

LABOR BUSTED, RISING INEQUALITY AND THE FINANCIAL CRISIS OF 1929: AN UNLEARNED LESSON

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ABSTRACT: Although the Great Depression and the financial crisis of 1929 that triggered it have been endlessly studied, there is little consensus and even much puzzlement as to why they occurred. This article claims that beneath the many causal factors that have been advanced lie deeper underlying determining forces that have received less notice: wage stagnation and the dramatic increase in inequality following World War I. Wage stagnation and rising inequality fueled three dynamics that set the stage for a financial crisis – the focus of this study --and contributed to the duration of the depression that followed. The first is that consumption was constrained by the smaller share of total income accruing to workers, thereby restricting investment opportunities in the real economy. Flush with greater income and wealth, the elite flooded financial markets with credit, helping keep interest rates low and encouraging the creation of new credit instruments, some of which recycled the rich’s surplus assets as debt to those less well off. The second dynamic is that greater inequality pressured households to find ways to consume more to maintain their relative social status. As a result, household saving rates declined, households took on greater debt, and may have worked longer hours. The third dynamic is that, as the rich took larger shares of income and wealth, they gained relatively more command over everything, including ideology. Reducing taxes on the rich, favoring business over labor, and failing to regulate newly evolving credit instruments flowed out of this ideology.

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The Great Depression looms large in U.S. history and has been extensively studied. Yet there is little consensus as to why it happened. Ben Bernanke avers that “To understand the Great Depression is the Holy Grail of macroeconomics” (2000: 5). Paul Krugman claims that “...the Great Depression had no obvious cause at all” (2001: 36). For Peter Temin, “...one of the problems with modern views of the Depression has been an absence of causes” (1991: 35). James claims “The unique feature of the American panic is that no one has ever been able convincingly to explain what caused it...” (2010: 132). This article claims that there is an explanation, albeit one that requires looking beyond the narrow scope of mainstream economics to political and social economics. From this broader perspective, the triggering event for the Great Depression, as well as its duration, can be understood as the result principally of wage stagnation and exploding inequality.

Although inequality remained an underlying reason why getting out of the crisis was so challenging, because severe policy mistakes, the gold standard, and uncertainty also contributed to the severity and duration of the Great Depression (Friedman and Schwartz 1963; Temin 1991; Romer 1990), and because of space constraints, attention in this article will be limited to what created the setting for its triggering event, the financial crisis of 1929. A need to re-examine this

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earlier crisis is suggested by the financial crisis of 2008.

Not all students of the 1929 financial crisis have been as timid as those noted above.² In fact, many have been in agreement that low interest rates, financial innovation, indebtedness, excessive speculation, and laissez-faire ideology supporting lax regulation played important causal roles. While this analysis is not incorrect, it addresses proximate as opposed to more profound underlying causality.³ At this deeper level, the preconditions for the crisis were being set by wage stagnation and dramatically rising inequality.

Given the importance Keynes assigned to it in accounting for inadequate aggregate demand, it is surprising that so little attention has been given to inequality, much less growing inequality, as a potential causal factor in the 1929 crisis.⁴ A glance at highly influential treatises on the Great Depression, e.g., Bernanke (2000), Friedman and Schwartz 1963, 1965, and Temin (1976, 1989) finds no mention of a role for rising inequality in the generation or perpetuation of that crisis.⁵

However, although most students of the crisis of 1929 ignore any role of increasing inequality, a few who draw upon Keynesian/Kaleckian underconsumptionist thought have recognized the importance of rising inequality for aggregate demand, given that the marginal propensity to consume is lower among higher than lower income households. Galbraith noted “The bad distribution of income...[as one of his] five weaknesses [that] seem to have had an especially intimate bearing on the ensuing disaster” (1954: 177). Hughes points out that the building boom of the late 1920s ended as “demand simply died off...It was not the case that the country was suffering from an excess of housing, but, given the distribution of family incomes, demand was exhausted” (1987: 434). Faulkner notes “the tendency to pile up wealth where it would be used chiefly for further expansion of industrial units rather than to place it in the hands of those who would use it to purchase manufactured commodities” (1960: 642). Potter speculated that “the failure to redistribute incomes, especially towards the end of the 1920s, must be held to have been instrumental in holding consumption down below its fullest potential and...to have increased saving at a time when the economy required even further increases in spending” (1974: 68). Livingston (1994; 2009) and Stricker (1983-84) place considerable importance directly on rising inequality, although their perspective is far narrower than that developed in this article. In response to critics who claim that had demand been inadequate, then prices would have adjusted downward, underconsumptionists point to rigidities that

² For Christian Saint-Étienne, “...the causes and the consequences of the Great Depression can be identified with reasonable certainty” (1984: xiii).

³ An example is provided by White who notes that “many of the hypotheses offered to explain the 1929 boom and bust...played trivial or insignificant roles [and his evidence] favors that a bubble was present in the 1929 market” (1990: 67). However, he does not provide an explanation of the underlying dynamics for why a bubble evolved.

⁴ What makes this even more surprising is that even well before Keynes, the role of rising inequality in reducing consumption and thus production was recognized by many earlier economists. Indeed, as early as the end of the 17th C, Pierre de Boisguilbert noted that the distribution of income in favor of the rich who would hoard much of it and away from the poor who would spend it contributed to the disastrous decline of the French economy during the reign of Louis XIV (Boisguilbert 1695).

⁵ Friedman claimed that the Great Depression was not a failure of capitalism, but instead a failure of government, most notably by permitting the money supply to shrink. Although this claim has been contested, it was nevertheless a failure of government in another sense. A government controlled predominately by an elite permitted and fueled an explosion in inequality.

precluded adequate adjustment (Stricker 1983-84).

This article provides a more systematic and comprehensive treatment of the manner in which wage stagnation and rising inequality set the stage for the financial crisis of 1929. While the analysis of the causal importance of rising inequality developed in this article fits into the Keynesian/Kaleckian underconsumptionist school, it offers a far broader perspective by drawing upon Thorstein Veblen's theory of consumer behavior and Karl Marx's theory of ideology. These theoretical perspectives will clarify how declining labor power and greater inequality generated three dynamics that heightened conditions in which a financial crisis might occur.

The first was how the threat of inadequate demand resulting from far greater inequality was countered by two forces: a fall in household saving, and increased household indebtedness as a portion of the increasing surplus income and wealth of an elite was recycled to the less well off as debt. This rise of indebtedness among those who spend most of their income was abetted by an ever-richer elite flooding financial markets with credit and thereby helping keep interest rates low and encouraging the creation of new credit instruments. This first dynamic as to how stagnating wages and rising inequality set the pre-condition for the financial crisis of 1929 draws its explanatory framework broadly from the structural explanations in the theoretical tradition of Marx, Keynes, Kalecki, and Minsky.

The second dynamic was the consumption response of non-elite households to smaller relative income shares. As the wealthy with far greater income and wealth ratcheted up their consumption, especially on homes, automobiles, and other newly evolving consumer durables, consumption externalities were created that put pressure on those below to consume more to maintain their relative social status, their social respectability, and thus their self-respect. To do so, households saved less, augmented their indebtedness, and perhaps increased their work hours. Veblen's rich theory of consumer behavior provides a deep social understanding of the manner in which rising inequality affects household behavior.⁶

The third dynamic is that a wealthy elite's possession of an ever-rising share of society's resources enabled their increasing command over political ideology. This ideology legitimated laissez faire economics and the busting of labor's bargaining power. Reducing the size of government, tax cuts for the rich, deregulating the economy, and failing to regulate newly evolving credit instruments flowed out of this ideology. Further, political attention was diverted from economic to cultural issues. The 1920s saw political combat over such issues as evolution, prohibition, immigration, and the increasingly militant Ku Klux Klan.⁷ This third dynamic – the greater command over social ideology by the rich as inequality rose – has its roots in Marx's theory of ideology and is developed by analyzing the manner in which right-wing doctrines spread and influenced public policy following World War I.

Financial crises were hardly new. They had been endemic to the workings of capitalism

⁶ Veblen's theory of consumer behavior has been all but ignored by mainstream economics. James Duesenberry drew upon Veblen's theory to explain the empirical problems faced by Keynes' consumption function. However, as Taylor points out, "it lacked rational actor 'foundations,' which is the main reason why it has almost completely disappeared from view" (2010: 227).

⁷ This diverting of attention to cultural issues is evident in Coolidge's rejection of "the appeals of the American Jewish Committee for a clear-cut denunciation of the Klan during the campaign of 1924" (Edsforth 1998: 265). At its peak in the 1920s, the Klan claimed as members one of every six eligible Americans and was the country's largest private organization. The culture wars of the 1920s died out once the Great Depression refocused attention on the economic struggle for income and jobs.

from the beginning. Recovery was usually quick, mostly because the major consequence was the destruction of a great deal of paper wealth held by a small wealthy elite. What distinguishes the crisis of 1929 (and that of 2008 eight decades later) is that the speculative mania preceding it occurred not only in the stock markets, but in the real estate market as well. Real estate markets are more democratic than stock markets in that a larger share of the population, by taking on debt, participates in ownership, and thus a collapse of a speculative bubble in real estate has consequences that are far greater and potentially far longer lasting.⁸ In addition, real estate ownership possesses a social characteristic that is special: for a large number of households it constitutes not only the most important store of wealth, but also the most important symbol of social status. Although less important as stores of wealth, in addition to their utility, automobiles also played a major and increasing role in signaling status after World War I.

Busted Labor and Rising Inequality

The industrialization of the United States unleashed forces that dramatically increased inequality, conforming to a dynamic that Kuznets (1955) believed accompanied the earlier phase of economic development. The increase in inequality after the Civil War, although continual, witnessed two surges. The first began at the end of the Civil War and lasted until about 1900. It was this explosion in inequality and the behavior that accompanied it that led Veblen to write his most noted work, *Theory of the Leisure Class*, in which he laid out his theory of conspicuous consumption. The second surge began at the end of World War I and lasted until the late 1920s.

The economy during this second period leading up to the crisis of 1929 appeared economically healthier than ever. Growth of economic output averaged 5.9 percent per year between the end of the recession in July 1921 and August of 1929, in spite of two mild recessions (1923-24; 1926-27), while unemployment averaged 3.7 percent (White 1990: 69). This growth rate is extraordinary when compared to the long-run average growth rate of 3.0 percent for the U.S. economy (Hall and Ferguson 1998: 17).

However, labor's relative power was being busted. Popular support for labor weakened and union membership declined from about 17.4 percent in 1921 to about 10.5 percent by 1929 (Ohanian 2009: 2320). With the economic and political bargaining power of workers undermined, it is not surprising that wages relatively stagnated, resulting in productivity gains outpacing wages, with important distributional consequences. As Long pointed out, "So large is labor's share of national income that any substantial disparity between productivity and real wages would exert great impact on the other shares – either largely expropriating them or presenting them with huge windfalls" (1960: 112).

During the 1920s, with its bargaining power compromised, labor confronted technological innovations that were predominantly laborsaving and concentrated in manufacturing, causing a shift in demand for labor away from unskilled labor and toward more skilled labor.⁹ Low-skilled assembly-line workers were being replaced by laborsaving capital while the demand for more skilled workers such as machine repairmen increased, resulting in lower wages for the former relative to the latter (Hall and Ferguson 1998: 21).¹⁰ Labor

⁸ Gjerstad and Smith support a similar interpretation: "The hypothesis we propose is that a financial crisis that originates in consumer debt, especially consumer debt concentrated at the low end of the wealth and income distribution can be transmitted quickly and forcefully into the financial system" (2009).

⁹ Western notes that a high-tech revolution led by companies such as RCA during the 1920s gave the period a character not unlike the late 1990s (2004: 166).

¹⁰ Williamson and Lindert have estimated that technological innovation during the 1920s increased the premium for skilled labor by 0.98 percent per year (1980: 247).

productivity grew at an average annual rate of 5.44 percent between 1919 and 1929 (Smiley 1010: 9). Although total manufacturing output increased by 64 percent during the decade, the total number of workers in that sector remained almost constant (Stricker 1983: 22), resulting in the share of wages in manufacturing revenues declining from 52 percent in 1922 to 43 percent in 1929.¹¹ Between 1923 and 1929 weekly earnings declined about 20 percent in manufacturing, and about eight percent in steel production (Bernstein 1966, 66-67). Increasing productivity flowed almost exclusively to corporate profits, increasing them 62 percent enabling dividends to double.

The windfalls for the rich resulting from wages lagging behind productivity growth were further nourished by tax “reforms” that reduced corporate taxes and lowered the maximum personal income tax rate. President Calvin Coolidge and his Treasury Secretary Andrew Mellon energetically campaigned to drastically cut taxes on the highest incomes, and the large tax cuts undertaken in 1921, 1924, and 1926 benefited only the wealthy. Marginal tax rates that had been as high as 75 percent on net income above \$500,000 were reduced to a highest marginal rate of 25 percent on net incomes above \$100,000 (Smiley 1998: 218).¹² In 1926 the gift tax was repealed and in 1928, the estate tax was cut by one-half. Although these taxes had been raised to support the war, had the pro-labor Progressive Era political values survived into the 1920s, social programs might have been expanded in lieu of tax cuts on the rich.

According to Smiley’s revisions of Kuznets’ data, the share of total disposable income received by the richest one percent of the non-farm population increased from 19.1 percent to 24.6 percent between 1919 and 1929; the richest seven percent from 36.2 to 44.8 percent. This means that the share of the lower 93 percent fell from 63.8 percent to 55.2 percent (1998: 220). Their real per capita income increased at an average rate of \$5.64 per year, or 2.56 percent for the whole period (1998: 224). The share of total wealth held by the top one percent rose from 36.7 percent to 44.2 percent (Wolff 1996). Phillips estimates that whereas there were about 7,000 millionaires in 1921 or 1922, by 1929 there were about 30,000 (2002: 11). The real prosperity of the 1920s was reserved for those residing at the top of the income scale (Bernstein, 1966; Stricker 1985).

Inequality, Weak Aggregate Demand and Speculative Excess

The elite’s increased share of income and wealth was far greater than could readily be spent, even on the most lavish consumption.¹³ Whereas in 1922 the top one percent of income recipients accounted for 49 percent of total U.S. saving, by 1929 they accounted for 80 percent (Hall and Ferguson 1998: 21).¹⁴ With huge additional saving, they and their money managers sought to place these increased assets to maximum effect. But given the fact that those who

¹¹ Bernstein finds that wages as a percentage of value-added in manufacturing fell from 45.0 in 1923 to 36.9 in 1929 (1998: 198).

¹² These tax cuts foreshadowed repercussions for aggregate demand. Galbraith notes that “As practical experience with past tax reduction has shown (and as was duly reported by the Council of Economic Advisors), the initial effect of a cut in personal taxes is overwhelmingly to increase savings” (1979: 29-30).

¹³ Nevertheless, they did spend prodigiously: “...the top 10 percent made 36 percent of all food expenditures and 50 percent of all expenditures on non-essential items like recreation, health, and education” (Stricker 1983: 8).

¹⁴ Stricker reports that by 1929, the top decile of income distribution had 86 percent of total household savings, and thus the bottom 90 percent accounted for only 14 percent (1983-84: 50).

spend most or all of their income had a smaller share of total income to spend, profitable investment potential in the real economy was limited. Suggesting inadequate consumer demand, Hall and Ferguson claim that the mild deflation during the 1920s (an average of about 0.5 percent per year between 1921 and 1929) was traceable to the fact that the expansion in aggregate supply outpaced increases in aggregate demand (1998: 18).¹⁵ As a result, funds flowed into the financial sector, where they increased employment by 400,000 between 1925 and 1929 (Stricker 1983-84: 53).

Although new consumer durable goods such as automobiles, refrigerators, electric irons, and radios were driving forces for much of the economic dynamism of the early decades of the twentieth century, rapidly rising inequality during the 1920s constrained demand for these products.¹⁶ Nevertheless, a decline in household saving and the rapid expansion of installment credit permitted consumers to continue increasing their purchases, although rising indebtedness meant that this would ultimately be limited by creditworthiness and the need to pay down the debt. Watkins reports that “By the late 1920s, credit was used to finance up to 90 percent of the purchases of durable goods” (2000: 917).¹⁷ During the 1920s, short-term personal loans from personal finance companies soared by more than 1,200 percent. A more than doubling of nonmortgage consumer debt sent it to \$7.6 million by 1929, or 9.3 percent of income (Olney 1999: 321). Even major automobile companies were setting up financial divisions to make loans for the purchase of their cars. By 1927, two thirds of new cars were being purchased on credit (Eichengreen and Mitchener 2004: 203, 214). Stricker concludes that “Consumption-demand lagged behind potential output of consumption goods, and only installment credit and upper-class consumption smoothed over that problem for a while” (1983-84: 55). What was occurring was that a portion of the greatly increased share of income and wealth accruing to the elite was being recycled to those below as debt.

This negative inequality effect on investment opportunity in the real economy was augmented by robust increases in productivity, resulting in net investment in the real economy declining even as output expanded. Investment in plant and equipment, for instance, declined from \$15.5 billion in 1926 to about \$14.5 billion annually over the next three years (Stricker 1983-84: 51). Investment in construction also declined in the late 1920s (Stricker 1983-84: 52). Livingston reports that “According to Moody’s Investors Service...the proportion of net new corporate securities issues which was used ‘productively,’ for capital construction, declined from 62 to 29 percent between 1924 and 1929” (1994: 114-15). Suggesting a dearth of good investment options for retained earnings, dividends as a share of national income rose from 4.3 percent in 1920 to 7.2 percent 1929, about 82 percent of which were paid to the wealthiest five percent of Americans (Hall and Ferguson 1998: 21).

¹⁵ Rather out of character, a banker noted that “capital kept too much and labor did not have enough to buy its share of things” (cited in Hicks 1960: 230). So too the president of Sun Oil Co. proclaimed in an annual report in 1932 that “If a larger share of prosperity’s profits had gone to wages, there would have been more consumption and less speculation” (cited in Livingston 1994: 114).

¹⁶ Major durable goods spending as a percent of total spending increased from 4 percent in the 1898-1916 period to 7.6 percent in the 1922-29 period (Olney 1991: 25).

¹⁷ There was very little regulation of new credit instruments. Although the Progressive Era in the U.S. saw the rise of regulatory agencies, after the war, the regulated exercised increasing control over the regulators. There appears to have been predatory lending. Olney notes that “...the effective rate of interest ...was generally in the neighborhood of 30 to 40 percent but sometime ranged as high as 100 percent for installment contracts (1999: 322).

Investment funds were being switched from the production sector to the financial sector,¹⁸ greatly stimulating innovations in credit instruments and speculation that nourished a real estate bubble which developed and burst prior to the subsequent speculative frenzy in the stock market.¹⁹ As households below the top struggled ever-harder to maintain their relative social status, they became more indebted as a portion of the enlarged income and wealth of the elite was recycled to them through these more sophisticated financial markets.

Thus, despite a drop in the share of income of those with the highest marginal propensity to consume, economic growth continued nonetheless. Growth appeared, in Kalecki's terms, to be profit-led as opposed to wage-led.²⁰

The financial crisis of 1929 could sneak up on the economy because the dominant focus was on surface reality, on the fact, for instance, that growth was highly robust and price deflation was very mild. However, beneath this surface, wage stagnation and dramatically rising inequality were shifting investment from production to finance and speculation,²¹ thereby giving poignancy to Keynes's observation that "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation" (1936: 159). During the 1920s, speculative excesses sequentially occurred in two different sectors, first in real estate which crashed in 1926 and then in the stock market which crashed three years later.

Speculative Fever Leading Up to 1929

Before World War I, households frequently financed their purchase of homes by borrowing from family and friends. But urbanization and the expansion of financial institutions flush with assets and thus offering attractive credit conditions encouraged borrowing from institutional lenders. Whereas financial institutions provided about 45 percent of financing before World War One, this rose to about 60 percent by 1925 (White 2009: 24-25). Mortgage lending increased by 55 percent between 1922 and 1925 as the real estate market heated up, and mortgage debt rose from \$9.35 billion in 1920 to \$29.44 billion in 1929. Whereas residential

¹⁸ Schumpeter provides data on the explosion in the value of new capital issues of financial companies during the latter part of the 1920s (1939: 878).

¹⁹ Thus in contrast to Smiley's contention that "There are no definitive answers to why the [stock market] boom or why it gathered such strength at the end of the decade" (2002: 10), exploding inequality is offered as the answer. Hall and Ferguson point out, "There are many [e.g., Sirkin 1975; Bierman 1991; Santoni 1987] who contend that the gains in stock prices were quiet reasonable given the fundamentals of the mid- and late 1920s" (1998: 28). Yet Shiller points out that the stock market P/E ratio rose from a low of five in the early 1920s to a peak of 32.6 in September 1929 (Shiller 2005 www.econ.yale.edu/~shiller/data/ie_data.xls. Last accessed January 30, 2013).

²⁰ The empirical possibility of profit-led growth has been investigated in Bowles and Boyer (1995), Stockhammer and Onaron (2004), Barbosa-Filho and Taylor (2006), and Fernandez (2005). While these studies have opposing and incongruent results, the mere existence of a decreasing wage share accompanied by economic growth strongly suggests that growth must have been taking place in sectors other than consumption. Taylor argues that "Whether aggregate demand was wage- or profit- led [during the 1920s] is impossible to say. But it seems clear that saving from higher incomes at the top of the distribution in part flowed toward the stock market and fed into the boom" (Taylor 2010: 104). In any event, during the 1920s, growth predominantly took place in the financial sector, the designated playground of those with far more income than they would choose to spend. Keynes himself had claimed that "...a genuine profit inflation developed some time between [1927] and the summer of 1929" (Keynes 1930: 2: 190).

²¹ The dearth of attractive domestic investments in the real economy also led to soaring investments abroad (Stricker 1983-84: 50).

mortgage debt was 10.2 percent of household wealth in 1920, it rose to 27.2 percent in 1929 (Gjerstad and Smith 2009).²² As further evidence of speculation in real estate, from 1924 until 1927, the ratio of residential housing construction to GNP was at “by far its highest level of the twentieth century” (Gordon and Veitch 1986: 326). White claims that “...the nationwide ‘bubble’ that appeared in the early 1920s and burst in 1929 was similar in magnitude to the recent real estate boom and bust.” Residential housing starts reached “a peak in 1925 that was not surpassed until 1949.” The percent of households owning homes increased from about 45 to 50 percent. Commercial banks, insurance companies, and savings and loan associations “expanded their total mortgages by 76, 79 and 62 percent” between 1920 and 1926. Further, there was a wave of securitization of residential and commercial mortgages (2009: 1, 5, 50, 25-26, 29).

The bubble was pricked by a severe September 1926 hurricane that created widespread devastation in Florida where the boom had been most robust (Galbraith 1954).²³ Housing prices that had soared about 20 percent in the early 1920s, declined by about 10 percent before the stock market crash.²⁴ Foreclosures increased every year until the Great Depression (White 2009: 47). A relative decline in demand for consumer durables, especially automobiles, occurred after the real estate bubble popped in 1926.

Following the collapse of the real estate market, investment funds flowed more aggressively into the stock market²⁵. Indeed, the stock market boom only fully took off when real estate prices began declining. The stock market boom was fueled in part by the explosion of investment trusts (much like today’s closed-end mutual funds), which grew from about 40 in 1921 to more than 750 in 1929 (Carosso 1970). Investment trusts were financial innovations created by banks as “off-balance sheet” entities to shield their speculative activities from the scrutiny of regulators. Further, “Risk-taking by financial institutions in the boom of 2000-2006 was cloaked by use of off-balance sheet operations” (White 2009: 33). Toward the end of the 1920s, trusts came to hold the stocks of other leveraged trusts, creating a Ponzi-like structure.²⁶ Galbraith pointed out that “During 1928 an estimated 186 investment trusts were organized; by the early months of 1929 they were being promoted at the rate of approximately one each

²² Gjerstad and Smith write that “It appears that both the Great Depression and the current crisis had their origins in excessive consumer debt – especially mortgage debt – that was transmitted into the financial sector during a sharp downturn” (2009). They do not, however, link this debt to rising inequality.

²³ Galbraith (1954) viewed the real estate bubble as instrumental in setting the stage for the Great Depression. After 1926, foreclosures on nonfarm residential mortgages rose at an increasing pace until the onset of the Great Depression (White 2008: 15). White notes that “Where the collapse of the housing market may have had its strongest impact was on the balance sheets of households and financial institutions” (2008: 32). Although the residential market peaked in 1926, the commercial market continued to boom for the rest of the decade (White 2009: 31).

²⁴ The coup de grace to real estate came in 1929 when the Federal Reserve raised interest rates in an attempt to calm excessive stock market speculation. Smiley notes that the Federal Reserve had temporarily lowered interest rates in 1924 and 1927 to boost stock prices (2002: 10).

²⁵ White notes that “The market for industrial securities, which first emerged in the 1880s, came of age in the 1920s, as both old and new corporations issued equities to finance new plant and equipment” (1990: 69).

²⁶ Galbraith characterized “financial innovation” as “the invention of the wheel over and over again, often in a slightly more unstable version (1990: 19).

business day, and a total of 265 made their appearance during the course of the year. In 1927 the trusts sold to the public about \$400,000,000 worth of securities; in 1929 they marketed an estimated three billions worth” (1954: 49-50).²⁷ The Dow-Jones Industrial Index rose from 91.0 in 1922 to 290.0 in 1929, most of this rise occurring after the real estate bust. The index rose 29 percent in 1928 and another 30 percent in 1929, with 25 percentage points of the latter occurring in June, July, and August before peaking in September. Trading volume more than doubled in the last two years prior to the crash.

In the last few years before the stock market crash, there was enormous growth in loans by corporations to brokers who, with interest rates rising, were able to command higher returns on margin loans to speculators. With inequality-induced weak aggregate demand, corporations found higher profits in financial markets than in investments in the real productive capacity of the economy. Evidence of the speculative frenzy was that in spite of high real interest rates on brokers’ loans, stock market investors were seemingly unfazed as they borrowed ever more (Rappoport and White 1993). Hall and Ferguson note that “Loans to brokers totaled \$7.63 billion in 1924 and then rose to \$26.53 billion by 1929...while weekly rates on margin loans averaged 8.56 percent... individuals were paying 8.56 percent to borrow to buy stocks paying dividend yields averaging 2.92 percent” (1998: 24-25).²⁸

With a plethora of credit fueled by tremendous increases in the income and wealth of the very rich, overly expansionary monetary policy, inflow of foreign monies,²⁹ and greater use of financial instruments, financial institutions were tempted to take ever-greater risks. As Eichengreen and Mitchener put it, “The credit boom and its ultimate impact were especially pronounced where the organization and history of the financial sector led intermediaries to compete aggressively in providing credit” (2004: 186).

Rising Inequality and the Struggle for Status Security

During the 1920s, stagnating wages and rising inequality created consumption externalities that required that households increase spending in an attempt to protect the welfare of their families and maintain their relative social status. In their struggle to do so, they decreased savings, became more indebted, and possibly worked longer hours. The approach followed in this section views preference functions as at least partially endogenous -- to some extent, socially created. It is aligned with James Duesenberry’s view that a “real understanding of the problem of consumer behavior must begin with a full recognition of the social character of consumption patterns” (1967: 19).

²⁷ Although there were stories of porters and janitors speculating in stock, participation was in fact very narrow. Galbraith reported that, in a population of 120 million, only one and a half million (less than two percent of the population) “had an active association of any sort with the stock market, and not all of these were speculators...only about 600,000 of these accounts... were for margin trading” (1954: 78).

²⁸ Bernstein claims that “Margin-buying was the rule not the exception [and] brokers often allowed as much as 80 percent of the value of a stock purchase to be borrowed... frequently extended in the absence of any formal check on the credit-worthiness of the customer involved” (1998: 197). Kindleberger saw easy access to credit as the major ingredient fueling the asset price bubble (1996). A striking echo resounded some 80 years later in the reckless sub-prime loans that preceded the crisis of 2008.

²⁹ Prior to 1929, foreign funds flowed into the U.S., helping fuel credit expansion. The U.S. and France required that Germany pay its war reparations in gold, creating a net gold inflow into the U.S. that increased the availability of credit (Bernstein 1998: 204).

Frank has addressed the manner in which consumption externalities often require households to increase spending for the basic welfare of their families:

“Increased spending at the top of the income distribution has not only imposed psychological costs on families in the middle, it has also raised the cost of achieving many basic goals. Few middle-income parents, for example, would be comfortable knowing that their children were attending below-average schools. Yet the amount that any given family must spend to avoid that outcome depends strongly on the amounts that others spend.... [Moreover], people cannot send their children to a public school of even average quality if they buy a home in a school district in which house prices are well below average” (2000: 258).

A second manner in which, due to consumption externalities, wage stagnation and rising inequality prompts households to struggle to consume more is well captured by Veblen’s theory of consumer behavior. As rising inequality permits the rich, with far higher incomes and wealth, to consume much more, lower income households have to struggle harder to also increase their consumption levels so as to maintain their relative social status and hence their self-respect.

In the U.S. since colonial times, there has been a widespread belief that vertical mobility is readily possible.³⁰ Consequently, Americans have generally felt responsible for their own social status. Through adequate dedication and effort, anyone can move up, even to the very highest rungs of social status. It is the individual’s responsibility; it depends upon the individual’s willingness to work hard. One’s social status is not given, but earned.

However, how hard one works in modern societies is generally not directly observable. What more readily catches attention is how much one can consume, which can stand, more or less, as a proxy for how hard one has worked.³¹ Thus, because Americans believe they are individually responsible for their own social standing, they feel strongly compelled to demonstrate status and hence class identity through consumption. Greater inequality means that consumers must stretch further to maintain their relative social standing.

An attempt to maintain or increase social standing through consumption is what Thorstein Veblen meant by conspicuous consumption, and it manifests itself in two dimensions. Consumption that permits “invidious comparison” is meant to demonstrate one’s status to be above those below. “Pecuniary emulation,” on the other hand, refers to the practice of imitating the consumption standards of those of higher status with the intent of appearing also to possess that status. Veblen claimed that “With the exception of the instinct of self-preservation, the propensity for emulation is probably the strongest and most alert and persistent of the economic motives proper...[and] the propensity for emulation – for invidious comparison – is of ancient growth and is a pervading trait of human nature” (Veblen 1899: 110; 109).

³⁰ Until recent times, this belief mirrored reality. In the nineteenth century, Alexis de Tocqueville and Karl Marx both noted an exceptionally high degree of vertical mobility in the U.S. and termed it “American exceptionalism.” The extreme extent to which de Tocqueville believed this to be true is captured in the following passage from *Democracy in America*: “To tell the truth, though there are rich men, the class of rich men does not exist...the rich are constantly becoming poor” (1990: 160).

³¹ Thorstein Veblen put this as follows:

“One’s neighbours, mechanically speaking, often are socially not one’s neighbours, or even acquaintances; and still their transient good opinion has a high degree of utility. The only practicable means of impressing one’s pecuniary ability on these unsympathetic observers of one’s everyday life is an unremitting demonstration of ability to pay” (1899: 86-87).

Veblen's theory of consumer behavior is founded upon the fact that social status is critically important to people and thus strongly affects their behavior. His conception of social status conforms to that of Karl Polanyi's, whereby an individual is motivated "to safeguard his social standing, his social claims, his social assets. He values material goods only in so far as they serve this end" (1944: 46).³²

How people are judged by others constitutes the foundation for self-esteem, which John Rawls claimed to be "perhaps the most important primary good," such that without it nothing else has much value (1971: 440).³³ As Sayer, drawing on the work of Gilligan (2000) and Sedgwick and Frank (1995) notes, "The vulnerability of individuals consists in their dependence on others and not only for material support but for ongoing recognition, respect, approval and trust. While this may be adequately provided by small numbers of others, its absence can cause severe distress, shame and self-contempt – indeed, sometimes individuals may value respect more than their own lives" (2005: 54). Thus, "...recognition is not a luxury that ranks lower than the satisfaction of material needs, but is essential for well-being" (Sayer 2005: 54).

The human preoccupation with status or relative social position is understandable from an evolutionary perspective. Those with higher status, whatever its source, would possess disproportionate access to resources and members of the opposite sex, thus permitting more and better-cared-for progeny. A proclivity for seeking status would thus be naturally selected, and as Frank has put it, "falling behind ones local rivals can be lethal" (2005: 183).

Where there is a strong belief that vertical mobility is possible, a substantial increase in inequality could be expected to prompt households to respond in one or more of three ways: They might consume more of their incomes, forcing them to save less; they might become more indebted to enable greater consumption; and they might increase the hours they work to enable them to increase their income and hence consumption levels. As the evidence presented below demonstrates, as a whole, U.S. households did two, and possibly all three during the 1920s.

Houses, Automobiles, Household Durables, and Social Status

Stricker estimates that thirty-five to 40 percent of non-farm families still lived below the

³² Veblen gave an expressive account of the dynamics of this behavior in the following passage:

"In modern civilized communities the lines of demarcation between social classes have grown vague and transient, and wherever this happens the norm of reputability imposed by the upper class extends its coercive influence with but slight hindrance down through the social structure to the lowest strata. The result is that the members of each stratum accept as their ideal of decency the scheme of life in vogue in the next higher stratum, and bend their energies to live up to that ideal. On pain of forfeiting their good name and their self-respect in case of failure, they must conform to the accepted code, at least in appearance....No class of society, not even the most abjectly poor, foregoes all customary conspicuous consumption" (Veblen 1899: 84, 85).

Veblen essentially embraced what later social thinkers such as Bourdieu (1984) and Sayer (2005) refer to as a Pascalian view of human action, whereby rational deliberation is of lesser importance than socialization and habitualization. Thus conspicuous consumption for Veblen is not so much consciously pursued, but instead the engrained practice of struggling to maintain respectability:

"For the great body of the people in any modern community, the proximate ground of expenditure in excess of what is required for physical comfort is not a conscious effort to excel in the expensiveness of their visible consumption, so much as it is a desire to live up to the conventional standard of decency in the amount and grade of goods consumed" (1899: 102).

³³ This point was forcefully made by Veblen: "The usual basis of self-respect is the respect accorded by one's neighbors. Only individuals with an aberrant temperament can in the long run retain their self-esteem in the face of the disesteem of their fellows" (1899: 39).

poverty threshold at the end of the 1920s, and “a rough estimate would be that 40 percent of the non-farm families in the United States had insufficient incomes to buy an adequate diet at the end of the decade of prosperity” (1983: 23; 29). A 1934 Brookings Institution study found this to have been over 70 percent (Leven, et. al. 1934). Yet many others experienced considerable improvement in their material conditions and were able to benefit from a revolution in household durables that greatly improved the quality of life.³⁴ During the 1920s, the percent of urban households with flush toilets rose from 20 to 50 percent; electric lighting from 35 to 68 percent, vacuum cleaners from 9 to 30 percent, washing machines from 8 to 24 percent, and mechanical refrigerators from one to eight percent (Lebergott 1976: 272-88, 355; cited in Stricker 1983: 7). These goods possessed a dual character: On the one hand, they greatly improved the quality of life. On the other, because they signaled status for those able to afford them, their consumption was to some extent conspicuous.

The automobile industry expanded dramatically from the beginning of the century up until 1929, with only a couple of years of interruption during the First World War. In 1929, over four million vehicles were produced, a level not attained again until 1949. Two of every three families owned cars by 1929 (Livingston 1994: 108).

Arguably, no single new consumer good had heretofore more transformed society than the automobile. Its ownership signaled success and status. It made households mobile as never before and it helped fuel a housing boom by making suburban living more viable. Because suburban land was less expensive, housing could be in individual units as opposed to the multi-unit apartment buildings on more expensive in-town land.

Furniture had always played a role in marking social status. However, it was generally hidden inside and thus visible only to those invited in. Free-standing houses and automobiles opened up extraordinary potential to flash status. This was especially true of the automobile, since it could accompany you (although horse-drawn coaches had earlier performed the same function, they were far less convenient, and especially so in urban environments). Olney makes clear the importance of the advent and spread of automobiles for household spending:

“In 1899, 65 percent of durable goods spending (and 5 percent of total consumption expenditure) was for household goods, but just 7 percent (barely .05 percent of total consumption expenditure) was for transportation goods, and even this was mostly for horse-drawn vehicles. Thirty years later, transportation goods accounted for 36 percent of total spending for durable goods (and 4.4 percent of total consumption expenditure), while household goods accounted for only 51 percent (but now over 6 percent of total consumption expenditures)” (1991: 33).

A detached house has far greater potential for revealing status than units encased within an apartment complex. Automobiles and free-standing houses were primary status symbols, because as Wilkinson and Pickett point out, “research confirms that the tendency to look for goods which confer status and prestige is indeed stronger for things which are more visible to others” (2009: 225).

During the 1920s, as the wealthy took every larger shares of total income, they bought ever-more expensive houses, vacation properties, automobiles, country club memberships and

³⁴ Mandell notes of the 1920s that “For the first time in the country’s history, the majority of Americans were earning income in excess of what it took to pay for their basic needs. In addition, the necessities of war had produced a massive U.S. industrial base, which was prepared to produce consumer durables at a tremendous pace” (1990: xiv).

other luxury items. Automobiles made possible the dramatic expansion of private playgrounds for the rich – so-called country clubs. The real estate boom was especially robust in vacation facilities such as hotels, tourist cottages, and motor courts (Grebler, et. al. 1956). The fact that in 1929, the top one percent of the income distribution had 80 percent of total household savings and the top decile had 86 percent means that the nine percent just below the top one percent accounted for only six percent of total saving. This suggests that consumption competition was especially intense among the top decile elite (Hall and Ferguson 1998: 18; Stricker 1983-84: 50). Eighteen percent of families owning automobiles owned more than one (Striker 1983: 30). This consumption arms race put considerable pressure on all with lower incomes to consume more to maintain their relative social standing.

Financial innovations such as “shoestring mortgages” enabled property to be bought on margin. White notes that “...weakening supervision by the banking regulators contributed to the increase in easy finance that fueled the boom” (2008: 34). The expansion of credit instruments unhinged the traditional relationship between income and spending (Olney 1991: 130-31). Other forces were also working to erode the traditional protestant virtue of frugality and taboos on making use of consumer credit. Most notable was the decline of traditional sources of social certification and status that accompanied the deskilling of work and the decline of communities, just as technology and higher incomes made possible a consumer durables revolution. As traditional communities waned and how well and hard one worked became less visible with the rise of factories, how much one could consume became increasingly a gauge for how hard one worked. Households would increasingly seek social certification through consumption.³⁵

There was a “boom in post-World War I advertising” (Olney 1991: 169) that kept the consumption practices of the super wealthy ever on display, rising from \$2.28 billion in 1919 to \$3.43 billion in 1929 (Olney 1991: 137). As Edsforth notes, “In the 1920s, advertising’s pictorial images portrayed the comforts and luxuries of the well-to-do while advertising’s words promised everyone access to these things...During the Coolidge era, corporate elites advertised the ‘Democracy of Goods’ and urged every citizen to partake of the pleasures offered by the new and exciting mass popular culture” (1998: 260; 266).

As inequality dramatically increased during the 1920s, the struggle by households to maintain their relative status resulted in reduced saving,³⁶ greater indebtedness, and possibly more work hours for households. Between the periods 1898-1916 and 1922-29, personal saving as a percent of disposable income declined 42 percent, from 6.4 to 3.8 percent. Olney notes that “Such a sharp decline in the personal saving rate is astounding, particularly since the 1920s were rather prosperous years and we usually expect saving rates to climb, not fall, during periods of

³⁵ Thus the Protestant work ethic survived, but not the ascetic ethic. For a discussion of the transformed Protestant ethic, see Wisman and Davis 2013).

³⁶ The argument set forth here is directly opposite that of Keynes (1936: 372-75). For Keynes, an increase in inequality could be expected to increase saving since wealthier households have higher marginal propensities to save than do the less-well off. What Keynes failed to take into account is the manner in which rising inequality pressures all households beneath the top to increase consumption to maintain their relative social status. Yet Keynes obliquely recognized consumption externalities in his delineation of two classes of human needs, “those needs which are absolute in the sense that we feel them whatever the situation of our fellow humans may be, and those which are relative in the sense that we feel them only if their satisfaction lifts us above, makes us feel superior to, our fellows” (1932, 365). However, his view that less inequality would increase consumption does not concord with this distinction between absolute and relative needs. For an extended discussion of the manner in which Veblen’s theory of consumer behavior clarifies U.S. saving behavior, see Brown 2008; Wisman 2009.

prosperity” (1991: 48-49). The argument set forth here is that this “astounding” decline is in part due not only to attractive new consumer durables, but also to consumption externalities resulting from rising inequality.

In their struggle to maintain their relative status in the face of rising inequality, Americans became more indebted. Debt as a percent of income almost doubled, increasing from 4.64 percent in 1919 to 9.34 percent in 1929 (Olney 1991: 88-89). Total consumer debt, which was \$3 billion in 1920, rose to \$7.2 billion by 1929 (Bernstein 1998: 194). Calder notes that “By 1930, installment credit financed the sales of 60-75 percent of automobiles, 80-90 percent of furniture, 75 percent of washing machines, 65 percent of vacuum cleaners, 18-25 percent of jewelry, 75 percent of radio sets, and 80 percent of phonographs” (1999: 201). Between 1921 and 1929, consumer spending on durables grew 116 percent, whereas spending on non-durables grew by 34 percent (Hall and Ferguson 1998: 19). This increased indebtedness took place against a deep Protestant aversion to debt, and to consumption beyond essential necessities.³⁷

This rise in indebtedness fits the Veblenian hypothesis that in a society in which vertical mobility is believed to be highly fluid, increasing gaps in income all along the spectrum stimulate everyone to struggle harder to meet their consumption status targets, as those at the very top compete among themselves for the very pinnacle of status.

Inequality did not explode in other countries that would also fall into depression. Romer notes that a “feature of the American experience in 1930 was that the initial fall in industrial production was more concentrated in consumer goods and less concentrated in investment goods than in many other countries” (1993: 22). Households had reached the limits of their indebtedness and were increasingly unable to meet their debt obligations.

A third possible response of households in their struggle to maintain their relative social standing in the face of rising inequality would be to work longer hours. The work week continued its contraction during the 1920s, principally due to increased male retirement rates. However female participation rates increased from 24.3 to 25.1 percent (Smiley 2010: 4). Bernstein points out that “New expectations regarding appropriate family income levels... encouraged more women to enter the labor market” (1998: 195). Support is suggested by a study of more contemporary American society in which married women are found to be more likely to enter the labor market where there is greater inequality in men’s incomes (Park 2004). It is also supported by a transnational study that found “that increased inequality induces people to work longer hours [and] ...the underlying cause is the Veblen effect of the consumption of the rich on the behaviour of those less well off” (Bowles and Park 2005: F410). More generally, Huberman and Minns (2007) find that inequality was a strong predictor of average working hours at the national level during this time.

Resource Command and Ideology Control

The political pendulum swung dramatically toward laissez-faire ideology and against labor between World War I and 1929.³⁸ Although shifts in ideology are complex, a number of

³⁷ Milan Ayres wrote in 1926 that prior to the twentieth century, “...the things that a self-respecting thrifty American family would buy on the installment plan were a piano, a sewing machine, some expensive article of furniture, and perhaps sets of books. People who made such purchases didn’t talk about them. Installment buying wasn’t considered quite respectable” (Cited in Olney 1991: 130-31). However, according to Watkins “By the late 1920s, credit was used to finance up to 90 percent of the purchases of durable goods” (2000: 917). Bell characterizes “the invention of the installment plan [as] the most ‘subversive’ instrument that undercut the Protestant ethic...[and] Marketing and hedonism became the motor forces of capitalism” (Bell 1996: 38

³⁸ Hirshman (1982) finds that political ideology is cyclical and that reactions are extreme. The 1920s offer support

factors underling this swing stand out. Most notable was the ease with which labor's failure to fulfill its informal wartime "no strike" pledge could be depicted as unpatriotic at a time when the Russian Bolsheviks were introducing an alternative to capitalism. In a "Red Scare" environment, labor's struggles were increasingly portrayed as part of a communist conspiracy to turn the United States into the Western version of the Soviet Union, while business interests embarked on a campaign to demonstrate the patriotism of business³⁹ and the dangers inherent in labor's intransigence.

Reinforcing this ideological shift was the fact that rising inequality meant that the very rich had more resources with which to influence public opinion and policy. Different income and wealth groups have different interests and these interests are captured in ideologies that compete in the public sphere.⁴⁰ The generation and dissemination of ideology requires resources.⁴¹ Thus it would be surprising if the larger share of income and wealth accruing to the wealthy were to be without ideological and political consequences.

But given their economic resources, education, and superior command over essentially everything, it is understandable that the rich would, with increasing resources, progressively learn to craft their self-serving ideologies so that they become ever-more convincing to a majority of the electorate.⁴² Their disproportionate control over the media, educational institutions and think tanks made this outcome inevitable. As they received ever-larger shares of national wealth and income, this process was sped up.⁴³

The Surge of Laissez Faire Ideology During the 1920s

The election of 1920 returned control of the federal government to the Republican party,⁴⁴ and as Edsforth notes, "Business-oriented Republicans dominated national politics and lobbying efforts in Congress...and nativism shaped political debates all over the country. Longstanding white Protestant movements to impose Prohibition and restrict immigration finally

for this hypothesis. In the presidential election of 1912, 75% of the vote went to candidates who called themselves "progressive" or "socialist." Hundreds of socialists were elected between 1880 and 1920. See Keyssar 2000.

³⁹ A leader of the National Association of Manufacturers proclaimed that "Business and patriotism go hand in hand. Industrialism is beneficent, civilizing and uplifting. It is the enemy of war, of despotism, of ignorance and poverty. In truth, its foes are the foes of mankind" (cited in Watts 1991, 28-29).

⁴⁰ Following John Thompson, ideology as used here is understood as "the ways in which meaning is mobilized in the service of dominant individuals and groups" (1991: 73).

⁴¹ And, as Perelman notes, "only the rich and powerful have the resources to mount strong lobbying efforts, which bring them even more wealth and power, enabling them to lobby even more effectively (2007: 112).

⁴² Veblen believed that because the elite are emulated, their ideology would carry special weight: "The fact that the usages, actions, and views of the well-to-do leisure class acquire the character of a prescriptive canon of conduct for the rest of society, gives added weight and reach to the conservative influence of that class. It makes it incumbent upon all reputable people to follow their lead" (Veblen 1899: 200).

⁴³ Further, their expenditures on creating and disseminating ideology can promise high returns. As Perelman, citing the research of Glaeser 2004 and Glaeser, Scheinkman, and Shleifer 2003, puts it, "The rich wisely use their money to invest in the acquisition of influence rather than in anything that even remotely promotes economic and technological progress" (2007: 112).

⁴⁴ According to Edsforth, "the most important constitutional change of the 1920s, the implementation of universal female suffrage, appears to have benefited Republicans far more than Democrats" (1998: 246).

had succeeded in the Coolidge era” (1998: 246). As Keller has put it, “...the twenties were a ‘fabled interlude’ of moving away from governmental controls and moving toward a laissez-faire, pro-business, orientation of federal government” (Keller 1984: 133).

It was widely claimed that the American free-enterprise system promoted the values of “social harmony, freedom, democracy, the family, the church, and patriotism.” Advocates of “government regulation of the affairs of business” were characterized as subversive (Carey 1995, 27). Moreover, as Hicks notes, “Business control of government, so marked throughout the decade of the 1920s, made the regulation of business by government a farce” (1960: 232). Although the second great American merger movement occurred during the second half of the 1920s, little response came out of the Justice Department. By 1929, about half of all corporate wealth was controlled by 200 corporations (McElvaine 1981: 37). Price fixing, although illegal, also brought little response (Smiley 2010: 11).

The first major crushing blow to labor’s power came with the breaking of a strike in the steel industry in 1919. Thereafter, Ohanian notes, “Prevention methods included company unions and modest corporate welfare programs that are widely perceived to have kept unions out of the workplace, and the use of violence when unions attempted to organize or when workers called a strike” (2009: 2320). Tactics used “...included kidnapping union organizers, firing workers who met with organizers, evicting strikers from company-owned homes, denying medical care to striker families from company-directed health providers, and beating and shooting strikers” (Ohanian 2009: 2320). There was also widespread use of “yellow-dog” contracts requiring employees to contractually agree not to join unions. Company-controlled unions increased from 145 in 1919 to 432 in 1926 (Smiley 2010: 5).

With labor unions viewed negatively, the courts issued as many anti-labor injunctions during the 1920s as during the entire period from 1880 to 1920 (Bernstein 1966, 2000). The Supreme Court ruled minimum wage legislation in the District of Columbia unconstitutional in 1923. Undergirding these court decisions was the doctrine of “freedom of contract.” And, as Zieger notes, “Everywhere, except in a few unionized enclaves,...the right to organize was nonexistent....Everywhere, it was open season on anyone who dared to talk union” (cited in Edsforth 1998: 247). “Radical organizations were effectively repressed, and almost every union affiliated with the American Federation of Labor was put on the defensive” (Edsforth 1998: 247).

A new media technology – the radio – greatly assisted the dissemination of ideology. The first regular radio broadcast took place in November 1920. By 1923 more than 500 radio stations operated in the U.S. and 550,000 radio sets were sold that year. Two years later, two million. In 1928, 12 million sets catered to 40 million listeners (Blanning 2008: 204-05). By 1930, radios were in 40 percent of American homes (Bernstein 1998: 195). Because radio stations depended upon advertising, they were necessarily beholden to the business point of view. As Hicks put it, “...stations in search of advertisers were at great pains not to give offense” (1960: 174).

So completely did business dominate the climate of opinion during the 1920s that Roger Babson, a powerful investment advisor and founder of Babson College would claim that it had conquered “the press, the pulpit and the schools” (cited in Cochran and Miller 1942: 343-44). And in academia, “trustees and presidents in cooperation with the business community set up spy systems in their universities and colleges to identify the radical, un-American professors and students for dismissal; and a movement was launched to scrutinize economic textbooks for breaches of loyalty” (Lee 2009: 31).

Progressive academic economists were harassed and often forced out. “[E]conomics departments with too many progressives (as at the University of Washington) were restructured and placed in conservative business schools; and businesses threatened not to donate to universities that retained faculty with radical economic views” (Lee 2009: 31). Not surprisingly, within this climate, academic economists provided increasing support to free-market ideology, thereby lending support to right-wing policies, even when such was not their intent. The mainstream economic canon was highly supportive of unfettered and thus unregulated markets, even when the consequence was greater inequality.⁴⁵

Because of the wealthy’s increased command over society’s dominant ideology, the losers – the overwhelming majority of Americans – could not use the political process to stop the super-rich rip-off. Through the democratic process, in principle, they could have forced the creation of compensatory measures to relieve workers harmed by technological change or international trade.⁴⁶ Taxes could have been restructured in their favor, and public services that benefit them such as day care, better schools, health care and public recreational facilities could have been vastly expanded and improved. However, the wealthy’s increased control over the ideology infrastructure resulted in the majority buying into the rich’s ideology that such measures would not be to either their own or the country’s benefit.

Final Reflections

Rising inequality has long been dismissed, especially by the mainstream economics profession, as either irrelevant (if everyone is becoming materially better off, the size of shares is unimportant) or as missing the economic dynamism that inequality generates. A broader understanding of the scope of what constitutes economic phenomena, however, reveals the myriad ways in which inequality is central to economic processes and even, as this study demonstrates, how dynamics set in motion by rising inequality can set the stage for severe systemic dysfunction. A Keynesian/Kaleckian perspective reveals how rising inequality may result in a much richer elite redirecting investment away from the real economy into financial speculation, with a portion of it recycled as debt to those struggling to keep up. Veblen’s rich theory of consumer behavior clarifies the manner in which rising inequality may create consumption externalities, prompting households to save less, take on more debt, and perhaps work longer hours in their struggle to maintain relative social respectability and self-respect. Marx’s theory of ideology points to how rising inequality enables an elite to gain increasing control over economic and political ideology. An economic science worthy of its name needs to be capable of maintaining a tool box containing the full richness of the discipline’s theoretical perspectives.⁴⁷

However, after a Keynesian interlude between the 1930s and 1970s during which there was considerable appreciation of broader approaches, economics became increasingly formalized

⁴⁵ For a discussion of the manner in which economic science has served to legitimate inequality, see Wisman and Smith 2011.

⁴⁶ Government is critically important in determining distribution of income, wealth, and privilege. As Jencks puts it, “Almost everyone who studies the causes of economic inequality agrees that by far the most important reason for the differences between rich democracies is that their governments adopt different economic policies” (Jencks 2002: 52).

⁴⁷ This point was made by one of the foremost students of crises: “...the economist who resorts to only one model is stunted. Economics is a toolbox from which the economist should select the appropriate tool or model for a particular problem” (Kindleberger 1996: 201).

and narrow in its approach. Moreover, it increasingly depicted a tradeoff between growth and equity.⁴⁸ Even the study of inequality came to be seen by some as unnecessary, or even harmful to the science. The 1995 recipient of the Nobel Memorial Prize in Economic Sciences even went so far as to declare that “Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution” (Lucas: 2004).

Because economics has underestimated the importance of growing inequality, it has failed to capture its importance in setting the stage for the financial crisis of 1929 and the depression that followed. Consequently, it could not learn from that episode and foresee that the same phenomenon was repeating itself in the decades leading up to the financial crisis of 2008 (Wisman 2013). It was an unlearned lesson.

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⁴⁸ Recent scholarship challenges the claim of a positive relationship between inequality and economic dynamism, finding instead that greater income inequality causes economies to grow more slowly (Alesina and Rodrik 1994; Easterly 2002; Persson and Tabellini 1994).

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