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Comment on Epstein & Crotty and Heintz:  
Humanizing Political Economy

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## PREFACE

This working paper is one of a collection of papers, most of which were prepared for and presented at a festschrift conference to honor the life's work of Professor Thomas Weisskopf of the University of Michigan, Ann Arbor. The conference took place on September 30 - October 1, 2011 at the Political Economy Research Institute, University of Massachusetts, Amherst. The full collection of papers will be published by Elgar Edward Publishing in February 2013 as a festschrift volume titled, *Capitalism on Trial: Explorations in the Tradition of Thomas E. Weisskopf*. The volume's editors are Jeannette Wicks-Lim and Robert Pollin of PERI.

Since the early 1970s, Tom Weisskopf has been challenging the foundations of mainstream economics and, still more fundamentally, the nature and logic of capitalism. That is, Weisskopf began putting capitalism on trial over 40 years ago. He rapidly established himself as a major contributor within the newly emerging field of radical economics and has remained a giant in the field ever since. The hallmarks of his work are his powerful commitments to both egalitarianism as a moral imperative and rigorous research standards as a means.

We chose the themes and contributors for this working paper series, and the upcoming festschrift, to reflect the main areas of work on which Tom Weisskopf has focused, with the aim of extending research in these areas in productive new directions. The series is divided into eight sections, including closing reflections by our honoree himself, Professor Weisskopf. Each section except for the last includes comments by discussants as well as the papers themselves.

The eight sections are as follows:

1. Reflections on Thomas Weisskopf's Contributions to Political Economy
2. Issues in Developing Economies
3. Power Dynamics in Capitalism
4. Trends in U.S. Labor Markets
5. Discrimination and the Role of Affirmative Action Policies
6. Macroeconomic Issues in the United States
7. Applications of Marxist Economic Theory
8. Reflections by Thomas Weisskopf

This working paper is 3 of 3 included in Section 6.

- *Jeannette Wicks-Lim and Robert Pollin*

## *Comment on Epstein, Crotty and Heintz*

### HUMANIZING POLITICAL ECONOMY

When Charles Dickens launched his popular weekly, *Household Words*, he issued a plea for political economists to humanize their discipline. In his inaugural essay, Dickens wrote that, “Political economy is a mere skeleton unless it has a little human covering, and filling out, a little human bloom upon it, and a little human warmth in it.”<sup>1</sup> Humanizing political economy is surely a goal that we have all embraced. But few of us have contributed as much to reaching that goal and inspiring others to join in the effort to humanize political economy as Tom Weisskopf has.

The two papers in this session take up important dynamics of the U.S. macroeconomy in the spirit of humanizing of political economy. In “How big is too big? What should investment banks do and how much should they be cut down to size?” Gerald Epstein and James Crotty ask how much of the activity of the U.S. financial sector is “socially useless,” and how to reduce the U.S. financial sector to a size that effectively serves the broader economy. In “Unpacking the U.S. Labor Share.” James Heintz examines the multitude of factors that determine labor’s share of the income generated by the U.S. economy.

### EPSTEIN AND CROTTY “HOW BIG IS TOO BIG?”

This is an ambitious paper. Epstein and Crotty take up the multifaceted problem of determining the appropriate size of the financial system relative to services it provides to the “real economy,” and what of its activities are “not socially useful” That is a huge undertaking that required some intense data grubbing. But with the help of “well-designed descriptive statistics,” much like those Tom Weisskopf often used to great effect, Epstein and Crotty make some real progress in making the case for performing the sort of liposuction on the bloat of the financial sector we all would like to see happen.

#### *What counts as socially useless financial activity?*

Epstein and Crotty, of course, are far from the first to point out that the U.S. financial sector is “too big” and that much of what it does is “socially useless.” But unlike the others, Epstein and Crotty measure how much of financial activity is not functionally inefficient – a pre-condition for determining what it would mean to cut the financial sector down the size.

Epstein and Crotty have get at this question in two ways. They begin by describing how the ratio of the income extracted by the financial sector to the financing the sector provides to the real economy (measured by what they call “the financing gap”) rose dramatically beginning in the 1980s and reached its peak in the last decade (see Table 1).

Then using what their micro-level data, Epstein and Crotty they estimate wasteful financial sector by examining activities of the five largest investment banks. Investment bank trading and trading related activity -- more or less their proprietary trading – serves as their first approximation of socially useless financial activity. That

trading typically neither makes markets nor provides hedges for customers. Not socially useful financial activity turns out to be a surprising large share of net revenues of those investment banks. In addition, they find that the losses on that proprietary trading, which constituted one half or more of the income of many of these banks just before the crash of 2007, were a main component of the losses that led to the financial crisis and the financial bailout.

But to what extent are Epstein's and Crotty's results peculiar to investment banks or the five large investment banks in their study? If data were available would similar results hold for smaller investment banks or the rest of the financial sector – for instance, for the large commercial banks that dominate derivatives trading?

The answer to that question has important policy implications. For instance, should investment banks, or particular segments of the financial industry that are the locus of gambling, be the target of financial taxes such as transaction tax, or should those taxes be levied more widely across the financial sector.

*Socially destructive or socially useless?*

Epstein and Crotty also estimate that about one third of financial sector innovation is “motivated by tax, accounting, and/or regulatory, ‘arbitrage’ or ‘evasion,’” rather than “simple efficiency improvements.” But the authors believe that these figures underestimate the socially inefficient share of financial innovation because they do not capture the destructive impacts of innovations such as CDOs. In addition, as they point out, their own earlier research shows “in great detail the destructive nature of many of these innovations.”

So how is that we are to regard the CDOs and CDSs that, as Epstein and Crotty say “helped to crash the system” and played such a key role pushing up the rate of income extraction enjoyed by the financial sector in recent decades?

Is the trading of these financial instruments socially useless or socially destructive or both? And what exactly is the relationship between socially useless financial trading of investment banks and the socially destructive financial innovation?

Consider for a minute collateralized debt obligations, CDOs, whose value is derived from the value of the mortgage based securities on which it is based (which in turn derive their value from the value of the mortgages they contain). Is the buying and selling of these derivatives socially useless financial activity in the way Epstein and Crotty have defined the terms? Their first approximation suggests that CDOs are socially useless if they are part of the proprietary trading by an investment bank, but otherwise socially useful.

But if CDOs (along with CDSs) “helped to crash the system” and are therefore socially destructive, does that obviate the need to sort through whether CDOs are their ilk are part of proprietary trading and therefore socially useless?

Would it not be better to consider the vast array of derivatives spawned by financial innovation, including CDOs as transaction costs – the costs of buying and selling financial instruments, or as a public finance economist would put it, “the costs associated with exclusion?”<sup>2</sup> And compared with many other commodities are not the transaction costs associated with selling financial services unusually high? Take groceries for instance. The salaries of the checkout clerks, the cost of cash registrars, and the inconvenience of long lines are

all transaction costs associated with selling groceries. But no checkout clerk gets paid what the buyers and sellers of securities do. And no checkout clerk ever contributed a financial crisis like that of 2008. And if the level of waste and destruction that Epstein and Crotty report is endemic to the buying and selling of financial instruments, then doesn't the public finance prescription for commodities with prohibitively high transactions costs apply: provide those commodities through the public sector?

## HEINTZ: UNPACKING OF THE U.S. LABOR SHARE

Heintz's paper responds to "Marxian Crisis Theory and the Rate of Profit in the Postwar U.S. Economy,"<sup>3</sup> Weisskopf's classic article. Beyond that, Heintz manages to reproduce much of what was so influential about the Weisskopf article: its sharp insights rendered highly accessible through an extreme clarity.

In his article, Weisskopf examined the impact of three ratios on the U.S. rate of profit from 1949 to 1975. Each ratio is drawn from a different strand of Marxist crisis theory, the rising organic composition of capital, a realization failure, and the rising strength of labor. The labor share, which Heintz unpacks in his excellent paper, is meant to be both a barometer of the strength of labor and labor's ability to squeeze profits.

Heintz concentrates on Weisskopf's finding that workers were able to push up their wage share by defending their position through improving terms of trade with the capitalist class and in that way squeeze profits in the period from the mid 1960s to the mid 1970s. There is nothing arbitrary about Heintz's emphasis. He has tackled what Weisskopf called "the most interesting of the empirical results" of his paper. Weisskopf summarized those results as follows:

"The long-term decline in the rate of profit from 1949 to 1975 was almost entirely attributable to a rise in the true share of wages, which indicates a rise in the strength of labour. This rise, however, was largely defensive in nature. The working class did not succeed in making true real wage gains commensurate with the growth of true productivity; it merely succeeded in defending itself somewhat more successfully against a long-term deterioration in the terms of trade than did the capitalist class."<sup>4</sup>

I had two questions about Heintz's unpacking of the U.S. labor share, and a comment about his paper.

### *Heintz and Weisskopf on the defensive strength of labor*

My first question is about Heintz's finding that "the defensive strength of labor ... has evaporated." Heintz points out that the "relative rates of change of prices indices [the CPI-U and PCE prices indices] would have contributed to a decline the real labor share relative to the nominal labor share." He adds that "the decline attributable to price movements would be most pronounced beginning in the 1980s."

But to what extent do Heintz's results differ from the results in the Weisskopf paper for the years their studies overlap, from 1960 to 1975? And are the differences attributable to the choice of price indices or other factors strong enough to suggest that Weisskopf's finding that the defensive strength of labor lies behind the fall in the profit rate from the mid-1960s to mid-1970s does not hold and labor's defensive strength was already on the wane by then?

### *Changing capitalism and the real labor share*

One of the most impressive things about “Unpacking the U.S. Labor Share,” is how Heintz incorporates the changing contours of U.S. capitalism into his analysis of the real labor share. Two of those trends are especially worth mentioning:

First, Heintz finds that the growing internationalization of production and increased imports of consumer goods, specifically manufactured goods, into the United States were not driving the reduction in labor's terms of trade. The prices of consumer durables and certain categories of non-durable goods, e.g. clothing, actually decreased over the time period from 1991 to 2009. On the other hand, several categories of goods and services did show above average price increases over this period - housing, gasoline, medical care, financial services. Heintz attributes those rising relative prices to “pressure from economic rents.” Those rents reduced the real income of working people but “did not squeeze profits.”

Second, the dramatically worsening inequality of the last few decades, especially among wage workers, prompts Heintz to turn to the real labor share of production workers to gauge the strength of workers. Incorporating the rising inequality into any analysis of the real labor share is crucial at this moment. Despite a rising average income in the years before the crisis, most people experienced a virtual stagnation in their income and relied more and more heavily on credit to meet their needs

#### *How to assess the strength of in an era of extreme inequality?*

That brings me to my other question. Just how much does rising inequality alter Heintz’s analysis of the aggregate real labor share. In the current period, how useful is the aggregate labor share as a gauge of the strength of labor, either its offensive or defensive strength? Does the aggregate real labor share explain the declining strength of labor in today’s economy as well as the aggregate real labor share captured the rising strength of labor and its squeeze on the profit rate in the period from the mid-1960s to the mid-1970s?

Or should we concentrate on the labor share of production workers, as Heintz seems to suggest at some points, as the appropriate gauge of labor’s strength and labor’s impact on profitability?

## RESTORING FINANCIAL STABILITY AND THE LABOR SHARE

The Epstein and Crotty paper and the Heintz paper both expose the failure of the U.S. economy to serve humanity. One estimates just how much of financial sector activity is socially useless and in some cases socially destructive. The other unpacks the trends that have left an ever smaller proportion of national income devoted to the real labor share, especially of production workers.

Cutting down the financial sector to its functional size would help open up the space for the real labor share to rise again at the expense of profits and the rents extracted by the financial sector. That would mean restoring macroeconomic conditions more like those of that prevailed between mid-1960s and mid-1970s when financial regulation was more extensive, financial crisis were less frequent and, the real labor share was far greater than today.

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<sup>1</sup> As quoted by Sylvia Nasar in *Grand Pursuit: The Story of Economic Genius* (New York: Simon & Schuster, 2011), p. 10.

<sup>2</sup> Joseph E. Stiglitz, *Economics of the Public Sector*, Third Edition (New York: W.W. Norton and Company, 2000), p. 135.

<sup>3</sup> Thomas E. Weisskopf, "Marxian crisis theory and the rate of profit in the postwar U.S. economy," *Cambridge Journal of Economics*, 1979, 3, 341-378.

<sup>4</sup> *Ibid*, p. 370.