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THE CURIOUS BEGINNINGS OF THE CAPITAL GAINS TAX PREFERENCE

Ajay K. Mehrotra & Julia C. Ott***

Despite the importance of the capital gains tax preference, and the controversy it often evokes, there has been relatively little serious scholarly attention paid to the historical development of this highly significant tax provision. This Article seeks to move beyond the normative and presentist concerns for or against the tax preference to recount the empirical beginnings and early twentieth-century development of this important tax law. In exploring the curious beginnings of the capital gains tax preference, this brief Article has several aims. First, its main goal is to show that the preference is not a timeless or transhistorical concept, but rather a historically contingent one—a concept that has been shaped not purely by economic logic, but rather by political compromise and social experience. Second, it uses the capital gains tax preference to shed light on broader historiographical questions about the rise and fall of different guiding principles of American political economy. Third, by examining the shifting political coalitions and constituencies behind the tax preference, it intends to show that it is not simply wealthy and elite American taxpayers and their representatives who have supported this tax law. Rather, over time, the law has had a variety of proponents, suggesting that the provision's persistence can be explained as much by political forces and institutional inertia as by seemingly inexorable economic reasoning. Ultimately, an exploration of the beginnings and early twentieth-century development of the capital gains tax preference provides an opportunity to think about how "we are what we tax."

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INTRODUCTION 2518
I. 1920S BEGINNINGS 2523
II. THE GREAT DEPRESSION AND THE NEW DEAL ORDER 2530
CONCLUSION 2535

INTRODUCTION

In the spring of 1921, the U.S. Supreme Court decided the case of *Merchants' Loan & Trust Co. v. Smietanka*.[1] The Court held that gains derived from the one-time sale of property constituted taxable income.[2] Writing for the Court, Justice John H. Clarke maintained that the legal definition of taxable income historically had included gains from the sale of investment property or capital assets, and the recently adopted Sixteenth Amendment to the U.S. Constitution[3] simply ratified that longstanding interpretation.[4]

For Clarke, the legal issue was straightforward. "In determining the definition of the word 'income' thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted," wrote Clark, "what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution."[5] By including capital gains in the income tax base, the Court ensured that wealthy Americans, who owned most of the country's capital assets, were paying their fair share of the new income tax.

Although the Court's decision seemed to settle the constitutional question of whether capital gains were included in the tax base, determining the tax *rates* that applied to such gains remained an open question. Within the same year, Congress addressed this secondary question. The 1921 Revenue Act included a provision that taxed capital gains at 12.5 percent, well below the top marginal rate of 65 percent for ordinary individual income at the time.[6] Thus, the new law created the first preferential rate for capital gains. Since then, the Internal Revenue Code has almost always contained a capital gains tax preference in one form or another.[7]

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1. 255 U.S. 509 (1921).
2. *Id.* at 520–21.
3. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.
4. *Merchants' Loan & Tr. Co.*, 255 U.S. at 519.
5. *Id.*
6. Revenue Act of 1921, § 206(b), 42 Stat. 227, 233.
7. To be more precise, the current Internal Revenue Code taxes individual "net long-term capital gain" at a lower rate than "ordinary income" or "net short-term capital gain." *See* Internal Revenue Code, 26 U.S.C. §§ 1(h), 1221, 1222 (2012). This preference was repealed for a short period during the late 1980s as part of the landmark 1986 Tax Reform Act. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 301, 302, 311, 100 Stat. 2085, 2215–20.

Given the increasing concerns over rising inequality in the United States,[8] the social implications of the tax code and the preferential treatment of capital gains recently have captured the attention of many everyday Americans. In a 2015 Pew Research Center poll, 61 percent of Americans admit they are "bother[ed] a lot" by the idea that "some wealthy people fail[] to pay their fair share."[9] Among registered Republicans, 45 percent admitted they felt the same.[10] The recent surge in such sentiments can be traced to a number of factors including the revelation in 2012 that Republican presidential candidate Mitt Romney's tax bill totaled only 14.1 percent of his income.[11] Romney managed this because he received most of his income in the form of returns on his investments.[12] Romney's capital gains were taxed more lightly than his "earned" income received in the form of salary.

The specific tax treatment of capital gains also has drawn the attention of both parties' presidential candidates. Leading Democratic contenders have challenged the structure of the preference for capital gains. Bernie Sanders demands the federal government "[t]ax capital gains and dividends the same as work," eliminating the preference to achieve equity between "earned" income from wages and salaries and "unearned" income from capital.[13] Hillary Clinton has pledged to "raise" rates on capital gains by stretching out the amount of time that an individual must hold an investment before they qualify for the full preferential rate.[14] For Clinton, lengthening this holding period would mitigate against the short-term oriented quarterly capitalism that she claims has wreaked havoc on the U.S. economy. While Republicans uphold the preference and call for further cuts in capital gains taxes, 2016 presidential candidates Donald Trump and Jeb Bush both identified the carried interest exemption—whereby fund managers may classify their fees as investment income to qualify for the lower capital gains tax rate—as a fundamentally unfair loophole that they would close.[15]

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8. *See generally* THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (Arthur Goldhammer trans., 2014); Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913–1998*, 118 Q.J. ECON., 1, 1–34 (2003).

9. *Federal Tax System Seen in Need of Overhaul*, PEW RES. CTR. (Mar. 19, 2015), http://www.people-press.org/2015/03/19/federal-tax-system-seen-in-need-of-overhaul/ [https://perma.cc/NDR2-4MWE].

10. *Id.*

11. Associated Press, *Romney's 2011 Tax Rate 14.1%, Return Shows*, NEWSDAY (Sept. 21, 2012, 10:19 PM), http://www.newsday.com/news/nation/romney-s-2011-tax-rate-14-1-return-shows-1.4027336 [https://perma.cc/573R-VV5Q].

12. *Id.*

13. *See Ten Fair Ways to Reduce the Deficit and Create Jobs*, BERNIE SANDERS: U.S. SENATOR VT., http://www.sanders.senate.gov/top10 (last visited Apr. 29, 2016) [https://perma.cc/PGN5-ULK3]; *see also* JONATHAN TASINI, THE ESSENTIAL BERNIE SANDERS AND HIS VISION FOR AMERICA 13 (2015).

14. Laura Meckler, *Hillary Clinton Proposes Sharp Raise in Some Capital-Gains Tax Rates*, WALL STREET J. (July 24, 2015, 6:56 PM), http://www.wsj.com/articles/clinton-to-propose-rise-in-capital-gains-taxes-on-short-term-investments-1437747732 [https://perma.cc/4H8D-TBST].

15. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 11–15 (2008); Katy Osborn, *This Is the Tax Loophole Obama,*

Why does the federal tax code privilege income from capital gains? How has this preference persisted for nearly one hundred years through numerous permutations of federal economic policy and countless changes to the federal income tax code? Indeed, ever since 1921, when our tax laws first established the capital gains tax preference, commentators and scholars alike have analyzed the justifications for this tax preference.[16] While some have decried it as an inefficient and unnecessary benefit for wealthy taxpayers,[17] others have supported it as a much-needed provision to facilitate the free flow of capital.[18]

It is not only wealthy taxpayers and their representatives who have supported this feature of federal income tax law. For nearly one hundred years, policymakers across the political spectrum have maintained the preference for capital gains income as a much-needed provision to encourage and to reward property ownership among everyday citizens. In addition, organized groups hailing from the financial industries have doggedly opposed any proposed increase in the capital gains tax rate and persistently demanded its reduction, even calling for the abolition of any taxation on capital gains. As early as the 1930s, these groups developed a new language of "incentives" and "venture capital" and deployed particular models of how financial markets influence the real economy.[19] They managed to exploit fissures—and in many cases widen them—within both

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Bush, and Trump All Want to Close, TIME MONEY (Sept. 16, 2015), http://time.com/money/4036087/tax-loophole-carried-interest [https://perma.cc/G6JL-B65Q].

16. *See, e.g.*, Marjorie E. Kornhauser, *The Morality of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 119, 165 (1994) ("The equitable side of the capital gains debate reflects not only views on the nature of wealth distribution but on the nature of America."); Charles L. B. Lowndes, *The Taxation of Capital Gains and Losses Under the Federal Income Tax*, 26 TEX. L. REV. 440, 460 (1948) ("As far as showing ability to pay an income tax and their economic nature are concerned, there is not the slightest basis for any distinction between a capital gain and any other form of income."); Peter Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation*, 59 YALE L.J. 837, 838 (1950) ("Assuming that the federal income tax should treat like transactions alike, the special treatment accorded capital gains can be justified only if the transactions giving rise to such gains have characteristics which set them apart from transactions resulting in ordinary income."); Lester B. Snyder, *Taxation with an Attitude: Can We Rationalize the Distinction Between "Earned" and "Unearned" Income?*, 18 VA. TAX REV. 241, 244 (1998) (examining "why we tax income from capital investment differently than income form services," including the historical origins of taxing investment and earned income differently).

17. *See, e.g.*, Lowndes, *supra* note 16, at 440 ("Stripped of the bogus economic theology which has been cunningly employed to conceal their true origin and character, the capital gain and loss provisions of the federal income tax are a shrewd and cynical device for frustrating the progressive principle of the tax and shifting its burden from those best to those least able to bear it.").

18. *See, e.g.*, GREGG A. ESENWEIN, CONG. RESEARCH SERV., NO. 98-473-E, INDIVIDUAL CAPITAL GAINS INCOME: LEGISLATIVE HISTORY (1998) (concluding that cutting the tax rate on capital gains income would reduce "lock-in" on capital gain assets); Daniel N. Shaviro, *Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 415 (1993) (concluding that, while there are some inequalities in the tax preference, "a revenue-raising capital gains tax preference probably is better than no tax preference. . . . [A] revenue-raising preference probably increases efficiency").

19. *See, e.g.*, David Carris, Comment, *Capital Gains Taxation: A Full Circle?*, 14 T. MARSHALL L. REV. 43, 45 (1989) (citing Morris S. Tremaine, *The Capital Gains Tax*, 15 TAXES 517, 567 (1937)); *see also infra* Part II.

the Republican and Democratic parties. The preference for capital gains, long embodied in the tax code, thus has been shaped not purely by economic logic or class bias, but rather by political coalition making and social experience.

Despite the importance of the capital gains tax preference—and the controversy it often evokes—there has been relatively little serious scholarly attention paid to the historical development of this highly significant tax provision. Besides several studies that have used the origins of the tax benefit as a preface to an analysis of the existing conventional justifications for the preference,[20] only a few notable scholars have delved into what the historical origin of this tax law means for the structures of risk, wealth, and opportunity.[21] Building on these latter studies, this Article seeks to move beyond the normative and presentist concerns for or against the preference to recount the empirical beginnings and early twentieth-century development of this important tax law.

In exploring the curious beginnings of the capital gains tax preference, this brief Article has several aims. First, its main goal is to show that the preference is not a timeless or transhistorical concept, but rather a historically contingent one—a concept that has been shaped not purely by economic logic, but rather by political compromise and social experience. In fact, chronicling the early history of the tax preference may be one way to show the historically bounded nature of tax policy. By examining particular critical junctures in the path-dependent development of the preference, this Article intends to demonstrate how the preference has endured because of changing political and social conditions.

A critical history of the ideas and beliefs that undergird existing tax laws and policies also reminds us that the development of legal and economic theory is not simply a linear accretion of knowledge. Rather, the theories that support the capital gains preference are the product of shifting ideas and beliefs not only about economic growth, but also about the meaning of risk, wealth, and opportunity in modern American capitalism. This Article seeks to build upon some of the recent literature on the intellectual history of the economics discipline and its relationship to American law and capitalist development to tell a more nuanced and complicated story about

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20. For some examples of scholarship on the capital gains tax that has paid only passing, if any, attention to its history, see Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993); Arthur P. Hall, *Fifty Years of the Federal Capital Gains Tax Burden*, 67 TAX NOTES 553 (1995); Van Mayhall, *Capital Gains Taxation—The First One Hundred Years*, 41 LA. L. REV. 81 (1980); Richard L. Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 TAX NOTES 195 (1990).

21. *See* U.S. DEP'T OF THE TREASURY, REPORT TO CONGRESS ON THE CAPITAL GAINS REDUCTIONS OF 1973, *reprinted in* THE CAPITAL GAINS CONTROVERSY: A TAX ANALYSTS READER 219 (J. Andrew Hoerner ed., 1992); Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do With It?*, 39 SW. L.J. 869, 917 (1985); Kornhauser, *supra* note 16, at 151–54; William D. Popkin, *The Deep Structure of Capital Gains*, 33 CASE W. RES. L. REV. 153, 154–61 (1983).

the origins and early development of our current capital gains tax preference.[22]

Second, this Article uses the capital gains tax preference to shed light on broader historiographical questions about the rise and fall of different guiding principles of American political economy. More specifically, it seeks to challenge the conventional historical wisdom that Keynesian economic thinking dominated the post-World War II period only to give way to the emergence of neoliberalism in the 1970s and afterward. Instead, this Article claims that elements of both economic theories have been operating in tandem throughout the twentieth century and that one set of ideas has been at the forefront during particular historical periods because of changing political and social context.

Third, by examining the shifting political coalitions and constituencies behind the tax preference, this Article intends to show that it is not simply wealthy and elite American taxpayers and their representatives who have supported this tax law. Rather, over time, the law has had a variety of proponents, suggesting that the provision's persistence can be explained as much by political forces and institutional inertia as by seemingly inexorable economic reasoning.

In chronicling the curious beginnings of the capital gains tax preference, this Article analyzes two distinct historical periods. Part I begins with the formative era of our modern income tax regime to see how the ideas and actions of economic theorists and lawmakers influenced the adoption of the preference. The initial impulse behind preferential tax treatment for capital gains emerged from concerns about stimulating, protecting, and rewarding property ownership (whether in farms, homes, or financial investments) in the tumultuous years following World War I. It was during this period that the preference first became embedded in American tax law.

Part II explores the New Deal Order of the 1930s and 40s, when financial institutions like the New York Stock Exchange (NYSE or "the Exchange") began to stress the importance of economic incentives and the need either to maintain the preference or eliminate capital gains taxation all together. Faced with rising capital gains tax rates under President Franklin D. Roosevelt, the NYSE and its academic and corporate allies united with select southern Democrats to secure the reduction of capital gains taxes in 1938 and 1941. These broader political, social, and institutional forces had a significant impact on the development of the tax preference.

Finally, this Article concludes with a brief assessment of how our historical analysis of the first half of the twentieth century can inform our present understanding of the capital gains tax preference. Indeed, an exploration of the beginnings and early twentieth-century development of

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22. For a sampling of some of this literature, see generally MICHAEL A. BERNSTEIN, A PERILOUS PROGRESS: ECONOMISTS AND PUBLIC PURPOSE IN TWENTIETH-CENTURY AMERICA (2001); HOWARD BRICK, TRANSCENDING CAPITALISM: VISIONS OF A NEW SOCIETY IN MODERN AMERICAN THOUGHT (2006); ANGUS BURGIN, THE GREAT PERSUASION: REINVENTING FREE MARKETS SINCE THE DEPRESSION (2012); PHILIP MIROWSKI, MORE HEAT THAN LIGHT: ECONOMICS AS SOCIAL PHYSICS, PHYSICS AS NATURE'S ECONOMICS (1989).

the preference provides an opportunity to think about how "we are what we tax"—the theme of this law review symposium. This topic allows us to use a specific legal rule as a point of departure to analyze bigger questions about the causes and consequences of epistemic shifts and economic transformations. In contrast to neoclassical economic theory, which generally assumes that capitalist relations and arrangements are "natural" and inevitable, a historical approach to the study of American capitalism in general, and the capital gains tax in particular, questions these assumptions. It interrogates critically what is frequently presumed to be an inexorable part of everyday life.[23]

I. 1920S BEGINNINGS

At the turn of the twentieth century, when the conceptual foundations of our current income tax system were first being debated, many of the details of our modern system of direct and progressive taxation were still relatively uncertain. Although the United States adopted an income tax during the Civil War and again in 1894, neither of those measures contained a preference for capital gains.[24] In fact, the 1894 tax was quickly struck down by the Supreme Court as unconstitutional in 1895.[25] The Court's decision triggered a social movement that eventually concluded with the ratification of the Sixteenth Amendment in 1913.[26] Thus, when Congress began considering a new income tax law in that same year, it was operating with a relatively blank slate. Eventually, the 1913 income tax established general parameters of relatively high exemption levels and moderately low rates, but lawmakers were cautious in burdening the new law with too many complicated distinctions.

Powerful lawmakers counseled that because the 1913 income tax was an innovation, it was wise to defer until later the creation of distinctions like differing rates for different types of income. "[L]ike any new tax law," Tennessee Congressman Cordell Hull, one of the chief architects of the income tax, noted, "it will be necessary for the people to become acquainted with the proposed law and for it to become adjusted to the country before extending its classifications, abatements, deductions, exemptions, and so forth."[27]

To be sure, some economic theorists and lawmakers had been advocating for specific classifications of income well before the income tax became law. Decades earlier, University of Michigan political economist Henry Carter Adams argued that a truly progressive tax system ought to segregate

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23. *See* Sven Beckert, *History of American Capitalism*, *in* AMERICAN HISTORY NOW 314, 315 (Eric Foner & Lisa McGirr eds., 2011).

24. Joseph A. Hill, *The Civil War Income Tax*, 8 Q.J. ECON. 416, 416 (1894); Charlotte Twight, *Evolution of Federal Income Tax Withholding: The Machinery of Institutional Change*, 14 CATO J. 359, 367 (1994).

25. Pollock v. Farmers' Loan & Tr. Co., 157 U.S. 429, 583–84 (1895).

26. *See* JOHN D. BUENKER, THE INCOME TAX AND THE PROGRESSIVE ERA 22–56 (Robert E. Burke & Frank Friedel eds., 1985).

27. 50 CONG. REC. 499, 508 (1913) (statement of Rep. Hull).

income based on its source.[28] Adams and others believed that labor income truly was "earned" from the sweat of the worker's brow, while income from capital represented the "unearned" returns from the accumulated wealth of the idle rich.[29] Accordingly, different sources of income ought to be taxed differently.

In fact, countries like England were already using a schedule-based income tax that made distinctions between different types of income.[30] Yet, as Congressman Hull explained, the United States was not quite yet ready for such sophisticated distinctions. "[W]hile the bill should contain the essential features of a modernized income-tax law," stated Hull, "no attempt should be made to write into it the comprehensive system of rates such as is found in other countries, like England."[31]

It did not take long, however, for the country to take on such a comprehensive system of rates. With the onset of World War I and U.S. participation in the conflict, marginal income tax rates quickly skyrocketed and exemption levels declined.[32] While the 1913 income tax affected only about 2 percent of households,[33] by 1919 at the height of the war, nearly 20 percent of American households paid income taxes. Meanwhile, World War I bond drives set in motion an increase in the number of American households that invested in financial securities.[34] As a result, the income tax and the sale of bonds both became dominant sources of wartime public revenues, and many more Americans became acquainted with a levy that was no longer so novel.

Although World War I tax laws introduced many complicated elements into the tax code, including steeply progressive marginal rates, there was no preference for capital gains.[35] That did not arise until soon after the war. Faced with a mild post-war recession, and prevailing high marginal rates, business leaders and economic commentators protested that the elevated wartime rates were no longer necessary. In fact, many argued that the wartime legacy of high rates was preventing a return to "normalcy" and "industrial prosperity."[36] A sharp but short-lived recession and growing labor and racial unrest compelled political leaders to search for ways to

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28. HENRY CARTER ADAMS, THE SCIENCE OF FINANCE: AN INVESTIGATION OF PUBLIC EXPENDITURES AND PUBLIC REVENUES 332–35 (1899).

29. *Id.*

30. *See* Meade Emory, *The Early English Income Tax: A Heritage for the Contemporary*, 9 AM. J. LEGAL HIST. 286, 295 (1965); *A Tax to Beat Napoleon*, NAT'L ARCHIVES: HM REVENUE & CUSTOMS, http://webarchive.nationalarchives.gov.uk/+/http:/www.hmrc.gov.uk/history/taxhis1.htm (last visited Apr. 29, 2016) [https://perma.cc/5T8B-NKZR].

31. *See supra* note 27.

32. War Revenue Act, § 2, 40 Stat. 300, 301 (1917).

33. AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877–1929, at 7 n.14 (2013).

34. JULIA C. OTT, WHEN WALL STREET MET MAIN STREET: THE QUEST FOR AN INVESTORS' DEMOCRACY 2 (2011).

35. STEVEN A. BANK, KIRK J. STARK & JOSEPH J. THORNDIKE, WAR AND TAXES 49–82 (2008).

36. 61 CONG. REC. 5135 (1921).

revive the economy and return the country to a sense of normality.[37] It was in this political and economic context that Congress first began considering a tax preference for capital gains.

When Congress began drafting and debating the first post-war tax bill, one of the dominant aims was to find ways to relieve taxpayers of high tax burdens while stimulating commercial activity. "The reduction of the tax burdens," noted the House Ways and Means Committee, "is essential to business recovery."[38] Some business and political leaders believed that with the end of the war, the federal government could disband the wartime tax state and return to a system of more regressive and indirect taxation. Indeed, some even called for the adoption of a national sales tax to replace the income tax.[39] Other groups, including organized farmers and laborers, contended that the success of the wartime revenue laws signaled the need to maintain and perhaps even strengthen the progressive income tax.[40] It was amidst this political contestation that lawmakers forged a compromise: retain the progressive income tax, albeit at much lower rates, and allow a preferential tax rate for capital gains.

Many lawmakers and business leaders believed that the high marginal tax rates were preventing individuals and businesses from selling appreciated investments. A taxpayer "would refrain from making a sale of land or other property constituting capital assets because he would have to pay so large a proportion to the Government," reported Congressman William R. Green.[41] "It would so increase his income taxes that he would not make the sale."[42] Fiscal conservatives, including the then-recently appointed Treasury Secretary Andrew Mellon, also complained that the high marginal income tax rates were encouraging wealthy taxpayers to avoid taxes by investing in tax-free municipal and state bonds.[43] These public investments, Mellon and others argued, starved private enterprise of funds and allowed subnational governments to indulge in extravagant public projects.[44]

The specific idea to separate investment gains from ordinary income seems to have originated with Fredrick R. Kellogg, a leading corporate lawyer. Testifying before Congress in 1920 and 1921, Kellogg appeared more the practical expert than the interest-group puppet, more moderate, more flexible, and, at times, even obsequious compared to the other, rather

37. *See* Kornhauser, *supra* note 21, at 871–73.

38. Steven A. Bank, *Tax, Corporate Goverance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1169 (2004) (citing H.R. 350 (1921)).

39. *See Excess Profits Tax or Sales Tax?*, N.Y. TIMES, May 30, 1920, at 1, http://query.nytimes.com/mem/archive-free/pdf?res=9C03E1DB143AEE32A25753C3A96 39C946195D6CF [https://perma.cc/89KS-RE6C]; *see also* MEHROTRA, *supra* note 33, at 376–83.

40. *See generally* ELISABETH S. CLEMENS, THE PEOPLE'S LOBBY: ORGANIZATIONAL INNOVATION AND THE RISE OF INTEREST GROUP POLITICS IN THE UNITED STATES, 1890–1925 (1997); ELIZABETH SANDERS, ROOTS OF REFORM: FARMERS, WORKERS, AND THE AMERICAN STATE, 1877–1917 (1999).

41. 61 CONG. REC. 5289 (1921) (statement of Rep. Green).

42. *Id.*

43. MEHROTRA, *supra* note 33, at 396–98.

44. *Id.*

strident witnesses. In his testimony, Kellogg shifted the subject from taxpayers to transactions.[45] He agreed that high rates yielded less revenue—a notion that *long* predates Arthur Laffer's infamous curve—but not because the wealthy sheltered their funds. Rather, *all* Americans refrained from transacting in the face of high income taxes.[46]

Kellogg supported his views with anecdotal examples of how numerous Americans from all walks of life were refraining from taking part in economically productive transactions because of high tax rates. At the 1921 hearings, legislators swapped stories with Kellogg, stories of frustrated and beleaguered individual investors: a homeowner who swallowed a loss when relocation forced him to move; a "thrifty" worker who might be compelled to sell his "little home" if laid off; a farmer unable to exit in response to the agricultural crisis because he could not afford the tax liability; and the stockholder who "would not sell at the top of the market because of this tax law" and then watched helplessly as share prices plummeted.[47]

Frustrated investors could be found in all classes. Aborted transactions robbed the Treasury of revenue. Taken together, these forsaken transactions pointed to a different diagnosis for the postwar recession. Capital had not been diverted, but "frozen." In Kellogg's model, the relative freedom of capital to flow in a "fluid" fashion in and out of different enterprises and to assume varied forms determined the state of the economy.[48] "There can be no question, I think, as to the harm," noted Kellogg, "during a period of enormous demand for fluid capital for many reconstruction purposes . . . money [is] enchained in existing forms of investment."[49] Kellogg's *single* capital market held in motion *all* assets.

In defending his proposal, Kellogg articulated many of the rationales that defenders of the capital gains preference would repeat down to the present day. Unless granted a preferential rate, Kellogg claimed, capital gains taxes unfairly burdened the average property owner, who might realize one large gain in his lifetime only to see it eaten up by the government when that windfall bumped him into a higher income tax bracket in the year of sale.[50] Income from capital gains also deserved preferential treatment because inflation reduced the *real* value of capital gains, even before taxes were paid.

To counter these potential disincentives, Congress adopted section 206 of the Revenue Act of 1921[51] (or "the 1921 Act")—the first iteration of the capital gains tax preference. The new provision limited the taxation of "net capital gains" to 12.5 percent, well below the top marginal rate of 65

45. *Internal-Revenue Hearings Before the S. Comm. on Finance on the Proposed Revenue Act of 1921*, 67th Cong. 534–54 (1921) (statement of Frederick R. Kellogg).
46. *Id.* at 537–38.
47. *Id.* at 545–51.
48. *Id.* at 551.
49. *Id.*
50. *Id.*
51. The Revenue Act of 1921, § 206(b), 42 Stat. 227, 233.

percent on ordinary income.[52] Influential leaders in the Treasury Department and Congress agreed that a lower tax rate on capital gains would not only unlock the existing impediment taxpayers felt, but would also potentially increase total tax revenue. The new provision, opined Congressman Green, "will reduce the rates in many instances which people will pay on sales of real estate and in some instances on sales of personal property that are capital assets, but it is quite certain that it will bring about sales which otherwise would not occur."[53] As a result, Green and others believed, total revenue would likely increase. "It has been the opinion of all of the experts of the Treasury," Green concluded, "that the ultimate working out of this would bring more revenue into the Treasury."[54]

By 1921, the receipt of "unearned" investment income no longer seemed as plutocratic as it once did. American political culture had long coupled property ownership and citizenship, but World War I bond drives expanded the concept of property to encompass financial securities and championed the ideal of a mass investment society. In contrast with Henry Carter Adams's day,[55] the receipt of "unearned" investment income no longer seemed as risk free, given postwar inflation, depression, plummeting stock prices, and the long-term sectoral shift away from agriculture.

Yet what is perhaps most interesting about the 1921 origins of the capital gains tax preference is how the present-day justifications for the tax benefit were also there at its beginnings. Arguments about "unlocking" the free flow of capital were the dominant rationale, just as they are today. Likewise, levying a lower rate to compensate for the unfair "bunching" of income that had occurred over the course of many years was articulated back in the 1920s and also is used today. Such is the case with claims about inflation eroding nominal capital gains. And so too is the notion that it is not only wealthy elites, but all property-owning Americans, who suffer from high tax rates on the gains from the sale of capital assets.

The 1921 Revenue Act enacted the first capital gains tax preference, but it was the 1924 law that explicitly revived a distinction between "earned" and "unearned" income.[56] Back in the late nineteenth century, economic theorists like Henry Carter Adams questioned whether different types of income ought to be taxed differently. In his pioneering 1898 public finance treatise, Adams explained why he believed that all sources of income were not the same: "[T]he difficulty of obtaining the correct statement of income," wrote Adams, was aggravated by "the great variety of forms in which incomes exist."[57] During a simpler age, lawmakers could be more confident that "incomes [sh]ould be homogeneous" and that a given tax would lead to "the same treatment applicable to all."[58] But in the more

52. *Id.* at 233–37.
53. 61 CONG. REC. 5289 (1921) (statement of Rep. Green).
54. *Id.*
55. *See infra* notes 56–61 and accompanying text.
56. Revenue Act of 1924, Pub. L. No. 68-176, § 246(b)(5), 43 Stat. 253, 291.
57. *See generally* ADAMS, *supra* note 28, at 357.
58. *Id.*

modern age of industrial capitalism, "in society as it exists," wrote Adams in 1898, "incomes are not homogeneous. They do not reflect the same industrial conditions or measure with accuracy the energy expended to secure them."[59]

Adams elaborated on the distinct types of income. A cleavage existed for him between "[i]ncome from service[s]," by which he meant "wages, salaries, professional fees," and "income[] from property," which included the returns from capital investments.[60] For Adams, each income source was accompanied by different economic and social conditions and hence entailed different tax treatment. Because income from services (e.g., wages and salaries) was "both terminal and uncertain," while income from property (e.g., interest, dividends, and capital gains) is "by comparison considered as perpetual and certain," the difference warranted "a distinction in the law of taxation by which income from property is rated higher than income from effort."[61]

Although Adams's ideas did not initially gain traction as part of the 1913 income tax, it did not take long for some prominent policymakers to take notice. By the time Congress began considering a new tax bill in 1924, the economy seemed to be back on track, and Republicans had securely seized the powers of national lawmaking. This seemed to be an odd time for lawmakers to consider a tax preference for "earned income." Yet that is precisely what occurred. Secretary Mellon, one of the richest men in the world, began to popularize the idea of a lower tax rate for wages and salary income—of course, he knew full well that given existing exemption levels, it was not the everyday worker, but rather elite professionals who would benefit from such a preference for labor income.

In his highly popular and influential 1921 book, *Taxation: The People's Business*,[62] Mellon made the economic case for the tax preference for labor income. "The fairness of taxing more lightly incomes from wages, salaries and professional services than the incomes from business or from investments is beyond question," wrote Mellon.[63] Labor income "is uncertain and limited in duration; sickness or death destroys it and old age diminishes it."[64] By contrast, for the capitalist, "the source of income continues; the income may be disposed of during a man's life and it descends to his heirs."[65] Because the tax code already had provided a lower rate for capital gains, it was only fair, or so the argument was made, that a tax benefit also be granted to labor income.

Mellon's calls for an "earned" income tax preference soon became enacted as part of the 1924 revenue law.[66] The first $10,000 of income

59. *Id.*
60. *Id.*
61. *Id.* at 357–58.
62. ANDREW W. MELLON, TAXATION: THE PEOPLE'S BUSINESS (1924).
63. *Id.* at 56–57.
64. *Id.* at 57.
65. *Id.*
66. Revenue Act of 1924, Pub. L. No. 68-176, § 209, 43 Stat. 253, 263.

above exemptions levels was eligible to be categorized as earned income entitled to the lower tax rate of 12.5 percent.[67] Although the legislative history apparently was not as rich as it was for the 1921 Act and its adoption of the capital gains preference, economic commentators noted the significance of the new tax benefit for earned income. Writing in the *American Economic Review*, University of Minnesota political economist Roy Blakey acknowledged that this new tax benefit was a true innovation.[68] "Previous federal revenue acts made no differentiation in favor of 'earned' income," wrote Blakey.[69]

Yet Blakey also underscored that because the income tax as a whole was still an elite tax that affected only the country's wealthiest earners, the tax benefit was rather limited. "Though differentiation in favor or 'earned' income is desirable," wrote Blakey, "it would be much more important if exemptions were lower."[70] Blakey elaborated on the broader context of the existing U.S. tax system to illustrate that there were other areas where differentiation was occurring, including state and local property taxes, estate and inheritance taxes, and federal excise taxes.[71]

By the time the 1920s came to a close, the capital gains tax preference seemed to be securely ensconced in the Internal Revenue Code. Although there were still several business leaders who wanted to abolish all capital gains from the income tax base, there were relatively few who believed that capital gains ought to be taxed at the same rate as ordinary income. Indeed, if anything, there were some commentators who wanted to tax all sources of income, including labor income, as little as possible.[72]

Arguments about the need for capital mobility and fairness seemed to win the day. The preference was required not only to mitigate against the "lock-in" effect of holding appreciated investment assets, but also because the "bunching" of income over time meant that a onetime gain at sale or disposition exaggerated the tax liability. Equally compelling was the argument that inflation was overstating the real economic gain that came from holding and selling capital assets. Thus, from its beginnings, the capital gains tax preference has been undergirded by a variety of rationales and justifications—many of which are still made today.[73]

Yet many of these claims turned on empirical assumptions that were often difficult to sustain. For example, it was always presumed—without

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67. *See id.*

68. *See* Roy G. Blakey, *The Revenue Act of 1924*, 14 AM. ECON. REV. 475 (1924).

69. *Id.* at 476.

70. *Id.* at 499.

71. *Id.*

72. *See, e.g.*, EDWIN AMENTA, BOLD RELIEF: INSTITUTIONAL POLITICS AND THE ORIGINS OF MODERN AMERICAN SOCIAL POLICY 68 (Ira Katznelson et al. eds., 1998); Roy G. Blakey & Gladys C. Blakey, *Founders and Builders of the Income Tax*, 18 TAXES: TAX MAG. 271, 271 (1940); Lawrence Zelenak, *Tearing Out the Income Tax by the (Grass)Roots*, 15 FLA. TAX REV. 649, 651 (2014).

73. *See, e.g.*, WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 695 (15th ed. 2009); WILLIAM D. POPKIN, INTRODUCTION TO TAXATION § 3.04 (5th ed. 2008); Cunningham & Schenk, *supra* note 20.

much objective evidence—that the lower tax rate on capital gains led to greater tax revenue from the increased sale of capital assets. Similarly, business leaders like Kellogg were convinced that the preference could help all everyday property owners, not just the wealthy who owned most of the country's capital assets at the time. Finally, the juxtaposition of a tax preference for capital gains alongside a somewhat similar benefit for "earned" or labor income suggested that neither lawmakers nor economic experts were quite clear about which source of income—capital or labor—would be more responsive to changing tax rates.

The practical uncertainties did not, however, prevent advocates of the capital gains tax preference from continuing their support. As the country faced a new economic crisis in the 1930s, the voices for capital continued to press the case for a capital gains tax preference. And this time they blamed the crisis itself on the inability of capital to flow freely. President Roosevelt and his New Deal responded to the Great Depression in a variety of ways, including using the tax code as an occasional cudgel against the rich and wealthy "economic royalists."[74]

II. THE GREAT DEPRESSION AND THE NEW DEAL ORDER

When tax receipts plummeted during the Great Depression, Congress raised rates on top incomes and capital gains. In 1933, Senate hearings led by the fiery prosecutor Ferdinand Pecora revealed that some of the wealthiest Americans had avoided paying any income tax by deducting their capital losses against their ordinary income.[75] Among those who faced Pecora's wrath, no one was more famous than John Peirpont Morgan, Jr. Pecora revealed how the losses sustained by Morgan and his partners due to the market crash wiped out all of their income tax liability in 1931 and 1932.[76] Because lawmakers presumed that the rich traded more frequently, the Revenue Act of 1934 raised rates on capital gains for short-term investments, along with rates on the highest earned incomes.

Recently routed in its efforts to defeat New Deal securities regulation, the NYSE—the self-proclaimed "Citadel of Conservatism"—rallied for a new fight: the elimination of the capital gains tax. NYSE president Richard

74. ALAN BRINKLEY, THE END OF REFORM: NEW DEAL LIBERALISM IN RECESSION AND WAR 7, 178, 183 (1995); *see* Revenue Act of 1937, Pub. L. No. 75-377, ch. 815, 50 Stat. 813, 813 ("A[n act t]o provide revenue, equalize taxation, prevent tax evasion and avoidance, and for other purposes."); Revenue Act of 1936, Pub. L. No. 74-740, § 14, 49 Stat. 1648, 1655 (imposing a new tax on undistributed profits); Revenue Act of 1935, Pub. L. No. 74-407, § 101, 49 Stat. 1014, 1014 (raising statutory rates and introducing the "wealth tax").

75. *See Stock Exchange Practices: Hearings Before the Comm. on Banking and Currency*, 73d Cong. 879 (1933) (statement of J.P. Morgan & Co.) ("In the years 1930, 1931, and 1932 our capital losses (deductible under the law, just as previously the profits had been added) were such as more than to wipe out our income, and leave nothing taxable. Income taxes are after all payable upon income and not upon deficits."); RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 366 (1990).

76. *Stock Exchange Practices: Hearings Before the Comm. on Banking and Currency*, 73d Cong. 879 (statement of J.P. Morgan & Co.).

Whitney blamed the Great Depression on the very existence of a capital gains tax. Together with the National Industrial Recovery Act[77] and the National Labor Relations Act,[78] capital gains taxes now presented the chief impediments to economic recovery. Whitney emphatically stated that recovery must come in the future as it came in the past: through the work of private enterprises, the intelligence of their management, and the courage of private capital when it is incentivized by tax preferences.[79]

Whitney used the word "incentives" in a novel manner. Earlier in the twentieth century, scientific managers and behavioral psychologists had used incentive to refer to a prompt or nudge, deliberately designed by an expert to elicit a desired behavioral response from an individual when the status quo circumstances—instinct, habit, or even the market—would tend toward a decision or an outcome that the expert deemed undesirable for that individual and/or for society at large.[80] The meaning of incentive moved much closer to present-day usage in the Exchange's challenge to capital gains taxation. No expert need decide what was best for capital, or the best use of capital. The notion of "incentives" articulated by NYSE leaders lacked the coercive or paternalistic aspect of progressives' usage. Portrayed as individual investors of modest means, capital voiced its preferred incentive through NYSE spokesmen—or so they claimed.

Reduction or elimination of capital gains taxes would spur investors to trade, the NYSE maintained, setting in motion the "circulation" of "frozen" or "stagnant" capital. This incentive would *harness*, not circumvent, the innate American instinct of entrepreneurialism. More trading meant more investment, more new businesses, more innovation, more and better and cheaper goods and services, more jobs, more productivity, less inflation, and more growth. Ultimately, the Exchange spokesmen promised, the Treasury would collect more revenue from the larger economy.[81]

More gains for the investor meant more revenue for the government. But "incentives" insinuated something more than just an even exchange. "Incentives" now hinted at variable, potentially unlimited upsides for all parties, similar to its neoliberal usage (think stock-based compensation a.k.a "incentive pay"). The characterization of capital gains tax reductions as something like a Pareto-optimal trade disguised the policy's likely effects: the upward redistribution of wealth, the enhancement of the economic freedom for some, and the concealment of structural constraints experienced by others.

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77. Pub. L. No. 67-73, § 1, 48 Stat. 195, 195 (1933).

78. *See generally* National Labor Relations Act of 1935, Pub. L. No. 74-198, § 1, 49 Stat. 449, 449 (codified at 29 U.S.C. §§ 151–169 (2012)).

79. Richard Whitney, NYSE President, Address at the 53rd Annual Dinner of the Engineers' Society of Western Pennsylvania: Elements of Recovery 285 (Feb. 26, 1935) (on file with the NYSE archives).

80. *See* RUTH W. GRANT, STRINGS ATTACHED: UNTANGLING THE ETHICS OF INCENTIVES 17–18 (2012).

81. *Schram for Revision of Capital Gains Tax; Says It Tends to Depress Stock Quotations*, N.Y. TIMES, Nov. 28, 1941, at 38.

The NYSE's decades-long campaign against capital gains taxes forged a new meaning for "incentive"—a model of human motivation much closer to the one with which we live today. The Exchange reconciled "incentives" with "markets," as in present neoliberal usage, where incentives prompt individuals to enter markets to secure optimal outcomes for themselves and for society at large (think the 401(k) match). The new meaning of "incentives" would provide the core principle for supply-side marginal tax cuts.[82] "Incentives" spilled out of the arena of tax policy into debates over social policy, environmental policy, educational policy, and more.[83] Today incentives appear everywhere as an obvious, noncoercive method for eliciting desired behaviors.[84]

As we have seen, the Exchange integrated its demand for the reduction or removal of capital gains taxes into a broader rejection of the still-evolving tenets of the New Deal. The Exchange reasserted its pro-investment theory of political economy, which dated back to Woodrow Wilson's election. The Exchange's ideology of "shareholder democracy" included three core tenets[85]: First, broad-based share ownership reconciled democracy and industrial capitalism. Second, shareholders' interests warranted prioritization by lawmakers and by corporate managers. Third, economic resources and risk were best distributed when securitized (i.e., turned into stocks and bonds) and traded on privately administered markets, unhampered by taxation or state-based regulation.[86]

The double-dip "Roosevelt Recession" that hit in 1937 prodded new audiences to entertain the NYSE's pro-investment theories and its tax policy recommendations. The U.S. Chamber of Commerce and economist Irving Fisher took up the cause of capital gains tax and the language of incentives. Invitations poured into Exchange leaders' offices from a wide range of business associations, particularly ones located in the South and West. NYSE president Charles Gay warned them that stimulating consumers' income ahead of productive facilities—as proto-Keynesians close to the President had advised—would not produce or maintain prosperity.[87] Instead, enterprises needed new and enlarged "productive facilities."[88] That would require businesses to raise "new capital . . . through the issuance of stock and bonds."[89] And *that*, in turn, required the NYSE to maintain "a continuously liquid security market,"

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82. *See id.*

83. *See id.*

84. *See, e.g.*, RICHARD B. MCKENZIE & DWIGHT R. LEE, MANAGING THROUGH INCENTIVES: HOW TO DEVELOP A MORE COLLABORATIVE, PRODUCTIVE, AND PROFITABLE ORGANIZATION, at viii (1998) ("Incentives do more than provide worker drive, however. When they become part and parcel of the firm's policy structure, they are also an important means of communicating the firm's mission and most valued goals and objectives.").

85. OTT, *supra* note 34, at 216.

86. *Id.*

87. Charles Gay, Capital Markets and Business Recovery, Address at the Illinois Manufacturers' Association (Apr. 27, 1937) (on file with the NYSE archives).

88. *Id.*

89. *Id.*

which it could not do until the "deadening hand" of capital gains taxation released its grasp.[90]

In Congress, some southern Democrats came to the table with northern Republicans to listen more closely to opponents of the capital gains tax. In November 1937, the House Ways and Means Committee took up a bill to abolish taxes on capital gains. President Roosevelt threatened a veto.[91] "Desirable as it is to foster business recovery," the President scolded, "we should not do so by creating injustices in the tax system, particularly injustices at the expense of the man who earns his income—injustices to the advantage of the man who does not."[92] Senator Vanderberg (R-MI) responded, "I shall not yield to the President's demand for a tax on thrift and prudence, which is at least partially responsible for today's chaos. I prefer the route which leads to recovery as chartered by Senate Democrats and Republicans alike,"[93] i.e., the abolition of capital gains taxes recommended by the NYSE. Vanderberg and coauthor Senator Josiah W. Bailey (D-NC) released their "Conservative Manifesto" a mere month later.[94] Business organizations, including NYSE brokerages, circulated two million copies. The reduction of capital gains taxes stood at the top of their list of demands.

With the Revenue Act of 1938,[95] the tax code's preference for unearned income actually *increased* in the midst of the Great Depression. In the decades that followed, both the NYSE and southern Democrats pushed for further capital gains tax relief (in 1953, for example, Congressman Hale Boggs introduced a capital gains tax reduction bill named "the Revenue Incentives Act"[96]). The top maximum rate of taxation on capital gains bottomed out in 1942 at 25 percent—where it would remain until 1967 (efforts were made to reduce it even further)—even as taxes on ordinary (earned) income rose to 91 percent for the top bracket.[97] Remarkably, the capital gains preference *widened* during a period marked by rising real wages and diminishing inequality.

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90. *Id.*

91. *See Roosevelt Asks Profits Tax Be Retained in Bill*, SARASOTA HERALD, Apr. 14, 1938, at 1 [hereinafter HERALD], https://news.google.com/newspapers?nid=1787&dat=19380414&id=pyAhAAAAIBAJ&sjid=hmQEAAAAIBAJ&pg=5467,1121839&hl=en [https://perma.cc/9WUD-Q8BG]; *see also* H.R. 8471, 75th Cong. (2d Sess. 1937).

92. HERALD, *supra* note 91, at 2.

93. *Roosevelt Letter on Profits and Gains Taxes Irks Congress*, WALL STREET J., Apr. 14, 1938, at 14.

94. *See* John Robert Moore, *Senator Josiah W. Bailey and the "Conservative Manifesto" of 1937*, 31 J. S. HIST. 21, 32 (1965). The *New York Times* published the full text of the Manifesto the day after syndicated columnists Joseph Alsop and Robert E. Kintner published isolated portions of it. *See* Turner Catledge, *10 Points Drafted: Attempt Made to Unite All Conservatives and Moderates on Plan*, N.Y. TIMES, Dec. 16, 1937, at 1.

95. *See generally* Revenue Act of 1938, Pub. L. No. 75-554, § 1, 52 Stat. 447.

96. Revenue Incentives Act of 1953, H.R. 3686, 83d Cong. (1st sess. 1953).

97. *See* Revenue Act of 1942, Pub. L. No. 77-753, § 150, 56 Stat. 798, 843 (establishing a 25 percent capital gains tax rate). *See generally* Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906; CITIZENS FOR TAX JUSTICE, TOP FEDERAL INCOME TAX RATES SINCE 1913 (2011), http://www.ctj.org/pdf/regcg.pdf (describing federal rates since 1913) [https://perma.cc/L2EP-CD2K].

World War II sparked fierce debate over federal taxation. Congress transformed the income tax into a mass tax and raised marginal rates on earned—or what we would call today, ordinary—income. But the Revenue Act of 1942[98] (introduced by Rep. Patrick Boland, D-PA) *simultaneously* lowered taxes on capital gains in an effort to encourage private capital to invest in economic activity that could support the war effort. Lawmakers adopted the logic of the NYSE, expressed here by President Emil Schram, the former Chairman of the Reconstruction Finance Corporation:

> [L]owering of the capital gains tax will free equity capital, and by so doing will not only help to shift a portion of the financing of the defense effort from government to private capital but also to increase the revenue derived from the capital gains tax itself.[99]

At the time, rates destroyed incentives and rendered "venture capital impotent,"[100] Schram surmised, introducing another neoliberal keyword into American political discourse. Testifying in favor of the Boland bill, leaders of the American Taxpayer's Association and the U.S. Chamber of Commerce echoed Schram's sentiments and adopted the Exchange's language of incentives, diminishing returns, and venture capital.[101]

The nation's need to maximize production for an unprecedented global war gave rise to new experiments in government ownership of plant and infrastructure, much to the distress of many business and financial leaders. War bond speeches delivered and broadcast by NYSE representatives stressed the importance of preserving "our American way of life, which revolves around the system of initiative and enterprise" after the war.[102] Most alarming was the significance of the socialist trend represented by the $10 billion of property used for war production that was operated by private corporations but owned by the federal government through the Defense Plant Corporation[103] (DPC).

NYSE president Emil Schram articulated a postwar economic reconversion plan that included the privatization of all DPC facilities, as well as steep tax reductions. Taken together, the two reforms would provide private enterprise with the required incentives to ramp up both production and employment, rendering full employment legislation

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98. *See generally* Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798.

99. *Schram Asks Cut in Capital Gain Tax*, N.Y. TIMES, Mar. 20, 1942, at 1.

100. *Text of Emil Schram's Statement on Capital Gains Before Senate Group*, WALL STREET J., Aug. 8, 1942, at 3.

101. Statement of Emil Schram Before the Ways and Means Committee (Mar. 20, 1942) (on file with NYSE archives).

102. Emil Schram, President, N.Y. Stock Exch., America's Ability to Bear War Debt: Preserve Our System of Private Enterprise, Address Before the Nashville, Tenn., Chamber of Commerce (Apr. 13, 1942), http://www.ibiblio.org/pha/policy/1942/1942-04-13b.html [https://perma.cc/S43D-8DC7].

103. Emil Schram, Address at the San Francisco Chamber of Commerce: Postwar Horizons (1943) (on file with the NYSE archives); Emil Schram, Informal Off-the-Record Remarks at the Connecticut Newcomen Dinner (June 9, 1943) (on file with the NYSE archives); Emil Schram, Untitled Speeches (1943) (on file with the NYSE archives).

unnecessary.[104] Stumping for southern Democrats like Texas Congressman Hatton Summers—who led opposition to President Roosevelt's plan to "pack" the Supreme Court back in 1937—Schram sought to educate the audience on the capital gain tax's destructive effects on venture capital.[105] Schram also advised against the prospect of new taxes to support social programs, warning that Americans were learning to depend too much on Washington.[106]

Launching an institutional advertising campaign in 1946, the NYSE sought to educate the public on the key "requirements" for postwar economic reconversion and recovery. The Exchange understood the ongoing battle to preserve—and even expand—the capital gains preference as just one front in its larger war against the "regimented form of security" that was introduced by the New Deal and that threatened to extend its reach after the war.[107]

CONCLUSION

By the end of World War II, the capital gains tax preference had become an entrenched part of the Internal Revenue Code. Although the detailed mechanics of the provision continued to change throughout the century, with the preference even disappearing for a short time in the late 1980s, the concept of taxing gains from the sale of capital assets at a lower rate seemed to have become a natural and accepted part of U.S. tax law. Consequently, the preference has taken on an air of economic determinacy and logical inevitability.

The persistence and durability of the capital gains tax preference, however, is not the result of any inexorable or transhistorical logic. Rather, the origins and early development of the preference are rooted in changing social, political, and economic contexts. Adopted soon after World War I, when marginal tax rates were at historic highs, the preference initially was justified as a necessary incentive for the free flow of capital and as a fair way to tax gains that had accumulated over time.

Still, even then, economic experts and policymakers were not convinced that investment returns were the only type of income responsive to changing tax rates. For soon after the preference was enacted, Congress also created a lower tax rate for labor income. The simultaneous existence of these two tax preferences suggests that there is hardly anything natural,

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104. Emil Schram, Lunch Address Before the Advertising Club of Baltimore (July 11, 1945) (on file with the NYSE archives); *see also* Godfrey N. Nelson, *Eccles' Proposal for Tax Discussed*, N.Y. TIMES, Mar. 25, 1945, at 5(1).

105. Emil Schram, Address at the Annual Dinner of the Houston, TX Chamber of Commerce (Dec. 18, 1946) [hereinafter Schram, Annual Dinner Speech] (on file with the NYSE archives); *see also* Former NYSE Chairman of the Board Robert P. Boylan's Endorsement for Senator Robert L. Doughton (D-GA), Remarks Before a Joint Meeting of the Atlanta Chamber of Commerce and the Association of Stock Exchange Firms (Feb. 13, 1948) (on file with the NYSE archives).

106. *See* Schram, Annual Dinner Speech, *supra* note 105.

107. Emil Schram, Address Before the Rotary Club of Tampa (Feb. 5, 1946) (on file with the NYSE archives).

neutral, or necessary about the capital gains tax preference. Indeed, the enactment of a tax preference for labor income, however fleeting, suggests a fiscal path not taken—one that illuminates the contingency of current policy and the possibilities for variation and reform.

A critical history of the capital gains tax preference also demonstrates how economic and political elites have framed the supposedly widespread benefits of the preference. Using a new idiom of "incentives" and "venture capital," economic leaders in the 1930s depicted the capital gains tax preference as something that is available and enjoyed by all property owners across the socioeconomic spectrum, when empirically it was the wealthy elite who owned most of the country's capital assets. Similarly, lawmakers and policy analysts also deployed the language and logic of neoclassical economics to suggest the potential long-term benefits of tax cuts. Many advocates of the capital gains tax preference have contended that lower tax rates on capital gains would always and everywhere lead to increased tax revenue, even though there was little objective, empirical evidence to support that theory.

Ultimately, this story about the origins and early development of the capital gains tax preference is intended to provide a historical glimpse at tax law and policy that often is analyzed in ahistorical terms. For a symposium focused on "we are what we tax," an examination of the curious beginnings of the capital gains tax preference can teach us a great deal about how a seemingly innocuous tax provision—one that frequently has been assumed to be an organic and preordained part of our tax code—reflects changing conceptions of risk, wealth, and opportunity in the United States.