





Where the New Deal

The current economic crisis has made some nostalgic for Franklin D. Roosevelt's New Deal, an era that we are now inclined to remember as a grand – and successful – struggle to bring the economy back from the brink of chaos. After

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all, Roosevelt's social insurance programs, including Social Security, unemployment compensation and the WPA did aid millions of Americans. But despite the benefits of the New Deal safety net, and despite the success of Roosevelt's financial reforms – notably, the creation of the Federal Deposit Insurance Corporation and the

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Securities and Exchange Commission – this nostalgia is misplaced. The central component of the New Deal – the programs aimed at restoring private-sector jobs – was highly problematic, and largely accounts for why the Depression ground on through the 1930s.

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Few people today seem aware that the economy remained depressed long after it hit bottom in 1933. Even by the end of the decade, hours worked per person remained 21 percent below the level in 1929 level. And it wasn't just work that remained scarce. Consumption and investment didn't come close to recovering anytime during the 1930s. All told, economic production didn't reach full capacity until 1943, after the government had committed itself to massive deficit spending in mobilizing America's industrial capacity to support the titanic struggle against Germany and Japan.

The failure of the U.S. economy to recover from a downturn within a few years was unprecedented. Every previous economic crisis in the history of the United States, large or small, had been followed by a vigorous recovery. And by most objective measures, the

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economy did seem poised to rebound quickly after the nadir in 1933. Deflation ended, financial liquidity was more than ample, borrowing costs were low and, thanks to the introduction of deposit insurance, bank panics were no longer a threat. Indeed, we have calculated that, on the basis of productivity growth alone, employment and investment should have been back to their normal levels by 1936.

But don't take our word for it. The Nobel Prize-winning economist Robert Lucas and the economist Leonard Rapping calculated decades ago that the Federal Reserve's efforts to expand the money supply should have brought the economy back on track by 1935.

So what went so badly wrong? Our research suggests that a slew of policies, specifically those that suppressed market competition, are central to understanding why the economy remained so weak for so long.

Those policies were part of the New Deal, implemented shortly after Roosevelt took office in 1933. The New Deal was a pragmatic grab-bag of programs aimed at easing material hardship as well as restoring jobs and promoting growth. The centerpiece was the National Industrial Recovery Act (NIRA), signed into law in June 1933. It effectively suspended the antitrust laws so that firms could openly collude to raise prices by keeping the lid on total output as long as each industry cartel agreed to share some of the monopoly profits with its workers in the form of higher wages.

New Deal policies that promoted monopoly represented an about-face from long-held mainstream views of the virtues of free markets. In fact, the industrial and labor policies it embodied were designed to undo the pro-competitive reforms embodied in the Sherman and Clayton Antitrust Acts, which had been adopted in the Progressive era out of





concerns about increasing market concentration and the growth of business power.

This sea change in policy reflected popular perceptions (in Europe as well as in America) about the role of “excessive” competition in creating and prolonging the Depression. Roosevelt and many of his economic advisers believed that unregulated market economies were prone to a destructive race to the bottom in which falling profits drove down wages and, ultimately, production and income. From this perspective, the logical remedy was government planning that restricted competition. As Roosevelt put it during the 1932 presidential campaign:

“A mere builder of more industrial plants, a creator of more railroad systems, an organizer of more corporations, is as likely to be a danger as a help. Our task is not ... necessarily producing more goods. It is the soberer, less dramatic business of administering resource and plants already in hand.”

Roosevelt’s advisers drew their conclusions about the superiority of planning to decentralized market competition from their experiences with top-down economic decision making during World War I. As part of the war mobilization, production was coordinated by government committees, with the bureaucracy awarding production contracts without competitive bidding. Wages, by the same token, were regulated by a government labor board.

The result was positive, at least from the perspective of a government seeking to win the war to end all wars. Real output and wages both rose about 10 percent. And Roosevelt’s brain trust deduced that what had worked in wartime would also work in an economic crisis.

The problem with markets, they argued, is that competition in a period of slack demand leads firms to cut prices, which generates

pressure for wage cuts. As wages fall, household buying power falls and with it, consumer demand and incentives to invest in more production capacity. In other words, the economic collapse was the consequence of a vicious cycle of falling prices, wages and purchasing power.

The NIRA was passed to stop the cycle. It covered much of the private non-agricultural economy, dividing businesses into over 500 sectors ranging from large, concentrated in-

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dustries (like automobile manufacturing) to much smaller ones (like the live-poultry industry). In each, firms, along with worker and government representatives, hammered out codes of “fair competition.”

Each code was supervised by a government-sanctioned authority, which had the task of insuring that industry participants followed the rules. Most of the codes required direct collusion among producers, which was consistent with the NIRA’s goals of raising prices. They restricted output and set minimum prices, of course. But most went further, curtailing expansion of plant capacity and hours of operation.

The minimum price was the most widely adopted collusive element in these codes. The code authority assessed the fair-market price based on the minimum cost of production.

Some codes included open-price systems, requiring that any firm planning to reduce its price first file notice with the code authority, which passed on the information to other firms in the industry. Following this notification, the firm was required to wait a specified

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period before changing its price. This gave others time to react, and typically resulted in competitors convincing the firm that gave notice to cancel its price cut.

The government only approved these codes if the industry agreed to raise wages considerably and to engage in collective bargaining with labor. The codes were rapidly negotiated and approved, and most were in place by late 1933. The Roosevelt administration worked hard to build popular support for them, selling the NIRA as the patriotic way to go and pressuring firms to display the Blue Eagle, an emblem signifying recovery act participation.

The codes worked, in the sense that wages and prices in covered sectors rose substantially. In fact, by December 1933, a 20 percent gap had opened between prices in industries tightly covered by NIRA and those that weren't.

But not everybody approved of this massive experiment in economic planning. Consumers, and even some government agencies, complained about abuses of the market power given to businesses. And that led to investigations of trade practices by the National Recovery Review Board, a watchdog agency created by the NIRA.¹ In 1935, the board concluded that:

“the industry codes do not only permit but foster monopolistic practices. ... If monopolistic business combinations could have anything ordered to their wish, they could not order anything better than to have the antitrust laws suspended.”

The Supreme Court, whose members were mostly conservatives appointed in earlier decades, wasn't easily won over, either. It declared the NIRA to be unconstitutional in May 1935, only two years after it became law.

¹The board, incidentally, was led by Clarence Darrow, the famous trial lawyer.

And many historians have subsequently inferred from the quick demise of the NIRA that New Deal anti-competition policies could not have been responsible for the Depression's unprecedented duration.

That's not necessarily so. NIRA-type policies, designed to suppress competition and increase industrial prices and wages, continued long after the court's decision. There was virtually no antitrust prosecution in the wake of the NIRA's demise, despite a number of reports of widespread collusion from the Federal Trade Commission.

Harold Ickes, Roosevelt's interior secretary, reported receiving identical bids from steel companies on 257 occasions in just a one-year period. These bids were coordinated by steel firms using base-point pricing, a price-fixing method developed under the NIRA in which producers agreed to charge the same price to all customers, even when differences in the cost of shipping the steel to the customer represented a major portion of the cost of the commodity.

What's more, the price bids were 50 percent higher than the bids from foreign producers. As a matter of law, this price difference was sufficiently large to permit Ickes to purchase steel abroad, which he decided to do. But steel companies complained to the president about his decision, and he rescinded the order. Moreover, despite the obvious collusion among steel firms, the attorney general announced that the steel firms would not be prosecuted for restraint of trade.

Meanwhile, the National Labor Relations Act of 1935 significantly strengthened labor's bargaining power beyond that established by the NIRA. It guaranteed the right to collective bargaining, protected workers' rights during strikes and placed few restrictions on striker tactics. The sit-down strike, in which workers forcibly took over factories and stopped pro-



duction, was used with great success against General Motors in 1937. And the threat of a sit-down strike was used to similar effect in gaining concessions from U.S. Steel.

This new and legal leverage made it possible to fully unionize the bellwether auto and steel industries. And it fostered an economy-wide increase in unionization: the share of unionized employment rose from around 10 percent of non-agricultural workers to more than 25 percent. Wages rose substantially after the National Labor Relations Act of 1935, particularly after its constitutionality was upheld by the Supreme Court in April 1937.

Today, it seems only common sense that promoting and extending monopoly de-

presses employment and output by creating a wedge between prices and costs. In contrast to the NIRA's legalization of cartels, though, we are still inclined to celebrate the rise in union power and the resulting increase in wages. But few economists would disagree that one consequence of higher wages was a reduction in total employment as well as a further weakening of the economy in 1937 and early 1938.

We have calculated that New Deal labor and industrial policies, which raised wages and prices 20 percent or more in many industrial sectors, were directly responsible for stretching the Depression through the decade of the 1930s. All told, we estimate that these

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policies kept the economy below the growth rate one would have otherwise expected for an extra seven years.

Roosevelt learned (albeit slowly) from his mistakes. In 1938, he declared that the economy had become “a concealed cartel system, like Europe.” Roosevelt appointed Thurman Arnold as the new head of the Department of Justice in 1938, and he initiated antitrust litigation and doubled the department’s anti-trust staff.

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Labor policies changed significantly, as well. The Supreme Court ruled against sit-down strikes in 1939, which curtailed unions’ bargaining powder. And as the country began its war effort, Roosevelt met with union leaders to ask them to pledge not to strike during the war.

Union leaders agreed, provided that they could continue to use collective bargaining to determine wages and work rules. But during the war, the National War Labor Board was given the authority to veto wage increases. And in 1942, the steelworkers’ union was devastated by the board’s decision to deny a large wage increase for employees of Bethlehem Steel. In what became known as the Little Steel Case, the Board decided that wage increases would be limited to increases in the cost of living. The steelworker’s union appealed the decision to Roosevelt, but he declined to intervene.

In the years following the Little Steel case, there were a number of wildcat strikes (strikes that are not authorized by union leadership), particularly in the coal industry. These strikes angered the public, and President Harry S. Truman was sufficiently incensed that he asked his advisors whether the 60-year-old John L. Lewis, the fabled tough-guy president of the United Mine Workers, could be drafted into wartime service.

The tide of public opinion had clearly turned against labor, and much of the New Deal effort to strengthen unions was undone after the war. The National Labor Relations Act of 1935 was watered down by the Taft-Hartley Act in 1947. Changes included the elimination of the closed shop (the obligation to belong to the union in a unionized workplace) and the restriction of union actions during strikes. This reduction in union power gradually eroded the very high real wages that prevailed in the mid- and late-1930s. Indeed, by the end of the 1940s, the average industrial wage, which had risen by 25 percent relative to output per worker under the New Deal, was back in line with labor productivity. And since then, real wage gains have rarely outpaced productivity gains.

It’s fair to say, then, that the consequences of New Deal policies are widely misunderstood. Roosevelt’s industrial and labor policies retarded recovery by restricting employment and output in the name of raising profits and wages.

As noted earlier, Roosevelt did many things right, too, creating a social safety net, curbing some egregious financial-market abuses and insuring bank deposits. Just how one weighs the gains from New Deal efforts against the moves to undermine competition is still a matter of dispute among economic historians.

The year 2009 is not 1933. This time around, a combination of deposit insurance



and swift intervention in a slew of financial-market institutions prevented the money supply from collapsing. The prospect of massive fiscal stimulus has slowed the decline in consumer and business spending. The world's collective dependence on trade has tempered the political impulse to "beggar-thy-neighbor" protectionism. And nobody is proposing to cartelize vast swaths of American business with the goal of restricting output. Still, the experience of the Depression – in particular, the impact of a massive experiment in market regulation – offers some relevant lessons.

Almost all economic crises give rise to demands for sweeping changes in economic policy. But the fact that financial markets failed to manage risk and that two of the three American automakers went belly-up doesn't guarantee that any government fix is better than none. Indeed, we would argue that the primary test for judging the value of intervention should remain a familiar one: would the change preserve (or improve) market-based incentives to work, save, invest and innovate? By this measure, the New Deal plainly came up short. **M**