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How FDR Prolonged the Great Depression

by Jim Powell

President Franklin Delano Roosevelt's stock has long been overvalued. Now there are signs that his public image bubble is ready to burst and his lofty reputation is headed for a crash.

The 1950s through the 1990s were the glory years for FDR hagiographers such as James MacGregor Burns, Arthur M. Schlesinger Jr., Frank Freidel, William Leuchtenberg, Ted Morgan, and Kenneth S. Davis, who embraced the view that the Great Depression proved the failure of free-market capitalism, the greatness of FDR, and the need for continuing government intervention in the economy. That view continues to be heard, of course, as it was in *Freedom: A History of US* by Joy Hakim, whose children's history books have sold some 4 million copies. "The first hundred days of [FDR's] presidency are famous for their accomplishments," she gushes.

There is one small problem with this view: its central premise is wholly false. The New Deal failed to get America out of the Great Depression. If anything, it made matters worse. Throughout the New Deal era, the median annual unemployment rate was 17.2 percent. At no point during the 1930s did unemployment go below 14 percent. Although there was episodic recovery, the 1937 peak for per capita output was lower than the previous peak in 1929. And the 1937 peak was followed by a crash. As Milton Friedman and Anna J. Schwartz have observed, that was "the only occasion in our record when one deep depression followed immediately on the heels of another."

The Great Depression was the most important economic event in American history, ushering in the biggest peacetime expansion of federal power. Accordingly, more and more economists have focused on the New Deal's bottom line—the actual effects of New Deal policies—rather than on the good intentions of New Deal personalities.

The first crack in the conventional wisdom appeared with the publication in 1963 of Friedman and Schwartz's *Monetary History of the United States,* which showed that the principal culprits responsible for the Great Depression were Federal Reserve officials who presided over the contraction of the money supply by a third between 1929 and 1933. Erratic Fed policies contributed to prolonging the Great Depression. It was a government failure, not a market failure.

Since then, dozens of journal articles and several academic books have reported the effects of one New Deal policy after another, and the findings are overwhelmingly negative. The New Deal prolonged

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Cato senior fellow Jim Powell's book, FDR's Folly, How Franklin D. Roosevelt and His New Deal Prolonged the Great Depression, *will be published in September by Crown Forum.*

At a Capitol Hill dinner on Social Security reform attended by more than a dozen members of Congress, José Piñera makes a point about the urgency of giving workers private accounts to Rep. Jennifer Dunn (R-Wash.) and her fiancé, Keith Thomson.

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"The New Deal failed to get America out of the Great Depression. If anything, it made matters worse."

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the Great Depression by doubling taxes, making it more expensive for employers to hire people, making it harder for entrepreneurs to raise capital, demonizing employers, destroying food, promoting cartels, breaking up the strongest banks, forcing up the cost of living, channeling welfare spending away from the poorest people, and enacting labor laws that hit poor African Americans especially hard.

Reports of those findings had been accumulating in the shadows, largely ignored until 1999, when Stanford University historian David M. Kennedy won a Pulitzer Prize for *Freedom from Fear: The American People in Depression and War,* a popular work drawing on some of that research. "Whatever it was," he wrote, the New Deal "was not a recovery program, or at any rate not an effective one."

My new book, *FDR's Folly, How Franklin D. Roosevelt and His New Deal Prolonged the Great Depression,* is the first work to focus on the entire range of findings. It won't be the last such book, however, since critical analyses of the New Deal continue to appear.

New Deal Attack on Employers

FDR made it more expensive for employers to hire people, ensuring that fewer people would be employed. The National Industrial Recovery Act of 1933 established the National Recovery Administration, which authorized some 700 cartels with codes mandating above-market wages.

By giving its imprimatur to labor union monopolies, violent strikes, and surging wage rates in mass production industries, the 1935 National Labor Relations Act, commonly known as the Wagner Act, contributed to layoffs. Over the course of three months in 1937–38, General Motors dismissed a quarter of its employees, and overall U.S. car production dropped almost 50 percent. Economists Richard K. Vedder and Lowell E. Gallaway, in their 1997 study *Out of Work*, estimated that by 1940 unemployment was eight points higher than it would have been in the absence of higher payroll costs imposed by New Deal policies.

Taxes more than doubled during the Great Depression, and the federal take rose from $1.6 billion in 1933 to $5.3 billion in 1940. Federal taxes as a percentage of the gross national product jumped from 3.5 percent in 1933 to 6.9 percent in 1940. Ordinary people were directly hit with higher liquor taxes and Social Security payroll taxes. FDR increased the tax burden with higher personal income taxes, higher corporate income taxes, higher excise taxes, higher estate taxes, and higher gift taxes. He introduced the undistributed profits tax. Those taxes reduced the amount of money employers had to finance growth and jobs.

In their 1998 study, *The Great Depression,* economists Thomas E. Hall and J. David Ferguson wrote that "antibusiness tax laws would certainly have had a negative impact on employment. In addition, the uncertainty experienced by the business community as a result of the frequent tax law changes (1932, 1934, 1935, 1936) must have been enormous. Since firms' investment decisions very much depend on being able to plan, an increase in uncertainty tends to reduce investment expenditures . . . investment as a proportion of output was at low levels."

New Deal securities laws further depressed employment by making it harder for employers to raise capital. The 1933 Securities Act required detailed financial reports from issuers of new securities. Economic historian Lester V. Chandler of Princeton University has described the effect of the new rules this way: "The regulations on new security issues were burdensome, especially in the early stages before lawyers, financiers, and corporate officers became accustomed to them, understood procedures, and worked out routines. Compliance was time-consuming and expensive. Also, businessmen were fearful of the civil and criminal penalties that they might inadvertently incur."

The first empirical investigation of the effects of the Securities and Exchange Commission, established in 1934, was conducted by future Nobel laureate George J. Stigler. His work showed that fewer companies raised capital in the stock market after the SEC was established than before, and that rates of return on new stocks issued in the 1920s (the pre-SEC stock boom) were not significantly lower than rates of return on new stocks issued in the 1950s (the first boom after the Great Depression). New Dealers had claimed that the Great Depression was brought on by stock market abuses and fraud. But, if that were true, pre-SEC rates of return would have been depressed, and the SEC would have improved rates of return. Analyzing data on industrial company stocks issued between 1926 and 1939, economist Gregg A. Jarrell confirmed Stigler's findings. What, then, was the point of making it more difficult for employers to raise capital and hire people?

In 1938 FDR authorized an unprecedented antitrust crusade against big employers. The Department of Justice hired some 300 lawyers to file about 150 antitrust lawsuits. Often they were filed not just against a single company but against an entire industry. There were lawsuits against the milk, oil, tobacco, shoe machinery, tire, fertilizer, railroad, pharmaceuticals, school supplies, billboards, fire insurance, liquor, typewriter, and movie industries, among others. But the antitrust crusade was a flop. The government won few cases, and some dragged on as long as 13 years. FDR's antitrust crusade disrupted an already depressed economy, making it harder for employers to recover and provide more jobs. G. Warren Nutter and Henry Adler Einhorn's 1969 study, *Enterprise Monopoly in the United States,* was one of several showing that there wasn't any evidence of increasing private-sector monopoly during the 1930s. The whole antitrust crusade was based on an illusion.

As if all that weren't bad enough, FDR demonized employers with poisonous rhetoric. In accepting the 1936 Democratic presidential nomination, FDR lashed out against "economic royalists . . . the privileged princes of these new economic dynasties, thirsting for power. . . . They created a new despotism . . . this new industrial dictatorship. . . . We seek to take away their power." Is it any wonder that so many people concluded that America wasn't a safe place to invest?

Breaking Up the Strongest Banks

FDR's major banking "reform," the second Glass-Steagall Act, broke up the strongest banks, including J.P. Morgan & Company—universal banks that engaged in both

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"African Americans were major victims of the National Recovery Administration."

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commercial banking (deposits and loans) and investment banking (securities underwriting), because New Dealers imagined that securities underwriting was a factor in all the bank failures.

In 1986 Eugene N. White reported that during the 1920s, before the passage of the Glass-Steagall Act, banks that engaged in both deposits and loans and securities underwriting were less likely to fail than were investment banks that didn't engage in securities underwriting. White further reported that, between 1930 and 1933, 26.3 percent of all national banks failed, compared with only 7.6 percent of banks that engaged in securities underwriting. The reason for the greater safety of universal banks, White suggested, was diversification.

University of Chicago economists Randall Kroszner and Raghurm Rajan gathered data on securities issues during the 1920s and compared the performance of issues underwritten by universal banks and those issued by investment banks. They found that 40 percent more of the bonds issued by *investment* banks—the kind of banks approved by New Dealers—went into default.

FDR didn't do anything about a major cause of 90 percent of the bank failures, namely, state and federal unit banking laws, which limited banks to a single office, thus preventing them from diversifying their loan portfolios and their source of funds. Unit banks were highly vulnerable to failure when local business conditions were bad, because all their loans were to local people, many of whom were in default, and all their deposits came from local people who were withdrawing their money. Canada, which permitted nationwide branch banking, didn't have a single bank failure during the Great Depression.

FDR signed the Banking Act of 1935, which centralized power at the Fed. Allen H. Meltzer makes clear in his recent *History of the Federal Reserve* that the seven governors of the Fed almost always had to interpret conflicting information, and they were human beings prone to error. Centralizing power meant their errors would harm, not just a city or a region, but the entire United States.

The first bad call came in July 1936, just five and a half months after the new Fed began to operate. It increased the reserve requirement for banks by 50 percent, which meant a higher proportion of a bank's money had to stay in the vault, rather than be lent and reinvested. On January 30, 1937, the Fed increased bank reserve requirements another 33.3 percent. Those bad calls triggered a contraction of the money supply, which was one of the most important factors bringing on the depression of 1938—the third most severe since World War I. Real GNP declined 18 percent, and industrial production was down 32 percent.

What about FDR's federal deposit insurance reform? It didn't stop bank failures. Since depositors no longer worried about losing their money, though, there weren't any more serious bank panics. Deposit insurance transferred the cost of bank failures from depositors to taxpayers, undermining incentives for depositors to steer clear of risky banks. The full consequences of federal deposit insurance became apparent in the 1980s, when savings-and-loan bailouts cost taxpayers $519 billion.

Punishing Discounters, Destroying Food

National Recovery Administration cartels forced prices for goods and services above market levels, making everybody poorer. The "little people" fared worst. In April 1934, 49-year-old immigrant Jacob Maged of Jersey City was fined and jailed for three months after charging 35 cents to press a suit, rather than the 40 cents mandated by the National Recovery Administration's dry cleaning code.

The Agricultural Adjustment Acts (1933, 1938) forced up farm prices, which meant higher food prices for millions of Americans. Under the AAAs, Secretary of Agriculture and future vice president Henry Wallace had farmers plow under some 10 million acres of cultivated land, destroying wheat, corn, and other crops. Hog farmers were paid to slaughter some 6 million shoats (young pigs). That was the sort of thing John Steinbeck protested in *The Grapes of Wrath*.

The SEC enforced price fixing on Wall Street—the high commissions that investors paid to buy or sell securities. Real reform—deregulation, competition, and discount prices—didn't come to Wall Street until 1975.

The Robinson-Patman Act, amending the Clayton Antitrust Act in 1936, made it illegal for A&P, King Kullen ("World's Greatest Price Wrecker"), and other chain stores to share discounts on volume purchases with consumers. FDR struck another blow against consumers by signing the Miller-Tydings Retail Price Maintenance Act in 1937. That act amended the Sherman Act to let manufacturers fix the retail prices of branded merchandise and stop chain stores from offering great discount prices.

In 1938 FDR signed into law the Civil Aeronautics Act, which enabled the federal government to enforce an airline cartel. For 40 years, not a single license was issued for a new interstate airline, and consumers were hit with high fixed fares.

The New Deal Made African Americans Worse Off

African Americans were major victims of the National Recovery Administration. The labor codes, drafted by craft unions that excluded African Americans, specified above-market wages, which effectively outlawed price competition in labor markets. Since large numbers of black workers were unskilled, their best hope was to work at a lower rate and get on-the-job experience that would increase their skills and their ability to compete. "Because of the NRA, wages in the South's largest industry, textiles, increased by almost 70 percent in five months," reported George Mason University law professor David E. Bernstein. "Employers responded to such massive wage increases by investing in mechanization and dismissing their unskilled workers." Some 500,000 black workers were estimated to have lost their jobs because of the National Recovery Administration's minimum wage codes.

Black workers were big losers under the National Labor Relations Act, hailed as the "Magna Carta" of compulsory unionism. "To the extent that the Wagner Act raised wages and labor standards beyond market levels," wrote Bernstein, "it had the same effect as a minimum wage law in eliminating marginal African American jobs."

Black farmers were left high and dry when their land was flooded by the Tennessee Val-

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Cato president Edward H. Crane and adjunct scholar Walter E. Williams received honorary doctorates at Francisco Marroquin University in Guatemala on May 10.

Ed Crane receives the Adam Smith Award, "given to recognize an individual who has made a sustained and lasting contribution to the perpetuation of the ideals of a free market economy," from the Association of Private Enterprise Education at its annual conference on April 6. APEE vice president Jane S. Shaw presents the award.

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ley Authority. According to economist John Moore, TVA dams "permanently flood a total of about 730,000 acres . . . an area which is approximately as large as the state of Rhode Island." A reported 15,654 people were forced from their homes to make way for dams. Farm owners received cash settlements for their condemned property, but the thousands of black tenant farmers got nothing.

The AAAs reduced farm acreage and gave millions of dollars to big farmers, but the 600,000 black sharecroppers got nothing. In a 2001 National Bureau of Economic Research study, Price V. Fishback, William C. Horrance, and Shawn Kantor reported that "income inequality was exacerbated as the landowners' incomes increased and the incomes of the much larger group of tenants, croppers and workers declined."

What about all the New Deal relief programs? The bulk of that money was skewed away from the South, which was the poorest region. Historian Leonard Arrington estimates that, on average, a person living in the West received 60 percent more New Deal money than a person living in the South. Historian Don Reading found there was less New Deal spending in the states that had higher percentages of black residents, higher percentages of tenant farmers, and lower per person incomes.

Economic historian Gavin Wright of Stanford concluded that less New Deal welfare spending went to the southern states that gave FDR big winning margins (over 67 percent) in 1932, presumably because FDR was sure to win those states again. More New Deal spending went to western states where FDR had won less than 60 percent of the vote in 1932, to help ensure victory in 1936.

Warren Harding Beats FDR as Anti-Depression Fighter

The Great Depression wasn't written in the stars. After all, the severe depression of 1920 was over in about a year. The president then was Warren G. Harding, who succeeded where FDR failed. Harding cut federal spending, cut taxes, and went back to his card games. Harding's slogan "less government in business" turns out to have been a vastly better guide than FDR's disastrous "New Deal." Everybody, especially the poorest among us, is better served when private property is secure, the currency is stable, markets are open, people are free to make their own bargains, government burdens are lifted, and it's safe to invest for the future. ■

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programs like the Children's Scholarship Fund, and do that by making large-scale tax credits available for both businesses and individuals who donate to those funds, we could easily raise tens of millions of dollars in very short order. Pennsylvania found that out: the state has a tax credit for businesses that donate to a scholarship fund. Businesses give money to the scholarship fund, and the fund subsidizes the education of low-income children. There is a $20 million cap on the amount of money that can be collected under this program from businesses, and the cap's usually hit in the first two weeks of eligibility each year. If Pennsylvania got rid of that cap, businesses would donate more money.

The flexibility that such funds offer and the level of hands-on interaction with the recipients are tremendous benefits in and of themselves. That flexibility would allow a progressive need-based system of financial assistance. The lowest income families would either be fully subsidized or pay only a very small copayment; the subsidy would decrease as incomes rose, and the wealthiest families would not receive any subsidy. ■