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Proposals Wall Street *Really* Won't Like

WHO ARE THE BIG WINNERS at the fantasy-finance casino? Many of the very richest people in America. In 1982, the top 400 individuals held an average net worth of $604 million each (in 2008 dollars). By 1995, their average wealth jumped to $1.7 billion. And in 2008, the 400 top winners averaged $3.9 billion *each.*[1] Just imagine. Your Lear Jet lands on the private runway out back and you are whisked to a gold-plated game room. You and 399 other multibillionaires take your drinks and settle into the plush leather chairs at the gaming tables. In front of each of you are your chips—3,900 of them, with each chip worth $1 million! The total for the 400 high rollers adds up to a cool $1.56 trillion. That's equal to about 10 percent of the entire gross domestic product of the United States.

Has fantasy finance been good to you or what?[2]

This year you sense the crackling excitement as the top 25 hedge fund managers arrive at the casino. In 2008, a year that saw the collapse of the stock market, the implosion of pension funds, 401(k)s, and college endowments, the destruction of millions of jobs, and the worst recession since the 1930s, the top 25 hedge fund managers received $11.6 billion in compensation. You join in the thunderous applause as these guests of honor waltz in.[3]

But just outside the window, if you dare to look, are 94.6 million nonsupervisory workers who earn less than the average worker did in 1973. Also out there are about 44 million Americans with no health care. They could use some of those chips. If each billionaire inside the casino walked out with "only" $100 million per person, they would leave $1.52 trillion sitting

on the table. If these chips landed in the public coffers, let's say via steeply progressive income and wealth taxes, we could invest $150 billion a year in developing and deploying renewable energy alternatives—ten times what President Obama called for during his campaign. Or we could provide free tuition for every student at every public college and university—in perpetuity.

Yet, we Americans are skittish about redistribution. As President Obama said, "This is America. We don't disparage wealth. We don't begrudge anyone for achieving success."[4] In fact, we believe both in the equality of opportunity *and* in the inequality of income. Nearly all of us would agree that those who have talent, study hard, and work hard should earn more than those who don't. We admire the most successful in every field. We more or less agree that it's fine to be rich. Most of us would like to be rich as well. But we also have a sense of fairness. We worry when the gap between the superrich and the rest of us grows and grows, especially while most of us run in place. And there's that nagging feeling that the billionaire CEO who makes 1,000 times more money than his average employee isn't actually 1,000 times smarter, 1,000 times more studious, or 1,000 times harder working. In other words, the extent of inequality we see today in America cannot possibly be due to merit. It comes, largely, from those who are in the right positions at the right times to game the casino.

The more their wealth accumulates, the more the superrich are able to lobby for reducing taxes on capital gains, on inheritance, and on the highest incomes. In 2008, corporate recipients of our tax dollars, in the form of Troubled Asset Relief Program (TARP) bailouts, spent $77 million on lobbying and $37 million in campaign contributions. According to the Center for Responsive Politics, their return on that investment was 258,449 percent.[5] It's hard to get elected to anything without the financial backing of these elites. In fact, the best way to get elected is to be one of them.

We also worry that the superrich are severing their social

connections with the rest of us. They no longer live anywhere near us (or if they do, it is behind well-protected walls, fences, and gates). Their kids don't go to our schools. They don't ride on our buses and trains, and they're not in line with us at the airport either. They don't see our doctors or go to our hospitals. So they don't suffer the indignities of our crowded services and collapsing infrastructure. Do they have any idea what our lives are like?

After the December 2008 auto-industry bailout, Bob Lutz, the vice-chairman of GM, was suffering from culture shock. He found himself in a strange land—America. He had been forced to go native. "I've never quite been in this situation before of getting a massive pay cut, no bonus, no longer allowed to stay in decent hotels, no corporate airplane. I have to stand in line at the Northwest counter. I've never quite experienced this before. I'll let you know a year from now what it's like."[6]

Our sense that the rich have been pulling away from the rest of us is confirmed by the statistics. As chart 9 illustrates, in 1970 the gap between the top 100 CEOs' average pay and the pay of average workers was 45 to 1 ($296,170 to $6,542), reflecting the restraints of lingering New Deal financial controls and mores. As those controls weakened, the gap increased to 127 to 1 by 1980.

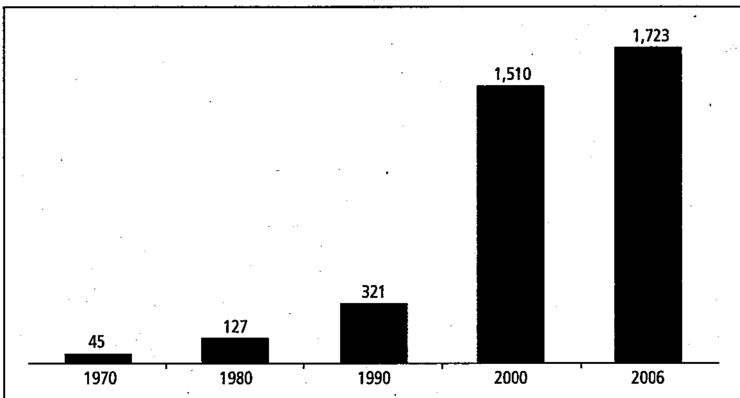

Chart 9. Ratio of Top 100 U.S. CEO Salaries to Average Worker Annual Earnings. CEO pay from "CEO Compensation Survey," *Forbes*, April or May issues, 1971–2008; earnings for workers from Bureau of Labor Statistics.

As deregulation, tax cuts, and the union bashing of the Reagan era took hold, the gap jumped to 321 to 1 by 1990. In 2000, as "financial innovation" pumped up fantasy finance, the ratio of CEO pay to the average workers' pay hit an obscene level of 1,510 to 1. And then by 2006, at the height of the fantasy-finance boom, it climbed to a whopping 1,723 to 1 ($50,877,450 to $29,529).

When it comes to the pay gap, we lead the world. Table 1 shows how the United States stacked up in 2000 measuring a broader group than in chart 9.

Of course not all these overpaid CEOs come from the financial sector. But the financial sector sets the pattern. And its sky-high salaries have lured some of our brightest minds away from other less lucrative fields in science and medicine or, God forbid, the humanities. As historian Niall Ferguson writes:

> Back in 1970 only around 5 percent of the men graduating Harvard, where I teach, went into finance. By 1990 that figure had risen to 15 percent. Last year the proportion was even higher. According to the Harvard Crimson, more than 20 percent of the men in the Class of 2007, and 10 percent of the women, expected their first jobs to be at banks. And who can blame them? In recent years, the pay packages in finance have been nearly three times the salaries earned by Ivy League graduates in other sectors of the economy.[7]

Country	Ratio	Country	Ratio	Country	Ratio
Japan	10	Spain	18	Britain	25
Germany	11	Belgium	19	Hong Kong	38
Switzerland	11	Italy	19	Mexico	45
Sweden	14	Canada	21	Argentina	48
New Zealand	16	Australia	22	South Africa	51
France	16	Netherlands	22	United States	495

Table 1. Ratio of CEO Compensation to Average Employee Compensation in 2000. Non-U.S. values from Michael Hennigan, "Executive Pay and Inequality in the Winner-take-all Society," Finfacts Ireland, August 7, 2005. U.S. value from author calculation based on Hennigan and BLS at www.bls.gov/oes/2000/oes_51PR.htm.

Why study the big bang when you can become a master of the universe with the money you make building fantasy-financial models? If you have the urge to teach Shakespeare, why not wait until you retire—early and rich?

How the hell did we let so much wealth go to so few people?

If this outrageous wage gap concerns you, now may be the best time in history to do something about it—starting with the financial sector. But first we need to understand why financial workers earn so much more than the rest of us. Are these bankers and derivative traders really worth more in a year than we can earn in a lifetime? Is there something special about the combination of brains, experience, skill, and entrepreneurial ability that truly accounts for the outsized compensation packages?

If you listen closely to bankers, financiers, and TV financial commentators, the word "smart" comes up a lot. It's all about working with the smartest people. If you can recognize the smart ones it implies that you must be smart too. But the only true measure of financial smarts is how much you make. If you're really smart, you'll earn more. And if you earn more, you must be really smart. (And if you don't buy this logic, by definition, you're not smart enough to earn more.)

Smart fits into human capital theory, which tells us that the more we invest in ourselves—and build up our human capital—the more money we should be able to fetch in the market. For instance, the further you go in school, the more you are likely to earn over your lifetime. Studies confirm a sizable and consistent gap between those who complete only high school and those who finish four years of college or more. But this doesn't explain why a banker should earn ten times more than a brain surgeon.

Robert Frank and Philip Cook, in *The Winner-Take-All Society*, believe that in our global marketplace, it's profitable to pay the very top performers much, much more than the next best. They point out that in a winner-take-all market, "High salaries are

associated with positions that entail a great deal of leverage on the worker's efforts. In these positions small differences in performance translate into large differences in the profitability of the venture."[8] And if you apply this idea to the financial sector, as the value and volume of trade mushroomed, "The skills of any given salesman in this environment were suddenly given much greater leverage, so that one with exceptional flair and persuasiveness with customers was worth millions of dollars per year to the investment house."[9]

One of my high-finance soccer dads said he thought it had more to do with the sheer size of the industry. As he put it: "The world's money runs through New York and a few other money centers. The size of deals, trades, and sales is enormous. Even a very slight fee—let's say 3 basis points [three one-hundredths of 1 percent] of $100 billion in transactions—comes out to $30 million for the firm and for the bankers."

In their recent paper for the National Bureau of Economic Research, Thomas Philippos and Ariell Reshef applied statistical tests to various theories for why financial sector employees are paid so much more than other people. They find that neither modern technology, nor education, nor the higher risk of losing one's job on Wall Street can explain the disparity. Instead, they conclude that "financiers are overpaid."[10]

Even candid bankers will tell you that. But *why* are they overpaid?

Paul Krugman believes it has a great deal to do with social and political forces, especially unionization. He argues that "we had a society 25 years ago in which there were some constraints imposed by public opinion, by strong unions, by a general sense that there were things that you don't do. And maybe that led firms to make a decision to think of there being a sort of tradeoff between a 'let's have a happy high morale' workforce, or let's have a super star CEO and squeeze the workers for all we can."[11]

Krugman's right, but there's one more critical element: fantasy finance. When you are creating it, trading it, and unloading it,

your earnings become fantastic—literally. When you get a cut of the biggest casino games ever created, your take will be huge. As economist Robert Reich put it: "[T]here's no reason to believe Wall Street executives have been smarter than executives in the real, non-financial economy. They've been paid more because they've been smarter at creating schemes that have only appeared to create value, while keeping investors in the dark.[12]

The President's Wage Cap

Can we really do anything about this? It won't be easy. We may already have reached a tipping point where the wealthy can so successfully control public policy that they will repel any serious effort to reduce the wage gap. But the public is growing angrier by the day, so this is the time to try. How about: *No salaries at these institutions shall be greater than that of the president of the United States?*

I wrote those words in October 2008. Then events passed me by. Within three months Wall Street awarded $18.4 billion in bonuses to itself. While these bonuses were actually for work done in 2007, they were paid out in 2008 and first reported in January 2009—after a year of record losses, and only months after receiving hundred of billions in federal bailout funds. Bad timing.

President Obama immediately called the bonus money "shameful," and the "height of irresponsibility." The next day Senator Claire McCaskill (D-Missouri), an Obama ally, proposed a $400,000 cap—the president's salary—for all executives whose firms receive government bailout funds. On February 5, 2009, the Obama administration called for a wage cap of $500,000 on top executives, not for all bailed-out firms, but only for those who receive "extraordinary help from U.S. taxpayers."[13] But there were plenty of loopholes that allowed large amounts of deferred compensation, and that limited the cap only to the top few executives. (To gain perspective on the

enormity of this cap, many Wall Street executives and traders make more than that in *one week*—$500,000 per week, after all, equals "only" $26 million a year.)

Then events passed him by. On February 13, Congress added a stronger wage-cap provision to the $787-billion stimulus package—over the objections of the Obama administration. Responding to rising popular revulsion, the bill limited bonus money and deferred compensation to no more than one-third of salaries, and it covered all institutions that had or would receive bailout funds. The provisions not only would include the top five executives, but also the top twenty highest paid employees. The cap, therefore, would cover the stock, bond, and derivative traders who had earned tens of millions on their deals. Many of these elite traders are the ones who dreamed up and profited from the opaque and exotic games—the croupiers of the fantasy-finance casino.

The Obama administration seemed concerned that these provisions would cause a brain drain from the sector. Compensation consultants agreed. As one put it, "Those rules won't work. Any smart executive will (*a*) pay back TARP money ASAP or (*b*) get another job."[14]

But isn't that the whole idea? Paying back the taxpayer quickly is not a vice. And it might be virtuous if some of these smart folks applied their talents to other pressing issues like alternative energy, education, or health care.

Experts also worry that the talent will shift to hedge funds and foreign banks, taking their lucrative clients with them, and starting a downward spiral within banks that have accepted government funds. As one Wall Street consultant put it, "At some point you begin to wonder: has the government given up on these companies anyway? Why would the government or the White House want to go along with that unless they have come to the conclusion they will have to nationalize these firms anyway?"[15]

Not to worry. The Obama administration refuses to institute hard wage caps. Instead, it has appointed a "Pay Czar" to review

the compensation packages of the top executives and traders at bailed-out companies; except the Pay Czar will ignore those banks that have repaid their TARP money, even though they are still profiting from other forms of taxpayer support.

On this issue, Obama and his treasury secretary, Timothy Geithner, may be lagging behind Main Street. It seems, the average citizen is questioning the Wall Street definition of "smart," "valuable," and "talented." For those suffering or fearing economic hardships, the logic is straightforward: The bankers played at the high-stakes fantasy-finance casino and lost. Then they asked taxpayers for billions of dollars to cover their bets or else the economy would collapse even more than it was already doing. We gave them the money. But in return they can't scrape by on what the president of the United States is making?

Is this cap still too generous? Why should we allow struggling financial corporations to provide presidential-level benefits for their executives? After all, some pundits have even gone after *workers* in firms seeking a government rescue. *New York Times* business columnist Andrew Ross Sorkin blasted assembly-line autoworkers whose "gold-plated benefits are one reason why GM is no longer competitive." After citing misleadingly high estimates of the average auto worker's wages and benefits, he says workers shouldn't expect good health benefits when their employer is "asking the taxpayers—many of whom don't have health coverage—to pay your salary and health insurance."[16]

But Sorkin utters not a peep about the diamond-studded benefits of financial executives who already have been bailed out by taxpayers—benefits that far exceed anything an autoworker could hope for. Shouldn't we ask these bailed-out executives to give up their health coverage as well?

No. This race to the bottom has got to stop. The problem is not that autoworkers and the financial executives have "gold-plated" health care benefits. The problem is that so many Americans don't. This crisis should move us toward high-quality universal health care, like the rest of the industrialized world, not toward

draconian cuts. If we had universal health care, a major burden would be removed from Detroit automakers and no one would be talking about depriving autoworkers or Wall Street executives of health care.

Maybe the president's salary cap will catch on. As the crisis deepens, Americans are discovering the ins and outs of elite compensation. It was a rude awakening to learn that AIG executives received $160 million in "retention bonuses" after their ruined company had hauled in about $170 billion in government bailouts. That's really hard to explain to an unemployed autoworker or a retired teacher in Miami trying to make her mortgage payments. It's possible that this anger could build into a more general call to cap top salaries in all firms that get big subsidies from the federal government—like military contractors.

If so, then Sam Pizzigati, a tireless labor activist, will get his due. For the past fifteen years he's been on a crusade for a *maximum* wage that caps executive pay at all companies to fifty times the lowest paid worker in the firm. (Remember, that's still a larger pay gap than in most countries, and than what it was during the "Golden Age" of American capitalism from the late 1940s to the early 1970s.) If the CEO wants a big raise, Sam argues, the CEO had better raise everyone's wages as well. Many of us thought this idea, while perhaps justified in theory, was too utopian for a modern economy. But Sam is starting to look like a hardheaded realist, just a little ahead of his time.[17]

I'm still a step behind. I'm not ready to push for an across-the-board cap. The public, I believe, would thoroughly reject it. However, we have a once-in-a-lifetime opportunity to reduce the wage gap on Wall Street. That's where the pay is most outrageous and harmful to the entire economy. Let's keep our focus on that enormous problem. As economist Robert Frank puts it:

> A money manager's pay depends primarily on the amount of money managed, which in turn depends on the fund's rate of return relative to other funds. This

> provides strong incentives to invest in highly leveraged risky assets, which yield higher average returns. But as recent events have shown, these complex assets also expose the rest of us to considerable systemic risk.
>
> On balance, then, the high pay that lures talent to the financial industry may actually cause harm. So if Congress wants to cap executive pay in financial institutions receiving bailout money, well and good.[18]

Slapping around the superrich as they hold their cups out is satisfying, but too easy. In fact, indulging our righteous indignation is a luxury we can't afford, especially if it diverts us from real solutions. The eminent French sociologist Emil Durkheim called it "ressentiment"—an expression of powerlessness that he believed the masses show toward the powerful. In the vernacular, it means we'd rather bitch about the rich than exercise more power and take more responsibility for ruling society. Bitching won't get regular workers a bigger piece of the pie or reduce fantasy finance's "super-senior slice." To do that, we need to cut off the supply of surplus capital that feeds fantasy finance.

As we discussed in chapter 2, productivity increases and wage increases were decoupled during the 1970s. As a result, trillions of dollars in surplus capital went to the investor class because average real wages failed to rise along with productivity. There was so much surplus capital held in so few hands that it could no longer find solid investments in the production of goods and services. (Had it gone to working people, there would have been more spending on real goods and services, and more investment opportunities in the real economy.) Instead, it then funneled into the fantasy-finance casino. Clouds of financial instruments were created to suck up the surplus capital, and this put us all at risk.

In 2004, economists Jamal Rashed and Subarna Samanta statistically tested whether this gap caused financial instability. They

concluded that when the discrepancy between rising productivity and wage stagnation is large, "stock markets crash, banks fail, currencies depreciate, unemployment rises, and a longer recession or a full-fledged depression may follow." They predicted that "an increase in the productivity-wage gap over time should lead to 'irrational exuberance' in the stock market."[19] In fact, this was also the primary source of the housing bubble.

But why did productivity and wage increases diverge? Many economists say that workers' education levels didn't increase fast enough to keep pace with the jobs needed in a modern, technologically sophisticated economy. We need more technical professionals and fewer manual laborers and machine operators. But there are other factors that have more force. First, globalization opened up vast new labor markets overseas. Manufacturing, once the engine of America's middle-class incomes, shifted to countries with far lower labor costs. Even companies that didn't move overseas forced workers' wages down to compete with low-cost producers. People in the service sector also faced competition as call-center jobs and other white-collar work moved elsewhere. Trade agreements failed to take into account the different countries' vastly disparate labor and environmental laws and conditions. It became increasingly difficult for American workers to compete against labor markets in countries where union organizers were murdered, where health and safety conditions were deadly, and where companies could pollute the environment with abandon. The net result of all this was downward pressure on real wages of the average American worker, even while labor productivity increased.

Another reason wages have fallen behind is the dive in union membership and the accompanying decline of workers' collective-bargaining power. For many reasons, including legal obstacles that make it very difficult for workers who want a union to get one, a shrinking percentage of the workforce is represented by unions. (Chart 10 tracks unionization rates in the private sector. The rate including public-sector workers in 2008 is 12.4

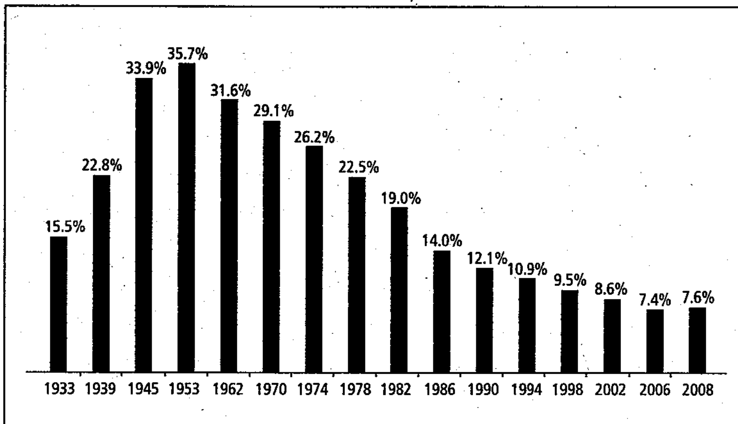

Chart 10. Percent of Private Sector Workers in U.S. Unions. Data from 1933–1982 come from Leo Troy and Neil Sheflin, *U.S. Union Sourcebook* (West Orange, NJ: IRDIS, 1985). Data for 1986–2008 are from Bureau of Labor Statistics, Employment and Earnings, January issues, 1987–2009.

percent, up from 12.1 percent in 2007.) Some argue that workers have rejected unions because of leadership's failure to be attentive to the members' needs. However, in most cases unions have lost members because the industries that they had unionized declined drastically or moved out of the country. This lower "union density" makes it harder for even organized workers to bargain for higher wages: They face competition not only globally but from low-wage, nonunion workers in this country. As labor declined, it lost much of its ability to affect the pace of globalization and the content of free-trade agreements.

It's time to stitch these patterns together to form one reasonably coherent explanation for the current crisis.

But first a word of extreme caution. The global economic system is enormously complex. Therefore, systemic explanations always should be offered with great humility. Most will be wrong. I recall a story from my late colleague Tony Mazzocchi (1926–2002), the visionary labor leader. At a labor-management pension-fund meeting Mazzocchi attended in the late 1990s, one

of the consultants made a euphoric speech about the economy's "new paradigm." The consultant believed that we had reached a new era of perpetually rising stock markets. Hence, he argued the pension fund should bank on a higher rate of return for the indefinite future. Mazzocchi flashed a wily smile and asked, "Since when did they repeal the laws of capitalism?" Mazzocchi was right, of course. He had lived through the Depression and feared it could happen again. But I recall at the time thinking that maybe Mazzocchi was wrong. Maybe something about the structure of capitalism really had changed so that extreme booms and busts were a thing of the past. Go figure.

Have I finally figured out all the laws of capitalism?[20] No. But I am sure of one: We can count on more booms and busts. So, I offer this explanation:

- Because productivity and real worker wages diverged starting in the 1970s, income gushed to the top—to the richest 1 percent or so among us. Tax cuts for the wealthy, deregulation, globalization, antiunion policies, reduced social programs, and declining value of the minimum wage all accelerated that process. The productivity bonus went to the investor class instead of to workers, where it had gone between 1945 and 1973.
- Some of that capital went to productive investments. But eventually it ran out of moderate-risk investment opportunities in the real economy. It became surplus capital when it could no longer find stable investments to make in the real economy.
- The problem of surplus capital that couldn't find a home was "solved" by the derivative industry. CDO-type investments offered higher rates of return, supposedly at little risk. The casino was open for business.
- Through the magic of fantasy-finance derivatives, these funds were recycled to cover risky consumer and corporate debt, and to create instruments that

were leveraged again and again upon these debts. All this was enormously profitable for the financial firms that arranged, sold, and traded these products. It also made hundreds of billions of dollars available both for housing and credit card debt and for additional fantasy-finance betting. The surplus capital fueled the housing boom via the derivatives, and it led to a vast expansion of the financial sector.

- Meanwhile, working families had to work harder and longer to make ends meet. More and more families needed two wage earners. More families increased their debt loads.
- The bubble burst because that's what bubbles do. At some point marginal buyers could no longer buy enough houses or pay for the ones they had bought. Too many builders built too many homes because the boom had accelerated prices. American workers with stagnating real wages had reached their debt limits and could no longer fuel the boom.
- When the housing bubble burst, the entire fantasy-finance edifice that had been built upon it collapsed as well. Investors and banks all over the globe were loaded with toxic derivatives based on risky mortgages that had crashed in value. The risk supposedly had been engineered out of these derivatives, but it hadn't. Many financial institutions central to the economy became insolvent or nearly so. The banking system froze. The stock market crashed. The global economy tanked.

And here we are.

Whether or not this summary gets the story exactly right, there are strong reasons to narrow the wage gap as a way of dealing with the ongoing crisis. If real wages rise, workers will spend

more money in the real economy and the superrich will have less money to spend on speculative investments. With more money in their pockets, workers will increase the demand for goods and services, and fewer of them will default on their mortgages.

Another good reason to raise workers' wages is to guard against deflation. In October 2008 consumer prices dropped one full percent—the biggest decline since the Great Depression. Then in November it dropped another 1.7 percent, setting another record. (Fortunately, the drops mitigated over the next few months as prices began slowly to rise again.) But if price declines do take hold, we're in serious trouble. Deflation is a sustained, overall drop in prices. It happens when demand for goods and services declines because of a systemic crisis like the one we're going through. If you're losing your job or fear you might soon, you hold back on purchases. If you see millions of people losing their jobs you're not going to go on a spending spree. And when you notice that prices are falling, you might delay buying something, especially a big-ticket item, because you're hoping prices will fall even further. All of this further reduces demand, which causes economic activity to slow. Investment and consumption continue to fall, more workers lose their jobs, prices drop some more, and we get stuck in a deflationary spiral. This describes the Great Depression. We don't want to go there again. One of the very best antidotes is to move more money into the hands of working people—the sooner the better.

Employee Free Choice Act

The New Deal came about in part because of pressure from a growing labor movement. And the New Deal itself further strengthened unions. New Deal policy makers believed that, as union members, working people would have a better chance at getting their fair share of productivity. Roosevelt welcomed a new wave of union organizing. He supported the Wagner Act, which made

it much easier for workers to unionize. And history shows that the plan worked: Postwar unionization did boost workers' real wages—and in a way that was perfectly compatible with innovation and profits for business owners. We could do it again by passing the Employee Free Choice Act, now before Congress.[21]

Since the late 1940s, labor law has been whittled away—and employers have become increasingly aggressive in squelching union drives. Workers who try to organize a union are routinely harassed or even fired. For unions, it has become extremely costly and difficult to conduct an organizing drive. Without question the playing field has been tilted toward employers. Cornell University professor Kate Bronfenbrenner found in a survey of NLRB election campaigns in 1998 and 1999 that employers illegally fired employees for union activity in 25 percent of organizing drives.[22] An updated study done by the Center for Economic and Policy Research estimates that in 2007, one in five union organizers or activists was illegally fired during organizing drives.[23]

It's estimated that about 60 million Americans would like to join a union. If we remove the roadblocks, many of them could. And then they could win better wages and safer working conditions—at least 50,000 American workers die from job-related injuries or disease every year.[24] Even if EFCA doesn't result in a sudden rise in unionization, nonunion firms are likely to raise wages just to keep workers from turning to unions.[25] And rising wages will stabilize our economy. Working people will stop holding back on spending, and that will chase deflation away. The Chamber of Commerce ought to promote unionism—it was good for business in years past and would be good for business again today.

Raising the Minimum Wage

A higher minimum wage would also guard against deflation and direct additional wealth away from the casino. And it's the right thing to do. No one can live a decent life at the current

minimum wage, which rises from $6.55 to $7.25 in 2009. If you adjust for inflation you can see that the real buying power of the minimum wage peaked in 1979 at about $8.89 in current dollars (see chart 11). This is an excellent time to jump the minimum wage to at least $10 an hour and index it permanently to inflation. (For those worried about potential job loss, see studies by David Card and Alan Kreuger.[26])

Will raising real wages through unionization and increasing the minimum wage actually pull us out of this crisis? We won't know until we try. But we do know what happened when we let real wages decline—the top 1 percent ended up with more money than they knew what to do with. We tried deregulation and got "exotic and opaque derivatives" and the worst financial meltdown since the Great Depression. We tried trickle down and it widened the income gap. We tried to encourage investment by and for the rich, and we got a fantasy-finance boom and a slew of billionaires. We created a finance-heavy economy that was supposed to be the wave of the future. Instead we got a taste of the past—a near 1930s depression. Let's find out what happens

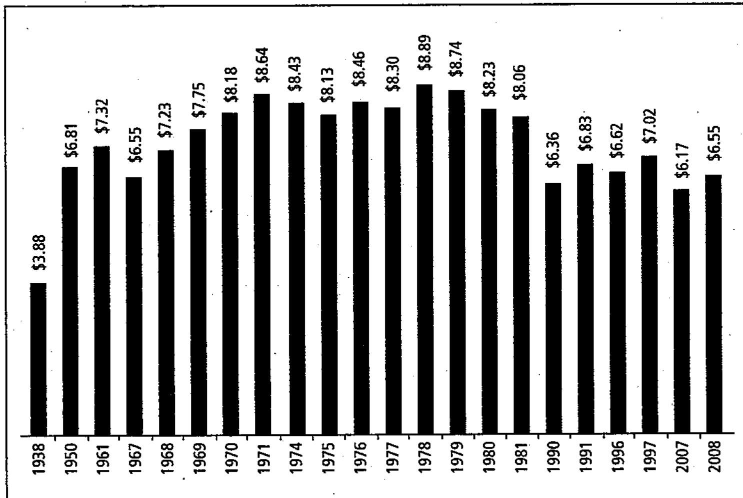

Chart 11. The Minimum Wage Adjusted for Inflation (2008 dollars). Adapted from U.S. Department of Labor, Wage and Hour Division.

if we allow middle class and lower-income people to earn decent wages.

It's not that these two changes can guarantee that we will never have another financial crash. They can't. No amount of reform can guarantee that, as long as we have a free-enterprise financial sector. But the occasional mild recession is not what we're worried—and angry—about. It's the wild swings of excess and catastrophe that need taming. And unionization and a livable minimum wage *will* go a long way in moving us toward that goal.

This is the time to try these pro-worker strategies precisely because the financial world is changing so dramatically. Our financial elites have wheedled the government into handing the banking industry over a trillion dollars. More corporate handouts are sure to come. The orthodoxy of deregulation—embraced for years by both Republicans and Democrats—is being trashed by many of the very policy makers who once touted it. Right now, it's going to be hard for financial leaders to argue that the minimum wage, unions, and fairer trade agreements interfere with free markets. We've needed a new direction for decades. Now is the best chance we'll ever have to make it happen. Let us learn from the bankers and take bold action while we can.

We've come full circle since our initial tour of Whitefish Bay, Wisconsin. To date, the town seems to be surviving its flirtation with fantasy finance. Its mansions still tower over Lake Michigan. Its middle-class neighborhoods don't look the worse for wear. The doors of its art deco movie theater on Silver Spring Drive are still open, as are the tasty-foods shops. And, its white-collar residents still care deeply about its schools. But its pride, as well as its coffers, have been wounded at the fantasy-finance casino.

Local school officials had hoped that fantasy finance would enrich their school systems, not themselves. But they played a game they didn't understand. They were enticed into buying a financial weapon of mass destruction—a synthetic collateralized

debt obligation—the exotic and opaque financial instrument so key in crashing our economy. They were romanced by the purveyors of the fantasy-finance dream, and they fell for it head over heels. The courts will decide whether they were illegally deceived and deserve redress. But obviously they were taken in, as was our entire economy.

Our out-of-control privatized financial system created, marketed, and peddled junk dreams. It's very tempting to blame individuals for the years of outrageous profiteering, speculative borrowing, lending, and investing. In Wisconsin we could point to the town officials who should have known better, the brokers who led them down a risky path, the investment houses that cooked up the risky deals, and the bankers, here and abroad, who profited so handsomely from the junk securities. Columnist David Brooks suggests that the big unanswered question of the crash of 2008 is "how so many people could be so stupid, incompetent and self-destructive all at once."[27]

A good question—but not the most productive one for understanding this crisis. We will not find the root causes of the global financial meltdown in our irrational psyches, in our bad behavior, or even in our greedy financiers. Instead, we should examine our privatized financial system. Why is it so unstable? And how can it be stabilized?

We've heard the wisdom of philosophers and prophets who, for over five thousand years, have worried that money-making-money disrupts the social order. They feared that indebtedness would lead to poverty and inequality (which it does), and that unfettered finance would cause social instability (which it does). We saw that as capitalism matured into a global system, political economists tried to understand and tame destructive booms and busts, and to draw a line between sound investing and casino gambling, between risk-taking and recklessness. These economists hoped to foster the intrepid entrepreneurial spirit that created new wealth, while discouraging the gambling that caused instability. Unfortunately, their attempts largely failed. Perhaps

that's because in the private financial sector, risk-taking and recklessness are intractably entwined.

Economists John Maynard Keynes and Hyman Minsky believed that our privatized financial system was inherently unstable—that it would always wobble between booms and busts.[28] As Minsky wrote, the "instability of financial markets—the periodic crunches, squeezes, and debacles—. . . is a normal functioning internally generated result of the behavior of a capitalist economy."[29] Although critical of the status quo, these economists believed deeply in the overall value of the capitalist system. But they saw an enormous difference between markets for goods and services and financial markets. They thought that decentralized free markets were much more efficient and productive that any state-run system could ever be. Like Milton Friedman, they believed that the free market protected and enhanced individual freedoms and offered people opportunity. Like New Deal Democrats, they also believed capitalism could promote social justice and increase equality. But while they extolled the virtues of decentralized markets for producing and distributing goods and services, they had seen that private financial markets could melt down and lead to severe depressions.

In this book, we sought to pinpoint and demystify the financial instruments that promoted our latest bout of financial instability. Of course, these products were not solely responsible for the crash. But they contributed mightily to systemic risk by lining up a fragile set of global financial dominoes. Early on, people on Wall Street began calling these financial instruments "toxic waste." But they had no idea how toxic and wasteful they would become.

In these last chapters we've suggested ways to protect ourselves from financial instability: financial-disaster insurance, the president's wage cap, financial-engineering controls, unionization, and increasing real wages and the minimum wage. These reforms would shift resources to the real economy and away from fantasy finance. But even these proposals may not be sufficient.

It may be time to look more closely at the most radical proposals offered by Keynes and Minsky. To protect our decentralized capitalist system from collapse, they thought it might be necessary to "socialize" the largest pieces of the private financial sector. Not temporarily "pre-privatize" them, but socialize them for good. A few years ago this would have seemed absolutely outrageous. The major banks, insurance companies, and investment houses were wildly profitable and seemed to be dynamic engines of economic growth. They were attracting our most able minds. They were minting new wealth for their employees and stockholders.

But now these same institutions are in shambles—even after we've bailed them out with our billions. It was not a cabal of socialists who began nationalizing these institutions. It was the ultraconservative, free-market Bush administration. It realized that without massive intervention, these banks would fail, taking the entire financial system with them. If the government hadn't begun its stutter-step program of nationalization, we might already be deep into Great Depression II.

The public now, more or less, owns Freddie and Fannie, AIG, Citigroup, and a good deal of Bank of America as well. Soon other banks will be begging us for bailouts. We are becoming the saviors of all the financial institutions that are too big to fail, but are failing anyway. Yet we seem afraid to take over these institutions, or even hold them strictly accountable for how they spend our money.

We now face a set of fateful choices. We can hold onto and supervise the semi-socialized financial sector, or we can return the entire banking system to private investors. We can enact policies that allow workers' real wages to rise, or we can keep the wealth flowing upward to the superrich. We can put limits on financial engineering, or we can wait and see what the next orgy of fantasy finance does to our economy.

Policy makers face deep political crosscurrents. Many will try to avoid these stark choices by steering a middle path. They don't

want to nationalize more banks. And they want to return the ones we own to the private sector as soon as possible.

When the government first began its bailout effort, its aim was simply to rid the banks of their toxic assets, like a giant financial superfund cleanup project. But then they decided this fix wouldn't be fast enough. So instead they tried to get banks lending again (and aid bank stockholders) by pumping in hundreds of billions in cash, along with billions more in asset guarantees. But this cash came with virtually no strings attached. And soon the feds discovered that the banks were using our money to sit tight, pay bonuses and dividends, and buy up other companies. As one banker defiantly put it in January 2009, after receiving $300 million from the federal bailout: "Make more loans? We're not going to change our business model or our credit policies to accommodate the needs of the public sector as they see it to have us make more loans."[30]

As of this writing, the Obama administration is unveiling a new plan that insures investors who are being encouraged to buy the toxic assets and get them off the books of the crippled banks. But no one knows what this financial toxic waste is genuinely worth, and so it's unclear just how much of a risk Obama is taking with taxpayer money, or how much of a windfall his plan will be for these insider investors. Also, the definition of "toxic" will get increasingly murky as financial assets lose value during the deep economic recession. The price tag for our largesse for the banks could reach the trillions.

And all because we are tiptoeing around nationalization. We fear it conjures up vast bureaucracies staffed with do-nothing civil servants who will screw it up. But could they really screw it up more than the private-sector bankers already have?

Some fear that a full-scale financial takeover will scare away investors and further depress the stock market—the global symbol of financial health. But why should we continue to protect investors who bet big on junk, profited immensely, and then turned to us for help?

Some fear being called socialists by conservative pundits, even though the Cold War is long gone. But if banks continue to spiral down and threaten the entire economy, isn't it time to say that the only thing about nationalization we have to fear is fear itself?

Perhaps the biggest problem with our government's avoidance of nationalization is that the alternatives may not work. We are gambling that somehow, the hodgepodge of bailouts, regulations, and stimulus bills will get us out of the current mess. The odds are even longer that these measures will eliminate long-term financial instability. History provides little reassurance. Never before has so much human energy been devoted to investigating, analyzing, and managing our economy. And yet the most advanced and sophisticated economic system ever created crashed all over our research papers, our econometric models, and our free-market theories, not to mention our real lives. And the odds are, if we don't change the way we do things, it will crash again.

Alan Greenspan not only agrees, but considers these crashes a small price to pay for all that we have achieved. On the CNBC documentary "House of Cards," first aired on February 12, 2009, he readily admitted that greed was the fundamental economic motivation that drove the economy—both up and down. Moreover, he argued, we would have to live with it, because greed would always be with us, and it could never be legislated away. Like Solomon he weighed the productivity of capitalism against its periodic destructiveness:

> This is one of the most extraordinary things about this whole episode. Looking at the way we all behaved—how is it possible that this species built up such an extraordinary world standard of living, which has drawn hundreds of millions of people out of poverty? The thing we should be most extraordinarily appreciative of is how far this system has carried us. Because there is no doubt that somewhere in the future we are going to have

> this conversation again. It will not be for quite a period of time, but it will occur because the flaws are such in human nature that we cannot change that—it doesn't work.[31]

But the choice is not between changing human nature and accepting unregulated free markets. Also, the choice is not between total socialism and unfettered capitalism. Given the vast complexities of our global economic system, we need to make room for more nuanced alternatives. Free-enterprise principles can govern most of our markets for goods and services, while we also tightly control finance. We need to square up to reality. The financial sector, when measured by its overall impact on our economic world, produces systemic instability and runs inefficiently when structured as a small set of for-profit enterprises that are too big to fail. At the very least we need some sort of way to protect ourselves from the crises that even Alan Greenspan has "no doubt" will occur again, such as the proposal for financial disaster insurance in chapter 10. But our children and grandchildren deserve better than the very least we can do.

Let's hope we won't throw away much of our children's inheritance because we did not have the courage to do the obvious: Take over the failing major banks, drastically trim their astronomical salaries, control their hazardous financial engineering, and run the damn things for the good of us all.

Once again, events may be passing me by. Each day we hear more and more references to nationalization. Economists, both from the left and right, are advocating temporary government ownership of failed banks (euphemistically called "pre-privatization"). A consensus is building rapidly, not because of ideology, but out of desperation. Obama's toxic-asset public-private partnership plan released in March 2009 is the last effort to avoid that strategy. If it fails, he might be forced to reach for the only option left on the table. But even among the strident critics, few, if any, seem willing to let the government run key financial institutions

for the long haul. It seems that we'd rather gamble yet again on unstable private markets.

If, by the time you read these words, we have avoided a full-scale depression, we should consider ourselves more fortunate than wise. Or as Bob Dylan lamented,

> "An' here I sit so patiently
> Waiting to find out what price
> You have to pay to get out of
> Going through all these things twice."[32]