Depreciation Goes to War: 
The Political Genius of FDR at Work

By Brian Grinder and Dan Cooper

There has never been a shortage of political expediency. Every American president has compromised on critical issues, and the current administration is no exception. But few Americans fully understand the crucial role that a presidential compromise regarding depreciation played in preparing America to enter the second World War. In the summer prior to the 1940 election, Franklin Roosevelt turned to political expediency by supporting a tax amortization schedule that was very favorable to business but a horror to ardent New Dealers. The Tax Amortization Act (TAA) became law on October 8, 1940, and played a crucial role in gearing the nation’s industrial facilities up for war. The United States would not enter the war until December 1941, but Roosevelt understood the importance of support for the Allied cause and believed that the States should be prepared should it become necessary to enter the conflict.

Roosevelt’s problems in the summer of 1940 were two-fold; a frosty relationship with the business community and a defense industry that was woefully outdated and undercapitalized. New Deal legislation was seen as government intrusion into the affairs of business. Work reforms such as minimum wages, limits on work hours, bank regulation, and unemployment insurance were all brought about through New Deal legislation. In fact, the National Recovery Act of 1933 (later ruled unconstitutional by the Supreme Court in 1935) had attempted to establish federal control over the nation’s industrial structure. From the beginning, the general tone of New Deal legislation was discomforting to the nation’s business leaders. Adding to the problem was the fact that the industries that serviced defense needs had been particularly hard hit during the long Depression.

A brick wall was formed in 1940 against Roosevelt’s determination to make the United States “the arsenal of democracy” because businesses were unwilling to commit capital to production for a war in which the United States was not currently involved. If the war was short, corporate America would be stuck with idle facilities; an unpleasant prospect for industries that had recently suffered through a depression that had idled many capital investments. Furthermore, the prospect of high taxes and legislation that would limit the profits from war production provided little incentive for industries to act. New Dealers, including Eleanor Roosevelt, believed that corporate reluctance to expand defense material manufacturing was rooted in lingering resentment over New Deal labor reforms.

“The New Dealer” Roosevelt became “the Pragmatist” Roosevelt at this point. He threw his support behind the TAA legislation that allowed defense related industries to amortize capital investments over a five-year period (an annual rate of 20 percent). Prior to this, firms were allowed to amortize only five to 10 percent of original cost per year. At the same time, additional legislation suspended the eight percent ceiling on profit levels in defense industries which had recently been imposed under the provisions of the Vinson-Trammel Act of 1934 and replaced the profit caps with new high tax rates for “excess profits.” Secretary of the Treasury Henry Morgenthau relates the following episode which casts a great deal of light on the President’s pragmatic attitude towards the tax bill:

“I sat on the President’s back porch at Hyde Park. He was in a rocker and he says, ‘I can tell you very simply how I feel. …I want a tax bill; I want one damned quick; I don’t care what is in it; I don’t want to know…. The contracts are being held up and I want a tax bill’

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The new high tax rates on excess profits coupled with generous depreciation allowances resulted in a tremendous depreciation tax shield.* The after-tax cash flows for any given year for a project (such as an aircraft factory) are calculated as:

\[(\text{Revenues} - \text{Costs}) \times (1 - \text{Tax Rate}) + \text{Depreciation} \times \text{Tax Rate}\]

The final term, \(\text{Depreciation} \times \text{Tax Rate}\) is known as the depreciation tax shield. The depreciation tax shield is enlarged by increasing the amount of the depreciation allowed each year or increasing tax rates. Conditions in 1940, after the passage of the new tax amortization law, were such that the tax shield was substantial. Furthermore, since there was great demand for the war materials produced, earnings were high and businesses were able to take full advantage of the tax shield. Industry was now willing to do business with the government and contracts began to clear quickly. New Dealers, however, from Eleanor Roosevelt on down were dismayed. Morgenthau wrote to the President concerning the new law that it "sponsored the very kinds of discrimination that the President and the Treasury had for so many years opposed." In addition, Interior Secretary Harold Ickes wrote:

"This is abandoning advanced New Deal ground with a vengeance. We are supposed to be engaged in an earnest struggle to do away with the unjust disparities between the very rich and the very poor. The President has announced more than once that no new crop of war millionaires will spring up out of the war preparedness program. ...[However] in effect, the Government is building these plants and equipping them at its own expense, while permitting private individuals and corporations to make excessive profits at practically no risk to themselves. (Ickes, pp. 295–296)

Roosevelt was undaunted by the criticism. He did what was necessary to prepare the country for war, as well as to set the stage for his election to an unprecedented third term in the fall of 1940. Such action also showed that Roosevelt recognized the importance of private industry to the war effort. He was not willing to engage in a government take-over of private industry in order to accomplish his goal of preparing the nation for war. Rather, he showed an ability to cooperate with big business in the face of enormous criticism from his political advisors including his wife. Mrs. Roosevelt had written in her widely read newspaper column that government must be prepared to "draft industry as well as to draft men." Countering Mrs. Roosevelt's views, Ralph Robey, writing for Newsweek, argued that should Mrs. Roosevelt's ideas for "taking over our accumulated supplies of wealth," be implemented then:

"...our system of private enterprise will necessarily come to an absolute end. There will be no supply of private savings with which to go ahead — no private wealth out of which to make the investment necessary to create jobs — Everything, from top to bottom, will have to be government.

President Roosevelt's support of generous depreciation allowances has direct application to the finance classroom of today. This historical event shows the importance of the depreciation tax shield to students.

Depreciation is often considered a confusing (and uninteresting) topic for many students of accounting and finance. This particular slice of American political and financial history illustrates the importance of this often under-appreciated topic. Without the TAA depreciation legislation, the country would not have been as prepared for its entry into the war. Roosevelt realized that the profit motive was an excellent motivator, and he was able to use it very effectively. The use of generous depreciation allowances is instructive in this age of "accelerated cost recovery systems" because it illustrates to students that changes in depreciation allowances can make a difference in the decision of accepting or rejecting a project. Before the amortization law went into effect, few firms were willing to risk gearing up for war production. After the law went into effect, one might say that negative Net Present Value (NPV) projects became positive NPV projects.

Additionally, this event sheds light on the dynamic interaction between government and private industry. Government, whether it be federal, state, or local has been an important factor in the business world since the earliest days of this country's existence. Wise business leaders do not ignore the potential impact of government in any business decision they make. Furthermore, as Roosevelt demonstrated, wise political leaders cannot long ignore the needs of the business community.

Sources:


* According to Smith (1991), "...federal corporate income taxes consisted of a 24 percent 'normal' tax plus an excess profits tax with rates varying from 25-percent for the first $25,000 to 50-percent for excess profits beyond $500,000. These rates were increased after Pearl Harbor to the point where excess profits tax took as high as 90-percent of marginal corporate income." pp. 457–458.