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By Richard K. Vedder

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Roughly two decades ago, the noted South African economist William H. Hutt told my colleague Lowell Gallaway and me that the Great Depression in the United States was caused by Herbert Hoover's intervention in the labor market. Professor Hutt said that businesses followed the requests of the President to maintain wages at a high level in order to maintain purchasing power in the wake of the October 1929 stock market crash. We were more than a little skeptical. After all, why would profit-maximizing businesses increase their labor costs and reduce profits in order to appease the President? Jawboning, we felt, was an ineffective technique to change private economic behavior.

At the same time, however, Professor Gallaway was a labor economist who believed that wage rates were important determinants of employment. I was an economic historian who knew that Hoover was a former businessman who was much revered by America's business elite. Accordingly, we began a study that has continued sporadically for two decades, culminating in our new book, *Out of Work: Unemployment and Government in Twentieth-Century America* (New York: Holmes & Meier 1993), which we wrote for the Oakland-based Independent Institute.

In our book, we look retrospectively over the past nine decades, concluding that not only was Bill Hutt correct, but that various labor market interventions of the federal government have done more to harm than to help provide job opportunities for the American worker. Not only has the government contributed to the instability and volatility of unemployment in several important episodes in American history, but the overall long-term level of unemployment has been raised by governmental policies. Finally, we conclude that the victims of these well-intentioned government policies have been largely the poor, the unskilled, and minorities, not the more affluent educated middle classes.

Law of Demand. Let me make the unremarkable but critical observation that when something becomes more expensive, people usually buy less of it. This is the Law of Demand. Economists evoke it constantly to explain phenomena. For example, when oil prices soared in the 1970s because of the OPEC cartel, economists knew this would lead eventually to voluntary energy conservation. When stores have surpluses of unsold goods, they have clearance sales and the problem of surplus inventories disappears. Yet when it comes to dealing with surpluses of labor, which we call unemployment, a majority of economists pay relatively little attention to the price of labor (wages), despite the fact that it is an important determinant of employment.

There are four mechanisms by which the labor market can bring about a reduction in unemployment. First, if money wages fall, employers will hire more workers, reducing joblessness. Second, if prices of goods rise, employment will likewise rise, since the dollar value of each worker's output goes up, and thereby it becomes profitable to hire more workers at any given money wage. Third, if the productivity of labor rises, the dollar value of each worker's output likewise increases, stimulat-

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ing employment. Fourth, a decline in the number of workers willing to supply their labor services can reduce unemployment.

Historically, major shifts in labor supply—the willingness of individuals to work—are rare. However, changing wages, prices, and productivity often induce changes in unemployment. We can say that unemployment varies with the "adjusted real wage," which is money wages adjusted for price and productivity change. Over time, over 90 percent of the variation in joblessness in the United States can be explained by variations in the adjusted real wage and its three components—money wages, prices, and labor productivity. Put a little differently, when labor costs rise as a percent of sales revenue, profits get squeezed and employment falls. Falling relative labor costs, by contrast, reduce unemployment and increase employment.

Fed Failure. With this by way of background, it is interesting to look at the unemployment experience of the United States over time. Arguably the most successful period in this century was the first three decades, when the average level of unemployment was well under 5 percent. This also was the least interventionist period in the century. There was one short period of extremely high unemployment, called the Depression of 1921, when the annual unemployment rate approached 12 percent. This episode arose because of an abrupt change in the direction of prices that caught people off guard. Prices had roughly doubled during the era of World War I and its immediate aftermath, but in 1920 prices began their steepest descent in modern history, temporarily pushing up real wages and leading to reduced unemployment. This did not just happen by chance: the newly created bank, the Federal Reserve, assisted in creating the double-digit annual monetary growth that proceeded the 1920 debacle, and they failed to counteract the deflationary tendencies that brought about the downturn. Rather than an example of market failure, it might be viewed as the first big failure of our new instrument of monetary policy, the Federal Reserve.

What did the government do about the rising unemployment? Was there a massive new infrastructure program, a job retraining problem, or the like? No. The government did nothing. Indeed, during most of the downturn, the President of the United States, Woodrow Wilson, was seriously ill with a stroke, and a normally interventionist government adopted a classic laissez-faire stance not out of choice but out of necessity. In March 1921, the new president, Warren Harding, continued Woodrow Wilson's do-nothing policy out a sense of conviction. What happened? The unemployment rate fell sharply in 1922 and by 1923 was well below 3 percent. Money wages began to fall in 1921, contributing to an end of the labor market disequilibrium situation.

Hoover High-Wage Policy. The contrast with the Great Depression is stark and tragic. An interventionist President, Herbert Hoover, began to jawbone leading industrialists within a month of the October 1929 stock market crash. They listened to Hoover, imbued by his pre-Keynesian underconsumptionist philosophy that demand could create its own supply. If we just raise wages, workers will spend money, assuring prosperity. Henry Ford said, "Wages must not come down, they must not even stay on their present level; they must go up." The nation's business elite virtually unanimously publicly stated their support of the Hoover high-wage policy.

The high-wage policy was aided by the Smoot-Hawley tariff, which reduced international labor competition, thereby reducing normal wage cutting pressures. As a consequence of both jawboning and the tariff, wages in 1930 were about 8 percent higher than they normally would have been. This squeezed profits enormously. As a consequence, companies increasingly had a cash flow problem that began to make bank loans to corporations more risky. This led to a declining real market value of bank loans to corporations. The markets acknowledged this, as bank stocks fell far more in price than stocks generally throughout 1930. By the fourth quarter of that year, stockholder concerns over bank safety had spread to depositors, beginning the banking crisis. Labor market intervention led to crisis in banking.

While financially desperate companies finally abandoned the high-wage policy in 1931, the salutary effects of wage reductions were more than offset by deflation brought on by the bank failures induced, in our opinion, in large part by the Hoover labor market interventions. As Friedman and Schwartz have so magisterially pointed out, Federal Reserve policy failures added to the earlier Administration errors, compounding the downturn. The labor market became the primary transmission mechanism by which the policy failures of the Fed were transmitted.

The bottom was reached in March 1933. In the first months of the New Deal, great progress was made in reducing the massive unemployment rate—before the New Deal agenda had taken effect or, in some cases, even been approved. We estimate that the unemployment rate fell on average more than one percent a month from March to August 1933. But then recovery stalled, with unemployment rates falling hardly at all in 1934 and most of 1935. Why? The answer again is government intervention. Roosevelt continued the Hoover high-wage policy, using statute rather than moral suasion to implement it. From 1933 to 1941, real wages rose more than 4 percent a year, about double the most optimistic estimate of long-term real wage growth in the United States.

While the policy sins of the era are many, a few especially stand out: the National Industrial Recovery Act of 1933 brought about an early version of the minimum wage, with that wage set at approximately the average wage prevailing in manufacturing at the time of its passage in June 1933. From June 1933 to December 1933, wages rose by an average of more than 20 percent—at a time when the unemployment rate exceeded 20 percent. This killed the market-led recovery. The Wagner Act of 1935 provided the legal basis for the use trade union growth of early 1937, which led to another wage explosion, bringing on the 1938 downturn. The Social Security Act similarly contributed to the rise in labor costs with its new payroll taxes. In terms of harmful effects, these acts even exceeded the harmful effects of such Hooverseque legislation as the Smoot-Hawley tariff, the Davis-Bacon Act, or the Norris-LaGuardia Act.

Postwar Prosperity. The policy sins did not end in the 1930s. Ironically, the prosperity of the late 1940s and 1950s can be attributed to relative inactivity in labor markets. Harry Truman talked a liberal expansionist line, but followed relatively conservative non-interventionist monetary and fiscal policies. Legislation such as the Taft-Hartley Act and the Landrum-Griffin Act actually repaired some of the damage created by New Deal legislation.

The greatest testimony of the powers of the labor market to adjust to changing conditions came right after World War II. Think of it: from June 1945 to June 1946, the federal government reduced its own employment by 10 million—the equivalent today of about 20 million. The government went from running a budget deficit the equivalent today of over one trillion dollars to running a massive budget surplus. Monetary growth slowed abruptly. No job training problems were implemented. Keynesian economists freely predicted double-digit unemployment was around the corner. What happened? The annual unemployment rate never reached 4 percent. The post-World War II transition makes the current Cold War transition look puny by comparison. At the very time Keynesian economics achieved statutory victory with the Employment Act of 1946, the economy and the labor market were demonstrating the inappropriateness of federal demand management policies.

The prosperity of the postwar era continued and indeed expanded in the 1960s, but in some respects it was a false prosperity in that the seeds of the 1970s decline were sowed. The Kennedy-Johnson-Nixon Administrations pursued policies of Keynesian activism. The supply-side effects of the Kennedy tax cut were very real and positive, and the deliberately inflationary policies of the government temporarily lowered real wages, boosting employment. The policy of inflation, intellectually supported by the newly discovered Phillips curve, ultimately led to disaster. The first great believer in the role of expectations in economic theory, Abraham Lincoln, said it best: "You can fool all the people some of the time, some of the people all the time, but you cannot fool all the people all the time."

Whereas in the late 1960s a 4 percent inflation rate gave the nation some economic stimulus, the same amount of inflation by the early 1970s was expected, and distinctly unfoolish workers demanded and got bigger wage increases. Like the individual in advanced stages of drug addiction, ever larger injections of stimulus seemed to provide less and less happiness. The prosperity of fiscal stimulus proved as artificial as the powdered happiness of drugs. The 1970s was the first decade in American history where we ran a deficit every single year. In half of the years, the money supply (M2) increased more than 10 percent, compared with no years in the previous decade. In spite of all this attempt to inflate the economy to keep real wages artificially low, the adjusted real wage actually rose. Incidently, this process began even before the oil price explosion following 1973.

By 1980, the bankruptcy of interventionist macropolicies as a remedy for high unemployment was apparent to most of the American population. In 1980, unemployment was over 7 percent, historically a high figure, while prices were rising at an annual rate of at least 10 percent. The Reagan-Volcker approach at disinflation had the desired effect. The 1982 recession was almost inevitable, as the sharp reduction in inflation was not instantly followed by corresponding declines in money wage growth. Real wages rose for a while, leading to some reduction in the quantity of labor demanded. Within a year, however, market forces began to respond, setting the stage for the extraordinary 1980s peacetime expansion.

While Ronald Reagan will be rightly remembered for the supply-side policies he promoted as President, the decline in the adjusted real wage in the 1980s and the corresponding jobs explosion in fact reflects many factors. The government stopped policies that increased wages. We had the longest period in the history of the minimum wage without any increase. The firing of striking air traffic controllers was a new departure in labor relations, and contributed to a significant decline in the relative importance in labor unions. And, of course, the tax law changes helped increase labor productivity growth from the anemic levels of the 1970s. All of these factors contributed to a fall in the adjusted real wage.

Compromise and Accomodation. In our view, the 1990 recession reflected in part George Bush's policy of compromise and accommodation. In the late 1980s, wages rose at an annual rate of roughly 4 percent a year. Beginning in early 1990, a wage explosion occurred, with wages rising at an annual rate of over 8 percent in the second quarter. In part, this reflected rising inflationary expectations as people began to doubt that Bush and Alan Greenspan had the same commitment to inflation reduction that Reagan and Paul Volcker had earlier. More important, however, was the 13 percent increase in the minimum wage on April 1, 1990, followed by another double-digit increase just one year later.

In addition, the minimally accepted wage for employment for those that were unemployed, what economists call the reservation wage, was pushed up by government policies. On three occasions, unemployment insurance benefits were extended, so many unemployed were on the dole for more than a year. Why push hard to get a job when the government is subsidizing you not to work? The wage-enhancing effects of these policies was aggravated by three pieces of legislation destined to lower long-term productivity growth: the Clean Air Act amendments, the new Civil Rights Act, and the Americans with Disabilities Act.

Despite these negative shocks to the adjusted real wage, the market's resiliency should not be underestimated. Money wage growth began slowing in 1991 and 1992, and recent productivity growth brought about by cost-reduction strategies of companies have helped lower the adjusted real wage. We are on record as predicting fairly noticeable decline in unemployment in the coming months, which the Clinton Administration will no doubt take credit for, but which in reality reflects the lagged effects of falling real unit labor costs.

Government labor market intervention has not only contributed to unemployment instability, but also has added to the gradual upward drift in unemployment observed in the 1970s and 1980s. Of even greater interest, however, is the fact that the biggest victims of these policies have been disadvantaged Americans. Let me ask a couple of questions:

1) Why was it that in the era between 1900 and 1930 the black unemployment rate was about the same as that for whites, but today the incidence of black unemployment is more than double that for whites?

2) Why is it that in the years since the beginning of the civil rights era with *Brown vs. Board of Education* in 1954, has the proportion of black Americans of working age that work actually fallen, while for whites that proportion has increased significantly?

Harming the Poor. While rising black unemployment over time reflects to a considerable extent the geographic and occupational migration of nonwhites, it also probably reflects the fact that the unemployment-creating effects of public policy tend to hurt those in lower paying jobs the most. The minimum wage is more likely to price black workers out of the market than white workers. The Davis-Bacon Act was actually implemented in part to keep black construction workers out of the North in the Great Depression. The welfare programs of the Great Society and after have had the effect of creating the equivalent of very high marginal tax rates on work income for low-income Americans, disproportionately black, relative to high-income ones. I would surmise that the typical marginal tax rate on work income for black Americans is much higher than for white Americans, all a consequence of government policies ostensibly designed to help the disadvantaged. The same principle holds true with unemployment insurance.

If our observation about labor markets has any generalized validity, it would seem that the unintended consequences of government policies particularly hurt the poor, the politically weak, including children, and minorities. It is also our observation that the market has great egalitarian tendencies seldom appreciated by those on the left. The income differential between the northern industrial states and the American South has dramatically narrowed over time, not because of government policies as much as because it historically has been in the self-interest of labor to move North and for capital to move South, equalizing considerably the capital resources available per worker.

What does our historical study of labor markets say about the future? What is the prognosis, for example, for the Clinton years?

If the campaign policy utterances have any validity, we have every reason to be gravely concerned. We have already seen failed policies of the past being proposed. Raising tariffs on steel and proposing expansionary fiscal policy to provide stimulus are two Clinton ideas that history tells us are bad. The tariff increases of the 1930s and the fiscal expansionism of the 1970s contributed to making these arguably the two least successful decades in the 20th century from the standpoint of the U.S. economy. Proposed tax increases will dull the spirit of enterprise and reduce resource usage, and, even worse, probably will stimulate some increases in federal spending. It may not be true that each new dollar of new taxes will induce $1.59 more spending, as Lowell Gallaway, Christopher Frenze and I have suggested in a study done for Republicans on the Joint Economic Committee. But it sure strains reality to assert, as Budget Director Leon Panetta has, that we anticipate two dollars in spending *reduction* for each new dollar of new taxes. We have heard those claims before, and it just does not happen given the political benefits of spending.

But these are not all of my concerns. Labor Secretary Reich seems determined to push higher minimum wages, probably indexing the minimum wage to the overall wage level. This will increase pressures on the adjusted real wage, and particularly will hurt the disadvantaged. Reich talks of

strengthening labor's hand by outlawing the hiring of replacing workers in strike situations, a move which, other things equal, will tend to increase labor costs and reduce employment.

The Family Leave Bill will similarly increase labor costs which, if not offset by lower wages, will further cause unemployment. Again the Law of Unintended Consequences is at work: mandatory family leave increases employer incentives to hire males and females over 45 relative to younger females. Reich is in favor of extending unemployment insurance, already historically high with respect to the duration of benefits, again increasing employee wages and fueling unemployment. A training tax will boost the cost of labor. Presumably, this will be offset by higher productivity from better trained workers. There is, however, not one scintilla of reliable evidence to support the contention that productivity gains will exceed the losses associated with higher labor costs. Indeed, past experience with government job training programs makes me pessimistic about the effects of such a program.

Productivity Increase Needed. Lets look at the longer run. We are not saying that the path to progress is through lower wages. What we are saying, however, is that higher employment and a higher standard of living are both possible only if labor productivity rises sufficiently to keep labor from becoming relatively more costly. The key to having both job opportunities and material prosperity is an increase in the productivity of American labor.

Statistics on labor productivity are subject to a good deal of error—how, for example, do you measure the productivity of most government employees? Nonetheless, the evidence is pretty clear that there was a slowdown in productivity growth after 1973. It is equally clear that in the height of the Reagan era, say 1982 to 1988, that labor productivity growth increased markedly, about 1.6 percent a year. Finally, it is true that manufacturing productivity growth was quite high in the U.S. in the 1980s, so high that America actually on balance probably increased its comparative international advantage in manufacturing.

Still, it boils down to the fact that economic progress requires productivity growth. Productivity growth, in turn, requires increases in the quality and quantity of resources, plus an ability to allow those resources to migrate to where they are most productive. Public policy at the present highly discriminates against achieving a high productivity environment.

Physical capital formation is stymied by near confiscatory taxes on capital gains brought about by the fact that the income tax is applied on nominal, not real gains. The double taxation of corporate income is another example of an anti-capital formation bias to public policy. Savings in general are taxed at extremely high marginal rates. If you had put $1,000 in a passbook savings account on January 1, 1992, at 3 percent interest, you would have had $1,030 in that account at the beginning of this year. The real value of the $1,030 is almost precisely the same as the $1,000 deposited in the account a year ago. Yet the government makes you pay taxes on the $30 in fictitious interest you earned. Is it no wonder that the Americans save a nickel of each dollar of after-tax income, compared with a dime in Canada and 15 to 25 cents in most other major industrialized nations?

Investment spending is similarly hampered by dubious regulation. Environmental, disability, and other forms of legislation have enormously raised the price of capital goods, and lowered the effective rate of return on capital investment.

Technological advances are hindered also by a plethora of policies, including high taxes and a growing dearth of highly educated younger American scientists. Why should an Asian scientist develop innovative computer advances in the U.S. where he will pay marginal tax rates, if Bill Clinton gets his way, of approaching 50 percent, counting local taxes, when he can do the same thing in Hong Kong and pay less than half as much in tax?

Our rate of human capital formation is similarly abysmally low, for two reasons. First, a socialistic and monopolistic system of educational delivery provides the same sorts of performance as the old Soviet economic system. Second, the sharp and alarming deterioration in the American family has removed much of the encouragement and out-of-school support necessary to develop educated persons. The decline in the family, in turn, is largely a consequence of public policies ranging from tax discrimination to the corrosive welfare system.

While our record on permitting the mobility of resources is better than many nations, a more liberalized immigration policy encouraging human capital in-migration could stimulate the revival of a spirit of entrepreneurship.

Reteaching the Lesson. The message is simple. Let markets do their job. Markets are efficient and they are fair. They do not discriminate against blacks or gays or even liberals. The stifling of markets leads to less efficiency, more injustice and a reduction in the standard of living. With regards to labor markets, that lesson was pointed out two generations ago by economists such as A.C. Pigou, Ludwig von Mises, Bill Hutt, and Lionel Robbins. One generation ago, Murray Rothbard repeated the lesson, showing how Hoover's labor market interference contributed to the Great Depression. Every generation, it seems, needs to be retaught. We hope that our work will make a modest contribution in educating the present generation into the pitfalls of intervening in market forces.