

# Tax & Budget

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## High Taxes and High Budget Deficits The Hoover–Roosevelt Tax Increases of the 1930s

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In the 1920s, Treasury Secretary Andrew Mellon championed a series of income tax cuts that reduced the top individual rate from 73 percent to just 25 percent by 1925. As rates fell, the U.S. economy boomed until the stock market crash in 1929. After the crash and a sharp monetary contraction that pushed the economy into the Great Depression, the lessons of Mellon's successful tax cuts were forgotten. Presidents Hoover and Roosevelt pursued large tax increases based on the mistaken ideas that the budget should be balanced during a contraction and that high tax rates would achieve that goal.

Today, the relationships between tax rates, deficits, and economic growth continue to be debated. In the 1930s, high and rising taxes coincided with large budget deficits and poor economic performance.

### The Hoover–Roosevelt Tax Increases

President Hoover radically changed course from the low-tax policies of the 1920s with the Revenue Act of 1932. That law sharply increased individual tax rates at all income levels, with the top rate rising from 25 percent to 63 percent. Following Hoover, President Roosevelt signed into law a series of large tax increases for taxpayers at all income levels. At the bottom end, personal exemptions were reduced, and an earned income credit was eliminated. At the top end, the highest marginal rate was increased to 79 percent in 1936.

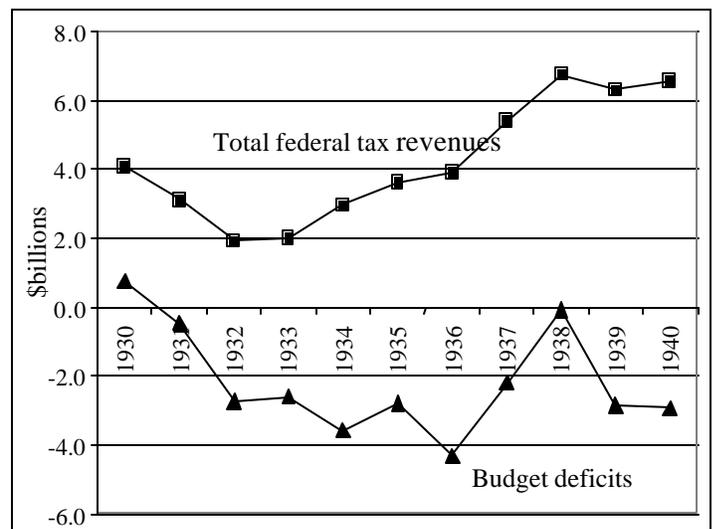
Between 1930 and 1940, the corporate income tax rate was doubled from 12 percent to 24 percent, and an "excess profits" tax was added on top. In addition, Roosevelt imposed an excise tax on dividends, a capital stock tax, and liquor taxes, and he increased estate taxes. Finally, the Social Security payroll tax was imposed with a 2 percent rate beginning in 1937.

The scale and scope of the 1930s tax increases were extraordinary. Hoover and Roosevelt argued that large tax increases were necessary to balance the federal budget. Hoover proclaimed repeatedly, that "nothing is more necessary at this time than balancing the budget."<sup>1</sup> Although Hoover believed in restraining spending, he also believed in large "temporary" tax hikes. Roosevelt argued that "we should plan to have a definitely balanced Budget...and seek a continuing reduction of the national debt," and blamed Hoover for not increasing taxes enough.<sup>2</sup>

### Tax Increases and Deficits

Whereas the federal budget was balanced throughout the low-tax 1920s, the huge tax increases of the 1930s coincided with large deficits. On the campaign trail in 1932 Roosevelt noted: "For over two years our federal

Figure 1. Soaring Tax Revenues and Sustained Deficits in the 1930s



Source: FY2004 Budget of the U.S. Government, Historical Tables.

government has experienced unprecedented deficits, in spite of increased taxes.”<sup>3</sup> Under Roosevelt, however, total federal tax revenues jumped from \$1.9 billion in fiscal year 1932 to \$6.5 billion by FY1940. Yet, the FY1940 deficit of \$2.9 billion was larger than the FY1932 deficit of \$2.7 billion (see Figure 1). That tripling of tax revenues occurred during a near-zero inflation period. (In 1938, a near budget balance occurs because of a sharp drop in veterans spending and a sharp tax increase under the new Social Security payroll tax).

### Dynamic Responses to Tax Rate Increases

A key problem with trying to balance the budget with tax increases is that higher taxes fuel more spending. Milton Friedman recently explained the problem: “Raise taxes by enough to eliminate the existing deficit and spending will go up to restore the tolerable deficit.”<sup>4</sup>

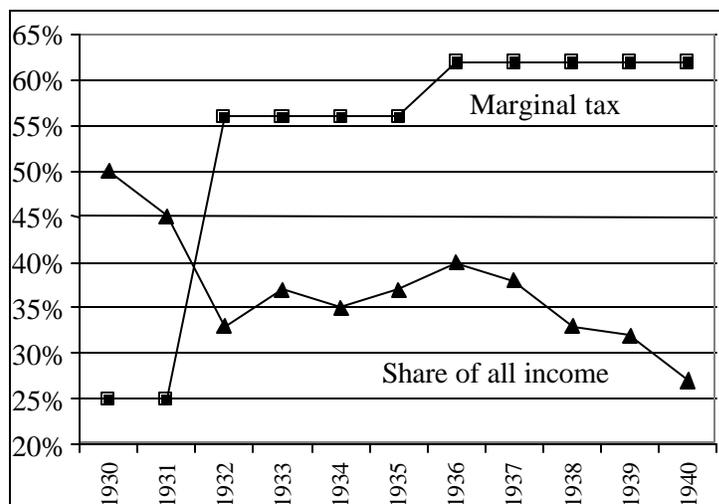
Another reason that tax rate increases do not succeed in balancing the budget is that they shrink the tax base by reducing economic growth and spurring greater tax avoidance. As a result, the government typically gains only a fraction of the revenues it hopes to receive. Thus Hoover was tragically misguided when he advised in 1933 that “it is obvious that the budget cannot be balanced without a most substantial increase in revenues.”<sup>5</sup>

The inverse relationship between tax rates and the tax base is evident in 1930s tax return data for high-income individuals. Figure 2 shows that as the marginal tax rate on those earning over \$100,000 was sharply increased from 25 to at least 62 percent, the share of overall taxes paid by that group fell from 50 to 27 percent.<sup>6</sup> That occurred partly because taxes were increased at all income levels. But the very high tax rates at the top end stifled the economy and encouraged tax avoidance, thus suppressing tax revenues. By contrast, in late 1920s the top tax rate was just 25 percent, the economy was strong, and those earning over \$100,000 paid up to two-thirds of all income taxes.

Roosevelt’s ideological devotion to soaking the rich blinded him to the economic reality unfolding around him. He claimed that “increasing the tax paid by individuals in the higher brackets—those of income over \$50,000—was the American thing to do and increasing still further the taxes paid by individuals in the highest brackets—those with incomes over one million dollars a year—was even more the American thing to do.”<sup>7</sup> Yet that “American thing to do” and other anti-growth policies certainly killed incentives for work, investment, and entrepreneurship. As a result, while the U.S. unemployment rate fell sharply during the tax-cutting 1920s, it soared to 25.2 percent in

1933, and remained very high through to 1940 when it was still 14.6 percent.<sup>8</sup>

Figure 2. Tax Rate and Tax Share for Those with Income over \$100,000



Source: U.S. Department of Treasury, “Statistics of Income,” annual 1930 to 1940.

### Conclusion

The tax increases of the 1930s coincided with large deficits and economic stagnation. While the monetary and trade policy mistakes of the 1930s are now widely understood, the tax policy mistakes are less appreciated. As Congress grapples with today’s budget deficit and mediocre economic growth, it should look to the tax cuts of the 1920s for inspiration rather than the failed “budget balancing with high taxes” approach of the 1930s.

<sup>1</sup> “Message to Congress,” May 5, 1932, in *State Papers and other Public Writings of Herbert Hoover*, ed. William Starr Myers (New York: Doubleday, Doran, 1934).

<sup>2</sup> “Annual Budget Message,” January 3, 1934, in *Public Papers and Addresses of Franklin D. Roosevelt*, ed. William Starr Myers (New York: Random House, 1938).

<sup>3</sup> “Campaign Address on the Federal Budget,” October 19, 1932, in *Public Papers*.

<sup>4</sup> Milton Friedman, “What Every American Wants,” *Wall Street Journal*, January 15, 2003.

<sup>5</sup> “Message to Congress,” January 17, 1933, in *State Papers*.

<sup>6</sup> U.S. Treasury, “Statistics of Income,” annual 1930 to 1940.

The tax rate shown is for those at \$100,000; those with higher incomes faced even higher marginal rates. Lazar Antonic helped research and analyze the data.

<sup>7</sup> “Campaign Address at Worcester, Massachusetts,” October 21, 1936, in *Public Papers*.

<sup>8</sup> Bureau of the Census, *Historical Statistics of the United States*, 1975, Part 1, p. 126.