A return to Normalcy

A study of the laissez-faire policy of the Harding administration during the 1920-1921 depression

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"America's present need is not heroics, but healing; not nostrums, but normalcy; not revolution, but restoration; not agitation, but adjustment; not surgery, but serenity; not the dramatic, but the dispassionate; not experiment, but equipoise"[1]

[1] Harding, W.G., "Back to Normal: Address Before Home Market Club," Boston, Massachusetts, May 14, 1920

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Introduction

The United States faces a miserable and stagnated economic situation, high unemployment, rapidly rising cost of living, ballooning government debt, and seemingly no end in sight to the troubles. Alas, this is no historical study; it is a description of the current state of economic affairs in the United States. American historians benefit from this situation, for, as is often the case in difficult times, people look to the past for answers. Opposing economic schools of thought propose different solutions to combat the recession and American history takes center stage in their arguments.

Influential Keynesian-minded economists such as Nobel Prize winner Paul Krugman and Christina Romer have joined the fray. Krugman for instance has argued that the 2009 round of Federal government stimulus was too small and that more Federal spending is necessary, and champions an inflationary Federal Reserve policy to stimulate the economy and fight unemployment.[2] Krugman warns strongly against austerity measures proposed by conservative American politicians, as he believes "The worst thing you can do […] is slash government spending, since that will depress the economy even further" and "Budget cuts hurt [a country's] economy and reduce revenues."[3] Using American history, Krugman argues that austerity and government budget cuts would lead to a situation like 1937, in which the US returned to a severe recession by trying to balance its budget.[4] "If you do the 1937 thing, you shouldn't be surprised at getting the 1937 result."[5] Christina Romer, former economic advisor to the Obama administration, also strongly warns against austerity measures: "Reduce spending, and less government money would be pumped into the economy." "A spending cut of [1%] […], reduces G.D.P. by about 1.5 percent. […] Reducing spending alone would probably be the most damaging to the recovery." Romer argues that taxes

[2] Krugman, P., 'The intimidated Fed' in *The New York Times*, April 28, 2011
[3] Krugman, P., 'The President Surrenders' in *The New York Times*, July 31, 2011
[4] Krugman, P., 'That 30's feeling' in *The New York Times*, June 17, 2010
[5] Krugman, P., 'Anti-Stimulus' in *The New York Times*, July 9, 2011

should be increased to fund government stimulus to the economy and bases this on her post-war study of tax policy by the Federal government.[6]

On the other side of the economic spectrum are free-market oriented academics, prominently among which is the Austrian school of economics. Economists and economic historians related to this school of economic thought argue that the exact opposite fiscal and monetary policy should be adopted. They argue in favor of government spending cuts and call for no stimulus and lower taxes to combat the economic downturn and unemployment. In the words of economist and economic historian Murray Rothbard: "If government wishes to alleviate, rather than aggravate, a depression, its only valid course is laissez-faire – to leave the economy alone."[7] Austrian economists also use American history to make their case for current policy. Scholars such as Thomas Woods, Robert Murphy and Jim Powell all point to the 1920-1921 depression and the policy response of the Harding administration to make their case. They argue a combination of budget cuts, tax decreases, and all-round laissez-faire economic policy by Harding ushered in quick and strong economic recovery.[8] In Woods' words: "The experience of 1920–21 reinforces the contention of genuine free-market economists that government intervention is a hindrance to economic recovery. It is not in spite of the absence of fiscal and monetary stimulus that the economy recovered from the 1920–21 depression. It is *because* those things were avoided that recovery came."[9]

This thesis will focus on the 1920-1921 depression, and judge the accurateness of this laissez-faire case. Powell, Murphy and Woods don't offer extensive articles to back up their case, and leave significant room for research into the Harding administration's policies. This leads to the main questions this thesis will address: What were the policies by the Harding administration to combat the 1920-1921 depression? Were these policies indeed *laissez-faire*, and what impact did they have on economic

[6] Romer, C.D., 'The Rock and the Hard Place on the Deficit' in *The New York Times*, July 2, 2011; Romer, 2010, p. 763-801
[7] Rothbard, 1963, p. 185
[8] Powell, 2009; Woods, 2009 and Murphy, 2009
[9] Woods, 2009, p. 29

recovery? Finally, what was the role of monetary policy in these years? In order to answer these questions, this thesis will examine the economic policy of the administration of President Warren G. Harding. By examining whether a laissez-faire counter-recession policy took place, and showing the results of such a policy, this thesis will be directly relevant to current discussions on achieving economic recovery.

Before the actual policy making of the Harding administration is examined, it is first necessary to examine the 1920-1921 depression. Its effects on the GDP, unemployment, production, prices, cost of living and its duration need to be examined to understand the severity and timeline of this economic slump.

The second chapter will delve into several policy aspects of the Harding government. First, an examination of the 1920 presidential election will discuss the Harding campaign, his plans, ideas and philosophy on government policy and economic recovery.

The second part of the chapter deals with taxation policy. It will first examine tariff policy, before studying one of the cornerstones of Harding's economic policy; the Revenue Act of 1921. The contents of the Act, as well as the political debates leading to its adoption will be examined.

Thirdly, the Federal budget under Harding will be studied. The reform of the budgeting system, as well as the size and scope of government spending and the national debt will be examined. Congressional action on spending legislation will be taken into account.

Finally, policies on wages, prices and unemployment will be examined, focusing on Herbert Hoover and his Conference on Unemployment.

The third chapter of the thesis examines monetary policy. Federal Reserve discount rate policy, open market operations, and monetary aggregates will be studied. Although not under control of Harding, and not a part of Harding's economic policy, it is important to examine Federal Reserve policy. Any significant interventionist, stimulatory actions by the central bank during 1921 would reduce the impact of Harding's fiscal policy and would undermine the laissez-faire account of the depression.

This thesis will fully examine the business depression, the Harding administration's policies and monetary policy by the Federal Reserve. This thesis will thus conclude whether the Harding administration pursued a laissez-faire course in combating the 1920-1921 Depression and what the result of this policy was. These finding will have important applications to current economic debates about how to achieve economic recovery.

1. The 1920-1921 Depression

Starting in 1920, a severe, historic economic downturn began that would dominate the American economy for the following two years. As economic downturns go, the 1920-1921 depression has not been among the most popular or most studied in American economic history. It is overshadowed by 'the Great Depression' of the 1930s and added to this is the general unpopularity of the Harding presidency, which is ranked consistently at the bottom of American presidential administrations. In both of Schlesinger's presidential rankings Harding receives the lowest grades, and in subsequent rankings he doesn't fare much better.[10] [11]

These detractions aside, the 1920 depression is of note for several reasons. For one, it was an uncharacteristically strong and severe economic slump with significant decreases in production and prices, as well as very rapid increases in unemployment levels. Despite the slump's severity, it did not turn into a major depression and strong economic growth returned within eighteen months.

The accounts of when the depression started differ. The National Bureau for Economic Research places the start of the downturn in January 1920 and the end at July 1921.[12] Other sources date the start as late as May 1920.[13] The influential economist Milton Friedman puts the real start even later, saying: "There is little sign of any severe decline until past the middle of the year. Indeed, it was not until early fall that contemporary observers were in substantial agreement that a sizable contraction was under way."[14] Chicago University business cycle expert Victor Zarnowitz puts the speculative peak at the summer of 1920.[15]

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[10] Schlesinger, A.M., 'Historians Rate the U.S. Presidents' in *Life*, November 1st, 1948: pp. 65-66, 68, 73-74
[11] Schlesinger, A.M., 'Our Presidents: A Rating by 75 Historians' in *New York Times Magazine*, July 1962, pp. 12-13, 40-41, 43
[12] NBER, 'US Business Cycle Expansions and Contractions', p. 1
[13] Persons, 1922, p. 5-6
[14] Friedman, 1963, p. 231
[15] Zarnowitz, 1996, p. 106

An explanation of these different accounts can be linked to the fact that the downturn affected different sectors of the economy at different times. Manufacturing declines for instance did not start until the middle of March 1920, and severe price decreases did not start until May 1920.[16] It was clear however that by the summer of 1920 a severe economic downturn had hit the US economy.

On the causes of the depression there is also academic disagreement. One theory is that demobilization, and the subsequent re-entry into the labor force of former soldiers caused adjustments, stresses and unemployment. The effects of demobilization were limited however. In 1920, there was a 4.1 percent increase in the civilian labor force, with immigration making up more than a quarter of this number.[17] Also, demobilization had mostly finished by the beginning of 1920.[18] Another theory held by Roose places much blame on large strikes and supply disruptions in the steel and coal industries at the end of 1919.[19] These strikes and disruptions had only temporary negative effects which can be seen in a depiction of the volume of manufacturing for eight major industries. Although both the strikes and major railroad congestion cause a temporary and limited decrease in manufacturing, growth resumed strongly shortly after.[20] These were minor factors and did not cause the downturn.

Keynesian examinations of the 1920-1921 downturn blame the shift from a Federal government deficit to a surplus under President Wilson (coupled with a decline in exports). This, combined with monetary restraint by the Federal Reserve in 1920, created a decline in aggregate demand which is seen as the primary factor behind the severity of the ensuing slump.[21]

The most widely accepted cause of the depression holds responsible Federal Reserve policy during and after the war. It stipulates that the Federal Reserve drastically increased the money supply by buying up government debt, lowering reserve standards

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[16] Persons, 1922, p. 12 and Friedman, 1963, p. 196
[17] Lebergott, 1964, p. 512 and Vernon, 1991, p. 2
[18] Mock and Thurber, 1944, p. 134-135
[19] Roose, 1958 and Vernon, 1991, p. 2
[20] Graph 1 of the Appendix, p. 94 and Persons, 1922, p. 12
[21] Wilson, 1948, p. 92-114; Gordon's, 1974, p. 17-23 and Vernon, 1991, p. 2

and lowering the discount rate.[22] In an informal agreement with the Treasury Department, the Fed indeed kept discount rates low throughout the war years and 1919, in order to finance the war debt. The Fed pursued this policy until the last of the so-called Victory bonds had been given out in October 1919.[23] These actions caused the money supply to increase greatly, leading to easy availability of credit, drastic price increases, 'speculation', and unsustainable and misdirected investments.[24] The consumer price index shows the effects of this policy with strong double digit inflation numbers throughout the war and post-war period, up until 1921. Where the years 1914 and 1915 still saw very low, one percent inflation statistics, this rapidly accelerated to 7.9 percent in 1916, before shooting up to 17.4 percent in 1917, 18 percent in 1918, 14.6 percent in 1919 and 15.6 percent in 1920.[25] The policies by the Federal Reserve caused a major bubble to form in the economy and caused prices to rapidly increase. The correction and liquidation of this situation took place during the 1920-1921 depression.

There is, for the most part, academic agreement over the depth and seriousness of the downturn. Friedman called it "a severe decline" and "one of the most rapid declines on record," with the national product in current prices "more than 18 percent lower in 1921 than in 1920" using Simon Kuznets' GDP figures in current prices.[26] Other academics have tempered these numbers. Nathan Balke and Gordon put the decline at 3.5 percent of GNP, Christina Romer estimates 2.4 percent, and the US Department of Commerce estimated the decline in GNP numbers at 6.8 percent.[27] The Romer and Balke and Gordon decline seems small however when looked at the other economic data and estimates. Kuznets' GDP estimate in 1929 prices, which he argues is more

[22] Patterson, 1923, p. 153-157 and Woods, 2009, p. 27
[23] Smiley, 2008
[24] Graphs five and six of the appendix show this drastic increase in the money supply during the last two years of this Federal Reserve policy. A major increase can be seen all throughout 1918, 1919 up to October of 1920. Appendix, p. 96-97
[25] U.S. Department of Labor, Bureau of Labor Statistics, 'Consumer Price Index: All Urban Consumers (CPI-U)'
[26] Friedman, 1963, p. 231
[27] Vernon, 1991, p. 1 and Romer, 1988, p. 91

reflective of the actual economic situation at that time, mirrors the Department of Commerce number, showing a 6.5 percent decline.[28] Zarnowitz, judged the decline of 1920-1921 to be the greatest in more than 65 years, greater than any other in the period between 1873 and the Great Depression. He called it a "major depression", and put the average GNP decline at 13.4 percent.[29] While the estimates differ, a decline in GDP of between 6.5 and 13.4 indicates a very serious economic downturn.

The depression was perceived as very serious by contemporary actors as well. Secretary of the Treasury Andrew Mellon stated in his 1923 annual report: "the crisis of 1921 was one of the most severe this country has ever experienced."[30] Although the estimates differ, it is clear that the depression had a severe negative impact on the economic output of the United States.

The unemployment data further shows that the nation was hard-hit by the economic slump. The unemployment figure in non-agricultural sectors of the economy went from 2.3 percent in 1919 to 4 percent in 1920, before shooting up to 11.9 percent in 1921.[31] Another employment measure by Lebergott sees a similarly drastic increase from 1.9 percent unemployment in 1919 to 5.2 percent in 1920 and 11.7 percent in 1921.[32] Zarnowitz too concludes an increase in unemployment of 9.6 percent.[33] The US Employment Service of the Department of Labor estimated industrial unemployment on the first of July 1921 at between four and five million people. However, this number disregarded employment in large mining and railroad corporations, as well as companies that employed less than 501 workers.[34] In August 1921 the Secretary of Labor revised this number upward to 5.75 million in his report to the Senate. Between January 1920 and January 1921 there was a 36.5 percent reduction in the amount of

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[28] Kuznets, 1937, p. 8
[29] Zarnowitz, 1996, p. 24, 106-107
[30] Cannadine, 2006, p. 278
[31] Trani and Wilson, 1977, p. 13 and D'Arista, 1994, p. 59
[32] Lebergott, 1964, p. 512
[33] Zarnowitz, 1996, p. 24
[34] *The Wall Street Journal*, 'Nearly 5,000,000 Industrial Workers Unemployed July 1', July 22, 1921

workers in mechanical industries, with sectors such as the building industry (52.4 percent) and the automobile industry (69.2 percent) particularly hard-hit.[35]

Enormous decreases in production were another indication of the strength of the depression. From 1920 to 1921, agricultural production declined by more than twenty percent.[36] A monthly production index of eight important industrial groups, including iron, steel, lumber, petroleum, textiles, food and tobacco showed significant decreases from its peak in March 1920. Between March and the end of 1920, production declined by forty percent and would continue to weaken until July 1921, where it would be about fifty percent below the March 1920 level.[37] At the absolute worst of the depression, in July 1921, total industrial production was 32.6 percent below its January 1920 level.[38]

The slump affected every aspect of American economic life. There were 100,000 bankruptcies, a 12 percent sales decline by department stores and 32 percent by mail-order stores, and foreign trade declined by almost 50 percent in 1921.[39] The stock market was also hard hit. Sales of stocks declined almost 30 percent, while new capital raised by corporations was 33 percent lower in 1921 than in 1920. The number of bank failures also quickly increased from 63 in 1919 to 155 in 1920 and 560 in 1921, beating the previous record of 491 failures in 1893.[40]

Beside the unemployed and investors, the crisis also affected those who still had jobs. Many employers were forced to lower wages and reduce work hours, reducing prosperity even among the employed. Between 1920 and 1921 one in six working hours were lost. The worst hit sectors of the economy were factories, mines, railways and construction companies. Large companies with over 100 employees saw cuts of up to 28 percent of working hours. Smaller companies of over 20 employees averaged 14 percent of working hours lost. The smallest companies of up to 20 employees were largely

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[35] Andrews, 1921, p. 194
[36] Smiley, 2008
[37] Persons, 1922, p. 11-13
[38] Vernon, 1991 and Persons, 1922, p. 13
[39] *The Wall Street Journal*, 'March Manufactures 50% of March 1920, Exports', April 27, 1921; Trani, 1977, p. 13; Persons, 1922, p. 15 and Smiley, 2008
[40] Friedman, 1963, p. 235 and D'Arista, 1994, p. 62

spared and suffered only a three percent reduction in lost hours.[41] Wages of the employed were affected as well. Workers in companies of over a hundred employed earned on average $1,544 in 1920, but only $1,112 in 1921. Workers in small firms were spared for the most part; they saw their incomes decline from $1,121 to $1,077. Workers in intermediary sized firms saw their yearly paychecks reduced to $1,122 in 1921, compared to $1,354 in the previous year.[42]

All these factors strongly affected government revenues. In fiscal year 1921, from June 30th 1920 to June 30th 1921, revenues to the Treasury were 15 percent lower than they had been the previous year. The strongest decrease was seen in federal income tax receipts, which totaled $3,228,137,673, $728,798,329 less than the previous year, without significant changes in taxation measures.[43]

Perhaps the most remarkable aspect of the downturn was the extremely sharp deflation. This was no mere streak of moderate price decreases, it was the most severe bout of price deflation the United States had ever seen, or would experience since. Milton Friedman, in his magnum opus on US monetary history, described it as the most severe period of deflation in the history of the US and noted "an unprecedented collapse in prices".[44] By May 1920, prices were about 2.5 times as high as they had been in September 1915. After May 1920, the price level dropped sharply, returning to the 1917 level in July 1921. By June 1921, prices were only 56 percent compared to a year earlier.[45] The price index of the American Bureau of Labor Statistics shows a similarly remarkable 46 percent decline, from 272 in May 1920, to 148 in June 1921. Bradstreet's General Index fell from $20.87 to $10.62, a drop of 49 percent, and an index based on ten leading commodities fell from 277 to 107, a 61 percent decrease. Finally, the Aberthaw index of building costs shows a decline from 265 on July 1920 (relative to 1914) to 153 in December 1921.[46] The US government's official measure of inflation, the

[41] King, 1923, p. 143
[42] King, 1923, p. 144
[43] *Wall Street Journal*, 'Internal Revenue Bureau's activities in 1921 year', November 28, 1921
[44] Friedman, 1963, p. 231 and Vernon, 1991
[45] Friedman, 1963, p. 196-197 and p. 232
[46] Persons, 1922, p. 6-8

Consumer price index (CPI) figures from the US Bureau of Labor Statistics of the department of Labor definitively show the deflation of 1921. The yearly average percentage change in CPI figures for urban consumers was determined at negative 10.5 percent, indicating the strength of the deflationary movement.[47]

The price declines hit farmers. The price of wheat, which stood at $2.56 per bushel on June 15, 1920, dropped to $1.03 in August 1921. The price of hogs went down from $13.18 per hundredweight to $7.22 a year after June 1920. Cotton prices suffered an even worse fall, declining from 41.2 cents per pound on July 15, 1920, to 12 cents per pound on June 15, 1921. Corn farmers were hit hardest as they saw their prices collapse from $1.85 per bushel to $0.42 between June 15, 1920 and the end of 1921. The combination of drastic price decreases, strongly increased land prices, land rent and transportation costs, as well as increases in property taxes, caused a horrible economic situation for the American farmer.[48] The average net income per farm fell by 50 percent, from $1000 to $500 (in 1929 dollars).[49]

For American consumers the price deflation held benefits. The cost of living had been rising sharply in the years preceding the downturn. Between June 1920 and June 1921, prices of food items decreased by 34.2 percent, returning to pre-war levels. Similar decreases were witnessed in furniture and clothing items. The cost of living for the average American consumer went down substantially, and 'real money wages' actually rose significantly.[50] After July 1921, the price level decreased more slowly and began to gradually climb again after January 1922.[51] It wasn't until October 1921, that a general increase in prices and the cost of living took place.[52]

From all these figures it becomes clear that the 1920-1921 depression was no mere light recession. It was a full blown, serious economic downturn that struck all aspects of American society. From farmers to the millions of unemployed, from workers

[47] U.S. Department of Labor, Bureau of Labor Statistics, 'Consumer Price Index; All Urban Consumers (CPI-U)'
[48] Link, 1946, p. 166-167
[49] Smiley, 2008
[50] Persons, 1921, p. 9-10 and Vedder and Gallaway, 1997, p. 63 and p. 81
[51] Friedman, 1963, p. 196-197
[52] Persons, 1921, p. 10

facing wage cuts to investors losing their bank deposits, the economic crisis affected the entire nation.

After eighteen months of hardship, the economy began to recover, growth resumed and unemployment started decreasing. The National Bureau of Economic Research estimates that economic recovery started in July 1921.[53] Investment activity sharply rebounded with an increase in the amount of shares traded on the stock market by 50 percent. The stock market started climbing again in July, stalled briefly in August, before taking off in September 1921.[54] Total investment had been a lethargic $3.3 billion throughout 1921, but started strongly moving upward in August, reaching $3.6 billion at the end of the year, and roughly $4.5 billion a year later.[55] Manufacturing and industrial production started growing again in the middle of July 1921. Like the stock market, its growth briefly stalled in August, before strongly taking off in September.[56] GDP jumped from $62.550 billion in 1921 to $68.482 billion in 1922, increasing by 9.5 percent.[57] And even more striking were the changes in manufacturing and production in 1922: pig-iron production increased by 63 percent; steel ingots by 71 percent; zinc by 73 percent; gasoline by 18 percent; sugar meltings by 45 percent; hogs slaughtered by 6 percent and cattle slaughtered by 11 percent. Furthermore, raw cotton consumed by manufacturers rose 14 percent and raw wool increased by 22 percent. The production of yellow pine rose with 24 percent and Douglas fir with 56 percent. In the building sector there was a 55 percent increase in new floor space of contracts awarded.[58] Unemployment also lessened substantially. The unemployment number stood at 11.9 percent in 1921, with some five to six million Americans without a job. In 1922 the number was reduced to 6.7 percent of the workforce, dropping to 2.4 percent by 1923.[59]

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[53] NBER, 'US Business Cycle Expansions and Contractions', p. 1
[54] Persons, 1923, p. 6
[55] Ibid., p. 5
[56] Ibid., p. 2 and Persons, 1922, p. 12
[57] Kuznets, 1937, p. 8
[58] Persons, 1923, p. 5
[59] Powell, 2009; Woods, 2009, p. 23 and Vedder and Gallaway, 1997, p. 63 and p. 81

Not only was there quick economic recovery between July 1921 and January 1922, it was very robust and would turn into strong growth the next few years. Although interrupted by minor recessions, the United States economy would experience strong, persistent growth for almost a decade, bringing unprecedented levels of wealth to its citizens.

The figures show that the 1920-1921 depression was a severe, deflationary downturn that heavily affected the American economy. From strong production decreases, reductions in trade, quickly increasing and high unemployment levels, a strongly declining stock market, to severe price decreases and a slump in the GDP, it was a serious economic downturn. We have also seen that the worst of the downturn took place between approximately May 1920, and July 1921, after which economic recovery started. This thesis will now examine the policy of the Harding administration to combat the depression in 1921 and will look at what caused this return to strong persistent economic growth.

2. The Harding Program

2.1 The 1920 Election and the Harding Plan

The 1920 election was an important political event that took place at a pivotal time in American history. Following the costly First World War and falling in the middle of a strong economic downturn, it provided the American people with a clear choice for the direction of the country. It ensured that the political and economic policy of the United States for the coming decade would experience a large shift.

On the Republican side, Ohioan Warren G. Harding unexpectedly became the nominee at the Republican convention, with Calvin Coolidge as his running mate.[60] The Democrats nominated James Cox, also from Ohio, as candidate, with Franklin Delano Roosevelt as his running mate. With the victory of Cox at the Democratic convention, the election became a contest between the two Ohio newspaper men. The campaign would be mainly waged on the League of Nations and on the Federal government's role in the economic slowdown. Other issues such as female suffrage, prohibition, war profiteering and a fear of radicals and communism also played a role.

On the issue of the economy the candidates held sharply differing views. James Cox held strongly progressive views, arguing that: "When conditions are obviously wrong and unjust, the great mass of our people look upon government action for relief, for the reason that individual action or community co-operation are not effective."[61] He argued for more government intervention to stabilize agriculture and economic crises

[60] *The New York Times*, 'Harding nominated for President on the tenth ballot; Coolidge chosen for Vice-President', June 13, 1920
[61] 'IV. The United States', in *Political Science Quarterly*, Vol. 36, No. 3, Supplement (September, 1921), p. 28

and had a very progressive record as governor of Ohio.[62] It is clear that Cox was a strong progressive, striving for more government regulation of industry and a bigger role for the Federal Government in fighting the depression. Had Cox won, the US Federal government would almost assuredly have pursued an activist, interventionist and not a laissez-faire approach to the downturn.

Harding held different views on the economy, friendlier towards business and capital. A Wall Street Journal editorial described him as having "always maintained a constructive attitude toward big business", praised him for having on occasion "publicly attacked the demagoguery which attributes to Wall Street most of the ills that the nation is heir to" and praised his entrepreneurship.[63] A large section of leading figures in the industrial, financial and the investment world recognized these views as well. They hailed Harding's nomination and the selection of the equally conservative Coolidge, recognizing him as a strong conservative and a man that would represent their interests.[64] Harding would provide a "common sense", "conservative" and "sane" administration along the lines of President McKinley, pleasing the business community.[65] When the results came in, and it was clear that Harding had won, most of the leading bankers in America openly celebrated and proclaimed their belief that under this new administration business would regain its confidence and would be stimulated.[66]

Harding expressed pro-business, generally pro-market views many times during his campaign. In his address to the Republican convention, thanking them for his nomination as presidential candidate, he offered several examples of these stances. Harding praised capitalistic competition, asserting that: "It must be understood that toil alone makes for accomplishment and advancement, and righteous possession is the reward of toil, and its incentive. There is no progress except in the stimulus of

[62] *The New York Times*, 'Cox says Congress balked attempts to curb profiteers', September 19, 1920; *The New York Times*, 'Gov. Cox identified with Ohio reforms', July 7, 1920 and *The New York Times*, 'Campaign issues as seen by Governor James M. Cox', May 23, 1920

[63] *Wall Street Journal*, 'Harding Constructive Toward Big Business', June 15 1920

[64] *Wall Street Journal*, 'Wall Street Sees Good in Selection of Harding', June 15, 1920

[65] *Wall Street Journal*, 'Investors Well Pleased with Republican Nominee', June 16, 1920

[66] *Wall Street Journal*, 'Bankers Elated over Senator Harding's Victory', November 4, 1920 and *The New York Times*, 'Election Result Suits Financiers: Business Will be Stimulated by Victory of the Republicans, They Believe', November 4, 1920

competition. [...] When competition—natural, fair, impelling competition—is suppressed, whether by law, compact or conspiracy, we halt the march of progress, silence the voice of inspiration, and paralyze the will for achievement. These are but common sense truths of human development."[67]

Harding developed these conservative views over the course of both his entrepreneurial and political careers. It is clear that he became a strong Republican early on, supporting James Blaine in 1884. During his time in the Ohio state senate he was well-liked by both the progressive and conservative factions of the Republican Party in the state, although he clearly supported the latter side. Here he worked closely with Mark Hanna and Harry Daugherty, both conservative, prominent men within the Republican Party and strong allies of conservative and largely laissez-faire Republican president McKinley. Daugherty would turn into one of Harding's closest confidants and was his campaign manager in 1920. Harding continued to support the conservative faction of the party all throughout the Theodore Roosevelt presidency and supported William Howard Taft over Roosevelt in 1912. The McKinley, Roosevelt and Wilson presidencies shaped Harding's views on the executive. McKinley was his clear favorite and Harding believed the executive branch should have a limited role. As we have seen, many of his supporters, in addition to many in the business community believed Harding would be a second McKinley.[68]

Harding's role as a uniting force between progressive and conservative Republicans forced him to take a shrewdly neutral position on labor issues, Harding called for peace between different classes, arguing that the destruction of one would mean the demise of the other.[69] Addressing issues of monetary and fiscal policy, Harding attacked the Democrats for reckless fiscal and inflationary policies: "Gross expansion of currency and credit have depreciated the dollar just as expansion and inflation have discredited the coins of the world. We inflated in haste, we must deflate

[67] Harding, W.G., 'Address Accepting the Republican Presidential nomination', June 12, 1920
[68] Trani and Wilson, 1977, p. 33-35 and 42-43
[69] Harding, W.G., 'Speech of Acceptance of the Republican Party's Nomination to the Presidency delivered at Marion Ohio, July 22, 1920, by Senator G. Harding', p. 26

in deliberation. We debased the dollar in reckless finance, we must restore in honesty." Harding would continue with this theme throughout the campaign. In a speech to a delegation of West-Virginians he said: "We have witnessed the inflation of the currency, enormous expansion of credits - aye, a fevered inflation of business [...]."[70]

According to Harding, the solution to the vast economic problems confronting the country was to be found in deflation and a reduction of government borrowing and expenditures: "Deflation on the one hand and restoration of the 100-cent dollar on the other ought to have begun on the day after the armistice, but plans were lacking or courage failed. [...] We will attempt intelligent and courageous deflation, and strike at government borrowing which enlarges the evil, and we will attack high cost of government with every energy and facility which attend Republican capacity. We promise that relief which will attend the halting of waste and extravagance, and the renewal of the practice of public economy, not alone because it will relieve tax burdens, but because it will be an example to stimulate thrift and economy in private life. [...] There hasn't been a recovery from the waste and abnormalities of war since the story of mankind was first written, except through work and saving, through industry and denial, while needless spending and heedless extravagance have marked every decay in the history of nations."[71]

We can see here the conservative economic plans Harding held for his future administration. Harding believed in individual thrift and saving and opposed government extravagance. He saw the solution to the depression not in expanding government and government expenditures, or in printing money, but rather in austerity and deflation. He wanted to lower the tax burden, cut government spending, allow deflation to take place to lower the cost of living. Harding envisioned a laissez-faire federal government approach to the economic downturn.

Harding's campaign of an optimistic promise of a 'return to normalcy', Americanism and prosperity, coupled with strong resentment for the League of Nations,

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[70] *The Washington Post*, 'Assails Ship Board', September 25, 1920

[71] Harding, W.G., 'Speech of Acceptance of the Republican Party's Nomination to the Presidency delivered at Marion Ohio, July 22, 1920, by Senator G. Harding', p. 26

the terrible state of the economy, high unemployment, high cost of living, a general weariness of the Wilson administration, and a fear of Bolsheviks and radicals produced a landslide Republican victory, its greatest in American history. With 404 Electoral College votes to Cox and Roosevelt's 127, and 16,138,914 votes versus Cox and Roosevelt's 9,142,438, out of almost 27 million, Harding broke many previously held voting records and captured most parts of the country.[72] Furthermore, the political landscape had been strongly altered as a wave of Republicans rode on Harding's coattails into Congress. The previous 66th Congress had consisted of 237 Republicans versus 190 Democrats in the House and 49 Republicans versus 47 Democrats in the Senate. The 67th Congress now had 300 House Republicans versus 132 Democrats (and 1 Socialist) and in the Senate there were now 59 Republicans versus 37 Democrats.[73] Harding now had a strong mandate and was supported by strong majorities in both houses of Congress. The election ensured that Republican politics would dominate the 1920's.

[72] *The New York Times*, 'Gigantic Majorities', November 3, 1920 and 'IV. The United States', in *Political Science Quarterly*, Vol. 36, No. 3, Supplement (September, 1921), p. 28-29.
[73] Ibid.

2.2 Taxation: Tariff policy and The Revenue Act of 1921

During much of 1920, Harding and many others argued passionately for change in the tax environment. It was clear to many experts that the situation was archaic, still mostly directed at wartime needs, and in need of an overhaul. The ‘Excess profits tax’ and personal income tax rates were criticized. It was believed they had grown too burdensome, and that all kinds of consumption, luxury and commodity taxes that had to be reduced.[74] Furthermore, President Harding believed that lower taxes were important to combat the depression, stating: “A prompt and thoroughgoing revision of the internal tax laws, made with due regard to the protection of the revenues, is; in my judgment, a requisite to the revival of business activity in this country.”[75]

Revising the tax structure became one of the major priorities of the administration. The speed with which they tried to tackle this reflected both a belief in the need for less taxation, as well as a belief that it was necessary for businesses to know as soon as possible “the foundation on which to build in 1921”.[76] Harding placed special emphasis on the need for: “eliminating confusion and cost in the collection” of taxes.[77] As this chapter will show, Harding’s belief in the importance of regime certainty in regards to taxation would play an important role in the economic recovery.

2.2.1 The Emergency Tariff

An important priority to Harding was a revision in the tariff structure of the country. President Wilson in his last days in office had vetoed an emergency tariff bill

[74] *The New York Times*, ‘Harding to Ask Repeal of Excess Profits Tax; Message Will Tell Business Where It Stands’, April 19, 1921
[75] Harding, W.G., ‘Address of the President of the United States’, April 12, 1921
[76] *The New York Times*, ‘Harding to Ask Repeal of Excess Profits Tax; Message Will Tell Business Where It Stands’, April 19, 1921
[77] Harding, W.G., ‘Address of the President of the United States’, April 12, 1921

and failed to achieve any changes to the tax code, and Harding saw it as his job to achieve what Wilson could or would not.

As early as the 22nd of March, shortly after his inauguration, Harding requested Republican members of the House Ways and Means committee to draft new emergency tariff legislation.[78] Pressured by farmers and agricultural interests that were hard hit by the depression, and supported by a historically strong protectionist faction within the Republican Party, Harding led a bipartisan push for higher tariffs.[79] The Committee proceeded with haste, and less than three weeks later Chairman Fordney submitted his bill to the House. The bill raised tariffs on almost all imported agricultural products, contained an anti-dumping provision meant to protect American manufacturers, and was meant to be a temporary, six month legislative solution until a permanent tariff act would be established.[80] The legislation passed quickly through the House, the Senate, and the conference between the two chambers. The final report breezed through the Senate by a 52 to 25 majority, and was signed by the President only a week later, on the 27th of May.[81]

The effect of the act was a profound raise in import rates that affected basic foodstuffs, livestock, agricultural products and manufacturing necessities. In addition, there were now strict anti-dumping measures policed by the Treasury department and a plethora of rules were made regarding invoices and the conversion of foreign currency into dollars.[82] While this was anything but laissez-faire policy by the Harding administration, it should be concluded that the tariff act remained relatively limited in its impact on the economy. Wheat for instance was a major export product and the duties therefore had only limited effects on consumers.[83] Consumer prices that were affected by the tariffs also experienced strong deflationary pressures. Even with the agricultural tariffs, agricultural products saw vast price decreases. Finally, customs

[78] *Wall Street Journal*, 'Harding asks for Emergency Tariff Bill', March 22, 1921
[79] Blakey, 1922, p. 75-76
[80] *Wall Street Journal*, 'Emergency Tariff Bill Ready', April 9, 1921
[81] *Wall Street Journal*, 'Senate Adopts Tariff Conference Report', May 21, 1921 and *Wall Street Journal*, 'President signs Tariff Bill', May 28, 1921
[82] *Wall Street Journal*, 'Emergency Tariff Law covers many products', June 2, 1921
[83] Ibid., p. 24

revenue in 1921 actually decreased. Receipts went from $323 million in 1920 to $308 million in 1921.[84] This decline probably reflects a reduction in trade as a consequence of bad economic conditions, but it also shows the limited significance of the 1921 emergency tariff legislation. Had the 1921 tariff been significant in its size and impact on the economy, an increase in custom receipts surely would have followed. In addition, these receipts pale in comparison to the effects of the tax relief that was to follow and the ongoing austerity measures in the Federal Budget.

There certainly were negative effects. Shortly after the emergency tariff was passed, Minnesota bankers and businessmen complained that Canadian wheat, which had formerly been shipped through their state, benefitting mills and the transport sector, was now diverted to England. Cattlemen in Montana were experiencing difficulties as well, as the legislation made it harder to import cattle from Canada.[85] However, most of these painful effects remained mostly local and regional.

Because the 1921 Emergency tariff was a decidedly interventionist piece of legislation, this would seem to affect the account that the Harding administration acted with laissez-faire policies during the downturn. However, because the negative effects of the 1921 Emergency Tariff were limited, its size and effects were minor when compared to the rest of Harding's 1921 fiscal policy, and it remained mostly local and regional, it did not significantly affect the economic recovery of 1921 or Harding's overall laissez-faire policy during the downturn. More permanent, far-reaching protectionist tariff legislation, aimed at both the agricultural and manufacturing sectors of the economy was not enacted until late September 1922.[86] By then however, economic growth was already well underway.

[84] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 590
[85] Anderson, 1949, p. 89-90
[86] Berglund, 1923, p. 14

2.2.2 The Revenue Act of 1921

After the passage of the Emergency Tariff, the time arrived to deal with taxation. By 1921 many politicians and economists felt that the taxation situation desperately needed change. The introduction of the income tax less than a decade earlier created low, progressive income tax rates ranging from 0 to 7 percent. These rates subsequently veered upwards with the advent of the War, reaching 77 percent in 1917 and 1918. Even President Wilson felt these rates had become unmanageable and called for tax cuts, as the rates had "passed the point of productivity."[87] Corporate taxation was high as well. Companies faced the combination of a corporate income tax of 12% in 1918 and 10% in subsequent years, in addition to the complex Excess Profits Tax that heavily affected profit-making companies.[88] Harding was determined to alter this situation and together with his new Treasury Secretary offered up plans to this effect, resulting in the Revenue Act of 1921.

The act was the brainchild of Andrew Mellon, the iconic, conservative Secretary of the Treasury in the Harding, Coolidge and Hoover administrations. Mellon's appointment was crucial in shaping the administration's fiscal and taxation policy. Mellon grew up in a wealthy, influential and Republican Pittsburgh household. He became a successful banker, entrepreneur and a lifelong Republican. Mellon also developed clear ideological beliefs on the importance of business, the need for a small Federal government and the need for a low burden of taxation.[89]

In his 1924 work, Mellon set out his views on taxation. He strongly favored lower income tax rates, mainly based on his belief that high tax rates led to high tax evasion and that lower tax rates would therefore lead to more revenue: "The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the

[87] Smiley and Keehn, 1995, p. 286-287
[88] Murnane, 2004, p. 825
[89] Cannadine, 2006, pp. 27-245

realization of taxable income."[90] Mellon also believed that lower rates would lead to a more productive society, stating: "The vital defect in our present system is that the tax burden is borne by wealth in the making, not by capital already in existence. We place a tax on energy and initiative" and "where the Government takes away an unreasonable share of his earnings, the incentive to work is no longer there and a slackening of effort is the result."[91] In his yearly statement, at the close of 1921, Mellon again expressed this strong belief in the damaging effects of taxation, saying: "[The] idea seems prevalent that in taxing large incomes, only person(s) receiving the income, and who is to pay the tax is really concerned. This is a mistake. For whatever the Government takes, in the way of tax, out of any income, which would otherwise be saved and invested, and thereby become a part of the capital and of the wealth of the Nation, affects not so much the individual from whom it is taken as it does the whole people of the country, in direct loss of productive capital. So that in considering the effect of high taxes upon incomes, particularly on very large incomes, it is not so much a question of the effect on the individual who is called upon to pay the tax as it is the effect upon the whole community. […] the effect upon the community – upon the people of the whole country – is serious indeed."[92]

Both tax evasion and the loss of productivity, investments and wealth, he believed, led to lower tax revenues for the government. For society as a whole, lower taxes, especially on wealthier people, would be beneficial. Mellon believed that: "If a sound system of taxation is adopted and the present policy of economy in government is continued, the country may look forward during the present generation not only to a decrease in the tax burden but to increased prosperity in which everyone will share."[93] It was this policy Mellon would actively pursue. The coming years, especially 1921, would be marked by Mellon's quest for tax reform, a quest on which Harding proved a reliable ally.

[90] Mellon, 1924, p. 13
[91] Mellon, 1924, p. 94-95
[92] *Wall Street Journal*, 'Secretary Mellon points out essentials to prosperity', December 8, 1921
[93] Mellon, 1924, p. 138 and Keller, 1982, p. 780

Information about the administration's taxation plans wasn't secret. Hearing the campaign statements and knowing the personality and ideology of Harding and Mellon, most businessmen and investors had a decent idea of the new government's plans. More specific information about the tax plans had steadily been publicized during April.[94] On April 30th, Mellon announced his estimates of the size of the Federal budget in 1921 and 1922 and made several important suggestions for lowering taxes. In these recommendations, Mellon included a repeal of the unpopular Excess Profits Tax, to be replaced with a small increase in the tax on corporations and a repeal of an exemption of $2,000. The proposal also included a strong reduction of income tax rates to a total of 40 percent in 1922 and 33 percent in 1923, the repeal of many sales or excise taxes, as well as the tobacco tax, the transportation tax, the tax on admissions and the capital-stocks tax, and other 'nuisance taxes'. Finally, Mellon called for a clearer settling of tax cases in court, simplification in administrative provisions of the law and several new taxes to cover revenues barring further cuts in government spending.[95]

Mellon clearly believed that any tax reduction should only be done when there was a government surplus, stating in his work Taxation that: "tax reduction must come out of surplus revenue."[96] He repeated these beliefs in a presentation for the House Ways and Means Committee on August 4th: "[…] there is no one more interested than the Secretary of the Treasury in reducing government expenditures, and I have no hesitation in saying to you that the Treasury would many times prefer further assured cuts in expenditures to additional taxes of any kind." Mellon called for cuts in government spending of more than $250,000,000 in order for the administration's tax revision plans to work, and to prevent having to raise additional taxes. Barring such cuts Mellon again said that he would see himself forced to introduce several new taxes in order to safeguard revenues. One of his ideas was to introduce: "An annual Federal

[94] *The New York Times*, 'Harding to Ask Repeal of Excess Profits Tax; Message Will Tell Business Where It Stands', April 19, 1921
[95] Blakey, 1922, p. 77
[96] Mellon, 1924, p. 20

license tax upon motor vehicles, averaging about $10 a piece and to be graded according to power." Mellon also proposed a stamp tax of 2 cents on bank checks, an increase of first-class postage from 2 to 3 cents per ounce as well as "an increase in the tax on cigarettes and smoking and chewing tobacco."[97] Had such new taxes passed, they would have weakened the proposed tax relief as they would have kept higher revenues in place. Much was riding on how Congress would react to the plan, and how much spending would be cut. As will be seen, Mellon's threat of implementing new taxes would not come to fruition, and significant tax relief would take place, positively impacting the American economy.

The publication and low tax nature of Mellon's proposal was a confirmation of Harding's campaign statements about tax relief. It showed businessmen, investors and (wealthy) Americans that their tax situation would improve under Harding. This was important for the sense of regime certainty about taxation, and about the Harding government in general, and thereby had positive effects on the economy.

Mellon's plan came under fire from both sides of the aisle. Conservative Republicans heavily criticized the Secretary for proposing new taxation to cover revenue shortages. Attacks from the Democratic minority held that the administration's taxation program primarily benefitted the wealthy and corporations over those of moderate and small means. Their main target was a provision in the proposed legislation that would repeal all surtaxes over 32 percent on an individual's income.[98]

Harding and Mellon quickly responded to the criticism by going into conference with the Republican leadership in the House and drew up new plans. Government expenditures would now be cut by $520,000,000 and taxes would be lowered by $600,000,000. Mellon's newly proposed taxes were abandoned and the corporate income tax would now rise by 2.5 instead of the suggested 5 percent. The proposal was now even more conservative.[99] The bill was now heavily supported by Republicans in

[97] *Wall Street Journal*, 'Government expenditures must be cut $250,000,000', August 5, 1921 and Blakey, 1922, p. 77-78
[98] *The Washington Post*, 'The Tax Bill', August 22, 1921
[99] *The Washington Post*, 'Cut of 600,000,000 in Taxes decided upon', August 10, 1921

the House and was accepted without changes by the members of the Ways and Means Committee. Chairman Fordney introduced the bill to the House, where it was passed four days later.[100] Last minute Democratic attempts to scuttle it failed, despite substantial support from progressive Republicans, and it easily passed the House.[101]

The bill's passage in the Senate was more difficult. The agricultural bloc led by Republican Senator William Kenyon of Iowa, formed a coalition with progressive Republicans led by Progressive Senator Robert M. La Follette of Wisconsin to oppose large sections of the bill. The result was a collection of Senators from Mid-Western and Western agricultural states who vehemently disagreed with the proposed reduction in surtaxes. They instead proposed taxes of 50 percent on income over $200,000.[102]

Another major disagreement was over when the new taxes would become active. In the proposal, the new surtaxes, a reduction of the transportation tax and the elimination of the Excess Profits Tax would become law retro-actively on January 1st, 1921. The Senators wanted to push this deadline forward to January 1st, 1922. Finally, the Senate also proposed to increase the tax on corporations from 12.5 percent in the House version, to 15 percent.[103] Had such an increase taken place, it would have had negative effects on capital investments, as profit would have resulted in higher taxation. Passage of this Senate plan would have undone a large part of the proposed tax relief. As will be seen, due to executive and House pressure, the outcome would be more beneficial to companies.

The Senate's deliberations took up all of September and October, resulting in a Senate wide compromise. Many proposals to increase or retain taxation, especially on corporations were (sometimes narrowly) defeated.[104] After heavy debates, the Senate passed their version of the bill on the 8th of November, and the House and Senate were

[100] Blakey, 1922, p. 76
[101] *The Washington Post*, 'The Tax Bill', August 22, 1921
[102] Murnane, 2004, p. 828
[103] *Wall Street Journal*, 'Tax conferences discuss measures of revision', September 19, 1921
[104] Blakey, 1922, p. 93-95

forced to go into conference to work out their differences. The final bill reached the President's desk at 3.55 p.m. on November 23rd.[105] The Revenue Act of 1921 was a fact.

Although the act differed from Mellon's original proposal, it was nonetheless a landmark piece of legislation. It contained large changes in taxation policy and tax rates that had a large positive impact on the American economy. Firstly, the Excess Profits Tax was abolished. The Excess Profits Tax was an addition to the corporate income tax of 10 percent, created mainly to punish 'war profiteering' and form an additional revenue stream for war expenses. The tax "exempted $3,000 and 8 percent profit on invested capital. It then took one fifth of the profit in the bracket between the exemption and a profit of twenty percent on invested capital, and two fifths of profits in excess of 20 percent." The Senate Finance Committee described complaints about it succinctly in its statement: "whatever may be its theoretical merits, in practice it exempts the overcapitalized corporation, falls more heavily upon corporations of small or moderate size than upon larger corporations, penalizes business conservatism, and places upon the Bureau of Internal Revenue tasks beyond its strength."[106] The final bill decided that the elimination of the tax went into effect on January 1st, 1922, a year later than originally intended.[107] Nevertheless, the scrapping of the Excess Profits Tax was celebrated by most businessmen, investors and economists and had important positive effects on economic growth. Not only did businesses now retain more of their profits to invest, keeping more capital in the private sector. The incentives for capital investments were increased greatly. These positive effects did not begin to directly affect the economy until January 1922, but as we will see, the knowledge that this tax would be scrapped had important effects on the 1921 recovery through the phenomenon of regime certainty.

Another compromise in the final bill was the corporate income tax rate. The House proposal prevailed and the rate was increased from 10 percent to 12.5 percent. Also, there was a major change in the way capital gains were taxed. Where these

[105] *Wall Street Journal*, 'Federal Tax legislation during past year', January 2, 1922
[106] Blakey, 1922, p. 90
[107] *Wall Street Journal*, 'Federal Tax legislation during past year', January 2, 1922

previously fell under the income tax surrates (reaching up to 73 percent), they would now be taxed at 12.5 percent, provided the taxpayer would not pay less tax over his income, leading this measure to become attractive only for persons earning over $31,000 a year.[108] These measures provided a large boon for companies and investors. Although the exchange of the Excess Profits tax with the higher corporate income tax partly shifted taxation burdens, the new taxation structure, coupled with the severe decrease in capital gains taxes, greatly benefited companies and investors.[109] Perhaps equally important, the new tax structure removed all of the uncertainties, difficulties, bureaucracy and headaches that were formerly associated with the Excess Profits Tax. Once again, the direct effects of these measures in 1922 were significant, but the indirect effects through regime certainty were crucial to resuming economic growth in 1921.

Arguably the most important shift in taxation policy was the significantly lower income tax rates, predominantly benefiting wealthier Americans. This was hotly debated and Mellon's original proposal of a 32 percent maximum tax rate got amended severely. The final bill introduced a maximum surrate of 50 percent, and therefore a maximum income tax bracket of 58 percent. That meant that Americans earning more than $200,000 annually would now have to pay 58 percent taxes over this income. While higher than Mellon's proposal, this formed a significant reduction in the tax burden of wealthy Americans.[110] Americans earning over $200,000 a year now had to pay 10 percent less to the taxman (58 percent instead of 68 percent). Those earning over $1,000,000 annually paid 15 percent less (58 percent instead of 73 percent). For lower and middle-income Americans there were also improvements, albeit less spectacular. Most Americans saw a one to two percent decrease of their tax rates.[111]

Tax measures that heavily benefitted lower- and middle income Americans were also passed. Although regular tax rates remained the same at 8 percent over incomes of

[108] Blakey, 1922, p. 86-87
[109] *Wall Street Journal*, 'Federal Tax legislation during past year', January 2, 1922
[110] Murnane, 2004, p. 829
[111] Smiley and Keehn, 1995, p. 286

over $4,000 a year, and 4 percent on incomes below that, income tax exemptions for low income families were substantially extended. The personal exemption for the head of a family whose income did not exceed $5,000 was increased to $2500 from $2,000 and of persons younger than 18 and other dependents it was increased from $200 to $400, effectively lowering taxes on the lower class.[112] Numerous smaller, regressive taxes on 'luxury' items were scrapped. From January 1st, 1922, multiple taxes on ice cream, soft drinks, toilet powders, pills and patent medicine, musical instruments, sporting goods, chewing gum and toilet soaps were abolished. The tax on candy was reduced from 5 to 3 cents per pound, and the taxes on expensive carpets, clothing and lighting fixtures were reduced from 10 to 5 percent.[113] Another large regressive tax cut was the removal of the 'tax on transportation'. Starting January 1st, 1922; "all taxes on transportation of freight, passengers, express packages – and oil pipelines" would be scrapped, leading to a loss of revenue of roughly 370 million dollars. It was celebrated as "a great saving to the people and to business".[114] Mellon originally planned to gradually implement this tax cut, but the House and Senate disagreed. These were all tax cuts that directly benefitted mainly lower and middle income Americans. As such, they ensured that all Americans would notice the positive effects of tax relief in the coming year.

In order to truly understand the impact of the tax reforms it is necessary to examine the calendar years of 1920 and 1921. This is important because most of the tax cuts went into effect starting January 1st, 1922. When doing this, the effect of the tax reforms and cuts to government revenue becomes clear. In 1921, the Federal government's total receipts numbered $5,571,000,000. In 1922 the receipts were drastically lowered to $4,026,000,000, a 28 percent reduction.[115] Because of the fact

[112] Blakey, 1922, p. 80
[113] *Wall Street Journal*, 'Federal Tax legislation during past year', January 2, 1922
[114] Ibid.
[115] OMB Historical tables: Table 1.1: Summary of Receipts, Outlays, and Surpluses or Deficits (-): 1789-2016 and Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 593

that the economy was already growing substantially in 1922, leading to more incoming tax revenue makes this reduction even more significant.

The Revenue Act of 1921 had a significantly positive impact on the American economy and society. Income tax rates were lowered, the business and investment tax climate was much friendlier and many regressive taxes had been scrapped. The nation's tax burden was lightened. Harding and Mellon succeeded in their attempt to lower the burden of taxation and conducted an undeniably laissez-faire taxation policy. However, as the next section of this thesis shows, previously made arguments about the positive direct effects of Harding's laissez-faire taxation policy should be disregarded.

2.2.3 Regime Uncertainty

Almost all of the academic and Austrian literature arguing that Harding pursued a laissez-faire response to the 1920-1921 depression, cite tax relief as a major component hereof. Woods for instance states that: "Tax rates were slashed for all income groups." He makes the argument that tax relief led to economic recovery.[116] This thesis argues that the empirical evidence is more complex, and that the direct effects of Harding's laissez-faire taxation policy should be disregarded when studying the crisis and the 1921 economic recovery.

Although Mellon had attempted otherwise, the tax relief did not go into effect retroactively in 1921. Instead, the new taxation rules went into effect on January 1st, 1922. Lower taxes therefore had no direct effect on economy in 1921, or on the economic recovery that started between July and December. Previous academic accounts of the laissez-faire policy response to the crisis incorrectly combine the direct tax relief of 1922 with the recovery of 1921.

It is important to note that previously held theories that Harding's lower taxation led to economic recovery are not completely inaccurate. On the contrary, the new

[116] Woods, 2009, p. 23

taxation regime did in fact have significant beneficial effects on the nascent recovery during the latter half of 1921. However, this thesis argues that this was a largely *indirect* effect, caused by the important phenomenon of 'regime uncertainty', or more accurately the lack thereof.

Regime uncertainty is a term coined by economic historian Robert Higgs in a study of the reasons for the length of the Great Depression. The theory is based on the observation of, among others, Douglass North, that "In an economy where entrepreneurship is decentralized, economic actors will hold back on long-term investments unless the state makes credible commitments to honor its contracts and respect individual ownership rights."[117] It holds that for business people to be willing to invest and hire, they must be confident and not "uncertain about the regime" (the regime being the government in power). This certainty can be undermined by government policy ranging from "simple tax-rate increases, to the imposition of new kinds of taxes, to outright confiscation of private property." Other factors are "various sorts of regulation, for instance of securities markets, labor markets and product markets." Very important was the "character of the government that enforces, or threatens, presumptive [private property] rights."[118] Higgs uses these factors to develop the argument that the Roosevelt's New Deal program created regime uncertainty among businessmen, undermined business confidence and thereby prolonged the Great Depression.[119]

Under the Harding administration, particularly regarding its taxation policy, the exact opposite occurred. Although the final version of the tax bill wasn't adopted until November, the administration's proposals of significant tax cuts intentionally started to reach the public as early as April. The plans became clearer over the summer. It was a confirmation of Harding's statements on the campaign trail in which he had mentioned drastic tax relief. The plans proved to businessmen and investors that they had been right in supporting Harding in the election and that the character of the government was

[117] Alsont, Eggersson and North, 1996, p. 4
[118] Higgs, 2006, p. 8-9
[119] Ibid., p. 1-36

sound. This provided regime certainty as businesses knew to expect lower taxes. Businessmen, investors and (wealthy) individuals knew to expect the scrapping of the Excess Profits tax in return for a somewhat higher corporate income tax rate, knew that the income tax rates would probably be significantly reduced, and knew that a new, and much lower capital gains tax was coming. In other words, they knew they would be rewarded to a greater degree for investments they were to make. In fact, they had ample reason to believe that their taxation regime was to improve even more into the future, as Secretary Mellon had made quite clear he wished to pursue this course after 1921. Harding's 1921 taxation policy made clear that the administration would protect private property for individuals, businesspeople and investors, and would allow them to keep more of it, increasing regime certainty and contributing to economic recovery.

The implementation of the 12.5 percent capital gains tax for instance became clear in August 1921.[120] Total investments thereafter saw a strong, ten percent increase between August and December 1921, rising from \$3.3 billion to some \$3.6 billion. Investments would then grow to about \$4.6 billion at the end of 1922, a 27.8 percent increase, bringing with them positive (long-term) effects for the American economy.[121] Also, Stock and bond prices in industries across the board saw strong increases beginning in either July or August. Growth would continue in 1922, although for many industries it took until 1923 before 1919 production levels were reached. [122]

Unfortunately, questionnaires on business confidence among businessmen and investors would not be held until the late 1930's and therefore newspaper articles, investment statistics, stock and bond levels is the only information available to analyze business confidence in the regime.[123] These all show the business and investment

[120] *Wall Street Journal*, 'Tax on Casual Profits reduced to 12½ Percent', August 25, 1921.
[121] Persons, 1923, p. 5
[122] Graph 2 of the Appendix shows the common and preferred stock prices of 20 major industrial companies, including: Am. Locomotive, Am. Cotton Oil, U.S. Steel Corporation, Central Leather and United States Rubber, p. 94. (in Persons, 1923, p. 6);
Graph 3 of the Appendix shows stocks of 58 major US corporations divided into several sectors, including: Merrimack, Pacific Mills, Bethlehem Steel, United States Steel, American Locomotive, Central Leather, American Cotton Oil, American Tobacco, General Motors and General Electric, p. 95. (in Persons, 1923, p. 7-8)
[123] Higgs, 2006, p. 19

community's overwhelmingly positive response to the Harding administrations' laissez-faire tax policies.

This thesis therefore holds that it is inaccurate to claim that Harding's significant tax decreases directly caused the economic recovery between July and December of 1921, as much analysis of the laissez-faire response of the Harding administration has previously done. This thesis instead argues that it is the *indirect* effects of Harding's laissez-faire taxation policy that are crucial to the 1920-1921 account. Tax relief induced regime certainty contributed to the economic recovery of the latter half of 1921. Regime certainty should therefore be an important addition to the account of the 1920-1921 depression.

2.3 The Federal Budget: 'Business in Government'

President Harding spent the greater part of 1920 campaigning for a large change in government spending policy. Integral to his campaign were complaints about a runaway Federal government, specifically Federal spending. In his campaign speeches Harding often reiterated his belief that: "America [must] undertake certain tasks of cleaning house and building administrative government upon a business basis", which he neatly summed up with one of his campaign slogans: "Less government in business, and more business in government." This 'house cleaning' was necessary because: "Unless we do it, the unparalleled prodigal wastes of these last eight years, for which we all have to pay as consumers, or as taxpayers, will go on. [...] With another year or two of the experiment we have had the administrative government would crack under its load of folly, waste, grotesque experimentation and gross inefficiency." It is fair to conclude that Harding was no great fan of Wilson's domestic policy. Harding believed one of the solutions was to pass a 'National Budget Plan'.[124]

Upon entering the White House, it quickly became clear that the campaign statements had not been empty platitudes, but that Harding indeed intended to cut government spending and reform the budget. In his April 12th message to both houses of Congress, he again emphasized the urgent need for economy in expenditures and the adoption of a national budget system.[125] Harding stated: "I know of no more pressing problem at home than to restrict our national expenditures within the limits of our national income […]. One can not be unmindful that economy is a much-employed cry, most frequently stressed in reelection appeals, but it is ours to make it an outstanding and ever-impelling purpose in both legislations and administration."[126]

Harding believed austerity was needed for several reasons. First, there was a mounting government debt due to war expenses, which had to be tackled: "The

[124] *Wall Street Journal*, 'Harding declares for less government in business', November 12, 1920
[125] 'IV. The United States', in *Political Science Quarterly*, Vol. 36, No. 3, Supplement (September, 1921), p. 31
[126] Harding, W.G., 'Address of the President of the United States', April 12, 1921

staggering load of war debt must be cared for in orderly funding and gradual liquidation. […] Our current expenditures are running at the rate of approximately five billions a year, and the burden is unbearable."[127] Later he stated: "the things which governments accomplished during the war were accomplished at a staggering cost - a cost which society could not bear for long, a cost that has left society burdened with debts which mortgage generations of the future."[128] During the previous war years, the debt had ballooned from $1.281 billion on April 5th 1918, to around $24.1 billion in November 1920 (at one point reaching $26 billion in 1919).[129] Harding wanted to address the debt situation and continue efforts undertaken by Wilson to restrain it.

Another important reason for austerity was because it allowed Harding's desired tax relief: "We shall hasten the solution and aid effectively in lifting the tax burdens if we strike resolutely at expenditure."[130] Since Harding viewed tax relief as necessary for economic recovery, it leads that for Harding, spending cuts were prerequisites for economic recovery from the depression as well: "There are two agencies to be employed in correction: One is rigid resistance in appropriation and the other is the utmost economy in administration. Let us have both. […] I wish it might find its reflex in economy and thrift among the people themselves, because therein lies quicker recovery and added security for the future." Later he added: "There can be no complete correction of the high living cost until government's cost is notably reduced."[131] It becomes clear that Harding would strive for a smaller Federal government and lower government spending, for he believed this to be necessary for both tax relief and recovery from the economic downturn.

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[127] Ibid.
[128] Harding, 1921, p. 100
[129] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 613
[130] Harding, 1921, p. 100
[131] Ibid.

2.3.1 The Budget and Accounting Act

Harding believed that an overhaul of the budget system was part of the answer, because it would: " […] be employed in establishing the economies and business methods so essential to the minimum of expenditure."[132] In other, subsequent presidential speeches, Harding continued to emphasize the importance of this plan: "Establishment of a budget system is the foundation on which reorganization must be based."[133] Harding believed that a new national budget system would give the executive branch more control of spending and he could use this to further his goals of reducing the Federal budget.

The idea of budget reform had been around for several years. In 1917, Illinois adopted a modern budgeting plan, and due to the enormous growth of the Federal government during the World War, both parties believed this was needed in the Federal government as well. A bill to this effect was introduced by Representative McCormick from Illinois in 1918, but was vetoed by President Wilson.[134]

Due to a bipartisan belief that the Federal budgetary system was outdated, the budget bill that was introduced in April 1921 sped its way to the President's desk. On April 26th, the Senate adopted the McCormick Budget Bill without a roll-call vote or much debate. In a show of bipartisanship it passed the House by 344 yeas and only 9 nays on May 5th. The conference between the House and the Senate was a brief affair; the bill was accepted on May 27th and eventually signed into law by Harding on June 10th. The Budget and Accounting Act of 1921 was a fact.[135] All in all, it was a major legislative success for Harding, allowing him to make good on his promises to reduce spending.

Before the passage of the Budget and Accounting Act, the Federal budget was shaped by the heads of all of the departments individually drawing up their budget

[132] Ibid.
[133] Harding, 1921, p. 101-102
[134] Marx, 1945, p. 655
[135] 'IV. The United States', in *Political Science Quarterly*, Vol. 36, No. 3, Supplement (September, 1921), p. 32

estimates. These were sent to the Treasury Department, which had no authority to revise or alter them. The department could only submit them to Congress, which would eventually decide on them. The heads of departments had every incentive to submit the highest possible estimates, and no-one looked at government spending as a whole.[136] It was this system of perverse incentives that reformers and supporters of the budget act hoped to change.

One of the main changes under the new act was a clarification and systematization of existent, but scattered legislation. The new legislation provided the presidency with a personal budget agency; the so-called Bureau of the Budget, with a director he could appoint.[137] The agencies could no longer directly appeal to Congress for funding and now had to go through the President, who had the power to alter their requests. Requests for funding and the shaping of the budget were now the President's prerogative and responsibility.[138] With every budget there would now also be included not only the estimates of proposed expenditures, but also the estimates of revenues, so that it immediately became clear whether one exceeded the other, helping to ensure Harding's balanced budget.[139] Finally, the budget would now contain items such as a balance sheet and an operating statement, showing the financial state of the Treasury, and could now also contain any statements, analysis or information the President deemed necessary for informing Congress about the state of the Treasury.[140] The budget would now be more informative and encompassing with clear space for executive guidance.

It is clear that a close relationship between the director of the Bureau of the Budget and the Secretary of the Treasury would be necessary. This relationship, though awkward at first, worked very well. Both men were glad to be associated and cooperate with each other, and shared a similar view on the need for a smaller Federal

[136] Seidemann, 1924, p. 40
[137] Marx, 1945, p. 656
[138] Seidemann, 1924, p. 40
[139] Ibid., p. 40-41
[140] Ibid., p. 41

government.[141] This was important, as it made the process of drafting and designing a smaller Federal budget go much smoother, and aided Harding in his goal of cutting spending.

The Budget and Accounting Act and the ensuing new budgeting system did have its share of critics and criticism. Firstly, there were doubts about the improved accuracy of the proposed spending estimates. Using data of budgets before and after passage of the act, economic historian Hugh Rockoff has disputed any improvements in accuracy. He argues that errors in budget estimates were not significantly smaller in the twenties than they were during the First World War, and that real improvements only followed after the Second World War.[142]

Seidemann in turn argues that the success of the act was mainly due to the Harding government austerity drive, and the fact that Charles Dawes was the competent director of the Bureau of the Budget. The act provided a framework, but was by itself not enough to lower government spending. This would depend largely on the administration in charge, on the President's desire to cut spending, and on the actions and ideology of the director of the Bureau of the Budget.[143] These three factors ensured that the new budgeting system under President Harding was put to work to drastically lower government spending. Nevertheless, the passage of the National Budget Act indicated Harding's seriousness toward lowering Federal spending. The increased executive control over the budget enabled this ambition and made cutting spending much easier. The passage of the budget system was therefore an important aspect of Harding's laissez-faire spending policy.

[141] Cannadine, 2006, p. 281 and Marx, 1945, p. 670-671
[142] Rockoff, 1985, p. 379
[143] Seidemann, 1924, p. 49-50

3.2.2 The Bureau of the Budget and Charles Dawes

Harding knew the person he chose to fill the position of the Director of the Bureau of the Budget would be crucial to the success of his plans. He chose the conservative Chicago banker Charles Dawes for the job after reading an article written by him titled: "How a President Can Save a Billion Dollars." Harding offered the position to Dawes, saying: "let's save that billion dollars you wrote about."[144] When Harding had earlier offered him the Treasury Department, Dawes refused, telling the President: "As much as I would like to see your Administration a success, nothing could tempt me into public life now, except possibly Director of the Budget, if that office is created—and that I would take only for a year for the purpose of putting it in running order."[145]

Dawes had been an outspoken critic of the Wilson administration's spending policies. Acting as the head of the central Trust company in Chicago and addressing the Boston Chamber of Commerce in January 1921, he stated: "the primary responsibility for extravagance has been in executive administration" and protested "the riot of extravagance which has characterized departmental administration." Harding, he believed, would remedy this situation by replacing the bad people in government and utilize the budget system to ensure austerity.[146] Dawes even offered his own plans on how to achieve this long before he was appointed. In a February speech addressing the American Bankers Association, Dawes suggested that: "The very first step in reducing taxes and bringing economy and co-ordination into our Government is the consolidation of the Army and Navy Departments under one central head."[147]

On the 22nd of June, after the passage of the National Budget Act, Dawes was officially appointed as Director of the Bureau of the Budget.[148] He immediately asked that Harding call for an unprecedented meeting with 600 bureau chiefs and the entire

[144] Timmons, 1953, p. 200
[145] *Time Magazine*, 'National Affairs: The Logical Man', January 23, 1956
[146] *Wall Street Journal*, 'Dawes speaks for government economy', January 21, 1921
[147] *Wall Street Journal*, 'Dawes wants Army and Navy departments united', February 19, 1921 and Timmons, 1953, p. 203
[148] *Wall Street Journal*, 'Dawes for director of the budget', June 22, 1921

cabinet, to explain his plans and ideas.[149] In this meeting, on the 29th of June, Dawes held a passionate speech in favor of austerity and asked the cabinet heads and the President for latitude in judging their estimates and calculating expenditures.[150] Dawes explained that the new system required sacrifice from the cabinet members and asked the participants to respect his new function: "A Cabinet officer, as I see him, is on the bridge with the President, advising him on the direction in which the ship shall sail. He will not properly serve the captain of the ship or its passengers, the public, if he resents the call of the Director of the Budget from the stokehole, put there by the captain to see that coal is not wasted ... The way coal is handled and conserved determines how far in a given direction the ship will sail."[151] Dawes made clear that he had the support of the President and required their full cooperation. He immediately requested them to cut 25 percent of their budget, and pledged to do the same with his bureau. At the end of the speech, he asked all present to stand up and pledge to the President their dedication to help the country through the current depression and high unemployment by cutting spending.[152]

Harding then required all cabinet officials to appoint 'budget men' within their departments and emphasized the importance of austerity: "The present administration of the Federal government is committed to a period of economy and efficiency in government" because "there is not a menace in the world today like growing public indebtedness and public and mounting public expenditures."[153] Dawes' words had reached the bureau chiefs, and they knew they would have to cut their budgets.

On July first, in a more personal meeting between Dawes, Harding and the budget representatives of the various governmental departments, various measures were discussed to cut spending. Harding once more emphasized that Dawes had his full support: "He is going to have all the authority of this Government back of him." Harding believed this was necessary because: "It isn't any easy thing to change the habits of a

149 *Wall Street Journal*, 'Launches economy program', June 28, 1921
150 *Wall Street Journal*, 'Dawes wants free hand', June 29, 1921
151 *Time Magazine*, 'National Affairs: The Logical Man', January 23, 1956
152 *The New York Times*, 'Dawes puts whole government back of economy drive', June 30, 1921
153 Ibid.

century. It isn't an easy thing to stand up against those who want to spend."[154] Out of the meeting came a system of promotions and pay increases for bureau chiefs who managed to effect savings.[155]

Dawes immediately started drafting his first budget and undertook actions to ensure more efficiency. First, Dawes set out to conscript a hundred volunteer businessmen who would enact cuts and efficiencies in government. He asked them to volunteer for this task, or work for a symbolic $1 dollar annual salary, out of public service. Dawes also ensured that personal allies were placed in several departments. The War department for instance received a general and a colonel who had served under Dawes in the War and would be reliable liaisons.[156]

Another early move was an agreement with the head of the Government Printing Office, Charles A. Carter, to reduce public printing. Carter was apparently spurred by the new administration's zeal for budget cutting and proposed the enactment of "a permanent conference on printing, composed of representatives of the various departments and establishments of the Government, empowered to recommend or adopt 'uniform standards, business-like methods and proper economies in the public printing and binding, and the distribution of Government publications." Carter recommended that members of the legislative and judicial branches would be invited as well for greater coordination. He also called for a "requisitions review board to examine orders on the public printer for printing and binding with a view to determining before expensive work is undertaken whether the job so ordered is authorized by law, whether it will occasion waste or unnecessary duplication and whether any real economy could be effected […]." Dawes immediately agreed and the suggestions were put into effect.[157]

On the 30th of June, Dawes had been given thirty days to complete a first draft of the budget for the 1922 fiscal year. On the 19th of July, Dawes managed to send Harding

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[154] *The New York Times*, 'Budget machinery started by Harding', July 2, 1921
[155] Timmons, 1953, p. 205
[156] *Wall Street Journal*, 'Dawes to make draft on business leaders', June 24, 1921 and Timmons, 1953, p. 208
[157] *The New York Times*, 'Adopt plan to cut public printing', July 14, 1921

a letter with his first estimates of immediate savings. Senator Warren of Wyoming, chairman of the Senate Appropriations Committee, handed in his report of Congressional appropriations for the 1921 fiscal year the day before. Total Appropriations amounted to $5,337,996,722.23. In his letter Dawes expressed "That where Congress has directed the expenditure of certain sums for specific purposes, an executive pressure will now be exerted for more efficient and economical administration in order to […] complete the given project for a less amount than the total appropriated for the purpose." Fulfilling this vision, he stated with barely concealed pride: "I have, therefore, the honor to report $112,512,628.32 as the estimated savings in expenditures reported to me by the heads of departments and independent organizations […]." Dawes boasted: "Pretty good for nineteen days, huh." Savings would be made in the Treasury Department, the War Risk Bureau, the War Department, the Navy Department, the Interior Department and the Postal Service, with $30.3 million, $16 million, $15 million, $10 million, $19.8 million and $14.9 million respectively.[158]

The savings caused adjustments to estimated expenditures of the Federal government. In August, Mellon had still counted on expenditures of $4,554,000,000. However, "On August 10, 1921, it was announced after conference with the committee on ways and means and the President that the administration had determined to reduce this amount by $520,000,000, of which […] $350,000,000 would be through reduced ordinary expenditures. The administration thus announced its intention to keep expenditures for the fiscal year 1922 down to $4,034,000,000."[159] At the end of September Dawes confirmed these numbers and promised that he could deliver the necessary cuts.[160]

Other cost-saving measures were undertaken by the administration. Just before Christmas 1921, Harding signed an executive order, on the recommendation of Dawes,

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[158] *The New York Times*, 'Dawes announces cut of $112,512,628', July 20, 1921 and *The Washington Post*, '$112,612,628 saved, Dawes estimates', July 20, 1921
[159] *The Washington Post*, 'Deficits to Dawes', October 15, 1921
[160] *The Washington Post*, 'Dawes estimates cut totals $350,000,000', September 28, 1921

to create the 'Federal Personnel Board.' This commission would be tasked with improving the service and lowering costs of employment methods in government departments. The board operated under the civil service commission and could shift government workers between departments in need of extra manpower. Also, part-time government employees would be kept on, a system of personnel records would be developed and qualified personnel would be given promotions. Finally, the board was tasked with considering all matters relating to retirement, leaves of absence and other labor related questions.[161] This measure, implemented too late to have an effect in 1921, would ensure that the organization of Federal employees would be more flexible in the future and that costs could be brought down. In the coming years, this would add to the cost saving measures undertaken by the Harding administration.

Federal employees were also reduced in number. On July 31, 1921, there were a total of 597,482 active civil service members. On June 30, 1922, the number of active civil service members had been reduced to 560,863, a reduction of approximately 6.2 percent. The heaviest cuts occurred in Mellon's Treasury Department, who cut its employees from 73,230 to 55,970, a reduction of 23.6 percent. The Department of War reduced its numbers from 68,544 to 51,279, 23.2 percent less. The Navy went from 69,749 to 55,847 employees, a reduction of 20 percent.[162] The cuts in the War and Navy Departments reflected the demobilization and both executive and Congressional pressure to become leaner. The shedding of Federal employees throughout the government showed the department's need to economize.

Another administrational measure increased the frequency of the budget meetings of all major government officials to twice a year. The June 29th meeting was a success, and Harding wanted this repeated. Also, the bureau heads were now expected to deliver periodic reports of their departmental expenditure situation to the Bureau of the Budget on January 23rd and July 25th of each year.[163] This meant that on February 3rd

[161] *The Washington Post*, 'Federal Personnel Board', December 24, 1921
[162] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 638
[163] *The New York Times*, 'President calls economy meeting', December 22, 1921

1922, Dawes could again display zeal for budget cutting to the 1000 assembled bureau chiefs and department heads. He first congratulated them on $136 million saved and praised them for making possible a budget surplus. He then attacked those public officials who did not comply as "peewees" and "rat poison in breakfast food", and threatened that their efficiency records would be examined at the end of the year.[164] Dawes ensured that pressure remained on all government officials to increase departmental efficiency and to reduce spending.

When the year was over, Dawes did as he had promised and quit to go back to banking in Chicago.[165] Dawes proudly stated: "One cannot successfully preach economy without practicing it. Of the appropriation of $225,000 we spent only $120,313.54 in the year's work. We took our own medicine."[166] Dawes' zealous efforts had ensured total efficiency cuts of $250 million in the 1922 fiscal year.[167] It amounted to 6.4 percent of the Federal budget. Dawes' efficiency drive hereby formed an important part in Harding's ambition to reduce the Federal budget in size and cut government spending. It was a significant aspect of Harding's laissez-faire policy towards federal spending and the budget.

3.3.3 A Balanced Budget and the National Debt

Besides reducing expenditures, Harding wanted to balance the Federal budget. Due to war spending, the national debt had ballooned to more than $24 billion. At its peak, on August 31, 1919, the National Debt stood at $26.594 billion, up from $1.281 billion on April 5th, 1918, as a consequence of the war. President Wilson realized the debt was growing too large, and in the remainder of his term managed to reduce it by more than $2.3 billion to around $24.1 billion. Harding believed the situation was

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[164] *The New York Times*, 'President praises budget system as Dawes rakes chiefs', February 4, 1922
[165] *The New York Times*, 'Lord takes budget office', July 2, 1922
[166] Timmons, 1953, p. 209
[167] *The Washington Post*, 'President reports $1,600,000,000 saved by administration under budget system in current year', May 8, 1922

irresponsible and formed a threat to the economic wellbeing of the country. Balancing the budget and lowering the national debt would aid the economic recovery, set an example of thrift to American society.

In this, Harding was successful. Government spending remained behind revenue in the 1922 fiscal year, ensuring not only a balanced budget, but also a lower national debt.[168] Due to higher than expected cuts, the government ran a surplus of $313 million, adding to the part of the budget already designated to reduce the national debt.[169]

While Harding's surpluses and debt reduction were significant, they demonstrate previous academic flaws in the laissez-faire account of Harding's counter-recession measures. Thomas Woods for instance asserts that: "The national debt was reduced by one-third."[170] This is clearly not the case in 1921. This does not however detract from the significance of Harding's counter-recession measures. It remains a fact that instead of opting for 'pump-priming' deficit spending, Harding cut spending, produced a surplus and lowered the national debt. He managed this during a severe economic slump, with its resulting lower revenues, while also lowering taxes. Harding inherited a national debt of $24 billion, and had managed to reduce it to $22.964 billion at the end of fiscal year 1922.[171] In balancing the budget and lowering the national debt, Harding continued his laissez-faire policy on spending. Adverse effects of this lack of deficit spending did not materialize in the economic recovery after July 1921.

2.3.4 Congressional Austerity and Spending Pressures

Pressure for cuts in federal spending did not only originate in the executive branch, but was exerted by the Republican dominated legislative branch as well. Before

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[168] *The New York Times*, 'House adjourns, reconvenes Aug. 15', July 1, 1922
[169] *The Washington Post*, 'Republican economy', July 18, 1922 and *The New York Times*, 'President's message submitting the budget and the estimates made for 1922 and 1923', December 6, 1921
[170] Woods, 2009, p. 23
[171] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 613

it was complete, Congressional leaders and members of the Appropriations Committee tried to amend Dawes' budget plan. They considered proposed expenditures as maximum instead of minimum suggestions.[172]

With the war over, Congress focused heavily on the armed forces in their attempts to ensure lower spending. The Navy came under heavy scrutiny when it was discovered using much more oil than planned for 200 destroyers Congress had assumed were held in reserve. Congress exerted heavy pressure on the department for large cuts and greater economy in overheads. The Washington Post summarized Congress' newfound zeal for budget cutting, stating that the discussion about the appropriations for the armed forces: "discloses the spirit of economy in Congress. Every dollar of expenditure will have to run the gauntlet at the Capitol."[173]

However, there continued to be strong legislative pressure for spending increases. Two popular bills were the Federal Highway Act also known as the Townsend Good Roads bill, and the Veteran bonus bill. The Townsend bill saw its first Congressional hearings in 1920. The bill proposed that the Federal government should stimulate the construction of highways, and thereby improve infrastructure, increase employment and boost the economy. With rising unemployment, pressure for the bill increased in 1921. Senator Charles E. Townsend, a Michigan Republican submitted the bill in 1921 to a favorable reception. Congressional hearings on it began on May 13th, and it appeared to pass without much opposition. It was supported by a slew of powerful people such as Governor Boyle of Nevada, the president of the American Automobile Association George Diehl, Chief of Staff of the Army General John Pershing, and a large list of state highway commissioners and the President's conference on unemployment. The bill envisaged a system of interlinked highways between states, and would spend $200 million; $100 million for fiscal year 1922 and $100 million for fiscal year 1923. The money would be apportioned to the states according to strict guidelines and acceptance by the state legislature or the Governor. A Federal Highway Commission

[172] *The Washington Post*, 'Budget faces cuts', November 27, 1921
[173] Ibid.

would be created to centralize control over the issue of highways which would no longer be scattered over various government departments.[174]

The bill, although widely supported, was amended and lost a large part of its funding. Nevertheless, on November 10th, 1921, President Harding signed it into effect.[175] The amount to be allotted to the states would be $75 million, instead of the proposed $200 million. States would receive an amount of money from the Federal government equal to what they would spend on highways. In effect, this ensured that $150 million would be spent to stimulate highway spending. It was estimated to lead to the construction of 6,261 miles of highway employing 200,000 workers.[176] It was the most supporters of a Keynesian-like stimulus program to attack the economic downturn could achieve under the Harding administration.

Although this bill would seem to contradict the laissez-faire nature of the Harding Presidency, it was too small in size and significance to do any such thing. $75 million was only a fraction of the $1.6 billion that the Federal government cut its spending by in fiscal year 1922, as we will see in the final part of this chapter. Any Keynesian effects of such stimulus must therefore take into account the total reduction in government spending in fiscal year 1922. The net result renders this stimulus bill insignificant. Furthermore, using Kuznets' GDP figures, the $75 million amounted to approximately 0.12 percent of GDP in 1921. This was not enough to produce any significant stimulatory effect on the economy. Nevertheless, despite lackluster stimulatory measures, economic recovery resumed after July 1921 and grew stronger in 1922.

Beside roads, the Federal government initiated no other public work programs, as Otto Mallery, Secretary of the Committee on Public Works of the President's Conference on Unemployment would later write: "Aside from roads, Congress did not increase public works appropriations. The Reclamation Service expended for

[174] *Wall Street Journal*, 'What Townsend Bill will do for highways', June 6, 1921
[175] *Wall Street Journal*, 'Good roads bill signed', November 10, 1921
[176] *Wall Street Journal*, 'Highway building to be started by thirty states', November 16, 1921

construction in 1921 less than the ten-year average and less than one-half of the fund available. River and harbor and other public works appropriations were not increased and the normal appropriations were not made available earlier for use in the winter and early spring. Federal "economy" was held to preclude an increase of productive public work during the depression and to require postponement of new undertakings no matter how necessary or economical their immediate execution might be.” [177] Mallery was an avowed progressive and a supporter of Keynesian-like spending on public works programs to stimulate the economy. It is therefore no surprise that these words reflect his bitterness at the laissez-faire state of affairs under the Harding government. He clearly disagrees with the fact that the government was spending much less on public works, and with Harding’s overall austerity program. Harding’s drive for ‘economy’ effectively stopped progressive wishes for Federal public works spending. Nevertheless, Harding’s laissez-faire attitude toward public works, and Keynesian-like spending programs did not prevent economic recovery and substantial reductions in unemployment to occur after July 1921 and into 1922.

The Veteran bonus bill was a different spending issue. After the war, the US had tens of thousands of wounded and disabled veterans who needed government assistance. To thank soldiers for their duty in the First World War, and to compensate them for their losses and damages, Congress proposed to give them a small annual bonus. The bonus bill provided Harding with a problem; it distracted Congress from enacting tariff legislation and a new Revenue Act, Harding’s two main legislative goals for 1921. Furthermore, he wanted to cut government spending, and passage of the veteran’s bonus would throw a wrench in this plan. Harding therefore went to Congress to persuade it to delay the legislation. He emphasized that the country faced a difficult economic situation with high wartime taxation and increased government debt. Passage of the bonus bill would exacerbate this situation and make it impossible for the administration to lower taxes: “It is quite as unthinkable to reduce our tax burdens

[177] Mallery, 1923, p. 244

while committing our Treasury to an additional obligation which ranged from three to five billions of dollars. The precise figures no one can give. […] if the exercise of the option should call for cash running into billions, the depression in [*sic*] finance and industry would be so marked that vastly more harm than good would attend. […] A modest offering to the millions of service men is a poor palliative to more millions who may be out of employment." He also warned that: "the overburdening of the Treasury now means positive disaster in the years immediately before us. Merest prudence calls out in warning." Harding asserted that enough was already being done to help veterans recover from the war. The government had already spent large sums for training and rehabilitation of disabled soldiers. The bill would mean $400 million more was needed annually, "more than the entire annual cost of the Federal Government for many years following the Civil War". A majority in the Senate was impressed by Harding's speech and Senator Penrose immediately moved to refer the Veterans bonus bill back to the Finance Committee, effectively killing its progress.[178] In 1922 Harding successfully stopped another attempt to pass the bonus bill.[179] He now no longer had to worry about a sudden need to increase government spending for the veterans and could achieve his desired budget cuts and tax relief. Had the bill been passed, it would have meant a larger Federal budget and less room for tax cuts. Furthermore, Harding's actions towards this bill show his devotion to his laissez-faire spending program. By successfully opposing a very popular bill, he was able to ensure the spending and tax cuts he believed necessary for economic recovery.

2.3.5 The Federal Budget

On December 5th 1921, Harding presented his first budget to Congress. In his accompanying message he immediately opened with the numbers: "the total estimated

[178] *Wall Street Journal*, 'Harding says bonus now would imperil country', July 13, 1921
[179] *Wall Street Journal*, 'Bonus bill seems dead for the current session', February 24, 1922

expenditures for 1922 show a reduction under the total actual expenditures for 1921 of $1,570,118,323.30." Federal spending would drop from $5,538,040,680.30 in fiscal year 1921 (ending on June 30, 1921), to $3,967,922,366 in fiscal year 1922, and an estimated $3.5 billion for fiscal year 1923.[180] At the end of the budgetary year, in May 1922, actual expenditures numbers were $45.550 million lower than the estimates and were determined at $3,922,270,030. Harding's drive for austerity had managed to reduce the Federal budget by approximately $1.6 billion.

A significant part of the $1.6 billion savings consisted of military cuts. The War department (including rivers, harbors and the Panama Canal) was cut to $331 million by the Army appropriations bill, signed by the President on June 30th, reducing the army to 150,000 men.[181] The Navy Department was significantly reduced as well, from around $650 million to $417 million in fiscal year 1922. This was determined in the Navy Appropriations bill, passed by both houses of Congress on July 12th.[182] Total civil spending saw an even greater cut.[183] Using the government's estimates, these can be classified per department. Significant spending reductions were achieved in Mellon's Treasury department, cutting its size from $476 million to $169 million, saving some $307 million. Another important spending reduction came with the gradual phasing out of the 'Railroad Administration and Transportation act' which cut some $390 million from the budget. $60 million was saved in the Shipping Board and Fleet Corporation, $82 million in the Postal Service, $100 million in the Federal Board for Vocational Education, $90 million in the purchase of foreign obligations and farm loan bonds, $66 million in the War Finance and Grain Corporations, $10 million in the department of Commerce, $14 million in the department of Agriculture and $8 million in the Indian

[180] *The New York Times*, 'President's message submitting the budget and the estimates made for 1922 and 1923', December 6, 1921 and *The New York Times*, 'First Dawes budget cuts 1922 expenses to $3,967,922,366', December 6, 1921
[181] 'IV. The United States', in *Political Science Quarterly*, Vol. 36, No. 3, Supplement (September, 1921), p. 35 and Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 649
[182] 'IV. The United States', in *Political Science Quarterly*, Vol. 36, No. 3, Supplement (September, 1921), p. 34-35.
[183] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 649

service.[184] Some of these savings reflected a reshuffling of departments, as for instance the newly created Veterans Bureau centralized veterans affairs, and incorporated for instance the Bureau of War Risk Insurance, the Veterans Rehabilitation Division of the Federal Board for Vocational Rehabilitation and the Pensions Bureau, and formed a new $438 million item on the budget.[185] Nevertheless, these figures show that the austerity measures were widespread and affected most government departments.

The cuts that took place in the second half of 1921 and the first half of 1922, under the guidance of Harding and Dawes and with help from Congress, lowered Federal government spending by 29.2 percent, offsetting the lower revenues of the new Revenue Act. Federal spending, exclusive of debt repayment, now stood at $3.375 billion.[186] Compared with 1921, the estimated 1923 budget composed of a $2 billion or a 36.7 percent reduction in spending. Harding had clearly been serious when he talked about reduced government spending on the campaign trail, and his austerity drive had resulted in significant budget cuts.

To correctly understand the consequences of the budget cuts under the Harding administration, it is necessary to look at the spending effects on calendar instead of fiscal years. Government spending stood at $6.358 billion in the last year of the Wilson administration, at the end of 1920 (a two thirds reduction compared to 1919). Harding lowered spending to $5.062 billion in 1921, a reduction of $1.296 billion, or 20.4 percent. The cut was the size of 2.07 percent of GDP.[187] Spending was reduced even more in 1922 to $3,289 million, a further $1,773 or 35 percent decline. After 1922, the Federal government spent 51.7 percent of what it did at the start of Harding's presidency.[188] It is very significant that this cut the size of 2 percent of GDP occurred within the severe economic downturn. It is crucial to note that negative effects of these large-scale budget cuts did not materialize. Harding's laissez-faire policy toward

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[184] *The New York Times*, 'President's message submitting the budget and the estimates made for 1922 and 1923', December 6, 1921
[185] Ibid. and *The New York Times*, 'Veterans' Bureau Plan in Congress', May 26, 1921
[186] Timmons, 1953, p. 209 and Anderson, 1949, p. 79
[187] Kuznets, 1937, p. 8
[188] OMB Historical tables: Table 1.1: Summary of Receipts, Outlays, and Surpluses or Deficits (-): 1789-2016

government expenditures and the resulting large scale austerity cuts did not negatively impact the economic recovery that resumed after July 1921 and continued into 1922.

Previous analyses of the 1921 austerity measures contain inaccuracies in regards to the timing of the budget cuts. For instance, Woods' assessment that "Harding cut the government's budget nearly in half between 1920 and 1922" is accurate, but it should be emphasized that the 1922 budget cuts should be left out of the equation when considering the 1921 recovery.[189] Murphy makes a similar, but weaker statement on the Federal budget, stating: "From FY 1919 to 1920, federal spending was slashed from $18.5 billion to $6.4 billion – a 65 percent reduction in one year". This is correct, but irrelevant for judging the recovery of the 1920-1921 depression, as it describes the time period between July 1919 and July 1920. These cuts were undertaken by the Wilson administration as war spending was halted, and this therefore doesn't allow any conclusion about Harding's spending policies in the 1920-1921 depression. Murphy does state that: "The budget was pushed down the next two years as well, to $3.3 billion in FY 1922."[190] Once again, this is correct, but it deals with the time period between July 1920 and July 1923. Murphy neglects to make a specific point about 1921 spending and economic recovery.

This thesis argues that the timeframe of the spending cuts is crucial when evaluating the results thereof on the economic recovery. The latter half of 1921 presents the most important part of the timeframe for judging Harding's spending policy, as economic growth resumed at this time. In the second half of 1921, budget cutting was already well underway. In fact, Mellon made clear that in the first half of fiscal year 1921, Federal spending had already been reduced by $670 million. This was a decrease of some 12.5 percent in the federal budget, or about 1.07 percent of GDP.[191] Any weak recovery that had been started would, using Keynesian arguments, surely have been hurt by the spending cuts, and resulting reduction in aggregate demand. This

[189] Woods, 2009, p. 23
[190] Murphy, 2009
[191] *The Washington Post*, '$670,186,900 cut in US expenses', January 21, 1922 and Kuznets, 1937, p. 8

scenario did not materialize. The Harding austerity measures did not hurt, forestall or prevent economic recovery in the second half of 1921 and in 1922. The continued spending cuts also did not cause a relapse into an economic slump in 1923. Previous academic analyses of spending cuts positively affecting the 1920-1921 depression are in this instance accurate. However, this thesis argues that the timeframe of examining these cuts should be limited both to the calendar and fiscal year of 1921.

In addition, the phenomenon of regime certainty should also be considered when looking at the spending cuts. Economic historian Benjamin Anderson argues that "This [sound] policy on the part of the government, generated, of course, a great confidence in the credit of the Government, and the strength of the gold dollar was taken for granted. The credit of the Government and confidence in the currency are basic foundations for general business confidence."[192] The business and investment community was indeed very pleased with the budget cuts and Federal austerity. Paul M. Warburg, head of the International Acceptance Bank, director of the National Budget Committee, former Federal Reserve board member and an influential figure in the banking sector, praised both Harding and Dawes for the lower government spending, saying: "The executive branch of the Government has done its work - and done it well." He called for continued vigilance and pressure on Congress not to increase spending or take a "backward step in the matter."[193] Businessmen, bankers and investors saw that the President made good on his campaign promises. In spending policy too, the Harding administration ensured regime certainty, which had positive effects on business confidence and thereby on the economic recovery that took place after July 1921. This thesis therefore argues that the regime certainty induced from Harding's laissez-faire austerity measures was important to the economic recovery from the 1920-1921 depression.

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[192] Anderson, 1949, p. 80

[193] *Wall Street Journal*, 'Warburg urges success of first executive budget', December 8, 1921

2.4 Wage, Price and Unemployment policies

Any complete evaluation of a government's policies toward an economic downturn must take into account policies on prices, wages and unemployment, important fields where government interventions occur to counter a depression.[194] The root of some of these interventions can be found in the 1920-1921 depression. This thesis will examine whether the Harding government pursued laissez-faire policies in these fields.

2.4.1 Wage and Price Controls

The 1920-1921 depression witnessed the strongest monetary deflation in the history of the United States. Prices saw strong decreases, reaching 50 percent in some indexes. In the 1930's during the Great Depression, President Roosevelt tried to stifle price changes. After signing the National Industrial Recovery Act into life in 1933, Roosevelt used the newly created National Recovery Administration to mandate prices in numerous industries.[195] The Harding administration acted very differently in the 1920-1921 depression. Lacking a significant government effort to affect them, wages and prices were allowed to adjust naturally.

Harding held strong views on price controls, which he expressed in a speech late in the presidential campaign. When addressing government price-fixing of agricultural products, Harding stated: "[…] we know that there can be no repeal of natural laws—the eternal fundamentals. The history of the last three thousand years records the folly of such efforts. […] In times past, many nations have tried to hold down living costs by arbitrarily fixing prices of farm products. All such efforts have failed, and have usually

[194] Rothbard, 1963, p. 19-20
[195] Powell, 2003, p. 119-124

brought national disaster."[196] It becomes clear that Harding strongly believed in the negative effects of price controls, and none would be imposed by his administration. No significant policies were undertaken to support the agricultural community by artificially propping up prices. Instead, this laissez-faire stance left prices to naturally decrease, hurting farmers, but benefitting the American consumer and raising living standards.

On the issue of wages, Harding made many diplomatic statements. In his book 'Our Common Country', Harding stated that: "[…] for the high wage, the American workman shall give to his task the highest degree of efficiency. […] There isn't any other way to keep wages high and lower the cost of living to any appreciable degree."[197] In other public statements and in his acceptance speech to the Republican nomination, in July 1920, Harding spoke more clearly for wage reductions, saying: "I would be blind to the responsibility that marks this fateful hour if I did not caution the wage-earners of America that mounting wages and decreased production can lead only to industrial and economic ruin."[198] Harding believed that rising wages alone were not a good thing, and that they needed to be coupled with production increases to avoid negative economic consequences. Since industrial production was declining, Harding viewed increasing wages as counterproductive to achieve economic recovery.

Under Harding, wages were allowed to naturally adjust based on the market, and subsequently dropped significantly. The Railway Labor Board decided that from July 1st, 1921, wages of railway employees would be reduced by an average of 12 percent. Clothing workers in New York and seamen saw wage cuts of 15 percent. Tens of thousands of cotton workers' wages were decreased by 22.5 percent. Chicago Pullman Car Company employees voluntarily offered to take a 20 percent cut and 150,000

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[196] Harding, W.G., 'A Speech by Senator Warren G. Harding Delivered at Minnesota State Fair, September 8, 1920'

[197] Harding, 1921, p. 38-39

[198] Harding, W.G., 'Dinner in Celebration of the One Hundred and Twenty-fifth Anniversary of the Founding of the New York Commercial at the Hotel Commodore, New York, Monday evening. May 23, 1921.' And Harding, W.G., 'Speech of Acceptance of the Republican Party's Nomination to the Presidency delivered at Marion Ohio, July 22, 1920, by Senator G. Harding', p. 26

laborers for the US steel corporation saw a similar cut.[199] Other industries across the country pursued similar policies. Economists Richard Vedder and Lowell Gallaway estimate that: "in the 1920-1922 depression a roughly 20 percent fall in money wages was observed in one year".[200]

Throughout 1921, the Harding administration reassured businesses that it would not meddle with wages. After rumors had started that the government was mulling imposing 'standard wages' for various large industries across the country, Secretary of Commerce Herbert Hoover emphatically denied this, stating: "The Government is not going to tell anybody what wages to pay or whom to pay them."[201] Once more, this was an indication of regime certainty to businesses.

Harding's laissez-faire wage policy had significant positive effects on economic recovery. First of all, it showed businesses and investors that the Federal government would not intervene in propping up wages, increasing regime certainty and business confidence. Furthermore, unemployment started decreasing rapidly after July 1921 when wages had been allowed to adjust to the economic situation. The laissez-faire stance of the Harding administration towards wages allowed a natural correction to take place, prevented the arrival of 'Great Depression' type unemployment numbers and allowed for unemployment to start decreasing after July 1921.

2.4.2 Herbert Hoover and the Conference on Unemployment

In March 1921, Harding appointed Herbert Hoover as Secretary to the Commerce department. Hoover held strong views on what he wanted his department to become: "If I take the post it will only be if I have the support of Mr. Harding in making it a real Department of Commerce. Ever since it came into existence the bureau has been

[199] 'IV. The United States', in *Political Science Quarterly*, Vol. 36, No. 3, Supplement (September, 1921), p. 26-27, 51-54
[200] Vedder and Gallaway, 1997, p. 63 and p. 81
[201] *Wall Street Journal*, 'Hoover on Wages', May 6, 1921

the Department of Commerce in name only – a collection of scientific bureaus with little real power. […] I believe the Department of Commerce, properly reorganized, can be made to cover a large field."[202]

Hoover deemed a reorganization of the entire Federal Government necessary. He believed the problem was: "Such functions as public domain, public works, assistance to veterans, public health functions, aids to navigation, to industry, to trade, purchasing of major supplies, are each and every one scattered over from four to eight departments, most of which are devoted to some other major purpose. Economies can be accomplished from a public point of view by an elimination of the overlap in these different units of administration through unification into groups of similar purpose." According to Hoover, it was necessary to "secure effective concentration of government effort into service to the community." More centralization was necessary and the Commerce Department would play an important role in Hoover's newly envisioned Federal Government.[203] During the rest of the decade, he increased the power and reach of his department. He wanted it to be "the economic interpreter to the American people (and they badly need one)".[204]

Hoover's more expansive view of his department translated to the overall Federal Government. He championed a paradoxical mix of anti-statist thinking and positive views on centralized planning, and supported an increased government role in promotional activities, committees, conferences and providing information and support to associative groups and businesses in American society.[205] Hoover believed that: "We have reached a state of national development of such complexity [...] that we must have a national planning of industry and commerce."[206] He also believed that Adam Smith's model of individual competition could not work for twentieth century America, and that

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[202] *Wall Street Journal*, 'Hoover wants a real Department of Commerce', February 25, 1921
[203] Hoover, 1921, p. 119-122
[204] Hawley, 1974, p. 126-131 and Rothbard, 1963, p. 190
[205] Hawley, 1974, p. 117-121
[206] Hoover to Roy Cheney, 15 July 1923, "Herbert Hoover Personal: Government Ownership and Regulation, Personal File, Commerce Papers,", quoted in Arnold, 1980, p. 339

unemployment was a challenge for the viability of capitalism in the US.[207] Before he took office, shortly after the war, Hoover had drafted a 'Reconstruction Program' which featured increases in inheritance taxes, public dams and regulation of the stock market. These ideas were embraced by prominent progressives such as Louis Brandeis and Franklin Roosevelt, and he was popular among many Democrats.[208]

After assuming his post, Hoover vowed to combat unemployment. On July 28th, he tried to pressure Governors of all states into quickening road building projects to relieve unemployment.[209] His main initiative, however, was the organization of a Conference on Unemployment in September 1921.

Hoover invited 300 prominent industry and labor leaders to devise a national strategy for tackling unemployment.[210] In Hoover's vision, the Federal government would play an important role in such a strategy.[211] The Conference was based on ideas Hoover and several of his progressive associates held, to use public works and construction as a "balance wheel" on the economy, providing stimulus in depression, and slowdown during a boom period.[212] He described the idea as follows: "the deferment of public work and construction work of large public-service corporations to periods of depression and unemployment, which, while in the nature of relief from evils already created, would tend both by their subtraction from production at the peak of the boom and addition of production in the valley of depression toward more even progress of business itself."[213] Hoover and his progressive associates proposed implementing counter-cyclical policies to combat economic downturns.

President Harding clearly held a different view. Early in his presidential campaign, Harding declared: "There isn't any governmental part in fixing pursuit, profession or employment. Perhaps I ought to modify that and say—except during war.

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[207] Metcalf, 1975, p. 61
[208] Rothbard, 1963, p. 188-189
[209] American Association for Labor Legislation, 'Legislative Notes' in *The American Labor Legislation Review*, Vol. XI, No. 3, September 1921, p. 189
[210] Report of the President's Conference on Unemployment, 1921, p. 15
[211] Metcalf, 1975, p. 61 and Rothbard, 1963, p. 191
[212] Hawley, 1974, p. 131
[213] Hoover, 1923, p. vi

Government did interfere for the war, and we want to end that interference. We want a free America again."[214] This would not remain empty campaign rhetoric. In his speech, opening the conference, Harding proceeded to dispute the idea that the Federal Government should play a significant role in combating economic downturns and attacked the idea of public works as a balancing wheel.[215] He warned the attendees at the conference that: "I would have little enthusiasm for any proposed relief which seeks either palliation or tonic from the public treasury. The excess of stimulation from that source is to be reckoned a cause of trouble rather than a source of cure. We should achieve but little in a remedial way if we continued to excite a contributing cause."[216] It is clear that Harding opposed the idea of Federal government public works activism as a cure for economic downturns, and clang to his laissez-faire beliefs.

The Conference's conclusions were decidedly different, and more progressive. Hoover and his associates were in complete control of its agenda, direction and resolution. More than half of the Economic Advisory Committee that prepared the agenda and background reports for the conference belonged to the American Association for Labor Legislation, the AALL. The AALL was a strongly progressive organization that railed against a "do nothing" Congress and States, and "industrial autocracy", and argued for large-scale Federal government intervention on unemployment, wages and labor issues. Its members believed that "the principle of state intervention itself no longer stands in need of defense; for the laissez-faire theory is universally discarded".[217] The secretary of the Public Works Committee, Otto Mallery, was a longtime leading advocate for public works to alleviate depressions. He would later write that "decoys" were placed on the committees, for the sake of appearance.[218] The conference's conclusions reflected the progressive idea that more government planning was necessary to combat depressions, and that public works should be used to

[214] Harding, W.G., 'A Speech by Senator Warren G. Harding to Delegation from Wayne County, Ohio, Marion, Ohio, August 4, 1920', p. 46
[215] Rothbard, 1963, p. 191-192
[216] Report of the President's Conference on Unemployment, 1921, p. 26-27
[217] American Association for Labor Legislation, 'Introductory Notes' in *The American Labor Legislation Review*, Vol. XI, No. 3, September 1921., and p. 221-224
[218] Metcalf, 1975, p. 72

stabilize the economic situation. The conference urged more coordination on public works between all levels of government.[219]

The concrete results from the Conference varied in impact. Out of the conference came the Committee on Civic and Emergency Measures that provided relief to Americans in the winter of 1921 and 1922. The Committee's job remained limited to organizing and coordinating local organizations and it did not provide jobs or relief itself.[220] Unemployment Committees were organized with branches across the country, particularly in states with high unemployment, and 'Mayor's Emergency Committees' were set up in 31 cities.[221] Hoover describes its actions as follows: "We developed cooperation between the federal, state, and municipal governments to increase public works. We persuaded employers to "divide" time among their employees so that as many as possible would have some incomes. We organized the industries to undertake renovation, repair, and where possible, expand construction."[222] The Federal government played a coordinating role and was not engaged in the development of public works itself. Crucially, no federally executed public works resulted from the conference, as Harding stuck to his laissez-faire traditions, and economic recovery took place regardless of this fact.

In addition, the Conference created a boom in municipal bonds issued for public works by local governments. In 1921, a total of $1.383 billion in bonds was issued, more than double of any preceding year, which would seemingly undercut the laissez-faire account of the downturn. However, Otto Mallery warned against attaching too much importance to these bond sales, as: "The amount of work executed was, however, much less than the amount of bonds sold. The F. W. Dodge Company statistics for twenty-seven northeastern states show that about the same amount of public works was contracted for in that section in 1920 and 1921. The Engineering News-Record's figures for the whole country show a gain of 13 per cent in 1921 over 1920. Neither of these

[219] Report of the President's Conference on Unemployment, 1921, p. 19-22 and Rothbard, 1963, p. 192
[220] Hawley, 1974, p. 135
[221] Rothbard, 1963, p. 190
[222] Hoover, 1937, p. 41-42

sources account for more than one-third of the municipal bonds issued in 1921" Mallery explained that: "First, the letting of the contract often lags many months behind the bond sale. Second, large sales of bonds are often made for projects requiring several years to complete." Furthermore, it was sometimes unclear what the proceeds of these bonds were spent on: "the expenditure of a large percentage of the proceeds remains unaccounted for." Also, part of the bonds was designated for "non-productive purposes such as refunding, soldiers, bonus, etc." Mallery found that an increase in actual contracts awarded occurred only during the first half of 1922.[223] At this point recovery was already well underway. An NBER study on public works in the 1920's shows that actual impact of municipal bonds increases in 1921 was limited. In a survey of 27, mostly Northeastern states, total public construction contracts rewarded increased just slightly, from $762.356 million in 1920, to $771.009 million in 1921, hardly a seismic shift.[224] The increase in municipal bonds can therefore not be pointed to as a significant factor in the 1921 economic recovery.

Another result of the Conference was legislative action in Congress. On the 16th of November, Senator Kenyon from Iowa, a prominent figure in the Farm Bloc, introduced a bill providing for the long range planning of public works. Kenyon had submitted similar legislation in early 1919, to no avail.[225] After the Conference, he believed it would be passed. The preamble of the bill echoed Hoover's 'balancing wheel' desire. The bill gave heads of executive departments the authority to prepare public works and plan their construction in times of business depression, and greatly enhanced presidential power over the initiation or halting of public works.[226] Supporters of the bill ranged from the Chamber of Commerce to the American Federation of Labor, and believed that it could reduce unemployment during downturns by as much as one

[223] Mallery, 1923, p. 241
[224] Wolman, 1930, p. 111
[225] Mallery, 1923, p. 240
[226] Ibid., p. 248

third.[227] By February, the bill had come under unexpected and increasingly strong bipartisan fire. The primary fear was that it would destroy, rather than stabilize the economy, and that it would also greatly increase executive power over public works.[228] After an amendment was passed gutting it, the bill was sent back to the committee and died.[229] There were no other significant legislative moves to reduce unemployment. Even at the state level, with the exception of California and Wisconsin, legislative action was limited.[230] In fact, the secretary of the AALL, John B. Andrews, complained: "Acute unemployment continued throughout the year, yet Congress and more than forty States met in legislative session and adjourned with apparent indifference to the immediate need for adopting a constructive program for permanently combating the disastrous results of industrial depression."[231]

Hoover's plans for a full-scale federal attack on unemployment by public works and committees came too late and were too limited to have a significant effect on the economic recovery of 1921. The Federal government did not engage in public works or adopted anti-unemployment programs. Furthermore, Hoover found no support for many of his ambitious plans among the rest of the cabinet. His vision was different from that of Harding, Mellon and other conservative Republicans. While this benefitted Harding initially, as it allowed him to satisfy the progressive wing of the Republican party, it is not surprising that the relationship between Hoover and some conservative administration officials was strained by the differing ideological views. The conservative Mellon reportedly severely disliked Hoover, seeing him as rigid, narrow and "too much of an engineer". Mellon also detested Hoover's interference and expansion into areas formerly controlled by the Treasury Department.[232] Harding's conservative, laissez-faire

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[227] *The New York Times*, 'For Public Works to end Depressions: Kenyon Introduces Bill to Give Effect to Unemployment Conference Plans', November 22, 1921 and *The New York Times*, 'Favor Public Works Bill: Spokesmen for Business and Labor Support Kenyon's measure', December 22, 1921
[228] Mallery, 1923, p. 248
[229] *The New York Times*, 'Senators halt Kenyon Unemployment Bill', February 16, 1922 and *The New York Times*, 'Unemployment Bill Killed in the Senate', February 17, 1922
[230] American Association for Labor Legislation, 'Legislative Notes' in *The American Labor Legislation Review*, Vol. XI, No. 3, September 1921, p. 220
[231] *The New York Times*, 'New Labor Laws give big benefits', January 29, 1922
[232] Cannadine, 2006, p. 280

approach to Federal government action during an economic downturn won out. Hoover would have to wait nine more years to put his desired plans into action.

Despite Hoover's inability to enact an interventionist Federal agenda on public works, and Harding's persistent laissez-faire approach, the economy managed to recover after July 1921, and unemployment gradually decreased. Hoover's failure to enact his interventionist agenda turned out not to be necessary for economic recovery in 1921.

3. Federal Reserve Policy

In order to draw conclusions about the effects of Harding's fiscal policies, Federal Reserve policy during the 1920-1921 depression needs to be examined. If the Federal Reserve had pursued an interventionist strategy that led to the recovery of the second half of 1921, this would weaken the laissez-faire account of the 1920-1921 depression. If the Fed did not initiate significant monetary stimulus, allowing for liquidation to take place, conclusions about Harding's fiscal policy become more potent and the laissez-faire account of the crisis would be strengthened.

The Federal Reserve System was created in 1913 as a consequence of the Federal Reserve Act. A system of twelve regional banks was shaped that had a monopoly on money creation and could act as a 'lender of last resort'. Overseeing the twelve banks was the Federal Reserve Board, tasked with coordinating monetary policy between the banks. The act required specific amounts of reserves for banks, and allowed the Federal Reserve banks two broad policy tools with which to affect monetary policy; the discount rate and open market operations.[233]

3.1 Discount rate policy

As 1920 progressed, it became increasingly clear to Federal Reserve officials that the country was approaching or entering a severe economic downturn. Already in November and December of 1919, most Federal Reserve banks raised their discount rates to 4.75 percent. The late January and early February move to uniformly increase rates to 6 percent, by April had no effect on inflation, as prices were still increasing rapidly.[234] In a conference on the 18th of May 1920, the Federal Reserve Board made known the policy it would pursue. In his statement, Governor of the Board Warren

[233] Smiley, 2008
[234] Friedman, 1963, p. 229

Harding, not to be confused with President Warren G. Harding, announced that the Fed favored a policy that would "restrict credit and expand production, letting the expansion of production proceed at a greater rate than the reduction of credit." This would come about due to "a sensible and gradual liquidation", although he warned that "any attempt at radical or drastic deflation merely for the sake of deflation ... should be avoided."[235] The director of the Boston Federal Reserve bank supported these statements and added: "I also think that the rates for money should continue on a high level with the hope of causing liquidation in commodities. Of course, liquidation would result in low prices and the easing up of business. I do not think this body should encourage any drastic measures of readjustment. I think the deflation should be gradual [...]"[236] The Federal Reserve chose for a difficult, liquidationist and deflationist policy to reverse the inflationary bubble that had formed.

These words would soon be supported by actions, as the powerful New York Federal Reserve branch proposed to increase the discount rate from 6 to 7 percent. On June 1st 1920, the New York, Chicago and Minneapolis Federal Reserve Banks followed through and increased the discount rate on commercial paper to an historic 7 percent. The Boston branch followed on the 4th of June, Atlanta raised its rate on November 1st and Dallas finally followed on February 15th 1921. The remaining banks retained their 6 percent rate.[237] These rates would be maintained for almost a year, until April and May of 1921 and were implemented to end the inflationary spiral and price increases. It was an unparalleled move by the Fed, as this was "the highest rate that has ever been imposed by the System, before or since."[238]

The reaction to the rise in the discount rate was twofold. Many contemporary academics supported the Fed's discount rate actions. Sprague, professor at Harvard, argued that the Feds credit tightening policy was the right thing to do: "A period of

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[235] D'Arista, 1994, p. 56
[236] Ibid., p. 57
[237] Ibid., p. 59
[238] Friedman, 1963, p. 233

readjustment and liquidation was inevitable. Liberal credits at low rates in 1920 would have deferred its advent somewhat, but with the certain consequence that the difficulty and losses incident to readjustment would have been materially enhanced."[239]

There was much praise too from the business and banking communities, as bankers heavily supported the need to curtail the easy credit of preceding years. In the words of one banker: "I am in thorough accord with the actions of the Federal Reserve in raising its rates of discount. It is about time to have borrowers and the public generally realize the credit situation. […] it is necessary to […] call a halt in too free borrowing." Another head of a leading bank commented: "The action is a wise one, and it exactly reflects the real credit situation. The decision is sound, every way you take it, and is bound to create, or go a long step toward creating, a more sane use of credit." Paul Warburg, former Federal Reserve official, praised the discount hikes: "I believe increasing the discount rate of the Reserve Bank of New York is well advised." He too was concerned with the situation of loose credit and deemed the moves necessary "to bring to a halt this unbridled spirit of indiscriminate expansion and extravagance."[240]

However, the discount rate increases also caused a large amount of criticism. Criticism was heaviest from farmers and the Farm Bloc in Congress. Farmers were hard hit by the severe deflation of 1920 and 1921, and they viewed the Federal Reserve as the main culprit. Specifically the increased discount rate was blamed for the deflation, the lower prices of their agricultural products, and the credit restrictions which made it much more difficult for them to pay off their debts. Some of the agrarian attacks held that the Reserve banks purposefully withheld credit to the agricultural sector to enable Wall Street speculation, and that city banks were being favored over their rural counterparts. Statements by both the Governor and other Federal Reserve board members that deflation was not only necessary, but also unpreventable and 'natural', that commodity prices were too high and that a return to the pre-war price level was

[239] Sprague, 1921, p. 20
[240] *Wall Street Journal*, 'Higher Discount rates favored by bankers', June 2, 1920

needed, only increased their ire. Many Congressmen defended the farmers and vehemently attacked the Federal Reserve's actions.[241]

The Fed's discount actions have also come under much academic fire. Later economic historians have derided the discount rate increases as a lack of understanding by Federal Reserve officials on how to act in economic crises. Economic historian R.G. Hawtrey argued that Benjamin Strong, Governor of the Federal Reserve Bank of New York, was "blind to the disastrous results of maintaining high discount rates when activity had already given way to depression". Elmus Wicker, a professor at Indiana University, agreed with this assessment, and believed the Fed should have actively lowered their discount rate in order to stimulate economic activity.[242] Milton Friedman also criticized the Fed's behavior, both before and during the downturn. He argued that the Federal Reserve was much too late in raising its discount rate. He also believed that because of exaggerated attention to the gold reserve standard, the lowering of discount rates in 1921 was too little and too late.[243]

Eventually, criticism was voiced by administration officials as well. After assuming office in March 1921, Andrew Mellon repeatedly pleaded for lower discount rates. During his first meeting with the Federal Reserve Board in April, Mellon asked that discount rates be reduced to a maximum of 6 percent.[244] Pressure came from the President as well. While an April 12th Federal Reserve Governors Conference was ongoing, Harding told the press "that the Federal Reserve Board has to lower rates generally and help the farmers", thereby contradicting pro-deflationary statements made on the campaign trail. Ironically, this statement persuaded several proponents of this same policy to change their position so they wouldn't appear to be under presidential influence. [245]

That same month, the heavy political criticism of the high discount rate policy of the Fed began taking its toll. Inside the Federal Reserve System debates were waged on

[241] Link, 1946, p. 167-168 and Meltzer, 2003, p. 114 and 128
[242] Wicker, 1966, p. 230-232
[243] Friedman, 1963, p. 237-239
[244] Meltzer, 2003, p. 112-113
[245] Friedman, 1963, p. 234

whether to start decreasing the discount rate to reduce deflation. At the Governor's conference, it appeared only the Boston and Atlanta branches were in favor of the rate cuts proposed by Andrew Mellon. Benjamin Strong, Governor of the New York Federal Reserve bank strongly opposed rate cuts. He believed this would lead to speculation on the stock market and clearly stated: "I think the sound policy is to leave the rate unchanged." Strong believed that further liquidation needed to take place, that a rate reduction would not stimulate business conditions, but would lead to "a period of inflation with all the accompanying evils of speculation and extravagance."[246]

However, the advocates of rate cuts eventually won out, and the Boston branch reduced its rate by one point to 6 percent on April 15th. The New York bank followed shortly after with a 0.5 percent rate cut in early May. Strong indicated that political pressure was the reason for this cut: "So far as I can discover, the demand [for lower rates] comes from no other class than those engaged in agriculture. They made an impressive showing and their complaints reached all classes of Congressmen and executive officers of the government right up to the President."[247]

The rest of the Federal Reserve Board was more susceptible to the political pressure and on June 10th a memorandum was sent to all branches recommending a reduction of the discount rate to 6 percent. Within the month, all branches had decreased their rate. In July, the New York, Boston, Philadelphia and San Francisco branches lowered their rates by another 0.5 percent to 5.5 percent, which would remain at this level until the start of November.[248] Rate decreases are often considered inflationist policy and this would seem to indicate that the Fed chose a more interventionist approach to enact economic growth. This is not the case however, as there are several factors that limit the significance of these rate decreases. Firstly, market rates had already been trending downward (albeit slightly). The Fed therefore simply followed the market trend, although with more pronounced rate decreases.[249]

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[246] Meltzer, 2003, p. 113
[247] Ibid., 2003, p. 114-117
[248] Ibid.
[249] Appendix, Graph 4, p. 96

Looking back on the action, even Governor Strong believed that the discount rate decreases had little effect, as he stated at the Governors Conference of October 1921: "The reduction in our rate had no influence in the market. It was the competition to lend money that did it."[250]

Rates would also still be historically high. Meltzer calls it: "the only business cycle in Federal Reserve history where market interest rates on many instruments – including commercial paper, long-term Treasury and corporate bonds – were higher at the NBER trough than at the preceding peak."[251] Anderson too concludes that "At no time, however, did interest rates in the period, 1920-1923, go really low". Basing his findings on the 1927 Annual Report of the Federal Reserve Board, he shows that open market commercial paper rates in New York City fluctuated between a high of 7¾ percent and a low of 5 percent in 1921, and would be at 4 percent for the duration of only one month in 1922.[252] Crucially, the 'real long term interest rate' on commercial paper, accounting for the heavy ongoing deflation, actually lay much higher: "between 13 percent and 26 percent around the recession trough".[253]

A final factor that shows the limited impact of the rate decreases was the amount of bills discounted. As Milton Friedman explains: "a rise in discount rates tends to reduce the volume of discounting by member banks, hence to reduce Federal Reserve credit outstanding and to tighten credit conditions, and conversely." However, Friedman warns that market conditions should be taken into account for judging the effect of discount rate policy: "A rise in rates may therefore be consistent with an easy-money policy if it is less than the rise required to offset other factors making for a higher level of market rates, and conversely."[254] Instead of solely looking at the lower rates, it is better to look at the effects of the lower rates. Whereas it would be expected that the lower rates would lead to an increase in discounting, and therefore an increase in the money stock or money supply, the exact opposite was occurring. As Friedman shows,

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[250] Meltzer, 2003, p. 126
[251] Ibid., p. 117
[252] Anderson, 1949, p. 85
[253] Meltzer, 2003, p. 118 and Murphy, 2009
[254] Friedman, 1963, p. 272

there was a sharp drop in 'Bills discounted', from around $1.75 billion to $400 million between July 1921 and September 1922, leading to a tightening of credit conditions and further deflation during the start of economic recovery.[255] Rothbard agrees with this assessment and put the bottom of the number of bills discounted in August 1922.[256] Federal Reserve numbers further show that the largest decline of bills discounted actually took place between July and December 1921. The total number of bills discounted decreased from $1.771 billion on June 29th, to $1.179 billion on December 28th.[257] Credit conditioned therefore tightened even after the rate decreases. Further evidence of this is reflected in the money supply, or the monetary base. If the lowering of the discount rate had a stimulative effect, the monetary base, or the money supply would have to reflect this. This will be examined in part three of this chapter.

It should be concluded that despite lofty campaign rhetoric about attempting "intelligent and courageous deflation", this was cast aside under pressure of agrarian discontent.[258] In asking for monetary stimulus, Harding and Mellon acted decidedly 'un laissez-faire'. However, the lack of significant monetary consequences to this executive pressure does not undercut the actual laissez-faire fiscal policy of the Harding administration.

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[255] Friedman, 1963, p. 272-273
[256] Rothbard, 1963, p. 111
[257] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 532.
[258] *The Washington Post*, 'Assails Ship Board', September 25, 1920

3.2 Open Market operations

The Fed's second important policy tool, under section 14 of the Federal Reserve Act, was the so-called 'open market operations'. In 1920 and 1921, this was still relatively new to the central bank. Open Market operations allowed the Fed the "purchasing and selling of federal government securities, short-term securities of state and local governments issued in anticipation of taxes, foreign exchange, and domestic bills of exchange."[259] It was a policy tool mostly designed to aid in making discount rates effective.[260] By buying up securities, the Fed *de facto* created money and increased the money supply, arguably providing a temporary stimulating effect on the economy.

Near the end of 1921, the Federal Reserve System made limited use of open market operations. Between June 28th and December 28th, the Federal Reserve bought approximately $84 million bills on the open market, in either bankers' or trade acceptances, increasing its assets from $31.6 million to $114 million, not even half of the December 28th 1920 level.[261] Professor Robert West registers this increase in open market paper and places most of it between the months of September and December.[262]

There was movement in Government securities as well. Both Friedman and Meltzer note that the Reserve Banks purchased a total of almost $400 million in government securities between October 1921, and May 1922, with the vast majority of purchases taking place in February and March of 1922.[263] Professor Wicker is in agreement with Friedman, and also sees Federal Reserve banks initiating the purchase government securities, but specifically dates it between January and June 1922.[264] Federal Reserve records show an increase in United States securities held by Federal Reserve banks from $241 million on December 28th, 1921, to $603 million on May 31st

[259] Smiley, 2008
[260] Meltzer, 2003, p. 141
[261] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 532.
[262] West, 1977, p. 191
[263] Friedman, 1963, p. 251 and p. 271; Rothbard, 1963, p. 110-113 and Meltzer, 2003, p. 143
[264] Wicker, 1966, p. 59-60

1922.[265] This 'stimulus' took place six or seven months after economic recovery had started. Between July 1921 and January 1922, the crucial months of economic recovery, Federal Reserve records document a decrease in the amount of US government securities held from $257 million to $241 million at the end of December, interrupted by two brief periods of minor increases between August-September and October-December.[266]

Friedman warned strongly against attaching too much importance to these purchases, as "open market operations were not yet coordinated but were being carried out by separate Reserve Banks, which engaged in purchases primarily to increase earnings rather than as a part of a general credit policy", a development that Meltzer too concludes.[267]

Rothbard further dampens the significance of government securities purchases by the Fed, by showing that uncontrolled bank reserves, directed by the general public rather than the government, fell by $303 million between July 1921 and July 1922, causing a net increase of only $157 million.[268]

More figures show the limited significance of the open market operations. Total treasury securities held by the Fed at the end of 1920 were $287.4 million and total bankers' acceptances $187.2 million, to make for a total of $474.6 million. At the end of 1921, the Fed held between $234.1 million and $241 million in treasury securities, and $145 million in bankers' acceptances, a total of between $379.1 million and $385 million.[269] In 1921, Federal Reserve holdings had decreased by some 20 percent.[270]

Total open market purchases by the Fed stood at much lower levels than previous years. Purchases of bankers' acceptances had been $1.748 billion in 1918, $2.788 billion in 1919 and $3.143 billion in 1920. In the first nine months of 1921, these

[265] As will be seen, it would be tempered by a continued drops in Bills discounted and Federal Reserve notes in circulation.
[266] Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 532; West, 1977, p. 191
[267] Friedman, 1963, p. 251, p. 271 and Meltzer, 2003, p. 142-143
[268] Rothbard, 1963, p. 103, 109 and 113
[269] Ibid.
[270] Marshall, 2002, p. 48 and Friedman, 1963, p. 271

purchases amounted to only $996 million. Interestingly, June until October 1921 show 40 to 60 percent lower monthly purchases than the first six months of the year.[271] Purchases of trade acceptances, although a much smaller part of open market operations, show an even stronger decline. Purchases of these acceptances stood at $61 million in 1918, at $36.5 million in 1919 and at $74.6 million in 1920. After the first nine months of 1921, this number had decreased to only $6.6 million. Here too, activity in the months June until October was much lower than it had been in the first five months of the year.[272]

The $83 million increase in bills bought on the open market between June 28th and December 28th 1921, was rendered inconsequential by the $16 million decrease in US government securities held, the $592 million decrease in bills discounted, or the $180 million decrease of Federal Reserve notes in circulation during that same time period.

Two conclusions can be drawn from these developments. Although the Federal Reserve System conducted open market operations in 1921, it was on a very limited scale, without much coordination or intent, and too insignificant to provide an economic stimulus. Finally, the majority of open market operations occurred after January 1922, when economic recovery was already almost six months underway. Open market operations therefore did little to impact the economic recovery.

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[271] The average monthly purchase of bankers' acceptances from January until June was approximately $139 million. From June until October, purchases averaged around $75 million, 53 percent of the January-June level.

[272] The average monthly purchase of trade acceptances from January until June was approximately $1.26 million. From June until October, purchases averaged around $0.066 million, 5.2 percent of the January-June level.
Agger, 1922, p. 216

3.3 Effects on the Money Supply

Despite higher market and discount rates in 1920, it wasn't until November that an actual, significant decrease in the money supply started. The decrease would persist throughout 1921 and into 1922 and was aided by the record number of 560 bank failures in 1921.[273]

Between October 22nd and December 28th 1920, the amount of Federal Reserve Notes in circulation dropped slightly from $3.356 billion to $3.344 billion.[274] This trend then started to accelerate. On February 28, 1921, the amount of Federal Reserve Notes in circulation had dropped to $3.048 billion and by May 31, 1921, it stood at $2.751 billion.[275] The decline persisted in the final half of 1921, during the economic recovery. Federal Reserve Notes in circulation declined from $2.634 billion on June 28th to $2.443 billion on December 28th 1921.[276]

Another indicator of monetary deflation, or lack of monetary stimulus by the Fed, was the amount of outstanding Federal Reserve credit. Friedman explains: "An increase in Reserve credit tends to expand the quantity of money and to ease conditions; a decrease, to reduce the quantity of money and to tighten credit conditions." Friedman notes a sharp drop in Reserve credit between July 1921 and the beginning of 1922, the start of economic recovery, from approximately $2.1 billion to $1.25 billion. It isn't until 1922 that Reserve credit stabilizes.[277] Rothbard shows a similar decline of $996 million between July 1921 and July 1922.[278]

Friedman also shows that the amount of so-called 'High-powered money', money under the control of the Federal Reserve System, experienced a sharp decline all throughout 1921. From January 1922 till March 1922 a small uptick can be seen bringing

273 Friedman, 1963, p. 235 and D'Arista, 1994, p. 62
274 *Wall Street Journal*, 'Decrease in Federal Reserve Notes indicates deflation', November 24, 1920
275 Link, 1946, p. 173
276 Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 532 and *The New York Times*, 'Financial Markets', January 18, 1922
277 Friedman, 1963, p. 270-271
278 Rothbard, 1963, p. 109

the level of high-powered money back to the December 1921 level. The changes in the amount of high-powered money are reflected in the total 'money stock', and here a similar pattern can be seen. The open market operations of some of the Reserve branches between October 1921 and March 1922 don't produce more than a small temporary uptick in the money stock between October and December 1921.[279] In Friedman's words: "the stock of money declined fairly steadily until the reference trough in July 1921, then flattened out, and reached bottom in January 1922." In other words, the Federal Reserve did not affect the money supply between July 1921 and January 1922, deflation still continued.[280]

Finally, if we look at the monetary base there is almost no increase to be seen. Using data from the Federal Reserve Bank of St. Louis it is clear that the money supply saw a very small increase, only in December 1921. Afterwards, the money supply continued its downward trend, dropping in January and reaching its lowest level since August 1918 in February 1922.[281] The sharp reduction in the monetary base translated to deflation throughout 1921. As was shown in chapter one, the CPI declined by an annual average of 10.5 percent throughout 1921.[282]

These decreases in the monetary base and the money supply took place despite large inflows of gold into the country. The New York Times estimated that 1921 saw an influx of $872 million in gold.[283] Meltzer reports that the monetary gold stock rose by 28 percent in 1921, "moderating the effects of falling discounts on the monetary base and the money stock" and increasing the gold reserve ratio of Federal Reserve banks. Despite this gold inflow however, both the monetary base and the money stock declined.[284]

[279] Friedman, 1963, p. 273
[280] Ibid., p. 232
[281] Appendix, Graph 5 and Graph 6, p. 96-97
[282] U.S. Department of Labor, Bureau of Labor Statistics, 'Consumer Price Index: All Urban Consumers (CPI-U)'
[283] *The New York Times*, 'Financial Markets', January 18, 1922
[284] Meltzer, 2003, p. 118-121

These facts shows that Federal Reserve operations, with the slight exception of December 1921, did not significantly impact the money supply, and therefore weren't a substantial intervention in the 1921 US economy. The economic recovery that took place between July 1921 and January 1922 started without benefiting from any significant monetary stimulus. In fact, it got underway while substantial deflation was still ongoing and the monetary base was still in decline.

It can be concluded that no Federal Reserve stimulus policy aided economic recovery in 1921. Neither the effects of the lowering of the discount rate, the limited open market operations, the money supply or the monetary base give indications of any significant monetary stimulus, and instead point to deflation. There is widespread academic agreement with this assessment. Economic historian Kenneth Weiher concludes: "Despite the severity of the contraction, the Fed did not move to use its powers to turn the money supply around and fight the contraction."[285] Keynesian economist Robert Gordon argues: "The Federal Reserve authorities were largely passive."[286] Finally, Meltzer says: "The economy recovered despite these high rates and the restrictive Federal Reserve policy."[287]

Previous academic studies of a lack of significant Federal Reserve actions to stimulate the 1921 economy are accurate. As Woods summarizes: "The Federal Reserve's activity, moreover, was hardly noticeable."[288] Economic recovery in the second half of 1921 proceeded during a deflationary period, without any significant monetary stimulus from the Federal Reserve. Also, although small increases in the money supply occur after March 1922, no substantial increases in either the monetary base, the total earning assets of the Federal Reserve, or the amount of Federal Reserve notes in circulation take place until September that year.[289] Government CPI figures for

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[285] Weiher, 1992, p. 35
[286] Gordon, 1974, p. 21-22
[287] Meltzer, 2003, p. 118
[288] Woods, 2009, p. 23
[289] The total earning assets of the Federal Reserve consists of a combination of total bills discounted, bills and US securities bought on the open market and municipal warrants.
Department of Commerce; Bureau of Foreign and Domestic Commerce, (1923) 'Statistical Abstract of the United States: 1922, forty-fifth number', p. 532.

1922 show that prices continued to deflate significantly, declining by an annual average of 6.1 percent.[290] Economic growth in most of 1922 therefore occurred with continuing deflation. This shows that there was no active, stimulatory monetary policy, and this gives more weight to the fiscal policy of the Harding administration in the 1920-1921 downturn. Nevertheless, despite the absence of significant stimulatory monetary policy throughout 1921, the economy managed to recover after July 1921.

[290] U.S. Department of Labor, Bureau of Labor Statistics, 'Consumer Price Index: All Urban Consumers (CPI-U)'

Conclusion

This thesis now arrives at its conclusion, and the need to answer the question to what extent Harding's policies to combat the depression were laissez-faire and what impact they had on the hard-hit economy.

First of all, Harding's campaign and early days in the presidency were filled with laissez-faire statements and pro-market plans for combating the depression. Harding stated clearly that he wanted tax relief, government cuts (economy) and a less burdensome and smaller Federal government. Harding also expressed his views on the need to let wages and prices readjust, and let deflation occur unhampered. We have seen that the business and investment community heartily approved of these views and fully supported Harding during his campaign and Presidency.

Secondly, significant tax reform took place under the Harding administration with the passage of the 1921 Revenue Act. The appointment of the conservative Andrew Mellon, as Secretary of the Treasury coupled with the administrations leaked intentions of substantially lowering taxes, are important. After tough negotiations with Congress, important tax relief was passed with large adjustments to the income and corporate income tax, and scrapping many luxury taxes and the Excess Profits Tax. Taxes on investors and businessmen were strongly decreased and investments shot up accordingly. Harding's tax policy was laissez-faire as it decreased taxation to spur private enterprise and wealth.

This thesis argues that previous studies linking the direct effects of Harding's tax relief to economic recovery in 1921 are inaccurate, as the new tax regime went into effect on January 1922. This thesis instead proposes that the Harding tax relief had an important *indirect* effect on economic recovery in 1921, due to the phenomenon of regime certainty. The approaching tax relief improved the outlook of investors, businesses and high income individuals on their economic situation, leading to investment increases, hiring and growth on the stock and bond markets. Only through regime certainty did the laissez-faire tax measures of the Harding administration have a significant and positive impact on the 1921 recovery. In addition, regime certainty and business and investor confidence was increased through other actions and measures of the Harding administration, such as the campaign rhetoric, tax reductions, significant austerity measures and the wage- and price policy reassurances of the administration. Regime certainty is a crucial addition to, and improvement on previous studies of the 1920-1921 depression, and forms a crucial part of the answer how the Harding administrations laissez-faire policies managed to enact the 1921 economic recovery.

Finally, it should be noted that the 1921 Emergency Tariff, enacted on Harding's urging, was a protectionist piece of legislation that was far removed from the rest of Harding's laissez-faire fiscal policy. However, the tariff remained limited in size and scope, it was minor compared to overall fiscal policy and its effects were of little insignificant to the economic recovery.

Thirdly, there are the changes in the Federal budget. The passage of the National Budget System, resulting in Charles Dawes' role as the zealous head of the Bureau of the Budget, which in turn resulted in reforms, savings and increased efficiency the size of 6.4 percent of the Federal budget. Furthermore, Harding managed to avoid deficit spending, balanced the Federal budget and reduced the national debt by $1 billion in 1921. Aided by Congressional austerity pressures, and successfully withstanding most of Congress' pressure for spending, Harding managed to reduce Federal spending from $6.358 billion in 1920 to $5.062 billion in 1921, a reduction the size of 2 percent of GDP. More critically, a significant spending cut of more than one percent of GDP occurred in the second half of 1921, when economic recovery started. Harding's laissez-faire, austerity policy toward the Federal budget, and the subsequent spending cuts of 1922, did not hurt economic recovery.

Next, there is the area of wage, price and unemployment issues. Harding held clear views on wage and price controls, no significant federal action was undertaken and prices declined rapidly, raising living standards for the average consumer. Wages were allowed to naturally decline as well, and the administration promised not to intervene to artificially prop them up. On unemployment, Harding resisted Hoover's interventionist inclinations, and Kenyon's legislative action designed to create an active role for the Federal government in constructing public works to counter the depression and unemployment. The Conference and Committees on unemployment arrived too late and its consequences were too limited to contribute to the economic recovery of 1921. Harding's laissez-faire attitude toward Federal government involvement during an economic downturn prevailed and the administration's policies in these fields were mainly laissez-faire. Nevertheless, unemployment dropped and the economy managed to recover after July 1921.

Finally, in the field of monetary policy there were strong discount rate increases in 1920, reaching 7 percent. These were followed by smaller discount decreases from May 1921 that did not alter the deflating money supply. Open market purchases were limited in scale, occurred after economic recovery had started, and did not significantly affect the deflating money supply. The money supply and monetary base decreased throughout 1921 and far into 1922 which translated to CPI decreases of 10.5 percent in 1921 and 6.1 percent in 1922. The Federal Reserve did not significantly stimulate the economy or impact the economic recovery that started in the second half of 1921. No significant stimulatory monetary policy occurred to offset Harding's laissez-faire fiscal policy.

This thesis concludes that Harding pursued a predominantly classic laissez-faire policy to combat the 1920-1921 depression. British historian David Cannadine summed it up well when he stated: "Not since the laissez-faire heyday of McKinley at the turn of the century had Washington seen an administration so unequivocally in favor of private enterprise and individual self-advancement."[291] Taxes were significantly reduced, Federal government spending was cut substantially, deficit spending was avoided, the national debt was lowered, government policies on wages, prices and unemployment were decidedly laissez-faire, and the administration created a climate of regime certainty among businessmen and investors. In addition, no significant monetary intervention by the Federal Reserve occurred to stimulate the economy and protectionist measures were limited in their size and scope. Harding's predominantly laissez-faire program had beneficial effects on the economic recovery and unemployment decreases that took place in the latter half of 1921, and continued strongly into 1922. Negative effects due to the lack of significant monetary or fiscal stimulus, or due to ongoing deflation and Federal budget cuts, did not materialize. Historians and policy makers should take note of the intriguing lessons this offers.

[291] Cannadine, 2006, p. 277

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Appendix

Graph 1:

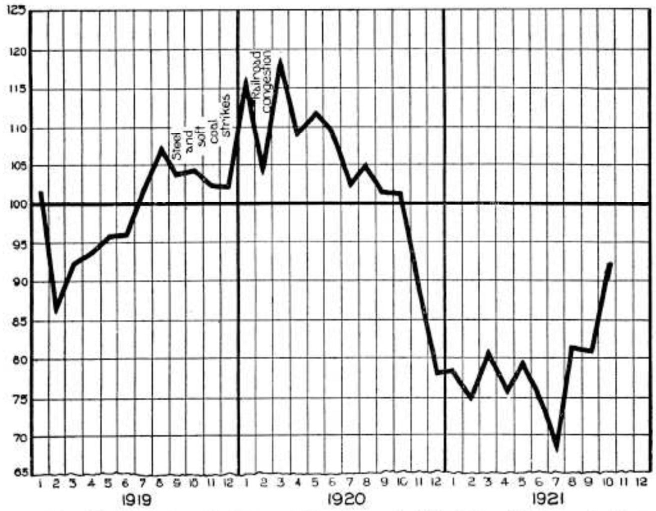


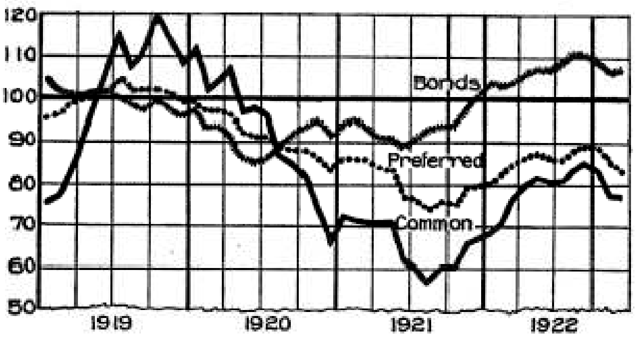
Chart II.—The Index of the Volume of Manufacture for Eight Industrial Groups Combined (iron and steel, lumber, paper, petroleum, textiles, leather, food and tobacco), Monthly, 1919-21.

(Persons, 1922, p. 12)

Graph 2:

CHART 6. — PRICE INDICES OF TWENTY COMMON STOCKS, TWENTY PREFERRED STOCKS, AND TEN RAILROAD BONDS

(*Average for 1919 = 100*)



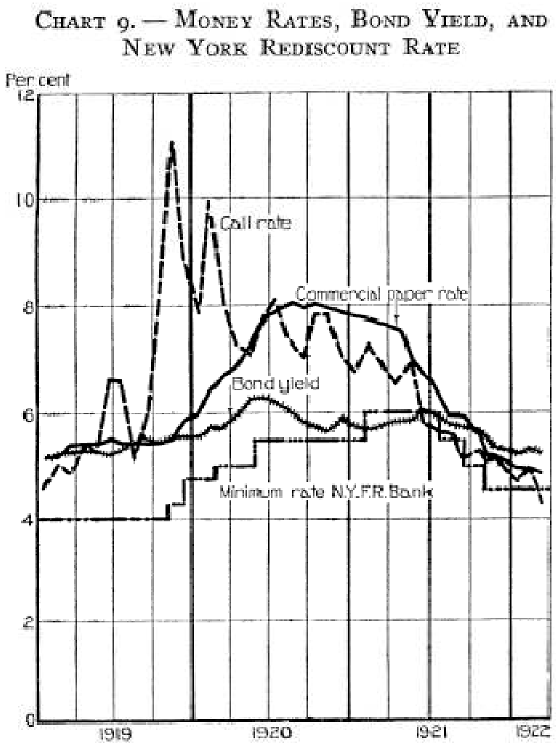
(Persons, 1923, p. 6)

Graph 3:

CHART 7. — PRICE INDICES OF STOCKS OF TEN GROUPS OF MANUFACTURING COMPANIES
(*Average for 1919 = 100*)

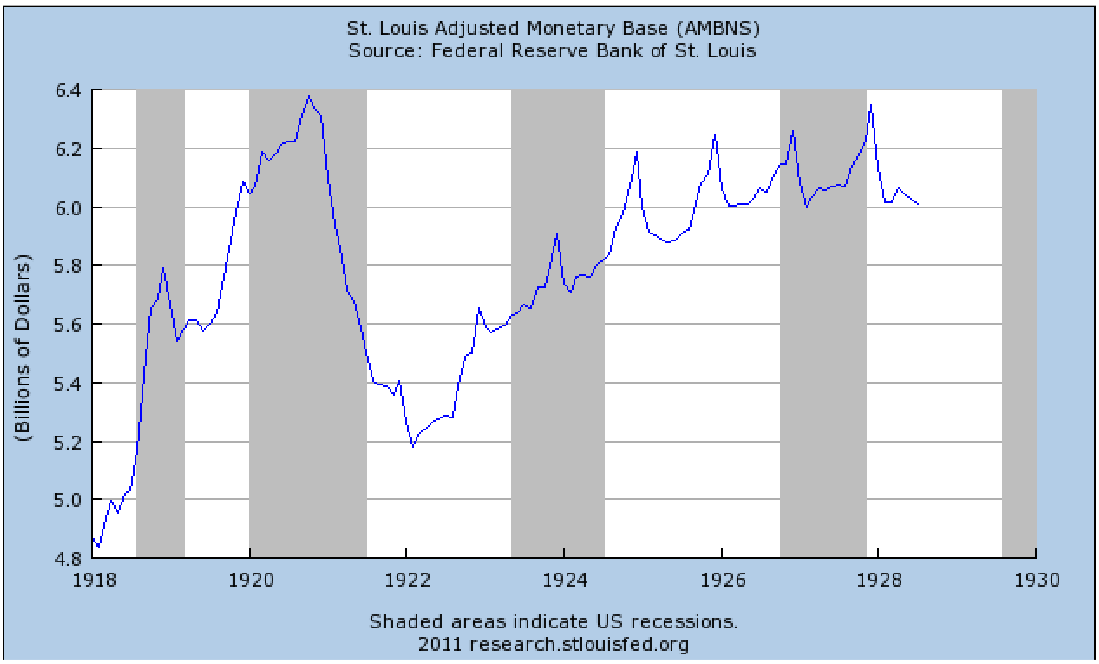
(Persons, 1923, p. 7-8)

Graph 4:

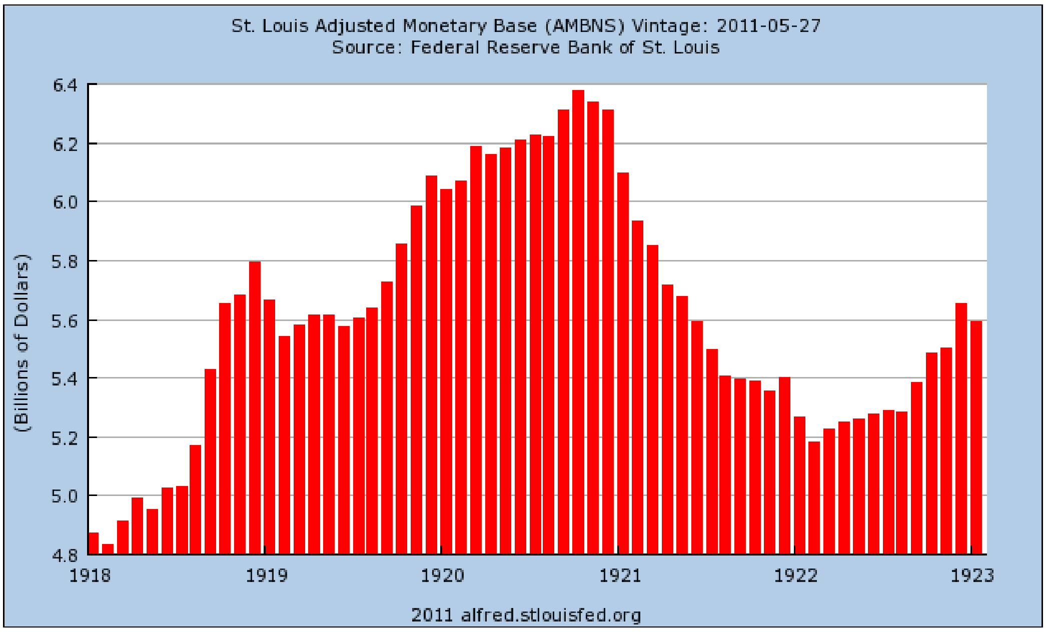


(Persons, 1922, p. 60)

Graph 5:



Graph 6:


St. Louis Adjusted Monetary Base (AMBNS) Vintage: 2011-05-27
Source: Federal Reserve Bank of St. Louis
(Billions of Dollars)
6.4
6.2
6.0
5.8
5.6
5.4
5.2
5.0
4.8
1918
1919
1920
1921
1922
1923
2011 alfred.stlouisfed.org