

## CHAPTER 2

# What Was the Postwar Social Contract, Where Did It Come From, and What Made It Work for Three Decades?

Throughout this book I borrow the concept of a “social contract” first developed by Jean Jacques Rousseau and other philosophers to describe the ideal relationship between citizens and their government to capture what I believe constitutes a social contract at work. By the social contract at work I mean *the mutual expectations and obligations workers, employers, and their communities and societies have regarding work and employment relationships*. In this chapter I bring this concept to life by describing the central feature of the social contract that emerged out of the New Deal labor legislation of the 1930s and took hold after the end of World War II. Figure 1.3 captures the essence of that postwar social contract: Wages and productivity moved upward together from 1945 to about 1980 and in doing so helped expand the American middle class and achieve a sustained era of broadly shared prosperity. Let’s now look at how this happened.

In the 1920s, the economy was booming and business was flourishing, but the majority of Americans were left behind. Then the economy fell into crisis of the Great Depression. The Roosevelt administration considered British economist John Maynard Keynes’s macroeconomic theory that government needed to spend money to get the economy back on track and tried to pursue it in a half-hearted fashion. It succeeded in stabilizing the economy and helping those most in need by enacting a comprehensive set of policy reforms regarding the labor market and labor relations.

The New Deal labor legislation created unemployment insurance, social security retirement and disability pensions, minimum wages, and the regulation of hours through overtime premiums beyond 40 hours per week. Finally, but perhaps most important for the longer run, it created a labor relations law and policy that enabled workers to join and sustain unions that were capable of bargaining for wages, hours, and working conditions and created a set of policies for resolving labor-management disputes. (See Box 2.1 for a summary.) These achievements laid the foundation for a new social contract for the American economy and workforce. But they were not enough to usher in that new social contract. It took a set of actions on the part of workers, employers, unions, and government policy makers to build on this foundation during and after World War II. The result of the New Deal foundation and the collective actions that built on it was a postwar social contract that worked well for most parties (less well for women and minorities than for men) for three decades—a period that in hindsight looks like a golden era for the American economy.

### Box 2.1

#### The New Deal foundations

Four Pillars of the New Deal Labor Policy	What They Did
Unemployment Insurance	Provided income to unemployed workers for a temporary period of time with the expectation they would either be rehired or find a new job as economic conditions improved
Social Security and Disability Insurance	Provided retirement benefits to employees who had worked a minimum number of years and benefits to workers who become disabled and unable to work
National Labor Relations Act	Protected the right of workers to form independent unions and engage in collective bargaining
Fair Labor Standards Act	Established a national minimum wage and overtime pay requirements for a work week of more than 40 hours

## The New Deal

Imagine it is 1930 and you are about to finish school and enter the labor force. What is going through your mind?

You came of age in the roaring 20s when the economy was booming. President Calvin Coolidge told you that the “business of the country is business,” and the booming stock market proved his point. But somehow you don’t feel so optimistic. Your family shared only a little bit of the growth in the mid-1920s (wages went up about 8 to 10 percent, but the giant portion of the gains went to the top 10 percent of the population). And whatever income gains your family made were quickly wiped out by the events following Black Tuesday in October 1929, the day the stock market crashed. By the end of 1930, real wages for average workers were no higher than they had been a decade earlier. Unemployment was 10 percent and rising rapidly. If your family was part of the 13 percent of the population that lived and worked on a farm, you were in even worse shape: You had steadily lost income throughout the 1920s even in the face of the business boom.

And then came the Great Depression. At its worst, 25 percent of the workforce was unemployed. Homelessness grew to the point that a name was invented to describe the communities of shanties homeless people created with anything they could find: Hoovervilles. The point was clear: President Hoover was doing too little to combat the Depression. Farming families in Texas and Oklahoma who could no longer cope with the combination of the Depression and years of drought began the trek westward toward the promise of a better life in California that John Steinbeck described in *The Grapes of Wrath*. It all looked quite hopeless, and to those who valued our American way of life and political system, it looked quite dangerous. Radical insurrection seemed just around the corner!

Losing a job was disastrous in the 1920s and 1930s. There was no unemployment insurance and no health insurance. Keeping your job likely meant a cut in wages and work hours. One report indicated that by 1933 nine out of ten companies had cut wages, 60 percent of the workforce was working part time, and family income had dropped by 45 percent.<sup>1</sup>

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<sup>1</sup> “Chapter 5: The Depression,” Digital History, [http://www.digitalhistory.uh.edu/teachers/lesson\\_plans/pdfs/unit9\\_5.pdf](http://www.digitalhistory.uh.edu/teachers/lesson_plans/pdfs/unit9_5.pdf), accessed March 15, 2014. For other reviews of wage cuts during the Great Depression, see Leo Wolman, “Wages during

That combination of frustration and desire for change led to political change. After the Republicans had controlled the White House for 10 years, Democrat Franklin D. Roosevelt was elected. He ushered in what would become known as the New Deal.

While Roosevelt didn't come into office with a clear agenda for change, at least one of his advisors did. Frances Perkins famously warned the new president that if he chose her to be his Secretary of Labor she would press for legislation to provide unemployment insurance, a national minimum wage, and a program of retirement insurance and disability insurance (see Box 2.2).

## Box 2.2

### Frances Perkins's vision and agenda

Roosevelt came right to the point. "I've been thinking things over and I've decided I want you to be Secretary of Labor."

Since the call from his secretary, I had been going over arguments to convince him that he should not appoint me. . . . I said that if I accepted the position of Secretary of Labor I should want to do a great deal. I outlined a program of labor legislation and economic improvement. None of it was radical. It had all been tried in certain states and foreign countries. But I thought that Roosevelt might consider it too ambitious to be undertaken when the United States was deep in depression and unemployment.

In broad terms, I proposed immediate federal aid to the states for direct unemployment relief, an extensive program of public works, a study and an approach to the establishment by federal law of minimum wages, maximum hours, true unemployment and old-age insurance, abolition of child labor, and the creation of a federal employment service.

The program received Roosevelt's hearty endorsement, and he told me he wanted me to carry it out.

Source: Frances Perkins, *The Roosevelt I Knew* (New York: Viking Press, 1946).

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the Depression," *National Bureau of Economic Research Bulletin* 46 (May 1, 1933): 1–5, <http://www.nber.org/chapters/c2256.pdf>; and Horst Mendershausen, "Changes in Income Level, 1929–1933," in *Changes in Income Distribution during the Great Depression* (New York: National Bureau of Economic Research, 1946), 12–22, <http://www.nber.org/chapters/c5307.pdf>.

Where did her ideas come from? She didn't make them up. This brings us to our first lesson that can inform efforts to build a new social contract going forward.

*All innovations are local. Most of our federal labor and social legislation was first conceived, incubated, and tested at the state level and/or in private-sector settings.*

Frances Perkins knew first-hand that there had been a good deal of experimentation with these programs in progressive states such as Wisconsin, New York (where Perkins had been commissioner of the state department of labor when Roosevelt was governor), and Massachusetts. Many of these programs were first developed by academics from the University of Wisconsin under the tutelage of Professor John R. Commons. He earned the title of “Father of the New Deal,” since many of his ideas, carried forward by his students, found their way to Washington in the Roosevelt administration.

Consider, for example, how unemployment insurance and Social Security came into being. This is how historian Arthur Schlesinger Jr. told the story. Shortly after taking office, President Roosevelt gave his secretary of labor, Frances Perkins, the green light to work on the agenda she had laid out for him prior to accepting his offer to become “Madam Secretary,” as she was later called. She went to work on the idea of creating an unemployment insurance system by drawing heavily on experts from Wisconsin who had worked with John R. Commons to first propose an “experienced-based” state system in 1921. Commons’s students Paul Raushenbush and Elizabeth Brandeis Raushenbush (the daughter of Supreme Court Justice Louis Brandeis), University of Wisconsin professor Edwin Witte, and Arthur Altmeyer developed a plan that called for state-level administration of unemployment insurance funded through a payroll tax that was prorated based on the level of unemployment a firm experienced. After considerable debate over the technical details of this approach, the Roosevelt team adopted it and the president endorsed it.

In parallel, another group tackled the question of how to create an old-age insurance system and some means of providing for the families of workers who died or became permanently disabled. The president had already expressed his views to Madam Secretary on this issue. According to Schlesinger, Roosevelt said to Frances Perkins: “I see no reason why every child, from the day he is born, should not be a member of the social security system. . . . From the cradle to the grave they ought be in a social insurance system.” He went on to describe his views on how this insurance system should be financed: “If I have anything to say about it, it will be contributed . . . both on the part of the employer and the employee, on a sound actuarial basis. It means no money out of the Treasury.”<sup>2</sup>

The rest is history. In January 1935, Roosevelt’s social security and unemployment insurance bill was submitted to Congress. It was hotly debated, often in terms that should sound quite familiar to those who have followed the debates over “Obamacare.”

A leading business group, the National Industrial Conference Board (I will return to this group’s views on issues later), said: “Unemployment insurance cannot be placed on a sound financial basis. It will facilitate ultimate socialist control of life and industry.” Alfred Sloan of General Motors said, “The dangers are manifest.” James L. Donnelly of the Illinois Manufacturers’ Association insisted that the new bill would undermine the American way of life by “destroying initiative, discouraging thrift, and stifling individual responsibility.”<sup>3</sup> Republicans in Congress such as Representative John Taber of New York channeled these views: “Never in the history of the world has any measure been brought in here so insidiously designed as to prevent business recovery, to enslave workers, and to present any possibility of the employers providing work for the people.” Representative Daniel A. Reed concurred: “The lash of the dictator will be felt and twenty-five million free American citizens will for the first time submit themselves to a fingerprint test.”<sup>4</sup>

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<sup>2</sup> Arthur M. Schlesinger Jr., *The Age of Roosevelt: The Coming of the New Deal, 1933–1935*, vol. 2 (Boston: Houghton, Mifflin, 1958), p. 308.

<sup>3</sup> *Ibid.*, p. 311.

<sup>4</sup> *Ibid.*

In the end, after a long debate and a number of amendments, the Social Security Act of 1935 was enacted. It provided unemployment insurance, old-age insurance, and disability insurance programs. Little did these policy makers or their supporters and critics in Congress know that some 50 years later Republicans and Democrats alike would describe Social Security as the “third rail” of politics that was never to be touched.

If this social legislation was controversial, consider the most difficult of all parts of the New Deal to be enacted—legislation to protect workers’ rights to join a union and engage in collective bargaining over their wages, hours, and working conditions.

This was not one of the pieces of legislation Roosevelt or his cabinet members initiated or even initially supported. Instead, its chief sponsor was Senator Robert Wagner of New York. The “Wagner Act” (formally the National Labor Relations Act), passed in 1935, shared two similarities with other parts of the New Deal: It built on local-level innovations, in this case in the private-sector clothing, coal, and railroads industries, and it was informed by the work of labor economists and historians who had studied and help guide collective bargaining programs in the era before the New Deal.

The final plank of the New Deal labor legislation, the Fair Labor Standards Act of 1938, instituted the nation’s first minimum wage (25 cents per hour), required employers to pay overtime for a work week of more than 44 hours (later lowered to 40 hours), and abolished most child labor. President Roosevelt strongly supported this legislation, which Secretary Perkins and her staff at the Department of Labor had developed. Business strongly opposed it. Labor leaders were lukewarm in their support, fearing in part that government-mandated minimum wages would undermine unions and collective bargaining. Secretary Perkins’s staff developed parallel laws that required government contractors and employers in government-financed construction projects to pay “prevailing wages”; these laws were also enacted.<sup>5</sup>

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<sup>5</sup> See Jonathan Grossman, “Fair Labor Standards Act of 1938: Maximum Struggle for a Minimum Wage,” *Monthly Labor Review* (June 1978) <https://www.dol.gov/general/aboutdol/history/flsa1938>.

I present this history, focusing particularly on the staff work done at the Department of Labor under a strong and well-informed secretary, to contrast it with the inaction on labor policies in recent Democratic (and Republican) administrations.

*What can we learn from this experience that would help inform where we need to go? I believe the key lesson to take away from this New Deal history is that if we are to go beyond the divided policies that are always associated with labor legislation in the United States, the following elements must be in place: a strong policy champion, a government department staffed with professionals who can provide deep analysis of labor issues, and access to the expertise created by academics who have helped invent the private and state-level innovations that provide the evidence that proposed policies work.*

## The Macro Engine for Growth

Roosevelt did not begin his efforts to cope with the Great Depression with the New Deal legislation. His first and most urgent task upon taking office in 1932 was to stabilize the financial system. He implemented a bank holiday to stop the run on withdrawals. Then he embarked on a spending program to try to regenerate economic growth. By 1937, he had partially succeeded. But then the inflation hawks of his administration won out and took actions to raise interest rates and limit the inflow of gold into the country (our currency was still tied to the value of gold) and the country fell back into recession.<sup>6</sup> It took the military buildup and subsequent wartime production and expansion of the military forces to finally bring unemployment down to pre-Depression levels.<sup>7</sup>

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<sup>6</sup> Peter Temin and David Vines, *The Leaderless Economy* (Princeton, NJ: Princeton University Press, 2013), p. 56.

<sup>7</sup> Robert J. Gordon and Robert Krenn, “The End of the Great Depression 1939-41: Policy Contributions and Fiscal Multipliers,” National Bureau of Economic Research Working Paper 16380, September 2010, <http://www.nber.org/papers/w16380>.

While the government spent enough in the 1930s to keep the economy from sinking further into decline and to contain the social chaos that threatened to replace our democratic government with a more radical—socialist, Communist, or right-wing totalitarian—alternative, it took the massive expenditures of World War II to finally pull the economy out of recession and get back to something close to full employment. At the same time, the wartime labor shortages (of military-age men) brought in massive female labor force participation. Rosie the Riveter helped produce wartime goods and keep young families afloat while young men—husbands and fathers—went to war.

Again there is a lesson for today.

*It took massive government spending to recover the jobs that had been lost in the Great Depression. After the war, the restored purchasing power of consumers was able to sustain a strong labor market for years to come.*

While the war buildup brought the unemployment problem under control, a new challenge emerged: How could the government keep wartime production going without work stoppages and without letting inflation get out of control? The answer turned out to be a little-known and underappreciated institution composed of government, business, and labor leaders that was quite effective in the short run and important for creating the principles and practices that would help usher in decades of shared prosperity after the war. The institution was called the National War Labor Board (NWLB).

### **Government as Innovator: The War Labor Board**

Imagine you are a newly minted PhD economist schooled in the latest developments in economic theory who is suddenly called upon to help manage the wartime agencies. You now must put your theoretical knowledge to work on the practical processes of collective bargaining, wage determination, and labor-management relations. Box 2.3 presents a quote from one the best known of these young economists, Clark Kerr, who went on to become one of the nation's leading mediators and arbitrators and eventually the president of the University of California.

## Box 2.3

### Clark Kerr's story

When I entered the field of industrial relations, I had a chance to practice the art of peaceful solutions. My first experience in the field [while studying for my PhD] was in the fall of 1933 during the bloody cotton pickers' strike in the great Central Valley of California. Then, later[,] . . . from 1940 to 1945 I became the leading arbitrator of industrial disputes in the Seattle region. This led to my participation during World War II in the work of the regional War Labor Board stabilizing wages and settling labor disputes, hundreds of them. After the war, I continued in arbitration and became a leading arbitrator on the West Coast. I saw how violence once unleashed came to lead an uncontrolled life of its own. I saw how patience and reason led to less costly processes and better solutions than did passion and violence.

Source: Clark Kerr, *The Gold and the Blue: A Personal Memoir of the University of California, 1949–1967*, vol. 1, *Academic Triumphs* (Berkeley: University of California Press, 2001), p. 14.

Members of the NWLB such as Clark Kerr and Professor George Taylor from the University of Pennsylvania helped invent and spread many of the employment practices that enabled professional personnel management and collective bargaining to work effectively for decades to come. Rational internal job structures and wage differentials, formulas that adjusted wages for changes in the cost of living, comparisons of wages within industries and occupations, fringe benefits including health insurance and pensions, grievance procedures that included arbitration for resolving day-to-day disputes—all of these grew out of decisions or recommendations of the NWLB. And based on their experiences in their early careers in working with management and labor to apply these new principles, a cadre of young professional labor relations “neutrals” (i.e., individuals who were neither labor nor management representatives but worked with both sides as mediators or arbitrators to resolve their disputes) was created who went on to apply and adapt these practices in industry for decades to come.

*The lesson: Creative and knowledgeable “neutrals” can make a difference and invent solutions to practical problems. But they have to understand the nature of labor (and other) market forces and not be captured by the interests of one party or another—in this case business or labor. And, they can’t be so tied to past practices that they are not able to invent new solutions for the future.*

By far the most important of these innovations involved fringe benefits. The NWLB encouraged bargaining on health insurance and pensions as a way of holding wages in check and keeping labor peace. This is how employers became the providers of long-term economic security and health care coverage, something that worked well for many years for those who were covered. But this legacy is now an albatross around the neck of the economy. I will discuss how to wean ourselves from this legacy in Chapter 6.

*The lesson: It made good sense to use employers as the transmission belt for spreading health insurance and pension coverage when large firms and long-term employment with a single firm was the dominant model of employment relations. This is no longer the case, and we now have to wean ourselves from this outmoded approach to funding and transmitting coverage of these key benefits.*

## **The Postwar Economy and Labor Market: Boom or Bust?**

Following World War II, many economists worried that the economy would fall back to prewar levels of stagnation as government wartime expenditures declined. In 1943, economist Paul Samuelson, who later was awarded the Nobel Prize in economics, wrote that when the war ended, “some ten million men will be thrown on the labor market” leading to the potential for “the greatest period of unemployment and industrial dislocation which any economy has ever faced.”<sup>8</sup> Another future Nobel Prize

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<sup>8</sup> Paul Samuelson, “Full Employment after the War,” in *Postwar Economic Problems*, edited by S. E. Harris (New York: McGraw-Hill, 1943), quoted in Cecil Bohanon,

winner, one of the most famous European economists of the time, Gunnar Myrdal, offered the even more dire warning that the economic challenges in Europe would lead to an “epidemic of violence.”<sup>9</sup>

But lo and behold, neither Samuelson’s nor Myrdal’s prediction came to pass. Instead, the postwar period saw the emergence of a robust economy in the United States led by pent-up consumer demand and fueled by international financing that supported the rebuilding of the war-torn societies of Europe and Japan. This was achieved by a combination of the private-sector investment that was needed to help industry transition from military goods back to the production of consumer goods and a supportive set of education and labor market policies and institutions that matched the needs of the postwar economy.

Together, these business investments and institutions created what would become known as the postwar social contract. Here’s how it was created and sustained for the three decades following the war.

## The Postwar Social Contract

### *The Role of Education*

Let’s start with the role education played in helping to build a prospering postwar economy. When World War II ended, 10 million veterans who had put their careers on hold to serve their country returned home to relaunch their family lives and careers. Some, like Ted Williams, the most famous Red Sox player ever, were so talented that they could pick up where they left off. The first year he was back William batted .342, hit 38 home runs, batted in 123 runs, and led the Red Sox to win the American League pennant (but, as all Red Sox fans know, not the World Series; that would have to wait until 2004).

Others were not yet at the top of their game, and the nation worried about what to do with them. Fortunately, national leaders were also worried about the futures of veterans and felt they owed them some

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“Economic Recovery: Lessons from the Post World War II Period,” September 10, 2012, <https://www.mercatus.org/publication/economic-recovery-lessons-post-world-war-ii-period>.

<sup>9</sup> Ibid.

assistance. For those who grew up on their family's farm, going back was not a good option since advances in technology—tractors and milking machines, for example—were greatly reducing the need for farm labor and small family farms were becoming more and more tenuous and less likely to survive long enough to be passed on to the next generation. Fortunately, the manufacturing sector beckoned. Large industrial firms were growing and needed middle managers and talented technical engineers. But these opportunities required further education.

The GI Bill was created to meet these needs. By any standard (particularly compared to today!), the benefits were generous. The Servicemen's Readjustment Act of 1944 (the official name of the GI Bill) entitled anyone with 90 days or more of military service to one year of tuition and paid fees for education up to a maximum of \$500 per year. This increased for each month of service up to a maximum of 4 years of support. In addition, single veterans received a stipend of \$50 a month and married veterans received \$75 a month while in school.

About 12 percent of returning veterans took up the opportunity to go to college. One study estimates that the net effects of the GI Bill and military service in World War II increased college graduation rates by between 5 and 8 percent. Although other studies estimate smaller effects, there is no question that the benefits were generous enough to provide a strong incentive for veterans to go to college, support a family sufficiently while the veteran completed a degree, and leave the veteran with little or no debts to repay. These extensive benefits not only encouraged college attendance but very likely helped increase the range of colleges available to many who otherwise would have been limited to lower-cost institutions. As just one example, over 90 percent of those admitted to the Harvard Business School in 1947 were supported by the GI Bill.

During the postwar years, American universities grew in size and stature to become the world's best and most accessible system of higher education. My favorite example of a great public university is the University of Wisconsin. The relatively low cost of college allowed many young people to become the first member of their families to attend and graduate from college, often through a combination of part-time work, scholarships, low-interest loans, and family support. My first semester of tuition at the University of Wisconsin, Manitowoc County Center, a

two-year institution that provided transfer credits to the Madison campus, was \$105. (In 2013, one semester's tuition at the same institution cost \$5,000). If I recall correctly, I earned about \$800 to \$1,000 in summer jobs and another \$500 or so in part-time jobs during the school year. This was more than enough to finance the costs of these years and to put enough aside to cover the cost of living in Madison for the final two years of undergraduate work. Years later I enjoyed telling our youngest son that my wife and I spent more on his preschool education than I spent on my entire college education, right up through the PhD! This would not have been possible without the supports of a low-cost, high-quality state university, scholarships from the state and from the local community, and fellowships from the National Science Foundation and other government agencies.

The quality of this education was unsurpassed. While funding higher education was always controversial in state politics, successive waves of state legislators and governors supported Wisconsin's state university with generous budgets. But this support has decreased markedly since 2005 and reached a nadir (I hope) with the budget cuts Governor Scott Walker imposed after he was elected in 2010. The year I graduated from the university (1973), the state government covered 43 percent of the university's total budget; by 2012, the state's contribution had fallen to 15 percent. Over this same time period, the proportion of the university's income from tuition increased by nearly 50 percent, rising from 11 percent in 1973 to 16 percent in 2012.

I summarize the University of Wisconsin experience to illustrate the risks America is facing as it defunds public universities and makes it harder and harder for young, ambitious, and talented people from families of modest means to use these premier institutions as a channel for upward mobility. Although higher education remains one of the things America excels at, if the nation is to retain this position, significant transformation will be necessary in the years ahead. For this reason, we need to understand the role of education in fostering and supporting the postwar social contract, if only so we can figure out what features need to be retained and reinforced and what features need to be changed and transformed in the future.

### *The Role of Collective Bargaining*

In the postwar years, demand for production workers was brisk as factories retooled to meet the pent-up demand for consumer goods that had not been available during the war. Unions entered a period of growth and became permanent institutions in the United States, thanks in part to the duty of employers to bargain with unions specified in the 1935 National Labor Relations Act. But workers also had pent-up demands following years of wage controls. As these controls were lifted, numerous strikes broke out. More time was lost to strikes in 1946 than any other year before or after. If any business leaders thought the end of the war would open the door to a return to the preunion conditions of the 1920s, the strike wave and the newfound power of industrial unions demonstrated that this was not an option. Instead, employers needed to come up with a way to stabilize labor relations so they could take advantage of growing markets for American goods at home and abroad. The postwar social contract emerged from this setting.

President Truman hoped that the cooperation between labor and business that had developed during World War II could be carried over to the peacetime economy. In 1945, he called a meeting of national labor and business leaders to discuss the principles of a potential postwar labor-management accord. Although the parties came close to such an agreement, they came up short on one issue: They could not agree on the limits of union influence in management decisions.

Progressive union leaders such as Walter Reuther, president of the United Auto Workers (UAW), envisioned a postwar labor relations system in which workers would contribute to improving operations and help steer businesses to broader social purposes, just as he had led the process of retooling industry in the early 1940s to build tanks and ships to support the war effort. But business leaders strongly opposed having an open-ended agenda for labor-management relations—they wanted to retain management’s right to manage businesses.

*The lesson: It is likely that there will never be a permanent accord between labor and business. But when the nation is in crisis, both sides can be mobilized to act in the national interest. At least this*

*was the case in the past. What steps might be taken to rally the same sense of national solidarity to help forge a new social contract suited to today's economy and the workforce of the future?*

In the absence of a shared vision for the future of labor-management relations in the postwar years, the parties each had to pursue their own strategies. Walter Reuther, who, depending on one's point of view, was either the "most dangerous man in Detroit" or the most progressive labor leader of his time, pursued his vision through bargaining with auto companies. (George Romney, the future governor of Michigan and father of Mitt Romney, the Republican candidate for U.S. president in 2012, is the one who called him "the most dangerous man in Detroit."<sup>10</sup>) Reuther wanted workers to have a voice in management decisions about production, pricing, and product development in addition to the legally prescribed range of bargaining over wages, hours, and working conditions. But management had a different idea, and few of Reuther's labor leader colleagues supported his "socialist"-sounding ideas. Instead, GM's CEO proposed what the editors of *Fortune Magazine* labeled the Treaty of Detroit. In return for labor peace, GM would agree to a wage formula that would link wage increases to growth in productivity and to the cost of living.<sup>11</sup>

How did the wage norms and settlements between GM and the UAW spread across the economy? It is worth reflecting on this question, not just for the historical record but because, as I will discuss later, a big strategic puzzle today is how to make the best practices of leading firms the norm in business. To understand how this happened, we need to introduce an old labor relations term: pattern bargaining.

Pattern bargaining is the process whereby unions seek to spread wage settlements achieved in one firm to competing firms in their industry or labor market in order to take wages out of competition. By doing so, they provide stability in labor relations and gradually raise or ratchet up the floor on wages, benefits, and working conditions. In today's parlance, we might describe this as a way of avoiding a race to the bottom.

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<sup>10</sup> Nelson Lichtenstein, *The Most Dangerous Man in Detroit: Walter Reuther and the Fate of American Labor* (New York: Basic Books, 1995).

<sup>11</sup> *Ibid.*

For example, the UAW took the GM agreement to GM's direct competitors, Ford and Chrysler, and was able to get them to agree to the same settlement. Unions in other industries such as steel, electronics, oil and gas, utilities, and rubber likewise sought to match what the auto workers achieved. The net result was the tandem movement in wages and productivity from the mid-1940s through the 1970s that is depicted in Figure 1.3. This how the postwar social contract became the national norm.

Econometric evidence has demonstrated that collective bargaining was a particularly effective way to use pattern bargaining to reduce wage differences within industries. That meant that there was no single national wage pattern. Instead, a norm developed by which unions bargained for wages and employers agreed to wage proposals based on comparisons with the wages of similar-sized competitors in the same industry. This norm was enforced by the bargaining power of unions and was copied by nonunion firms that wanted to remain nonunion. That is how wage increases were spread across competitors within industries and labor markets. The wages of white-collar workers and middle managers also increased as the result of union-negotiated wage increases because personnel managers were careful to maintain reasonable differentials between managers' wages and the wages of the workers they supervised. The salaries of CEOs and top management were held in check for fear that unions would demand equivalent pay increases if they observed those at the top of their companies disproportionately feathering their own nests. This combination of union power and pattern bargaining is how what some refer to as social norms kept wage and income inequality from getting out of hand in the postwar period.

I polled the students in the online class about whether they thought wages and productivity should move together as they did in the heyday of the postwar social contract. An overwhelming majority—83 percent—agreed that they should. They saw it as a sensible general norm or principle for wage setting. But many also worried that this might be difficult to do in the future. Here is a sampling of student comments on this issue.

The lack of congruence between wages and productivity [in recent decades] is one of the reasons we have such drastic income inequality. If the benefits of all that productivity are not going to

the workers, then they are going to the owners. Thus the owners, i.e., the major stockholders, are becoming enriched at the expense of the workers who are creating the wealth for them.

Shareholders and managers have always been and always will be motivated to increase profits[,] which means paying workers the lowest possible wages. In the post-war era, workers had the power (mostly through unions but government also played a role) to force employers to pay higher wages. Since the 1970s workers have lost that power. To increase wages, workers must regain the power to force wage increases. Wage increases will not happen through employer charity.

*The lesson: Norms don't appear out of thin air. Behind every norm lies an idea and the power to enforce and spread that idea.*

### From Steady State to Atrophy

All these cross-cutting institutions helped support and sustain the social contract from the 1950s through the 1970s. During these years, as the lines in Figure 1.3 indicate, the wage-setting formula initiated by GM and the UAW in the 1940s kept productivity and real wages moving upward roughly in tandem. This is not to say that there were not rough spots along the way. In the 1960s, concerns that wage-price spirals were fueling inflation led the Kennedy and Johnson administrations to introduce wage and price guideposts in an attempt to restrain inflation. In the early 1970s, runaway wage increases in the construction industry that threatened to spread to other industries led the Nixon administration to take even stronger action in the form of wage and price controls. And later in the 1970s a period of “stagflation”—slow economic growth while wages and prices continued to increase—created a crisis that eventually led to dramatic change in both economic policies and political leadership. The postwar social contract had matured but was not adapting to an incrementally changing environment.

Indeed, the 1960s proved to be a tumultuous decade in both employment relations and American society in general. In employment relations, the

1960s began with much concern that advances in technology (referred to at the time as “automation”) were gradually but steadily eliminating jobs and creating a population of permanently unemployed workers (called structural unemployment). A host of new policies were implemented to support retraining, geographic relocation, and regional economic development to cope with the consequences of persistent unemployment. The employment and training policies and infrastructure in place today are essentially carryovers from these beginnings of a national labor market policy.

The automation scare proved to be overstated and premature. Just as World War II expenditures brought the labor market out of the Great Depression, expenditures for the Vietnam War in the 1960s did more to bring down the unemployment rate than the new employment and training policies did, helped along by the technological innovations that spawned the growth of the emerging high-tech industries. Once again the lesson is clear:

*When an economy needs to create new, high-quality jobs, it must have strong, growth-oriented macroeconomic policies in place and must nurture technological invention, entrepreneurship, and innovations.*

But the trauma of the Vietnam War and the civil rights battles of the 1960s began to create schisms in the fabric of the social contract. Coming of age and entering the labor force in the 1960s was a heady experience. Everyone was fighting with everyone. The civil rights movement took off with marches in Selma, protests in Birmingham, and the famous March on Washington, where Martin Luther King Jr. gave his “I Have a Dream” address. The Vietnam War tore the country apart, and student protests at leading universities brought police and the National Guard to campuses across the country, in some cases, as at Kent State, with tragic consequences. Cities such as Los Angeles and Detroit were literally on fire as the result of civil rights riots. Young people became disillusioned with all major institutions—with labor unions for being “hardhats” who supported the war and resisted integration, with businesses for making napalm and other horrific war materials, with university leaders for being part of the establishment. American society seemed to be coming apart.

While college students opposed the war, the most visible leaders of the labor movement and the business community either continued to support it or kept their personal misgivings to themselves. While some labor and business leaders supported civil rights activism, the most visible leaders—particularly the leaders of the AFL-CIO—remained silent or aloof. George Meany, president of the AFL-CIO, chose to be out of town the day of Martin Luther King’s March on Washington in 1963, leaving his rival, Walter Reuther, to be the highest-ranking labor leader to march with Rev. King. Young people saw unions as so entrenched a part of the “establishment” that they had little to offer the next generation.

Meanwhile, the world of work was changing below the sight lines of both established labor and management. New ideas for organizing work in more flexible ways had begun to emerge that allowed individuals and teams to flourish and informed how work was done, especially in the new high-technology industries and companies such as Hewlett Packard, Texas Instruments, Digital Equipment Corporation, and, later, Intel, Apple, Dell, and their progeny. These companies used new ideas to organize work, motivate employees, and provide a satisfying and challenging work environment. Labor unions, stuck in organizing models that assumed that workers would be dissatisfied with their jobs and distrusted their bosses, never adapted in ways that convinced workers in these emerging industries that they needed union representation. Gradually, the firms and unions that occupied the high-road cell in Figure 1.1 in the postwar era were migrating in the direction of the low-road cell with high wages but declining profits and competitiveness. As a result, throughout the 1960s and 1970s, union membership began what would turn out to be a long-term decline.

By the mid-1970s, the divide between the unionized sector of the economy that carried forward the wage formulas and work practices of the earlier era and the newer, faster-growing high-tech sectors of the economy was apparent. The difference between union and nonunion wages had increased from about 5 percent to 10 percent in the 1950s and 1960s to an average of 20 percent by the mid-1970s—a differential that caused employers with unionized workforces to cut jobs and to become more and more concerned about their ability to compete. The pressures for significant change were building.

The most visible political warning signal—really a shot across the bow of labor-management relations—came in 1977–1978, during the Carter administration, when a mild form of labor law reform (the Labor Law Reform Act of 1978) that was backed by the labor movement failed in Congress. The business community was emboldened by the experience of blocking this reform in a government led by a Democratic president and Congress. Labor and the Democrats fell one vote short of breaking a Senate filibuster.

Economic warning signs were equally ominous. The stagflation of the 1970s doomed Jimmy Carter. It took the shock of a movie-star president to change the course of history, a history today's next generation is inheriting.

*The lesson: Organizations and institutions fall into patterns of behavior that do not automatically or easily adapt to incremental changes in their environment. They are like the mythical frog put in a kettle of water that is heated gradually and doesn't take action to hop out until it is too late. Radical or disruptive change—departures from well-established routines that have worked for a long time—often can only be achieved (or certainly have a higher likelihood of being tried out) in new organizations or institutions.*



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