Leave the New Deal in the History Books
Cut corporate taxes to zero and create real jobs.
Wall Street Journal (January 17, 2009)
By Mark Levey

When Barack Obama takes office on Tuesday, his first order of business will be a stimulus package estimated to be close to $1 trillion, including $300 million in tax cuts and the largest new government spending program for infrastructure since Franklin Delano Roosevelt. Sages nod that replicating aspects of FDR's New Deal will help pull the country out of a recession. But the experience under FDR largely provides a cautionary tale.

Mr. Obama's policy plans are driven by the conventional economic wisdom that the New Deal economic programs ended the Great Depression. Not so. In fact, thanks to New Deal policies and programs, the U.S. economy faltered for years longer than it might otherwise have done.

President Roosevelt came to office much as Barack Obama will, shouldering an economic crisis that began under his predecessor. In 1933, Roosevelt's first year, unemployment hit nearly 25%, as people lost jobs and homes in towns across the country. Believing that government played a key role in restarting growth, FDR, within his first 100 days as president, created an alphabet soup of new agencies that mandated actions or controlled public spending and impacted private capital flow within the U.S. economy.

At first, it seemed to be working. After four years of FDR's policies, joblessness declined to 14.3% -- still very high but heading in the right direction. Then things turned for worse again: By the fall of 1937, the U.S. entered a secondary depression and unemployment began to rise, reaching 19% in 1938.

By 1939 Roosevelt's own Treasury secretary, Henry Morgenthau, had realized that the New Deal economic policies had failed. "We have tried spending money," Morgenthau wrote in his diary. "We are spending more than we have ever spent before and it does not work. . . . After eight years of this Administration we have just as much unemployment as when we started. . . . And an enormous debt to boot!"

The problem was that neither Roosevelt nor President Herbert Hoover before him grasped the essential nature of the crisis, which was not the stock-market crash, but global deflation. At the end of the roaring '20s, an overhang of intergovernmental war debt from World War I, coupled with falling commodity prices and a currency crisis, had started the decline. Weak credit structures and European banks hurt by wartime inflation worsened it. When the Austrian Creditanstalt Bank failed, it ignited a global banking crisis that slashed across the international financial system cutting down everything in its path. Deflation went into full howl.

The same perils are now confronting President-elect Barack Obama, as the risk of deflation casts a long shadow over the economy. Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson have been correctly focused on shoring up financial institutions to prevent a collapse of the financial system, and stave off a severe decline in the general price level. If that were to occur, the unspoken fear has been that the U.S. and global economy could go into a deflationary death spiral that would cause the collapse of the international financial system.

As a short-term matter, the moves of the Fed and other central banks have been correct, but in the long term a return to growth will depend on dynamic job creation by American business -- not the U.S. government. Under a two-year plan designed to create three million to four million jobs, Mr. Obama's plan would have the federal government begin distributing funds for public-works projects carried out by the states. With government already spending 20% of GDP, federal government, not private enterprise, will become the growth industry.

The effect of these policies, like FDR's, will be to lengthen the pain.

Early on, Roosevelt's economic thinking was that laissez-faire competition drove prices and wages down, resulting in unemployment, which in turn collapsed demand for goods and services. To remedy this, his administration passed laws such as the National Industrial Recovery Act (NIRA) that encouraged business to collude and raise prices without fear of antitrust prosecution. The hope was that this would allow business to raise wages.

By the time NIRA was found unconstitutional a few years later, the damage had already been done. For example, the Department of the Interior complained that over two years it had received 260 bids from different steel companies that were identical to the penny and 50% higher than foreign bids. The policy had put chains on every normal free-market instinct and price feedback mechanism needed to restore economic growth. Roosevelt himself rued the decision in the late 1930s as a secondary depression was gripping the economy. "The disappearance of price competition," he said, "is one of the primary causes of the difficulties."

In addition to New Deal spending programs, a series of new taxes were introduced that crushed the innovation, risk taking, and growth plans of entrepreneurs, corporations and investors. From 1930 to 1940, the top marginal income-tax rate rose to 79% from 25% while the corporate income-tax rate doubled to 24% from 12%. In addition, Roosevelt tacked on an excess profits tax and undistributed profits tax. He imposed an excise tax on dividends. Even the new Social Security payroll tax added 2%.

As a result, the New Deal forced the allocation of money away from the private sector. As economist Henry Hazlitt wrote back in 1946, New Deal programs prevented the creation of the types of jobs which have the multiplier effect of successful businesses. Creating "work" prevented innovation and new jobs that would create other jobs.

The quickest way to strengthen the credit system and begin the end of this crisis is to get money into the economy for true job creation, and not into government work programs. The way to do this is to slash taxes. The U.S. corporate tax rate, currently the highest in the world, should be cut to 0% (corporate income would still be taxed, of course, when distributed to shareholders as dividends). The capital-gains tax should be cut further.

The positive impact on corporate-credit markets, the stock market, the attractiveness of the U.S. to foreign investors, and the willingness to take business risk and create new jobs would be immediate. Capital-gains tax collections would rise. Capital flows would be in the hands of those who are driven to build businesses and permanent jobs efficiently instead of pushing that capital through a government pipeline with endless amounts of friction. If the U.S. is to lead the international economic community out of this crisis, this is the place to start.

Mr. Obama will come to office next week with plenty of political capital and the faith of a majority of Americans that he can help pull the country out of its economic woes. As he takes over the reins, his success will be judged not on rhetoric but on the numbers his policies can generate. The best thing he can do is leave the New Deal in the history books.

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