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Tax Rates and Tax Revenue
The Mellon Income Tax Cuts of the 1920s

by Veronique de Rugy, Fiscal Policy Analyst, Cato Institute

The Bush administration has proposed that the phased-in income tax cuts that were enacted in 2001 become fully effective this year. Individual tax rates of 27, 30, 35, and 38.6 percent would be immediately reduced to 25, 28, 33, and 35 percent. To understand the possible revenue and economic effects of the proposed cuts, this bulletin looks at the effects of the 1920s tax rate cuts engineered by Treasury Secretary Andrew Mellon under Presidents Warren Harding and Calvin Coolidge.

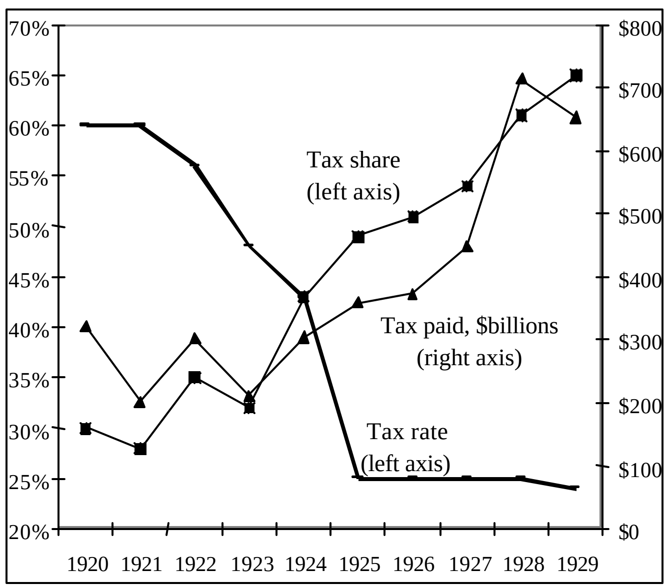
Changes in marginal income tax rates cause individuals and businesses to change their behavior. As tax rates rise, taxpayers reduce taxable income by working less, retiring earlier, scaling back plans to start or expand businesses, moving activities to the underground economy, restructuring companies, and spending more time and money on accountants in order to minimize taxes. Tax rate cuts reduce such distortions and cause the tax base to expand as tax avoidance falls and the economy grows.[1] A review of tax data for high-income earners in the 1920s shows that as top tax rates were cut, tax revenues and the share of taxes paid by high-income taxpayers soared (see Figure 1).

The Mellon Tax Cuts

When the federal income tax was enacted in 1913, the top rate was just 7 percent. By the end of World War I, rates had been greatly increased at all income levels, with the top rate jacked up to 77 percent (for income over $1 million). After five years of very high tax rates, rates were cut sharply under the Revenue Acts of 1921, 1924, and 1926. The combined top marginal normal and surtax rate fell from 73 percent to 58 percent in 1922, and then to 50 percent in 1923 (income over $200,000). In 1924, the top tax rate fell to 46 percent (income over $500,000). The top rate was just 25 percent (income over $100,000) from 1925 to 1928, and then fell to 24 percent in 1929.

Secretary Mellon knew that high tax rates caused the tax base to contract and that lower rates would boost economic growth.[2] In 1924, Mellon noted: "The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business."[3] He received strong support from President Coolidge, who argued that "the wise and correct course to follow in taxation and all other economic legislation is not to destroy those who have already secured success but to create conditions under which every one will have a better chance to be successful."[4]

Figure 1. Marginal Tax Rate, Tax Paid, and Tax Share for Those with Income over $100,000



Source: U.S. Department of Treasury, "Statistics of Income," annual 1920 to 1929. The tax rate shown is for taxpayers at $100,000; for years before 1925, the top rate was even higher.

The Effects of the Mellon Tax Cuts

It is often assumed that broad cuts in income tax rates only benefit the rich and thrust a larger share of the tax burden on the poor. But detailed Internal Revenue Service data show that the across-the-board rate cuts of the early 1920s–including large cuts at the top end–resulted in greater tax payments and a larger tax share paid by those with high incomes.[5] Figure 1 focuses on those earning more than $100,000. As the marginal tax rate on those high-income earners was cut sharply from 60 percent or more (to a maximum of 73 percent) to just 25 percent, taxes paid by that group soared from roughly $300 million to $700 million per year. The share of overall income taxes paid by the group rose from about one-third in the early 1920s to almost two-thirds by the late 1920s. Table 2 provides details of taxes paid and tax shares for five income groups. (Note that inflation was virtually zero between 1922 and 1930, thus the tax amounts shown for that period are essentially real changes).[6]

The tax cuts allowed the U.S. economy to grow rapidly during the mid- and late-1920s. Between 1922 and 1929, real gross national product grew at an annual average rate of 4.7 percent and the unemployment rate fell from 6.7 percent to 3.2 percent.[7] The Mellon tax cuts restored incentives to work, save, and invest, and discouraged the use of tax shelters.

The rising tide of strong economic growth lifted all boats. At the top end, total income grew as a result of many more people becoming prosperous, rather than a fixed number of high earners getting greatly richer. For example, between 1922 and 1928, the average income reported on tax returns of those earning more than $100,000 increased 15 percent, but the number of taxpayers in that group almost quadrupled. During the same period, the number of taxpayers earning between $10,000 and $100,000 increased 84 percent, while the number reporting income of less than $10,000 fell.

The decade of the 1920s had started with very high tax rates and an economic recession. Tax rates were massively increased in 1917 at all income levels. Rates were increased again in 1918. Real GNP fell in 1919, 1920, and 1921 with a total three-year fall of 16 percent. (Deflation between 1920 and 1922 may also help explain the drop in tax revenues in those years, evident in Table 1).

As tax rates were cut in the mid-1920s, total tax revenues initially fell. But as the economy responded and began growing quickly, revenues soared as incomes rose. By 1928, revenues had surpassed the 1920 level even though tax rates had been dramatically cut.

Table 1. Tax Receipts and Share of Taxes Paid by Income Group

Income Tax Receipts ($ millions)					
Income	1920	1922	1924	1926	1928
$5,000	166	96	48	13	13
5,000-10,000	98	70	29	20	23
10,000-5,000	172	124	78	72	83
25,000-100,000	318	270	246	254	331
100,000	321	302	304	373	714
Total	1,075	861	704	732	1,164
Share of Total Income Taxes					
Income	1920	1922	1924	1926	1928
Under $5,000	15.4%	11.1%	6.8%	1.8%	1.1%
5,000-10,000	9.1%	8.1%	4.1%	2.7%	2.0%
10,000-25,000	16.0%	14.4%	11.1%	9.8%	7.1%
25,000-100,000	29.6%	31.4%	34.9%	34.7%	28.4%
Above 100,000	29.9%	35.1%	43.2%	51.0%	61.3%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: U.S. Department of Treasury, "Statistics of Income," annual 1920 through 1928.

Conclusion

The tax cuts of the 1920s were the first federal experiment with supply-side income tax rate cuts. Data for the period show an initial decline in federal revenues as tax rates were cut, but revenues grew strongly during the subsequent economic expansion. After the cuts, total tax payments and the share of total taxes paid by the top income earners soared. President Bush's current proposal to make phased-in rate cuts effective immediately also promises to expand the tax base. Indeed, Congress should consider further rate cuts to stimulate even larger gains in incomes and economic growth.

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1 For a discussion, see Martin Feldstein, Testimony before the House Committee on Ways and Means, February 13, 2001.
2 Joint Economic Committee, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," June 18, 1982, p. 4.
3 Andrew Mellon, *Taxation: The People's Business* (New York: Macmillan, 1924), p. 13.
4 Peter Hannaford, *The Quotable Calvin Coolidge* (Bennington, Vermont: Images from the Past, 2000), p. 151.
5 Data in Figure 1 and Table 1 were tabulated by the author from U.S. Treasury, *Statistics of Income*, annual 1920 to 1929. Lazar Antonic helped research and analyze the data.
6 Measured by the consumer price index. See U.S. Bureau of the Census, *Historical Statistics of the United States*, 1975, Part 1, Series E135-166, p. 211.
7 U.S. Bureau of the Census, Series F1-5 and D85-86, pp. 135, 224.