The New Deal Debunked
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Macroeconomic model builders have finally realized what Henry Hazlitt and John T. Flynn (among others) knew in the 1930s: FDR's New Deal made the Great Depression longer and deeper. It is a myth that Franklin D. Roosevelt "got us out of the Depression" and "saved capitalism from itself," as generations of Americans have been taught by the state's education establishment.

This realization on the part of macroeconomists comes in the form of an article in the August 2004 *Journal of Political Economy* entitled "New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis," by UCLA economists Harold L. Cole and Lee E. Ohanian. This is a big deal, since the *JPE* is arguably the top academic economics journal in the world.

"Real gross domestic product per adult, which was 39 percent below trend at the trough of the Depression in 1933, remained 27 percent below trend in 1939," the authors write. And, "Similarly, private hours worked were 27 percent below trend in 1933 and remained 21 percent below trend in 1939."

This should be no surprise to anyone who has studied the reality of the Great Depression, for US Census Bureau statistics show that the official unemployment rate was still 17.2 percent in 1939 despite seven years of "economic salvation" at the hands of the Roosevelt administration (the normal, pre-Depression unemployment rate was about 3 percent). Per capita GDP was lower in 1939 than in 1929 ($847 vs. $857), as were personal consumption expenditures ($67.6 billion vs. $78.9 billion), according to Census Bureau data. Net private investment was minus $3.1 billion from 1930–1940.

Cole and Ohanian write as though they were surprised—even shocked—to discover these facts, not so much because they were bamboozled by the Myth of the New Deal, but because of their devotion to "neoclassical model building" as opposed to the study of economic reality. They label as "striking" the fact that the recovery from the Great Depression was "very weak" (a dramatic understatement). And why is it so striking? Because "[t]hese data contrast sharply with neoclassical theory."

The neoclassical theory of depressions might well be thought of as a Frankenstein's Monster theory. As explained by Cole and Ohanian, "The weak recovery is puzzling because the large negative shocks that some economists believe caused the 1929–33 downturn—including monetary shocks, productivity shocks, and banking shocks—become positive after 1933." Thus, according to neoclassical theory, the economy during a depression is somewhat like a prostrate Frankenstein's Monster, with economists playing the role of mad scientists who "shock" the beast into becoming a living being once again. They do this with various "injections" of government spending or easy credit that will supposedly cause a "roaring" recovery (just as the rejuvenated beast roared as he left the laboratory to terrorize the townsfolk in the movie, *Young Frankenstein*).

"The monetary base increases more than 100 percent between 1933 and 1939," the authors write, making the case that such a "monetary shock" should have returned the economy to normalcy. They invoke the authority of well-known macroeconomists Robert Lucas and Leonard Rapping, who once proclaimed that "positive monetary

shocks should have produced a strong recovery, with employment returning to its normal levels by 1936."

But as Murray Rothbard showed in *America's Great Depression*, it was the easy money policies of the early and mid-1920s that created all the malinvestment that was the trigger for the Great Depression. The only wise thing to have done was to allow the liquidation of hundreds of overcapitalized businesses to occur. Instead, the Fed increased the monetary base by 100 percent in five years, causing more of the same overcapitalization problems that were the source of the problem in the first place.

On top of that, virtually every single one of FDR's "New Deal" policies made things even worse and prolonged the Depression. Austrian economists have known this for decades, but at least the neoclassical model builders have finally caught on—we can hope.

Cole and Ohanian apparently emerged from the rarified world of macroeconomic model building for a long enough period of time to discover that the so-called First New Deal (1933–1934) was one giant cartel scheme, whereby the government attempted to enforce cartel pricing and output reductions in hundreds of industries and in agriculture. This of course was well documented in John T. Flynn's book, *The Roosevelt Myth*, first published in 1948. Henry Hazlitt had also written about it some 15 years earlier. "New Deal cartelization policies are a key factor behind the weak recovery, accounting for about 60 percent of the difference between actual output and trend output," the authors write.

The fact that it has taken "mainstream" neoclassical economists so long to recognize this fact is truly astounding. For generations their own neoclassical textbooks have taught that cartels "restrict output" to raise prices. It has also been no secret that the heart and soul of the First New Deal was to use the coercive powers of government to prop up wages and prices by cartelizing the entire economy.

FDR and his advisors mistakenly believed that the Depression was caused by low prices, therefore, high prices—enforced by threats of violence, coercion and intimidation by the state—would be the "solution." Moreover, it is hardly a secret that if less production takes place, fewer workers will be needed by employers and unemployment will subsequently be higher. Thus, the First New Deal could not possibly have been anything but a gigantic unemployment-producing scheme according to standard neoclassical economic theory.

FDR's tripling of taxes, his regulation of business, and his relentless antibusiness propaganda also contributed to a worsening of the Great Depression, but his labor policies were probably the most harmful to the employment prospects of American workers. In this regard the most disappointing thing about the Cole-Ohanian article is that they do not even cite the pioneering work of Richard Vedder and Lowell Gallaway—*Out of Work: Unemployment and Government in Twentieth-Century America*—first published in 1993.

Indeed, it is somewhat scandalous that they do not cite this well-known work while making essentially the same arguments that Vedder and Gallaway do. They recite many of the same facts about labor policy: The NIRA codes established minimum wages for less-skilled and higher-skilled workers alike; employers were told that they

must bargain collectively with unions, which were given myriad legislated advantages in the bargaining process, all enforced by the newly-created National Labor Relations Board. All of these policies made labor more expensive. Consequently, as the economic law of demand informs us, the inevitable result has to be less employment.

Strike activity doubled from 14 million strike days in 1936 to 28 million a year later, and wages rose by about 15 percent in 1937 alone. The union/nonunion wage differential increased from 5 percent in 1933 to 23 percent by 1940. Newly-enacted Social Security payroll and unemployment insurance taxes made employment even more expensive. What all of this means is that during a period of weak or declining derived demand for labor, government policy pushed up the price of labor very significantly, causing employers to purchase less and less of it.

Vedder and Gallaway conducted an econometric evaluation of these labor cost-increasing policies and concluded that most of the abnormal unemployment of the 1930s would have been avoided were it not for these policies. They estimated that by 1940 the unemployment rate was eight percentage points higher than it would have been without the legislation-induced growth of unionism and government-mandated employment costs. They conclude that "The Great Depression was very significantly prolonged in both its duration and its magnitude by the impact of New Deal programs" (p. 141).

Cole and Ohanian reach the exact same conclusions, but express them in the somewhat convoluted language of the "top economic journals": "New Deal labor and industrial policies did not lift the economy out of the Depression. . . . Instead, the joint policies of increasing labor's bargaining power and linking collusion with paying high wages prevented a normal recovery by creating rents and an inefficient insider-outsider friction that raised wages significantly and restricted employment . . . the abandonment of these policies coincided with the strong economic recovery of the 1940s."

This last conclusion—that the abandonment of FDR's policies "coincided" with the recovery of the 1940s is very well documented by another author who is also ignored by Cole and Ohanian, Robert Higgs. In "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War" (*Independent Review*, Spring 1997), Higgs showed that it was the relative neutering of New Deal policies, along with a reduction (in absolute dollars) of the federal budget from $98.4 billion in 1945 to $33 billion in 1948, that brought forth the economic recovery. Private-sector production increased by almost one-third in 1946 alone, as private capital investment increased for the first time in 18 years.

In short, it was capitalism that finally ended the Great Depression, not FDR's harebrained cartel, wage- increasing, unionizing, and welfare state expanding policies. It's good to see that the *Journal of Political Economy*, the University of Chicago, and UCLA are finally beginning to catch up to the libertarian scholarship of Richard Vedder, Lowell Gallaway, Robert Higgs, Jim Powell (author of *FDR's Folly*) and such predecessors of theirs as Henry Hazlitt, John T. Flynn, Murray Rothbard, F.A. Hayek, William H. Hutt, Benjamin Anderson, and others associated with the Austrian School.

Better late than never.