THE WALL STREET JOURNAL.

Hillary Parties Like It's 1938

Clinton's capital-gains tax proposal has been tried before—by FDR, with disastrous results.

Alan Reynolds

September 2, 2015

Hillary Clinton's most memorable economic proposal, debuted this summer, is her plan to impose a punishing 43.4% top tax rate on capital gains that are cashed in within a two-year holding period. The rate would drift down to 23.8%, but only for investors that sat on investments for six years.

This is known as a "tapered" capital-gains tax, and it isn't new. Mrs. Clinton is borrowing a page from Franklin D. Roosevelt, who trotted out this policy during the severe 1937-38 economic downturn, dubbed the Roosevelt Recession. She'd be wise to consider how it played out.

President Herbert Hoover raised taxes in 1932 and expanded the number of brackets to 30 from 23. The top rate skyrocketed to 63% from 25%. But the highest capital-gains rate remained 12.5% until Congress enacted the tapered tax in 1934. Here's how it worked: 20% of an individual's capital gains were excluded from taxes after one year, 40% after two years, 60% after five and 70% after 10. This initially resulted in a maximum tax of 40% on capital gains for assets sold after two years.

But things took another left turn in 1936, when the top income-tax rate was bumped up to 79% from 63%. This didn't smack only top earners. All 15 of the highest rates increased: Those previously in a 40% tax bracket were pushed into a 43% bracket, the 49% bracket became 55%, the 59% bracket turned into 70%, and the top 63% rate increased to 79%.

A separate 1936 bill allowed dividends to be treated as taxable income in all 31 tax brackets. This was a first. Most taxpayers were exempt from dividend taxes before 1936; nobody paid more than a 55% rate.

Yet since the capital-gains tax rate grew in tandem with income-tax rates, the top income-tax bracket increased to 79% in 1936, while the capital-gains tax rate jumped to 63% for assets held one year, 47% after two years, 32% after five and 24% after 10. Even worse, the 1936 law added a surtax on "undistributed profits"—those not paid out as dividends but kept to finance business investment.

It didn’t take long for economic consequences to bubble up: In the 12 months between February 1937 and 1938, the Dow Jones Industrial stock average fell 41%—to 111 from 188.4. That crash presaged one of the nation’s worst recessions, from May 1937 to June 1938, with GDP falling 10% and industrial production 32%. Unemployment swelled to 19% from 14%.

Harvard economist Joseph Schumpeter, in his 1939 opus “Business Cycles,” noted that “the so-called capital gains tax has been held responsible for having accentuated, if not caused, the slump.” The steep tax on short-term gains, he argued, made it hard for small or new firms to issue stock. And the surtax on undistributed profits, Schumpeter wrote, “may well have had a paralyzing influence on enterprise and investment in general.”

More recent research confirms these insights. A 2011 study from the Federal Reserve Bank of St. Louis reported that monetary policy tightening, contrary to received wisdom, can’t explain the 1937-38 recession. “The 1936 tax rate increases,” they concluded, “seem more likely culprits in causing the recession.” Higher taxes on investors tended to fall on the more affluent individuals that supply capital to new firms.

A 2012 study in the Quarterly Journal of Economics attributes much of the 26% decline in business investment in the 1937-38 recession to higher taxes on capital. “Especially important,” University of Minnesota economist Ellen McGrattan wrote, “are the sharp rise in tax rates on individual incomes.” And “although few households paid income taxes,” Ms. McGrattan added, “those who did earned almost all of the income distributed by corporations and unincorporated businesses.” Again, more signs of depressed business investment. After 1936 tax rates on undistributed profits “led to another dramatic decline in investment,” the study notes.
The prospect of steep tax rates from cashing in on investments no doubt reduced wealth and investment, as did higher taxes on dividends and profits. The capital-gains taper’s severe penalties on selling assets before five or 10 years also reduced the liquidity of corporate shares, making it far more hazardous to provide equity financing to new firms.

Relief finally arrived in May 1938, when public ire about the recession prompted Congress to overturn FDR. Legislators shortened the taper to two years from 10 and cut the highest capital-gains tax to 15% from 47%. The surtax on undistributed profits was greatly reduced in that year as well, and abolished in 1939.

The 1938 congressional tax revolt, championed by Senate Finance Committee ChairmanPat Harrison, a Mississippi Democrat, intended to turn a recession into a recovery. Roosevelt allowed the bill to become law without his signature, an unusual way of expressing his disapproval. But Harrison’s plan worked. Stocks lifted immediately—the Dow reached 152.3 in November from 111 in April. The recession ended the next month, and the economy grew 8% in 1939 and 8.8% in 1940.

It is ironic, then, that Hillary Clinton’s fix for an economy suffering under 2% growth is resuscitating a tax scheme with a history of ushering in recessions. The economy would be better off if the idea remained buried.

Alan Reynolds is a senior fellow with the Cato Institute.