The Jerome Levy Economics Institute

Who is Jerome Levy?

An address by S Jay Levy to the scholars and friends of the Jerome Levy Economics Institute of Bard College

Blithewood, September 13, 1991

I welcome all of you, old friends and new, to The Jerome Levy Economics Institute. I will try to answer a question this evening that many of you may have asked – "Who is Jerome Levy?" The Institute was conceived by my brother, Leon, not simply as a tribute to our father, Jerome, but to fulfill an obligation.

Jerome Levy devoted most of his life to furthering personal freedom, economic justice, and economic well-being through original and exceedingly intelligent analyses. I venture to say that no one in this room has as clear a concept as Jerome Levy of how an economy can and should promote personal freedom. And even more emphatically I assert that none of us is sufficiently influenced by a firm idea of what should be meant by economic justice. I will try tonight to encourage you to be more deeply and rigorously concerned with economic justice. I am here as Jerome Levy's spokesman. However, I certainly do not agree with everything Jerome advocated, and some of the things I will say would bring his wrath upon me. But I find little to criticize in his approach to understanding the economy and solving its problems.

Jerome Levy described an ideal economic system, an economic utopia, if you will. I suggest that our economy is moving away from ideal performance. Long-term trends of rising unemployment, declining standards of living for low-and middle-income people, and increasing poverty are hardly utopian developments. Probably all of us believe that these are undesirable developments, but we are less likely to agree on what is full employment, what the standard of living ought to be, and how the economic pie should be distributed among workers and between workers and capitalists. Yet it would be highly useful to have a model of an ideal economy as a standard against which to measure the performance of the United States and, in fact, any other country. I will illustrate this point as I go along.

Jerome Levy was born in 1882 in Honesdale, Pennsylvania. When he was still a young boy, his family moved to New York City, where Jerome later attended City College, intending to be a physicist. He graduated in 1901 and soon thereafter, finding little opportunity for a budding physicist, heeded his family's call to come and help its struggling wholesale knit-goods business. He was disturbed by the unemployment that came with the 1907-08 recession and in 1908 concluded that economics did not know how to overcome this problem. He determined to find the answer – Jerome was not modest. He said to himself, "I employ people. Why? I employ people because I expect to make a profit." He noted that he would expend $1000, he would pay rent, buy supplies, pay the wages of his employees. Jerome told us, "I expended the $1000 because I expected to get $1100 back. Now, I knew how the $1000 got into circulation – I put it there. But where does that other $100, my profit, come from?"

Jerome Levy, despite ten-hour business days and six-day weeks, found the time to derive the equation of profits he had achieved by 1914. This equation or identity was rediscovered in the 1930s by Michael Kalecki, was a central focus of the work of the late A. Asimakapulos, and is integral to the work of Hyman Minsky and other contemporaries. Because everyone seems to recognize the profit identity but few pay much attention to it, I am going to review it. The easy way to derive the profit identity is to begin with the saving=investment identity. I shall briefly review the process using national income and product account terminology.

(diagram 1, page 3) Saving, of course, equals investment. And saving comprises business saving, government saving, and personal saving. Business saving equals undistributed corporation profits plus capital consumption allowances. We are looking for profits. So far, our only reference to profits is the term "undistributed corporate profits." *(diagram 2, page 4)* Let's isolate undistributed corporate profits by subtracting personal saving, government saving capital consumption from both sides of the saving=investment equation. Undistributed corporate profits equals investment minus capital consumption allowances, government surplus, and ersonal saving. But we want profits before tax, not undistributed profits. Profits before tax equal undistributed corporate profits plus corporate profits tax plus dividends. *(diagram 3, page 5)* We add corporate profits tax and dividends to both sides of the equation, which makes the left-hand member represent corporate profits before tax. We have in simple algebraic language the equation that is the profit identity.

I regard what I have just done as the inelegant way of deriving the profit identity. Jerome Levy traced every flow of funds in the economy that represented legal income from wages to interest on installment loans; he recognized every type of accounting entry that affected costs; he, therefore, had constructed the national income and product accounts in 1914, about three decades before they were re-created. Jerome, however, was not particularly interested in gross national product or national income.

An indication of his thorough analysis is Jerome Levy's inclusion of the "inventory valuation adjustment" in his mathematical description of the whole economy. I admit that Jerome did not have the "capital consumption adjustment," but neither did the national income accounts until about 15 years ago. He did include depletion charges, an item not covered by the NIPA data. And his equation also has the term "exhaustion," which covers the decline in the value of patents and copyrights due to their limited, legally fixed lives. In this respect, Jerome, at least in the eyes of the software industry, remains far ahead of the Commerce Department.

Jerome Levy, recognizing the quite different roles that they played in the economy, derived separate equations representing the profits of the consumer goods industries, the capital goods industries, landowners, money lenders, and the legal tender industries. (Money lenders provided credit for consumers and for investors who were leveraging their investments. The legal tender industry sold precious metals, in those days gold, to the government to be monetized.)

Jerome's achievement as I described it was epochal. We live in a profit-motivated economy. Almost the whole world, at least as of three weeks ago, has chosen to live under a private profit system. We all know that when profits go down, private businesses retrench – they stop employing new people and they begin to reduce their existing labor force. Conversely, when profits increase, business is encouraged to expand its output and its payrolls. Profits are important.

Jerome Levy described profits as the fuel that powers a private enterprise economy. Yet only a minority of scholars who are concerned with the macro-economy pay much attention to profits. Jerome compared this lack of attention to automotive engineers trying to explain an internal combustion engine without mentioning the fuel and the carburetor or, today, the fuel-injection apparatus.

I urge you to devote more attention to profits. I believe that the profit perspective on the economy leads to insights that can, in turn, lead to better government economic policies. Yet were

Diagram 1

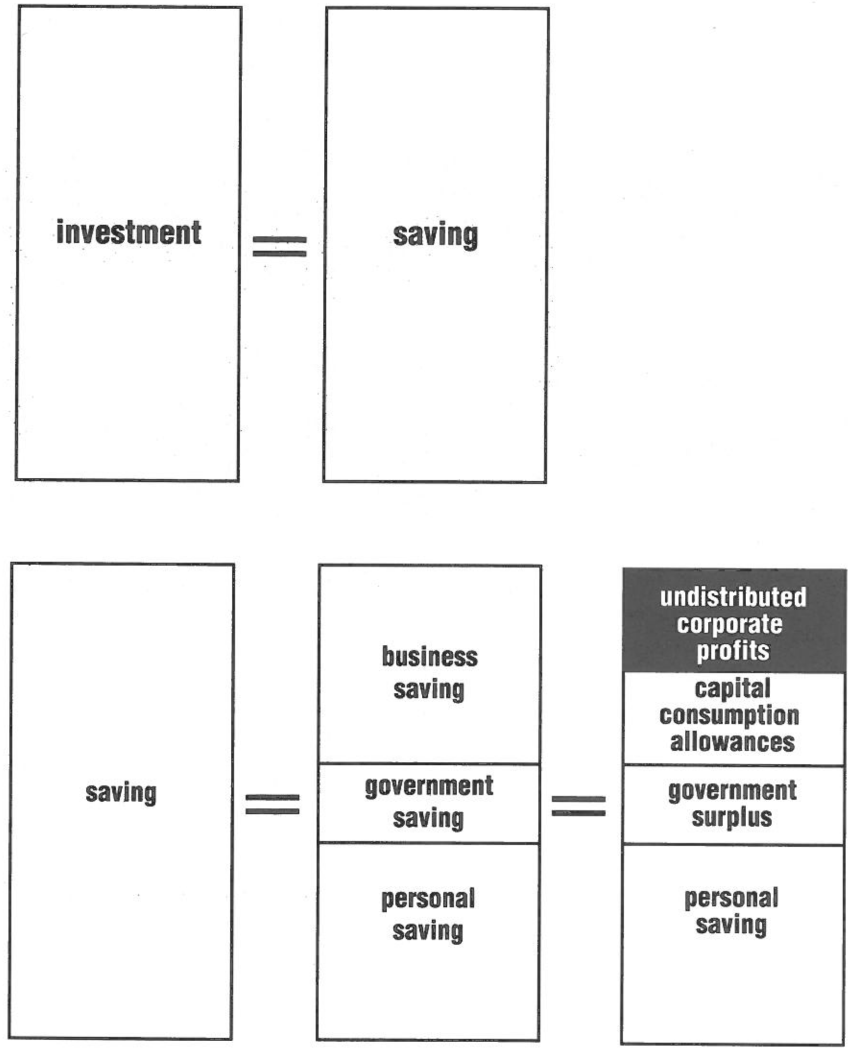
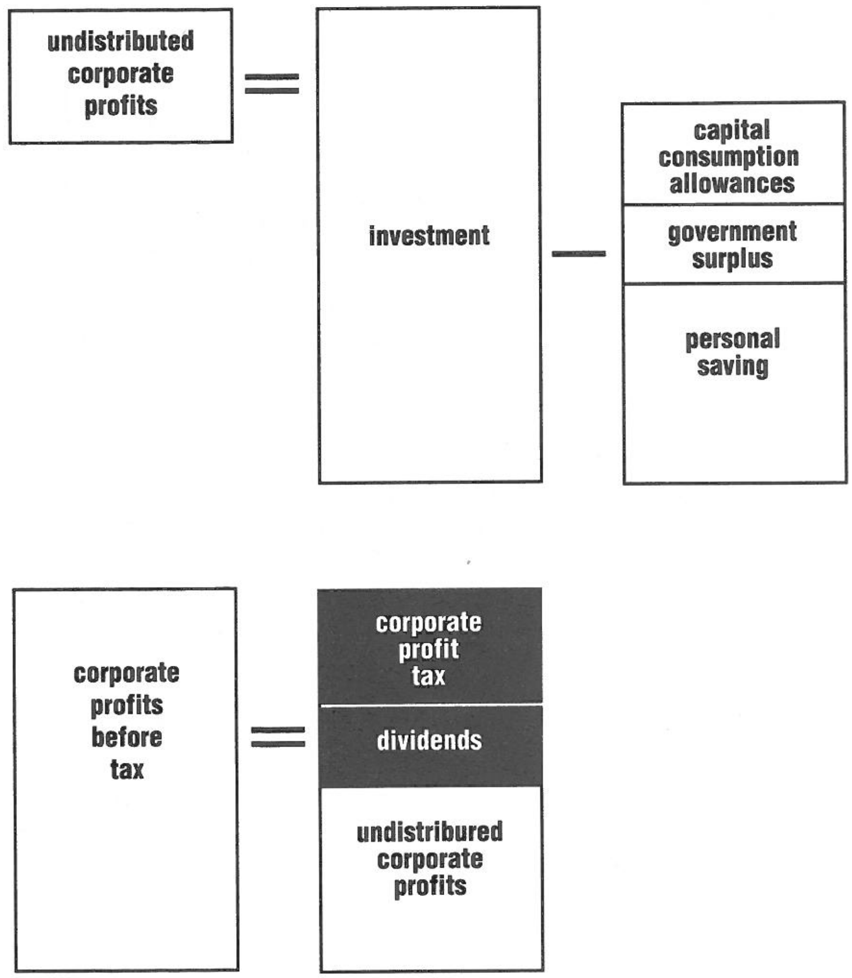
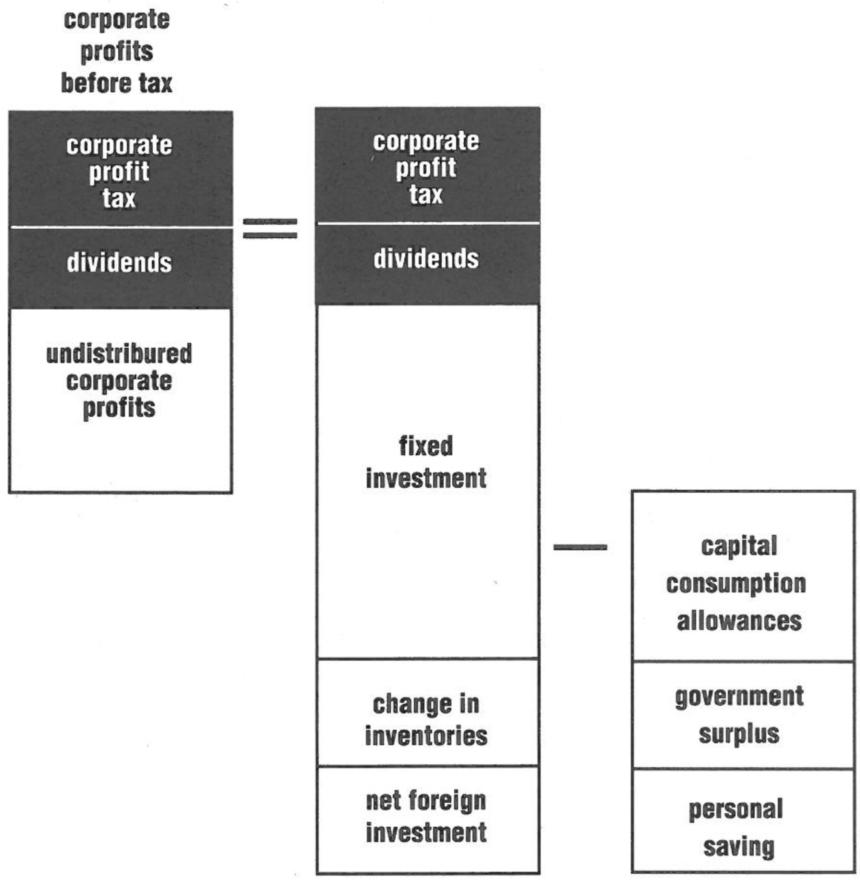

investment
=
saving
saving
=
business saving
government saving
personal saving
=
undistributed corporate profits
capital consumption allowances
government surplus
personal saving

Diagram 2



undistributed corporate profits
=
investment
—
capital consumption allowances
government surplus
personal saving
corporate profits before tax
=
corporate profit tax
dividends
undistribured corporate profits

Diagram 3



corporate profits before tax =
+ fixed investment
+ change in business inventories
+ net foreign investment
- personal saving
- capital consumption allowances
- government surplus (or + deficit)
+ dividends
+ corporate profits tax

Jerome Levy here, listening to me make this statement, he would bristle. He'd heatedly state that, by itself, the profit identity is useless as a tool for determining economic policy.

Until recently, I tended to dissociate myself from this Jerome Levy assertion. Perhaps I was being intellectually lazy or cowardly. Or maybe circumstances warranted my view. After all, the leading industrial nations had all achieved high employment rates, enviable standards of living, and a large degree of personal freedom during the postwar era. Indeed, events and government policies, based on efforts to understand the economy from other perspectives, seemed to have largely eliminated major economic problems.

The climate has changed. The United States is in what David Levy, the director of the Institute's Forecasting Center, has termed a "contained depression." We believe that our country faces a prolonged period of economic malaise. The unemployment rate in the United States, 6.8 percent according to the latest reading, is probably understated. Perhaps by some standard, 6.8 percent is not so bad. But unemployment around the world is a tragic problem of considerable proportions, a problem in industrial as well as developing countries. According to the latest OECD compilation, the standardized unemployment rate is 11 percent in Canada, 9 percent in Australia, 9 percent in Belgium, 9 percent in France, 16 percent in Italy, 16 percent in Spain, 9 percent in the United Kingdom. Conditions are far worse in Latin America, and the numbers of jobless are likely to soar catastrophically in central and eastern European countries before unemployment begins to recede. One can wonder whether the ability of national economies to achieve full employment is better in 1991 than it was in 1908, when Jerome Levy concluded that economics had not provided the solution to the problem of unemployment.

I began this talk by emphasizing Jerome Levy's concern for justice. To him economic justice began by providing the opportunity to have a job for everyone who was willing and able to work. I emphasize the word "everyone." Jerome wrote that the worker has the right "to seek and secure a position among those occupations for which he is relatively best qualified."

You will remember that Jerome Levy was an incipient physicist. He was educated at the end of the era in which Newtonian physics dominated. Newton derived laws of mechanics which explained how machines worked – indeed, how the solar system worked. Neither Newton nor Jerome Levy advocated measuring various phenomena over periods of time and seeking similarities between their behaviors as a means of explaining which phenomenon caused what result. Jerome went after the basic laws of economics from which he could derive an image of the perfectly functioning economic system.

What Jerome Levy sought would, I suspect, be congenial to Adam Smith and Karl Marx. It is rather antithetical to the approaches of late-twentieth-century economists. Jerome Levy held that to prescribe economic policy one needed an understanding of the whole system, of the economic machine. The carburetor that I referred to before was only one part of the machine. He originally named nine parts of the system; how he defined them does not seem to me to be controversial. The parts are: working class, investing class, money-lending class, land, consuming class, profits, monetary system, taxes, and government. The economic machine needed all of these parts to function well if it were to operate efficiently. Since it would break down if any one of them failed, they were all important.

Before I tell you why Jerome ultimately decided that there was a tenth part of the system, I want to tell you something about his personality. Leon and I often discuss our father, his strengths and weaknesses. He, as you might infer, was extremely rational compared to most people, not only in approaching economics but in other ways too. He lived long and observed much, both as a boy involved in gang fights on New York's Lower East Side and as an adult during both World Wars, during the stock market speculation of the late 1920s, the subsequent crash, the depression, and the rise of fascism in the 1930s. As a result of living through this turmoil, he did not think much of rational expectations at markets. But to a difficult-to-explain degree, he expected people to be rational.

For all of his sophistication in some respects, Jerome believed that if one presented a model of a system that would assure full employment, justice, and a rising standard of living, people would support the idea. He was confident that the system he formulated, which would deprive virtually every group in the economy of some of its privileges and perquisites, would be acceptable to everyone. After all, it provided the greatest good for society and, in the long run, for the vast majority of its members.

I might add that Jerome's views of social behavior led him to look upon the Soviet Union with expectations that were too optimistic. He believed that private enterprise – he called it individualism – would provide more economic freedom and, consequently, a higher standard of living than socialism. But he expected people to work for the success of the system in the U.S.S.R and that, as a result, progress would be made there.

When Jerome explained how the economic system should function, people told him that his scheme was too mechanical, that it did not consider the human element. So he concluded that the system had a tenth part: self-interest. People, he maintained, would act in accordance with their self-interest. Self-interest, Jerome held, was served if people were justly compensated for their economic activities. He seemed to overlook the notion that self-interest, as far as individuals and various groups were concerned, was also served if they were over-compensated.

Jerome's views were a reflection of his rigorous sense of ethics. For example, when he was in business, he would never allow a salesman to take him to lunch. People in his industry on occasion asked him to arbitrate their disputes. When my brother decided to make his career in finance, Jerome was not totally pleased. He believed that people on Wall Street were looking for something for nothing, unlike, say, a manufacturer whose success would be tied to producing a good product efficiently.

To determine whether a system or a machine does a good job, one has to understand its purpose. The purpose of the economic system is to produce desired goods efficiently and distribute them equitably. To encourage the production of this wealth, people should be compensated in accordance with their contribution to production. Burglars make no such contribution. Burglary is not, I hope, encouraged. I do not believe anyone quarrels with the concept.

In describing the various parts of the system–for example, the working class, the investing class, the money-lending class – Jerome explained the contributions to production of their members and, therefore, the basis on which they should be compensated. Moreover, he asserted that when people receive wages and salaries, and profits that measure their contributions to production, the taxes they pay should not leave them with relatively more or less than they have earned.

Jerome observed that land made a contribution to production that had nothing to do with whose name was on the deed. Farmers, mine operators, office builders, and others who productively used land were entitled to a profit, but not landowners per se. He therefore said that land should be owned by the state and leased for private purposes. The theory is nice, but the practice would be disastrous. Yet we should keep the theory in mind. It should be useful in determining how land should be taxed and in considering the taxes that should be levied on land capital gains. Perhaps it is more than coincidence that after World War II there was land reform in three countries with market economies – Japan, South Korea, and Taiwan – and not in the Philippines or Brazil, to mention only two. The profit identity strongly indicates that the profits which go to landowners, as distinguished from users, are a drag on the whole economy.

In any short period, an economy's aggregate profits will be largely predetermined, and in any case they will be finite. If an economy, such as Spain's, has chronically high unemployment, we should ask this question: Is a large proportion of the aggregate profits channeled into the pockets of landowners? Do too few profits remain for productive private industry? Is industry's incentive therefore too small to induce it to employ more workers and produce more goods and services? Jerome's prescription – socializing land – is ridiculously impractical, but its goal becomes a standard by which to diagnose and prescribe for the economy.

In Jerome Levy's elegant derivation of the profit identity, terms for employee compensation as well as profits are present. The equation shows that if average wages and salaries are increased, total profits will rise practically proportionately. Pay raises are therefore not a means for increasing the real incomes of employees as a class. But wages and salaries should measure employees' contributions to the production of goods and services. Jerome, therefore, held that two persons doing the same or similar work for different employers in, perhaps, different parts of the nation were making the same contributions to production. They should be paid the same wage. He therefore proposed that almost all employee compensation should be determined by a nationwide system of job evaluation. Perhaps, in this era of computers, such a scheme could be implemented. However, it is pretty far down on the list of policy recommendations that are likely to be acted on. Yet Jerome was right. People should be compensated at the same rate for the same work and their compensations should be related to the degrees of skill, responsibility, risk to health, and so forth involved in the performance of their jobs.

To what extent, if any, does the trend of the past decade, which witnessed growing gaps between the wages of lower- and higher-paid workers, reflect the economy's failure to compensate people for their contribution to production? Framing the question in accordance with the Jerome Levy view would lead to enlightening and even useful answers. Profits as well as wages should measure contributions to production. They should reward those who assumed the risks of production and succeeded in the marketplace. Jerome did not believe that those who were guaranteed a profit by the state, namely public utilities, were entitled to any profit whatsoever. He would be infuriated by the profits on lending money, by the high interest rates, of the past decade. Indeed, current monetary policy raises a basic question about economic justice.

In simple, personal terms, am I entitled to the 5 1/4 percent return on the money that I have invested in a money market mutual fund? I choose to leave my money there even though not so long ago the return was 10 percent. And what would I do with my funds if the yield was 3 percent or 1 percent? Keep them under my mattress? How is competition supposed to achieve equitable pricing at the credit market when the supply of money is limited by the central bank? Interest income was one ninth as large as wage and salary income 25 years ago. Now it is one fourth as large as total wages and salaries. Does this huge rise in interest income reflect investors' contributions to the production of goods and services?

A second question about the profit on lending money: What, if any, is the relation between the rise in interest income and the decline in the real incomes of approximately half the labor force during the past 15 years? If some people are receiving something to which they are not entitled, they must be doing so at the expense of someone else. At whose expense? Jerome Levy's view of a whole economy provides the framework for this question. The profit indentity, particularly his elegant derivation, points to the research that can answer the questions I have just asked about economic justice.

I hope that Blithewood's blissful atmosphere is not too effective a soporific against an awareness of worsening economic conditions that may increasingly affect almost every corner of the earth. We are concerned that here in the United States we are in a lengthy period of high unemployment and disappointing standards of living, a "contained depression." Conditions in central and eastern Europe are likely to get worse before they get better. Even many of the more prosperous parts of the world are not looking so prosperous. Yet the changes that have occurred promise great economic growth not only in the former centrally planned economies but in the countries that will supply them with the means of advancing their productivity. Economic ideas, I hope, will influence the outcome in favor of freedom and a rising standard of living for the masses of people.

Yet I am not sure that John Maynard Keynes was correct when he said, "Practical men, who believe themselves quite exempt from any intellectual influences, are usually the slave of some defunct economist." I suspect that economists are often the slaves of practical men. They use economists as advocates. The practical men use those economists whose ideas seem likely to abet their pursuit of power.

Nonetheless, ideas that hold the prospect of justice for every individual who seeks to earn a livelihood can be powerful. This Institute has undertaken the obligation to seek justice in economies and, to date, we have no better inspiration than Jerome Levy. As we scan our world and observe its awesome economic problems, we realize that it also offers vast opportunities for progress. Surely, the times call for heroic appoaches to effective economic policy.

BARD
Post Office Box 5000
Annandale-on-Hudson, New York
12504-5000