IDEAS ON LIBERTY
JUNE 2003

Why Wages Used to Be So Low

by Thomas E. Woods, Jr.

A widespread misconception about the market economy is that it was responsible for low wage rates from the beginning of the Industrial Revolution through the early twentieth century. One answer to that claim, as all respectable economic historians now concede, is that the Industrial Revolution introduced the era of rising living standards for the great mass of the population.

But there is much more to be said, since such criticism of the market is not only historically incorrect, but it also completely misconceives the issue. Perhaps the best way to explain why is by recourse to what George Reisman refers to in *Capitalism*, his sizable 1996 treatise, as "the productivity theory of wages."* Reisman provides an algebraic derivation of the theory in his book, but I shall simply describe the idea and demonstrate its fruitfulness in the study of economic history.

Reisman cautions against thinking that a rising standard of living implies that workers consistently earn more money. In an economy with what he calls an "invariable money" (essentially an unchanged quantity of money), it is impossible for *everyone* to earn more money over time. Thus the fundamental way in which people's standard of living rises is for money to command greater purchasing power. This happens through increases in the productivity of labor—the amount of output per worker. The more output the economy is capable of producing, the greater the purchasing power a worker's wages will command. According to Reisman, "it is the productivity of labor that determines the supply of consumers' goods relative to the supply of labor, and thus the prices of consumers' goods relative to wage rates" (p. 621). In other words, the more production per capita, the lower prices will be relative to wages.

Think of it this way: The American economy in the 1870s possessed a dramatically smaller productive capacity than the American economy of 2003. Labor was drastically less productive back then. As a result, it was physically incapable of producing the sheer volume of products per capita of which our present economy is capable—and, of course, a whole host of goods that we take for granted hadn't been invented yet.

Although by historical standards nineteenth-century England and the United States enjoyed a far higher standard of living than Europe had ever known, many people understandably look back on that era with revulsion. Goods were certainly far more scarce than today. Leaving emotion aside, let's use economic science to consider the

Thomas Woods holds a Ph.D. in history from Columbia University and is assistant professor of history at Suffolk Community College, a unit of the State University of New York.

*George Reisman, *Capitalism* (Ottawa, Ill.: Jameson Books, 1996). All quotations are from this book.

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inevitable constraints that scarcity imposes on living standards.

Suppose some catastrophe wiped out all capital equipment invented and developed over the past 150 years. Gone also are all automobiles and the knowledge to create new ones, fax machines, cellular and standard telephones, e-mail, the Internet, radio, and television. Many conveniences we take for granted no longer exist at all, and the vast majority of the remainder must be made either by hand or with the clumsiest and most inefficient machines. Needless to say, this economy is capable of far less production than it was before the catastrophe. The productivity of labor has plummeted.

Does it not stand to reason that under these drastically changed circumstances we would all have to work much longer and harder to maintain even a minimally acceptable standard of living? Compared with today, the goods we need would be unusually scarce and expensive in terms of the labor time it took to earn the money to buy them. A great many consumers chasing relatively few goods would inevitably produce high prices. Since the relative lack of capital equipment would mean a low productivity of labor, workers throughout the economy, as a matter of simple logic, would have to toil long and hard to produce the amount of consumer goods desired. If in our obstinacy we all determined to maintain a 40-hour work week even in the face of such changed conditions, we would not produce anything approaching the amount of consumer goods previously made, and the result would be still greater impoverishment. It is this simple fact of low worker productivity, rather than any sinister machinations of greedy businessmen, that would account for our low standard of living.

Unconscionable Exploitation?

In effect, this is something like the economy in England during the early Industrial Revolution and, to a lesser but still considerable extent, the American economy in the latter nineteenth century, the periods of alleged unconscionable exploitation by greedy businessmen. Apparently, it has never occurred to critics of the market that the reason people back then could afford far fewer and considerably lower quality goods might have something to do with their inability to produce more. The working assumption among critics appears to be that feeding, clothing, and housing more and more people over time, and making possible a steadily rising life expectancy, is nothing too impressive (although it had never been done in such a sustained and remarkable way anywhere in the world until the eighteenth century). No, these critics expect the increased population that capitalism makes possible to enjoy, right away, spacious and commodious homes, fine cuisine, and ample leisure time, and if they lack these things the only explanation can be that wicked businessmen are depriving the workers of them. That these things might not even exist in any great numbers is not even considered.

What, specifically, could have been done to improve this situation? If goods could be provided in greater abundance, they would be less dear and more within reach of the ordinary consumer. How can goods be provided in greater abundance? By increasing the amount of output per worker. And that can be accomplished through technological innovation and investment in capital goods. When capitalists reinvest their profits they can purchase steam shovels instead of hand shovels, computers rather than typewriters, copy machines rather than the labor of scribes. They can equip warehouses with forklifts, allowing a single worker to perform tasks that might well have required ten workers.

As a result of such investment, productivity and output are increased considerably. The whole process is driven by the profit motive, which leads businessmen continually to search for new and improved products and to cut costs in order to earn premium profits. Competition then serves to pass the quality improvements and cost cuts on to the consumers, who obtain progressively more and better products at lower and lower real prices.

When labor becomes more productive in a given industry, the number of workers it employs can rise or fall, depending on consumer demand. In the automobile industry, where improvements in productivity and consequent cost and price reductions opened up a mass market, the number of workers increased vastly. In agriculture, where improvements in productivity were accompanied by far less than a proportionate increase in food consumption, the number of workers diminished. In this and all other cases in which an increase in productivity led to fewer workers being needed, labor was released for employment elsewhere in the economy. This freed-up labor could then produce goods that consumers wanted but could not have had before because the workers were needed to make things consumers wanted more urgently. Thus the rise in the productivity of labor creates wealth—and raises real wages.

This process is not understood by most of the people who consider themselves qualified to teach economics, history, and "social studies." Their implicit judgment is that the conditions in the late-eighteenth and nineteenth centuries called for government intervention to redistribute wealth from the capitalists to the workers. One problem with such a plan, says Reisman, is that

> there was virtually nothing to redistribute. The workers of the early nineteenth century did not lack automobiles and television sets because the capitalists were keeping the whole supply to themselves. There simply were no automobiles or television sets—for anyone. Nor did the workers of those days lack sufficient housing, clothing, and meat because the capitalists had too much of these goods. Very little of such goods could be produced when they had to be produced almost entirely by hand. If the limited supplies of such goods that the capitalists had could have been redistributed, the improvement in the conditions of the workers would hardly have been noticeable. If one person in a thousand, say, is a wealthy capitalist, and eats twice as much and has twenty times the clothing and furniture as an average person, hardly any noticeable improvement for the average person could come from dividing the capitalists' greater-than-average consumption by 999 and redistributing it. At the very best, a redistribution of wealth or income would have been useless as a means of alleviating the poverty of the past. (p. 653)

In fact, Reisman goes on, such wealth redistribution, in addition to being ludicrously inadequate for fulfilling the expectations of its supporters, would directly harm the long-term interests of the workers themselves, as well as everyone else. If businessmen wish to prosper they must reinvest the vast bulk of their profits to expand their capital stock. That in turn further increases the productivity of labor, increasing the supply of goods produced. These increases, by raising the ratio of consumer goods to the supply of labor, lowers prices relative to wage rates and raises real wages. The cost of wealth redistribution would include the investment in capital equipment that business would be unable to make because its profits would be taxed away. "The truth is," says Reisman, "that what made possible the rise in real wages and the average standard of living over the last two hundred years is precisely the fact that for the first time in history the redistributors were beaten back long enough and far enough to make large-scale capital accumulation and innovation possible" (p. 653).

Taking Credit

Politicians, who have to justify their existence somehow, naturally want to take credit for the economic progress and rising living standards we have enjoyed for the past two centuries. Virtually all textbook treatments of these issues dutifully parrot the government line: were it not for the power of the state, people would still be toiling 80 hours per week and children would be working in mines. Again contrary to what most people have been led to believe, it is logically inescapable that reduced working hours and the elimination of child labor were brought about precisely by the *extension* of capitalism. It is beyond tiresome to listen to a modern-day professor's moral outrage at the fact that nineteenth-century workers often worked 60, 70, or even more hours per week. If only people had been more "socially conscious," goes the typical argument, these laborers might have been spared having to work so many hours.

There is no doubt that by today's standards, people in the nineteenth century did indeed work an exhausting schedule. But, again, when output per worker is miserably low, a supply of consumer goods that most people consider adequate requires long hours of work. As productivity increases, and with it the level of real wages, people begin to opt for leisure over additional goods. Without the prod of legislation, employers will discover it is in their interest to require fewer hours of their workers. If someone who once worked 80 hours per week now wishes to work only 60 (three-fourths as many hours) and is willing to accept a wage less than three-fourths his previous wage as a premium on the added leisure, it makes perfect sense for his employer to offer these terms (pp. 660–61).

Reisman does not hesitate to draw the obvious if all-too-rare conclusion from all this: it is the capitalists, routinely portrayed as devilish villains, who are alone responsible for the dramatically higher standard of living that American workers enjoy today. The typical American worker owns an abundance of things that people of previous ages could scarcely have imagined and would have regarded as luxuries. These are due primarily not to the physical effort of ordinary laborers, important as their contribution is, but to the scientific genius of those who invent the machines and tools with which workers can multiply many times over what they could have produced with their bare hands, and to the organizational genius of businessmen who oversee the process of production and who put those machines and tools in the hands of their workers.

Both in the productivity theory of wages and in his treatise taken as a whole, Reisman makes it clear what we should think of those educators, politicians, journalists, and activists who, decade after decade, have poisoned popular opinion by leveling the same drearily predictable accusations against capitalism. By consistently offering more and better products at lower and lower prices the market has made possible the physical survival of countless millions who in more-primitive conditions would surely have perished—the very opposite of those allegations about the "survival of the fittest." Out of envy, malice, or sheer ignorance, the market's opponents have denigrated and actively sabotaged the only social order that has been able to rise above the stagnation and squalor of the past. □