From Hoover to Johnson: A Supply-Side Take

by Raymond J. Keating

Introduction: After Harding and Coolidge

The supply-side-led prosperity of the Harding-Coolidge years came crashing down into the Great Depression during the administrations of President Herbert Hoover (elected in 1928) and Franklin Delano Roosevelt (elected in 1932). Make no mistake, it was anti-supply-side policymaking that created and deepened the Great Depression.

What was the Great Depression? Economist Gene Smiley summed it up this way:

> "A worldwide depression struck countries with market economies at the end of the 1920s. Although the Great Depression was relatively mild in some countries, it was severe in others, particularly in the United States, where, at its nadir in 1933, 25 percent of all workers and 37 percent of all nonfarm workers were completely out of work. Some people starved; many others lost their farms and homes. Homeless vagabonds sneaked aboard the freight trains that crossed the nation. Dispossessed cotton farmers, the 'Okies,' stuffed their possessions into dilapidated Model Ts and migrated to California in the false hope that the posters about plentiful jobs were true. Although the U.S. economy began to recover in the second quarter of 1933, the recovery largely stalled for most of 1934 and 1935. A more vigorous recovery commenced in late 1935 and continued into 1937, when a new depression occurred. The American economy had yet to fully recover from the Great Depression when the United States was drawn into World War II in December 1941. Because of this agonizingly slow recovery, the entire decade of the 1930s in the United States is often referred to as the Great Depression."[1]

What were the governmental policies that sent the economy off its rails? From the beginnings of the Great Depression to current day, debates have raged not just about the causes of the Great Depression, but when and why it ended.

Indeed, perhaps no other period in U.S. history is so riddled with errors and outright lies. For example, we often hear that Herbert Hoover was a laissez faire, free market president. In reality, nothing could be further from the truth. As we shall see, Hoover was a big government Republican. The other big mistake or falsehood is that President Franklin Delano Roosevelt's New Deal saved the U.S. economy. Again, the exact opposite turns out to be the truth.

Following are the four most important lessons to be learned from the Great Depression:

• First, while the extent of its role is still debated, trade protectionism played a role in triggering the Great Depression. As it looked more likely that the now-infamous Smoot-Hawley Tariff Act would become law, imposing large increases in tariffs, the stock market crashed in October 1929. Against the advice of economists at the time, Hoover wound up signing Smoot-Hawley in

June 1930. A trade war was unleashed. By 1933, exports had plummeted by 66 percent compared to 1929 levels.

• Second, huge tax increases deepened and extended the Great Depression. Both Hoover and FDR were big on higher taxes. Hoover, for example, increased personal income taxes, with the top rate going from 25 percent to 63 percent in 1932; the estate tax (or death tax) rate more than doubling from 20 percent to 45 percent; and the corporate income tax rising as well.

As part of his New Deal, FDR piled on even more taxes. From 1933 to 1941, the top personal income tax rate climbed to a stunning 81 percent, and the corporate income tax rate gradually increased from 13.75 percent in 1935 to as high as 44 percent in 1941. The death tax rate was pushed up to 77 percent. As for the capital gains tax, it effectively more than doubled in 1934, and while it would be cut in 1938, the top rate stood 140 percent higher than it had been just a few years earlier.

• Third, federal government spending was increased to unprecedented levels during the Great Depression. Federal outlays during Hoover's four years in office jumped by nearly 50 percent. FDR further accelerated spending. In 1930, federal outlays stood at 3.4 percent of GDP. In 1939, it was at 10.3 percent, and it hit 12 percent of GDP in 1941.

In terms of GDP, in 1929, gross private domestic investment registered 15.9 percent of GDP, with government consumption and investment at 9.0 percent. A decade later, in 1939, private investment had fallen to 10.1 percent, with government consumption and investment climbing to 16.0 percent. In effect, the expansion of government crowded out private-sector investment in the 1930s, with the economy suffering as a result.

• Fourth, and finally, the Great Depression was a period of unprecedented expansion in government regulation. Expanding on Hoover's own activism, FDR got the government involved in, among other escapades, setting prices, wages, farm production, and labor agreements. Combined with higher taxes and vast increases in government spending, FDR's hyper-regulation created fear and uncertainty in, and imposed higher costs on the investment and business communities. Again, it's no surprise that investment and the economy declined.

As for the results, unemployment went from 1.6 million in 1929 to a peak of 12.8 million in 1933, and was still at 9.5 million in 1939. In fact, total employment in 1939 was still lower than in 1929. There also were fewer business concerns in 1939 than a decade earlier. And as late as 1938, the size of the U.S. economy in real terms was smaller than it had been in 1929. That's why it was called the Great Depression.

FDR famously declared, "We have nothing to fear but fear itself." When you think about it, though, that amounts to nothing more than vacuous political rhetoric. After all, as noted, very real reasons existed for fear during the Great Depression. And it was anti-supply-side policymaking that played the key role in bringing about a fear-generating economic depression.

Various economists and historians have asserted that World War II brought about the end of the Great Depression. Given the hardships that people lived through during the war – from economic shortages to destruction and death – it flies in the face of common sense, and common decency, to put forth such claims.

On the economics of World War II acting as a stimulus ending the Great Depression, Smiley pointed out:

> "The number of unemployed workers declined by 7,050,000 between 1940 and 1943, but the number in military service rose by 8,590,000. The reduction in unemployment can be explained by the draft, not by the economic recovery. The rise in real GNP presents similar problems. Most estimates show declines in real consumption spending, which means that consumers were worse off during the war. Business investment fell during the war. Government spending on the war effort exceeded the expansion in real GNP. These figures are suspect, however, because we know that government estimates of the value of munitions spending, to name one major area, were increasingly exaggerated as the war progressed. In fact, the extensive price controls, rationing, and government control of production render data on GNP, consumption, investment, and the price level less meaningful."[2]

During the war, tax rates were pushed even higher. For example, the top marginal personal income tax rates climbed to 94 percent by the end of the war, and the top corporate tax rate moved 24 percent in 1940 to 40 percent by 1942.

Amazingly, after World War II concluded, tax rates did not return to more reasonable levels. The top personal income tax rate fell just below 90 percent (into the eighties) from 1946 to 1950, but then was pushed back above 90 percent (91 percent in 1951, 92 percent from 1952 to 1953, and 91 percent subsequently). Meanwhile, the corporate tax rate fell to 38 percent from 1946 to 1949, and then quickly rising to 52 percent by 1952.

During this continued anti-supply-side period – from the end of World War II to the early 1960s – the U.S. economy experienced four recessions, according to the National Bureau of Economic Research. That is, recessions prevailed in 40 out of 192 months.

President Kennedy Explains

After eight years of a Republican presidency – Dwight D. Eisenhower (1953-1961) – it took President John F. Kennedy, a Democrat, to start the process of injecting supply-side notions back into the public policy debate. While President Kennedy's economic advisers largely subscribed to Keynesian demand-side economics, Kennedy seemed to have a better grasp of how the economy actually works. On December 14, 1962, Kennedy gave a speech at the Economic Club of New York that included some clear supply-side concepts on the need to cut and reform taxes. Consider the following key points from that address:

• First, Kennedy explicitly argued against increased government spending to stimulate the economy, as Keynesians would favor, and for tax relief impacting incentives:

> "I am talking about the accumulated evidence of the last five years that our present tax system, developed as it was, in good part, during World War II to restrain growth, exerts too heavy a drag on growth in peace time; that it siphons out of the private economy too large a share of personal and business purchasing power; that it reduces the financial incentives for personal effort, investment, and risk-taking. In short, to increase demand and lift the economy, the federal government's most useful role is not to rush into a program of excessive increases in public expenditures, but to expand the incentives and opportunities for private expenditures."

> "Corporate tax rates must also be cut to increase incentives and the availability of investment capital."

• Second, Kennedy correctly assessed the problems with the tax system at the time – including that tax rates were so high that special breaks and provisions were needed to allow the economy to breathe, though this produced substantial inefficiencies – and why reform was needed:

> "Third, the new tax bill should improve both the equity and the simplicity of our present tax system. This means the enactment of long-needed tax reforms, a broadening of the tax base, and the elimination or modification of many special tax privileges. These steps are not only needed to recover lost revenue and thus make possible a larger cut in present rates, they are also tied directly to our goal of greater growth. For the present patchwork of special provisions and preferences lightens the tax loads of some only at the cost of placing a heavier burden on others. It distorts economic judgments and channels undue amounts of energy into efforts to avoid tax liability. It makes certain types of less productive activity more profitable than other more valuable undertakings. All this inhibits our growth and efficiency, as well as considerably complicating the work of both the taxpayer and the Internal Revenue Service. These various exclusions and concessions have been justified [in the past] as a means of overcoming oppressively high rates in the upper brackets, and a sharp reduction in those rates — accompanied by base-broadening, loophole-closing measures — would properly make the new rates not only lower, but also more widely applicable. Surely this is more equitable on both counts… I am confident that the enactment of the right bill next year will in due course increase our gross national product by several times the amount of taxes actually cut. Profit margins will be improved, and both the incentive to invest and the supply of internal funds for investment will be increased. There will be new interest in taking risks, in increasing productivity, in creating new jobs and new products for long-term economic growth."

• Third, Kennedy understood the link between tax rates, the federal budget and economic growth:

> "Our true choice is not between tax reduction, on the one hand, and the avoidance of large federal deficits on the other. It is increasingly clear that no matter what

> party is in power, so long as our national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenues to balance our budget — just as it will never produce enough jobs or enough profits. Surely the lesson of the last decade is that budget deficits are not caused by wild-eyed spenders but by slow economic growth and periodic recessions, and any new recession would break all deficit records. In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now… And the reason is that only full employment can balance the budget, and tax reduction can pave the way to that employment. The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus."

Kennedy Tax Cut, Part I

The Kennedy tax cut came in two parts. The first part came in 1962, and featured faster depreciation for investment expenditures, and a new, seven-percent investment tax credit.

As economist Stephen J. Entin explained in a study of the tax policies implemented during the administrations of President Kennedy and President Lyndon B. Johnson (titled "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration"): "The government requires businesses to write off the cost of investment in plant and equipment over many years, rather than when capital is purchased. The delayed deductions lose value due to inflation and the time value of money."[3] As a result, faster depreciation (i.e., being able to more quickly write off the costs of capital expenditures) and an investment tax credit (i.e., a tax credit can be subtracted directly from a firm's tax bill) up to seven percent for the cost of certain types of assets mean reduced tax costs for business investment, and therefore, increased incentives for making such investments.

Kennedy Tax Cut, Part II

Part two of the Kennedy tax cuts was not implemented until after his death. President Johnson continued with his predecessor's tax cut efforts. Congress passed the measure in 1964.

The Revenue Act of 1964 featured reductions in both personal and corporate income tax rates. As Entin explained, "The 1964 Act included a two-stage reduction in the corporate tax rate, reducing it from 52 percent to 50 percent in 1964 and to 48 percent in 1965. Most famously, the 1964 Act reduced the marginal personal income tax rates in the various tax brackets across-the-board, from a range of 20 percent in the bottom tax bracket and 91 percent in the top tax bracket, to a range of 14 percent at the bottom and 70 percent at the top. The rates were cut in two steps, in 1964 and 1965."[4]

In thinking about these and other tax proposals, Entin highlighted five critical points in understanding, from a supply-side economics perspective, the full benefits or costs of tax changes:[5]

1) “Tax cuts that increase GDP recover a portion of their apparent static revenue cost. Tax increases that reduce GDP do not raise their full estimated static revenue. Tax cuts are not as expensive, and tax increases are not as rewarding to the government on a dynamic basis as the static numbers indicate.”

2) “Some types of tax changes have much more effect on GDP than others, and their dynamic revenue reflow can be quite large. They create more growth per dollar of net tax cut, or destroy more GDP per dollar of net tax increase.”

3) “The tax treatment of capital is especially important, because capital formation responds more sharply to tax changes than does the supply of labor. Changes in capital taxation have a greater effect on GDP, income, and employment, and generate greater revenue feedback, than changes in taxation of wages.”

4) “Very few types of tax changes have so strong an effect on income that their dynamic revenue reflow exceeds the static revenue change. That is, a tax cut raises revenue and ‘pays for itself’ in a federal budget sense, or a tax increase loses revenue and defeats itself. In such cases it costs the government nothing to raise GDP and people’s incomes by cutting the tax”

5) “Even when a tax cut does not pay for itself in the federal budget sense, it is often a very good deal for the taxpayer to give up a small amount of government spending to pay for a tax cut that raises after-tax income by a much larger amount, and increases total employment.”

Kennedy Tax Cut: The Results

So, what resulted from the Kennedy tax cuts?

Entin noted: “The Kennedy tax cuts succeeded in boosting investment and employment over the next several years. Real GDP rose at a 4.9 percent rate from the first quarter of 1962 through the first quarter of 1969, well above the 2.9 percent rate of growth from the first quarter of 1953 through the first quarter of 1962. Personal income climbed in real terms, and several million jobs were created. Unemployment peaked at 5.7 percent in 1963 and fell to 3.5 percent in 1969.”[6]

Using a model “driven by the impact of marginal tax rate changes on incentives to work, save, and invest in additional capital formation,” Entin found, “The whole package of Kennedy’s individual and business tax changes is estimated to have lifted the long run equilibrium GDP by 7.7 percent, or $56.4 billion at 1966 income levels. Private business sector output is estimated to be 8.2 percent higher with the tax reductions than without. Wages and hours worked in private businesses are higher with the tax reductions, lifting total labor compensation 8.2 percent, in line with business output. The equilibrium stock of private business capital is higher by 21.2 percent, or $228 billion.”[7]

Finally, in terms of the tradeoff between federal government services for economic benefits from tax cuts, the Kennedy tax cut package ranked as a massive positive. Entin reported: “For the whole tax package, the public would have to give up only $0.11 in federal services to gain a dollar in after-tax income. For the individual tax reductions, the sacrifice would be $0.22 in government output per dollar of after-tax income gain; for the business tax cuts, less than a penny."[8]

Johnson Tax Increase

Four years after the Kennedy income tax cuts were passed, a tax increase pushed by President Johnson played a key part in bringing about the end of the Kennedy expansion with a recession in 1969-70.

As Entin explained: "In 1968, Johnson asked Congress to pass a temporary 10 percent tax surcharge on individual and corporate income to help fund the Vietnam War and the Great Society programs. The 10 percent Johnson surtax was initially in place for the last three quarters of 1968 (an effective annual rate of 7.5 percent) and throughout 1969 (at the full 10 percent rate). The Revenue Act of 1969 later extended the surtax through the first quarter of 1970 (a 2.5 percent effective annual rate), after which the surtax expired. At its peak in 1969, the surtax raised the 48 percent corporate income tax rate to 52.8 percent, more than offsetting the Kennedy corporate tax rate reduction. It effectively increased the top individual marginal income tax rate from 70 percent to 77 percent."[9]

Johnson Tax Increase: The Results

According to supply-side economic theory, such a tax increase should have a negative impact on investment, production and growth, and therefore, should not raise as much revenue for the government as anticipated.

In his study, Entin looked at two aspects of the Johnson tax increase – the impact if the tax increase had been permanent, and the negative effects over the short time the tax increase was imposed.

> • "Had the surtax been permanent, it would have eventually reduced private business GDP by 3.4 percent and cut the capital stock by 8.3 percent. Instead of bringing in an estimated static revenue increase of $11.6 billion (based on unchanged 1969 income levels), it would have raised only $4.2 billion after economic adjustments. The surtax would have lost 64 percent of the expected revenue to a weaker economy. Had the full effect of the tax increase been achieved, it would have lowered the GDP by $32.5 billion, nearly eight times more than its net federal revenue gain, and over five times more than its reduction in the federal deficit after allowing for lower federal wage costs. Put another way, it would have cost the public $1 in after-tax income to get the government $0.11 in higher revenue via the surtaxes."[10]
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> • "Because the surtax was temporary and short-lived, it never achieved its long run effect on the economy. Nonetheless, the temporary increase in the tax on production had two consequences. First, it discouraged investment in very short-

> lived assets to be used during the surtax period, and, if people were not sure that the surtax would be temporary, may have discouraged longer term investment as well. Second, insofar as people believed the surtax to be temporary, it would have encouraged people to postpone the realization of income, including capital gains, until the surtax expired. For these reasons, the surtax had some negative short term consequences for the economy, and could not raise as much money as the static revenue estimate (assuming no recession) would have indicated."[11]

The lessons from the Kennedy tax cuts and the Johnson tax increases confirm the supply-side economics view of how taxes affect the economy. As Entin concluded, "This neo-classical approach is consistent with the microeconomic price and incentive signals that govern how labor and capital markets and the production process operate in the real world, where income is linked to production decisions. This is in contrast to Keynesian models that assume that government fiscal measures work by manipulating total spending and aggregate demand in the economy separately from the supply of goods and services."[12]

Regarding the tax relief passed in the early 1960s, President Kennedy turned out to be largely correct, and for the first time since the 1920s, the U.S. economy reaped rewards from supply-side economics informing tax policy.

Something More to Think About

Were Kennedy's Tax Cuts Really on the Supply side?

In the policy arena, President Kennedy's speech before the Economic Club of New York and his 1962 and 1964 tax cuts remain hotly debated to this very day. First, the debate includes whether Kennedy and his tax cuts were rooted in Keynesian or supply-side economics.

Those of a Keynesian bent assert that Kennedy was a pure Keynesian, and had nothing to do with supply-side thinking. For example, USNews.com's Robert Schlesinger wrote the following in a January 26, 2011, column ("The Myth of JFK as Supply Side Tax Cutter"): "Kennedy's economic policies were rooted in a Keynesian belief in the stimulative effects of budget deficits. While FDR and his aides had embraced countercyclical deficits as necessary in times of recession or depression, Kennedy was the first to advocate planned deficits in a time of neither war nor economic emergency. The aim was for the tax cuts to stimulate demand, driving the economy from the bottom up."

In contrast, in an August 16, 2013, column ("Obama Skips the Kennedy Tax Cuts" at NationalReview.com), economist Larry Kudlow wrote: "But then came the 1960s, the decade liberals love to hate. Why? Because the path-breaking supply-side tax cuts of John F. Kennedy generated one of the greatest booms in economic history… [Brian] Domitrovic reminds us that the eight-year expansion from 1961 to 1969 saw growth of 48 percent — a third more in an eight-year period than in the 16 years ending in 1960. So the post-war prosperity of 1944 to 1969 *did* exist at roughly 3 percent per year. But only because the 1960s lifted everything up. Kennedy cut the top tax rate from 91 percent to 70 percent, but all other tax rates were also reduced for top-to-bottom income earners."

Were Kennedy's Tax Cut a Success or Failure?
The success of the Kennedy tax cuts had been widely accepted, with disagreement coming over why they succeeded. Now, some are raising questions about the long-term effects of the Kennedy tax cuts.

In a March 3, 2013, *Washington Post* column ("How JFK's mistake led to the sequester mess"), Robert Samuelson argued that the Kennedy tax cuts were the source of seemingly all economic ills that occurred after 1969, including how high inflation was in 1980, and that those tax cuts were the beginning of the loss of budgetary discipline. Samuelson wrote: "We are now suffering from — and have for decades — the second defect of JFK's decision: the loss of budgetary discipline. Since Kennedy's tax cut passed in 1964 — after his assassination — there have been 43 budget deficits and only five surpluses (1969, 1998, 1999, 2000 and 2001)… Debt became benign. The promise of Kennedy's tax cuts was that, by promoting faster and more stable economic growth, government could afford more because the economy would perform better. When Republicans proposed "supply side" tax cuts in the 1980s, they made similar arguments and referred admiringly to Kennedy. Over time, what was politically convenient — higher spending, lower taxes — became habit-forming. It pleased the public, which deplored deficits in the abstract but rejected specific (unpopular) measures to control them."

In a March 12, 2013, column at Forbes.com ("Trashing JFK's Tax Cuts, One of the Greatest Policy Successes of All Time"), Brian Domitrovic answered Samuelson's assertions. He wrote: "Three major things went unsaid in Samuelson's column. First was the greatness of 1960s growth, the sine qua non of postwar prosperity. Second was the federal spending explosion in the wake of the receipts boom coincident with the tax cuts. As I put it in my book, *Econoclasts*: 'From 1962 to 1965, federal outlays increased by 10.7% total, or 3.4% a year. Taking inflation into account, real outlays increased 2% annually over these three years. These are small numbers. From 1965 to 1969, in contrast, federal outlays increased by 55% total, or 11% per year—7% annually, in real terms. These are large numbers.' JFK's successor, Lyndon B. Johnson, was such a spend-a-holic that the real 5% increases in federal receipts thanks to the JFK tax policy were not enough to cover his Great Society/Vietnam ambitions. That's where budget deficits came from."

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[1] Gene Smiley, "Great Depression," *The Concise Encyclopedia of Economics* (Indianapolis, In: Liberty Fund, Inc., 2008, edited by David R. Henderson), p. 230.
[2] Gene Smiley, "Great Depression," *The Concise Encyclopedia of Economics* (Indianapolis, In: Liberty Fund, Inc., 2008, edited by David R. Henderson), p. 234.
[3] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 2.
[4] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 3.

[5] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, pages 6-7.
[6] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 5.
[7] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 7.
[8] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 12.
[9] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 5.
[10] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, pages 16-17.
[11] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 17.
[12] Stephen J. Entin, "Economic Consequences of the Tax Policies of the Kennedy and Johnson Administration," IRET Bulletin, Institute for Research on the Economics of Taxation, September 6, 2011, page 18.