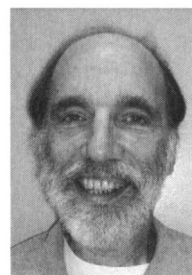


THE ECONOMICS OF CRISIS AND THE CRISIS OF ECONOMICS AS SEEN FROM THE US EPICENTER

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Abstract: The intertwining of excessive financialization and extreme inequality was undermining the foundations of the US economy prior to the recent crisis. Mainstream economists were unable to recognize the symptoms. This failure was a repetition of economists' prior failures during earlier economic crises. In the midst of these crises, the reputation of economics suffers, but each subsequent recovery revives their reputations and their confidence in the market. The article concludes by showing how a defective conception of capital prevents a proper understanding of economic processes.

Key words: financialization, inequality, imbalance, economics of crisis, crisis of economics

I want to begin by discussing the buildup to the recent economic meltdown. Next I will briefly discuss how, after each crisis, many people recognize the shortcomings of economics, only to soon forget the lesson, and then get swept up with free-market enthusiasm once again. Finally, I will discuss why economics has been unable to understand the problem. In this discussion, I will explain why conventional economics is a barrier to understanding the economy.

We have all seen how the illusion of the wealth creation from the previous decade disappeared in a flash with the onset of the financial meltdown. The outcome should have been foreseen. In fact, I published a book just when the stock market peaked explaining what happened in the United States. The book, entitled *The Confiscation of American Prosperity: From Right-Wing Extremism and Economic Ideology to*

the Next Great Depression (Perelman 2007) explained how a thirty-year project to undo the progress of the New Deal shifted the balance of power in favor of capital tore the US economy apart.

Following the Great Depression and World War II, the United States entered into the most prosperous period in its history, yet business did little to create the productivity that could have sustained that momentum. For example, since the end of World War II, the capital stock in manufacturing has continued to age, except for a brief spurt with the excessive expectations of a booming information economy in the 1990s.

Rather than focusing on the creation of a strong economy, business engineered a social revolution to benefit capital at the expense of the rest of society. In fact, since the election of Franklin Roosevelt in 1932, every Democratic administration with the exception of Lyndon Johnson's has been more conservative—often far more conservative—than the previous Democratic administration. Johnson, of course, initially came to power because of the assassination of J. F. Kennedy rather than through an election. Similarly, every elected Republican administration, with the single exception of George Herbert Walker Bush's, has been more conservative than the previous Republican administration. Given this relentless drift to the right, the policies of Richard Nixon now appear well to the left of those of Bill Clinton.

Acting in the name of economic efficiency, this increasingly business-friendly US government enacted measure after measure that purported to increase productivity, but did little or nothing in that respect. For example, the circumvention, or even outright elimination of inconvenient regulations altogether provided an implicit subsidy to profits. Certainly, by the 1970s, growth in profits no longer reflected improved productivity; instead, it became increasingly dependent upon income redistribution, especially by way of curtailing wage growth. By the time of the 2008 crisis, income inequality had become obscene.

Increasing Inequality

The right-wing revolution in the United States created an outrageous degree of inequality. Despite a historically slow rate of growth, between 1970 and 2007, the Gross Domestic Product adjusted for inflation more than tripled, from \$3.8 trillion to \$11.5 trillion (President of the United States 2009: 297, table B-12). Because the population also increased by about 35 percent during that same period, per capita income grew more slowly than the Gross Domestic Product. On average, per capita income still more than doubled—but not for everybody.

Hourly wage earners certainly did not benefit from the economic growth. According to official government statistics, hourly wages corrected for inflation peaked in 1972 at \$8.99 measured in 1982 dollars. By 2005, hourly wages had fallen

to \$8.17, although they rose modestly during that period using a different measure of inflation (President of the United States 2009: 340, table B-47).

In a path breaking series of studies, economists Thomas Piketty from the French research institute CEPREMAP and Emmanuel Saez of the University of California at Berkeley produced a veritable treasure trove of data for researchers interested in the distribution of income. Using data from the Internal Revenue Service, Piketty and Saez reported gross pretax income for taxpaying units measured in 2000 dollars. This income excludes all government transfers to taxpayers—such as Social Security, unemployment benefits, welfare payments, etc.—as well as employees' payroll taxes, and capital gains. Their data is especially valuable because, unlike most data sets, it provides information about the highest incomes.

These data show that for the bottom 99 percent of taxpaying units, the average income stood at \$36,008 in 1970, then peaked in 1973—at the same time as hourly wages—at \$38,206. This figure bottomed out in 1993 at \$33,087. By 2004, average income for the bottom 99 percent recovered somewhat to \$37,295, but was still below where it had been three decades earlier (Piketty and Saez 2006; see also Johnston 2003: 38–39; and Krugman 2002).

During the same period, the top 10 percent increased its share of total income from about 31.51 percent in 1970 to 42.91 percent in 2004—that is, an increase of 11.40 percentage points. Even among the richest 10 percent of the population, the unseemly distribution of income is increasingly skewing toward the richest of the rich. During the same 1970 to 2004 period, the share of the top 1 percent rose from 7.80 percent of total income in 1970 to 16.21 percent in 2004, an increase of 8.41 percentage points, meaning that this group enjoyed almost three-quarters of the 11.40 entire percentage point increase of the top 10 percent (Piketty and Saez 2006).

Even higher on the economic pyramid, this skewed pattern of income reproduces itself. The share of the top 0.1 percent increased from 1.94 percent of total income to 6.95 percent. This increase of 5.01 percentage points means that the top 0.1 percent of households captured almost 44 percent of the total increase of the share of income of the top 10 percent (Piketty and Saez 2006: figure 3).

Moving up even further, the top 0.01—a mere 13,100 tax-paying households—increased its income share from 0.53 percent in 1970 to 2.87 percent in 2004, not much below where it stood on the eve of the Great Depression. This increase of 2.34 percentage points represented almost 21 percent of the total gains of the entire top 10 percent. Looked at from another perspective, between 1972 and 2001, this group saw its wages and salaries increase fifteen-fold (Dew-Becker and Gordon 2005: 104).

These estimates of inequality are certainly far too conservative. For example, corporate executives get unmeasured benefits, such as access to corporate jets for personal use. In the case of poor people, the price indices used to measure

real income do not take account of the extra costs that poor people face, such as higher interest rates.

The Corrosive Consequences of Inequality

Yet, on the surface, this revolution appeared to be a great success, but the corrosive effects of inequality go well beyond the obvious deprivations of poverty. For example, military spending and consumer credit helped to create demand that productive investment might have otherwise produced. As manufacturing capacity withered, consumption depended on imports. Lacking a comparable level of exports, the US economy increasingly depended on credit from abroad, mostly from Asia.

Similarly, environmental deregulation eliminated incentives to develop the productivity of environmentally-friendly technologies. Such technologies could have propelled the US economy into leadership in a sector that appears increasingly vital in the face of the threat of global warming. Instead, the US is a laggard in this area.

These imbalances also created many other long-term problems (see Perelman 2007). One of the most troubling consequences is the loss of future human potential resulting from children raised in poverty in a society that is increasingly shortchanging public education. The lack of adequate support for public education is ironic given the rhetoric about the economic importance of information and the development of new technology.

Inequality is also detrimental to productivity in more immediate ways. Most directly, inequality undermines the effectiveness of both rich and poor. I explore such human costs in more depth in *The Confiscation of American Prosperity* as well as in a more recent book, *The Invisible Handcuffs of Capitalism: How Market Tyranny Stifles the Economy by Stunting Workers*, which will appear next year.

Growing Imbalances

The adjustment to this imbalance of extreme inequality was unlike what one might expect from economic textbooks. Even though great profits should have stimulated investment, business investment remained anemic, except for the earlier-mentioned surge of spending on information technology. Instead, low interest rates spurred speculation.

Employment in manufacturing withered. Because many of the shuttered plants had lower than average productivity, shutting down manufacturing contributed to the illusion of productivity growth. Even traditional manufacturing giants, such as General Motors and General Electric, increasingly depended upon their financial

arms for much of their profits. Measured productivity growth mostly depended on retailing and finance.

Low interest rates promoted consumption. This effect was two-fold. First, low interest rates made credit cheaper. Second, low interest rates created a wealth effect by dramatically pumping up stock prices and then, after the dot.com collapse, housing prices. The resulting asset inflation, gave the illusion of wealth creation encouraging debt-driven consumption, even among the non-affluent.

The combination of wage stagnation and consumption growth was not sustainable. For a while, the economy could substitute consumer debt for increased salaries—as if capital were giving workers loans instead of increased wages. The difference between these two methods of funding consumption is that interest payments represent an additional source of profit. Indeed, just prior to the meltdown, measured financial profits represented 40 percent of total profits (Henry 2005). This estimate is certainly far too conservative. Many non-financial companies earn substantial income from the credit cards and fees that they collect from customers, although such earnings may escape the measures of financial profits.

Much of the product of the financial system is what Karl Marx called fictitious capital, which is unconnected with the underlying productive system. This explosion of fictitious capital distorted the entire economy. The excessively debt-driven consumption was a product of fictitious capital. Fictitious capital made possible the outsized salaries of financial operators, some of whom made more than \$1 billion in a single year.

Less obviously, the lure of fictitious capital changed the entire structure of investment. Investment in productive capital became less attractive, while significant physical resources went into the construction of expensive office space and duplicative retail outlets. Many firms were able to pass nonproductive costs on to other businesses, which then added these expenses to the prices that consumers paid.

On a still more subtle level, salaries throughout the top-level of the economy rose in tandem with those in the financial sector. Incomes for chief executives in other businesses rose with those in finance, while even university presidents' pay moved along with chief executive officers in industry. Presently, 23 presidents of private universities earn more than \$1 million (Lewin 2009).

A headlong rush into financial deregulation, claimed to be crucial for market efficiency, amplified the destructiveness of the economic imbalances. The resulting accumulation of fictitious capital accentuated inequality, which created still more fictitious capital. Unsuspecting investors, both inside the United States and abroad, lost heavily in investment schemes that ultimately depended upon the continual growth of the bubble.

Economic theory teaches that, in an unregulated market, prices provide signals that guide people to make rational decisions, but fictitious capital distorts the

price system. Economic crises work to eliminate the distortions. The greater these distortions are, the more painful the crisis (see Perelman 1987: chapter 6).

The media in the United States refers to the current meltdown as a subprime crisis, which is totally misleading. Of course, subprime excesses would not have occurred without deregulation and wage stagnation, but, on a far deeper level, the problem was a substantial distortion of the entire economy.

Summing up, wages stagnated making people more dependent on credit. Business neglected to invest in the real economy because profits in industry were anemic compared to finance. Mesmerized by financial profits, the economy looked healthy on the surface. Many powerful forces in the United States tried to convince the rest of the world to emulate the US economic system—a push that was surprisingly successful. However, economic health ultimately depends upon productivity—not the kind of productivity that comes from just driving labor harder, cutting wages, or avoiding environmental regulations, but real productivity.

Inequality and Crises

President Richard Nixon's chief economic advisor, Herbert Stein, proposed Stein's Law: if something is unsustainable, it cannot go on forever. The current crisis confirms Stein's law.

Indeed, history reinforces the idea that inequality breeds crises. In fact, each time the United States has dramatically increased income inequality, disaster has followed. Here is the assessment from an influential book on income distribution, co-authored by the recent chair of the Harvard economics department:

The period from 1860 to 1929 is thus best described as a high uneven plateau of wealth inequality. When did wealth inequality hit its historic peak? We do not yet know. We do know that there was a leveling across the 1860s. We also know that there was a leveling across the World War I decade (1912–1922), which was reversed largely or entirely by 1929. This leaves three likely candidates for the dubious distinction of being the era of greatest inequality in American personal wealth: c. 1860, c. 1914, and 1929. That each of these pinnacles was followed by a major upheaval—Civil War and slave emancipation, world war, or unparalleled depression—suggests interesting hypotheses regarding the effects of these episodic events on wealth inequality (or perhaps even the impact of inequality on these episodic events). (Williamson and Lindert 1980: 51)

Despite the mainstream theory about rational markets, markets are, in fact, inherently unstable (Perelman 1999). Within a market economy, the best chance to avoid disaster is to try to maintain a rough balance. Thus, while radical policies favoring business may boost profits in the near-term, within a relatively short time

virtually everybody—even the most favored business sectors—will have to pay a hefty price. In short, the victors become victims of their own victory.

Disrepute of Economics

Crises repeatedly occur in market economies, yet economists stubbornly continue to teach that free markets virtually guarantee efficiency. For a while, after each crisis, some people who would normally be expected to be sympathetic to economics—even including some distinguished economists—reprimand the discipline. Economists go to great lengths to avoid blame for their role in economic downturns.

For example, in the late 19th century, when the world was in the midst of what was then called the Great Depression, the world held economists in very low regard. For example, Walter Bagehot, longtime editor of London's *Economist*, wrote:

Political Economy is not altogether satisfactory. It lies rather dead in the public mind. Not only does it not excite, the same interest as formerly, but there is not exactly the same confidence in it. Younger men either do not study it, or do not feel that it comes home to them, and that it matches with their most living ideas. New sciences have come up in the last few years with new modes of investigation, and they want to know what is the relation of economic science, as their fathers held it, to these new thoughts and these new instruments. They ask, often hardly knowing it, will this "science" as it claims to be, harmonise with what, we now know to be sciences, or bear to be tried as we now try. (Bagehot 1885: 4)

Consider the verdict of Henry Varnum Poor, an important financier and cofounder of the influential Standard & Poor's, one of the ratings agencies at the heart of the current crisis. Originally, Poor's company informed investors about the conditions of the railroads, then the dominant US industry. Poor described the standing of economics in the popular mind at the time:

I am aware that Political Economists have always been regarded as coldblooded beings, devoid of the ordinary feelings of humanity, little better, in fact, than vivisectionists. I believe that the general public would be happier in their minds for a little time, if Political Economy could be shown up as imposture, like the greater part of what is called "Spiritualism". (Poor 1877: 392)

By the 1920s, market dogma was in vogue again until the Great Depression of the 20th century (see Davis 1975: chapter 15). Again, economists' reputation suffered. Although none were charged with criminal neglect, the *Economist* reported:

In the spring of 1933 a "mock-trial—not entirety mockery—" of "the economists" was staged at the London School of Economics, Robert Boothby, M.P. representing "the state

of the popular mind," charged the economists with "conspiring to spread mental fog," charging that they "were unintelligible; that they had in general proved wrong; and that in any case they all disagreed." Sir William Beveridge, Sir Arthur Salter, Professor T. E. Gregory, and Hubert Henderson answered Boothby's charges without wholly refuting them.... Mr. Boothby declared that economists were unintelligible; that they had in general proved wrong. (Anon. 1933)

An irrational confidence in market efficiency helped to set the stage for the current crisis; however, economics has not yet been subjected to the same degree of humiliation as before.

Once each crisis has passed, the critiques of economics fall from memory. Economists once again preach the dogma of free market efficiency, attributing recent economic gains to the influence of their own theories.

Why Economics Fails

If economists were able to anticipate economic calamities, their claim of scientific knowledge would be much stronger, but they have constructed their theory in a way to make it unlikely that they could ever warn the public of impending disasters. Instead, economists have perfected a way of making, what should be easy, extremely complicated, while simplifying what is really complicated to the point of irrelevancy.

For example, economics purports to offer a scientific analysis of profit-oriented capitalism, but this theory lacks any analysis of either profit or capital. The closest economics comes to a theory of profit is to propose that the marginal product of capital determines profits; that is, how much more production will one more unit of capital produce. However, this explanation raises more questions than answers.

First of all, economists have no way to measure capital. Let me explain. True, if I buy a new piece of equipment today, I know how much it is worth. However, like a new car driven out of a showroom, its value begins to shrink immediately. Economists have no way to measure such depreciation. They can turn to past patterns, but the past is not an accurate way to understand the future any more than concentrating on the rearview mirror would be recommended as a safe driving technique.

The economic value of capital depends upon how much it can produce over its economic lifetime and how much the market will value this production. Neither the economic lifetime nor the future economic values can be known in advance. Consider how the economic value of a gas-guzzling Hummer declined sharply with rising gas prices and then increased a bit as gas prices subsided. An inexpensive and efficient electric car would accelerate the rate at which Hummers would be scrapped.

The discussion of scrapping points to another serious deficiency in economic theory: the absence of a solid theory of investment. Just as a person buying a gas-guzzling Hummer may have trouble predicting an imminent fuel price spike, investment in capital goods “gives hostages to the future,” as Nobel laureate J. R. Hicks once observed (Hicks 1932: 183).

An even more complex question in investment theory regards replacement investment. An entirely different psychology seems to guide the decision to replace prior investments.

Decades ago, economists commonly spoke of capital widening and capital deepening. Widening referred to investment in expanding plant capacity, while deepening meant making existing capacity more efficient, often by replacing outdated equipment.

The theoretical treatment of capital widening is easy. Just as a person may plan a vacation as if everything is known from the start, investors supposedly look at all possible investments and choose the one that has the highest expected profit relative to the cost. The trick is to unrealistically assume that investors have full knowledge of the probabilities of all contingencies—future technology, future demand, future competition, etc. These expected profits will also depend upon the economic lifetime of the investment; that is, when it will be replaced. The optimal replacement decision will depend, in turn, upon when that replacement will be replaced.

In 1940, Gabriel Preinreich explained the complexity of this infinite chain of replacement decisions. By casually subsuming such complications in the calculation of expectations, assumed investment decision becomes simplified (Preinreich 1940). The problem is that this simplification undermines the foundation of any theory in which investment is an important component.

Even so, the optimal calculation must be done backwards. Imagine a machine purchased sometime in the distant future, say 95 years from now, which will be replaced in five years. Then, determine when to purchase the machine that this machine will replace, say 88 years from now. Next, calculate when to purchase equipment that will replace that last model. Continue the process, working back to the present and you will have an optimal pattern of investment—so long as you know the future of the next century in advance.

Economists have more or less ignored replacement investment probably because the time dimension of the replacement decision cannot be assumed away as casually as it is in the conventional treatment of capital widening. After all, in the replacement decision, timing is a central consideration. The inattention to replacement investment is an important component of deindustrialization that contributed to the current crisis.

Of course, economists might defend their investment theory by arguing that nobody can know the future. Yes, one can respond, but then how can economics

pretend that markets ration capital, efficiently putting resources to use where they can function most effectively. Economists should be embarrassed when they invoke that logic to “prove” that markets are superior to state planning.

Here again, economists cleverly sidestep the difficulty. Just as they assume that individuals can make rational investment decisions, economists, at least until recently, presumed that markets could somehow aggregate all information efficiently. Of course, when crises do occur—and they always do—the fallacy of this assumption becomes obvious.

In effect, then, economists virtually rule out crises. No wonder they have trouble anticipating them. Then, when faced with crises, they typically respond that the problem is that people did not follow their advice.

In the midst of crises, society turns from economic ideology to nonmarket solutions—often to rescue the market participants most responsible for making the mess worse. These patchwork solutions never go far enough in correcting market deficiencies. Inevitable dissatisfaction with the outcome eventually makes market solutions more attractive once again, setting the stage for a new crisis. Well, that is exactly what is happening in the United States today.

The great physicist, Albert Einstein, once said that the definition of insanity is to do the same thing over and over, expecting a different outcome. By this standard, economics does not come out well. The question is, how can we break through this insanity? Einstein’s challenge is more pertinent than ever.

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