Living in the Short-Run:

Comment on Capital for the 21st Century

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We all owe a debt to Thomas Piketty and his various co-authors for hugely advancing our understanding of income distribution at the top. As a result of their work, we now have a much clearer picture of the big gainers over the last three decades and the process that has resulted in this upward redistribution.

This past work is the basis for the great expectations around his new book. And there is much here to like, including a vast amount of new research on the distribution of income over the last three centuries that will provide the basis for much future work and analysis.

I also am happy to see that I am no longer the only person doing policy-related work who does not think that higher house and stock prices are a good thing. Those who are fond of arithmetic should recognize that high house and stock prices will pose more of a burden on the young than any tax increases that might be associated with an increasing ratio of Social Security beneficiaries to workers. While concerns over the latter have provided a substantial source of employment for people doing policy work in Washington, the much larger negative impact on the young of inflated house and stock prices has generally been ignored.

And I was especially impressed by Piketty's reference to Robert Barro and rational expectations. As a first year graduate student I recall being exposed to a Barro paper on the impact of unexpected money growth on output. The paper had an utterly absurd model of anticipated money growth that undoubtedly did not correspond to any individual's expectations and almost certainly did not bear any relation to average expectations. When one of my fellow students suggested to the professor (a student of Barro) that we could seriously test Barro's hypothesis about the relative impact of anticipated and unanticipated money growth by examining predictions at the time from economic forecasters, he said that we are doing economic theory, not economic history.

However, as much as I share Piketty's disdain for an approach to economics that sees its goal as explaining everything in terms of an unrealistic theory of individual behavior, I am afraid that the core thesis in Capital for the 21st Century also has serious limitations. To hugely simplify, Piketty sees a world where the ratio of capital to income rises and where patterns of bequests cause ownership of capital to become ever more concentrated. Piketty's method for preventing an ever great concentration of wealth and income is to impose sharply progressive income taxes and stiff inheritance taxes.

I wouldn't object to this policy prescription, but it doesn't seem to hold much hopes of success, certainly not in the current U.S. political environment. I would also say that we actually have a much larger menu of options than Piketty suggests.

The larger range of options becomes clearer if we start to look at the specifics of the corporate sector. In this respect it is worth noting that Piketty departs in an important way from Marx in treating capital as wealth and not distinguishing between different forms, such as pure financial wealth (e.g. government bonds), wealth in housing, and corporate capital. Presumably it is the trend in the last category that will have the most long-term impact on both the economy and distribution of income. I don't think we have

to worry that the super-rich will overwhelm the rest of us because the price of their mansions rises ever further out of the reach of normal mortals.

If we turn to the corporate sector we see that there are several clearly identifiable mechanisms through which government policy has acted to increase private sector profits in recent decades:

1) Implicit subsidies in the form of government guarantees or exemptions from taxes;

2) Rents earned through government granted monopolies in the form of patent and copyright protection;

3) Rents earned from the government provided access to valuable resources at little or no cost;

4) Rents earned from the failure to maintain even minimal anti-trust standards to restrict monopoly power;

5) Rents earned by privatizing sectors of the economy where services are more efficiently performed by the government.

In addition to these five areas, the United States government has also adopted a trade policy, the main effect of which has been to depress the wages of large segments of the workforce. This has almost certainly also contributed to the rise in the profit share in the last three decades.[1]

These areas all offer clear paths for reducing the profit share of output in the decades ahead in ways that increase productivity and growth. They offer a clear alternative to the path of ever greater concentration of wealth and income inequality described by Piketty.

When it comes to beneficiaries of government subsidies, the financial industry is at the top of the charts. Finance, insurance, and bank and other management companies accounted for nearly $300 billion in after tax profits in 2012 out of total of $1,755 billion.[2] These firms depend on a variety of implicit and explicit government subsidies for their profitability.

The most obvious item on the list of subsidies is the guarantee provided by too big to fail (TBTF) insurance granted to the largest firms in the sector. A new report from the International Monetary Fund estimated the value of this guarantee at $50 billion a year in the United States and $300 billion a year for the euro zone countries.[3] If the large banks were either broken up or taxed an amount large enough to offset this gift from the government, it would be a large hit to profits in the sector. Of course the reduction in profits would not be equal to the full size of the subsidy. To some extent lower profits at the TBTF banks would be offset by higher profits at other banks. In addition, some of the hit would come

[1] A fuller discussion would include policy on labor and unions as well.
[2] NIPA Table 6.19D, lines 52, line 65, and line 1, respectively.
[3] International Monetary Fund, 2014. "Big Banks Benefit from Government Subsidies," Global Financial Stability Report, International Monetary Fund.

out of the wages of top executives in the TBTF banks. The top executives of these companies include many of the top incomes in the country, so cutting back their pay is a strike against inequality even if it is not a direct hit to capital.

The financial sector has also enjoyed a special status as a hugely under-taxed segment of the economy, a point recently noted by the International Monetary Fund (IMF), among others.[4] A modest tax on financial transactions, like the one the United Kingdom currently has on stock trades and many other countries had or still have in place would do much to further reduce profits and high incomes in the sector. The IMF suggested a financial activities tax set at a level that could raise roughly 0.2 percent of GDP ($34 billion a year in the U.S. economy). Japan had a set of financial transactions taxes in place that raised more than 1.0 percent of GDP at the peaks of its bubble in the late 1980s. If we see permanently higher ratios of stock prices to corporate earnings, as Piketty suggests, then a comparable tax take would certainly be possible on an ongoing basis. As with the too big to fail subsidy, additional taxes on the industry would not fall exclusively on profit. However since most research shows trading elasticity tends to be close to -1.0, virtually the entire tax take would come out of the industry's revenue.[5]

A third way to reduce the rents in the sector would be to curtail the tax breaks that largely form the basis for the private equity (PE) industry. While PE companies do occasionally provide the management and capital needed to turn around struggling companies, their true expertise is in gaming the tax code.[6] If the tax loopholes that provide the basis for their profits were eliminated (limited the deduction for interest would be the most important), their profits would take a serious hit.

It would take a more careful analysis than I am prepared to do just now to estimate the full impact, but these three measures taken together would certainly be a sizable dent in the financial sector's profits. And finance is far from the only sector benefitting from such rents.

My other favorite example is the prescription drug industry. Profits in this sector depend hugely on government granted patent monopolies and related forms of protection. It is not easy to pull up a quick number for profits in this sector because some of the profits would show up in retail due to excessive mark-ups, and much of the profit is concealed as foreign earnings through tax arbitrage arrangements. However the impact of the protection is clear; the United States spent $386 billion (about 2.4 percent of GDP) last year on pharmaceutical products.[7] (We also spent $30.5 billion on therapeutic medical equipment, which raises the same issues.[8]) The cost likely would have been 10-20 percent of this amount without patent and related protections.

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[4] International Monetary Fund, 2010, "A Fair and Substantial Contribution from the Financial Sector, Final Report to the G-20, International Monetary Fund.

[5] The proportionate reduction in trading volume would be roughly equal to the rise in trading costs due to the tax. This means total trading costs would be little changed and the industry would bear the full burden of the tax as a reduction in revenue.

[6] See Appelbaum, Eileen. and Rose Batt, 2014. *Private Equity at Work: When Wall Street Manages Main Street*, New York: Russell Sage Books.

[7] NIPA Table 2.4.5U, Line 120.

[8] NIPA Table 2.4.5U, Line 65.

The cost of patent monopolies in prescription drugs is not just the unnecessarily high prices and the resulting distortions; there is also a serious problem from the perverse incentives created. In a situation where drug companies can sell their products for several thousand percent above marginal cost they have enormous incentive to conceal evidence that their drugs might be less effective than advertised or possibly even harmful. News accounts regularly produce evidence of drug companies executives behaving as economic theory would predict.

It would be necessary to find alternatives to patent support for prescription drugs to foster future innovation, and such alternatives do exist. For example, Joe Stiglitz has proposed a patent buyout system where the government would buy up important patents and place them in the public domain.[9] Alternatively we could expand on the funding that the National Institutes of Health now receives and use public funding to finance the actual development and clinical testing of drugs.[10] This would have the advantage that all results would be placed in the public domain so that research findings could be quickly shared.

In both cases, especially the case of upfront funding (which could go through the private sector) profits in the industry would likely fall to a fraction of their current level. Many expenses associated with rent-seeking such as the marketing of drugs and patent lawyers, would also be eliminated. The latter might affect some high-end earners, but would not have a direct impact on profits in the economy.

Patents also pose serious problems in other sectors. For example, Samsung will probably never release a new phone without drawing a patent infringement suit from Apple and vice-versa. This provides work for highly paid patent lawyers but is pure waste from an economic standpoint. The argument for patent support research is stronger in the tech sector than with pharmaceutical, but it is at least plausible that a substantial portion of the revenue and profits in the tech sector are attributable to a patent structure that could be altered to lower prices without substantially dampening innovation. The total revenue of sectors where intellectual property constitutes the bulk of the value added almost certainly exceeds $1 trillion a year in the United States, making a substantial target for the elimination of unnecessary rents.

There are many other sectors of the economy where identifiable rents are large relative to industry profits. There is no obvious reason that airwaves should be given away to television and radio broadcasters rather than auctioned off to the highest bidder. The same is true of landing spots at highly desirable airports.[11]

There are also large sectors of the economy where textbook regulation of monopolies or old-fashioned anti-trust actions may have a substantial impact on industry profits. The cable sector is an obvious example, with the telephone industry a close second. Clearly anti-trust enforcement has been

[9] Stiglitz, Joseph, 2007. "Prizes, Not Patents," Project Syndicate, http://www.project-syndicate.org/commentary/prizes--not-patents (accessed April 3, 2014).

[10] Baker, Dean, 2004. "Financing Drug Research: What Are the Issues?" Washington, DC: Center for Economic and Policy Research, http://www.cepr.net/index.php?option=com_content&view=article&id=149, (accesses April 3, 2014).

[11] A carbon tax or permit system would also be the obvious way to charge for damage done to the environment, although the effect on profits is ambiguous.

substantially weaker in the last three decades than in the three decades following World War II. In at least some sectors this has allowed for substantial monopoly rents.

In addition there are many sectors where a government provided service could offer large efficiency gains and savings to consumers at the expense of corporate revenues and profits. The Social Security system in the United States provides a core retirement income to beneficiaries with an administrative cost of less than 0.6 percent of annual payouts. The cost in the private sector of savings and annuities is close to twenty times as large. There could be enormous potential savings by offering voluntary government savings products modeled on the Thrift Savings Plan for federal government employees. There would also be enormous potential savings from giving people the option to buy into a publicly run Medicare-type health insurance plan. And tens of billions spent on tax preparation services would be saved each year if the government prepared people's tax returns – giving them the option to protest—rather than require they file on their own.

In these and other instances there is good reason to believe that publicly run services would be more efficient than the private ones that now exist. If the government were allowed to compete it would further reduce the profits earned in the private sector and thereby lessen share of national income going to corporate profits.

Of course in some cases, services have been privatized with the seeming goal of increasing the profits of politically connected corporations. The 75-year lease of parking meters in Chicago provides an obvious example. This arrangement allowed a consortium led by Morgan Stanley to collect the revenue on the city parking meters for three quarters of a century for a fee that might have been less than half of the fair market value.[12] There is a wide range of public services, covering everything from custodial work to running public schools, that has been contracted out over the last three decades at all levels of government. While there are undoubtedly cases where this privatization has led to real efficiency gains, in many cases the primary purpose was to enrich corporate allies of politicians.

This actually raises a question that should be front and center to thinking about the future of capitalism, what do we want markets for? Piketty has described a world where growth slows due to stagnant labor forces and a dwindling pace of innovation. But capitalism is really about innovation. The Social Security system in the United States is boring, simple, and old-fashioned, but it accomplishes its function in a very efficient manner. If we really expect growth to slow to a trickle then there will presumably be more sectors of the economy that look like Social Security. In such cases, it would be efficient for the government to supplant the private sector. This would both directly reduce the profit share of output and by crowding more capital into a smaller share of the economy likely reduce the return to capital as well.

[12] "Morgan Stanley Group's $11 Billion Makes Chicago Taxpayers Cry," Bloomberg News, August 9, 2010, http://www.bloomberg.com/news/2010-08-09/morgan-stanley-group-s-11-billion-from-chicago-meters-makes-taxpayers-cry.html (accessed April 3, 2014).

There is one final aspect to the distributional issue that should be noted. Workers' wages in the United States and other wealthy countries were reduced in the last three decades to some extent by competition with low-paid labor in the developing world. One benefit of this development has been a rapid increase in living standards and wages in the developing world. According to the International Labor Organization wages in China nearly tripled over the decade from 2002-2012.[13] There is clearly a great deal of uncertainty around this measure and wages in China are still far below wages in the United States or Europe, but it is no longer a location of super-cheap labor.

While corporations may look elsewhere for still cheaper labor, there are no more Chinas out there. Other countries that establish themselves as low-wage havens will soon be overwhelmed by the inflow of capital from the United States, Europe, Japan, and now China. They cannot possibly have the same dampening effect on wages in the United States over the next three decades as did China and other developing countries in the last three decades. This suggests that workers may have the opportunity to gain back lost shares of output in the decades ahead, assuming that the Federal Reserve Board is not run by people determined to protect the share of capital.

The anti-rents agenda outlined here will have political realists screaming at the top of their lungs. Powerful lobbies stand prepared to go nuclear to stop all of the items on this list. But that would be true also for Piketty's recipe to combat inequality: confiscatory top marginal income tax rates and wealth taxes. This list has the advantage that the items should be associated with increased economic efficiency, which should leave room to buy off some of the losers.

Some may go through this list and other items that could be added and insist that we will still be stuck in Piketty's world where $r>g$, the return to wealth exceeds the growth rate of the economy and we are again are seeing a growing concentration of wealth. That could prove to be true, but then we are probably talking about capital in the 22nd century, not the 21st.

[13] International Labor Organization, 2012. *Global Wage Report 2012/2013: Wages and Equitable Growth* (Executive Summary) http://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms_194844.pdf (accessed April 3, 2014).