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The Government and the Great Depression

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The economic policies of the 1930s are a continuing source of myth and confusion. Many people believe that capitalism caused the Great Depression and that President Franklin Roosevelt helped to end it. A recent History Channel special on Roosevelt said that his New Deal resulted in "recovery and reform" while creating "millions of jobs."[1]

Such often-stated claims are incorrect. Misguided federal policies caused the downturn that began in 1929, and they prevented the economy from fully recovering for a decade. Policy blunders by the Federal Reserve, Congress, and Presidents Herbert Hoover and Roosevelt battered the economy on many fronts.

The events of the 1930s influence economic policymaking today. Many people think that we need a big government to prevent, or to reverse, recessions. But the 1930s illustrate that activist policies increase, not decrease, economic instability. Government interventions reduce the flexibility that markets need to adjust to shocks and return to growth. This bulletin looks at the 1930s economy and highlights the worst policy failures.[2]

Policy Failures Lead to a Long and Deep Downturn

The Depression was a uniquely severe contraction. Real gross domestic product fell for four years before finally beginning to recover.[3] Real output only regained its 1929 level in 1936, but then output plunged again in 1938. The unemployment rate stayed persistently high at more than 14 percent for 10 years (1931 to 1940).[4]

By contrast, the economy recovered rapidly after a sharp contraction in 1921. Real output fell 9 percent in 1921 and unemployment rose to 11.7 percent.[5] But the economy bounced back with output recovering all its lost ground in 1922. Unemployment fell to 6.7 percent in 1922 and 2.4 percent in 1923. The secret to the quick recovery was that the government generally stood aside and let the market recover by itself—wages and prices adjusted, resources shifted to new areas of growth, profits recovered, business optimism returned, and investment rose.

By contrast, government policies in the 1930s prevented the U.S. economy from recovering. The following are some of the key policy mistakes: [6]

Monetary Contraction. The Depression was precipitated by a one-third drop in the money supply from 1929 to 1933, which was mainly the fault of the Federal Reserve. The Fed made further errors that helped put the economy back into recession in 1938. Meanwhile, a flood of bank failures in the early 1930s compounded the money supply shrinkage and heightened economic fears. A key problem was that most states restricted bank branching, which prevented banks from diversifying their portfolios across jurisdictions. By contrast, Canada allowed nationwide branching and did not suffer a single bank failure during the Depression.

Tax Hikes. In the early 1920s, Treasury Secretary Andrew Mellon ushered in an economic boom by championing income tax cuts that reduced the top individual rate from 73 to 25 percent. But the lessons of these successful tax cuts were forgotten as the economy headed downwards after 1929. President Hoover signed into law the Revenue Act of 1932, which was the largest peacetime tax increase in U.S. history. The act increased the top individual tax rate from 25 to 63 percent. After his election in 1932, Roosevelt imposed further individual and corporate tax increases. The highest individual rate was increased to 79 percent. State and local governments also increased taxes during the 1930s, with many imposing individual income taxes for the first time. All these tax increases killed incentives for work, investment, and entrepreneurship at a time when they were sorely needed.

International Trade Restrictions. In 1930, President Hoover signed into law the infamous Smoot-Hawley trade act, which raised import tariffs to an average of 59 percent on more than 25,000 products. More than 60 countries retaliated by slapping new restrictions on imports of U.S. products. As new trade restrictions were imposed around the world, trade plummeted. By 1933, world trade was down to just one-third of the 1929 level.

Keeping Prices High. The centerpiece of the New Deal was the National Industrial Recovery Act of 1933. It created "codes" or cartels in more than 500 industries in order to limit competition. Businesses were told to cut output and maintain high prices and wages. Businessmen who cut prices were cajoled, fined, and sometimes arrested. Fortunately, NIRA was struck down by the Supreme Court in 1935.

The Agricultural Adjustment Act of 1933 similarly restricted production to keep prices high. "Excess" output was destroyed or dumped abroad. While millions of Americans were going hungry, the government plowed under 10 million acres of crops, slaughtered 6 million pigs, and left fruit to rot. Production of milk, fruits, and other products was cartelized to boost prices under "marketing orders" begun in 1937.

These policies reduced employment and burdened families with higher prices. At a May 1935 press conference, Roosevelt read letters from businessmen thanking him for keeping prices high.[7] With millions out of work and short of money, Roosevelt thought that his job was to shield high-cost producers from entrepreneurs wanting to offer lower prices to hard-pressed families.

Keeping Employment Costs High. Many New Deal policies raised employer costs, contributing to the extraordinarily high unemployment of the 1930s. NIRA industry codes required high wages. The new Social Security tax increased compensation costs. New minimum wage rules reduced demand for low-skilled workers. The Davis-Bacon Act required the payment of excessively high wages on federal contracts. Compulsory unionism and militant union tactics were encouraged under a series of laws. One result was that U.S. work stoppages soared from an average 980 annually between 1922 and 1932 to a peak of 4,740 in 1937.[8] While "millions of jobs" were created in the government during the 1930s, private-sector jobs were destroyed. Total U.S. private employment was lower in 1940 than it had been in 1929.[9]

Harassment of Businesses. Investment stagnated in the 1930s as a result of uncertainties in the economy and the new risks of adverse federal actions.[10] Roosevelt and members of his administration demonized business leaders and investors in their speeches. FDR called them "economic royalists" and "privileged princes" seeking a "new despotism" and "industrial dictatorship."

Laws and regulations poured forth from Washington like never before. Roosevelt issued more executive orders than all presidents from Harry Truman through Bill Clinton combined. Presidents typically issue just a few hundred executive orders, but Roosevelt issued 3,723.[11]

Roosevelt's antitrust crusade was typical of his anti-market approach. The Justice Department hired hundreds of new attorneys and began a lawsuit blitzkrieg in 1938 against dozens of industries for conspiring to keep prices high. The irony was that Roosevelt had spent his first term encouraging cartels, monopoly unionism, and other policies designed to boost prices and production costs.

Conclusion

New Deal interventions were not only bad for the economy, but favored fat cats over average families. Most farm subsidies went to major land owners, not small-time farmers. Required reductions in farm acreage devastated poor sharecroppers. Efforts to keep farm prices high led to the destruction of food while millions of families went hungry. Compulsory unionism led to discrimination against blacks because it gave monopoly power to union bosses who often didn't want them hired. NIRA cartels prevented entrepreneurs from cutting prices for consumers.

Roosevelt's strategies of handouts, federal jobs, subsidized loans, demonizing businesses, and public works projects in swing states worked well politically. But economically, Roosevelt and his "brains trust" had no idea what they were doing. They attempted one failed intervention after another. The Great Depression was a disaster, and sadly an avoidable one.

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[1] The History Channel, "America's Man of Steel," advertisement, *Washington Post*, April 17, 2005, p. R2.
[2] See Chris Edwards, *Downsizing the Federal Government* (Washington: Cato Institute, November 2005), Appendix 1.
[3] U.S. Bureau of Economic Analysis, *Survey of Current Business*, April 2000, p. 15.
[4] U.S. Bureau of the Census, *Historical Statistics of the United States*, 1975, Part 1, p. 135.
[5] For the change in output during the 1920s, see U.S. Bureau of the Census, Part 1, p. 224. For unemployment, see p. 135.
[6] Most facts are from Jim Powell, *FDR's Folly: How Roosevelt and His New Deal Prolonged the Great Depression* (New York: Crown Forum, 2003). See also Alan Reynolds, "What Do We Know About the Great Crash," *National Review*, November 9, 1979.
[7] http://newdeal.feri.org/court/fdr5_31_35.htm.
[8] Powell, p. 204. Powell cites data from Morgan O. Reynolds.
[9] www.bea.doc.gov/bea/dn/nipaweb. See Table 6.4A.
[10] Real gross private domestic investment did not recover to its 1929 level until 1936. Investment fell again in 1938. U.S. Bureau of Economic Analysis, p. 15.
[11] William J. Olson and Alan Woll, "Executive Orders and National Emergencies: How Presidents Have Come to 'Run the Country' by Usurping Legislative Power," Cato Policy Analysis no. 358, October 28, 1999, p. 13.