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Author(s): Peter Temin

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Socialism and Wages in the Recovery from the Great Depression in the United States and Germany

PETER TEMIN

The sustained unemployment in the United States during the recovery from the Great Depression has proved difficult to explain, as has the rapid elimination of unemployment in Germany. I argue that employment in the United States was restricted by high wages, which government policy raised above the level of efficiency wages. Socialist control and military expansion by the Nazis reduced unemployment, but also held down consumption.

Socialism was the common thread running through recovery policies in the 1930s. But German national socialism differed from American social democracy in many ways. Most relevant here was its emphasis on military and investment spending over consumption. The result was both lower unemployment and lower wages in Germany than in the United States. This contrast was the result of government policy rather than of efficiency wage setting by American firms. And the German economy increasingly resembled that of Russia, more conventionally socialist than either Germany or the United States. This article describes the socialist aspects of recovery policies and then focuses on wage and consumption behavior.

I

Free market capitalism and the orthodox finance of the gold standard had led to disaster in the early 1930s. Direct management of the economy could only do better. In both the United States and Germany, new and actively interventionist administrations took office in early 1933. And though there was no tight theory of a managed economy that led each country down the same path, socialist ideology led them in similar directions. I identify the following features of an economy as socialist: first, public ownership *or regulation* of "the commanding heights" of the economy, particularly of utilities and banking; second, heavy government involvement in wage determination; and third, a welfare state providing everyone with, in Oscar Lange's words, "a

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The author is Professor of Economics, Massachusetts Institute of Technology, Cambridge, MA 02139.

social dividend constituting the individual's share in the income derived from the capital and the natural resources owned by society.''[1]

This definition differs from the one used today to distinguish Eastern from Western Europe. Instead of emphasizing the ownership of assets in a formal sense, it considers ownership in the sense of having control over an asset.[2] A nominal owner of an asset who cannot sell it and is forced to sell output through a government agency at a government-dictated price is not much of an owner. (This is a capsule description of Nazi agriculture.) The functional similarity between this concept and the more conventional one is shown by the common orientation of the Nazi and Soviet economies. Workers received Lange's ''social dividend'' in both Nazi Germany and Soviet Russia in the form of public monuments and military expenditures.

The Nazis seized control of an economy that already had many socialist characteristics. The Weimar government was heavily involved in mediating collective bargaining for wages throughout the 1920s. The government had virtually nationalized the banks in the wake of the currency crisis of 1931.[3] But the government's commitment to the gold standard had vitiated any gains from these policies, assuring that there was no ''social dividend'' to distribute.

In order to stimulate recovery, the Nazis—like the Democrats in the United States—had to establish a startling new policy regime. To do so, they destroyed many of the socialist institutions of the Weimar republic and replaced them with their own institutions that performed the functions of socialism. Personal freedom and autonomy were sacrificed in the process of controlling production and wages and distributing the ''social dividend'' to the populace. As Hitler is reported to have said, ''Why need we trouble to socialize banks and factories? We socialize human beings.''[4]

The Nazis set out to reduce unemployment by a variety of complementary actions. They centralized and appropriated the job of wage bargaining, entrusting it to a government agent, the Nazis' labor trustee. They also destroyed the unions within a few months of taking power, a form of out-socializing the socialists. The Nazis used tax incentives and propaganda to convince women to leave the labor force. And they introduced compulsory labor service in 1935.[5]

Wage payments failed to keep pace with the growth of national

[1] Peter Temin, *Lessons from the Great Depression* (Cambridge, MA, 1989), chap. 3; Oscar Lange and Fred M. Taylor, *On the Economic Theory of Socialism* (New York, 1964; 1st edn. 1938), p. 74.

[2] Sanford J. Grossman and Oliver D. Hart, ''The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration,'' *Journal of Political Economy*, 94 (Aug. 1986), pp. 691–719.

[3] Gustav Stolper, Karl Häuser, and Knut Borchardt, *The German Economy, 1870 to the Present* (New York, 1967), pp. 106–17.

[4] Peter Hayes, *Industry and Ideology: IG Farben in the Nazi Era* (New York, 1987), p. 73.

[5] Karl Hardach, *The Political Economy of Germany in the Twentieth Century* (Berkeley, 1980).

income, falling from 64 to 57 percent of national income between 1932 and 1938. Higher taxes on wage earners meant that consumption rose even more slowly, falling from 83 to 59 percent of national income in the same six years.[6]

The sum of investment and government expenditures thus rose from 18 to 41 percent of national income in this same period, a change in the composition of output that rivals the change under the Soviet First Five Year Plan. Productivity in the production of consumer goods, however, did not rise correspondingly. As in other socialist regimes, there was little incentive to innovate. In fact there were disincentives. High profits were taxed heavily. Good products that were competitive on world markets could not find outlets due to the extensive trade restrictions. The Nazis opted for exchange controls rather than devaluation, in part to isolate Germany from the world economy and promote their desired autarky and in part to exploit another tool for direct control over the economy.[7]

The Nazis introduced administrative controls over investment through licensing and direct allocation of raw materials. But their brand of socialism emphasized centralized control over economic activity rather than public ownership of firms. Instead of dispossessing private owners, the Nazis severely circumscribed the scope within which the nominal owners could make choices by currency controls, taxes on profits, and direct allocation measures of the state. This was nowhere more evident than in agriculture, where farms were nominally private, although they could not be sold and their output was marketed by government cartels.[8] Despite the retention of private ownership, government spending rose to one-third of GNP in 1938, while private investment rose only to one-fourth of that level.[9] As Karl Hardach noted, "In the long run, the Nazis aimed essentially at an economic system which would be an alternative to capitalism and communism, supporting neither a laissez faire attitude nor total planning."[10]

Extensive government spending did not initially mean military spending. Construction of housing and roads and the manufacture of automobiles were important sources of expansion. Hitler supported motorization for its presumed effects both on production—through imitation of Henry Ford—and on the working class, as shown by his enthusiasm for

[6] R. J. Overy, *The Nazi Economic Recovery, 1932–1938* (London, 1982), p. 34.

[7] Ibid., p. 37; Hardach, *The Political Economy of Germany*, pp. 71–72.

[8] Harold James, *The German Slump: Politics and Economics, 1924–1936* (Oxford, 1986), pp. 355–57.

[9] Overy, *The Nazi Economic Recovery*, p. 35; Charles S. Maier, *In Search of Stability* (New York, 1987), p. 98n, calculated from the same data as Overy that net private fixed investment was essentially zero through 1936. The rise in private investment was primarily inventory accumulation.

[10] Hardach, *The Political Economy of Germany*, p. 66.

the Volkswagen. Only after 1936, by which time the recovery was well under way, did the Nazis turn to preparation for war. After that time, of course, government expenditure increasingly shortchanged civilian investment in favor of the military.[11]

The American recovery under the New Deal was similar to the German expansion in its use of a socialist approach to the role of government, but it was very different in its internal dynamics. The German recovery emphasized consumption at first, only to reverse course and emphasize investment over time. The American recovery, by contrast, started with investment and went on to emphasize consumption. Germany increasingly emphasized military production; the United States did not start war production until the end of the 1930s. The German economy was subject to increasing control, while the New Deal imposed many controls all at once and withdrew partially under various pressures. The Germans kept wages low and reached full employment quickly; the Americans raised wages and had to cope with continued unemployment.

No one can doubt that Roosevelt's first hundred days comprised a whirlwind of activity. The New Deal certainly was expansionary, or "reflationist," a term that does not seem to have lasted beyond the Depression. It also took control over the economy in a way that was unprecedented.[12] The socialist elements in this extensive intervention can be seen in terms of the three attributes of socialism defined above.

Control over industry and wages in 1933 came primarily through the National Industrial Recovery Act. Control over agriculture was introduced with the Agricultural Adjustment Act, normally interpreted simply as price supports but included here as part of the growing government control over prices and marketing.

The change in the process of wage determination had a clear effect on the level of wages. Real earnings in both countries fell from their peak in 1929 to their trough in 1932 at precisely the same rate. This parallelism echoes the similar rate of deflation in the two countries, but it is remarkable in view of the well-known contrasting paths of real wages in the 1920s. Real wages in both countries started up at the same rate in 1933, but then their paths diverged. Even though prices rose under the NRA, real wages rose as well, faster than in Germany. By 1937, just before the American recession, real earnings in the United

[11] R. J. Overy, "Cars, Roads, and Economic Recovery in Germany, 1932–8," *Economic History Review*, 28 (Aug. 1975), pp. 466–83; G. F. F. Spenceley, "R. J. Overy and the Motorisierung: A Comment," *Economic History Review*, 32 (Feb. 1979), pp. 100–6; R. J. Overy, "The German Motorisierung and Rearmament: A Reply," *Economic History Review*, 32 (Feb. 1979), pp. 107–12.

[12] Peter Temin and Barrie Wigmore, "The End of One Big Deflation," *Explorations in Economic History* (forthcoming, 1990).

States were 30 percent above their 1933 level, while German real earnings were only just over 10 percent higher.[13]

The American high-wage approach therefore contrasted sharply with the low-wage program of the Nazis. The smaller gains in real wages in Germany encouraged the growth of employment, as did other Nazi policies, with dramatic effect. German unemployment fell from 30 percent to 2 percent between 1932 and 1938, while unemployment in the United States fell only from 24 to 14 percent in 1937, before rebounding to 19 percent in 1938.[14]

This capsule comparison of the New Deal and Nazi economic policy exposes a paradox. Conventional wisdom asserts that high wages raise costs and reduce international competitiveness. (This is the effect of an upward shift of the aggregate supply curve.) The American economy in the late 1930s then should have found itself with a less favorable trade balance than the Nazis. The United States should have been imposing more controls over foreign trade, while Germany was relaxing its controls. But, of course, the reverse is what we observe. The Americans passed the Reciprocal Trade Agreement Act and began to reduce tariffs, drawing back from the protectionist stance adopted under Herbert Hoover. The Nazis imposed ever more controls over their economy and over Germany's foreign trade, as each intervention seemed to create the need for another.

The contrast is sharpened by an appreciation of American business support for the high-wage component of Roosevelt's policy. Industrialists had never been as staunch deflationists as had financiers, and they supported the imposition of high wages. Firms engaged in exploiting new technology and active in international trade were not trying to cut costs by cutting wages. High wages and low tariffs were the keys to success in their eyes.[15] The United States economy was strong and progressive in the 1930s, while the normally innovative German economy began to produce lower-quality goods and found it increasingly difficult to export under the Nazis.

II

The contrast resulted from the overall policy regime in the two countries. Wages were only one aspect of national economic policies and must be seen in context. But before characterizing policy as a

[13] Gerhard Bry, *Wages in Germany* (Princeton, 1960), p. 362; U.S. Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970* (Washington, 1975), pp. 164, 169.

[14] Brian R. Mitchell, *European Historical Statistics, 1750–1975* (New York, 1980), p. 178; U.S. Bureau of the Census, *Historical Statistics of the United States*, p. 135.

[15] Thomas Ferguson, "From Normalcy to New Deal: Industrial Structure, Party Competition and American Public Policy in the Great Depression," *International Organizations*, 38 (Winter 1984), pp. 41–94.

whole, it is necessary to show that high wages in the United States were the results of government policy.

Richard Jensen recently championed the hypothesis that the United States sustained continued unemployment because employers paid "efficiency wages," that is, wages above the market wage designed to elicit greater effort from workers. The higher pay in the United States encouraged worker productivity, giving rise to higher-quality goods.[16]

This explanation has a number of problems. Efficiency wage models are, first of all, theories of wage setting. Employers choose to pay efficiency wages in order to attract or keep hard-working employees. But, as shown above, the high wages in the United States did not result from the choice of individual firms. It was the result of legislation and the regulation that followed. True, the NRA was responsive to employer wishes, but it reflected the wish to cartelize industry more than the wish to bind the labor force to individual firms.

In addition, the efficiency wage theory predicts that efficiency wages are lower in times of high unemployment than in prosperity. The reason is clear. Employers expect loyalty and effort in response to an efficiency wage because the job and its wage are better than the worker's alternative. If the alternative is another job, then the efficiency wage must be high. But if the alternative is likely to be unemployment, then the job itself is better than the alternative. The efficiency wage need not be so high.[17] Efficiency wage theory therefore does not predict the 20 percent rise in (nominal) wages in 1934.

Finally, the evidence brought to bear on this problem to date has not examined the effort of workers, failing to demonstrate a connection between wages and effort. Many theories of the labor market imply Jensen's central finding: that employers in a slack labor market hired the best workers first. Martin Weitzman, for example, argued recently that one need only assume that wages are sticky in the short run to produce a hierarchy of jobs and conditions where employers hire the best candidates first.[18]

High wages in the United States are better seen as the result of "hysteresis." Olivier Blanchard and Lawrence Summers argue that group interests in wage setting can prevent the real wage from falling enough to restore full employment. In their model wages are set to preserve the jobs of those people already employed, not to move others out of unemployment. Workers react to negative external shocks—like

[16] Richard D. Jensen, "The Causes and Cures of Unemployment in the Great Depression," *Journal of Interdisciplinary History*, 19 (Spring 1989), pp. 553–84.

[17] Carl Shapiro and Joseph Stiglitz, "Equilibrium Unemployment as a Discipline Device," *American Economic Review*, 74 (June 1984), pp. 433–44; Lawrence F. Katz, "Efficiency Wage Theories," in *NBER Macroeconomics Annual, 1986*, Stanley Fischer, ed. (Cambridge, 1986).

[18] Martin L. Weitzman, "A Theory of Wage Dispersion and Job Market Segmentation," *Quarterly Journal of Economics*, 54 (Feb. 1989), pp. 121–37.

the deflation of the early 1930s—by accepting lower real wages, but only low enough to preserve the jobs of those still employed. The result is that the economy lacks a strong force tending to full employment.[19]

Under the NRA wages were set to serve the interests of those already employed, not those who wanted to be employed. The policies established by the AFL in the 1920s of protecting existing jobs for members and resisting wage cuts in slowdowns was generalized to industry as a whole.[20]

Just as wage patterns in the United States and Germany were the effect of government policies, the allocation of revived production followed directly from the government's aims. Germany's expansion under the Nazis was stimulated by an increasing emphasis on the military. In contrast to the United States experience, government spending was the engine of recovery.

Harold James argued recently that the Nazis expansion was not Keynesian. He asserted that the government expenditures undertaken during the later 1930s were not countercyclical in *intent*. They were directed toward the militarization of the German state and preparation for the war that the Nazis felt was both desirable and inevitable.[21] Granting James's argument, it is still true that the Nazi fiscal expansion had Keynesian *effects*.

Comparison with the United States in the 1980s makes the point. Reaganomics was hardly Keynesian in intent. The underlying theory was supply-side economics, fixated on the allocative effects of marginal tax rates. But the effect was the same as if the same dollars had been spent for the same purposes under a Keynesian banner.[22] So too in Germany in the 1930s. However baleful, political, or suicidal their intent, the Nazis expanded the economy by investing in military preparedness.

The effect on consumers was straightforward. The expansion put people back to work. But the military build-up siphoned off the goods they produced. The purchasing power of consumers was restricted and the government expanded its demand for munitions and armor. These are the products of heavy industry, which in turn depend on highly paid and highly skilled workers. Those industries thrived under Nazi control.[23]

In contrast to the experience of the 1930s, the United States has become a low-wage country in the 1980s. The two economies discussed

[19] Olivier J. Blanchard and Lawrence H. Summers, "Hysteresis and the European Unemployment Problem," *NBER Macroeconomics Annual, 1986*.

[20] Alexander Keyssar, *Out of Work* (Cambridge, 1986), p. 221.

[21] Harold James, "What is Keynesian about Deficit Financing? The Case of Interwar Germany," paper presented to the All-UC Conference in Economic History, April, 1989.

[22] Olivier J. Blanchard, "Reaganomics," *Economic Policy* (Oct. 1987), pp. 17–56.

[23] Hayes, *Industry and Ideology*.

here have begun to differentiate themselves, with the Germans specializing in products requiring highly trained and highly skilled workers and the United States expanding employment in lower skilled activities.[24] Why didn't the low-wage Nazi economy experience the same shift of resources out of heavy industry? Because there was no sign of international specialization in the 1930s to rival the shift of output mix in the 1980s. International trade ground to a halt in the Depression, breaking a critical link between the wage level and the composition of industry. Nazi Germany was among the worst offenders, sharply curtailing the opportunities for competition in foreign trade. International transactions were tightly controlled for purposes of national power and military advantage.

The Nazis' militaristic policies generated inflationary pressure on the economy. The military expansion actually created a shortage of labor, due to both the expansion of aggregate demand and the reallocation of workers. It gave rise to shortages of raw materials for the expanding industries, shortages which were compounded by the emphasis on military self-sufficiency and economic autarky.

The Nazi response was to control the German economy ever more tightly. Just as Stalin increased the centralized control of the Russian economy in the 1930s to cope with Russia's economic problems, so Hitler extended the reach of government into every corner of the German economy at the same time. Socialist as defined above, the Nazi economy increasingly resembled the paradigm of socialist economies.

The Nazis had proclaimed their economic aims long before they came to power. These plans were utopian, and they contained prominently the socialist theme of divorcing production from individual consumption, promoting instead the collective good. Once in power, the Nazis gave this a special twist; the communal aim was defined to be military expansion. This peculiar interpretation of the common good intensified the need to control ever more tightly the operation of the economy.

The Soviet government was not militaristic in the same way as the Nazis, but placed similar emphasis on heavy industry and war preparation. The USSR was second only to Germany in its munitions production in the late 1930s, far ahead of any other country.[25] Heavy industry was encouraged in Russia for its role both in war and in economic growth, but the fruits of this growth were directed toward investment and military expenditures rather than consumption. The Soviet and Nazi definitions of the public good had many similarities.

The Nazis dealt with inflationary pressure by freezing all prices in

[24] Gary W. Loveman and Chris Tilly, "Good Jobs or Bad Jobs: What Does the Evidence Say?" *New England Economic Review* (Jan.-Feb. 1988), pp. 46–65.

[25] Mark Harrison, "Resource Mobilization for World War II: The U.S.A., U.K., U.S.S.R., and Germany, 1938–1945," *Economic History Review*, 41 (May 1988), pp. 171–92.

1936. Prices quickly began to lose their economic function of allocating resources; the void was filled by direct allocation from the government bureaucracy. Purchasing permits and selling orders were needed for transactions in industry; production quotas were instituted in agriculture. Control was even tighter in foreign transactions as H. Schacht worked his magic to arrange for imports.[26]

The Nazis also refused to devalue the mark. This deflationary policy was a partial offset to the inflationary pressures of the economic expansion. The Nazis also preferred exchange controls to devaluation to insulate the German economy from the still-depressed world economy and to maximize political control over the economy. The overvalued mark, of course, made imports hard to come by, and Schacht worked on behalf of the government, not the consumer. The economic expansions in Nazi Germany and in the Reaganomic United States therefore had very different implications for consumption. The United States was flooded by imports in the 1980s, creating a consumption boom and a large foreign deficit. Nazi Germany, unable to accumulate a large foreign deficit, restricted consumption sharply. "In the end every sort of economic activity . . . was made to conform to government regulation, leaving little more than the title of private ownership."[27]

The result was a planned economy. The Nazi Four Year Plans were similar in kind and effect to the early Soviet Five Year Plans.[28] In both cases, the government sought to allocate resources by administrative means. The market and prices were abandoned as unstable and unresponsive to the national needs. Socialist planning was necessary to channel the efforts of the economy into the industries valued by the government.

Socialism was a particular approach to a planned economy, whether or not associated with explicit ownership of industrial enterprises. It was clear even in the 1930s that socialism did not necessarily mean that the workers' lot was improved. The Soviet workers suffered at least as much during the collectivization of agriculture in the early 1930s as the German workers did under the Nazis.[29] James observed that in Nazi Germany "price controls and an effective limitation of wages produced a continual worsening of qualities in consumer goods. The deterioration of textile qualities was particularly evident to the public. If, we may

[26] Larry Neal, "The Economics and Finance of Bilateral Clearing Agreements: Germany, 1934–8," *Economic History Review*, 32 (Aug. 1979), pp. 391–404.

[27] Stolper, Häuser, and Borchardt, *The German Economy*, p. 131.

[28] C. W. Guillebaud, *The Economic Recovery of Germany from 1933 to the Incorporation of Austria in March 1938* (London, 1939); Eugene Zaleski, *Stalinist Planning for Economic Growth, 1933–1952* (Chapel Hill, 1980).

[29] Michael Ellman, "Did the Agricultural Surplus Provide the Resources for the Increase in Investment in the USSR During the First Five Year Plan?" *Economic Journal*, 85 (Dec. 1975), pp. 844–63.

speculate, there had been no war, Nazi policy would have produced a society with low wages and high saving ratios manufacturing ever cheaper and shoddier goods.''[30]

It is now apparent at the end of the 1980s that all socialist economies have severe problems in maintaining the quality of consumer goods produced. Centralized plans direct firms to make specified quantities of goods. These goods are then allocated to other firms or sold to consumers without competition from outside goods. Without the discipline of the market, there is no force keeping up the quality of goods. And there is every incentive to produce the needed goods at the lowest cost. The sacrifice of quality does not enter into the calculation with anything like the force it has in a competitive environment.[31]

In addition the Nazis wanted to make the German invulnerable to a wartime boycott. They promoted economic autarky to promote this end, encouraging the use of synthetic materials in place of imports. The result was higher-cost, lower-quality consumer goods made of ersatz materials. Nazi consumers therefore suffered doubly. Their wages were controlled and kept from rising in an increasingly tight labor market and they could buy only a limited range and quality of goods. The use of ersatz materials was good for defense and the foreign trade balance, but it led to inferior textiles and shoes. Inferior metals replaced gold in dental work. The normal insulation for electrical cables was replaced by ''Ersatzstoffe.'' Cellulose replaced natural fibers; young women buying linens for their dowries discovered that they turned to pulp when washed. The Nazi economy produced progressively lower-quality products for the German consumer.[32]

III

The contrasting recovery of the United States and Germany therefore had many interconnected causes. Recovery was started in each case by a similar change in policy regime that replaced gold-standard orthodoxy by socialist measures. But the recoveries began to diverge very quickly. Recovery in the United States became based on the expansion of consumption while recovery in Germany became ever more militaristic.

The result was a contrast between the two countries in many dimensions: wage policy, exchange rates, fiscal expenditures, controls. The Nazi economy shared some characteristics of the United States under Reagan (military expansion, unwitting ''Keynesianism,'' overvalued exchange rate) and some of the Soviet Union (direct control over the economy, low wages, military emphasis, poor consumer goods).

[30] James, *The German Slump*, p. 417.

[31] Ed A. Hewett, *Reforming the Soviet Economy: Equality versus Efficiency* (Washington, 1988).

[32] *Deutschland-Berichte der Sozialdemokratishen Partei Deutschlands* (1937); Willi A. Boelcke, *Die deutsche Wirtshaft, 1930–1945* (Düsseldorf, 1983), pp. 253–59.

High wages in the New Deal United States were the result of government policy rather than efficiency wage payments by individual American firms. And the American emphasis on consumption was reflected in a growing production of high-quality goods. The socialist control and military expansion of the Nazis, by contrast, increasingly shortchanged people as both workers and consumers.