Ways and Means Committee concurred with the joint committee’s recommendations (p. 2).

No sources give estimates of the possible revenue effects of the action. The 1937 Treasury *Annual Report* stated: “the preventative tax evasion and avoidance provisions of the Revenue Act of 1937 will tend to prevent revenue losses which might otherwise occur” (p. 30). Secretary Morgenthau, in a letter quoted by Roosevelt, said: “if tax evasion and tax avoidance can be promptly stopped through legislation and regulations resulting from a special investigation a very large portion of the deficiency in revenues will be restored to the Treasury” (Message to Congress on Tax Evasion Prevention, 6/1/37, p. 1). In a Message to Congress on April 20, 1937, the President said that “income taxes will produce \$267,200,000 less than the former [January] estimate for the fiscal year 1937” (Message to Congress on Appropriations for Work Relief for 1938, 4/20/37, p. 1). Thus, even if a large portion of this underestimate were due to the loopholes addressed by the act, the revenue effects would be fairly small.

As discussed above, the Revenue Act of 1937 had no effect on individual income tax rates, including no effect on capital gains taxes or the estate and gift taxes. One of the key changes included in the act was to raise the surtax on undistributed adjusted net incomes of personal holding companies. Under previous law, the rate ranged from 8 to 48 percent, depending on net income. The Revenue Act of 1937 raised the rate to 65 percent on the first \$2000, and 75 percent on all income over \$2000. The act also changed the treatment of trusts, and the ability to incorporate yachts and homes. The changes were effective after 12/31/36.

Revenue Act of 1938

Enacted May 28, 1938

The Revenue Act of 1938 was an extensive revision of the corporate income tax and the tax on

capital gains. It was designed to be roughly revenue-neutral. The act became law without the President's approval, suggesting that Congress's motivation is the key one to consider.

The Ways and Means Committee report on the bill said: "The purpose of the bill, as reported, is to improve our existing revenue system, to remove inequities, to equalize the tax burden, and to stimulate business activities, and to accomplish this without reducing the revenue which would be obtained by existing law under present conditions" ("The Revenue Bill of 1938," 75th Congress, 3^d Session, House of Representatives Report No. 1860, 3/1/38, p. 2). Of these motivations, the last is the most unusual. The macroeconomic effects of tax actions were rarely mentioned in the interwar era. Perhaps as recognition of the fact that the economy was in the midst of a severe recession, the committee singled out these possible effects saying: "Finally, and most important, it is believed that there will be very substantial stimulation to business by the enactment of the bill into law which will bring into being a well-balanced tax system, improved with respect to certainty and equity" (House of Representatives Report No. 1860, p. 2).

The further motivation for revising the corporate tax was the sense that the undistributed profits tax imposed by the Revenue Act of 1936 had caused "a substantial number of cases of hardship" (House of Representatives Report No. 1860, p. 3). Among the perceived problems with the tax was that it discouraged business expansion and thus hurt employment, it was particularly hard on small, financially weak corporations, and that it penalized corporations which found it necessary to use current earnings to pay debts (pp. 3-4). The committee felt that "the principle of the undistributed-profits tax is sound and should be retained. However, it is believed that it should be substantially modified" (p. 4). President Roosevelt agreed that some modification of the law to help small corporations might be useful, but he objected to the other changes, such as a relatively flat corporate tax, that Congress was considering (Letter on the Tax Bill, 4/13/38, p. 2).

Another motivation for the bill had to do with the capital gains tax. The Ways and Means Committee report said of this tax: "It is claimed that the present tax is so high, especially in the case of taxpayers subject to high surtax rates, that assets become frozen and few transactions take place" (House of Representatives Report No. 1860, p. 7). At the same time, the Committee did not want to do anything that would encourage or benefit short-term speculation (p. 7). The President expressed a similar concern in his Message to Congress Recommending Legislation in November 1937. He said: "Nor should we extend tax privileges to speculative profits on capital where the intent of the original risk was speculation rather than the actual development of productive enterprise" (11/5/37, p. 2). More generally, Roosevelt seemed less sympathetic to the claims of hardship from the existing capital gains tax and emphasized that "capital gains should be taxed at progressive rates" (Letter on the Tax Bill, 4/13/38, p. 2).

Congress, in the end, did not produce a bill that allayed Roosevelt's concerns about equity. As a result, Roosevelt took the somewhat unusual step of allowing the bill to become law without his signature. In his Address at Arthurdale, West Virginia, he said: "By taking this course, I am calling the definite attention of the American people to those unwise parts of the bill that I have been talking to you about today—one of them which may restore in the future certain forms of tax avoidance of the past, and of continued concentrated investment power, which we in Washington had begun to end; and the other feature, a definite abandonment of a principle of tax policy long ago accepted as part of our American system" (5/27/38, p. 5). This principle was that taxes should be set "in proportion to ability to pay" (p. 4).

The Revenue Act of 1938 was fundamentally a reform measure not a revenue raising measure. The committee report stated: "According to the best information the committee has been able to secure, from the Treasury Department and other sources, it appears reasonably certain that the revenues of the Government will be as great under the bill as under existing law" (House of Representatives Report No. 1860, p. 2). This is consistent with the 1938 *Treasury Annual Report* which stated: "The effect of these

statutory changes on income tax liabilities for relatively low income years such as calendar years 1938 and 1939 is decidedly less important in determining the income tax receipts than are the changes in the business situation” (p. 35). It is also consistent with the President’s charge in November 1937 that “Nor can we at this time accept a revision of our revenue laws which involves a reduction in the aggregate revenues” (Message to Congress Recommending Legislation, 11/5/37, p. 2).

The Revenue Act of 1938 included fundamental changes in the corporate income tax. Under the Revenue Act of 1936, all corporations were subject to a normal tax graduated from 8 to 15 percent, and a surtax on undistributed profits graduated from 7 to 27 percent. The Revenue Act of 1938 removed the undistributed profits tax on firms with net incomes of less than \$25,000. Such small firms paid a tax graduated from 12½ to 16 percent (1938 *Treasury Annual Report*, p. 28). According to the Ways and Means Committee report, this change exempted 88 percent of corporations from the undistributed profits tax (House of Representatives Report No. 1860, p. 4). For firms earning more than \$25,000, a tentative tax of 19 percent was imposed on adjusted net income. To retain the spirit of the undistributed profits tax, the tentative tax “is reduced by the sum of (a) 16½ percent of the credit for dividends received and (b) 2½ percent of the dividends paid credit, but not to exceed 2½ percent of the adjusted net income” (*Treasury Annual Report*, pp. 28-29).

The Revenue Act of 1938 also effected substantial changes in the capital gains tax. Under the Revenue Act of 1936, individuals paid the sum of their normal and surtax rates on capital gains. The fraction of capital gains included in the calculation of the tax varied according to how long the asset had been held. The new law divided capital gains into three categories depending on how long the asset had been held. Short-term capital gains were assets held for less than 18 months. All of these short-term gains were included as income and taxed at the applicable normal and surtax rates. Long-term capital gains were divided into two categories, those for assets held between 18 and 24 months, and those for assets held for more than two years. For the first of these two groups, two-thirds of the gain was counted as income; for the second, one-half was counted. Long-term capital gains were taxed at the lower of the taxpayer’s normal plus surtax rate and 30 percent. The changes in both the capitals gains tax and the corporate income tax took effect after December 31, 1937.

Revenue Act of 1939

Enacted June 29, 1939

The Revenue Act of 1939 was a revenue-neutral tax action that extended a number of excise taxes and revised the corporate income tax. The corporate tax change was designed to continue the move toward simplification begun in the Revenue Act of 1938.

The extension of the excise taxes was straightforward. Roosevelt had recommended it in his 1939 Annual Budget Message. He said: “I am recommending the reenactment of the excise taxes which will expire in June and July of this year, not because I regard them as ideal components of our tax structure, but because their collection has been perfected, our economy is adjusted to them, and we cannot afford at this time to sacrifice the revenue they represent” (1/5/39, p. 3). The Ways and Means Committee report on the bill concurred with this assessment, saying: “If the temporary taxes ... are permitted to lapse at this time, a loss in revenue of over \$600,000,000 will occur” (“The Revenue Bill of 1939,” 76th Congress, 1st Session, House of Representatives Report No. 855, 6/16/39, p. 14). It then parroted the President’s statement that the government could not afford the loss of revenue (p. 15).

The revision of the corporate income tax was motivated by a desire to make the tax calculation less burdensome, and, by doing so, to stimulate economic activity. The Ways and Means Committee report stated that the first objective of the bill “is to remove from the existing corporate income-tax

structure such business deterrents and tax irritants as may be possible to consider at this time” (House of Representatives Report No. 855, p. 1). It said that following passage of the Revenue Act of 1938, “further inequities have become evident and attention has been drawn to a number of instances where our existing tax laws act as a deterrent to a free flow of business activity. In addition, our existing law contains certain tax ‘irritants’ which are relatively unimportant from the point of view of revenue but are burdensome and irritating to taxpayers” (p. 2). Chief among these perceived irritants was the undistributed profits tax component of the corporate income tax, which the committee suggested had “acquired prominence as a psychological irritant largely because of the widespread emotional criticism which has been directed against it” (p. 8).

This motivation appears to have been at least partially suggested by the administration. The committee report stated that at a hearing on May 27, “the Secretary of the Treasury appeared and stressed the desirability of making certain changes in our corporate income-tax structure, which, it was thought, would encourage business activity and a freer flow of capital into productive enterprise” (House of Representatives Report No. 855, p. 2). At the same time, the President seemed somewhat cool to the changes. In his Address Before the American Retail Federation in May 1939, he emphasized that “especially in view of the unbalanced budget, ... we ought not to raise less money from taxation than we are doing now,” and he suggested that “it would be bad for business, to shift any further burden to consumer taxes” (5/22/39, p. 4). Therefore, he argued that any change to reduce deterrent taxes on corporations needed to be replaced by other taxes on corporations. He was somewhat dismissive of what he referred to as the “great hullabaloo for the repeal of the undistributed earnings tax,” which he said raised only \$20 million of revenue (p. 4). He said that he was willing to have this tax repealed subject to two conditions: that the same revenue be raised through another tax on corporations earning more than \$25,000 a year and that the loophole the undistributed profits tax sought to close did not re-emerge (pp. 4-5).

By its nature, the extension of the excise taxes, which had been first introduced in 1932 and had already been renewed three times, did not raise revenues relative to the previous year. Likewise, all of the discussion suggests that the corporate tax revision was designed to keep revenues the same. For example, the Ways and Means Committee report said: “While one purpose of the bill as reported is to stimulate business activity, the committee has sought to accomplish this without endangering the productivity of the existing tax structure. According to the best information the committee has been able to secure, it appears reasonably certain that the revenues of the Government will not be reduced appreciably under the present bill” (House of Representatives Report No. 855, p. 3).

The key change that the Revenue Act of 1939 brought about was a change in the income tax rate on corporations earning more than \$25,000. Under the Revenue Act of 1938, such firms paid a rate ranging from 16½ to 19 percent, depending on their distribution of dividends. The differential between the rate paid and 16½ percent is what was referred to as the continuation of the undistributed profits tax. This graduated rate was replaced by a flat rate of 18 percent. The income tax rates on small corporations were unchanged. The Revenue Act of 1939 made many other small administrative changes designed to be more taxpayer-friendly. For example, one method of calculating the normal profit involved the declared capital stock used as the base for the capital stock tax. Firms were given the option of increasing the declared valuation in both 1939 and 1940.

The Revenue Act of 1939 was to take effect after December 31, 1939. However, according to the 1941 *Statistics of Income*, “The rates of tax provided by the Revenue Act of 1939 were never in effect, being superseded by those of the Revenue Acts of 1940” (Part 2, p. 315, fn. 31).

Revenue Act of 1940

Enacted June 25, 1940

The Revenue Act of 1940 was a widespread tax increase motivated by an increase in defense spending and concern about the related deficit. It included a mixture of temporary and permanent tax changes and affected almost all existing tax rates.

The proximate cause for the tax increase was the increase in defense spending necessitated by the deteriorating international situation. Roosevelt detailed the need for more defense spending in both his January 3, 1940 Annual Message to the Congress, and, more forcefully, in his May 16, 1940 Message to Congress on Appropriations for National Defense. The May message emphasized the rapidity of modern warfare and said: “The clear fact is that the American people must recast their thinking about national protection” (p. 1). Roosevelt asked for nearly \$1 billion in extra appropriations for national defense.

The President asked for new taxes to pay for the increased expenditures because he felt economic conditions did not warrant a large increase in the deficit. In his January 3, 1940 Annual Budget Message, Roosevelt defended the large budget deficits of the mid-1930s on strikingly Keynesian grounds. He said: “The deliberate use of Government funds and of Government credit to energize private enterprise—to put purchasing power in the hands of those who urgently needed it and to create a demand for the products of factory and farm—had a profound effect both on Government and on private incomes” (p. 1). Likewise, the President defended allowing the budget to deteriorate again during the 1938 recession, saying: “The experience of 1938-1939 should remove any doubt as to the effectiveness of a fiscal policy related to economic need” (p. 1).

However, Roosevelt felt that by 1940 the situation had changed substantially. He said: “we are achieving the highest levels of production and consumption in our history,” though he emphasized that unemployment was still quite high (Annual Budget Message, 1/3/40, p. 1). The President concluded that:

Against this background of aims substantially but not fully attained, I propose in the field of fiscal policy that we adopt the following course: We should count upon a natural increase in receipts from current taxes and a decrease in emergency expenditures, and we should try to offset the unavoidable increase in expenditures for national defense by special tax receipts, and thus hope to secure, for the over-all picture, a gradual tapering off, rather than an abrupt cessation, of the deficit (pp. 1-2).

He reiterated this stance in his Annual Message to the Congress the same day, saying: “Therefore, in the hope that we can continue in these days of increasing economic prosperity to reduce the Federal deficit, I am asking the Congress to levy sufficient additional taxes to meet the emergency spending for national defense” (1/3/40, p. 4).

In addition to his view of the desirable path for the deficit, Roosevelt also stressed the notion that temporary defense expenditures should be covered by dedicated taxes. In his Annual Budget Message, he said: “I believe that it is the general sense of the country that this type of emergency expenditure be met by a special tax or taxes. Moreover, this course will make for greater assurance that such expenditures will cease when the emergency has passed” (1/3/40, p. 3).

The Ways and Means Committee report stressed similar motivations for the bill. It began by stating that: “Recent developments in the European War have reminded us forcefully of the inadequacy of our means of defense against modern weapons of aggression” (“The Revenue Bill of 1940,” 76th Congress, 3^d Session, House of Representatives Report No. 2491, 6/10/40, p. 1). The committee fully supported the President’s program for increased defense spending. It then discussed the fiscal situation

and said that the increased defense expenditures would result in a large deficit without the proposed tax increase (p. 2). The committee did not invoke views about the appropriate size of the deficit, but instead acted as if it was obvious that keeping the deficit from ballooning was desirable. The concrete reason it gave for the tax increase and increased authorization for borrowing was that it “will give the Treasury that flexibility in its financing which [is] so necessary for the effective management of the public finances in times like these and thus obviate the payment of higher interest rates” (p. 2).

The President and Congress both expressed views on the desirable nature of the tax changes. The President said that he hoped “the Congress will follow the accepted principle of good taxation of taxing according to ability to pay and will avoid taxes which decrease consumer buying power” (Annual Budget Message, 1/3/40, p. 3). At a Press Conference in late May, he stressed the desirability of simply increasing all taxes by 10 percent (5/28/40, p. 4). Congress stressed its desire to “enable a larger proportion of our citizens to participate in the responsibility of providing an adequate national defense” (House of Representatives Report No. 2491, 6/10/40, p. 3). It was also concerned about the creation of “war millionaires,” but postponed until later in the year the creation of a new excess profits tax in order to reach closure on the current bill (p. 3).

The House report on the bill said that it would yield additional annual revenues of \$1,004 million (House of Representatives Report No. 2491, p. 2). Of these additional revenues, \$322 million came from permanent tax increases and \$682 million from temporary taxes expected to last for only five years (p. 2).

The nature of the tax changes was both extensive and highly varied. For individuals, the Revenue Act of 1940 permanently lowered the personal exemption by 20 percent (from \$2500 to \$2000 for married couples). It also raised surtax rates on net incomes between \$6000 and \$100,000. At some levels the increase in rates was quite dramatic: for example, the marginal surtax rate on net incomes of \$50,000 rose from 27 percent to 40 percent. The rates on incomes above \$100,000 remained at their already very high marginal rates: the top marginal rate (on incomes greater than \$5,000,000) was 75 percent. On top of these permanent tax increases, the act imposed a temporary “defense tax” equal to 10 percent of essentially all regular taxes. Thus, the effective normal and surtax rates were 10 percent higher than the stated rates.

The Revenue Act of 1940 permanently raised the normal corporate tax by 1 percentage point at each level of income. As with the individual income tax, these rates were then raised by 10 percent. Thus, the effective top rate rose to 22 percent (from 19 to 20 percent, plus 10 percent more).

The act was effective after December 31, 1939. However, no corporate tax was filed under this act because later acts superseded it for the 1940 tax year.

Second Revenue Act of 1940

Enacted October 8, 1940

The Second Revenue Act of 1940 was a tax increase aimed primarily toward corporations. Its key feature was the introduction of a new excess profits tax.

Like the Revenue Act of 1940, the Second Revenue Act of 1940 was passed in the context of rapid increases in defense expenditures. However, the deficit and the need for revenues received little attention in the discussion. Rather, concern about fairness played a central role. In his short Message to Congress on a Steeply Graduated Excess Profits Tax, Roosevelt said: “We are asking even our humblest citizens to contribute their mite. It is our duty to see that the burden is equitably distributed according to ability to pay so that a few do not gain from the sacrifices of the many. I, therefore, recommend to the

Congress the enactment of a steeply graduated excess profits tax” (7/1/40, p. 1). Likewise, at a Press Conference on August 27, 1940, the President stated: “it is up to the Congress to pass whatever excess profits tax Congress thinks should be put on, in order to prevent the creation of another crop of American millionaires” (p. 4).

Congress had expressed similar sentiments in its discussion of the Revenue Act of 1940, but had postponed creation of the excess profits tax. The Ways and Means Committee report on the Second Revenue Bill of 1940 summarized this discussion saying: “your committee expressed the desire that the rearmament program should furnish no opportunity for the creation of new war millionaires or the further substantial enrichment of already wealthy persons” (“Second Revenue Bill of 1940,” 76th Congress, 3^d Session, House of Representatives Report No. 2894, 8/28/40, pp. 1-2). The report went on to say that “Your committee is still of this opinion,” but that it felt some incentives were necessary “to stimulate the cooperation of private enterprise in the defense program” (p. 2). For this reason, Congress coupled a steeply graduated excess profits tax with a suspension of the profit limitations of the Vinson-Trammel Act covering construction of military ships and aircraft.

The President had asked for an excess profits tax “to be applied to all individuals and all corporate organizations without discrimination” (Message to Congress on a Steeply Graduated Excess Profits Tax, 7/1/40, p. 1). However, the Ways and Means Committee decided that individual and partnership income were already subject to heavy surtaxes (House of Representatives Report No. 2894, p. 2). For this reason, it limited the tax to corporations.

The committee report estimated that the excess profits tax would yield \$305 million in calendar year 1940 (p. 3). The report also estimated that the revenue would be over \$700 million per year once the defense program was fully operative (p. 3).

The Second Revenue Act of 1940 made no changes to the individual income tax. One provision was to permanently raise the normal income tax rate on corporations with incomes greater than \$25,000. The rate was raised to 22.1 percent. The temporary defense tax was retained as an additional 10 percent of the tax called for by the Revenue Act of 1940 (which was 19 percent). Thus, the total tax on corporations at this income level was 24 percent.

The Second Revenue Act of 1940 added a new excess profits tax, in addition to the declared-value excess profits tax which had been in effect since June 30, 1933. The tax was collected on net income over the specific exemption of \$5000, plus a credit. The credit could be calculated in either of two ways: 95 percent of average base period net income (where the base was the five years 1936-1940), or 8 percent of invested capital. The rates rose from 25 percent on the first \$20,000 of excess profits to 50 percent on excess profits over \$500,000. The act took effect after December 31, 1939.

The excess profits tax component of the Second Revenue Act of 1940 was modified slightly by the Excess Profits Tax Amendments of 1941, enacted March 7, 1941. The amendments were designed to “deal with the effect of certain abnormal situations upon the excess profits tax liability of corporations” (1941 Treasury *Annual Report*, p. 59). For example, the method of computing the base period net income was adjusted to aid companies whose earnings in the second half of the base period were higher than in the first half. The amendments were made retroactive to tax years after December 31, 1939.

Revenue Act of 1941

Enacted September 20, 1941

The Revenue Act of 1941 was an enormous tax increase affecting both individuals and

corporations. While the act was fundamentally driven by the increase in defense expenditures related to developments in Europe, macroeconomic conditions and notions of fairness also played a role.

In his 1941 Annual Budget Message, Roosevelt outlined the tremendous increase in defense expenditures and the resulting rise in the budget deficit (1/3/41, pp. 2, 4). He then went on to say: "There is no agreement on how much of such an extraordinary defense program should be financed on a pay-as-you-go basis and how much by borrowing" (p. 4). The President, however, clearly felt that conditions warranted a substantial move toward higher taxes. He said: "We cannot yet conceive the complete measure of extraordinary taxes which are necessary to pay off the cost of emergency defense and to aid in avoiding inflationary price rises which may occur when full capacity is approached. However, a start should be made this year to meet a larger percentage of defense payments from current tax receipts" (p. 4). Roosevelt was clearly walking a fine line in his proposal. He noted that "Economic activities and national income are rising to record heights" (p. 3). But, at the same time, he was "opposed to a tax policy which restricts general consumption as long as unused capacity is available and as long as idle labor can be employed" (p. 4). His goal was a "policy aimed at collecting progressive taxes out of a higher level of national income" (p. 4).

As with so many Roosevelt-era tax changes, concern about equity was a substantial concern. The Budget Message said: "The additional tax measures should be based on the principle of ability to pay," and "it is the fixed policy of the Government that no citizen should make any abnormal net profit out of national defense" (1/3/41, p. 4). Likewise, the President's Annual Message to Congress on January 6, 1941 said: "I shall recommend that a greater portion of this great defense program be paid for from taxation than we are paying today. No person should try, or be allowed, to get rich out of this program; and the principle of tax payments in accordance with ability to pay should be constantly before our eyes to guide our legislation" (p. 5). In May 1941, when the President recommended that "three and one-half billion of additional taxes should be levied during the coming year to defray in part the extraordinary defense expenditures," he again emphasized fairness concerns. He wanted a law "so devised that every individual and every corporation will bear its fair share of the tax burden," and one "which will convince the country that a national defense program intended to protect our democracy is not going to make the rich richer and the poor poorer" (both quotations from Recommendation for Additional Taxes, 5/1/41, p. 1).

The Ways and Means Committee report on the bill made it clear that rising defense expenditures were the fundamental motivation for the tax increase. It stated: "The bill is unprecedented in the amount of revenue it is designed to provide. It lays a substantially increased burden upon the American people. But there is convincing evidence that this burden will be borne cheerfully in the light of the overwhelming importance of national defense" ("The Revenue Bill of 1941," 77th Congress, 1st Session, House of Representatives Report No. 1040, 7/24/41, p. 2). Like the President, Congress said it aimed "to distribute the additional tax burden as equitably as possible" (p. 2). Congress, however, gave more prominence to macroeconomic conditions. The report talked of the tax increase "supplying a needed restraint upon inflationary tendencies" (p. 2). This more direct focus on inflation could reflect differences in timing of the statements on the tax increase between the President and Congress. In late July 1941, the President also became very concerned about inflation and proposed price controls (see, Message to Congress on Price Control Legislation, 7/30/41, p. 1).

The President asked for a tax increase of \$3.5 billion (Recommendation for Additional Taxes, 5/1/41, p.1). The Ways and Means Committee report said that the proposed bill would yield at least that amount in a full year of operation (House of Representatives Report No. 1040, p. 2).

The Revenue Act of 1941 increased a wide variety of taxes. For individuals, the act raised surtax rates and integrated the temporary 10 percent defense tax into the permanent tax structure. A key change

was that the surtax, which used to begin at a net income of \$4,000 with a rate of 4 percent, now started at a net income of zero with a rate of 6 percent. Surtax rates, in general, increased dramatically. The rate at \$10,000 increased from 10 percent to 25 percent. The top marginal rate (at a net income of \$5 million) rose from 75 percent to 77 percent. The personal exemption was reduced (from \$2000 to \$1500 for a couple) and the \$400 credit for the first dependent was eliminated for the head of family.

The act left the normal tax on corporate income largely unchanged: the rate on corporations earning more than \$25,000 remained at 24 percent. However, the act added a surtax of 6 percent on the first \$25,000 of surtax net income, and 7 percent on income above \$25,000. The act raised the excess profits tax rates from a range of 25 to 50 percent to 35 to 60 percent. The act also tightened up the "invested capital" method for determining the base from which excess profits were calculated. Instead of the base being calculated as 8 percent of total invested capital, it was reduced to 7 percent of invested capital in excess of \$5 million.

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