On the Roots of the Current Economic Crisis and Some Proposed Solutions

by Andrew Kliman, Author of *Reclaiming Marx's "*Capital*": A refutation of the myth of inconsistency*

Some prominent radical economists and non-economists have denied that Marx's theory of the tendential fall in the rate of profit helps to explain the current economic crisis. I want to begin by explaining why they dismiss this theory, and then argue, to the contrary, that the current crisis does have a lot to do with the tendential fall in the rate of profit as analyzed by Marx.

In the 1970s, as an outgrowth of the New Left, and because of the global economic crisis of that decade, there was a renewal of scholarship that attempted to reclaim Marx's value theory and theories grounded in his value theory, such as his theory of the tendential fall in the rate of profit and his theory of capitalist economic crisis. But these efforts met with a strong reaction, in the form of a resurgent myth that Marx's value theory and law of the tendential fall in the rate of profit had been proved internally inconsistent. It needs to be stressed that the resurgence of this myth of inconsistency came from *within* the Left; almost all of the critics of Marx's value theory in this period, and ever since, have been Marxist or Sraffian economists.

Why does the myth of inconsistency matter? Well, internally inconsistent arguments simply cannot be correct, so a theory that is founded upon them cannot possibly explain events correctly. It may *seem* to do so; it may be intuitively plausible, even convincing, and it may be consistent with all of the available evidence. Nonetheless, the fact remains that internally inconsistent arguments are always wrong, even if they accidentally happen to arrive at correct conclusions in a particular case. A theory founded upon them must therefore be rejected or corrected. For instance, in an influential 1977 work, *Marx After Sraffa*, Ian Steedman, a leading Sraffian economist, argued, "value magnitudes are, at best, redundant in the determination of the rate of profit (and prices of production)" (p. 202). "Marx's value reasoning—hardly a peripheral aspect of his work—must therefore be abandoned, in the interest of developing a coherent materialist theory of capitalism" (p. 207).

One key aspect of the "internal inconsistency" critique was the so-called "Okishio theorem." In 1961, the Japanese Marxist economist Nobuo Okishio claimed to prove that technical innovations introduced by profit-maximizing capitalists can *never* cause the rate of profit to fall. Thus Marx's diametrically opposed conclusion was based on internally inconsistent reasoning. Once it was discovered during the debates of the 1970s, Okishio's theorem caught on quickly.

Owing to the supposed mathematical rigor of their arguments, and undoubtedly owing to the changed political climate as well, Marx's critics won these debates hands down. By the start of the 1980s, the myth that Marx's theories of value and the falling rate of profit have been proven internally inconsistent, and therefore false, was almost unanimously accepted as fact.

This myth has since been disproved by proponents of what is now known as the temporal single-system interpretation of Marx's value theory. I am proud to have contributed to this effort and I've tried to make the issues and the refutation of the myth accessible to a general audience, i.e., to explain things with minimal math and in as simple a way as I can, in

Reclaiming Marx's "Capital": A refutation of the myth of inconsistency, which came out in 2007.

Nonetheless, the myth of inconsistency largely persists, and it affects the debate over the causes of the current crisis. As I said at the start, some prominent radical economists and non-economists have been denying that Marx's theory of the tendential fall in the rate of profit helps to explain the current economic crisis. As we'll see, the reason they dismiss his theory has a lot to do with the Okishio theorem. But first let me report what they say.

Writing in the *International Socialism* journal last July, Fred Moseley, a prominent Marxist economist, wrote, "there has been a substantial recovery of the rate of profit in the US economy…. Three decades of stagnant real wages and increasing exploitation have substantially restored the rate of profit, at the expense of workers. This important fact should be acknowledged. … The main problem in the current crisis is the financial sector. … The best theorist of the capitalist financial system is Hyman Minsky, not Karl Marx. The current crisis is more of a Minsky crisis than a Marx crisis." [Moseley, "Some notes on the crunch and the crisis," http://www.isj.org.uk/index.php4?id=463&issue=119]

Similarly, an attendee at last November's *Hisotrical Materialism* conference recently reported that another prominent Marxist economist, "Gérard Duménil, … mock[ed] the idea that 'the profit rate had to be behind the crisis'. . . . [H]e thought the crisis was of financial origin and that the profit rate had been relatively steady and had little to do with it." The same report states that Costas Lapavitsas, another well-known Marxist economist, was "also dismissive of the profit-rate line." [Mike Beggs, Feb. 16, 2009, http://mailman.lbo-talk.org/pipermail/lbo-talk/Week-of-Mon-20090216/002355.html]

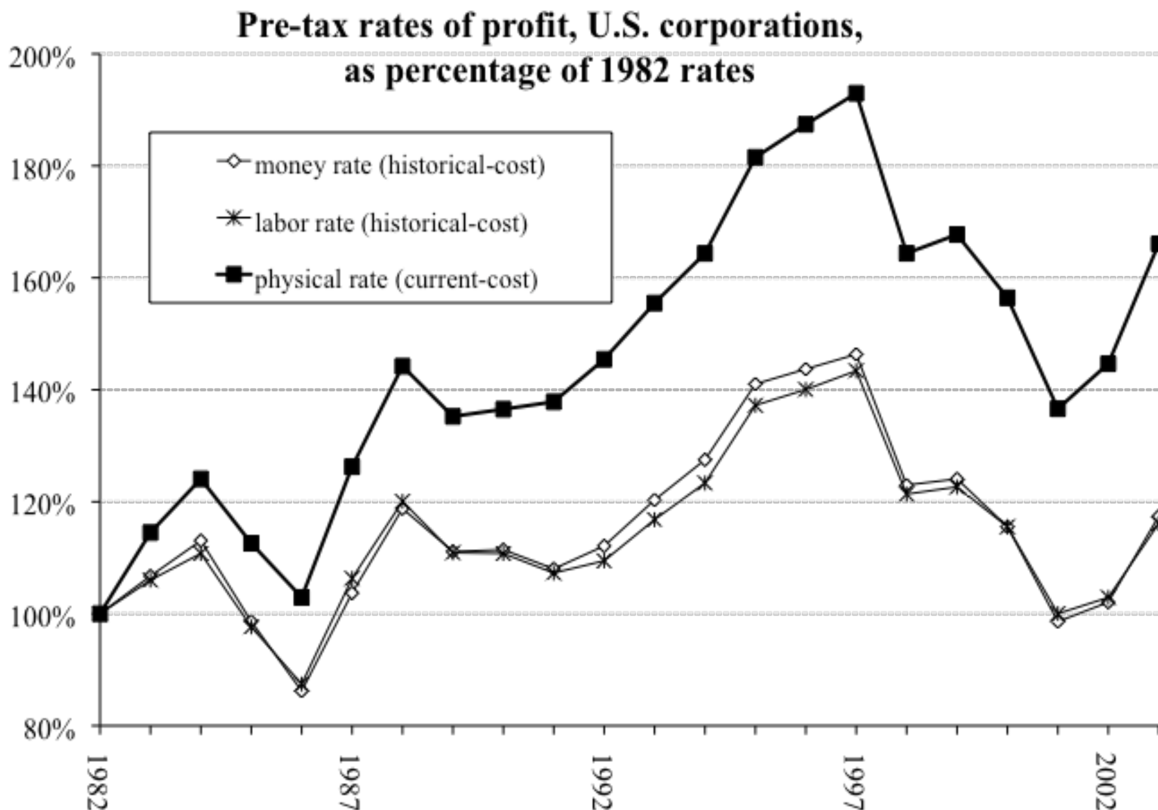
Now the main reason they dismiss the notion that Marx's law of the falling tendency of the rate of profit helps account for the current crisis is that the so-called "rate of profit" that they are talking about has indeed recovered substantially since the early 1980s. But their so-called rate of profit is *Okishio's* rate of profit, the measure he used to try to prove Marx internally inconsistent, not the rate of profit that Marx talked about when he said that technological progress tends to cause it to fall.

Okishio's rate of profit is essentially a *physical* measure, not a *monetary* or *value* measure, and so it actually isn't a rate of profit in any normal sense. It has little to do with what capitalists in the real-world mean by "rate of profit," namely their *money* profit as a percentage of the *actual sum of money* they've invested. But since Okishio supposedly disproved Marx's theory, and since Marx's value theory was supposedly proved to be internally inconsistent, the Marxist economists have chucked his *value*-based rate of profit into the dustbin of history. During the last three decades, when they've discuss the tendency of the rate of profit, they've been discussing the tendency of Okishio's physical measure.

This substitution matters a lot when the question is whether the rate of profit has recovered from the fall it underwent from the mid-1960s to the early 1980s.

As Figure 1 shows, the physical rate of profit rose by 37% from 1982 to 2001. (All of my data come from the U.S. government—the Bureau of Economic Analysis and the Bureau of Labor Statistics—and are obtainable online for free.)

But again, the physical rate of profit isn't a rate of profit in any real sense, and the myth of Marx's internal inconsistency has been refuted, so we can in good conscience return to an examination of the money rate of profit, measured on the basis of the actual sums of money invested, and labor, or value, rate of profit, which we see is very closely associated with the money rate. These two rates were no higher in 2001 than in 1982. They experienced only a cyclical rise, no long-term recovery.

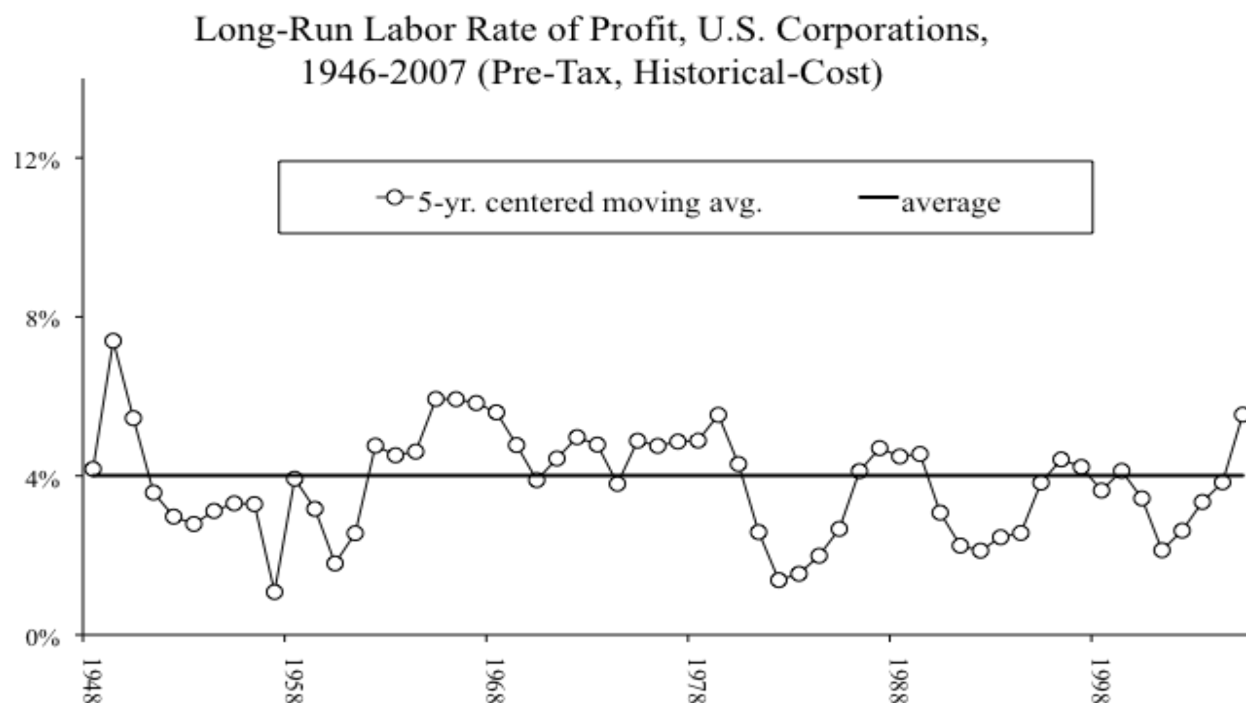


Given that the rate of profit hasn't recovered, perhaps Marx's theory can help to explain the current economic crisis after all. I will now argue that it does help. In brief, my view is this: The rate of profit heads toward "the long-run rate of profit." At the start of a new boom, the rate of profit is well above the long-run rate of profit, so it tends to fall over time. This situation persists unless there's sufficient "destruction of capital." Destruction of capital restores profitability, and thus ushers in a new boom. This is what happened in the Great Depression and World War II. But there was insufficient destruction of capital in the economic crises of the mid-1970s and early 1980s. Rather than allowing there to be a depression (and subsequent boom!), policy-makers have continually encouraged excessive expansion of debt. This artificially boosts profitability and economic growth, but in an unsustainable manner; it leads to repeated debt crises. The present crisis is the most serious and acute of these. Policy-makers are responding by again papering over bad debts with more debt, this time to an unprecedented degree.

My first theoretical point in the above sketch is that the rate of profit heads toward the long-run rate of profit. So what I'm calling the "long-run" rate of profit is the rate toward which the actually observed rate of profit tends in the long run, all else being equal. What is this long-run rate? According to Marx's theory, all profit comes from workers' labor. Thus the long-run rate of profit depends in part upon the rate of growth of employment. This is held down by labor-saving technical progress. The long-run rate also depends upon the share of profit or surplus-value that is reinvested.

There are two other factors determining the value of the long-run rate of profit: the relationship between profits and wages, and the rise in money prices above the real value of

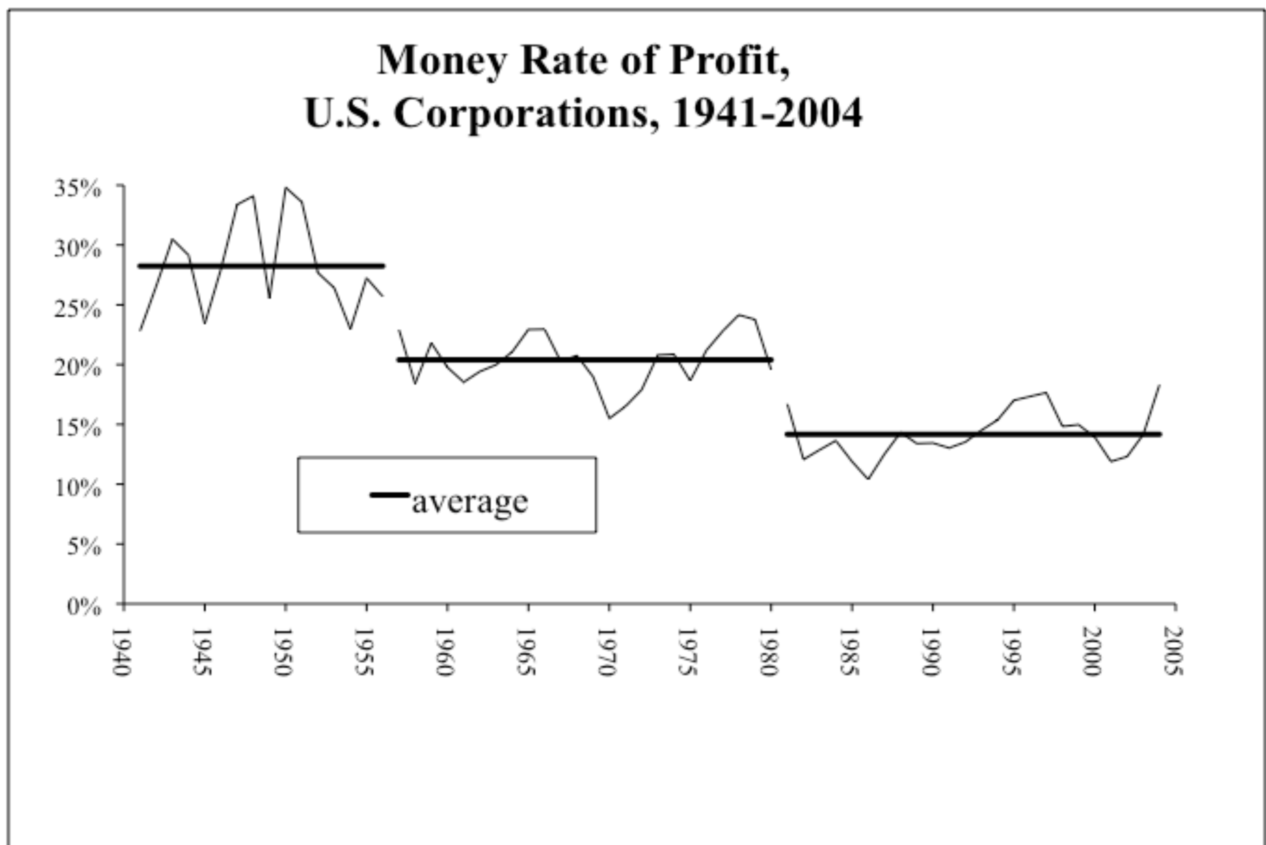
goods and services, which, according to Marx's theory, is determined by labor-time. But just for the moment, let's ignore these factors. In other words, let's consider what the long-run rate of profit *would be* if the relationship between profits and wages were constant, and money prices didn't rise above real values. (1)



Over the last 61 years in the U.S., this long-run rate of profit, which I'm calling the long-run labor rate, as distinct from the long-run money rate of profit, has been trendless, a constant 4% on average.

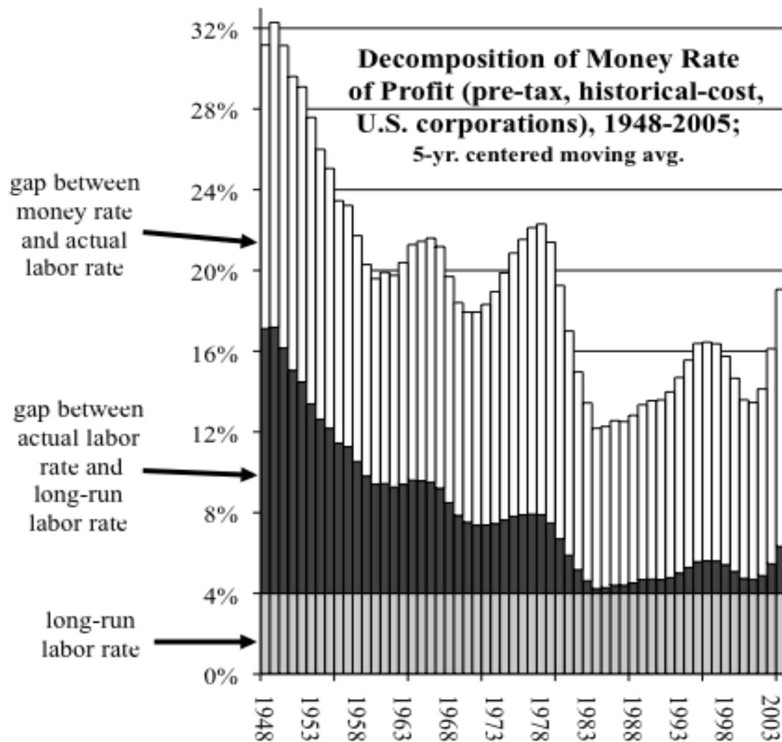
My second point in the above theoretical sketch was that, at the start of a new boom, the rate of profit is well above the long-run rate of profit, so it tends to fall over time.

Money Rate of Profit, US Corporations, 1929-2007
(Before-tax profits as % of historical cost of fixed assets)



The next slide shows that the money rate of profit did in fact start off much higher in the boom that began after the Great Depression, and that it has tended to fall consistently since then.

A closer look at this graph reveals that there have been three distinct periods since the start of World War II. From 1941 through 1956, the rate of profit averaged 28%, falling to 20% in the 1957-1980 period, and falling further to 14% in the period from 1981 through 2004. What caused the fall?



Well, according to the theory presented above, there is the long-run labor rate of profit, 4%. Then there's the actual labor rate of profit, which is what the money rate of profit *would have been* if money prices didn't rise above real values. We see a clear tendency for the actual labor rate of profit to head toward the long-run labor rate, just as the theory suggests.

Then there's the excess of the money rate over the actual labor rate. Prices have indeed consistently risen in relationship to the real values of goods and services, and this consistently boosts the money rate of profit over the labor rate. But the gap between the two rates has been roughly constant—in fact, it has fallen by several percentage points since the rate of inflation came down in the early 1980s. And since this gap is roughly constant, the fall of the labor rate of profit toward its long-run level has been accompanied by a fall, of basically the same extent, in the money rate of profit. These results match the theory to a greater degree than I expected before I began this analysis.

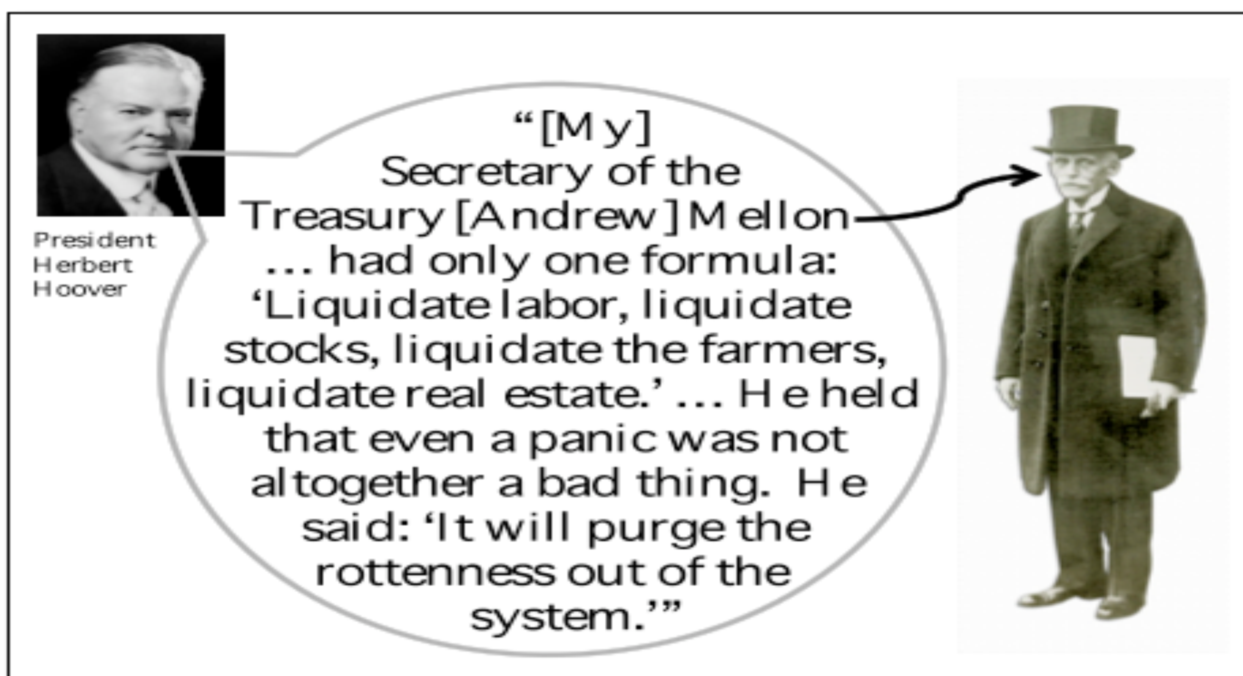
My next point of in the above theoretical sketch was that this tendency of the rate of profit to fall toward its long-run level persists unless there's sufficient "destruction of capital." This is a key concept of Marx's theory of capitalist crisis. By "destruction of capital," he meant not only the destruction of physical capital assets, but also, and especially, of the *value* of capital assets.

In an economic slump, machines and buildings lay idle, rust and deteriorate, so physical capital is destroyed. More importantly, debts go unpaid, asset prices fall, and other prices may also fall, so the value of physical as well as financial capital assets is destroyed. Yet as I

noted earlier, the destruction of capital is also the key mechanism that leads to the next boom. For instance, if a business can generate $3 million in profit annually, but the value of the capital invested in the business is $100 million, its rate of profit is a mere 3%. But if the destruction of capital values enables new owners to acquire the business for only $10 million instead of $100 million, their rate of profit is a healthy 30%. That is a tremendous spur to a new boom.

Thus the post-war boom came about, I believe, as a result of a massive destruction of capital that occurred during the Great Depression and World War II. One measure of that boom is the rise in the rate of profit that we saw earlier, from –2% in 1932 to 30% in 1943.

At the start of the Great Depression, the destruction of capital was actually advocated by conservative economists. This was called "liquidationism." According to Herbert Hoover, his Treasury Secretary, the financier Andrew Mellon, advocated it as well.



But in the 1970s and thereafter, policymakers in the U.S. and abroad have understandably been afraid of a repeat of the Great Depression. They have therefore repeatedly attempted to retard and prevent the destruction of capital. This has "contained" the problem, while also prolonging it. As a result, the economy has never fully recovered from the slump of the 1970s, certainly not in the way in which it recovered from the Great Depression. The failure of the rate of profit to recover is one indicator of the lack of a new boom.

The result is a relative sluggishness of the economy. But the sluggishness has continually been papered over by an ever-growing mountain of debt. For instance, reduced corporate taxes have boosted the after-tax rate of profit relative to the pre-tax rate, but this boost has been paid for by $2.5 trillion of additional public debt. Almost all of the remaining increase in the government's indebtedness is used to cover lost revenue resulting from reduced individual income taxes. These tax reductions have propped up consumer spending and asset prices artificially. Similarly, easy-credit conditions have led to inflated home prices and stock prices, and this has allowed consumers and homeowners to borrow more and save

less. Americans saved about 10% of their after-tax income through the mid-1980s, but the saving rate then fell consistently, bottoming out at 0.6% in the 2005–2007 period.

Thus, in the period since the crisis of the mid–1970s, there have been recurrent upturns that have rested upon debt expansion. For that reason, they have been relatively short-lived and unsustainable. And the excessive run-up of debt has resulted in recurrent crises, such as the savings and loan crisis of the early 1990s, the East Asian crisis that spread to Russia and Latin America toward the end of the decade, the collapse of the dot-com stock market boom shortly thereafter, and now the biggest crisis of all, brought on by the busting of housing market bubble.

Policymakers are responding to this crisis with more of the same—much, much more. The U.S. government is borrowing a phenomenal amount of money, for TARP, Obama's stimulus package, the new PPIP (Son of TARP) bailout of the banks, and so forth. If these measures succeed—and that is still far from a sure thing—full-scale destruction of capital will continue to be averted. But if my analysis is correct, the consequences of *success* will be continuing relative stagnation and more debt crises down the road, not a sustainable boom. To repeat, unless sufficient capital is destroyed, profitability cannot return to a level great enough to usher in a boom. And given the huge increase in debt that the U.S. government is now taking on, the next debt crisis could be much worse than the current one. It is therefore not unlikely that the next wave of panic that strikes the financial markets will be even more severe than the current one, and have more serious consequences.

But what about the notion that the crisis could have been averted by regulation, and that the next crisis can be averted by regulation? For decades, and until very recently, we heard a lot about how "free-market" capitalism is supposedly more successful than regulated capitalism. Now we're hearing a lot about regulated capitalism as the new solution.

But consider the savings and loan crisis of two decades ago. Thousands of S&Ls collapsed; the government eventually had to spend hundreds of billions of dollars to repay depositors. This crisis was a failure precisely of *regulated* capitalism. The S&Ls were very heavily regulated; both the interest rates that they paid on deposits and the rates they charged for mortgage loans were fixed by the government. The S&Ls were known as a 3-6-3 industry: bring in funds by paying 3% on deposits, lend them out at 6%, and be on the golf course by 3 in the afternoon. Very boring, but very safe and stable.

But one thing that Keynesian policies and regulations didn't regulate, and which they weren't able to prevent, was the spiraling-upward inflation of the mid- and late-1970s. When inflation took off, the 6% they were getting on mortgage loans didn't come close to the rate of inflation, which averaged 9.4% from 1974 through 1981. So in "real," or inflation-adjusted, terms, the S&Ls were losing money hand over fist. Also, the measly 3% interest that S&Ls were allowed to offer depositors was even further below the rate of inflation, so in "real" terms, depositors were losing tons of money by keeping their deposits in the S&Ls. But this latter situation led to the rapid growth of an unregulated alternative: money market mutual funds, which were paying interest rates that more than made up for inflation. Depositors were very happy to have this alternative to the regulated S&Ls. They fled the S&Ls and put their money in the money market mutual funds.

Now Congress eventually lifted the ceiling on the rates that S&Ls could offer depositors, and the ceiling on the rates they could charge for their loans. But the S&Ls were still losing massive amounts of money on the mortgages they had made in the 1950s and 1960s, which were still bringing in 6% interest. The only way they could stay afloat was to make new loans

that were riskier than home mortgage loans and which therefore paid higher interest. So Congress eventually undid a Depression-era law which stipulated that the S&Ls were to make home mortgage loans only. The S&Ls began to make very risky real estate and business loans in order to make up for their losses on old loans and cover their costs of borrowing depositors' funds. A lot of these loans never paid off, and in the end the industry essentially collapsed.

The basic problem with the notion that regulated capitalism is somehow better than free-market capitalism is the simple fact that, in the end, capitalism can't be regulated.

"These new regulations will fundamentally change the way we get around them."

P.C. Vey, The New Yorker, March 9, 2009

This was acknowledged recently by Joseph Stiglitz, the Nobel Laureate and former World Bank chief economist. In mid-September, he wrote an article that proposed a whole slew of new regulations and laws. But Stiglitz ended by conceding, "These reforms will not guarantee that we will not have another crisis. The ingenuity of those in the financial markets is impressive. Eventually, they will figure out how to circumvent whatever regulations are imposed." I think this is exactly right. [Stiglitz, "How to prevent the next Wall Street crisis," CNN.com, September 17, 2008]

Stiglitz did go on to say, "But these reforms *will* make another crisis of this kind less likely, and, should it occur, make it less severe than it otherwise would be." [ibid.] That doesn't make sense, however. If the financial markets *will* eventually circumvent whatever regulations are imposed, then, once they do, the next financial crisis will be just as likely and just as severe as it would have been otherwise. The best that can be said for new laws and regulations is that they can *delay* the next crisis, while the markets are still finding ways to circumvent the regulators. And a delay of the crisis means more artificial expansion through excessive borrowing in the meantime, so that the contraction will be more severe when the bubble does finally burst.

Footnotes:

(1) If prices equaled values, then the rate of profit could be expressed as a ratio of variables measured in terms of labor-time rather than as a ratio of variables measured in

terms of money. So let S stand for surplus labor, i.e., surplus value in labor-time terms; let L stand for living labor (or employment, a close approximation); and let C stand for capital advanced in terms of labor-time). In the long run, S/C, which is the rate of profit measured in terms of labor-time, tends toward the incremental, or long-run, rate:

$$r_{LR} = \Delta S / \Delta C = \frac{\Delta\left(\left[S/L\right]L\right)}{\Delta C}.$$

Now if the relationship between profit and wages were constant, then S/L, surplus-labor per worker, would be constant. Under this assumption,

$$r_{LR} = \left(\frac{S}{L}\right)\left(\frac{\Delta L}{\Delta C}\right) = \left(\frac{\Delta L / L}{\Delta C / S}\right) = \left(\frac{\text{percentage growth rate of L}}{\text{share of surplus-value re-invested}}\right).$$

My estimates of the long-run labor rate of profit are estimates of this ratio. In a paper I intend to complete within the next few weeks, the long-run rate of profit and its relationship to the actual labor-time and money rates of profit will be discussed in more detail.

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