# Prologue

This study is concerned with the interplay of economic ideas and events during a dozen years of extraordinary turbulence in the American economy. The administrations of Franklin D. Roosevelt confronted formidable challenges, including persisting depression, a major downturn in economic activity (in 1937–38) which the received learning could not readily explain, mobilizing resources for war while leaning against runaway inflation, and preparing for a postwar order from which the nightmares of the 1930s would be banished.

When he entered the White House in 1933, Roosevelt inherited a disorderly economy whose behavior was at odds with textbook teaching. At his death, he bequeathed a restructured economy – in which the role of government had been redefined – that would inspire a rewriting of the textbooks. Along the way, he was to execute more than one "U-turn" in his economic strategies. It is small wonder that this apparent disorder induced his critics to question whether Roosevelt's economic thinking was rooted in any coherent analytic perspective. His behavior also gave ammunition to those who would argue that his policies were driven solely by political opportunism.

Roosevelt never committed himself irrevocably to any single economic doctrine. He was certainly not immune, however, from intellectual influences. On the contrary, he was remarkably receptive to a broad spectrum of economic ideas. More than any of his predecessors in the American presidency, he was prepared to listen to the designs put before him by members of the economics profession. Indeed he was receptive to advice based on a remarkably broad spectrum of analytic perspectives – some of which were mutually incompatible. He never claimed standing as a producer of economic ideas. Instead he saw himself as their consumer and, on these matters, he was an uncompromising champion of consumer sovereignty.

These were years of disarray – not just for the economy, but also for practitioners of the discipline of economics. For economists, the impact of the Great Depression has been perceptively likened to that of the Big Bang for theoretical physicists. The cataclysmic events of the 1930s called into question most of the established verities of the orthodoxies of the day. There could be no escaping the disjunction between the realities of the observable world and the mainstream theoretical construct in which conditions of full employment were taken to be the "norm." The awkwardness of brute facts, however, was not sufficient to shake the faith of true believers in the fundamental validity of the basic "model." Stubbornly persisting unemployment, it could be argued, was the result of "rigidities" in price and wage making. As these phenomena were incompatible with the competitive conditions presupposed in the theory, one could conclude that the world – but not the model – was out of joint. This intellectual maneuver had the virtue of logical tidiness. But it could offer little comfort to a distressed populace or to economic policy makers pressured to find solutions to real problems.

The economic environment of the early 1930s proved to be auspicious for economic thinkers with heterodox leanings who then found some attentive listeners. Though their arguments were not identical in their substantive properties, they were projected from a shared point of view: namely, that it was futile to pretend that the nation's economic health could be restored without unconventional interventions by government. Given the conditions of the times, it was not surprising that Roosevelt should have provided house room for heterodoxies. The apparent bankruptcy of the old-fashioned remedies suggested that it was time to try something different. Roosevelt's willingness to experiment was one of the most engaging aspects of his presidential style. When doing so, he was prepared to break the inherited rules delineating the appropriate spheres for the private and public sectors in economic activity, as well as those defining the respective jurisdictions of various echelons of government within a federal system.

Roosevelt's activism always sparked intense controversy. But, much of the time, it had a positive effect in bracing badly bruised public morale. The experiments in economic policy in the early going were failures – or, at the minimum, produced results quite different from those that had been anticipated. Even the disappointments had compensating features. New learning emerged when economists tried to understand what had gone wrong. This could be a slow and uneven process. It was accelerated, however, in the president's second term.

Roosevelt's Washington was a laboratory affording economists an opportunity to make hands-on contact with the world of events. Their activities yielded a noteworthy payoff in 1937–38. Economists were then challenged by a fresh set of perplexities and the response that a number of the "insiders" came up with was to inspire the formulation of a "model" to guide economic policy.

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This left a significant mark on the flow of events. It also proved to be a catalyst to a revolutionary transformation in the discipline itself. The perspective then proclaimed insisted that a promised land was in sight if government intelligently deployed the tools of aggregate demand management.

At the time of Roosevelt's death, an Americanized version of Keynesian macroeconomics framed the agenda at the highest levels of economic policy making. Its conceptual categories had not been available when the course of the first New Deal had been charted in 1933. Even had they been at hand, the temper at that moment would have precluded their use. Post-1938, fundamental change in the atmosphere and in the inventory of analytic tools was in evidence. But there was still a sniff of heresy about this version of a "new economics" and it did not lack for critics. Within the bureaucracy, doctrinal innovation made considerable headway – indeed its insights were sharpened and refined in the management of wartime mobilization and in the preparations for a postwar economic order. Domesticated Keynesianism did not enjoy such repute in the academy. When Roosevelt left the scene, it was regarded as suspect by the bulk of the academic establishment.

The Roosevelt years marked a watershed in the development of policies to reshape the American economy and in the development of economic analysis as well. The chapters to follow aim to tell the story of how these outcomes were influenced by the competition between rival economic ideas – and by the creation of new ones – during a period of exceptional ferment.

# 1

# Stage setting in the presidential campaign of 1932

In the presidential campaigns of 1932 and 1992, Democratic challengers opposed Republican incumbents. In 1932, the slogan that was intended to keep the 1992 challenger's campaign staff focused – i.e., "It's the economy, stupid!" – would have been redundant. No alert observer could entertain any doubt that the economy was the central issue in Franklin D. Roosevelt's first campaign for the presidency. The wreckage wrought by three years of depression had a distressing immediacy in the form of mass unemployment, idled industrial capacity, collapsed farm prices, real estate foreclosures, and bank failures.

It is now a part of the conventional wisdom that a president running for reelection is in trouble if the "economic discomfort index" – defined as the sum of the unemployment rate and the inflation rate – is in double digits. (In the environment of 1932, it would have been fitting to rewrite this formula by substituting the deflation rate, which was then responsible for major economic distress, for the inflation rate.) By these standards, contemporaries might easily have concluded that the Hoover administration's economic performance meant that it was automatically doomed. Before the fact, however, the electoral result was less than self-evident. The electorate clearly had ample reasons to reject the party in power. But observers at the time also had valid grounds for wondering what a Democratic administration would bring. Only four times in the preceding eighteen presidential contests had the Democrats won control of the White House. By 1932, the party's core constituencies amounted to a coalition of contradictions: among them, boss-dominated big city machines that offended the champions of "clean government"; Southern landholders committed to perpetuation of racial segregation; Northern workers for whom advancing the rights of labor took high priority; groupings of intellectuals who were eager to promote economic and social reforms. The philosopher-comedian

Will Rogers captured the flavor of this when he remarked, "I belong to no organized party: I am a Democrat."

In the second half of the twentieth century, it has become standard practice for presidential candidates to invite academic social scientists – and particularly economists – to assist them in preparing position papers and speech drafts. Candidate Roosevelt broke new ground when he took that step in 1932. In his choice of academic advisers, he signaled that he was hospitable to heterodoxy. The three charter members of his Brains Trust were drawn from the Columbia University professoriate. Their selection had an obvious logistical recommendation – i.e., geographical proximity to the candidate. Nevertheless, if a professional organization (such as the American Economic Association) had been asked to nominate persons competent to advise a potential president, the names of those to whom Roosevelt turned would not have been on the list.

## 1 Designs for the industrial order

The original Brains Trusters shared a common perspective. As each saw matters, the deranged condition of the American economy reflected fundamental structural imbalances that could be corrected only through actions by government. They brought differing professional specialties to their assignment. Raymond Moley, who had served Governor Roosevelt as an advisor on reform of the criminal justice system in the state of New York, identified himself as a political scientist. Though he served as the coordinator of this experiment in idea brokerage, his substantive contribution to an economic model to inform campaign strategy was slight. Nonetheless, the moral of the one that was developed – i.e., the imperative need for public intervention to promote economic balance – was one that he could readily embrace. Adolf A. Berle, Jr., professor in Columbia's School of Law, and Rexford Guy Tugwell, professor in the university's economics department, were on hand to supply the economic arguments.

Berle and Tugwell converged in their readings of the dimensions of disorder in the industrial sector, though they did not begin from the same starting point. Berle's point of view reflected his background as a lawyer, a career he had embarked on following his graduation from Harvard Law School in 1916 at the age of 21. As the youngest graduate in its history, he had quickly acquired a reputation as an infant prodigy. (Some of his critics were later to assert that he remained an infant long after he ceased to be a prodigy.) By the late 1920s – and informed by his work in corporate law – he was persuaded that a "major shift in civilization" was underway as a by-product of the power acquired by large corporations.[1] In his search for a richer understanding of the implications of this phenomenon, he enlisted the aid of a graduate student in economics at Harvard, Gardiner C. Means, to conduct empirical studies of cor-

1. A. A. Berle, Jr., assisted by Gardiner C. Means, "Corporations and the Public Investor," *American Economic Review,* March 1930, pp. 54–71.

porate concentration. The fruits of this collaboration appeared in 1932 in a book entitled *The Modern Corporation and Private Property* and were to cause a mild sensation.

Through Berle, the essential arguments of this work were put before Roosevelt in memoranda and oral briefings early in the 1932 campaign. In a 39-page document of May 1932, for example, Roosevelt was informed that:

> Concentration has proceeded to a point at which 65% of American industry is owned and operated by about six hundred corporations. … Nearly 50% of American industry is owned and operated by two hundred large corporations. … This means that some six thousand men, as directors of these corporations virtually control American industry …[2]

In light of this, Berle anticipated that "at the present rate of trend, the American and Russian systems will look very much alike within a comparatively short period – say twenty years." And he added that "there is no great difference between having all industry run by a committee of Commissars and by a small group of Directors."[3]

The trends notwithstanding, there was nothing predetermined about this outcome. Governmental policies should be deployed to ensure that the public interest was better protected. Berle rejected totally the traditional trustbusters' solution to the problem of concentration. Bigness should be accepted as a fact of life in modern industry. He proposed instead that the antitrust laws be amended to permit consolidations and "even monopolies at will" – subject to the condition that federal regulation would be applied when the two-firm concentration ratio exceeded 50 percent. And he specified that such regulation "should include power to require uniform prices; to control security issues; and to control further consolidation."[4]

Rexford Guy Tugwell could embellish these themes as a prolific critic of mainstream economics. Throughout his academic career, he had championed his version of a "new economics," which rejected the doctrines of laissez-faire as unrealistic, wasteful, and socially immoral. He had cast himself as a promoter of a *Methodenstreit* in which the objective was no less than the banishment of standard neoclassical teaching, which, in his view, blinded those under its influence to correct perceptions of crucial economic problems.

Tugwell's thinking had its roots in a well-established body of home-grown American heterodoxy. Thorstein Veblen had pioneered this tradition with such trenchant works as *The Theory of Business Enterprise* and *Engineers and the Price System*. Within his analytic framework, the interests of those in business (as profit maximizers) and of "engineers" (as output and efficiency maximiz-

2. Berle (assisted by Louis Faulkner), "The Nature of the Difficulty," May 1932, Berle Papers, FDRPL.
3. Ibid., p. 30.
4. Ibid., pp. 34, 35.

ers) were fundamentally opposed. Indeed, business – in the pursuit of maximum profits – could be expected to practice "industrial sabotage." This was systematic waste that took the form of restricting outputs (with the sacrifice of cost-minimizing utilization of capacity) and of suppressing technical innovations to protect the value of the existing capital stock. For Veblen, these socially undesirable outcomes were inherent in the capitalistic industrial system and could be corrected only if decisions on resource allocation were transferred to technical experts. In the early 1920s, Veblen had called for a "Soviet of Engineers" to perform this planning function. Tugwell distanced himself from this emotionally charged terminology, though his style of thinking owed much to his study of Veblen.

Tugwell had articulated his vision of a new economic order in some detail before the December 1931 meeting of the American Economic Association. He then endorsed a system of comprehensive national planning, which he characterized as follows:

> Planning is by definition the opposite of conflict; its meaning is aligned to co-ordination, to rationality, to publicly defined and expertly approached aims; but not to private money-making ventures; and not to the guidance of a hidden hand. … Planning implies the guidance of capital uses; this would limit entrance into or expansion of operations. Planning also implies adjustment of production to consumption; and there is no way of accomplishing this except through a control of prices and of profit margins. It would never be sufficient to plan production for an estimated demand if that demand were likely to fail for lack of purchasing power. The insurance of adequate buying capacity would be a first and most essential task of any plan which was expected to work.[5]

Lest anyone mistake the meaning of this message, Tugwell emphatically asserted that:

> business will be logically required to disappear. … To take away from business the freedom of venture and of expansion, and to limit the profits it may acquire, is to destroy it as business and to make of it something else. … The traditional incentives, hope of money-making, and fear of money loss, will be weakened; and a kind of civil-service loyalty and fervor will need to grow gradually into acceptance. New industries will not just happen as the automobile industry did; they will have to be foreseen, to be argued for, to seem probably desirable features of the whole economy before they can be entered upon.[6]

5. R. G. Tugwell, "The Principle of Planning and the Institution of Laissez-faire," *American Economic Review Supplement*, March 1932, pp. 89–90.
6. Ibid., pp. 89–90.

This was strong stuff. Predictably, it drew fire from the mainstream professionals.[7] Tugwell, however, was undeterred by harsh criticism. He remained supremely self-confident about the "rightness" of his views, which, he maintained, had been validated by the course of events. In mid-1928, he had been one of the few to forecast an imminent downturn in economic activity. The hey-day of "new era" prosperity, he had then argued, had been associated with haphazard investment and mistaken business expectations about the demand for outputs that could be produced from newly created facilities. This had led to excess capacity and increases in overhead costs. To achieve profitability, industries had then cut back on their operations and set prices at levels that were needlessly high. This line of adjustment both choked off production and cost jobs. Tugwell predicted that presidential candidates in the election of 1928 "were going to have to talk to unemployed people, people, perhaps, who are hungry and who next winter will be cold."[8] But this outcome could have been avoided if proper public direction of the flow of private investment, combined with controls to compel producers to reduce prices as average costs fell, had been in place.

In a book completed in 1932 (though not published until May 1933), Tugwell added some refinements to the general positions he had set out earlier. Reiterating one of his standard themes, he argued that the problems of excess capacity and unemployment in industry could be traced to "inexpert allocation of capital." The remedy should be sought in a planning system that "allocated to specific industries capital sufficient to produce an amount of goods which would be taken by consumers at the price possible with capacity production, and no more ..."[9]

How, then, could the right balance be struck? In Tugwell's judgment, properly administered capital allocation "would depend on knowledge, from some planning agency, of how much for a measured future period ought to be put to one use rather than to another." He recognized that the issue was not solely the determination of the optimal future output of an industry as a whole. Decisions would also have to be made about the distribution of the industry's target production between its participating firms. This matter would be difficult unless

7. The University of Chicago's Frank Knight, for example, spoofed Tugwell's presentation to the American Economic Association: "... I think it is a most excellent oration of its kind, and a most excellent kind; also that in the time, place, and circumstances it was altogether appropriate. A little high-grade utopian-reformist soap-boxing should provide excellent – let us say – messianic relief from the nerve-strain of the solemn stodginess of a meeting of a learned society. But – perhaps it is out of place to remark as to how out of place it would be to think of such a performance in the light of a contribution to the solution of any social problem." (Frank H. Knight, "The Newer Economics and the Control of Economic Activity," *Journal of Political Economy,* August 1932, p. 475n.)
8. Tugwell, "Hunger, Cold and Candidates," *The New Republic,* 54 (May 2, 1928), pp. 323–4.
9. Tugwell, *The Industrial System and the Governmental Arts* (New York: Columbia University Press, 1933), p. 204.

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More information



firms within the industry were "either combined or sufficiently closely associated for practical action."[10]

When the industry was effectively integrated for planning purposes, the guiding principle should be to "drive corporate surpluses into the open investment market." This could be done through a tax on undistributed corporate profits. Such an innovation, he insisted, would automatically correct what he took to be a major flaw in the existing system: "self-allocation" of retained corporate earnings. But another step would be required to reach the overall objective. Government and its planning authorities would need to be empowered to control new capital issues.[11]

This was only the beginning of the comprehensive scheme of controls Tugwell had in mind. While industrial integration should be encouraged, it was imperative that producers should be denied the power to be price makers: "otherwise the advantage of efficiency will result in corporate profits, but not in lower prices."[12] Hence governmentally determined price controls were essential.

Tugwell was under no illusions that the totality of his grand design could be put in place quickly. But he hoped that some interim steps could be taken with little delay. As an initial one, he proposed that a governmental agency be empowered "to issue certificates of convenience and necessity" to industrial associations permitting them to "set up their own planning boards and central management devices for maintaining standards of competition and for controlling maximum prices and minimum wages." All of the individual industrial groupings would be subject to oversight and control by a central body – he suggested that it be named the Industrial Integration Board – which would be directed by representatives of affiliated industries and representatives of the government. The board would be charged to review policies on prices and security issues and be empowered to assess fines on firms failing to comply with the common policy. Administrative costs of this exercise could be met by an excise tax on industrial products, the proceeds of which would be paid into an Industrial Reserve Fund.[13]

10. Ibid., p. 205. Action before the desired degree of industrial integration had been accomplished would require, he argued, the adoption of some principle of apportionment between firms, such as relative size, relative contribution to the industry's total output, and perhaps "some recognition of the superior efficiency of one over the others." (Ibid., p. 205.)
11. Ibid., p. 206–7.
12. Ibid., p. 210.
13. Resources thus accumulated were to serve other purposes as well. Tugwell envisaged a tripartite division of the residuals (after administrative expenses had been met). One-third would be distributed to industries that had complied with the overall plan, scaled in proportion to the tax collected on their products. One-third would be retained as a reserve for dividend payments to corporate shareholders. One-third would be allocated to a wage reserve fund to be distributed to states that had organized programs of unemployment insurance. (Ibid., p. 215.)

All this amounted to an appeal for a radical reconstruction of the industrial order. There was some overlap between Tugwell's thinking and proposals then being floated by various business groups. The scheme most prominent in contemporary discussion was known as the Swope Plan, which had been proposed by Gerard Swope, President of the General Electric Company. When it was unveiled in September 1931, President Hoover had denounced it as "the most gigantic proposal of monopoly ever made in American history." Under its terms, trade associations would be invited to coordinate supply and demand with immunity from prosecution under the antitrust laws for the purpose of "stabilizing prices and sustaining wages." Swope and Tugwell parted company on a crucial point. Tugwell's version of planning provided no room for business autonomy. The ultimate decisions on resource allocation would be made by public authorities. There was no need for the state to own the means of production. But it was imperative that it should control their use.

When projecting their visions of industrial reconstruction, the Brains Trusters of 1932 left many questions unanswered. But they were unambiguous when distancing themselves from doctrines to which they were fundamentally opposed. They were united in insisting that their candidate for the presidency should purge his party's historic affiliation with economic thinking associated with Louis D. Brandeis (then an Associate Justice of the Supreme Court). In that view of the world, industrial bigness was a "curse" that should be banished through rigorous enforcement of the antitrust laws and the promotion of other procompetitive policies. Much to the consternation of Tugwell and Berle, Professor Felix Frankfurter of the Harvard Law School (who also aspired to gain access to the candidate's inner circle) kept reminding Roosevelt of the Brandeisian message. The Brains Trusters were also at one when denouncing mainstream neoclassical teaching on the virtues of vigorously competitive markets kept vital through surveillance by the Justice Department's Anti-Trust Division. There was no place in their world for the call for reinvigorated antitrust enforcement issued in 1932 under the leadership of Princeton's Frank A. Fetter, which was endorsed by 127 signators (including seven former presidents of the American Economic Association). Sound industrial policy, in the view of the Brains Trusters, called instead for "concentration and control" to replace "competition and conflict."

## 2 Competing designs for a new deal for farmers

For more than a decade, agriculture had been the economy's "sick sector." American farmers enjoyed boom conditions during and immediately after World War I. The upsurge in demand for farm products had then boosted prices and induced enlarged production. In the process, farmers had borrowed heavily to expand land holdings (purchased at abnormally high prices) and to add to their stock of equipment. This episode of euphoria had been short-lived. When European producers recovered from the devastation of war, export mar-