The first stirrings of real economic reform in the last decades of the nineteenth century came not from above—from the editorial offices and ivory tower classrooms of the self-professed reformers—but rather from below—from the victims of the new industrial order: the farmers, the industrial workers, and the small business owners and consumers who were being exploited by the railroads and the trusts.

The earliest laws to address the era’s economic abuses were enacted at the state level. Gradually, the concerns occupying state governments percolated upward to the U.S. Congress. As the century moved toward its final decade, Congress passed two important pieces of legislation, the Interstate Commerce Act (1887) and the Sherman Antitrust Act (1890). As practical solutions to the problems they addressed, both laws amounted to watered-down compromises, half-measures, indeed, barely more than window dressing. But an important threshold had been crossed. The federal government was now
officially in the business of regulating the economy for the benefit of the American public.

Simultaneously, the social conscience of the urban professional classes began slowly to awaken from the dogmas of the Gospel of Wealth. A new generation of writers, including such figures as Henry Demarest Lloyd, Henry George, and Edward Bellamy, focused on the growing inequalities and economic abuses of the era and called for new taxation and government action to regulate industry. Bellamy’s novel *Looking Backward from 2000–1887* (1888), which pictured a future utopian society freed from the poverty and inequities of the Gilded Age, sold over a million copies. Its importance, like that of many other writings of the new generation of thinkers, was to challenge the notion that the inequalities and injustices that Americans saw around them were permanent, unchangeable facts of nature—as Spencer, Sumner, Carnegie, and the other Social Darwinists were insisting. Bellamy and the new generation of writers helped a growing literate public to imagine the possibility of constructive social and political change. By the 1890s, Protestant clerics across the North—figures like George Washington Gladden and Walter Rauschenbusch—were adding their voices to the cry against injustice, countering Carnegie’s Gospel of Wealth with a Social Gospel that stressed biblical admonitions about the need to care for the poor. In the same years, a new generation of reformers emerged at the state and local levels, both to minister to the needs of the urban downtrodden and to campaign for laws to combat the worst consequences of the new industrial order.¹

The novelist William Dean Howells, a former writer for the *Nation* with good standing among Godkin and the reformers, privately wrote to the novelist Henry James of his growing misgivings about the direction the country was tak-
ing: “I’m not in a very good mood with ‘America’ myself,” Howells wrote in 1888. “. . . After fifty years of optimistic content with ‘civilization’ and its ability to come out all right in the end, I now abhor it, and feel that it is coming out all wrong in the end, unless it bases itself anew on a real equality.” Howells was in frequent contact with the former president Rutherford B. Hayes, who was increasingly disturbed by the same growing inequality in wealth that Howells deplored. “The question for the country now,” Hayes wrote in his diary in early 1886, “is how to secure a more equal distribution of property among the people. There can be no republican institutions with vast masses of property permanently in a few hands, and large masses of voters without property. To begin the work, as a first step, prevent large estates from passing, by wills or by inheritance or by corporations, into the hands of a single man.” Hayes, a staunch Ohio Republican and former Union general whose political sentiments harked back to Lincoln, was becoming an advocate of an estate tax.2

Reforms were also spearheaded by a new generation of college-educated women who turned their efforts to social services. In 1889, Jane Addams, an 1882 graduate of Rockford College, founded Hull House in Chicago with fellow alumna Ellen Gates Starr. Located in a neighborhood brimming with immigrants, Hull House offered a kindergarten, day care, and other services to residents. Florence Kelley joined Hull House and conducted investigations of Chicago’s notorious child labor sweatshops. By 1893, she had persuaded Illinois’s reform-minded governor John Peter Altgeld and the General Assembly to adopt laws regulating child labor and mandating inspections.3

The Ohio governor and former congressman William McKinley, who early in his legal career had taken the case pro bono of thirty-three miners imprisoned for rioting—winning
acquittal for all but one—established a state board of arbitration in the early 1890s to help settle labor disputes. He also signed legislation imposing fines on business owners who tried to prevent their workers from unionizing. Forced to call out the army against violent Ohio miners in 1894, he nonetheless led a private charity effort from the governor’s mansion to relieve the same miners during the starvation year of 1895. He was widely regarded as a friend of labor, a key factor in his victory in the presidential election of 1896.4

Whatever laissez-faire taboo may have existed against the enactment of economic regulation at the federal level, it was increasingly being worn away by the states. At the federal level little attention was paid to economic regulation not only because few national politicians envisioned any role for the federal government in regulating the economy, but also because the two national parties were preoccupied with what they considered much more momentous issues of the day: gold and tariffs.

A national debate over gold and tariffs certainly had important economic implications. But in the 1880s and 1890s, these issues functioned, at a political level, mainly as symbolic substitutes for the real problems occupying the nation: the concentration of economic power in the hands of the trusts and the Robber Barons, the increasing division between the wealthy and the rest of society, and the widespread suffering of the laboring classes. Gold and tariffs became the symbolic focus of a growing class conflict. Democrats increasingly saw the gold standard and high tariffs as symbols of a government that had come to favor business, wealth, and privilege over the mass of citizens. The Republican McKinley was able to counter the Democratic platform with a Republican vision of growing prosperity—“the full dinner pail”—based on sound money (the gold standard), protective tariffs, and high wages for Ameri-
can workers vis-à-vis their oppressed foreign counterparts. In the end, McKinley won both this argument and the election of 1896.

McKinley’s opponent in the election of 1896, Williams Jennings Bryan was the era’s most famous opponent of the unequal economic consequences of the Gilded Age. A former congressman from Nebraska and one of the nation’s most eloquent and fiery orators, Bryan accused the Republican Party of practicing what would later be called trickle-down economics: “The sympathies of the Democratic Party...are on the side of the struggling masses who have been the foundation of the Democratic Party. There are two ideas of government. There are those who believe that, if you will only legislate to make the well-to-do prosperous, their prosperity will leak through to those below. The Democratic idea, however, has been that if you legislate to make the masses prosperous, their prosperity will find its way up through every class which rests upon them.”

Bryan was the first to frame compellingly what would emerge as a major theme of the twentieth-century Democratic Party. Indeed, his contrast, in effect, between trickle-down and trickle-up economics almost anticipated the modern debate between supply-side and demand-side economists. In certain respects, one could argue that Bryan’s vision looked back to Lincoln, at least in favoring the interests of the ordinary worker. But perhaps reflecting the conditions of his age, Bryan’s vision was inherently more divisive and less inclusive than Lincoln’s, embodying a rhetoric of class conflict quite alien to Lincoln’s outlook.

Indispensable to McKinley’s electoral success against Bryan was his reputation—dating from his early career and his governorship—as a friend of labor. Kevin Phillips has argued that almost no other Republican could have beaten Bryan in 1896, certainly as decisively, since no other candidate could have escaped the Republican Party’s increasingly obvious stigma as
the party of big business. Despite his close connection with the rich Ohio business heir Mark Hanna, who shrewdly managed his political campaigns, McKinley was able to build a coalition knitting together the urban workers of the North and the very business owners who were, more often than not, exploiting them. It was an odd union, but like many of his fellow Ohio Republicans, McKinley believed strongly that business and labor had, at bottom, powerful interests in common. Like Ohio’s Hayes, his former commander and mentor since Civil War days, McKinley was one of the party’s “Lincoln men.”

Nonetheless, McKinley’s approach, as a politician and a leader, meant almost inevitably that the issues dividing the nation—the trusts, the growing economic inequality of the wealthy and the rest of society, the plight of labor—would remain unaddressed, at least for a time. McKinley was no visionary. He was a well-liked, technically astute, pragmatic, consensus-building politician who got his way through subtle persuasion rather than flaming oratory. As both congressman and governor, he had accomplished much, but always without fanfare. A key to holding the Republican labor–business coalition together lay in McKinley’s ability to finesse the obvious conflict of interests between these two groups—to act on labor’s behalf, especially as governor, without alienating the business interests that controlled his party. He succeeded by deemphasizing, rather than emphasizing, ideology.

The Bully Pulpit

During the 1880s and 1890s, while national political debate remained focused on gold and tariffs, popular journalism and literature increasingly dwelt on the injustices, corruption, and abominable conditions of life under the new industrial econ-
omy. In the 1880s, Henry Demarest Lloyd published a series of exposes in the *Atlantic Monthly* and the *North American Review* detailing business and political corruption. His book *Wealth and Commonwealth* traced the predations of John D. Rockefeller in creating the Standard Oil Trust. The photographer-journalist Jacob Riis’s *How the Other Half Lives* presented a jolting portrait of life in the New York tenements, while Stephen Crane’s novel *Maggie: A Girl of the Streets* offered a searing fictional portrayal of the same urban world. William Dean Howells’s novel *Annie Kilburn* described the evil effects of industrialism in a New England town. His controversial utopian tale *A Traveler from Altruria* satirized the abuses of the era. A swelling chorus of articles in popular magazines and newspapers held a mirror up to industrialized America and showed the urban managerial and professional classes images that increasingly appalled them.7

McKinley’s successor, Theodore Roosevelt, was the first president and arguably the first national politician to give voice to this rising new national consciousness. Bryan had championed the ordinary laborer, but his biblically tinged populist rhetoric had resonated mainly with the farmers and the rural poor of the West and South. Roosevelt, scion of a wealthy New York City family, former governor of New York State, and the youngest man to assume the nation’s highest office, spoke in a language that the citizens of America’s urban North could better understand.

Whereas McKinley worked by quietly building consensus, Roosevelt painted in bold public strokes. He famously called the presidency a “bully pulpit” (the word “bully” being slang for “great” or “wonderful”), and he used it in this fashion. In his first State of the Union message, issued less than three months after McKinley’s assassination, he finally put in words
what had been on the nation’s mind for over a decade. “The
tremendous and highly complex industrial development” of
recent years, he noted, “brings us face to face . . . with very se-
rious problems.” The “old laws, and the old customs . . . once
quite sufficient to regulate the accumulation and distribution
of wealth” were “no longer sufficient.”

Roosevelt was careful to hedge his proclamation to avoid
an appearance of fomenting class conflict or advocating so-
cialism. “Fundamentally,” he stated, “the welfare of each citi-
zen, and therefore the welfare of the aggregate of citizens
which makes the nation, must rest upon individual thrift and
energy, resolution, and intelligence” (emphasis added). Neither
was he willing to categorically condemn the Robber Barons:
“The captains of industry . . . have on the whole done great
good to our people.” He cautioned against measures that would
sap individual initiative in business; and he noted that regula-
tion of business could be “mischievous.” He denied wishing to
pit one social group against another. “All this is true,” he added,
“and yet it is also true that there are real and grave evils.” “There
is a widespread conviction in the minds of the American people
that the great corporations known as trusts are . . . hurtful to
the general welfare.”

He went on to set forth an agenda bold in both principle
and detail. He called for the federal government to “assume
power of supervision and regulation over all corporations doing
interstate business” and asked for amendments to strengthen
the Interstate Commerce Act. He proposed the creation of a
new cabinet secretary for commerce and industry with juris-
diction over commerce and labor matters. He called for reform
of the government’s labor policies, including legislation to
limit women’s and children’s labor hours and a factory law for
the District of Columbia. He praised the labor movement and
suggested that government action would be necessary to pro-
tect unions—though, significantly, he stressed that labor regu-
lation was still primarily a matter for the states rather than the
federal government. He proposed measures for environmental
conservation and outlined an assertive foreign policy, includ-
ing a proposal to move forward with the Panama Canal.⁸

Roosevelt well understood the power of his presidential
statements, his bully pulpit. His rhetoric would prove as im-
portant as his policies. His new tone and vision had a galva-
nizing effect on the nation. His statements, echoing the feelings
of an increasingly worried and conscience-stricken middle class,
unleashed the pent-up energies of a whole generation of ide-
alists and crusaders. The pace of journalistic and fictional ex-
poses of business and political corruption and labor abuses
quickened noticeably after Roosevelt’s State of the Union mes-
sage in 1901. Several popular magazines, including Cosmopoli-
tan, McClure’s, and Collier’s, began devoting an increasing por-
tion of their pages to the writings of those who later would be
called muckrakers (based on a metaphor from John Bunyan’s
Pilgrim’s Progress used by Roosevelt in a 1906 speech).⁹ A series
of new nonfiction and fiction works painted the grim portrait
of the age. Among the most notable were Lincoln Steffens’s
The Shame of the Cities (on urban corruption and the political
machines), Ida Tarbell’s History of the Standard Oil Company,
Frank Norris’s novel The Octopus, and Upton Sinclair’s The
Jungle. The writings of the muckrakers in turn built growing
public support for the new policies and laws Roosevelt would
pursue, many of them in his second term, after winning the
election of 1904.¹⁰ Progressivism, as it came to be called, was
becoming the dominant political idea of the age.

In the process, Roosevelt radically redefined the role and
vastly expanded the prerogatives of the federal government.
Taking advantage of the long-dormant provisions of the Sherman Antitrust Act, his administration pursued a series of highly visible prosecutions against the trusts, beginning with a case against the Northern Securities Company in 1902. Federal prosecutors took action against Standard Oil of New Jersey and the American Tobacco Company. In 1906 and 1908—following the publication of Sinclair’s *The Jungle*, exposing in gruesome detail the abusive and unsanitary practices in Chicago’s meat-packing industry—Roosevelt signed the Pure Food and Drug Act and the Meat Inspection Act, the first real consumer protection legislation. And he also sponsored a series of laws aimed at conservation of the natural environment.11

Yet while certainly radical compared with anything that had gone before, Roosevelt’s Progressivism still had about it a conservative tenor. His policies were motivated in large measure by a desire to preserve political stability. He was not, like Lincoln, a man of the people. Roosevelt thought like the patrician he was; he acted out of a sense of noblesse oblige. He believed it vital to prevent the nation from splitting asunder into two camps, the rich and the masses. He did not want a country, as he said, “divided into two parties, one containing the bulk of the property owners and conservative people, the other the bulk of the wage workers and less prosperous people generally.”12 Roosevelt’s program was a balancing act; he recognized the need to let some of the steam of social resentment out of the pressure cooker of the new industrial economy; but he also wanted, fundamentally, to keep the lid on. He believed he could do this by openly taking the side of the public against the trusts, becoming the public’s ombudsman, demanding from business, on behalf of all citizens, what he called a square deal. “Speak softly and carry a big stick,” he famously said. But in practice he spoke loudly, with the intention of giving an aggrieved public the sense they had someone in their corner in
Washington who would speak up for them, and not just someone, but the top fellow.

Roosevelt aimed his reforms primarily at the issues that most troubled the urban managerial and professional classes—the power and abuses of the trusts and the railroads (which often translated into higher consumer prices) and later the safety of consumer food and drugs. On the labor issue, he was less engaged, though his efforts to mediate the Pennsylvania mine strike in 1902, and the pressure he brought directly and indirectly on the mine owners, helped win important concessions for the miners.13

As time went on, however, Roosevelt was increasingly concerned to rein in the enthusiasm that his own rhetoric had unleashed. He suspected the motives of many of the muckrakers and saw them as stirring up dangerous revolutionary sentiments. As he wrote to his secretary of war and political heir apparent, William Howard Taft, in 1906, “Some of these [writers] are socialists; some of them merely lurid sensationalists; but they are all building up a revolutionary feeling which will most probably take the form of a political campaign. Then we may have to do, too late or almost too late, what had to be done in the silver campaign when in one summer we had to convince a great many good people that what they had been laboriously taught for several years previous was untrue.”14 Roosevelt was looking back to the “economics lessons” that McKinley had given the public during the 1896 campaign to counter Bryan’s class warfare based on the “cross of gold.”

Yet Roosevelt had also done what McKinley had not dared to do—break with the Republican Party’s core business constituency. By the end of his administration, many business-oriented Republicans had had quite enough of Teddy’s square deal. The president, observing the tradition since President George Washington of not seeking a third term, tilted his hat
to Taft, who easily captured the Republican Party’s nomination at the 1908 convention. Taft carried the general election against the Democrats’ Bryan almost effortlessly, since by now Roosevelt’s Progressivism had effectively stolen much of Bryan’s populist thunder. But Taft’s administration would be marked by increasingly open warfare between the Republican Party’s progressive and conservative wings. Despite having been blessed by Roosevelt, Taft was by temperament far more a creature of the Republican business class, and certainly much less of a maverick, than his colorful predecessor. An avid golfer, the 350-pound Ohioan enjoyed frequenting country clubs, where he hobnobbed pleasantly with the rich. He was not opposed to reform, but his instincts were conservative, and the pace of reform clearly slowed. Perhaps the most important innovations were a lowering of tariff rates (after a bitter fight between free trade progressives and protectionist conservative Republicans), a further expansion of the powers of the Interstate Commerce Commission (including jurisdiction over cable, telegraph, and telephone), and the Sixteenth Amendment, which now authorized the federal government to impose a graduated income tax (previously struck down by the Supreme Court on states’ rights grounds).

The rancor between Republican progressives and conservatives was deep enough by 1911–12 that Republican progressives mounted a challenge to Taft, seeking to replace him at the head of the ticket with the progressive senator Robert M. La Follette of Wisconsin. At the national convention, Roosevelt decided to throw his own hat into the ring, effectively elbowing La Follette aside. Taft, however, survived the progressives’ challenge and gained renomination. Roosevelt, infuriated, hastily organized a third party. The general election pitted Taft against Roosevelt, now representing the Progressive, or Bull Moose, Party, and the Democrat Thomas Woodrow Wilson, a
former Princeton University president who as governor of New Jersey had gained a reputation as one of the nation’s leading progressives. Wilson won with 42 percent of the popular vote, while the Democrats retained control of the House and captured the Senate. Together Wilson and Roosevelt had polled 70 percent of the popular vote, Taft just 24 percent. However the election results were read, it was a landslide victory for the Progressive agenda.

Lincoln Redux

Wilson was, in fact, an extraordinary figure. Whether he should be numbered among the nation’s greatest presidents remains in dispute among historians. But clearly he was among the most gifted. In America it was unheard of for a former professor to become president. But Wilson broke this mold, and many others. An academic of unusual brilliance—his doctoral dissertation, published as Congressional Government, earned him a national reputation at age twenty-eight—he was a former president of the American Political Science Association and an expert and writer on a wide range of subjects. Few presidents have probably had Wilson’s keen grasp of the details of policy matters, economic or otherwise. But unlike many a good technical brain, he never lost sight of the larger picture. He was quintessentially a man of vision (“Wilsonianism” today remains almost a synonym for the visionary approach to politics). Perhaps most surprisingly for one whose life had been lived in the shadow of the ivory tower, he was an eloquent orator with an ability to convey his vision—often new, often complex—in language that could quicken the heartbeats of ordinary people.

From the beginning of his career, Wilson was enflamed with the cause of progress and change. His Congressional Government recommended sweeping changes in the American politi-
cal system, challenging the sacrosanct doctrine of the separation of powers and calling on America to move to a parliamentary form of government. As president of Princeton, he attempted to revolutionize the university by sidelining the old boy network of exclusive dining clubs and reorganizing undergraduate education around a college-based system modeled on Oxford. As governor of New Jersey, he presided over a stunning succession of major reforms during a single two-year term. He effectively broke the Democratic political machine that had elected him and pushed through several important new laws: a law creating direct primary voting, a corrupt practices act to curb bribery, an employers’ liability law to provide workers’ compensation, and a bill establishing a public utilities commission to set rates.

Wilson had genuine insight into politics, and in the campaign of 1912 that insight took him back to Lincoln. What was remarkable was how Wilson’s campaign speeches amounted to a self-conscious effort to revive Lincoln’s vision of the American Dream. Roosevelt had spoken candidly about social evils and had used federal action and new laws to address many of them. But Roosevelt’s perspective on the issues was always a top-down vision, the view of a patrician, of an aristocrat who felt a responsibility for his society out of a sense of noblesse oblige. His emphasis, as noted above, was on preserving the political stability of the country and preventing a descent into class warfare.

Wilson reenvisioned the nation’s problems, as it were, from the bottom up. He adopted the perspective of the ordinary citizen, the common worker struggling to manage under the existing conditions of the economy and the political system. Citing Lincoln as a model, he explicitly linked the Progressive agenda to the cause of reviving America’s commitment to social
mobility and restoring equality of economic opportunity. For Wilson, it was precisely Lincoln’s understanding of the meaning of America that needed to be restored. Lincoln, he said, was “a man who rose out of the ranks and interpreted America better than any man had interpreted it who had risen out of the privileged classes or the educated classes of America.”

According to Wilson, what had been lost in the Gilded Age—and in the Republican Party—was precisely Lincoln’s profound sense that America was about the fate of the average person, about opportunities for the ordinary worker to get ahead. Wilson chided the Republicans for their elitism. “It is amazing,” he said, “how quickly the political party which had Lincoln for its first leader,—Lincoln, who not only denied, but in his own person so completely disproved the aristocratic theory,—it is amazing how quickly that party, founded on faith in the people, forgot the precepts of Lincoln and fell under the delusion that the ‘masses’ needed the guardianship of ‘men of affairs.’”

Wilson rejected outright the Gospel of Wealth notion that the industrial magnate was to be revered as the engine of the nation’s prosperity: “For indeed, if you stop to think about it, nothing could be a greater departure from original Americanism, from faith in the ability of a confident, resourceful, and independent people, than the discouraging doctrine that somebody has got to provide prosperity for the rest of us.”

Lincoln had spoken of the “prudent, penniless beginner.” Wilson spoke similarly of the beginner, the man “with only a little capital.” But industrial America was no longer Lincoln’s America. “American industry is not free, as once it was free,” he said. “American enterprise is not free; the man with only a little capital is finding it harder to get into the field, more and more impossible to compete with the big fellow. Why? Because
the laws of this country do not prevent the strong from crushing the weak.” Like Lincoln, he believed that America needed to be a middle-class nation, and a nation that assimilated beginners to the middle class. There needed to be “the constant renewal of society from the bottom.” The “middle class is being more and more squeezed out by the processes which we have been taught to call processes of prosperity,” he said. The whole point of American democracy was to provide the humble with access to the American dream, and government should act to ensure this access: “Anything that depresses, anything that makes the organization greater than the man, anything that blocks, discourages, dismays the humble man, is against the principles of progress.” This was vintage Lincoln.22

The legislative record of Wilson’s first term was almost unparalleled, even if history has tended to overlook it, focusing instead on Wilson’s entry into World War I, his negotiation of the Treaty of Versailles, and the collapse of his peace plan and the League of Nations after 1919. Yet the list of his domestic achievements was stunning and amounted to a comprehensive new set of government economic policies.

First came tariff reform. Increasingly, progressives had come to see tariff laws as, in effect, a regressive tax on consumers. Notoriously shaped by the efforts of lobbyists, the tariffs protected the trusts from foreign competition and kept prices high. Consumers footed the bill. Legislation during Wilson’s first year as president essentially overturned the tariff regime of the nineteenth century, radically reducing rates on hundreds of items (while raising rates on certain luxury goods), and—at the initiative of Representative Cordell Hull—instituted a graduated income tax to provide a new revenue base for the government. In effect, the law shifted the source of federal revenues from a regressive consumption tax in the form of tariffs
to a progressive tax on income. In 1916, the tax was significantly raised to cover war preparedness (after U.S. entry into World War I, income taxes were raised again), and for the first time a federal estate tax on large inheritances was established (the latter was a long-standing item on the Progressive agenda, advocated by President Roosevelt as early as 1906). This was both a new technical approach to and a new philosophy of taxation, an effort to gain lower prices through tariff reductions and simultaneously to shift the burden of taxation away from the middle class.23

As we have seen, mismanagement of the money supply—and lack of government tools to address the problem—had been a major factor in the raucous boom-and-bust economy of the nineteenth century. Wilson played a key role in crafting the Federal Reserve Act of 1913, which created a sophisticated system for regulating banks and controlling credit and the money supply. The Federal Trade Commission Act of 1914 gave the federal government decisive control over corporate business practices, empowering the commission to require reports from corporations, conduct investigations, and issue “stop and desist” orders to halt illegal practices. The Clayton Antitrust Act expanded prohibitions on monopoly practices and also provided new protections for labor, above all mandating that strikes not be considered acts “in restraint of trade” under the Sherman Antitrust provisions. In addition, laws were passed to require humane conditions for merchant marine sailors, to mandate an eight-hour day for workers on interstate railroads, and to ban from interstate commerce products produced by children under fourteen—though the last was struck down by the Supreme Court.24

It is tempting to conclude that the American Dream had made a comeback. Conditions were clearly improving. Once
unleashed, the impetus for genuine reform had proved unstoppable. Moreover, Wilson had recovered the essence of the Lincolnian vision and had the words to convey it to his fellow citizens. Ironically, the torch had been passed from Lincoln to Wilson and the Democrats, who now boasted a comprehensive agenda to support their long-standing claim to the mantle of champion of the common people. America was on the road to recovery. But Europe was already engulfed in a war that proved to be more terrible than America’s own bloody civil conflict of fifty years earlier. In 1916, Wilson campaigned on a platform of strict isolationism. “He Kept Us Out of War” was the slogan of his campaign. But in 1917, America under Wilson’s leadership would plunge headlong into Europe’s struggle. Once again war would derail progress toward a “more perfect union,” hardening hearts and inducing in Americans a fresh bout of amnesia about the true meaning of Lincoln’s American Dream.

Under Woodrow Wilson’s leadership, war became the last great cause of the Progressive movement, and it proved to be the movement’s undoing. By 1919, when the president returned from Paris with the Treaty of Versailles and his elaborate plan for a League of Nations, the public was sick to death of war and equally weary of Wilson’s seemingly inexhaustible store of idealistic rhetoric. As long as Wilson’s vision remained focused on improving the lives of ordinary Americans, the public stood behind him. War in the name of an abstract idea of human progress, however, left a bitter taste.

America’s direct involvement in World War I had been comparatively brief—eighteen months from early April 1917 to early November 1918. But the disruption of national life had been considerable. Selective Service, enacted in 1917, required over 24 million men to register for the draft. Overnight, the U.S. armed forces swelled from their prewar level of 200,000 to
some 2.9 million men. Two million of these shipped off to Europe; 1.4 million saw battle. Over 116,000 perished from combat and disease, while another 200,000 were wounded. At home, the government had seized control of much of the economy. The newly introduced income tax was raised to unprecedented levels.25

The impact of the war on economic life was substantial. War production was rapidly ramped up, producing a sharp spurt of growth in 1918. The end of government spending on the military in 1919 was followed by months of recession, succeeded in turn by a true depression. Moreover, by 1920, prices had doubled over their 1914 levels, while incomes had failed to keep pace. Unemployment was rising—peaking at 12 percent (some 5 million workers) in 1920.26 The public was fed up.
Republican correctly gauged the public mood and hit on an apt theme for the election of 1920: normalcy. “Not heroism, but healing,” said the Republican candidate, Warren G. Harding, “not nostrums, but normalcy.”1 The swipe at Wilson’s rhetorical grandiosity (dismissing it as so many “nostrums”) struck a powerful chord. Harding, an affable but otherwise unremarkable senator from Ohio, trounced the Democratic candidate, Governor James M. Cox of Ohio, winning sixteen million votes to Cox’s nine million. In certain respects, Harding’s postwar administration harked back to President Ulysses S. Grant’s administration following the Civil War. It would be remembered mainly for a string of spectacular scandals. Mercifully, perhaps, the president died of a sudden stroke in August 1923 before the malfeasance had come to light. The real importance of the Harding administration was to usher in twelve years of unabashed pro-business Republican rule—a revival of laissez-faire economic doctrine and a return to the Gospel of Wealth.
This time the public embraced the Republican probusiness approach with unparalleled fervor. The reason was simple: it seemed to work. The 1920s were a decade of dramatic economic growth and unprecedented rise in the living standards of most Americans. From 1921 through 1929, Gross National Product (GNP) expanded at an estimated real rate of 4.5 percent per year—well above the average annual growth rates of 3.1 percent per year we have seen since World War II. Once again, the American landscape was transformed. In the nineteenth century, the engines of technological change had been the railroads and steam power. In the 1920s, they were the internal combustion engine and electricity. Within a very few years, the automobile reigned as the new symbol of American life. Between 1919 and 1929, cars on the American road more than tripled, from fewer than 8 million to nearly 27 million, almost one automobile for every household in the nation. Miles of paved road nearly doubled, from 350,000 in 1919 to 662,200 in 1929. By 1929, two-thirds of homes had electricity, and 40 percent had telephones. A proliferation of new “labor-saving devices” filled the household—washing machines and vacuum cleaners, even some refrigerators, to say nothing of those modern marvels, the phonograph and the radio. A host of new products emerged. The modern retail chain store took shape. “You can’t lick this Prosperity thing,” quipped the comedian Will Rogers late in the decade. “Even the fellow that hasn’t got any is excited over the idea.”

Yet many of the forces that helped create the new prosperity would also lead to its catastrophic undoing. Chief among these was an economic force whose power to enliven or strangle an economy would only begin to be understood several years after the shock of the Great Crash and the onset of the Great Depression: the level of consumer demand. Historians have cited many factors in attempting to explain the prosperity of
the Roaring Twenties. Clearly, the internal combustion engine and the advent of electricity—as mainstays of a new technological revolution—played a critical role. Republicans’ pro-business policies, which deliberately encouraged business risk taking (as we shall see later), played some part. But to a degree that historical commentary often fails to reflect, the boom of the 1920s was in essence demand driven. The rapidly expanding demand within the U.S. economy had its source in a startling new phenomenon: widespread borrowing by American consumers.

Buy Now, Pay Later

In 1919, General Motors Corporation established a financial arm, the General Motors Acceptance Corporation (GMAC), to enable customers to buy GM cars on installment. It was a fateful decision, with revolutionary implications not only for the automobile industry, but also for the American economy as a whole. Installment buying was not an entirely new phenomenon. The Singer Sewing Machine Company had pioneered installment plans to sell sewing machines as early as 1850. By the turn of the century, pianos and furniture were often sold this way. In the war years, a handful of small finance companies sprang up to satisfy the apparently insatiable desire of even cash-pressed consumers to own automobiles. But until the end of World War I, installment buying had been largely confined to lower-income consumers, and it carried a social stigma. GM’s creation of GMAC changed all that. Overnight, installment buying became a middle-class passion. Indeed, consumers at all levels—except the most wealthy—took advantage of installment buying to acquire cars and eventually the host of new consumer durables produced by America’s “second industrial revolution.”3
“Now it’s easy for us to get our car,” read the headline of a magazine advertisement for Chevrolet in 1925. The ad pictured an attractively attired middle-class couple seated at a desk with a businesslike young salesman in the showroom, happily arranging their automobile financing, while their shiny new Chevrolet shimmered in the background. GM had done something brilliant. The company had found a way to give consumers the money with which to purchase its automobiles—and to charge consumers for the money they had been lent. The system obviously increased GM’s profit per sale: not only did the company pocket the margin for the actual sales transaction; it also collected handsome interest on the financing. Most important, GM had found a way to create the demand for its product. GM’s strategy set a new tone for American business. “Build a better mousetrap,” Ralph Waldo Emerson had said, “and the world will beat a path to your door.” Such had been the nineteenth-century conviction. But twentieth-century American business was no longer waiting passively for the customer to appear in the doorway. It was going out and roping customers in. The strategy of American business shifted from one of merely selling products to one of actively nurturing, shaping, and, where possible, creating consumer demand on a mass scale.

Advertising itself played a crucial role in this process. The 1920s saw the birth of advertising in its modern form. Its hallmark was often the direct use of emotion to foster demand for products and services. “They Laughed When I Sat Down at the Piano—But When I Began to Play!” So read the headline of one of the era’s most famous and successful ads—for a correspondence course purporting to teach customers how to play the piano. “I still believe that one can learn to play the piano by mail and that mud will give you a perfect complexion,” Zelda Fitzgerald, the novelist F. Scott Fitzgerald’s wife, observed wryly after the boom was over. In combination with installment
buying, advertising helped foster a culture of competitive acquisition, a true consumer economy.

Advertising also contributed to the political mood of the age. It sold the Gospel of Wealth—even to those for whom prosperity was, in Will Rogers’s words, more an idea than a reality, a mere dream. Installment buying put the new luxuries of the second industrial revolution within reach of people who, by earlier standards, could not afford them. Installment buying made the new luxuries suddenly “affordable.” The researchers Robert and Helen Lynd, in their famous study of Middletown (their pseudonym for Muncie, Indiana) found that in 1923 nearly half the town’s 123 working-class families owned automobiles. Of these 60 families, 26 lived in makeshift shacks, of which 21 lacked even a bathtub. Yet there was their automobile, parked out front.⁶

From the standpoint of economics, the impact of advertising and installment buying was to significantly expand consumer spending—both directly, by putting more (borrowed) money in the hands of consumers, and indirectly, by creating a culture of acquisition in which everybody was expected to own an automobile, a washing machine, a vacuum cleaner, a phonograph, a radio, and so forth. As installment buying spread from automobiles to other consumer durables such as furniture, washing machines, vacuum cleaners, radios, phonographs, jewelry, and even clothes, demand for such items accelerated. By the end of the decade, three-quarters of automobiles and washing machines, some 90 percent of furniture, two-thirds of vacuum cleaners, three-fourths of radio sets, and 80 percent of phonographs were being purchased on installment-based credit.⁷

Between 1919 and 1929, consumer debt nearly tripled, from $2.6 billion to $7.1 billion. Since installment loans in the 1920s typically had a one-year term, the yearly level of consumer
debt provided a rough indication of the amount of money being borrowed by consumers to finance their purchases in that year. In 1929, outstanding consumer debt of $7.1 billion equaled more than three-quarters of the total amount that consumers spent on durable goods ($9.2 billion). The manufacturing sector for durables—ranging from automobiles to radios—was increasingly dependent on installment buying for its economic health.

A second sector critically dependent on consumer borrowing was residential construction. Growth in mortgage borrowing for family homes followed roughly the same pattern as installment borrowing, with mortgage debt nearly tripling from $10.1 billion in 1919 to $31.2 billion in 1929. While consumer spending for new houses was not strictly speaking consumption (it is reckoned in National Income and Product Accounts as investment), it played a significant role in the health of the economy. Together durable goods purchases and residential construction amounted to 13 percent of GNP in 1929. But this figure (based on later estimates not available at the time) understates their impact, since both industries drew heavily on commodities and raw materials and therefore had a significant multiplier effect throughout the economy.

Even as American business increasingly embraced what might be termed a demand-side approach—spending increasing millions on advertising and marketing, stoking consumer demand, and financing the demand with installment credit—orthodox economic thinking retained its supply-side bias. As the British economist John Maynard Keynes was later to point out, economic thinking of the era was dominated by Say’s Law, named for the classical economist Jean-Baptiste Say, and often summarized by the formulation “supply creates its own demand.” “The encouragement of mere consumption is no ben-
efit to commerce,” wrote Say. “ . . . It is the aim of good government to stimulate production, and of bad government to encourage consumption.” Government policymakers tended to view production—supply as opposed to demand—as the driving force of the economy. In this respect, the prevailing point of view had changed little since the Gilded Age. In the era of the Robber Barons, the industrial magnate—the producer—was widely seen as the engine of economic progress. Woodrow Wilson had attacked this idea on political grounds, arguing that the view that wealth was created from above was essentially un-American. But in the 1920s, the cult of the businessman returned. Increasingly, the business leader was regarded as the hero of the new prosperity. Free the businessman to unleash his energies and creativity, his productive impulses—so the conventional wisdom went—and all would benefit. This production- and supply-oriented vision of economic life—codified in Say’s Law—was the basis for the notion that wealth by nature “trickled down” from above (to use the phrase made famous by Treasury Secretary Andrew W. Mellon). The business magnate was the true font of prosperity. In reality, to a degree that almost no one understood at the time, the prosperity of the 1920s was demand-driven, the product of the newly eager, big-spending, big-borrowing American consumer.

An Economy of Risk

The prosperity of the 1920s was not magic. In essence, it was based on increasing consumer demand heavily financed by consumer borrowing. This was all well and good, as long as prosperity continued on the upswing. But amid the exuberance of the era, it was easy to forget an elementary truth—namely, that borrowing carried risk.
“The business of America is business,” affirmed President Calvin Coolidge. The Republican administrations of the 1920s saw their economic mission as one of enabling business to do its job. For government, this meant mainly getting out of the way. Lower taxes. Less regulation. Indeed, virtually no regulation. Business should be helped or otherwise left alone. As business prospered, so would America. From their probusiness perspective, the Republicans saw prosperity coming from the producer, from the top down. “Give tax breaks to large corporations,” Secretary Mellon famously said, “so that money can trickle down to the general public, in the form of extra jobs.”

Mellon’s life story formed a link between the Gilded Age Gospel of Wealth and the cult of prosperity that dominated the Roaring Twenties. The country’s third richest man behind John D. Rockefeller and Henry Ford, Mellon hailed from the small circle of Pittsburgh’s superrich that had included, among others, Andrew Carnegie, Henry Clay Frick, and George Westinghouse. Carnegie, Andrew Mellon’s senior by twenty years, was a friend of the younger Mellon’s father, Judge Thomas Mellon, founder of the Mellon family banking fortune. Andrew Mellon, himself, was a close friend and frequent business partner of Frick, Carnegie’s young protégé, his successor as chairman of the Carnegie Steel Company, and later a bitter Carnegie rival. Frick was among the most notorious of the Robber Barons, famous for the execrable labor conditions in his coke plants. Mellon shared the Gospel of Wealth conviction that one’s economic circumstances were the product of one’s own initiative, and that the key to national prosperity was freeing exceptional individuals to pursue great wealth. “Any man of energy and initiative in this country,” he wrote, “can get what he wants out of life. But when that initiative is crippled by legislation or by a tax system which denies him the right to receive
a reasonable share of his earnings, then he will no longer exert himself and the country will be deprived of the energy on which its continued greatness depends.

Appointed as secretary of the treasury by Harding, Mellon continued in the post through the subsequent administrations of Presidents Calvin Coolidge and Herbert H. Hoover. As treasury secretary, Mellon’s main initiative was a series of tax cuts designed to reduce the wartime income tax rates on the nation’s highest-income citizens. He was, in fact, the nation’s first supply-side economist, though the term had not yet been coined. Adherents of supply-side economics in more recent years, under Presidents Ronald Reagan and George W. Bush, would later cite Mellon as a progenitor and a hero of the supply-side agenda.

Mellon subscribed to the laissez-faire view that the economy was self-regulating. Downturns might come, of course—the country had seen a bad one in 1920–21—but the economy would self-correct. To be sure, the costs of such episodes were unevenly distributed. The five million ordinary workers left jobless during the depression of 1920–21 paid the steepest price. But that was simply the natural order of things. It was the way the economy worked, and worked best.

The Republicans rejected outright the Progressive Era idea that business required oversight. Probusiness administrators committed to a hands-off posture took the reins of government. William E. Humphrey, Coolidge’s appointee as chairman of the Federal Trade Commission (FTC), openly referred to the commission as a “publicity bureau to spread socialistic propaganda.” Under Humphrey, the FTC, the federal government’s main arm for regulating corporations, was rendered largely toothless. Concern about trusts was discarded. Apparently illegal mergers multiplied while the government remained on the sidelines, with open eyes. “So long as I am Attorney
General,” said Harry Daugherty during Harding’s administration, “I am not going unnecessarily to harass men who have unwittingly run counter with the statutes.” The one area in which the Republicans showed an appetite for activism was in opposition to organized labor. “So long and to the extent that I can speak for the government of the United States,” said Daugherty, “I will use the power of government to prevent the labor unions of the country from destroying the open shop.” Companies moved against unions with administration blessing, while the Supreme Court handed down a series of defeats for labor’s ability to organize. Between 1920 and 1929, labor union membership declined by about 30 percent.12

The Republicans’ probusiness policies also brought two other by-products. One was quite visible at the time: a growing inequality in income and wealth. The other would come to light only when it was too late: mounting economic risk.

The benefits of the new prosperity were spreading unevenly: the rising tide was failing to lift all boats. According to estimates by the National Bureau of Economic Research, manufacturing productivity (measured in output per hour) grew by almost 50 percent from 1921 through 1929. Manufacturing profits exploded, but little or none of the massive productivity gains were being passed to the nation’s approximately ten million industrial workers in the form of higher wages. By 1929 average hourly wages of production workers—at $0.56—instead of advancing from 1921 had actually declined by 15 percent in real terms. Meanwhile, the share of total national income captured by the top 1 percent of earners rose from 12 percent in 1920 to 15 percent in 1929; in 1929, the highest-income 5 percent captured 26 percent of total income, and the highest 20 percent of households were taking in well over half (54 percent) of the nation’s entire yearly income.13
The effects of risk taking were more subtle, but more catastrophic in the long run. Republicans failed to grasp that in rejecting the idea of regulating business, they were willy-nilly exposing the economy to heightened risk. In the absence of government oversight, businesses engaged in increasingly risky practices. The fact that administration officials continually telegraphed an “anything goes” message to the business community hardly helped. The problem was particularly acute in the booming financial sector. On Wall Street, stock manipulation and insider trading were rampant. Ordinary investors were repeatedly cheated as big investors secretly pooled or coordinated their market activity to push stock prices up or down at will, getting out of a stock before the mass of investors suffered the loss.14 Brokers, meanwhile, promoted their own especially dangerous form of the installment plan, encouraging investors to buy stocks “on margin.” Individuals purchased stocks by paying as little as 10 to 25 percent of their value, essentially borrowing the rest from the stockbrokers. Such high “leveraging” was the essence of risk. An investor who bought a $100 stock by plopping down just $10 stood to double his money if the stock rose to $110. Fine and good. But if the stock fell to $50, he would not only lose his $10 but also be out an additional $40, which he now owed to his broker. Multiply that by 100 shares, and you were talking real money. Outside the stock market, unethical business and accounting practices abounded. Meanwhile, the richest of the rich on Wall Street were failing to pay their fair share. A congressional investigation in 1932 revealed that twenty partners of the nation’s leading and most prosperous investment bank, the House of Morgan, had paid not a penny in income tax.15

The experience of the 1920s suggests the existence of a “risk-return” trade-off for national economic growth, analo-
gous to the risk-return trade-off for an individual investment. The principle is basic to finance: investments that yield high returns usually carry higher risk; lower-risk investments generally yield lower returns. The Republicans’ laissez-faire approach was a potentially high-return strategy, but it also carried terribly high risks that at the time were not at all understood. A more regulated economy—one in which the government played an active oversight role—might produce somewhat lower levels of economic growth; but it also might offer greater insurance against the kind of catastrophe in which the Roaring Twenties culminated: the Great Depression.

Americans for the most part were buoyed by the ride up the 1920s roller coaster; but the ride down was too terrible to forget. Following the stock market crash in October 1929, the American economy descended into a rapid tailspin. By 1932, with twelve million out of work—nearly a quarter of the labor force—tens of thousands of men riding railroad boxcars from town to town in vain search of employment, tens of thousands more living in makeshift tent camps on vacant lots in major cities (popularly named Hoovervilles), countless families across the nation lacking shelter, heat, food, and even shoes and clothing for their children, the risk had simply become unacceptable. Business had taken the risks; now ordinary Americans were paying the terrible price. Overnight, the 1920s land of milk and honey had turned into a biblical land of famine. It seemed as if the Gospel of Wealth had destroyed the American Dream.

Explaining the Depression

At bottom, the forces behind the phenomenon of the Great Stock Market Crash of 1929 are familiar. In the history of fi-
nance, they represent a recurring phenomenon. Perhaps the best explanation for the phenomenon lies in a phrase used by Federal Reserve Chairman Alan Greenspan to describe a similar bull market many decades later: “irrational exuberance.” The Great Bull Market of 1928–29 was a bubble, not unlike the Tulip Bulb Craze that overtook the Netherlands at the dawn of the seventeenth century or the South Sea Bubble on which many a British fortune foundered in the eighteenth. A few select stocks began rising dramatically in March 1928, as large investors, anticipating a recovery from the 1927 recession, entered the market. Newspapers noticed the climb, and soon everybody was in the market or wanted in. The vast influx of new investors pushed up prices, which in turn raised expectations. Soon the mania was self-reinforcing as the market nearly doubled in a span of sixteen months, and some stocks tripled, quadrupled, or even quintupled in value. By 1928, however, the Federal Reserve was already tightening interest rates, partly to curb the rampant stock speculation. Industrial production was slowing. Stocks had lost their connection with economic fundamentals. A crash—a bursting of the bubble—was inevitable.

Even decades after the event, despite reams of scholarship on the era, the precise causes of the Great Depression that followed the Great Crash remain in dispute. We have witnessed stock market crashes since 1929, without the same subsequent catastrophic effects on the economy, notably in 1987 and 2000. How did the 1929 crash manage to disrupt the entire economy? And why did the economic tailspin continue unabated for years? From the best of recent scholarship, with all the benefits of hindsight, a set of plausible answers has emerged.

Keynes came close to identifying the trigger of the Depression in formulating the concept of “aggregate demand.” In his *General Theory of Employment, Interest, and Money* (1936), Keynes successfully challenged the supply-side bias embodied
in Say’s Law—focusing attention instead on the demand side of the economy. The real driving force in the depression was a sharp drop in consumption, as the economist Peter Temin was able to show decades later, using techniques partially derived from Keynes. Businesses failed to invest in production for a simple reason: they suddenly lacked customers to buy their products.

The general economic downturn in 1930 seems to have resulted from the impact of the market crash on consumer demand. It came via two avenues. First, the rising stocks of the 1920s had produced a “wealth effect” among the upper-income citizens who owned most stocks. As their paper assets rose, stock investors felt freer to spend. In the economy of the 1920s, the new generation of durable goods—from automobiles to vacuum cleaners to refrigerators—was being acquired most avidly and easily by those nearer the top of the income scale. Given that the top 20 percent of earners were taking in more than half the nation’s total yearly income, any change in the consumer spending behavior of this group would have a noticeable effect. Particularly because of the practice of buying stocks on margin, many of these individuals had gone from wealth to poverty nearly in a matter of days in October 1929. Almost all had been badly burned. Wealth effect purchasing dried up. Second, and perhaps more important, middle-income consumers had been buying automobiles and other durables on installment. Loans seemed a good bet when the market was booming. The Stock Market Crash suddenly raised questions about the future health of the economy. Consumers became cautious, reluctant to take on new borrowing commitments until the smoke from the stock market disaster cleared.

The impact of the new consumer caution was especially profound in two key sectors, automobile sales and new housing construction, both big-ticket items and both heavily de-
dependent on consumer borrowing. From 1929 to 1930, the number of cars sold dropped by close to 40 percent; the value of new residential housing put in place fell by nearly half. These were catastrophic declines. They occurred precisely in sectors with an especially strong multiplier effect on the rest of the economy.

The goose that had been laying the golden eggs of the 1920s—the American consumer—was suddenly panicked and clammed up.

Ways Out

There were two ways out of the Depression following the Crash and the catastrophic decline in consumption of 1929 and 1930. One was fiscal policy; the other was monetary policy. Neither was fully understood at the time. But it also needs to be emphasized that the reigning economic orthodoxy—the supposedly immutable natural laws underpinning the Gospel of Wealth—formed a major barrier to discovering these solutions. It was this orthodoxy that had to be overcome.

Fiscal policy, based on Keynes’s General Theory and developed into a mature theory by later generations of demand-side economists, suggested that the government could resuscitate the economy by using deficit spending to expand “aggregate demand.” By plowing new money into the economy, in the form of direct purchases by government of goods and services or wages paid to workers on government projects, the government could expand overall demand and get the economy moving again.

Even if the government in 1930 had understood this fiscal strategy, it would have been hard-pressed to execute it. The reason was simple: the government was just too small. Total
federal outlays in 1930 stood at about $3.3 billion, or about 4 percent of GNP. Between 1929 and 1930, GNP had fallen by $12.7 billion—a drop more than three times the size of the entire federal budget. Consumption alone had fallen $7.3 billion—a sum more than twice the total amount of federal spending. Even a substantial percentage increase in the spending side of the small federal budgets of the era would probably have been insufficient to overcome the Depression. Only when government was in a position to engage in a level of deficit spending equal to a significant percentage of GNP would it be in a position to “cure” the economy. This finally occurred decisively in 1942, after America’s entry into World War II, when federal outlays jumped to $35.1 billion, or 22 percent of GNP, while the federal deficit rose to $20.5 billion, or 13 percent of GNP.¹⁹ In that year, unemployment fell to 3.1 percent (aided by the fact that nearly four million military personnel were now on the government payroll, being paid for partly by money the government had borrowed).²⁰

The point is: the limited government of the 1920s and 1930s was simply too small to manage a massive modern industrial economy through fiscal policy. It was a tiny tugboat unable to steer the Titanic. When things went massively wrong, the government was simply too small and inconsequential an economic player for its fiscal policy actions to have much effect.

The other way out was monetary policy. That would have involved greatly loosening credit to put more money in the hands of consumers and producers. If credit became cheap enough, consumers might start borrowing again. Here again the reigning orthodoxy stood in the way—and this time the orthodoxy was enshrined in federal law. A critical element of the Gospel of Wealth, as we have seen, was the belief in “sound
money.” Sound money meant money based on gold. Sound money was not a terrible idea. It offered excellent protection against inflation (which would pose a major challenge to the American economy in a later era). The problem was that the gold standard severely circumscribed policymakers’ control over the money supply and closed off the option of meeting a severe deflation with a major increase in the supply of money. Theoretically, the Federal Reserve Bank might have pursued an aggressive “easy money” policy from 1930 onward. But we were decades away from the monetary theory which would have provided the rationale for such a policy. Moreover, the Federal Reserve was prevented from taking such action by a combination of law and ideology. Federal law required that the Fed have on hand $40 worth of gold for every $100 in circulation. The only way to ensure against a run on gold was to keep interest rates high. (With interest rates high, it was more profitable to collect interest than to cash the dollars in for gold.) But high interest rates and tight money were the last things the economy needed when the aim was to get consumers to spend. The Fed’s legal responsibilities were reinforced by an orthodoxy that saw the abandonment of sound money as the prelude to an apocalypse. Ironically, fear of one kind of apocalypse helped bring on another, as the economy sank deeper into its hole.21 The Fed’s tight money policy provided the context for the cascading sequence of thousands of bank failures, beginning in 1930, that turned already panicked consumers into paralyzed catatonics and wiped out the life savings of millions of citizens.22

The first casualty of the Depression was the belief that the economy would self-correct, that everything would right itself by the magic of laissez-faire. At first nearly everybody expected a quick recovery, following the pattern of 1920–21.
Businessmen urged consumers to tighten their belts and return to the frugal habits so widely abandoned in the 1920s (it was the wrong advice: what consumers needed was enough money to spend). Like many members of the business community, Secretary Mellon believed that periodic recessions were necessary to purge the economy of inefficiencies. His advice to President Hoover: “Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.”23 With unemployment already rising to unprecedented levels in 1930, Hoover, to his credit, understood that such words now had too harsh a ring for most Americans. The president initially took some small steps in what economists would later argue was the right direction, increasing the pace of federal spending for construction and exhorting the states to follow suit. But soon he reverted to the economic orthodoxy, resisting proposals for federal relief and attempting instead to encourage state relief and private charity efforts. As growing unemployment reduced increasing millions of Americans to insolvency, poverty, homelessness, and even starvation, state relief and private charity efforts were simply overwhelmed.

Economic conditions went from bad to worse. More than a thousand banks failed in 1930; from 1930 through 1932, the total would rise to over five thousand. In three years, nearly $3 billion in deposits were wiped out, the life savings of millions of Americans. Another nearly $3 billion would go up in smoke in 1933.24 Meanwhile, depositors rushed to withdraw their cash before banks went belly-up. Runs on banks became commonplace. From 1929 to 1932, the broader measure of the money supply ($M_2$, which, roughly speaking, included currency in circulation as well as money in checking and savings accounts) plummeted by $10 billion, or 22 percent.25 Money available for both lending and spending was simply evaporat-
ing, as banks collapsed and consumers hoarded cash; demand was rapidly draining out of the economy.

The irony was pitiful. Millions of tons of grain rotted in elevators as children went hungry. Warehouses remained stocked with goods that no one had the money to purchase. Thousands of factories simply shut down. The vast machinery of plenty, built up over centuries of economic striving and two industrial revolutions, had nearly ground to a halt.

In 1932, Hoover pushed Congress to create the Reconstruction Finance Corporation to provide federal government loans to banks, building and loan associations, and railroads to support construction projects. Here at last was a vehicle for modest fiscal stimulus. But the money was slow in trickling out of Washington, and the usefulness of the measure was undermined by an ill-advised tax increase in the same year (the brainchild of Mellon), which took money out of taxpayers’ pockets and further reduced demand.26
Franklin D. Roosevelt, the Democratic nominee in 1932, was no less a captive of economic orthodoxy than the Republicans. During the campaign, Roosevelt attacked the Hoover administration as spendthrift and called for a balanced budget and a reduction in federal spending. In other words, Roosevelt assailed Hoover for just about the only thing he was doing right. After the fact, a supporter of Roosevelt observed, “Given later developments, the campaign speeches often read like a giant misprint, in which Roosevelt and Hoover speak each other’s lines.”

Yet while sharing some of the orthodox beliefs of the time—in particular, favoring balanced budgets and sound money—Roosevelt departed from the orthodoxy in one critical respect: he believed strongly in the possibility of constructive government action. Roosevelt was a progressive, an heir to the progressive tradition on two different sides: he had served in Woodrow Wilson’s administration (as assistant secretary of
the navy), and he had married Theodore Roosevelt’s niece, the formidable Eleanor. Roosevelt knew from watching Wilson, and for that matter Teddy, that government could be an active instrument of change: it could be used to reshape economic life; it could establish a new and better set of rules for economic activity; it could be a tool for solving problems. It was a tool Roosevelt was fully prepared to use.

Against the relative passivity of the Republicans—a legacy of the long-standing laissez-faire taboo—Roosevelt proposed a bold course of government action. The byword of his approach was experimentation. “It is common sense to take a method and try it,” he said. “If it fails, admit it frankly and try another. But above all, try something.”

“Try something.” The words spoke directly to the public mood. Do something, anything, to halt the slide into economic apocalypse. At the Democratic National Convention, Roosevelt pledged “a new deal for the American people.” “New Deal” became the slogan of his administration and the synonym for a revolution in federal government policy.

Missing Macroeconomics

Interestingly, FDR’s New Deal did not really solve the problem of the Depression, or it did so only slowly and partially and more often by happenstance than by design. Although unemployment gradually fell from its peak of 25 percent in 1933, unemployment remained in the double digits for nearly the entire decade. While reliable official unemployment statistics were not available at the time (the government would only begin to track unemployment reliably in 1942), the fact that even by the end of the decade the economy had not yet returned to a state of prosperity was plain for all to see.
The immediate problem besetting the economy in the 1930s was essentially macroeconomic. The source of the economy’s weakness lay in the collapse of demand, and especially consumer demand. The Roosevelt administration never developed anything approaching systematic fiscal or monetary policies to address this core macroeconomic issue. One reason was lack of knowledge about how the economy worked: the conceptual tools for positive macroeconomic policies had not yet been developed. Only in 1936 would John Maynard Keynes publish his *General Theory*, and it would take the economics profession and policymakers a few years to absorb the lessons of Keynes’s new understanding. Keynes actually met with Roosevelt in 1934 and attempted to encourage the president to engage in more deficit spending. But the meeting was abortive on both sides. “He left a whole rigmarole of figures,” Roosevelt remarked to his labor secretary, Frances Perkins, after the session. “He must be a mathematician rather than a political economist.” For his part, Keynes was surprised at FDR’s lack of economic comprehension. Keynes “supposed the President was more literate, economically speaking,” he told Perkins.3

In fact, monetary remedies came more promptly than fiscal steps—though again this was a matter almost of politics rather than economic policy. In Congress, “soft money” men of the William Jennings Bryan tradition were gaining ground, while some financial experts were also calling for “reflation.” In April 1933, Senator Elmer Perkins of Oklahoma attached an amendment to the farm bill that would effectively take the United States off the gold standard, by authorizing expansion of the currency through monetization of silver and printing of greenbacks. Sensing the winds of political change, Roosevelt was gradually relinquishing his commitment to “sound money.” The president agreed to the amendment in modified form.
From a macroeconomic standpoint, Roosevelt’s abandonment of the gold standard in 1933 may have been the most important single policy measure setting the American economy on a path to recovery—though there is little evidence that the president fully understood this. Interestingly, even so conservative a financial authority as J. P. Morgan saw the positive implications of this step, publicly signaling his approval at the time. The new law freed the Federal Reserve Banks to pursue an easier money policy, pointing a way out of the killing credit crunch that was choking the economy nearly to death. The New York Federal Reserve Bank immediately lowered its discount rate from 3.5 to 3 percent in April and dropped it to 2.5 percent in May. The rate would fall to 1.25 percent by February of the following year. April 1933, the month the United States abandoned the gold standard, marked the first month since August 1929 in which the American economy actually experienced growth. By 1934 the money supply was expanding again, though ever so slowly. In a technical economic sense, the Depression could even have been said to have ended—since the contraction had hit its trough—but in reality the expansion would be so slow that recovery would feel like a continuing Depression for many years to come.

How do these Depression-era measures compare with policies pursued in more recent times? The pace of interest rate reductions by the New York Fed in 1933–34 (with other Federal Reserve Banks generally following suit) resembled the aggressive easy money policy pursued in 2001–02 by Federal Reserve Chairman Alan Greenspan immediately following the onset of recession in March 2001, a year following the technology stock bust. At the first signs of recession, the Fed in April 2001 began lowering interest rates at a comparable though slightly faster
pace than the rate cuts in 1933–34 (Greenspan also continued the process, ultimately taking rates even lower than the rates of the 1930s central bankers). The result in 2001–02 was a shallow, fairly short recession. As the success of Greenspan’s policies tended to confirm, easier money could have been the right medicine for the American economy during the Great Depression. But the first steps toward easier money in the 1930s came very late in the course of the disease. During the forty-three months before April 1933, the U.S. economy had been allowed to dig itself into too deep a hole. It would take years to climb out.

As for fiscal policy, there is no evidence that Roosevelt made conscious use of deficits to increase overall demand, or that he was in any measure influenced by Keynes’s new macroeconomic ideas. The federal government did run substantial deficits; they grew willy-nilly as a result of the panoply of new federal programs Roosevelt was putting in place. Between 1932 and 1936, the federal deficit rose from $2.7 to $4.3 billion—the peak deficit for the prewar years. But the dollar increase in federal deficit spending only amounted to about 1 percent of GNP over four years, a figure probably insufficient to affect the economy significantly. In addition, whatever minor stimulant effect the increased federal spending might have had was largely canceled out by tax hikes at the state level. As the states battled to eliminate their budget deficits, they increased annual revenue collection between 1932 and 1936. As the federal government was putting more money into the economy, the states were taking more out via taxation, partly to reduce their deficits. Much of what came in one door went out the other.

In addition, Roosevelt, still probably believing in balanced budgets, pursued a series of un-Keynesian tax increases in 1935, 1936, and 1937 that doubled federal revenues as a share
of GDP, from 3 to 6 percent. These tax increases had the effect of rapidly reducing the federal deficit from over 5 percent of GNP in 1936 to well under 1 percent of GNP in 1938.\(^9\) This budget balancing might have seemed a good thing to a certain orthodox cast of economic mind. But the effect of reducing deficits was to \textit{shrink} aggregate demand. Instead of putting borrowed money into the economy, the federal government was now taking money out. Indeed, Roosevelt’s tax increases were probably a factor in the onset of a second deep recession in 1937–38. Clearly, whatever else he may have been doing, FDR was not using fiscal policy or deficits to manage the economy in the modern sense of that term.

The New Deal

What, then, was the significance of the New Deal? In the first place, the psychological impact of Roosevelt’s leadership is not to be underestimated. By 1932, depression was not merely an economic phenomenon; it was an apt description of the country’s state of mind. Roosevelt’s easy optimism, self-confidence, and bold experimental spirit instilled hope, and hope was a vital ingredient of recovery. The famous line from FDR’s first inaugural—“The only thing we have to fear is fear itself”—was not just a masterful piece of rhetoric. It was also an economic analysis. The nation had been thrown off its horse. To move forward, people had to find the gumption to climb back into the saddle again. The country had absorbed the full brunt of risk inherent in a modern economy. But for modern economic life to go forward, Americans had to be persuaded to begin taking risks once again: the risk of spending, the risk of investing, the risk of borrowing, and for that matter the risk of
putting one’s money in a bank. If Americans who had money decided to sew most of it up in their mattresses—as some were doing and others were tempted to do—the modern economy was finished. There could be no economic life without risk, yet somehow the human consequences of that risk had to be reduced and distributed more equitably. Americans had remained relatively unfazed by the growing income inequality of the 1920s. What they found intolerable after 1929 was the unequal distribution of the terrible consequences of economic risk.

This was in a certain sense the central significance of the New Deal and its most enduring legacy—though New Dealers would probably not have described it in precisely such terms. The most enduring programs of the New Deal were designed to wring extreme risk out of the economy and to ensure that whatever risk remained was distributed more equitably among all segments of the population. Its major tools were regulation and insurance. Roosevelt sought to use regulation to prevent business from taking undue risks (and engaging in corrupt practices) of the kind that had brought on the stock market crash. At the same time, he sought to put in place social insurance programs—such as unemployment insurance and Social Security—to protect ordinary Americans from the worst perils of modern economic life. The two measures, regulation and insurance, were mutually reinforcing. While regulation may have reined in business, the combination of regulation and insurance instilled consumer confidence, especially in banks and financial institutions, in a sense gradually giving business back the customers who had fled when the roof came crashing in. By reducing or eliminating irresponsible business risk taking and by providing ordinary Americans with an insurance policy against the worst economic misfortunes, FDR rewrote the
American social contract in a way that preserved the free market economy, opened the way to continued prosperity, and protected the American Dream.

This is not to discount the importance of the many direct relief programs put in place by the Roosevelt administration—the Civilian Conservation Corps, the Civil Works Administration, the Public Works Administration, and later the Work Projects Administration, and so on. One critical effect of these federal investment and public works programs was to lower unemployment. It is a little-known fact that later statistics developed by the scholar Stanley Lebergott and the Bureau of Labor Statistics—and usually treated as the official estimates for unemployment during the era—counted the millions employed in federal public works projects as part of the unemployed (they were thought to be in temporary employment). By the mid- to late 1930s, there were 2 to 3.5 million such “emergency workers” on the federal payroll, which meant that real unemployment was actually 4 to 7 percent lower than the numbers the bureau has provided. The direct relief programs should not be dismissed: they created jobs for millions of breadwinners and incomes for millions of families who otherwise might have been hard-pressed to survive. Nonetheless, even counting the public works laborers as employed, unemployment remained in double digits for the rest of the decade, with the sole exception of 1937, when it stood at over 9 percent. As late as 1940, nearly a tenth of the workforce (9.5 percent) remained unemployed.¹⁰

After declaring a four-day bank holiday in early March 1933, Roosevelt pushed through an Emergency Banking Act that greatly expanded presidential powers over banking, instilling sufficient confidence to get the nation’s banking system
up and running again. A few months later, the Glass-Steagall Banking Act introduced fundamental banking reform, once again through a combination of regulation and insurance. The act required separation of commercial and investment banking (thereby segregating out the riskier investment activity from more manageable conventional banking). It expanded the regulatory powers of the Federal Reserve Board over member banks. And it created the Federal Deposit Insurance Corporation to insure deposits up to $5,000. The combination of regulation and insurance made it safe for citizens to bank again, and deposits began to grow. The subsequent Banking Act of 1935 further strengthened and reformed the Federal Reserve System.

Equally vital was the Securities Exchange Act of 1934. Designed to remedy the wholesale abuses of the 1920s stock market, the act created a Securities and Exchange Commission to oversee stock sales and granted the Federal Reserve the power to regulate margin selling. Just as regulation made banking safe, so the commission granted a measure of safety to investors and insurance against the worst scams of the 1920s boom.

The Depression led to a rash of mortgage foreclosures; millions of Americans lost their homes, and millions more homeowners were in jeopardy of losing them. In 1933, Roosevelt successfully pushed for the creation of the Home Owners Loan Corporation to provide refinancing for homeowners threatened by foreclosure. The following year saw the establishment of the Federal Housing Administration, to provide federal insurance for home mortgage lenders, an agency that ultimately helped promote widespread home ownership in the United States.

In 1935, Congress passed the Social Security Act, creating the nation’s first real social safety net (to use a phrase from a
later era): small old-age pensions and unemployment insurance to be administered by the states from federal grants. Both were paid for by new payroll taxes, to which employees and employers contributed.

One major consequence of the Depression was a rehabilitation of organized labor—and the extension of unions from skilled crafts to the nation’s major industries. The 1930s were a period of extensive labor unrest, multiple strikes, and violence; however, the pain of unemployment had become so widely shared that public opinion, once hostile to unions, grew more sympathetic. Roosevelt preferred to see cooperative relations between labor and management and disliked strikes. But he acquiesced in legislation sponsored by Senator Robert Wagner of New York to strengthen the bargaining power of unions. Ultimately the New Deal was responsible for two key pieces of legislation that revolutionized the American workplace. The National Labor Relations Act of 1935 created a three-member National Labor Relations Board with the power to protect workers’ right to organize, to conduct union elections, and to bargain collectively. As a consequence, by 1940 labor union membership rose to 7.2 million compared to 3.7 million in 1932. The board was also empowered to intervene to stop unfair labor practices. The Fair Labor Standards Act of 1938 established the first mechanism for determining minimum wages, mandated a forty-hour workweek with overtime paid at time-and-a-half, and ended child labor by forbidding the employment of children under sixteen.

Together, these elements—regulation, social insurance, federal underwriting of home ownership, and protection of workers and their right to organize—would eventually help bring forth a fundamentally new kind of industrial economy
in the post–World War II era, one in which ordinary industrial workers could aspire to and attain a middle-class standard of living and in which they enjoyed decent wages, relative job security, savings protected from financial mismanagement and malfeasance, the benefits of home ownership, and a measure of security in retirement. It helped put the American Dream within reach once again of the prudent laborer who started from the low rungs of the economic ladder.

To view the New Deal in retrospect, from the standpoint of its legacy, as we have done here, is perhaps to paint too pretty a picture of the events of the decade. Roosevelt’s approach was anything but systematic. His initial effort at recovery, embodied in the National Industrial Recovery Act of 1933, was an ambitious attempt to regulate economic life in a substantial way, moving in the direction of a centrally planned economy. The efforts of the National Recovery Administration were not too far along before the act was declared unconstitutional by the Supreme Court in 1935. Similarly, the president’s efforts to “pack” the Court by expanding its membership in 1937 were thought to be an assault on the Constitution: it was turned back by conservative Democrats in the Senate. There was a lot of trial and a lot of error in Roosevelt’s approach. But perhaps only a leader as bold as Roosevelt could have redrafted America’s social contract from the ground up. That the majority of the public felt a need for such radical reforms is evidenced by the fact that Roosevelt easily won reelection to three more terms.

The most important New Deal initiatives have become an integral part of our own economic life. They have become so much a piece of the fabric of American economic activity that we not only take them for granted: we fail to appreciate how critical they have been in reducing the risk inherent in a
modern economy, in effect, making the world safe for capitalism, and making capitalism safe for the ordinary worker and consumer. Those who wish to turn the clock back to a time before the New Deal often forget that the same forces that produced the prosperity of the Roaring Twenties also brought the catastrophe of 1929. Economic policies that maximize business and consumer risk taking may for a time encourage high rates of growth; but they also incur a much greater chance of economic disaster. The two go hand in hand.

Codifying the Dream

It was the World War II economy that finally ended the long Depression. Perhaps only war could have justified the truly massive expansion of government investment and government employment that was necessary to sufficiently expand aggregate demand. From 1941 to 1943, federal outlays as a percentage of GNP nearly quadrupled, from 11 percent to 41 percent, while the federal deficit expanded nearly sevenfold, from 4 percent to nearly 29 percent of GNP. As the ranks of the armed services rapidly swelled from prewar levels of well under a million to some nine million personnel in 1943, unemployment quickly fell—from nearly 10 percent in 1940 to 3.1 percent in 1942 and less than 2 percent in 1943.\(^{12}\) Eventually there was an acute labor shortage, which was largely met by millions of women who newly entered the workforce.

As war leader, Roosevelt was conscious of his predecessor Wilson’s mistakes and strove not to repeat them. One critical error of Wilson was to neglect domestic concerns when he turned his attention to war- and peacemaking. The result was an abrupt end to the Progressive Era. Roosevelt, by contrast, tried to codify the gains that had been made in the New Deal
and set forth the terms of the nation’s new social contract. In his State of the Union message in 1944, he described a “second Bill of Rights”—essentially a replacement of the laissez-faire belief in an inactive government economic policy:

This Republic had its beginning, and grew to its present strength, under the protection of certain inalienable political rights—among them the right of free speech, free press, free worship, trial by jury, freedom from unreasonable searches and seizures. They were our rights to life and liberty.

As our Nation has grown in size and stature, however—as our industrial economy expanded—these political rights proved inadequate to assure us equality in the pursuit of happiness.

We have come to a clear realization of the fact that true individual freedom cannot exist without economic security and independence. “Necessitous men are not free men.” People who are hungry and out of a job are the stuff of which dictatorships are made.

In our day these economic truths have become accepted as self-evident. We have accepted, so to speak, a second Bill of Rights under which a new basis of security and prosperity can be established for all regardless of station, race, or creed.

Among these are:

The right to a useful and remunerative job in the industries or shops or farms or mines of the Nation;

The right to earn enough to provide adequate food and clothing and recreation;
The right of every farmer to raise and sell his products at a return which will give him and his family a decent living;

The right of every businessman, large and small, to trade in an atmosphere of freedom from unfair competition and domination by monopolies at home or abroad;

The right of every family to a decent home;

The right to adequate medical care and the opportunity to achieve and enjoy good health;

The right to adequate protection from the economic fears of old age, sickness, accident, and unemployment;

The right to a good education.

All of these rights spell security. And after this war is won we must be prepared to move forward, in the implementation of these rights, to new goals of human happiness and well-being.\(^{13}\)

One way Roosevelt sought to implement this vision was by passage of the Servicemen’s Readjustment Act of 1944, better known as the G.I. Bill. The bill provided unemployment compensation, mortgage loan guarantees, and educational stipends for returning World War II veterans. Returning GIs received some $2.5 billion in unemployment payments in 1946 and 1947. From 1945 through 1950, the government provided veterans with over $10 billion for college and vocational training.\(^{14}\)

Not only did spending for veterans (nearly $35 billion from 1945 through 1950) stimulate the economy.\(^{15}\) It also created a massive new college-educated middle class, whose skills would add to the growth and productivity of the economy for a generation. The federal government had been generous with
veterans following previous wars. But after World War II, the money for veterans came in a form largely shaped by the social vision Roosevelt had set forth in his 1944 State of the Union message. Veterans were given immediate cash to tide them over through unemployment. But they were also given assistance, specifically, with gaining a college education and purchasing a home. Americans were perhaps especially prepared to extend these “rights” of education and home ownership to individuals who had risked their lives in defense of the nation. But the added effect of the G.I. Bill was to use government aid to build an entire new generation of middle-class Americans.

The G.I. Bill also had a ripple effect. It strengthened higher education by generating billions in indirect subsidies (in the form of the veterans’ tuition stipends) to the nation’s colleges and universities, greatly expanding the American higher education system. The New Dealers had hit upon a marvelously nonbureaucratic way of using federal resources to reshape an entire society. The costs of administering G.I. Bill benefits were relatively minimal. But the program’s impact in reshaping society was probably greater—and more effective—than anything that could have been accomplished through central planning or government command-and-control-style bureaucratic regulation.

Not everyone accepted Roosevelt’s ambitious new definition of economic rights. But FDR succeeded in forging a new economic consensus that would survive mostly intact under both Democratic and Republican presidents for three and one-half decades. In 1945, congressional sponsors of a proposed Full Employment Act sought to enshrine in law the right to a job and legislate Keynesian economics, requiring the government to engage in “compensatory spending” in times of recession to ensure “full employment.” Opponents of the act whittled
down its provisions. The right to employment was excised, as was the requirement for compensatory spending. The compromise Employment Act of 1946 established government’s responsibility to promote the more ambiguously phrased “maximum employment.” The act also required an Annual Economic Report from the president and established a Council of Economic Advisers. To be sure, the law did not guarantee full employment. But it was a powerful symbolic statement of the federal government’s new role. Not only was government’s right to intervene in the economy established; government’s role in the economy was now understood to be a responsibility. Like it or not, employment had now become the barometer by which presidents and their administrations were to be judged. As perhaps the leading measure of presidential performance, employment forged a direct link between the electoral fortunes of the president and his party, on the one hand, and the fate of the ordinary worker, on the other. It stood as a constant reminder that the economy existed to serve the American worker, and not (as had often been believed in previous eras) vice versa.

President Dwight D. Eisenhower was the first Republican president to follow FDR. During his eight years in office from 1953 to 1961, Eisenhower opposed expanding government’s role in the economy. He stood staunchly by Republican principles of fiscal conservatism. He had no patience with Keynesian theories and had no intention of tinkering with deficit spending to ensure maximum employment. Despite his fiscal conservatism, however, Eisenhower made no attempt to dismantle the legacy of New Deal programs—Social Security, unemployment insurance, federal support for mortgages, and home ownership under the Federal Housing Authority. The truth is, an attack on the New Deal legacy would have seemed
almost unthinkable. In combination with the G.I. Bill, the New Deal legacy was helping to create a solidly middle-class society of hardworking, homeowning workers and consumers, rich with opportunities for education and economic advancement. Under the aegis of national defense, Eisenhower himself expanded government’s role, pursuing his own program of internal improvements by pushing for the creation of the Interstate Highway System, established in 1956. After the Soviet Union launched Sputnik, the world’s first earth-orbiting satellite, in 1957, Eisenhower acquiesced in a Democratic plan for federal aid to education, signing the National Defense Education Act of 1958. Ostensibly intended to help Americans compete in the space and technology race with the Soviets, the act called for nearly $1 billion in student loans and fellowships, further expanding nonbureaucratic federal support for higher education.17

The economy continued to grow healthily in the 1950s. A comparison of the economies of the 1920s and the 1950s is instructive. By the mid-1920s, federal outlays stood at only about 3 percent of GNP. By the mid-1950s, federal spending hovered around 17 to 19 percent of GNP, a legacy partly of cold war defense requirements, partly of the New Deal programs. The government of the 1950s, in other words, was roughly a six times larger presence in the economy than the government of the 1920s. Yet growth rates in the two decades were comparable. From 1921, the year Republicans took the White House, through 1929, GNP grew at an average real rate of 4.5 percent a year. From 1951 through 1959, GNP expanded at an average real rate of 3.6 percent a year. However, if one included the year 1950, an especially good year, the average for the entire 1950s was 4.1 percent. By contrast, in the twelve years during which Republicans controlled the White House and pursued their laissez-
faire doctrine (1921 through 1932) the average real annual growth in GNP was actually negative (minus 4 percent a year).18

Unemployment in the 1950s stood at about the same level as in the 1920s—an average of 4.6 percent for 1921 through 1929 and of 4.4 percent for 1951 through 1959.19 In both decades, the economy had its ups and downs. But the difference was the unemployed of the 1950s could count on unemployment insurance and were not threatened with poverty and starvation, as were the unemployed of the earlier decade. From 1920 to 1929, average hourly wages of manufacturing production workers declined in real terms, even while productivity and manufacturing profits increased. From 1950 to 1959, average hourly wages of workers in the same category grew by 21 percent in real terms. The 1950s enjoyed a level of prosperity similar to that of the 1920s, but prosperity was much more widely shared. In 1929, families with the top fifth of incomes took in over half of the national income; by 1959, the share of this group was 44 percent.20 In the 1950s, thanks largely to the legacy of the New Deal, millions more Americans had access to home ownership, a college education, and decent-paying jobs with good working conditions. The forty-hour workweek was standard. Unions protected millions of workers from arbitrary actions by management. Child labor had been outlawed. Banking and investing were much safer activities. And, with or without conscious Keynesian policies, the large presence of government in the economy served as a kind of buffer against a total collapse of demand such as had been seen beginning in 1929.

The American economy that emerged after World War II—essentially the economy that we live and work in today—differed profoundly from the limited government, laissez-faire system of the pre–New Deal era. The contrast could be seen perhaps most dramatically in the way the economy now re-
sponded to recessions. Eisenhower presided over no fewer than three recessions in the course of his eight years in office—in 1953–54, 1957–58, and 1960–61. Yet by comparison to pre–World War II downturns, the Eisenhower recessions were remarkably short and mild.

The three Eisenhower recessions lasted an average of just over nine months each. Unemployment peaked in 1958, at 6.8 percent. By contrast, from 1869 through 1933, economic downturns had typically lasted an average of twenty-three months. From 1869, the dawn of the Gilded Age, through 1933, the U.S. economy suffered seventeen downturns. Of these, three dragged on for more than three years, five persisted for two years or longer, and only one ended in fewer than ten months. Moreover, the earlier slumps had typically brought catastrophic levels of unemployment, typically in the range of 12 to 25 percent.21

Something had clearly improved. What had happened? The most obvious answer was that the federal government had significantly grown. It was now an economic force to be reckoned with. During the mid-1920s, federal outlays amounted to only about 3 percent of GNP. By the mid-1950s, federal outlays had risen to 18 percent of GNP. Not all of this was social spending: about 60 percent of the budget was going to defense.22 Nonetheless, the new expanded government was providing a substantial cushion against economic free fall. As the economy slowed in postwar recessions, federal revenues naturally dropped, but federal expenditures continued at a high level. And now the government was large enough for these expenditures to matter. They substantially stimulated the economy by sustaining aggregate demand with increased federal spending largely because of the New Deal program of unemployment insurance. As unemployment went up, federal disbursements for unemployment payments went up simultaneously. This “auto-
matic” support for aggregate demand kicked in essentially immediately when recessions occurred and employment declined.

The post–World War II federal budget had become, in short, a kind of Keynesian counterdepression machine. It automatically produced additional government spending whenever the economy began descending into a slump. The result was a pronounced moderation of downturns. The fiscal stimulus from increased government expenditures was an important hedge against an economic tailspin.

Moreover, the Keynesian principles now operating in the economy had wide acceptance across the political spectrum. In the wake of the recession of 1953–54, Arthur F. Burns, chairman of Eisenhower’s Council of Economic Advisers, openly acknowledged the role of Keynesian demand mechanisms in ensuring a mild and short downturn. “During the last year,” he told the Economic Club of Detroit in 1954, “very few students of affairs seriously urged that taxes be increased to wipe out the public deficit; or that interest rates be raised to speed the liquidation of excessive inventories and of superfluous industrial plants; or that banks call in their loans and reduce the outstanding money supply in order to protect their solvency. . . . Yet, incredible as it may seem, these were precisely the remedies for curing a business recession that had had a considerable vogue in earlier times.”23 It was Keynes who had shown why the old prescriptions failed to work and pointed to the new solution based on government action to sustain aggregate demand. At the beginning of the 1953–54 recession, some still worried about a repeat of 1929. The mild recession of 1953–54 marked a historical turning point. It showed that the basic problem behind the Great Depression had probably been solved; the limited government, laissez-faire economy—the philosophy of the Gospel of Wealth—with all its attendant booms and busts and terrible risks, was now a thing of the past.
Keynesianism had thus become the consensus position among both Republicans and Democrats. But a new debate was already emerging between those who believed the economy was doing remarkably well and those who believed it might do even better.

The Neo-Keynesian Economics

Seen from a distance of decades, U.S. economic performance in the Eisenhower years (1953 through 1960) left little to complain about. Despite the three short slumps, GNP grew at a healthy annual real average of 3 percent. Unemployment averaged less than 5 percent, while inflation, averaging less than 1.5 percent, remained minimal. Prosperity was not limited to the richest Americans. Between 1950 and 1960, median family income in the United States rose by more than a third in real terms. The portion of Americans owning their own homes steadily expanded from 55 to 62 percent. As the economy grew, poverty declined by perhaps as much as a third, from roughly 30 percent of the population in 1950 to about 20 percent in 1960.24

But the conviction was strong among a new generation of Keynesian economists that they could do better. The peace and prosperity of the 1950s had brought forth a kind of intellectual renaissance in American universities, spurred by the coming of age of the modern social sciences. In an array of fields, from defense thinking, to business management, to social policy and economics, a new generation of university-based social scientists had built up an arsenal of theories, innovative methods, and fresh approaches—which they were now eager to try out in the real world.

Nowhere was the activity more energetic than in the field of modern economics. Keynes’s thinking had furnished economists with extraordinarily powerful fiscal tools to manage the
economy. But throughout the 1950s American economists attempted to improve on Keynes’s work. In the process, they subtly changed its thrust. Under the influence of a number of academic economists, Keynesianism gradually evolved in the 1950s from a broad answer to the crisis of depressions and massive unemployment into a neo-Keynesian tool of social engineering, a method for massaging the modern economy to coax a bit more performance out of it.

The neo-Keynesian economics developed in the 1950s was based on a simple proposition: if deficit spending could lower unemployment in a recession, could it not also be used to reduce unemployment to an even lower level during a boom? That is, might not deficit spending hold the key to permanently reducing unemployment to levels below the 4 to 5 percent range that seemed to persist even when the U.S. economy was doing well? And would not such a reduction in unemployment lead to even stronger growth and greater national income?

A turning point came in 1958, with the publication of an article by the British economist A. W. H. Phillips. The article focused on the historical relationship between unemployment and inflation. Phillips showed how in the United Kingdom these two numbers had historically tended to seesaw. When inflation was low, unemployment rose. When inflation increased, unemployment declined. He pictured the relationship between the unemployment and inflation rates graphically in what famously became known as the Phillips Curve.

Two American Keynesians, Paul A. Samuelson and Robert W. Solow, sought to put Phillips’s insight to practical use. If high unemployment went hand in hand with low inflation, and vice versa, might not these values represent policy choices? In the American experience, when inflation was near zero and
prices were not rising, it appeared that unemployment tended to hover around 5 percent. What would happen, they asked, if one were to run a modest inflation rate of 3 percent, allowing prices to increase? Would that not, by the logic of Phillips’s analysis, cause unemployment to drop to the 3 percent range? In other words, could one perhaps fine-tune the economy, using Keynesian tactics, to produce better unemployment performance than had been seen to date? What harm could there be in a little inflation, if millions more Americans could be put to work? It was a socially laudable agenda, and it sounded plausible enough.²⁶

Virtually all mainstream economists, Republican and Democrat, agreed by the mid-1950s that deficit spending was an effective antidote to recessions. What was new in the neo-Keynesian economics was the proposal to use deficit spending during an economic expansion to permanently lower unemployment and increase rates of growth. But the new approach carried a substantial risk: the threat of increasing inflation.

**Moving Again**

The Democratic nominee John F. Kennedy came to office in 1961 with a promise to “get this country moving again.” The question was, moving where? The reforms of the Progressive Era and the New Deal had been driven by a widely shared sense of social crisis. Strong majorities in both eras had felt a need for radical change. Kennedy’s narrow victory over Eisenhower’s vice president, Richard Nixon, in 1960 signaled no such popular mandate for reform. Kennedy won with only a 0.2 percent majority of the popular vote. The country was in the midst of a mild recession, which had worked to Kennedy’s advantage in the election. But there was no widespread sense of crisis.
Still, the memory of the New Deal reforms ran strong among Democrats. After eight years of Eisenhower’s rather prosaic presidency, there was a certain nostalgia for the poetry and high drama of the New Deal and Roosevelt’s first one hundred days—and a certain almost ritualistic evocation of the New Deal’s symbolism. Kennedy would christen his administration’s program the New Frontier, and Kennedy aides would speak reverently of the young president’s first one hundred days, as though Kennedy’s reign promised to equal FDR’s in boldness and accomplishments.

But the spirit of the New Frontier was in many respects quite different from that of the New Deal. The byword of the New Frontier was pragmatism. It was not so much that the Kennedy administration set out, in an ideological or moralistic spirit, to solve vast economic problems or right big social wrongs. Rather, it came to office with a confidence that it had superior technical solutions to the problems of modern governance. Kennedy himself apparently felt there was little of the New Deal passion left for social reform. The single major addition to the New Deal that was on the table—government-subsidized medical care for the aged, or Medicare—was the only such issue, in Kennedy’s opinion, still capable of arousing much public interest. Kennedy did what he could to press for adoption of Medicare, against resistance from Republicans and conservative Democrats in Congress—and the adamant opposition of the American Medical Association. The measure failed. But Medicare was never Kennedy’s top priority. Rather, he saw the major economic challenge as one of administration, of technically managing a modern economy.27

Kennedy himself, cautious by nature, was initially skeptical of ambitious economic plans. Immediately after the election, he rejected proposals to stimulate the economy through tax
cuts and deficit spending. Treasury Secretary C. Douglas Dillon and Federal Reserve Chairman William McChesney Martin opposed deficit spending, as did Kennedy’s close White House advisers McGeorge Bundy and Theodore Sorensen. In his State of the Union message in January 1961, the president treated the growing federal deficit as a problem. But by his State of the Union message in January 1962, Kennedy seemed to have embraced much of the Keynesian vision that deficits could be useful. He called on Congress to give the president discretionary authority (subject to what he called “Congressional veto”) to lower taxes or accelerate federal spending at the first signs of an economic downturn. This was the well-established Keynesian formula—in times of recession, cut taxes or increase spending or both to expand aggregate demand.

Noting that “we have suffered three recessions in the last 7 years,” Kennedy argued that “the time to repair the roof is when the sun is shining.” In particular, he repeated a call for an increase in unemployment compensation (increasing unemployment payments would not only further ease the suffering of the unemployed but also enhance the “automatic” Keynesian aggregate demand effect during a downturn). Yet the ever-cautious Kennedy was still not inclined to embrace dramatic economic programs. As late as February 1962, the president ruled out a tax cut in the face of evidence of “continued prosperity.” But when the recovery seemed in jeopardy in the spring of 1962, Kennedy was ready to break new ground. In a commencement address at Yale University in June of 1962, the president dismissed concern about federal deficits as one of many “myths” and “old clichés” that stood in the way of “sophisticated” policy. The nation needed, said the president, “a more sophisticated view than the old and automatic cliché that deficits automatically bring inflation.” It was not a
“political” issue, according to Kennedy, but a purely “technical” one: “The problems of fiscal and monetary policies in the sixties . . . demand subtle challenges for which technical answers, not political answers, must be provided.”

The economy was technically in recovery, but unemployment still stood well over 5 percent—hardly an improvement over the Eisenhower years. When disappointing reports on unemployment and GNP growth were followed by a sharp stock market decline on “Black Monday” in late May—the president announced his desire for an “emergency tax cut” to stimulate the economy. A handful of legislators supported him, ranging from the liberal Hubert Humphrey to the conservative Barry Goldwater. But most Republicans as well as the key Democratic committee chairmen in Congress were dead set against the measure. Their reasoning was straightforward: the federal government was already running a deficit, and a tax cut would only make it worse. Most in Congress were far from prepared to support the tax cut, and polls indicated that the public sided with their legislators. Kennedy was forced to withdraw the proposal in August.

At the beginning of 1963 Kennedy came back with the tax cut proposal again, this time putting it at the top of his legislative agenda. New arguments in support of the tax cut were now being made by the economists who filled advisory roles in his administration. Kennedy’s economic advisers had hinted at their ambitious neo-Keynesian agenda in their first Economic Report of the President in January 1962. The report departed sharply from Eisenhower administration positions in emphasizing what the New York Times called the human dimension of the economy. The text clearly implied that Kennedy’s Council of Economic Advisers favored not just maximum employment—in the words of the Employment Act of 1946—but full employ-
ment, achieved by neo-Keynesian means based on the Phillips Curve theory. That meant unemployment below the roughly 5 percent range that seemed normal for the postwar U.S. economy. The report noted that the economy would gain $10 billion in output if every individual who wanted a job had one. So not only would more people be employed, but the economy would also enjoy faster growth. (At the time, with the economy having recently emerged from the 1960–61 recession, unemployment still stood at a rather high level of 6 percent.) Kennedy’s Council of Economic Advisers, consisting of the neo-Keynesian economists Walter Heller, James Tobin, and Kermit Gordon, was clearly poised to use deficit spending not just to fight recession, but to improve the economy, to coax it toward lower-than-historical unemployment and faster-than-historical growth. “Heller’s Concepts Now Prevail,” headlined a story in the Washington Post in February 1963.32

Kennedy’s assassination in Dallas, Texas, on November 22, 1963, shocked the nation as perhaps no event since the Japanese attack on Pearl Harbor. It marked a social watershed between 1950s-style normalcy and the coming counterculture of the 1960s. But it also made possible what Kennedy would have been unlikely to accomplish while alive: adoption of his domestic legislative program, including his tax cut to stimulate the economy. Kennedy had died a martyr, and amid the shock and grief following his assassination, he was well on his way to becoming a national saint. Now, it seemed, almost anything could be accomplished in Congress in John F. Kennedy’s name.

Vice President Lyndon B. Johnson smoothly assumed the reins of power. His first order of business on the domestic front was Kennedy’s proposed tax cut. Johnson, a powerful former Senate majority leader and an old hand at ramming laws through Congress, now basking in Kennedy’s sainted aura,
pushed through the tax legislation in record time, a little over three months, signing the $11.5 billion tax cut bill at the end of February 1964.

Yet by the time the tax cut was passed, Kennedy’s original motivation for the measure had largely disappeared. Kennedy first proposed cutting taxes when the recovery seemed to falter in 1962. There was an original Keynesian rationale for such a “counter-cyclical” measure—to pump demand into the economy when it seemed to be flagging. Yet throughout 1963, the economy enjoyed strong, sustained growth, with GNP expanding by 4.4 percent in real terms. To cut taxes and expand deficits in a time of downturn was one thing. To cut taxes and expand deficits when the economy was growing at a faster-than-historical rate was quite another. The continuing justification was the disappointing numbers in the unemployment reports. When Johnson signed the tax cut bill, unemployment still stood at 5.6 percent. But now there was a new justification. The tax cut was no longer about using Keynesian methods to counter a recession; it was the new neo-Keynesian economics in action: using deficits to supercharge the economy and squeeze out better-than-historical-rates of unemployment and growth.

Initially, the measure seemed to work like a charm. It was as though someone had floored the accelerator of a new Corvette. As tax cut money poured into the economy and federal borrowing doubled and doubled again as a percent of GNP, real GNP growth shot up to 5.8 percent in 1964 and to 6.4 percent in both 1965 and 1966. Unemployment plummeted, from 5.7 percent in 1963, to 5.2 percent in 1964, to 4.5 percent in 1965, to as low as 3.8 percent in 1966.33

It was an astonishing result. The president’s Council of Economic Advisers seemed prepared to announce the permanent demise of the business cycle in the president’s Economic
Report at the beginning of 1966: “The past five years have demonstrated that the economy can operate free of recurrent recession. Now the United States is entering a period that will test whether sustained full utilization of our human and physical resources is possible without the injustice, dislocation, and decline in competitive position that accompany inflation.” The implication was that the new version of Keynesian economics had permanently overcome the problem of recession. So impressive was the economic miracle that *Time* magazine featured none other than John Maynard Keynes on the cover of its final issue of 1965, its lead story devoted to the New Economics miracle.34

The passage of the Kennedy–Johnson tax cut occurred at a critical time from the standpoint of Johnson’s emerging legislative agenda. After his landslide victory over the Republican Barry Goldwater in 1964, Johnson announced his Great Society program and promptly pushed a panoply of new social legislation through Congress, with costs in the mounting billions: the Economic Opportunity Act to wage the War on Poverty; the Appalachian Regional Development Act to fight poverty in Appalachia; new federal spending for education; and the Medicare Act, which would begin costing the government new billions in 1967. It was a legislative tour de force. The Great Society program was the greatest expansion of government programs since the New Deal. Johnson’s startling array of legislative victories stood in sharp contrast to the thin list of his predecessor’s legislative accomplishments. Johnson had out-Kenned Kennedy. He had almost out-Roosevelted Roosevelt. But it was also a strange way to follow up a major tax cut. Having just slashed revenues, the president was now substantially expanding outlays.

Simultaneously, on the advice of his foreign policy and
defense advisers, the president was sharply escalating American fighting in the war on Vietnam. The air force commenced bombing of North Vietnam in 1966, and U.S. troops were shipped off by the tens of thousands to the war. By the end of the year, there were 180,000 American troops in South Vietnam.

Between 1965 and 1966, social spending jumped by $6.7 billion, while defense spending shot up by $7.5 billion. In all, federal outlays increased by 15 percent. The deficit expanded from $1.4 billion to $3.7 billion, more than doubling as a percent of GNP. This addition to demand was more than an economy growing at the pace of 6.4 percent could digest without an increase in inflation.35

The neo-Keynesian economists understood that inflation posed a test of their effort to provide an additional spur to employment and growth. Herbert Stein, subsequently chairman of President Nixon’s Council of Economic Advisers, later described the dilemma in which the advocates of the new economics now found themselves:

In the years 1965 to 1968 a basic question about the New Economics of Kennedy-Johnson was to be tested. That economics called for vigorous, positive fiscal and monetary action to push the economy up to full employment whenever it tended to fall below the target. But the New Economics prescription had another half also. That was restrictive action when the economy rose into the inflationary zone. The first half of the prescription had been followed up until 1965. That was the easy part; that is, both the policy measures and the results were pleasant. The test would be whether the government would
have the determination to follow the second half of the prescription when the time came for that. In 1965 to 1968, the government failed that test.\textsuperscript{36}

In fact, Johnson was adamantly opposed to raising taxes, on purely political grounds. Raising taxes at almost any time was unpopular and carried risk for a president. That was in a sense Stein’s point. Expansionist policies are easy; restrictive policies inevitably bring pain. No politician wants to pay the price for inflicting pain on the electorate. But Johnson also had a more specific motivation. He feared that if he called for a tax increase, Congress would force him to abandon his Great Society programs as long as the Vietnam War continued. The war in Vietnam, in Johnson’s mind, was a necessary evil. It was the Great Society that represented his claim to presidential greatness. Johnson felt his entire legacy to be at risk. Congress, dominated by southern Democrats, was far more conservative than its legislative behavior in 1965 might have indicated. Johnson had won approval for the Great Society on the basis of a kind of national reverence for the memory of John F. Kennedy and his landslide victory in the presidential election of 1964. By 1966 all that had faded.

There was another effective way for Johnson to try to counter inflation—and that was to tighten the money supply. Watching the inflation numbers creep up, the Federal Reserve raised the discount rate at the end of 1965. Had the Fed continued to tighten rates aggressively throughout 1966 and 1967, it might have succeeded in stemming the inflationary tide. But Johnson would not permit this. Once again restrictive policies carried pain and risked slowing the economy and increasing unemployment. Johnson invited Fed Chairman Martin to his
Texas ranch in early 1966 and prevailed on him to hold the line on interest rates. 37 The discount rate remained steady at 4.5 percent throughout 1966.

By the spring of 1966, the New York Times was reporting a division within the new economists’ camp. Heller, now out of office, was calling for a tax increase to curb inflation, seconded by Samuelson and other major neo-Keynesian thinkers. By contrast, Gardner Ackley, Lyndon Johnson’s chairman of the Council of Economic Advisers, was defending the Johnson administration line that no tax increase was needed. 38

The economy slowed in 1967, with real GNP growth of just 2.5 percent. In three years, the economy’s post–tax cut ride was over. Johnson finally proposed a tax increase in 1968, and the Fed began hiking interest rates in the same year. But it was too late. Inflation rose to 4.7 percent in 1968 and continued to climb to 6.2 percent in 1969, despite an unprecedented Federal Reserve discount rate as high as 6 percent.

The inflation genie was out of the bottle, and no one would succeed in putting it back in for the next eleven years. Part of the problem was that at any given point, the political cost of trying to end inflation exceeded the political benefit. President Nixon inherited Johnson’s inflated economy in 1969. As a Republican and Eisenhower’s former vice president, he might have been expected to return to the policies of fiscal and monetary discipline that had served Ike so well. But part of the problem was that Nixon hated the idea of restrictive monetary policy. He blamed the Federal Reserve’s 1959 hike in interest rates—and the subsequent recession—for his defeat at Kennedy’s hands in 1960, and Nixon was not one to let grudges slide. 39 In the end he turned to the very un-Republican expedient of government-imposed wage and price controls—imposed in 1971. These worked—temporarily. In 1971, inflation dropped from
5.6 to 3.4 percent, where it essentially remained for two years. But pressure to lift the controls regime mounted, and controls were gradually lifted in 1973. Inflation shot up even higher than before, to near 9 percent. The following year, as Nixon was forced to resign over Watergate and Gerald Ford assumed the presidency, inflation topped 12 percent, this time aggravated by an oil boycott imposed by the Organization of Petroleum Exporting Countries in retaliation for U.S. support of Israel in the Yom Kippur war of 1973. The 1970s brought the first signs of what came to be called stagflation, that is, high inflation combined with high unemployment. Not only was the Phillips Curve clearly dead. By 1975, with the unemployment rate at 8.5 percent, the country was beginning to see unemployment levels reminiscent of the pre–New Deal years.40

Nixon, at least, had acknowledged inflation as a major problem. When President Jimmy Carter assumed office in 1977, he gave inflation a distinctly lower priority. The whole focus of the Carter administration was on reducing unemployment, then at 7.7 percent. Carter believed that the costs of wringing inflation out of the economy were simply too great to make it worth the effort. In 1978, Arthur Okun, former chairman of Johnson’s Council of Economic Advisers, calculated that every 1 percent drop in inflation would reduce employment by 3 percent and GNP growth by 9 percent. In 1978, this implied that a return to a 1 percent inflation rate would produce unemployment of 30 percent. Why even try? Instead, the Carter administration pursued an expansionary fiscal policy and prodded the Fed relentlessly to expand the money supply, first under Chairman Arthur F. Burns, then under the Carter appointee G. William Miller. From 1977 to 1979, the money supply \((M_1)\) grew at a faster rate than any time in postwar history. The impact on unemployment was minimal, but inflation predictably
went through the roof. In 1979, it crested at 13.3 percent. The University of Chicago economist Robert Barro devised what he called the “misery index” to measure the combined effect of inflation and unemployment (the index simply added the two figures together). In 1979, the misery index stood at 19 percent. The following year it rose to nearly 20, with unemployment back at 7.1 percent. The public was fed up.

“For the public today,” wrote the astute social observer Daniel Yankelovich in 1979, “inflation has the kind of dominance that no other issue has had since World War II. The closest contenders are the Cold War fears of the early 1950’s and perhaps the last years of the Vietnam War. But inflation exceeds those issues in the breadth of concerns it has aroused among Americans. It would be necessary to go back to the 1930’s and the Great Depression to find a peacetime issue that has had the country so concerned and so distraught.”

It is difficult to quantify the precise costs of inflation and to separate its psychological effects from the purely economic ones. Even during the inflationary era, the American economy enjoyed respectable growth—an average of 3.1 percent real expansion of GNP from 1967 through 1980. Yet from 1970 onward, unemployment was clearly a great deal higher on average than during the Eisenhower years, at 6.2 percent. Moreover, there were a number of very bad years with unemployment in the 7 percent to nearly 9 percent range. In general, inflation introduced enormous unpredictability and stress into economic life. Year to year, one never knew what inflation rate to expect. In a single year, it was possible that inflation could reduce the real value of one’s savings by 10 percent. No matter how big a raise one received, it might be eaten up by higher prices. Mortgage rates were in the double digits. A mortgage could become dangerously burdensome if inflation were suddenly to decline. With unemployment rising and falling wildly, jobs were clearly less secure.
Perhaps most important, inflation robbed the economy of much of the stability that the New Deal framework had originally introduced—the sense that there was a cushion against wildly high unemployment, that economic realities were relatively predictable, that recessions would end fairly rapidly, and that the government had a measure of control over economic life. Maintaining a middle-class standard of life in a highly inflationary economy—providing for one’s family, planning for the future—became a much more stressful proposition. Missing was the essential confidence that prosperity would grow steadily year after year—or that the government could do anything to help guarantee it.

What had gone wrong? In a sense, politicians led by President Johnson had used the neo-Keynesian economics in a way that challenged the New Deal consensus. They had tinkered with a well-oiled national economic machine, trying to make it run faster. In the process, they had run it aground. The economy under President Carter still benefited from many of the key achievements of the New Deal—the unemployed had a safety net, the aged a guarantee against pauperized retirement, consumers and investors had many protections against risk and fraud. But Americans no longer felt economically secure. The danger was that the entire New Deal consensus would now be tarred with the brush of inflation.

Just as Keynes’s *General Theory* in 1936 had unlocked the mystery of fiscal policy, so Milton Friedman’s and Anna Schwartz’s *A Monetary History of the United States* in 1961 revealed the importance of monetary policy in determining an economy’s health. Nobel laureate Friedman’s work would eventually stand beside that of Keynes as one of the two great pillars of contemporary economic policy making.

Keynes, as we have seen, offered perhaps the first plausible explanation of the Great Depression and the first hints of
a way out. Keynes saw the Depression as a result of the collapse of aggregate demand and business investment and believed that government should take up the slack with its own deficit spending for public works. Friedman and Schwartz offered a different explanation and a different solution. The Great Depression, they argued, was primarily a result of monetary policy—foolishly restrictive policies by the Federal Reserve System that had resulted in thousands of bank failures and a general collapse of the money supply. The central proposition of Friedman’s monetarist school was that deflation and inflation alike were monetary phenomena stemming from the relationship between the supply of money and GNP. If there was too little money to accommodate economic activity, the result would be deflation, a collapse of prices and economic activity as a whole. On the other hand, if there was an excess of money, the result would be inflation. (The “velocity” of money, people’s propensity to hold on to currency or to spend it, also played a role.)

Friedman’s work on monetary policy was initially greeted with great skepticism by an economics profession dominated by Keynes’s focus on the effects of fiscal policy. Yet as inflation became a growing problem in the late 1960s and the 1970s, Friedman’s monetary approach gained credence.

As a corollary of his analysis, Friedman exposed the fatal flaw in the Phillips Curve. He showed that high inflation would not, in and of itself, produce a reduction in unemployment. Only if actual inflation exceeded the expected rate of inflation would unemployment drop. This eventually helped to explain the phenomenon of stagflation—the coexistence of high levels of both inflation and unemployment. By the mid-1970s, the neo-Keynesian economists’ effort to go beyond maximum employment to full employment had failed. Economic theory
was commonly said to be in crisis. Meanwhile, the monetarists had come up with a plausible and coherent explanation for the central economic problem of the era: stagflation.

The difficulty was that if one accepted Friedman’s diagnosis of the inflation disease, the cure was not likely to be pleasant. Under Friedman’s model, the only way to squeeze inflation out of the economy was to tighten money. Tight money would cause unemployment to rise, probably to very high levels. One might have to endure high unemployment for as long as two or three years before the inflation monster was finally vanquished. One did not have to be a pure monetarist of the Friedman school to accept that ridding the economy of inflation would require restrictive fiscal or monetary policies or both. The politicians generally recognized the need for restrictive policies to reduce inflation. They simply thought that the human cost in unemployment might be too high.

But by the end of the 1970s, the facts of stagflation were so compelling that even Carter accepted the need for a different kind of program. Monetarism, which had originally been perceived in some economic circles as a challenge to Keynesian economics, had become a possible savior. With urging from the sachems of Wall Street, Carter appointed the monetarist Paul Volcker to be chairman of the Federal Reserve Bank, and Volcker proceeded to use monetarist tools to address the inflation crisis. He tightened the money supply by raising interest rates and in time demonstrated that Friedman’s monetarist tools could be as effective in overcoming inflation as Keynesian tools had been in increasing growth.
Chapter VII
The New Gospel of Wealth

The rise of inflation under the Democratic administrations of Johnson and Carter paved the way for the return of Gospel of Wealth thinking, focused on tax reductions, support for business enterprise, and a laissez-faire approach to regulation of business. Whatever else might be said about Ronald Reagan’s approach, it is clear he confronted a real economic crisis when he assumed office. The stagflation episode marked the worst economic dislocation since the Great Depression. The crisis provided the context for Reagan’s program. Reagan brought a new approach to economic policy. Clearly, inflation had to be gotten under control. There was also strong public sentiment in favor of tax cuts. Inflation-driven “bracket creep” had in effect meant a steady series of “hidden” tax increases for middle-class Americans. But the struggle now had taken on a powerful ideological dimension. The sentiment was strong among many businessmen, and even stronger among conservative intellectuals, that the American government, especially under Democratic
stewardship, had become “business-unfriendly.” “Government is the problem,” Reagan said.

A small cadre of conservative intellectuals, publicists, and economists sought nothing less than to overturn the reigning economic consensus at its foundations—and this meant going after the heart of Keynes’s legacy. In effect, this neoconservative group orchestrated a revival of nineteenth-century “political economy”—the laissez-faire doctrine of old—but with a new “explosive growth” twist. Keynes’s great innovation was to discover the centrality of demand to the business cycle. The neoconservatives returned to antiregulation, laissez-faire doctrines with renewed emphasis on production or supply. Inflation, they argued, was too much money chasing after not enough goods. The problem, they contended, was not simply that government was artificially inflating demand through deficit spending. The problem was that government policy—and especially tax policy—was inhibiting producers, causing inflation by inhibiting supply. High taxes were inhibiting work, savings, and investment—especially the last. High taxes were discouraging businesspeople from engaging in business. Thus was born supply-side economics. Supply-siders donned the mantle of Jean-Baptiste Say, the classical economist with whom Keynes had most clearly taken issue. With Say, the supply-siders argued that “it is the aim of good government to stimulate production, and of bad government to encourage consumption.” “In many respects, supply-side economics is nothing more than classical economics rediscovered,” wrote the leading supply-sider, Bruce Bartlett, later a senior policy analyst in the Reagan White House.1 But the supply-siders added a note that would have puzzled their eighteenth- and nineteenth-century predecessors. The supply-siders argued that the inhibitions on
investment and productive economic activity were so great that eliminating them would cause an explosion of new business activity so dramatic that the tax cut would virtually pay for itself.\(^2\)

One of the major architects of the supply-side doctrine, the neoconservative intellectual Irving Kristol, described the thinking behind the movement thus:

In response to this crisis in the theory of economic policy, a “new” economics is beginning to emerge . . . . Its focus is on economic growth, rather than on economic equilibrium or disequilibrium, and it sees such growth arising from a free response (e.g., investment, hard work, etc.) to the economic incentives of a free market.

It does retain the Keynesian macroeconomic apparatus for diagnostic purposes, but its inclination is “conservative” rather than “liberal” — i.e., it believes that only the private sector can bring us sustained economic growth, and that whatever tasks one might wish to assign to the public sector, economic growth cannot be one of them.

This “new” economics is sometimes described, rather cumbersomely, as “supply-side fiscal policy.” . . . It arises in opposition to the Keynesian notion that an increase in demand, by itself, will increase supply and therefore accelerate economic growth. The “new” economics asserts that an increase in demand, where the natural incentives to economic growth are stifled, will result simply in inflation. It is only an increase in \textit{productivity}, which converts latent into actual demand by bring-
ing commodities (old and new) to market at prices people can afford, that generates economic growth.3

To a country straining under the excesses of inflation, such arguments had a very plausible ring. Government was pumping demand into the economy via deficit spending. At the same time, it seemed to be interfering with and inhibiting business activity. It was regulating more. There was the Occupational Health and Safety Administration. There was the Environmental Protection Agency. Business complaints about government regulation and red tape were legion. Particularly under President Carter, Democrats appeared to have grown increasingly deaf to business’s concerns. Above all, the federal government taxes were increasing, as inflation drove taxpayers into higher and higher tax brackets. According to the supply-siders, government was increasing demand and simultaneously inhibiting supply, especially via the tax code, which was eroding the “natural incentives” of people to invest and work. Cut taxes, argued the supply-siders, remove the disincentives to economic activity, and supply will rise to meet demand and then demand will increase to match supply. Inflation will thus disappear. Supply-siders added to this a special twist. So profound would be the new incentives to “work, save, and invest” that economic growth would spurt forward, with the result that new revenues would be generated. The right kind of tax cut, structured to release these economic energies, would not even increase the deficit. The specific tax cut they had in mind was a cut in the marginal personal income tax rate for the highest-income taxpayers. They claimed that in response to this cut the investor class would put their newfound money to work in their own businesses by hiring new workers and buying new equipment. Such a tax cut, argued supply-siders, would
not only reduce the gap between demand and supply but would generate enough new growth to boost government revenues to an amount equal to the cut in taxes. The tax cut would pay for itself.

The supply-side approach was about one-tenth economics and nine-tenths politics. As a political doctrine, it was so cleverly crafted as an answer to the anxieties of the age that even people who knew better began to take it more seriously than they probably should have. To begin with, to call supply-side a school of economics was a stretch. The school had essentially one active and prominent tenured university economist—Arthur Laffer of the University of Southern California (though some of the economic thinking looked back not only to the work of Say but also to the work of Nobel laureate Robert Mundell). The rest of the supply-siders were mostly conservative political journalists, commentators, and politicians—including the editorial writer Jude Wanniski, his colleagues on the Wall Street Journal editorial page, Congressman Jack Kemp of New York, and Kristol—all of them noneconomists. In later years, Kristol admitted that his goals in this period were political rather than economic. “The task, as I saw it,” he wrote, “was to create a new majority, which evidently would mean a conservative majority, which came to mean, in turn, a Republican majority, so political effectiveness was the priority, not the accounting deficiencies of government” (emphasis added).4

The supply-side doctrine was, at bottom, an effort to solve a political problem rather than an economic one. The political problem was this: how to craft a credible, politically saleable conservative Republican alternative to the Democrats’ Keynesian economic policies. The problem Republican conservatives faced was that the readily available Friedman monetarist prescriptions for curing the inflation problem were tight
money and fiscal austerity, often referred to at the time as “cas-
tor oil economics.” When the conservative former California
governor Ronald Reagan challenged President Gerald Ford for
the Republican nomination in 1976, Reagan went to the public
with precisely such an economic prescription. Balanced bud-
ggets. Fiscal responsibility. Belt tightening. It did not sell very
well. Reagan lost to Ford, and Ford lost to the Democrat Jimmy
Carter.5

The political thinking behind the supply-side program
was in fact as sophisticated as its economic thinking was sus-
pect. Kristol, like most of the first-generation neoconserva-
tives, was a former man of the Left. As such, he had few of the
Republican reflexes when it came to such topics as taxation
and “big government.” He could perceive the strong sense of
discontent among the electorate under President Carter, which
Kristol shared. Kristol also believed that the government had
become too antibusiness. Yet at the same time, he understood
the classic weaknesses of the standard Republican fiscal re-
straint message, weaknesses going back to the failed Barry
Goldwater campaign of 1964. They were essentially two. First,
the conservative message was too dour—all castor oil and no
fun. Second, conservatives had a habit of attacking New Deal
programs that remained quite popular among most Ameri-
cans. For decades, in such venues as National Review, Ameri-
can conservatives had been railing against Social Security, pos-
sibly the most popular U.S. government program ever devised.

Supply-side economics was an essential part of Kristol’s
deliberate makeover of American conservatism. In executing
this makeover, he cooperated closely with the dynamic young
Congressman Kemp.6 Both had new ideas for the Republicans.
The first task was to give the Republicans an upbeat, opti-
mistic, saleable economic platform that was probusiness and
populist at the same time. The supply-side tax cut provided that. The second task was to get the Republicans out of the business of attacking the New Deal. The key was to draw a sharp line between the New Deal programs, which were popular, and the Great Society programs, which by and large were not. It was fine to attack Great Society programs, but key New Deal programs, especially Social Security, should be treated as sacrosanct (even one Great Society program, Medicare, was not to be attacked because it enjoyed widespread public support comparable to that of Social Security).⁷

As for the economics of supply-side doctrine, few economists believed that supply-side tax cuts would pay for themselves. The consensus view among economists was probably expressed by Alan Greenspan, former chairman of President Ford’s Council of Economic Advisers. He thought the tax cut might generate 20 percent new revenue, that is, a $100-billion tax cut would increase tax revenues by $20 billion and cost the government $80 billion.⁸

That the tax cut would solve the nation’s stagflation problem by increasing supply was another great stretch. Few economists outside the small supply-side circle probably took such a proposition seriously. Again, the issue had to do with the scale of incentives. Supply-siders presumed the scale to be very large. But where were the numbers to back up such assumptions? If economics as a field had become increasingly quantitative by the late 1970s, supply-side economics was non-quantitative to a fault. Reagan’s rival for the Republican nomination in 1980, George H. W. Bush, famously described these supply-side ideas as “voodoo economics.”

Yet the thinking of economists mattered less than the thinking of the new standard-bearer of the conservative Republican movement, Ronald Reagan. Reagan would be by far
the most conservative politician to occupy the Oval Office since Herbert Hoover. A former union leader and onetime ardent Democrat devoted to the New Deal, Reagan made the journey from liberalism to conservatism while working as a spokesman for General Electric in the 1950s. As early as the late 1950s, he was inveighing against the size and intrusiveness of the federal government—under none other than the Republican president Eisenhower. Reagan’s GE stump speech, later expanded into a famous television address on behalf of the Republican candidate Goldwater in 1964, was a distillation of the 1920s Gospel of Wealth creed. He lamented government intrusiveness, lambasted bureaucratic “do-gooders,” and routinely raised questions about Social Security. He campaigned against adoption of Medicare in the 1960s. He preached self-reliance. His complaints about the size and power of government clearly went beyond concerns about the Great Society. As an apostate Democrat, Reagan found himself increasingly at odds with the New Deal itself—though he remained an admirer of FDR and borrowed generously from his rhetoric and style. After his victory in the election of 1980, President Reagan had the portrait of Calvin Coolidge brought down from the White House attic, dusted off, and hung prominently in the Cabinet Room. The gesture, suggesting a desire to return to the pre–New Deal world of the 1920s, probably expressed where his heart lay.  

Reagan was also an extraordinarily able and, at sixty-eight years of age, a very seasoned politician. He had won two terms as California governor and, while preserving his image as a tough-talking conservative, had shown a pragmatic willingness to compromise when circumstances required (as governor, he signed a major state tax increase). He had an ability to learn from his political mistakes. His radical proposals for
cutting the federal government and his seemingly hostile remarks about Social Security had helped cost him the nomination in his presidential run against Ford in 1976. He grasped instinctively the need to reshape his message. He hated taxes. And he snapped up the proposal for the supply-side tax cut. Indeed, the proposal was almost tailor-made for him. He wished to cut the size of government, and a tax cut would be an effective first step. He also knew that taxes had become a cutting-edge populist issue. In 1978, Californians had passed a ballot initiative, Proposition 13, imposing draconian limits on state spending, as part of a grassroots “tax revolt.” Clearly, resentment of inflation-driven high taxes was percolating up from an anxious electorate. Finally, an inveterate optimist, Reagan was just Pollyannaish enough to accept the supply-siders’ claim (shown in a graph apparently sketched for him on a restaurant napkin by Laffer) that the tax cut would pay for itself.10

Reagan also had a strain of realism that would prove critical to his ability to address the economic problems of the U.S. economy in the 1980s. He understood early on that wringing inflation out of the economy would probably require a dose of castor oil. “I’m afraid this country is going to have to suffer two, three years of hard times to pay for the binge we’ve been on,” he said in 1978.11 He had been in frequent touch with Friedman over the years and at heart was probably as much a monetarist as a supply-sider. The majority of his economic advisers would probably be classed as monetarists, but the proposal for the supply-side tax cut became a centerpiece of his campaign. It was just too politically appealing to pass up.

Reagan’s greatest talent as a politician was an ability to communicate symbolically, to paint his policies in bold strokes that the public could understand. His economic policies were
perhaps in some ways bold enough. But in the end the impact of his policy choices—particularly his fiscal policy choices—on the shape of the economy and the government was far less profound than his rhetoric might have suggested. In 1980, the year before Reagan assumed office, federal outlays amounted to 22.3 percent of Gross Domestic Product (GDP). By his last year in office, federal outlays stood at 22.1 percent of GDP. This hardly amounted to an epochal change or a major shrinking of the size of government. Taxes showed a bit more of a shift: federal revenues totaled 19.6 percent of GDP in 1980 and fell to 18.9 percent by 1988. But again the small scale of this change belied the grand scale of the Reagan rhetoric. He had hardly rolled back the tax code. Federal revenues as a share of GDP had actually been lower under President Ford.

Yet as much as Reagan talked about changing the politics of the country, he put his real effort into changing the country’s mind. He sought to repeal the post–New Deal Keynesian mind-set. He sought to instill the idea that government should not attempt to overmanage the economy, that effective government policy should defer to business interests and economic laws. He sought to replace the idea of government as economic steward and manager with the notion of the free market as king. Low taxes. Less government regulation. Fewer government programs. Economic freedom. Incentives. Economic success based entirely on self-reliance. Such ideas had found little resonance among the majority of Americans from 1950 to 1980. Reagan revived these concepts and, over time, persuaded much of the public that they were sound ideas. More than he reshaped fiscal policy, he changed the terms of the economic debate.

He set forth the philosophical framework in straightforward language in his Inaugural Address: “In this present
crisis, government is not the solution to our problem; govern-
ment is the problem.” Already during the 1980 campaign, a
debate was under way on the merits of demand-side versus
supply-side economics (demand-side became a popular term
for Keynesianism, following the adoption of the supply-side
label by Kristol et al.). In his economic message to Congress in
February 1981, Reagan declared his opposition to the Keynes-
ian approach to fiscal policy: “The taxing power of Govern-
ment must be used to provide revenues for legitimate Govern-
ment purposes. It must not be used to regulate the economy or
bring about social change.” He also announced his support for
a restrictive monetary policy, along the lines recommended by
Friedman, calling for a “national monetary policy that does
not allow money growth to increase faster than the growth of
goods and services.”

Yet there was a certain amount of legerdemain in Rea-
gan’s approach. While the decline in inflation and the return to
prosperity were achieved through the monetarist policies of
the Fed under Chairman Paul Volcker, Reagan argued that they
were caused by his tax cuts. Because the tax cuts had been
based on a supply-side philosophy, Reagan and his supporters
attributed the return to prosperity to supply-side effects of his
tax reduction program.

The real story was more complex and quite different in
its implications. First, much of Reagan’s 1981 tax cut simply re-
versed the bracket creep of the previous decade and a half—
the involuntary, unlegislated tax increases that resulted from
galloping inflation. Reagan’s tax cut brought taxes back to
where they had stood as a percentage of GDP in 1968—at the
height of the Great Society. Second, the Reagan tax cuts had a
notably weak effect on both growth and investment. Despite
the 1981 tax cuts, GDP in 1982 fell by 1.9 percent in real terms.
Business investment (gross nonresidential fixed investment)
was negative. Growth of GDP rose by 4.5 percent in 1983, but business investment growth remained negative.

Not until 1984 did the U.S. economy really turn around; GDP jumped by 7.2 percent in real terms, while business investment skyrocketed by 17.7 percent. By then the tax cut was old news. What had changed? By pursuing a steady monetarist agenda and relentlessly tightening the money supply, the Federal Reserve under Chairman Volcker had squeezed inflation out of the U.S. economy. The costs had been high: unemployment in 1982 and 1983 stood at nearly 10 percent and was still at 7.5 percent in 1984 but on its way down. For the first time since the late 1960s, inflation had remained absolutely steady for two straight years. Inflation was still high by historical standards: 3.8 percent in 1982 and 1983, and 3.9 percent in 1984. But it was well below its 13.3 percent peak in 1979, and most important, it was not increasing; it was apparently under control. Two years of lower inflation rejuvenated the economy. The effect on consumer demand and business confidence was palpable. Consumers increased their purchasing, and businesses energetically invested to meet the higher demand of the revived economy.¹³

Reagan had initially promised tax cuts to be followed by major cuts in federal government spending. Predictably, however, the inevitably unpopular spending cuts had proved difficult to follow through on. And Reagan’s Cold War priority of building up U.S. military strength against the Soviet Union collided directly with his tax-cutting agenda. Yet remarkably, even with deficits in the range of 4 to 6 percent of GDP—much higher than Johnson’s—growing inflation failed to rear its head.

The 1980s were in truth a decisive affirmation of the value of the tools of monetarism. And to the degree that Reagan can be credited for the economic turnaround, the credit
lay mainly in his willingness to ride out a recession in order to have the Volcker Fed impose the needed monetary discipline. Yet Reagan continued to attribute the transformation to supply-side tax cuts. Supply-side economics started out in life more as a political story than a serious economic theory. And when implemented, it remained so. Indeed, the economic numbers show very little evidence of the promised supply-side effect. But the political success of Reagan’s supply-side rhetoric captured increasing public support.

With the Reagan tax cuts came a new economic and political philosophy, a return in many respects to the nineteenth-century Gospel of Wealth. Attention shifted from the ordinary worker to the exceptional entrepreneur, what supply-siders liked to call, in language almost reminiscent of Social Darwinist days, our “most productive citizens.” The key to a healthy economy was making sure these most productive citizens were free to be productive; it was they who “created wealth” for the rest. Government simply needed to get out of the way.

Perhaps the clearest indication of the fundamental shift in perspective was the gradual refocusing of attention from employment to overall economic growth (growth in GDP) as the main barometer of economic health and presidential performance. As long as there was growth, wealth would eventually also find its way into the hands of, well, the less productive. Critics disparaged the approach as “trickle-down economics,” recalling the phrase of Andrew Mellon.

Ironically, however, Reagan’s supply-side tax cuts and the shift to a laissez-faire regulatory philosophy in the end had little to do with the economic recovery of the 1980s. The key to a return to economic health lay almost entirely in defeating inflation, and this was a matter not of taxes or spending, but of monetary policy, controlled not by the president but by the
chairman of the Federal Reserve. Credit for the recovery of the
eighties lies mostly in the willingness of Chairman Volcker to
put the brakes on the money supply. Previous presidents, in-
cluding Johnson and Nixon, had pressured the Fed to keep
money loose, even at the expense of long-term economic sta-
bility. Reagan left the Fed chairman a free hand. Through care-
ful management of the money supply, the Fed was even able to
minimize the damaging effects of the unprecedented deficits
that emerged when the supply-side promise of self-financing
tax cuts largely fizzled and huge new outlays for defense swelled
federal spending. The resulting healthy recovery, nonetheless,
seemed to many citizens to provide a vindication of Reagan’s
new economic philosophy, which shifted focus from the middle
class and employment to investors and economic growth.

The political success of supply-side thinking during the
Reagan years caused academic economists to take supply-side
thinking more seriously. By the 1990s Martin Feldstein of Har-
vard, who had earlier dismissed the Reagan supply-side tax
cuts of 1982 as having no effect in reducing inflation or pro-
moting growth, was focusing his research attention on the im-
portance of reductions in taxes to increase investment. Feld-
stein and his colleagues at Harvard and at the prestigious
National Bureau of Economic Research began to produce
scholarly articles on the alleged “deadweight effect” of taxa-
tion. The point of this theoretical literature was to argue that
taxes imposed greater costs on the economy than the benefits
received from the revenues collected. The particular focus of
these academic supply-siders was on investment, which they
believed was the key to increasing the “natural” or underlying
rate of economic growth. They claimed there was an inverse
relationship between taxation and investment: that is, the less
taxation you have, the more investment you get, and conse-
quently the more growth. They were concerned especially with the relationship between investment and “marginal” tax rates, especially the top marginal income tax rate, arguing that reducing top marginal tax rates would substantially increase investment and total economic growth.

When the Democrats next captured the White House, in 1992, President William Jefferson Clinton argued for a middle-ground approach to economic policy. He accepted the centrality of the market and the importance of investment to the growth of the economy, and he stressed the importance of fiscal responsibility—especially deficit reduction. But he also insisted that government had a “limited, but critical” role to play in the economy.16 His actions departed from the supply-side consensus in important ways that were consistent with the economic and political vision at the heart of the American Dream. Clinton initiated legislation spearheaded by the Family and Medical Leave Act of 1993, which “cleared the path” for women to participate more fully in the economy and recognized the new realities of an economy dominated by two-earner families. He also supported federal spending for education and training to encourage the growth of “human capital.” His greatest achievement perhaps was to preside over a period of rapid economic growth after raising the marginal tax rates for the highest-income taxpayers, adding two new brackets of 36 percent and 39.6 percent above the then top marginal rate of 31 percent. The tax reforms eliminated the long-standing deficits, opening the way to accelerated economic growth and the eventual generation of substantial federal surpluses. Such growth, in the wake of Clinton’s increase in the top marginal income tax rate, posed a direct challenge to the supply-siders’ claim that growth comes from cuts in the top marginal rate. Indeed, the Clinton economy presented new evidence to support the
demand-side view that the principal source of economic growth comes from rising middle-class incomes as the basis for a healthy and growing demand for consumer goods by the mass of American consumers.

The explosive growth following the Clinton administration’s increase in the top marginal tax rate in 1993 might well have been understood as a refutation of the supply-side claim that low marginal tax rates hold the key to rapid economic growth. But the challenge to supply-side thinking embodied in the economic data of the Clinton years had a short life in political terms. Entering the White House in 2001, President George W. Bush began to see signs that the economy was edging into recession. Using the recession as a convenient rationale, President Bush aggressively propounded his personal economic philosophy and pursued a major restructuring of the tax code based on supply-side ideas.

The Bush administration cited the writings of the supply-side academics to provide what appeared to be an academically respectable justification for a major reorientation of the tax code, away from progressive taxes on income toward regressive taxes on consumption. And President Bush led the political battle to establish the supply-side argument as accepted economic wisdom. Repeatedly he justified his tax cuts with supply-side arguments:

Most small businesses are sole proprietorships, or limited partnerships, or sub-chapter S corporations, which means that they pay tax at the individual income tax rate. And so, therefore, when you accelerate rate cuts, you’re really accelerating capital to be invested by small businesses. And that’s what Congress must understand. . . . Capital expenditure
equals jobs, and the more capital accumulation and capital expenditure we can encourage, the more likely it is somebody is going to find work. . . . And so this plan focuses . . . on capital accumulation, capital formation, particularly at the small business sector of the American economy.

And we also drop the top rate, of course, from 39.6 percent to 33 percent. If you pay taxes, you ought to get relief. Everybody who—but everybody benefits, I’m convinced, when the top rate drops because of the effect it will have on the entrepreneurial class in America. . . . And you all can help by explaining clearly to people that reducing the top rate will help with job creation and capital formation; and as importantly, will help highlight the American Dream.17

Using his supply-side rationale, Bush engineered a cut in marginal income tax rates as well as tax cuts on dividends and capital gains. Even the estate tax—a centerpiece of Progressive Era legislation—was repudiated as a “death tax.” By the beginning of Bush’s second term, the portion of the tax burden shouldered by the wealthiest households had significantly declined, even as these households absorbed an ever-increasing share of the nation’s total yearly income. Yet Bush argued that this was all for the common good. In terms reminiscent of the Gospel of Wealth, the president repeatedly cited the entrepreneur as the true engine of economic growth—the key to a vibrant economy. The goal, he argued, was to free this enterprising individual from the burdens of excessive taxes and government regulation. Indeed, the president seemed to imagine that America—where the vast majority of citizens still la-
bored for wages and salaries—had transformed itself overnight into a nation of independent entrepreneurs and business owners. He spoke repeatedly of an “ownership society.” But in truth the ownership society was one in which government policies increasingly favored wealthy business owners and investors over middle-class professionals and wage earners.

The distributional shift effected by the Bush tax cuts was more profound than it might have seemed at first glance. It was not simply that the rich received a larger tax cut than the middle class, though they did. As the population aged, new crises were looming ahead in Social Security and Medicare. The Clinton-era federal surpluses might have gone a long way toward meeting the future liabilities of these programs, certainly of Social Security. But the Bush tax cuts had eliminated these surpluses and replaced them with sizeable deficits. The government had been drained of resources; taxes as a percentage of GDP were at their lowest level in a generation. It was only a matter of time before the other shoe dropped. At the beginning of his second term, Bush announced a crisis in Social Security. Under the Bush program, the wealthiest households were enjoying a windfall of billions in income and estate tax cuts, while future middle-class retirees could be subject to the prospect of substantial reductions in Social Security benefits. Bush’s conservative supporters could hardly have been more delighted. In 2003, Grover Norquist, probably the most important behind-the-scenes strategist of the antitax program, candidly stated the goal of the movement: to turn back the nation’s clock to the period not just before the New Deal, but before the Progressive Era—to the Gospel of Wealth policies dominant during the Gilded Age.18

Advocates of the Bush approach pointed to the return of growth in 2004 and 2005 as evidence of the soundness of the
Bush program. But once again, as under Reagan, the return to prosperity was largely engineered by the Fed, which loosened money to the point where the short-term interest rate was actually, at one point, negative in real terms. Not only did this radical easing of money provide a powerful across-the-board stimulus to the economy, but the sharp drop in interest rates—combined with the rapid run-up in housing prices—helped spur an unprecedented onetime surge in home equity borrowing and cash-out refinancing that pumped several hundred billion dollars of new consumer spending into the economy each year. From 2001 through 2004, American homeowners extracted an estimated $1.6 trillion in cash from their homes (after subtracting various fees and charges for loans and refinancing), according to a Federal Reserve study. In 2004 alone, homeowners extracted a net of nearly $600 billion in cash from their homes—a sum more than twice that (an estimated $285 billion) put in the hands of taxpayers as a result of the 2001–03 Bush tax cuts. As in the Reagan era, monetary effects—including, but not limited to, the equity cash-out boom—played a far greater role in the recovery than the tax reductions. A Tax Policy Center study concluded that the stimulative effects of the Bush tax cuts were notably weak, providing little “bang for the buck.”19