

# The Role of Collective Bargaining in the Global Economy

Negotiating for Social Justice

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10. New roles for unions and collective bargaining post the implosion of Wall Street capitalism

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## 10. New roles for unions and collective bargaining post the implosion of Wall Street capitalism

Richard Freeman

### 10.1 INTRODUCTION

I regard the growth of collective bargaining as essential. I approve minimum wage and hours regulation. (John Maynard Keynes, 1938, "Letter of February 1 to Franklin Delano Roosevelt, on policies to recover from the Great Depression)

Ages ago – or was it just months before Wall Street imploded? – Keynes' 1938 statement on the role of labour institutions and regulations in economic life seemed a historic relic from the museum of discarded economic thinking. Collective bargaining – essential? Minimum wages and hours regulation – something to laud? Policies to recover from a Great Depression – doesn't everyone know that *laissez-faire* is ideal?

Before Wall Street imploded, macro-economists believed that monetary policy with some automatic stabilizers tossed in had produced an era of great moderation in economic fluctuations.<sup>1</sup> Adherents to real business cycle theory argued that cyclic ups and downs reflected changes in technology and tastes in the real economy, not the vagaries of markets. Financial economists asserted that the efficient market hypothesis fit global finance, give or take a few minor anomalies not worth troubling over. Wall Street's "best and brightest" had developed mathematically sophisticated financial instruments that spread risks efficiently around the world.

The World Bank and IMF touted the US model of capitalism as the poster economy of the modern world. The crown jewels of the model were the weakly regulated capital market and a highly flexible labour market with a minimal role for labour institutions. The OECD (1994) *Jobs Study* blamed the high unemployment in the EU on inflexible labour markets that prevented an otherwise perfectly functioning labour market system from attaining full employment and maximal efficiency. If the labour market could just follow the lead of finance the world would attain

economic nirvana. Only some Rip Van Winkle unaware of modern thinking about the virtues of markets could possibly think that collective bargaining was essential and that minimum wage and hours regulation were useful in dealing with economic fluctuations.

When I agreed to write this chapter I had no inkling that the US financial system was about to collapse in ways that would torpedo the orthodox vision of market capitalism sketched above. My plan was to update evidence that collective bargaining compresses the distribution of earnings relative to market pay-setting while having little impact on aggregate efficiency and to emphasize that these findings fit a Coase Theorem interpretation of institutions in which unions and firms bargain efficiently to distribute income without shrinking the economic pie (Freeman, 2007b). I would remind readers that while the US led other advanced economies in some dimensions of economic performance (productivity, adoption of new technology, full employment, ease of business start-ups, absorbing immigrant and women workers) in the 1990s–2000s it trailed in other dimensions (income distribution, health care, ability of workers to form unions, personal debt, trade deficit, and the proportion of the young graduating university), which made its status as peak capitalist economy problematic at best (Freeman, 2007a, 2008). With unknowing prescience I was going to stress that one decade's candidate peak economy often becomes the next decade's basket-case, as per Japan in the 1980s and in the 1990s, Germany before and after re-unification, and Sweden in the 1970s vs late 1980s–1990s.

The meltdown of the US financial sector and the resultant global recession outmoded this plan. In 2011 it is as clear as it was in 1929 that the real economy does not operate according to some *laissez-faire* ideal and the Achilles heel of market capitalism is not labour institutions but an unregulated finance market. Orthodox economists, central bankers, and the IMF have endorsed cuts in interest rates and deficit spending initiatives that they would have denounced a few months earlier as irresponsible, socialist, or as upsetting Wall Street and the bond market. Alan Greenspan, who as head of the Federal Reserve opposed government regulation of derivatives for fear that this would hinder "the efficiency of markets to enlarge standards of living", admitted that "The whole intellectual edifice [on which his policies hinged] . . . collapsed . . . placing him in a state of 'shocked disbelief'" (Greenspan, 2008). In the crisis mainstream economists have ditched real business cycles, rational expectations, and associated models that predict that the market will solve all problems in favour of fiscal stimulus and central bank monetary expansion.

The implosion of Wall Street has opened the door for rethinking the role of institutions in a market economy as well as the impact of monetary

and fiscal policy in stabilizing the economy. Most of the discourse about institutions has focused on the financial sector and building a financial regulatory regime to control the risk-taking, financial fraud and chicanery that can undermine the real economy. In the labour market, the OECD no longer claims that flexibility is the cure to all ills. It now states (*Employment Outlook*, 2009):

there does not appear to be any strong reason to expect that recent structural reforms mean that OECD labour markets are now substantially less sensitive to severe economic downturns than . . . in the past . . . the “great moderation apparently cannot be attributed to . . . the types of structural reforms that have received a lot of attention from labour market analysts and policy makers” (p. 39)

there do not appear to be any clear grounds for concluding that workers, generally, are either better or worse prepared to weather a period of weak labour markets than was the case for the past several recessions (p. 40)

Indeed, following the lead of several countries that pressed firms to keep workers on payrolls in the late-2000s recession – Korea, Germany, Sweden, for example – the OECD recognized the employment protection legislation that it had opposed for decades might have some virtue by slowing job loss in a recession and maintaining the attachment of workers to their employer.

The financial implosion and global recession have, it is safe to conclude, demolished the case that labour institutions are the main source of weakness in a capitalist economy. But they have not demonstrated the converse – that labour institutions can contribute to the better functioning of a market economy as per the Keynes letter. How, if at all, can collective bargaining and labour regulations help an economy recover from a major economic downturn? Is a vibrant labour movement “essential” in reforming financial markets and rebuilding a sustainable capitalist economy?

In this chapter I argue that by reducing economic inequality and raising the purchasing power of the bulk of the work force, collective bargaining can contribute to a healthy recovery from global recession. Going a step further, I explore the more radical notion that a modern economy needs the countervailing power of labour institutions to develop and implement rules to make finance work for the real economy. Absent a strong labour voice in economic decision-making, bankers and financiers will stifle reforms of their industry and continue to operate as a loose cannon on the good ship Capitalism. Were Keynes to write his 1938 letter today he would most likely send President Obama an email that said, “*I regard the growth of collective bargaining as essential and favor passage of the Employee Free*

*Choice Act to enable workers to unionize without undue management pressure. I approve of banking and finance regulation and endorse a greater role for labor in revamping those regulations and rules.”*

I begin by examining the role of economic incentives in inducing the chicanery, risk-taking, and financial crime/near crime that contributed to the financial implosion and ensuing recession. I relate the failure of regulators and government officials to act before the disaster to regulatory capture and the “markets can do no wrong” ideology that replaced substantive analysis in much economic and policy discourse. I document the cost of the ensuing recession to workers that gives unions and other groups concerned with labour a huge stake in reforming financial markets. Finally, I examine ways in which collective bargaining can contribute to a healthy recovery and in which a strong labour input can contribute to rewriting the rules and regulations for finance.

## 10.2 WHAT WENT WRONG?

Why did a financial system that was supposed to spread risk and increase stability do the opposite? What impelled bankers and financiers to leverage debt obligations on debt obligations in ways that turned the financial system into a house of cards?

### Incentives, Incentives, Incentives

Seeking to understand how the “vast risk management and pricing system . . . combining the best insights of mathematicians and finance experts” could implode so completely as to require a massive government bailout to preserve financial markets, Alan Greenspan blamed “the data inputted into the risk management models [which] generally covered only the past two decades, a period of euphoria” (Greenspan, 2008). That experts did not use data from earlier periods or assess scenarios in which fat tailed distributions produce large negative shocks boggles the mind, particularly after the 1998 collapse of Long Term Capital Management, the \$5 billion hedge fund headed by Wall Street insiders, Nobel economists, and math whizzes,<sup>2</sup> which should have warned the financial sector that something was amiss with the risk models behind new financial instruments and risk strategies. That regulators accepted firms’ short run risk models without doing independent analyses of longer run systemic risk approaches criminal negligence.<sup>3</sup>

Economic analysis suggests, however, that rather than blaming the financial implosion on the incompetence of bankers and financiers, we

should ask “*cui bono?*” as we look at the incentives that induced them to make the short-sighted, risky, and self-interested decisions that led to the implosion. There were huge amounts to earn for executives in banking and finance and elsewhere if they could meet or seem to meet certain performance criteria. For three to four decades income inequality had been rising in the US and to a lesser extent in other advanced countries. In the US inequality reached levels comparable to those immediately before the Great Depression. American executives made 200 to 300 times the earnings of normal workers largely due to stock options and bonuses, which became the preferred mode of executive compensation following the Clinton Administration’s 1993 tax reform that denied a corporate tax deduction for pay in excess of \$1 million.<sup>4</sup> Financiers, bankers, and other top executives could make huge sums in options or bonuses if their firm reported high profits or if its share prices rose. They could raise profits and share prices by improving company performance (possibly at the expense of workers or consumers) or by finding imaginative ways to report high profits and boost share prices.

Finance benefited from these forms of pay more than other sectors. Compensation per full-time equivalent employee in finance rose from 18% above the national average in 1990 to 52% above average in 2007. In 1990 the total compensation bill for employees in finance was comparable to total compensation for federal civilian employees. In 2007 it was nearly three times as large. Much of the increased income went to those in the highest positions. In 2006 Wall Street paid out \$62 billion in bonuses. Some heads of hedge funds made \$1 billion to \$2 billion a year.

The problem with offering huge financial incentives to decision-makers is that it is difficult to tailor the incentives to induce the desired behavior. Reward someone with stock options and they are likely to make riskier decisions than otherwise since options are worth more the more volatile the share price. Sanders and Hambrick (2007) found that firms whose CEO compensation is loaded with stock-options show greater variation in performance than other firms. If the gains to the winners exceed the losses to the losers, this would raise total output and thus be in the interest of the economy writ large. But the riskier behaviour produces more big losses than big gains. In a simple maze-solving laboratory experiment, Gelber and I (2010) found that greater incentives for coming higher in a tournament induced participants not only to solve more mazes but also to misreport the number of mazes they had solved. As criminal investigators, business reporters, and economic historians probe the behaviour behind the financial implosion I anticipate that they will find more venality and financial crime motivated by the chance to make huge sums of money than they will find massive incompetence.<sup>5</sup>

With huge amounts of earnings at stake, executives learned how to game the system, by rewriting and backdating stock options and by reporting transactions in ways that made their options valuable at key moments. Just as Bernard Madoff knew he was running a Ponzi scheme, the big Wall Street firms knew what they were doing when they packaged sub-prime mortgages and earned their fees by selling them quickly to others: “a lot of people knew this was bogus, but the money was too good” (Drew, 2008, p. 2). The former General Council of the SEC testified before Congress that “if honest lending practices had been followed, much of this crisis quite simply would not have occurred.” But the rewards for legal or illegal dishonest practices were too great. The head of AIG, Hank Greenwald, resigned in 2006 not because the firm inputted the wrong data into its risk models, but because it had acted fraudulently under his leadership. The large banks that funded Enron’s off-the-books deals understood that Enron’s book-keeping was a shell game to make the firm appear profitable when it wasn’t, but they kept making loans because it earned their banks and themselves huge profits (McClellan and Elkind, 2004). Enron’s directors should have asked tough questions about the practices but management had appointed them for supporting management decisions, not to challenge those decisions on behalf of shareholders. A director who caused trouble would likely lose any chance to be on the board of another company.

Economics stresses conscious responses to incentives, but incentives can affect behaviour subliminally. Scientists whose research is supported by drug firms report more favourably on drugs than scientists whose research is funded elsewhere. Some of the recipients of drug company support may consciously distort their results but most presumably come up with the “right” answers through unconscious decisions made during their experiments. It is for this reason that the gold standard in clinical trials is set by double blind studies in which neither the researcher nor the subjects know who is in the control group and who is in the treatment group and in which an independent lab does assays of specimens, also with no knowledge from which group they came. I assume that the same was true for at least some of the decisions made by the bankers and financiers.

Factors beyond incentives also presumably contributed to the ultimately economically disastrous behaviour at the top of the financial food chain. Religious folk have blamed the amoral behaviour on the decline of moral standards in society. Some scientists stress biological factors – high testosterone among persons on trading floors.<sup>6</sup> The famous Milgram (1974) and Zimbardo (1971) experiments discovered that it is easy to induce people to behave reprehensibly if the experimenter sets the situation appropriately. Financial firms have a culture in which the sole goal

is to make money. It is possible that Wall Street attracts persons with less moral reservations about acceptable money-making behaviour.<sup>7</sup> But the incentives were so large that even honest souls like you or me (though perhaps not our moms) could find ourselves selling risky securities as if they were safe, reporting revenues and costs in ways to put our options in the money, just as the pretty lady in the Groucho Marx story could see herself sleeping with him.<sup>8</sup>

The implication of this analysis is the opposite of the usual supply side claim that huge inequalities are needed to motivate those at the top. It suggests that if the money was not so good, fewer people would have jumped on the “bogus” money-making bandwagon. Make the earnings from financial chicanery more modest, and even people like Ken Lay or Bernard Madoff might have behaved honorably. To the extent that inequality in the form of huge potential earnings for top executives induced some of the risk-taking and chicanery that produced the Wall Street implosion, policies that would have lowered inequality and the amounts on offer for top decision-makers would presumably have moderated their behaviour.

### 10.3 REGULATE FINANCE – WHO, ME?

Recognizing at least since the Great Depression that finance is the danger spot of capitalism, governments throughout the world have developed rules and regulations to control some practices – limiting margin purchases of shares, outlawing insider trading, and so on – that can threaten the stability of financial markets. All governments have regulatory agencies to monitor the financial actors. Central banks such as the Federal Reserve in the US, the Bank of England in the UK, the European Central Bank for countries with euro, have a particular responsibility for maintaining the stability of the financial system and containing systemic risk in financial markets. The 1929 crash led the US Congress to establish the Securities and Exchange Commission (SEC) to monitor securities firms, brokers, investment advisors, rating agencies and private regulatory organizations. The collapse of much of US commercial banking in 1933 led the US to enact the Glass-Steagall Act to separate commercial banking from the riskier investment banking and to create the Federal Deposit Insurance Corporation for insuring bank deposits. On the international plane, the Bank for International Settlements has been involved in developing and implementing accords regarding how banks measure their capital and assess risk.<sup>9</sup>

In the 1990s the US weakened its controls on banking. The Clinton Administration joined conservatives in the Congress to enact the 1999

Financial Modernization Act/Gramm-Leach-Bliley Act that undid the Glass-Steagall division between commercial and investment banking. This freed Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns to form huge holding companies that conducted business on all sides of the finance market and enabled Citigroup to underwrite and trade mortgage-backed securities and collateralized debt obligations and create investment vehicles to buy the securities. Indicative of its desire to reduce regulation, the new Act allowed only voluntary monitoring of regulations in some areas. When Brooksley Born, head of the Commodity Futures Trading Commission, sought public comments in spring 1998 on derivatives as a step toward regulating these financial instruments, Secretary of Treasury Bob Rubin, SEC Commissioner Arthur Levitt, and Deputy Secretary of Treasury Lawrence Summers joined Greenspan in squelching her efforts as “cast[ing] the shadow of regulatory uncertainty over an otherwise thriving market”.<sup>10</sup> A year later she left office. To prevent any future regulator from following her lead Congress enacted the Commodity Futures Modernization Act, which preempted derivatives from oversight under state gaming laws and excluded certain swaps from being considered a security under SEC rules. Believing that regulations on finance were no longer (if ever) needed to control capital markets, the *Wall Street Journal* headlined the newly created opportunity for the big banks under the headline “Finally, 1929 Begins to Fade.” Financiers were at long last free from the dead hand of government regulation to prove that laissez-faire worked in the crown jewel market of modern capitalism.

In stark contrast to this view, analysts in *Mother Jones*,<sup>11</sup> an investigative journal, expressed the fear that overturning the Glass-Steagall Act would “pave the way for a new round of record-shattering financial industry mergers, dangerously concentrating political and economic power . . . [and] create too-big-to-fail institutions that are someday likely to drain the public treasury as taxpayers bail out imperiled financial giants to protect the stability of the nation’s banking system” (Mokhiber and Weissman, 1999). Less than a decade later the *Wall Street Journal* headline read “The Week Wall Street Died”. And the bailouts that *Mother Jones* predicted began. That *Mother Jones* had a more realist view of the path on which financial markets and the economy were headed than the *Wall Street Journal* or most of the economics and financial profession is a shameful indictment of purported expertise and conventional thinking.

If the world or even just the US had avoided financial crises in the years since the Depression, the prevailing belief that the capital market could regulate itself might have seemed to be a reasonable reading of events. But the facts are different. The world was struck by a sizable number of financial crises in the 1980s and 1990s that should have alerted government

regulators to the dangers inherent in financial markets. There was the 1994–95 Mexican financial crisis, the 1997 Asian Financial Crisis, the 1998 Russian financial crisis and the late 1990s–early 2000s Argentine financial crisis. In the US there was the 1980s Savings and Loan crisis, which highlighted the criminal behaviour of bankers enriching themselves by looting the long run assets of their bank, the 1998 collapse of Long Term Capital Management, which highlighted the weakness of risk management models, the 2001 crash of Enron, the 2002 Global Crossing and Tyco scandals, and so on.

With example after example of countries and firms running into financial disaster, one might have expected the US Federal Reserve and other national and international regulatory agencies to increase their monitoring and regulation of finance. The Federal Reserve Bank of New York organized a bailout by LTCM's major creditors out of fear that its fall could destabilize the whole financial system but thereafter did nothing to limit risk-taking by other banks. Perhaps the financiers believed that whatever went wrong in the future, the big firms and the Fed could just get together in a back room and fix it as they had done the LTCM crisis.

Why were warning signs ignored and regulators unwilling to act? Ideology in the form of blind faith in the virtue of markets played a major role. Apparently having learned nothing from the 1980s Savings and Loan disaster nor from LTCM, Greenspan (2008) declared that: "We have tried regulation ranging from heavy to central planning. None meaningfully worked", and therefore chose to do nothing.<sup>12</sup> When Ned Gramlich, another Fed Reserve commissioner, expressed concern over rising house prices, Greenspan declared it was not possible to tell the difference between a speculative bubble and sustainable increase in asset prices. In December 2007, the *New York Times* compiled a list of the multiple warnings and pleas made fruitlessly to the Fed Chairman over the decade to address the dangers posed by subprime lending.<sup>13</sup> The Bush administration also appointed officials to other regulatory agencies ideologically committed to deregulation and removed those who acted differently.

Another reason for inaction is "regulatory capture" in which regulators become so entwined with the group they regulate that they come to represent the industry rather than the public interest. There is nothing new about regulatory capture. Galbraith described the process in life cycle terms: "In youth they [regulatory agencies] are vigorous, aggressive . . . Later they mellow, and in old age – after a matter of ten or fifteen years – they become, with some exceptions, either an arm of the industry they are regulating or senile" (Galbraith, 1961, p. 171). Regulators invariably spend lots of time with the group they are regulating and begin to see things from the perspective of that group. I assume that psychological

experiments could show, if some have not done so already, that "going native" in this fashion is a normal human response, as per the Stockholm or "Patty Hearst" syndrome in which some kidnap victims sympathize and identify with their kidnappers.

But here too there is a large role for economic self-interest. Top government officials often have worked or may work in the future in the sectors that they regulate. Top officials of the SEC leave the Agency to go to Wall Street where the pay is multiple times that in the Agency. Secretaries of Treasury of the US have come from Wall Street. Did the fact that Secretary of Treasury Paulson had been a Goldman-Sachs CEO influence the decision to let rival Lehman Brothers fail or the decision to shift bailout funds from mortgagees to banks? Treasury Secretary Rubin, also from Goldman-Sachs, brokered the deal between the Clinton administration and Congress that deregulated banks and allowed Citigroup to become the first true American financial conglomerate since the Depression. When he left Washington, Rubin moved on to head Citigroup. Prior to becoming chief economic advisor to President Obama, Larry Summers received millions of dollars from D.E. Shaw, the hedge fund. Leaving the Fed, Greenspan took a job as a consultant with the investment management firm PIMCO that has close ties with the Treasury and Federal Reserve and joined the advisory board of the hedge fund Paulson & Co., and so on.

Another form of regulatory capture occurs through the political process. Wall Street firms give money to politicians, contributing disproportionately to those on banking and finance committees. The *New York Times* noted that Senator Schumer of New York "embraced the industry's free-market, deregulatory agenda more than almost any other Democrat in Congress, even backing some measures now blamed for contributing to the crisis" (Lipton and Hernandez, 2008). Finance is an important NY industry, and financial firms contributed heavily to the Democratic Senatorial Campaign Committee which Schumer headed. He led Democratic support for the Gramm-Leach-Bliley Bill, sought to limit efforts to regulate credit-rating agencies, stopped a proposal to double taxes on executives at hedge funds and private equity firms, and helped enact legislation that cut fees that Wall Street firms pay to the SEC to fund Agency regulatory activities.

In 1958 President Eisenhower warned the US about the "industrial-military complex". Today, he would warn the country about the "financial-political complex" – crony capitalism, though it is doubtful he would use that phrase.

Finally, there is the capture of regulators by the mood of the times. The Americans have a saying "If it ain't broke, don't fix it". The British say "Leave well alone". The song from *Evita* captures the mood: "When the money is rolling in you don't ask how . . . When the money keeps rolling

out you don't keep books. You can tell you've done well by the happy grateful looks. Accountants only slow things down, figures get in the way . . . rolling, rolling, rolling. Rolling in and out . . ." It is easier to let things roll, as Greenspan did, than to play Cassandra or Isaiah to prevent future disaster. In the late 1990s and early to mid 2000s the country applauded Greenspan for letting things roll. The same pressures operate inside firms against managers who seek to forgo some investments as too risky or unscrupulous. The CEO of one major financial firm claimed that he dared not stop his investment managers from selling lucrative risky securities to clients at the height of the Wall Street bubble. If he had, his investment managers would have shifted to some other firm to sell comparable securities and make lots of money, and his career would have been in trouble.

If the real economy of jobs and production was separate from finance, unions and other groups concerned with the well-being of workers could ignore the shenanigans of Wall Street and its putative financial regulators, but in fact the failures of finance have a huge impact on the labour market. As the next section shows, when finance fails, workers are the big losers.

#### 10.4 LABOUR BEARS THE COST

The reason the Great Depression has burnt itself in the memory of the world is not that the stock market crashed, leading some wealthy financiers in tuxedos and top hats to jump off tall buildings, or even that GDP fell more rapidly in a short period than ever before, but that millions of workers were unemployed for over a decade. In the US, which was one of the countries that suffered most in the Great Depression, unemployment reached double digits in 1931 and did not fall below that until late 1941, having peaked at nearly 25% in 1933.

The biggest cost of the late-2000s Wall Street recession is also in employment, the main source of livelihood of most persons in every advanced economy. In the US the number of jobs fell by nearly 8 million from 2007 to October 2009, which reduced the employment-population ratio from 63.0 to 58.5 percentage points. The unemployment rate at the end of 2009 was around 10%. Duration of joblessness was the longest since the Great Depression. Millions were on involuntary short-term work. Millions were too discouraged by lack of jobs to seek work. As a result the Bureau of Labor Statistics' most inclusive measure of labour underutilization reached 17.5% of the work force in October 2009.<sup>14</sup> Advanced Europe, Canada and Japan also suffered major job losses and high rates of unemployment that will last for a long time. Spain, with temporary contracts that allow firms to fire workers quickly, had the biggest

increase in unemployment. Some countries, such as Germany, Sweden and Korea, have "hidden" their joblessness by paying firms to keep workers on board. This can work over a short period but risks becoming untenable over time.

Given the increased lag between recovery of GDP and employment growth in the 1990s and 2000s, the late-2000s recession is likely to be the deepest and longest since the Great Depression. The ILO estimates that, if all goes well, jobs will not recover in the advanced countries until 2015. The magnitude of job loss makes it clear that regaining full employment more quickly than that would require a near economic miracle. In the 1993-98 boom recovery from the early 1990s recession, the US created millions of jobs and raised the rate of employment by 5.4 percentage points. If employment increased at the same rate beginning in 2010, it would take until 2015 for the employment-population rate to regain its pre-recession level. Slow recovery in the US could drag down the recovery in other advanced countries and reduce their employment.

Evidence from other post-World War II finance-induced recessions also shows that workers bear the greatest cost of adjustment, through unemployment or depressed real wages or sluggish post-recession growth of real wages. In the early 1990s Sweden suffered a huge recession precipitated by a housing bubble and banking crisis. Its unemployment rate rose from 1.8% in 1990 to 9.6% in 1994 and then bottomed out at 5.0% in 2001. Sixteen years after the crisis and just before the late-2000s recession the rate of unemployment was 6.2% – more than three times as high as in 1990. In 1997 Korea suffered from the Asian financial crisis and from IMF and US insistence that it raise interest rates and undertake "Washington Consensus" style reforms to receive financial aid. Employment recovered but primarily in "non-regular" jobs with limited benefits, low wages, and little job security. Inequality in Korea rose from moderate levels to second highest (behind the US) among advanced OECD countries. In the late-2000s recession real wages fell sharply in Korea as they had in 1997, though this may have helped staunch the loss of jobs.

Surprisingly perhaps, there is no strong regularity in the pattern of change in real wages in an economic downturn. In some countries, in some periods, real wages rise in a recession, as prices fall more rapidly than wages, while in others real wages fall (Barsky and Solon, 1989; Abraham and Haltiwanger, 1995; Messina et al., 2008). In the late-2000s recession real wages increased in the US but fell sharply in Korea. In the Great Depression, the consumer price index in the US fell more rapidly than nominal wages so that the real wages of workers who remained employed rose. The loss to labour takes the form primarily of year after year of high unemployment, concentrated among persons with low earnings capacity.

Differing adjustments in real wages in a recession notwithstanding, extended periods of joblessness have a huge cost on economic well-being. In a weak job market, young persons who seek first jobs and experienced workers who lose jobs suffer economic losses that last their lives (Nakamura, 2008; von Wachter and Bender, 2006). Studies of happiness show that unemployment reduces happiness by as much as the loss of a family member (Clark and Oswald, 1994). The effects of a job loss on health are more equivocal. Ruhm (2000 and 2003) found that health improves in a recession, but looking at high-seniority men who actually lost their job in the 1970s and 1980s Sullivan and von Wachter (2009) found that they had a 10%–15% increase in annual death hazards, which implies a loss in life expectancy of 1.0 to 1.5 years. Longitudinal analysis for individual workers in five countries shows that mental health deteriorates when workers lose jobs. Conversely, when the unemployed obtain full-time regular jobs their mental health improves (OECD, *Employment Outlook*, 2008, chapter 4).

What about inequality of income or wealth? As best I can tell, during the early stages of the late-2000s recession in the US, the distribution of wages has become more unequal, and poverty has risen as median family incomes have fallen. Between 2007 and 2009 usual hourly earnings rose less for workers in the bottom decile than for those at the median, which in turn rose less than earnings in the top decile. Earnings rose less for high school graduates without college education than for college graduates, which in turn rose less than earnings for those with graduate or professional degrees. They rose less for younger workers than for older workers and so on.<sup>15</sup> Between 2007 and 2008 the rate of poverty in the US increased from 12.5% to 13.2% while median household income fell by 3.6% in real terms. While median household income in 2009 did not differ from that in 2008 in real terms, the poverty rate increased to 14.3% in 2009 (De Navas et al., 2010).

With respect to wealth Amble (2009) estimates that given the ownership patterns and changes in housing prices and share prices, the recession also increased inequality in wealth. The government bailout of banks helped raise share prices, which improved the wealth of families at the top of the wealth distribution while the price of houses, which constitute the main wealth of most families, had not recovered much by the end of 2009, though the markets are sufficiently volatile that the stock market could fall suddenly and reverse this conclusion.

These patterns diverge from the experience of the Great Depression, which destroyed the assets of the very wealthy to such an extent that the distribution of income and wealth narrowed. Kuznets (1953) reported that the share of incomes in the top 1% and 5% fell in the early depression

years. Mendershausen (1946) showed that the Gini coefficient dropped from 1929 to 1934. Using income tax data Piketty and Saez (2003) found that the share of income in the top 1% fell from 29% to 20% while that of the bottom 20% rose from 3.8% to 6.3%, though these data do not include those too poor to be covered by the income tax. Kopczuk and Saez (2004) found a drop in the share of upper 1% and upper 5% in wealth. Since a small proportion of the population holds a disproportionate share of stocks and other fixed assets, whose prices fall in recessions, most cyclic downturns tend to lower wealth inequality.

In sum, the evidence shows that the big losers from the late-2000s and most other recessions are normal workers, who suffer unemployment and who may fall further behind the higher paid. Finance causes the problem but labour takes the hit. Given this, it is incumbent for unions and other worker-friendly organizations to seek to reduce the likelihood and amplitude of such disasters at the place of incidence: financial markets.

## 10.5 CAN LABOUR HELP BUILD A HEALTHY ECONOMY?

The Keynes quote at the beginning of this chapter asserted that collective bargaining was “essential” for recovery from the Great Depression. While the letter to Roosevelt did not elaborate on the reasons for this position it is likely that Keynes favoured a larger role for unions and labour regulations because he believed they would prevent deflation by stabilizing or boosting wages. The danger of deflation to a recovery is that it delays consumption and investment spending through intertemporal substitution of purchases. Consumers or firms wait to buy tomorrow instead of today because prices are falling and are likely to do so in the future. This lowers demand today and feeds the fall in prices. It delays the increase in aggregate demand necessary for recovery. Collective bargaining and wage regulation put a downward floor on deflationary pressures. Stabilizing wages reduces uncertainty about future labour costs and prices. The reduction in uncertainty raises business investment and hiring decisions which depend greatly on expectations (Bloom, 2009). As a collateral benefit, bargaining and wage regulations reduce the dispersion of pay among firms, sectors, and geographic areas, which can rise in a recession/depression. This reduction in uncertainty can also boost demand for labour.

I expect that Keynes would also argue that collective bargaining and wage regulations can help recovery by assuring that the benefits of economic growth are spread more equally among the populace. Collective bargaining narrows the dispersion of labour earnings before taxes, and because unions



favour progressive taxes, narrows the dispersion of after-tax earnings even more. Before the financial implosion I was dubious that the distribution of income in a wealthy society mattered for macro-economic stability or performance. If the distribution tilted toward the rich, the economy would produce more luxuries for them to buy. If the middle class or lower income citizens had a greater share of output, they would demand a different set of goods that the economy would produce. An equitable income distribution was a matter of fairness, not economic necessity.

But the huge rise of consumer indebtedness in the US associated with two or more decades of stagnant real earnings for most workers suggests that in fact inequality increases instability. When analysts first noted that income inequality rose more rapidly than consumption inequality from the 1980s to the 2000s, some viewed this as evidence that the rise in income inequality exaggerated the welfare costs of the trend. If consumption was less unequal than income, low income persons were better off than indicated in the income data. However, this ignored the fact that the increase in consumption was funded by consumer debt, which people have to repay or default, adding to the instability of the economy.<sup>16</sup> Collectively bargained real wage increases would enable middle income or lower paid workers to increase consumption without falling into debt. Why take out a sub-prime mortgage or pay huge consumer credit charges if your income allows you to take a normal mortgage or purchase consumer items with cash instead of credit?

An increased share of income at the top of the distribution can also contribute to instability. First, to the extent that those at the top take greater risks with their investments than lower income persons, that adds to the overall riskiness in finance. The US in fact limits some highly risky financial assets to persons with income/wealth above specified limits. The more people with incomes above these limits, the more money will go to risky investments. Second, as stressed earlier, huge inequalities create incentives for amoral and/or illegal rent-seeking at the top.

Advocates of trickle-down economics view the link between inequality and aggregate outcomes differently. They stress the role of inequality as an incentive for wealth creation. This is indeed the virtue of inequality but the 2008–09 implosion of the US finance sector suggests that inequality had gone far beyond the level necessary to stimulate stable wealth creation.<sup>17</sup>

Collective bargaining is a *process* for making economic decisions as well as a determinant of distributional outcomes. Bargaining increases the space for creative solutions to problems by combining the knowledge and interests of labour and management. While I doubt that Keynes was thinking of concessionary bargaining as a contribution to economic recovery, under some circumstances it could indeed serve that purpose. In

a recession firms often seek wage freezes or cuts from workers to preserve jobs. Concessions can preserve employment not only at a given firm but in the labour market more broadly, though this depends on elasticities of labour demand, the spending decisions of workers and of job losers, the effects on work effort, and the particulars of the concessions. Workers who give concessions will invariably want some assurance that they are saving jobs and that they will gain back what they conceded in a recovery. Collective bargaining is one way to win that assurance.<sup>18</sup> In a similar vein, bargaining and regulations that provide “breakers” on adjustments in the labour market – say for instance by delaying layoffs – may also contribute to aggregate stability. Individual firms may profit from firing workers as quickly as they can but that may not be in the interest of the economy writ large. One problem in capital markets is that prices can change massively in short periods of time. The market starts to rise or fall, which alters expectations or creates herd behaviour, leading to wild swings. By building in formal procedures for making layoffs, with warnings to workers of mass layoffs weeks or months in advance, labour regulations add some stability to the overall economy.

In sum, there are reasons to expect that collective bargaining can help stabilize an economy and contribute to a sustainable recovery from recession and growth. Whether actual bargaining does this requires detailed studies of the specific policies of unions, employers, and governments. Since decision-makers learn from the past, moreover, analysts must take great care in generalizing from one situation to another. As a case in point, consider the different behaviour of unions, employers, and the government in Korea in the late-2000s recession than in the 1997 recession. In 1997 employers with government support fought for the right to lay off workers quickly, which produced a fast run-up of unemployment. In 2008 the Korean Employer Federation, government, and one of Korea’s union federations reached a national accord that contributed to an utterly different response that kept unemployment low. Firms preserved jobs and froze wages while the government provided financial support to small and medium firms that maintained employment. The best explanation for the change in behaviour is that Koreans learned from the 1997 recession that fast layoffs were not a good way to respond to a downturn generated by the financial sector.

To produce a sustainable recovery with shared prosperity for workers, however, unions have to do much more than traditional collective bargaining. They have to participate in a major way in the reform of capital markets. If they do not act decisively and succeed in reforming financial markets and strengthening regulatory agencies, the US and other advanced capitalist countries will almost surely fail to build the new

financial architecture necessary for long term sustainable growth and shared prosperity.

Those at the top of finance and business invariably oppose reforms that will constrain their behaviour and reduce their options to make huge sums of money. They will deploy considerable resources to delay, weaken, and subvert efforts to reform their practices even if they recognize that the reforms have some systemic virtues. In this they are no different than the tobacco firms who used their resources to delay, weaken, and subvert efforts to reduce cigarette smoking even when it would save lives. In the current crisis, despite (or because of) their reliance on government bailouts to survive, bankers and financiers show no willingness to accept reforms that would reduce their power and incomes. Many paid huge bonuses to top executives even as their firms tottered toward bankruptcy. Almost immediately after the federal government promised billions to bail out AIG, the company spent \$444,000 for executives to party at an exclusive California spa. Half a million for a party? Chickenfeed. The banks that received taxpayer bailouts paid 1.6 billion dollars in salaries and bonuses to their top executives in 2008. With at least \$170 billion of federal bailout money given to AIG, the insurance giant sought to pay \$165 million in bonuses and compensation to top employees in the branch that had caused it to go bankrupt. Justifying the payments, the firm's CEO complained that AIG would have trouble attracting and retaining "the best and the brightest . . . if employees believe that their compensation is subject to continued and arbitrary adjustment by the US Treasury" (CNN, March 15, 2009). In 2009 Goldman-Sachs granted so many billions in bonuses to its top executives that shareholders complained (they wanted a bigger portion of the firms' profits.) With four remaining huge investment banks on Wall Street, the danger is not only that the financial crisis has created banks too big to fail, but that the banks are so big that they have the power to stymie substantive reforms.

The notion that unions and labour institutions are critical in providing a "balance" or "countervailing power" to the forces of capital and in determining the rules for capital markets is a radical one but I do not see any other way that society can reform the Achilles heel of market capitalism.<sup>19</sup> Standard economic models generate desirable market outcomes through competition of persons on the same side of the market. But when the rules for the way markets function are at stake, countervailing power between parties on different sides of a market – labour and capital – may be an equally or perhaps more important factor. Moreover, I suspect that countervailing power can produce economic outcomes closer to the free market ideal than outcomes generated by a system in which one side of the market – capital – writes its own rules.

## 10.6 CONCLUSIONS

I draw three lessons from the implosion of the Wall Street model of capitalism.

The first is that "Financial markets can destroy economies whereas labour markets cannot". The implication is that much of the past two decades of debate on labour market reforms to improve economies has been misplaced. Analysts and policy-makers focused on modest welfare triangle inefficiencies due to regulations or union activity while ignoring the 800-pound financial gorilla. To avoid further economic disaster decision-makers will have to seek ways to tame the gorilla and turn it from master of the real economy into the servant of the real economy.

The second lesson is that "Unconstrained greed can destroy financial markets". Because market behaviour responds substantially to high-powered incentives, participants will invariably be prone to excessive risk-taking, chicanery, and financial fraud. Letting Wall Street be Wall Street in the belief that the market will police itself in the face of huge incentives is a ticket to another crash. Policy analysts and decision-makers must seek ways to reduce the incentives for financial misconduct and risk-taking to avoid further financial market breakdowns.

The third and potentially most radical lesson is that "Labour must have greater voice in economic matters outside the labour market". When I first reached this conclusion some of my colleagues thought I was losing my sense of reality. I was "ranting" about possibilities rather than analysing the economic world as an objective social scientist. Unions were a declining institution in much of the world. In the US they seemed unable to get the labour law reform they needed for their own survival, so why should any sensible person expect them to "step to the plate" on financial reform?

But in a period of crisis what seems radical one day can become the norm in short order. In 2009 nearly 200 US organizations, of which the AFL-CIO is among the most prominent, formed the Americans for Financial Reform "to spearhead a campaign for real reform in our banking and financial system."<sup>20</sup> The mission statement fits perfectly with what the analysis in this chapter has led me to conclude: "The reckless and greedy behavior of big Wall Street banks caused a financial crisis that is costing us millions of jobs, billions of dollars in taxpayer funded bailouts, and trillions of dollars in lost homes and lost savings. We cannot afford to let this behavior continue . . . We are fighting for real reform that will protect working families and responsible businesses by cracking down on the abuses and the irresponsible behavior of big banks, credit card companies, and Wall Street insiders. We are working to hold Wall Street accountable

and prevent another financial crisis. We cannot get our economy back on track or restore jobs and security without real reform.”<sup>21</sup> Yes!

## NOTES

1. Ben S. Bernanke, “The Great Moderation”, Federal Reserve Board, February 20, 2004.
2. In September 1998, the heavily leveraged hedge fund with mountains of derivatives told Federal Reserve officials that it could not cover \$4 billion in losses. Russia, swept up in an Asian economic crisis, had defaulted on its debt.
3. When the Government Accounting Office assayed the risks in the privatization of social security in 2002, they carried analysis back to the 1930s (Congressional Budget Office, 2006).
4. With a 35% corporate tax rate it cost corporations 35% more to pay their top executives above \$1 million per year than before, so companies shifted CEO compensation toward options, which recipients did not have to pay taxes on until exercised and which were not counted as an expense on corporate books.
5. It wasn’t until four years after the 1929 Crash that investigators arrested the leading banker Charles Mitchell for evasion of income tax and not for another five years that they arrested the former President of the Stock Exchange Richard Whitney for grand larceny (Galbraith, 1961).
6. For the morally deficient hypothesis, see Greenspan (2008), Colson (2008), McCain (as quoted in Klein, 2008), and Wallis (2008). Reuters reported the view of many Americans under the headline “Evangelicals see moral decline in Wall St. woes”. For the “animal spirits” hypothesis that testosterone contributed to excessive risk-taking see Coates and Herbert (2008); Apicella et al. (2008); Zald et al. (2008); Kuhnen and Knutson (2005), Knutson et al. (2008); and Kuhnen and Chiao (2008).
7. Laboratory studies of public goods games find that business students make fewer socially desirable investments than students in other fields (Meier, 2006). Meier and Frey (2004) report that selectivity was the main factor explaining the less socially responsible behaviour of Swiss business students than others. By contrast, Cadsby and Maynes (1998) report that nurses make socially desirable decisions.
8. Groucho (to pretty lady at dinner): Would you sleep with me for \$52 million? Pretty lady (laughing): Of course! Groucho (leering wildly): How about for \$10? Pretty lady: Mr. Marx, what do you take me for? Groucho: We’ve already established what you are. Now we’re just haggling over price.
9. <http://www.bis.org/publ/bcbs118.pdf>
10. Testimony of Treasury Deputy Secretary Lawrence Summers before the Senate Committee on Agriculture, Nutrition and Forestry (July 30, 1998). Her commentary on the risks of the unregulated derivatives shows more foresight/understanding than Greenspan, Rubin, Levitt, and Summers. See <http://www.cftc.gov/opa/speeches/opaborn-37.htm>
11. For a description of *Mother Jones*, see [http://en.wikipedia.org/wiki/Mother\\_Jones\\_\(magazine\)](http://en.wikipedia.org/wiki/Mother_Jones_(magazine))
12. In the lead-up to financial meltdown, Greenspan (2002) declared that credit default swaps were the ultimate arbitrator of market knowledge: “As the market for credit default swaps expands and deepens, the collective knowledge held by market participants is exactly reflected in the prices of these derivative instruments.”
13. Nation (June 9, 2005) <http://www.thenation.com/doc/20050627/trillin>
14. This is the BLS’s U-6 measure that includes total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labour force plus all marginally attached workers.

15. These comparisons take Q3 of 2009 versus Q3 of 2007 from the BLS’s Usual Weekly Earnings data, USDL 09-1242 and USDL 07-1584.
16. For a model along these lines see Iacoviello (2008). Foster (2006) gives another view of the process. Logemann (2008) compares the role of consumer debt in consumption spending in the US and Germany.
17. There are other ways to reduce “excessive” inequalities. More progressive taxes, particularly of earnings from speculative activities, can also make it less lucrative to engage in chicanery. Shared capitalist modes of pay, by which I mean all-employee profit sharing, share ownership, gain-sharing, and all employee stock options, have a similar impact. But, as I argue shortly, it likely requires a strong union movement to obtain these reforms.
18. There is a danger that wage concessions at particular firms could backfire in the aggregate, as it saves jobs at firm A but costs jobs at firm B that did not gain the concession.
19. Building more effective regulations in finance is not the only reform for improving the operation of advanced capitalism. Other areas include corporate governance reforms to provide greater monitoring of decision-making and executive compensation; greater anti-trust efforts; non-compete clauses for top government officials to constrain the financial-political complex.
20. <http://ourfinancialsecurity.org/>
21. <http://ourfinancialsecurity.org/about/>

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