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STATE FINANCE IN THE GREAT DEPRESSION

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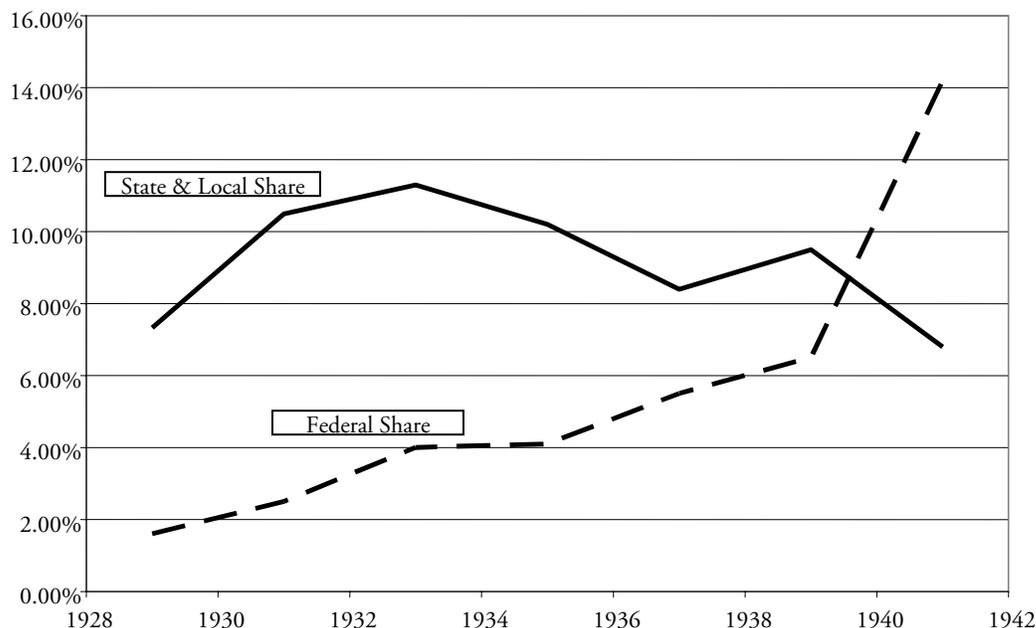
States and the Federal Government at the Beginning of the Depression

The Great Depression of the early 1930s was the most severe shock the American economy has suffered in the past century. After a period of unprecedented prosperity in the late 1920s, the stock market crash of 1929-1930 signaled the beginning of a disastrous depression. U.S. gross domestic product fell by 46 percent from 1929 to its low point in 1933. Prices fell sharply to about 72 percent of their 1929 level.¹ Unemployment soared from under 4 percent of the workforce in 1929 to 25 percent in 1933, and remained in double-digits until 1941, when it fell to 9.9 percent.²

These events brought an unprecedented response from government. For the first time in American history, the federal government exerted itself to stimulate the economy, beginning in the Hoover administration (1929-1933) and continuing in the first two Roosevelt administrations (1933-1941) until substantially increased defense spending from 1941 on replaced stimulative efforts. The Roosevelt years are notable for banking and financial reforms and the monetary inflation that led to the beginnings of recovery in 1934. Probably for most Americans of the time, the Roosevelt efforts to assist agriculture, create employment, and address the miseries of the unemployed were more evident.

Federal domestic activity had increased in the first quarter of the 20th century, but even so in 1929 the federal government had an almost unimaginably small economic presence in the United States. As shown in figure 1, federal spending composed 1.6 percent of gross domestic product in 1929 (as opposed to more than 19 percent in 2008). State and local government spending was several times larger before the Depression, and remained larger until 1941.

Figure 1. State-Local and Federal Shares of GDP, 1929 - 1941



Despite the disparity, state governments before the 1930s had a relatively small imprint on American life. Before the Depression hit, they functioned as much as highway departments as anything. In 1927, 30 percent of their general revenue came from motor fuel and vehicle licensing taxes, and 36 percent of their spending was for highway construction—a higher share than now goes for K-12 education. States at the time provided some funding for public universities and colleges, and a small amount of aid to local governments for elementary and secondary education. For health, hospitals, corrections, welfare and public assistance combined, including aid to local governments for those purposes, states spent less than half as much as they did on highways.³

Domestic spending (except for highway construction) in pre-depression days was a responsibility of local governments. Their budgets in the late 1920s were more than three times as great as those of the states and substantially larger than federal spending. More than half their spending was for public education and highways, with police, fire protection and utilities making up most of the rest. Health and welfare spending made up less than 5 percent of local government budgets in 1927.

The Crisis of Depression Finance

The Depression almost immediately hit state and local revenues. In 1927, two-thirds of all state and local government revenue came from property taxes: 20 percent of state revenue and 82 percent of local government revenue. For states, the only comparable revenue source was the motor fuel tax. Local governments had no other significant source. The property tax had been a fertile source of revenue growth in the mid and late 1920s, averaging close to 9 percent a year growth from 1922 to 1927.

Depression economics reversed the growth. After the Depression began, local government property tax collections did not again reach the 1927 level until 1944. For states, it took until 1952 to reach the 1927 level, although in the interval, states had reduced their reliance upon the tax.

Across the country, property tax assessments fell continuously from 1929 through 1936, and then began to grow slowly. For the 50 states and the District of Columbia, the total fell from \$167.6 billion in 1929 to a low of \$136.2 billion in 1936, almost a 20 percent drop. In some states, the collapse of property values was sharper; assessments fell nearly 50 percent in Arizona by 1936, and in Illinois by 40 percent.⁴ Whether or not the assessment changes reflected real change in values, they certainly affected property tax collections. Similarly, the economic hardships that followed collapsing farm prices and high industrial unemployment reduced taxpayers' ability to pay property taxes.

Consequently, property tax collections fell for state and local governments. State collections in 1932 were 11 percent below the 1927 level, and fell another 30 percent over the next four years. Local tax collections fell less abruptly, but were 13 percent below the mark of 1927 in 1934.⁵ State collections fell more sharply because of their base in corporate and utility property.

Initially, the state and local government response was to continue spending at approximately the level of previous years, with shortfalls financed by a small increase in federal aid to the states, continued growth in motor fuel and vehicle taxes, and borrowing. In 1932, gross revenues and spending were similar in amount and purpose to what they had been in 1927 for both state and local governments. The relatively slight decline in local government property taxes to that point made it possible for much of state and local government to continue the spending patterns of the turn of the decade.

However, rapid growth in unemployment posed new demands for public assistance that state and local government were institutionally and financially unprepared to meet. In 1927, the states' direct spending on public welfare (then known as "relief") was \$40 million, about 3 percent of their general spending, and local governments spent \$111 million, less than 2 percent of general expenditure. These figures reflect the facts of the era: assistance to low income people and the destitute was not a governmental priority and was primarily a matter of private charity. Simultaneous agricultural and urban industrial crises of unemployment soon overwhelmed both private and public sources of public assistance.

Federal Unemployment Relief and Its Effect on State Finance

State and local governments increased spending on public assistance programs during the Hoover administration (1929-1933). State spending grew to \$74 million in 1932, and local spending more than tripled from 1927 to 1932, rising to \$370 million, nearly 6 percent of general spending. Such efforts were insufficient. Because of their inadequacy, an early initiative of the Roosevelt administration was enactment of the Federal Emergency Relief Act (FERA) in May 1933. The act provided for \$500 million in grants to state governments,

"to aid in meeting the costs of furnishing relief and work relief and in relieving the hardship and suffering caused by unemployment in the form of money, service, materials, and/or commodities to provide the necessities of life to persons in need as a result of the present emergency, and/or to their dependents, whether resident, transient, or homeless."⁶

Half of the funding was provided as matching grants, with states to be reimbursed for state and local expenditures for the purposes listed at the rate of one federal dollar for each three state and local dollars spent. The other half was available to states basically as competitive grants available when governors certified that the federal, state and local money provided by their own efforts and the matching grants was inadequate to meet the goals of the act. In effect through the end of 1924 (when other programs replaced it), FERA eventually provided \$3.1 billion in direct aid to state governments, much of which states used to replace failing local relief programs.⁷

The availability of federal aid tied to a matching requirement dramatized the inadequacy of existing state and local government revenue systems. Local governments' property tax collections fell 13 percent from 1927 to 1934. State governments' total revenues held up somewhat better, but only because of buoyant growth in motor fuel taxes and vehicle-related charges, which often were tied to highway expenditures and not available for general purposes. State property tax collections fell even more sharply than local collections did, linked as they were to the value of corporate franchises and public-utility property.

Changes in State Revenue Policy

Expenditure demands on the one side and stress upon the existing tax system on the other induced a striking change in state finances from 1933 to 1940. State governments grew in absolute size. States adopted new general sales, personal income, alcohol, tobacco and other taxes to supplement and eventually supplant the state property tax.⁸

Measured in dollars of the time, state government spending grew by more than two and half times from 1927 to 1940. This measure underestimates the actual growth, because of the deflationary price structure of the time—prices in 1934 fell to 72 percent of the price level of 1927 and had reached only 80 percent of the 1927 level by 1940.⁹ Some of the expenditure growth was due to federal aid to the states, which grew from around \$100 million in 1927, mostly for highway finance, to nearly \$1 billion in 1934 before falling to two-thirds that amount by 1940. Most of the growth was financed by states' finding new sources of revenue. Revenue raised from state sources increased 250 percent from 1927 to 1940 because of the widespread adoption of taxes that had been insignificant or nonexistent before 1930.

States as a group revolutionized their tax systems in the 1930s, laying the foundation of the system of state and local government finance that exists in the 21st century.

Creation of general sales taxes. In terms of revenue, the most significant change was the adoption of state general sales taxes on a model similar to what exists in the 21st century. Mississippi enacted the first modern general sales tax in 1930. No revenue innovation has been greeted so enthusiastically by state legislatures. Twenty-one more states and the Territory of Hawaii adopted the sales tax by 1940, with 12 of them doing so in 1933 alone. Set at very low rates and based on a rough notion of ability-to-pay, the tax became a significant factor in financing the states that adopted it. Those tended in the 1930s to be the hard-hit Southern and Western states. The new sales tax did not find favor in the more populous, industrialized states until much later, and as a result sales tax collections for the 50 states did not even match those for motor fuel taxes until the mid-1940s.

New alcoholic beverage and tobacco taxes. Cigarette taxes were a rarity in the states before the 1930s (cigarettes themselves were a novelty in the 1920s) and taxes on other tobacco products were light. Twenty states created cigarette taxes in the 1930s, a number of them states that had not yet adopted a general sales tax. A bigger boost to state revenues came from the repeal of Prohibition in 1933. By 1939, all 48 states and Hawaii had either imposed excise taxes on distilled spirits or created systems of state-owned liquor stores. By 1940, tobacco and liquor taxes combined were a bigger source of state revenue than personal income taxes and amounted to about 60 percent of general sales tax collections.

Personal income taxes. Before 1930, state personal income taxes were a minor feature of state finance, although they existed in some form in 14 states and Hawaii. They were imposed mainly upon very high incomes at very low rates, and in 1927 produced less than 4 percent of state revenue collections. From 1930 through 1939, 16 additional states adopted personal income taxes. Most of the new adoptions were in agricultural states, where the personal income tax was seen as a means to shift some of the state tax burden from impoverished farmers to the relatively wealthy. This wave of adoptions did not significantly change state

revenue collections. Personal income tax collections rose only to 5.6 percent of total state tax collections by 1940.

Corporation income tax. States that adopted personal income taxes in the 1930s tended to adopt a corporation income tax at the same time if they did not already have one on the books. These business taxes had been somewhat more widespread than personal income taxes before 1930 (a number of states adopted them in the 1920s) and before the Depression were a larger source of state revenue than personal income taxes. They were not a promising source of revenue in the 1930s, as corporate profits fell, but were necessary to prevent individuals from incorporating themselves for tax avoidance purposes.

The chain-store tax. A 1930s phenomenon of the Midwest and South was the chain-store tax, now an historical curiosity. The years after the First World War brought a revolution in retailing in which national corporations established local retail outlets—J.C. Penny, Woolworth's, Walgreens, and Sears remain familiar names. The now-forgotten A&P was a grocery chain that had almost 16,000 stores in 1930. To preserve locally-owned stores, placate Main Street merchants and raise a little revenue, Midwestern and Southern states enacted special taxes on the proliferation of retail outlets under one name from the 1920s into the late 1930s. Original efforts were declared unconstitutional under the Commerce Clause, but in 1930 Indiana found a formula that satisfied the Supreme Court. By 1939, 20 states had enacted what could be considered either taxes or licensing fees on such chains.¹⁰ The chain-store tax serves as a reminder that although state revenue systems were beginning to look like modern systems in the 1930s, they retained characteristics of their time and place.

Table 1 makes the last point clear. The sales and income taxes that now provide around two-thirds of state general revenue remained distinctly minor players at the end of the Depression. The 1930s laid the foundation of the modern state revenue system, but not much more than a foundation.

Table 1. Sources of State General Revenue in 1927 and 1940*¹¹
Millions of Dollars.

| | 1927 | 1940 |
|------------------------|----------------|----------------|
| <i>Total Amount</i> | <i>\$1,827</i> | <i>\$3,657</i> |
| Personal Income Tax | 3.8% | 5.8% |
| Corporate Income Tax | 5.0% | 4.2% |
| General Sales Tax | ---- | 13.6% |
| Motor Fuel and Charges | 30.2% | 33.5% |
| Alcohol & Tobacco | ---- | 7.9% |
| Property Tax | 19.9% | 7.1% |
| Charges | 13.4% | 9.4% |
| Other | 27.8% | 18.5% |

*Figures do not include unemployment compensation taxes or state proceeds from the operation of liquor stores, neither of which existed in 1927.

State Government Budgets at the End of the Depression

The 1930s are correctly regarded as having changed the role of the federal government in American life. Before the Roosevelt administration, the federal government played almost no role in trying to stabilize the national economy, provide support to low-income and elderly people, support agriculture, or affect the policies of state and local governments. Programs like the demonetization of gold, FERA and the creation of the Social Security Administration, agricultural assistance and direct financial assistance to state governments changed American life permanently, even though the size of the federal government in relation to the national economy did not radically change until national defense spending exploded in 1941 (figure 1).

The changes in state government are pronounced, even when viewed from the perspective of all 50 states. As noted above, state government doubled its revenues in nominal terms and in many instances shifted its fiscal structure in the 1930s. Most states accepted federal dollars and the need to endorse the new social-assistance programs the dollars were tied to. Not all states adopted the revenue and policy changes with equal alacrity. Take, for example, state expenditures in 1939 for Aid to Dependent Children (ADC). ADC was the predecessor to AFDC (Aid to Families with Dependent Children) and TANF (Temporary Assistance to Needy Families). ADC was created in 1935 and funded in part by federal grants. State spending on ADC in 1939 ranged from 29 cents per capita in Arkansas to \$2.34 per capita in Utah. Nine states appear to have rejected ADC funding that year, including Connecticut and Illinois.¹² The New Deal clearly did not level the differences among the states.

Viewed as a group, however, states significantly shifted their priorities in response to federal prodding in the 1930s, as table 2 indicates.

Table 2. Major Categories of State Expenditure: 1927 and 1940
As a Percentage of Total State Spending¹³

| | 1927 | 1940 |
|--------------------------------|-----------------|-----------------|
| Education* | 24.9% | 21.6% |
| Highways* | 34.7% | 23.6% |
| Welfare* | 2.2% | 19.0% |
| Other aid to local governments | 4.9% | 4.1% |
| Hospitals and health | 8.3% | 6.0% |
| Law enforcement | 3.5% | 2.4% |
| Unemployment compensation | -- | 9.9% |
| All other | 21.4% | 13.5% |
| Total spending | \$2,047 million | \$4,985 million |

*Figures for these categories combine direct spending and aid to local governments.

Table 2 shows a moderate reduction in the share of state spending for the two priorities of the 1920s, education and highway finance. Since the pie had grown and since prices in 1940 were about 80 percent of what prices had been in 1927, these shares had not diminished in

dollars or in value.¹⁴ Nor had the other purposes of expenditure whose share table 2 shows as smaller in 1940 than in 1927.

The reason for those nominal shifts appears further down in table 2. Cash benefits and other assistance to low-income people had grown from a negligible share of state spending to 19 percent. (Local governments' welfare expenditures also grew in the period, but mostly because of transfers from state government.) In addition, states had adopted an entirely new program of unemployment compensation funded by a new tax on employers and by a relatively small federal subsidy. Overall, these shifts in spending reflected a significantly altered policy on the role of state government and, like the shifts in revenue policy, laid the foundations for the state and local governments of the 21st century.

Conclusion

The Great Depression of the 1930s forced significant change in the domestic role of the federal, state and local governments in the United States primarily because the Roosevelt administration adopted responsibility for stimulating the economy and addressing the crisis of unemployment in 1933. The lack of a federal structure to administer domestic policy and the need to act quickly meant that state and local governments became tools of the federal government. Before the Depression, state and local governments had a very narrow revenue base in the property tax, whose inadequacy in changed circumstances was apparent by the time the federal government offered matching grants for public relief to the states. The result was the adoption of new kinds of state taxes as well as the expansion of the activities of state government. Although by current standards the expansion brought only moderate growth in the role of government, it laid the foundations of modern federalism and the domestic role of state and local government.¹⁵

NOTES

Documents were available at the Internet sites listed in March 2009.

¹ U.S. Bureau of Economic Analysis, Gross Domestic Product. <http://www.bea.gov/national/index.htm#gdp>

² Robert VanGiezen and Albert E. Schwenk, "Compensation from Before World War I Through the Great Depression." <http://www.bls.gov/opub/cwc/cm20030124ar03p1.htm>

³ Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970* (Washington, D.C., 1975), Part 2, 1130-1131. *Historical Statistics* does not provide annual figures for state and local government finances before the 1960s. 1927 is the latest date for which such figures are provided before the Depression began. Although the Bureau of the Census continued the publication of the *Statistical Abstract* through the 1930s, its figures on state and local government finance were not regularly updated. The 1939 edition reported data for 1932. Old issues of the *Statistical Abstract* are available at <http://www.census.gov/prod/www/abs/statab.html>

⁴ Council of State Governments, "Assessed Valuations of Property: 1929-1938," *The Book of the States*, IV (Chicago, 1941), 128-130.

⁵ *Historical Statistics*, 1130-1134.

⁶ *Federal Emergency Relief Act of 1933*, 73rd Congress, 1st Session, Public Law 15.
http://tucnak.fsv.cuni.cz/~calda/Documents/1930s/EmergRelief_1933.html

⁷ Jean Edward Smith, *FDR* (New York: Random House, 2007), 372.

⁸ The Tax Foundation, *Facts & Figures on Government Finance*, 38th ed. (Washington, D.C., 2005), 215.
<http://www.taxfoundation.org/publications/show/147.html>; *Book of the States*, IV, 113.

⁹ CPI calculations are based on data from the Bureau of Labor Statistics at http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=dropmap&series_id=CUURA421SA0,CUUSA421SA0. Here are prices levels during the 1930s relative to prices in 1927.

| | |
|------|-------|
| 1927 | 100.0 |
| 1928 | 98.3 |
| 1929 | 98.3 |
| 1930 | 94.9 |
| 1931 | 85.8 |
| 1932 | 77.3 |
| 1933 | 72.7 |
| 1934 | 72.2 |
| 1935 | 75.6 |
| 1936 | 76.7 |
| 1937 | 80.7 |
| 1938 | 79.5 |
| 1939 | 79.0 |
| 1940 | 79.0 |

¹⁰ Joseph J. Thorndike, "Retail Revolt: Chain-Store Taxes in the 1930s," *State Tax Notes* 42, no. 1 (October 2, 2006): 69-74.

¹¹ *Historical Statistics*, 1129-1130.

¹² *Book of the States*, IV, 196-198.

¹³ *Historical Statistics*, 1130-1132.

¹⁴ See footnote 9.

¹⁵ These points are fully developed in two excellent studies of state government and federalism in the 1930s: James T. Patterson, *The New Deal and the States: Federalism in Transition* (Princeton, N.J.: Princeton University Press, 1969) and John Braeman, Robert H. Bremner and David Brody, eds., *State and Local Levels*, Vol. 2 of *The New Deal*, Columbus, Ohio: Ohio State University Press, 1975.