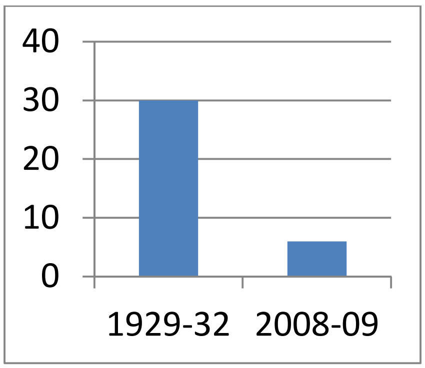
Great Depression and New Deal[1]

PART ONE: Timing and severity

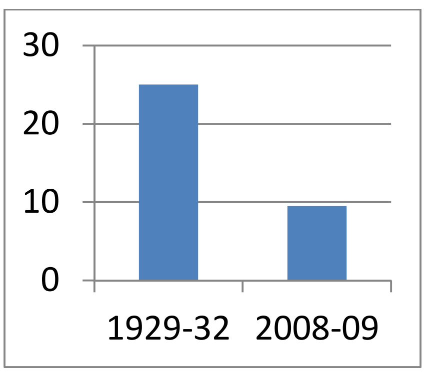
The Great Depression began in the United States as an ordinary recession in the summer of 1929. The downturn continued and grew worse, until early 1933. By 1932, our nation was suffering its worst economic decline ever. You can compare the decline in GDP and increase in unemployment, with the recent economic downturn in the US, below.

Percent decline in GDP



The decline in the size of the economy (called the gross domestic product, the total of all goods and services produced in the country in a given year) was 30%--five times worse than it was in our recent decline.

Percent increase in unemploy-ment



Unemployment in the Great Depression climbed to 25% in 1932, and never dropped below 14 percent, before the 1940s (when we went into WWII).

The U.S. economy began an incredibly slow recovery in the spring of 1933. If you only look at GDP, the recovery was decent: real GDP rose at an average rate of 9 percent per year between 1933 and 1937. While 9% growth per year in GDP is very impressive (most modern industrial economies average 2-3% growth per year), unemployment was another thing altogether. Unemployment remained high throughout the 1930s and into the 1940s. And even when the economy was healthiest during the New Deal (1937), unemployment was still 14%. It wasn't until 1942 that unemployment was low (4.7%), when almost every adult in America was either

[1] There are two good sources critical of FDR and the New Deal. One is at cato.org, "How FDR Prolonged the Depression;" another is at fee.org, "The Depression You've Never Heard Of."

working for wartime production, or actually in the armed forces. The number of unemployed workers declined by 7,050,000 between 1940 and 1943, but the number in military service rose by 8,590,000. The reduction in unemployment can be explained by the draft, not by Roosevelt's New Deal "stimulus package."

The Roaring 20s and the Stock market crash

Fueled by tax cuts, the economy grew at a fairly rapid rate in the 1920s. Industrial production boomed in the 1920s. For example, US factories made 1.9 million passenger cars in 1920. This figure rose steadily through the 1920s, to 3.8 million cars produced in 1928. In 1929, 4.5 million cars were made.

Now there was a decline towards the end of 1929, but even taking into account this lag, US auto production was still going at a pretty good rate. In the last 3 months of the 1929, the US made 580 thousand cars (noticeably less than the 760 thousand made in the last three months of 1928). But this was still many more than the 350 thousand made in the last three months of 1920. So there was a drop off in the latter months of 1929, but overall, 1929 was still a record year for automobile production, so nothing horrible seemed about to hit the economy.

And similar slight declines were seen in the latter part of 1929 in freight car loadings, steel production, prices, and personal income—but again, nothing that would indicate a massive oncoming depression.

Stock prices had risen more than fourfold from the low in 1921 to the peak in 1929. The stock market crash in October 1929 helped drive down demand for products. Both consumer purchases of durable goods, and business investment, fell sharply after the crash. Both consumers and businessmen grew worried about the future state of the economy, which made purchases of expensive items more unlikely. With so many wealthy Americans finding their fortunes vanishing, they spent a lot less in the months following the crash than they were before. As a result of the drastic decline in consumer and business spending, real output in the United States, which had been declining slowly up to this point, fell rapidly in late 1929 and throughout 1930.

Thus, while the great crash of the stock market and the Great Depression are two quite separate events, the decline in stock prices was one factor contributing to declines in production and employment in the United States. Another was a slight dropoff in production seen in the later half of 1929—but neither of these factors guaranteed that our nation was going to plunge into its worst economic crisis ever.

PART TWO: Causes of the Depression & Hoover's Response

Farms losing money

The decline in farm commodity prices following World War I made it difficult for farmers to keep up with their loan payments. Throughout the 1920s, average prices for wheat fell from $1.67 a bushel to 0.69 a bushel; corn fell from 88 cents to 57 cents a bushel; peanuts fell from 6.2 cents to 3.1 cents a pound.

While the **average foreclosure rate between 1913 and 1920 was 3.2 per 1,000 farms**, it jumped to **38.8 per 1,000 farms by 1933**. With prices falling as seen in the table above, you can see why this was the case.

Banking panics

After the stock market crash and dip in production in 1929, the next blow occurred in the fall of 1930, when the first of four waves of banking panics gripped the United States. These four banking panics, which took place between 1930 and 1933, saw a lot of runs on the banks. A run occurs when depositors at a bank all withdraw their money at the same time. When this happens, the banks, which typically hold only a fraction of deposits as cash reserves, must quickly raise more cash by selling off their assets (loans and property), often at rock bottom prices. When this happens, the bank can easily become insolvent (bankrupt) and have to go out of business. Widespread bank runs (when this happens to numerous banks at the same time) are relatively rare, but when they do happen, they can have a horrible impact on the economy. More than nine thousand banks failed in the United States between 1930 and 1933, equal to some 30 percent of the total number of banks in existence at the end of 1929. While the amount of savings lost to depositors was only 4 percent of the total amount of deposits (in other words, for every dollar deposited in banks, 96 cents was preserved), this probably didn't console the people who did see their life savings lost (or significantly depleted). By 1933, one-fifth of the banks in existence at the start of 1930 had failed.

Hoover's Response

Herbert Hoover, having won the 1928 presidential election, was inaugurated in March 1929. Widely blamed for the oncoming depression, Hoover and the Republicans were kicked out of office in the 1932 elections, which returned a Democrat President for the first time since the 1916 election. The Democrats in the House of Representatives gained 97 seats, and had over 70% of the seats there (313 out of 435).

Many people are not aware that Hoover also attempted many of the policies Roosevelt later implemented, although not on as large a scale as Roosevelt. They mistakenly believe that Hoover insisted on a free-market, laissez-faire response to the crash and Depression. But that is simply not true. Hoover was a believer in big government (just not as big as Roosevelt would later want it to be). Hoover dramatically increased the size of the federal budget (from $3.1 billion in 1929, to $4.6 billion in 1933, a 48% increase in spending in just four years). He instituted several of the programs that were later carried over into the New Deal.

Hoover met with industry leaders and got them to commit to maintaining wage levels (instead of lowering wages to cut costs in slow times). Unfortunately for the workers, this meant that the only way for corporations to cut their labor costs was to fire their workers (or cut down on their hours). The number of hours worked by wage earners in December 1930 was 30% less than the number of hours worked by wage earners in December 1929.

He got the Federal Reserve System to purchase many government bonds, putting money into the economy, and giving banks the ability to loan more to individuals and businesses. Hoover, through the Federal Farm Board, Grain Stabilization Corporation, and the Cotton Stabilization Corporation, sought to keep wheat and cotton prices high (to help out the farmers). Money was loaned to farmers if they kept crops from the market; eventually, these crops were bought and stored by the government itself. Over $300 million was lost in this attempt, as prices continued to fall (why limit production when the government is buying all your surplus?) and plummeted when the government decided to stop this experiment and put its stores of the two goods, back on the market.

He set up the Reconstruction Finance Corporation (RFC) which loaned over 2 billion dollars (most of which went to banks, either as direct loans, or by loaning the money to other companies, who would then pay off their own loans). In the case of the Missouri Pacific, the RFC granted the loan despite an adverse warning by a minority of the Interstate Commerce Commission, and, as soon as the railway had repaid its debt to J. P. Morgan & Co. bank, the Missouri Pacific went into bankruptcy. The Federal Home Loan Bank Act bought some $94 million worth of home loans (to prevent foreclosures) by March 1933.

Tax Increases

Tax rates were sharply increased. The lowest rate rose from 1.125 percent to 4.0 percent, and the top rate rose from 25 percent (on taxable income over $100,000) to 63 percent (on taxable income in excess of $1 million). It is now easy to see how such a huge tax increase could hurt the economy. Lowering the amount of money households can spend will limit their spending! It also greatly reduced the likelihood that businesses would invest, with more of their profits going to the government, in the form of taxation. And so with people less likely to buy things, and companies less likely to invest, it is easy to see how higher taxes can hurt an economy.

So while Hoover's spending and tax programs were not nearly as large as FDR's were, in no way can anyone say that Hoover's "free-market" solutions didn't work. He didn't utilize free market solutions, but big government solutions, and as they were implemented, the American economy plunged deeper into the worst Depression that we have record of.

PART THREE: The New Deal

Banking Measures

On March 6, 1934, the newly inaugurated President Roosevelt called a nationwide bank holiday, and on March 9, Congress passed the Emergency Banking Act, which provided for federal bank inspections, as well as gave him approval to shut down any insolvent bank. The Banking Act of 1933 (also known as the Glass-Steagall Act of 1933) established deposit insurance in the United States and prohibited banks from underwriting or dealing in securities. Through this insurance program, the FDIC has prevented bank runs in American banks for almost seven decades now. Depositors don't worry about their money, as they know that the federal government will insure any money they have deposited in a bank. The FDIC has placed limits on the amount of money that it will ensure for each depositor (originally it was $2,500 per depositor per insured account; that figure has now grown to $250,000).

The only downside to this? As of January 2013, the FDIC website reported that it insures some $9 trillion in deposits. At the end of 2012, the FDIC fund (to cover that $9 trillion in insured deposits) was at $33 billion. That's right—33 *billion*, to cover 9 *trillion* dollars in deposits, if the banks go bust. And if that $33 billion isn't enough to cover any failed deposits, you can expect the good old US taxpayer to pay for the rest of the tab. The fund, by 2020, will be required to have, as cash in hand, a whopping 1.35 percent of all the deposits that it insures.

Agricultural Adjustment Act

Congress in 1933 enacted a complex new farm bill, the Agricultural Adjustment Act. It provided several mechanisms to help raise agricultural prices, but the one most extensively used provided for government payments to farmers who destroyed or did not grow surplus crops. At a time when economic hardship was leaving people in other areas in need of food, the act outraged many. Since cotton plantings were thought to be excessive, cotton farmers were paid to plow under one-quarter of the forty million acres of cotton to reduce marketed production to boost prices. Most of the payments went to the landowners, not the tenants, making conditions desperate for tenant farmers. Though landowners were supposed to share the payments with their tenant farmers, they were not legally obligated to do so and most did not. As a result, tenant farmers, predominantly black tenants, received none of the payments and less or no income from cotton production after large portions of the crop were plowed under. Under the Acts, Secretary of Agriculture and future vice president Henry Wallace had farmers plow under some 10 million acres of cotton, as well as the destruction by exposure and lack of water, of another 20 million acres of grain (over the winter and spring, from 1933-34). Hog farmers were paid to slaughter some 6 million young pigs. As Roosevelt's critics responded with outrage, raising the price of wheat $1 per bushel to help the farmer was hurting the people who bought bread made from that wheat, by the same amount.

NIRA

The National Industrial Recovery Act (NIRA) was another innovative early New Deal measure passed in 1933. It provided for a vastly expanded public works effort, carried out by the Public Works Administration, and ultimately spent $6 billion on public works projects such as roads, bridges, tunnels, and dams.

When combined with the Works Progress Administration (not part of NIRA), which spent another $13 billion on public works projects, at least $20 billion was spent on these projects which provided jobs for millions of Americans, while providing important public construction projects.

Another part of the NIRA that is not nearly as widely known, is a one sentence (Title 1, Section 5) *suspension of the antitrust laws passed in earlier decades*. This allowed companies to essentially form cartels, and agree on pricing and production for future years. It was granted authority to help shape industrial codes governing trade practices, wages, hours, child labor, and collective bargaining. We'll read more about the effects of this part of NIRA in Part Five.

The hopes of 1933 for early recovery proved illusory. Even though real GDP was growing at a 9% rate from 1933 onward (probably not that difficult when you've already hit rock bottom), unemployment never dropped below 14% in the 1930s, and the median rate was 17% during Roosevelt's time in office.

The Second New Deal

Roosevelt continued his legislation with what has been termed the Second New Deal. Among the new measures were tax increases, as well as two other major pieces of legislation. The National Labor Relations Act (also known as the **Wagner Act** for its sponsor, Robert Wagner) of 1935 gave federal protection to the bargaining process for workers and established a set of fair employment standards. The federal Fair Labor Standards Act of 1938, the last major domestic program launched by the Roosevelt administration, mandated maximum hours and minimum wages for most categories of workers.

Perhaps the most far-reaching programs of the entire New Deal were the **Social Security** measures enacted in 1935 and 1939, providing old-age and widows' benefits, unemployment compensation, and disability insurance. This program contained three major programs—a retirement fund, unemployment insurance, and welfare grants for local distribution (including aid for dependent children). These programs, coupled with a new subsidized public housing program, began what some now refer to as a welfare state.

PART FOUR: Problems with New Deal Policies

Roosevelt pushed through a new tax on undistributed corporate profits, expecting this to cause firms to pay out undistributed profits in dividends. Though some firms did pay out part of the retained earnings in larger dividends, others, such as the firms in the steel industry, also paid bonuses and raised wage rates to avoid paying their retained earnings in new taxes. As these three policies came together, real hourly labor costs jumped without corresponding increases in demand or prices, and firms responded by reducing production and laying off employees.

The most damaging policies were those at the heart of the recovery plan, including the NIRA, which tossed aside the nation's antitrust acts and permitted industries to collusively raise prices provided that they shared their newfound monopoly rents with workers by substantially raising wages well above underlying productivity growth. The NIRA covered over 500 industries, ranging from autos and steel, to ladies hosiery and poultry production. Each industry created a code of "fair competition" which spelled out what producers could and could not do, and which were designed to eliminate "excessive competition" that FDR believed to be the source of the Depression.

One example of how the cartels were to the benefit of large companies, despite Roosevelt's populist rhetoric, was the case of Jacob Mage, a 49-year-old immigrant. In April 1934, he 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 Robinson-Patman Act, amending the Clayton Antitrust Act in 1936, made it illegal for A&P and King Kullen (the Wal-marts of their day) 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. This didn't change until the deregulation of airlines came in the 1970s.

Airline Cartelization

In fact, the airline industry is a good example of the cartelization that was enacted in the New Deal, and how good it was for large businesses. The Civil Aeronautics Board (the government agency charged with regulating the airline industry) limited the airline industry to 10 "trunk" airlines (major carriers flying to major cities), despite the fact that 79 other companies had filed applications to be allowed to compete in those markets. And when deregulation was enacted in 1979, airlines now had to face competition. In the 27 years before airline deregulation in 1978, no airline went into bankruptcy. In the 27 years after that, 160 airlines did. Some re-emerged;

others were liquidated. One can see why they have been facing bankruptcy: they have been forced to lower their fares that they charge customers. According to a 2006 General Accountability Office (GAO) report, the median fare has declined almost 40 percent since 1980 as measured in 2005 dollars. Since 1980, the industry has become more competitive; the average number of airlines flying into from any given airport to another given airport, has increased from 2.2 in 1980, to 3.5 in 2005. In total, industry capacity and passenger traffic have tripled as passengers hit the friendly skies with greater frequency. And so for 40 years, American passengers were forced to pay significantly higher rates to airlines, due to this cartelization of the American airline industry.

Critics of deregulation have charged that safety has been compromised, but that simply doesn't square with the facts. From 1962 through 1971, 133 out of every 100 million passengers died in a plane crash in the US; from 2001 through 2011, 2 out of every 100 million passengers died. Another way of looking at the odds of airline safety nowadays, is that *statistically speaking*, you could fly every day for 123,000 years before expecting to get killed in a plane crash.

Tax Increases to Fund the New Deal

During the 1930s, federal tax revenues more than tripled, from $1.6 billion in 1933 to $5.3 billion in 1940. The Revenue Act of 1932 increased American tax rates greatly in an attempt to balance the federal budget, and by doing so it dealt another blow to the economy by further discouraging investment. 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 (even though a small amount of lump-sum Social Security payments were made in 1935, when Social Security taxes were first levied, the monthly payments didn't start until 1940—and so for over four years, the government was taxing people for this program without giving anything of substance back).

Despite the recession of 1937–38, real GDP in the United States was well above its pre-Depression level by 1939 (this is sometimes diluted by the fact that prices were lower in 1939, which made the nominal GDP lower in 1939). At the same time, the U.S. economy was still somewhat below trend at the start of the war, and the unemployment rate averaged just under 10 percent in 1941. The number of unemployed workers declined by 7,050,000 between 1940 and 1943, but the number in military service rose by 8,590,000. The reduction in unemployment can be explained by the draft, not by the economic recovery.

PART FIVE: New Deal as a Radical Break from Limited Government of the Past

Supreme Court Reaction

To the chagrin of Roosevelt, much of his legislation was declared unconstitutional by the Supreme Court. The Supreme Court ruled the National Industrial Recovery Act unconstitutional on May 27, 1935, and the Agricultural Adjustment Act unconstitutional on January 6, 1936. These rulings were made on the grounds that neither the commerce nor the taxing provisions of the Constitution granted the federal government authority to regulate industry or to undertake social and economic reform. Roosevelt didn't back down. In 1937, he proposed to pack the court. He wanted to appoint six new justices (in addition to the nine who were already there), which would have decidedly turned the court in his favor. This proposal met with strong opposition and ultimate defeat (let's face it—what good is having a separate and independent judicial system, if the president can pack it with his supporters whenever he wants?), but the court meanwhile started ruled in favor of New Deal legislation in subsequent court cases—so even though he lost the battle, he won the war.

This objection about the constitutionality of the New Deal might seem strange to us now. But until the appearance of the Progressive movement, this was the conventional interpretation of the Constitution. In 1887, the Democrat President Grover Cleveland actually vetoed a Congressional measure that would have provided famine relief to farmers in Texas with the following: "I can find no warrant for such an appropriation in the Constitution."

Evaluation

Al Smith (Governor of New York from 1923-28 and Democratic candidate for the Presidency in 1928) blasted the New Deal, saying (among other things),

> Forget the rich; they can't pay this debt. If you took everything they have away from them, they couldn't pay it; there ain't enough of them, and furthermore they ain't got enough. There is no use talking about the poor; they will never pay it because they have got nothing. This debt is going to be paid by that great big middle class that we refer to as the backbone and the rank and file, and the sin of it is that they ain't going to know they are paying it. It is going to come to them in the form of indirect and hidden taxation. It will come to them in the cost of living, in the cost of clothing, in the cost of every activity that they enter into, and because it is not a direct tax, they won't think they're paying it. But, take it from me, they are going to pay it.[2]

Smith made these comments when the national debt was had just crossed the $30 billion mark. Imagine what he would say today, with our national debt (as of December 2013) of $16 trillion.

[2] *The Facts in the* Case, Speech at the American Liberty League, 25 January 1936.

Regardless of the constitutionality of the New Deal, it is obvious that FDR had been influenced by the Progressive movement, that saw the job of government as being that of an advocate and beneficiary of the poor, as opposed to a danger that should be watched, lest it become too powerful.

A major indictment of the New Deal came from one of its architects, Henry Morgenthau, FDR's Secretary of the Treasury from 1934-45. On May 9, 1939, he told a group of House Democrat leaders: "I want to see this country prosperous. I want to see people get a job. I want to see people get enough to eat. We have never made good on our promises….I say after eight years of this Administration we have just as much unemployment as when we started. ... And an enormous debt to boot!"

Finally, one can examine the continual increase in federal expenditure, throughout the 30s, as well as a persistently high unemployment rate:

Comparison of Unemployment and Federal Expenditures

	Unemployment (%)	federal budget ($ billion)
1929	3.2	3.8
1932	25	4.7
1936	17.5	9.2
1937	15	8.8
1938	20	8.4

Looking at the continually high unemployment rate throughout the 1930s, as well as the drastic increases in government spending (the costs of FDR's New Deal), it's hard to say that the New Deal saved America from the Depression. **The lesson from the 1920s (about lowering income taxes to spur the economy, and getting more tax revenue as a result) seems to have been lost in the 1930s.**

As Thomas Sowell, in his article "A Non-Prediction" has written:

> Unemployment never hit double digits in any of the 12 months following the big stock market crash of 1929 that is often blamed for the massive unemployment of the 1930s. Unemployment peaked at 9 percent, two months after the October 1929 crash, and then began drifting downward. **Unemployment was down to 6.3 percent by June 1930, when the first big federal intervention occurred. Within six months, the downward trend in unemployment reversed and hit double digits for the first time in December 1930**.