Martin Wolf: why rentier capitalism is damaging liberal democracy

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Economies are not delivering for most citizens because of weak competition, feeble productivity growth and tax loopholes

© Capital flows to the financial centres - London, New York, Silicon Valley and Frankfurt - exacerbating inequality. FT illustration; Getty Images

Martin Wolf

2 hours ago
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"While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders."

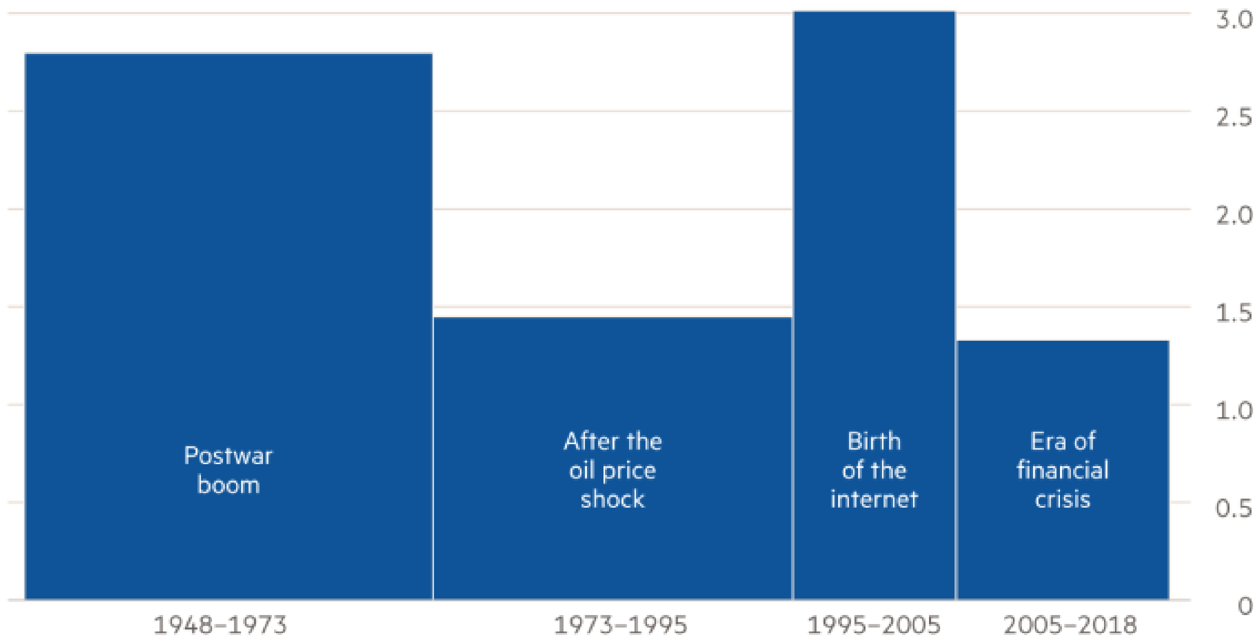
With this sentence, the US Business Roundtable, which represents the chief executives of 181 of the world's largest companies, abandoned their longstanding view that "corporations exist principally to serve their shareholders".

This is certainly a moment. But what does — and should — that moment mean? The answer needs to start with acknowledgment of the fact that something has gone very wrong. Over the past four decades, and especially in the US, the most important country of all, we have observed an unholy trinity of slowing productivity growth, soaring inequality and huge financial shocks.

As Jason Furman of Harvard University and Peter Orszag of Lazard Frères noted in a paper last year: "From 1948 to 1973, real median family income in the US rose 3 per cent annually. At this rate . . . there was a 96 per cent chance that a child would have a higher income than his or her parents. Since 1973, the median family has seen its real income grow only 0.4 per cent annually . . . As a result, 28 per cent of children have lower income than their parents did."

The slowdown of US productivity growth

Average growth in US real output per hour in the non-farm business sector (%)



Sources: BLS; Furman & Orszag (PIIE, 2018)
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So why is the economy not delivering? The answer lies, in large part, with the rise of rentier capitalism. In this case "rent" means rewards over and above those required to induce the desired supply of goods, services, land or labour. "Rentier capitalism" means an economy in which market and political power allows privileged individuals and businesses to extract a great deal of such rent from everybody else.

That does not explain every disappointment. As Robert Gordon, professor of social sciences at Northwestern University, argues, fundamental innovation slowed after the mid-20th century. Technology has also created greater reliance on graduates and raised their relative wages, explaining part of the rise of inequality. But the share of the top 1 per cent of US earners in pre-tax income jumped from 11 per cent in 1980 to 20 per cent in 2014. This was not mainly the result of such skill-biased technological change.

If one listens to the political debates in many countries, notably the US and UK, one would conclude that the disappointment is mainly the fault of imports from China or low-wage immigrants, or both. Foreigners are ideal scapegoats. But the notion that rising inequality and slow productivity growth are due to foreigners is simply false.

An Amazon warehouse in the UK. The platform giants are the dominant examples of monopoly rentiers

Every western high-income country trades more with emerging and developing countries today than it did four decades ago. Yet increases in inequality have varied substantially. The outcome depended on how the institutions of the market economy behaved and on domestic policy choices.

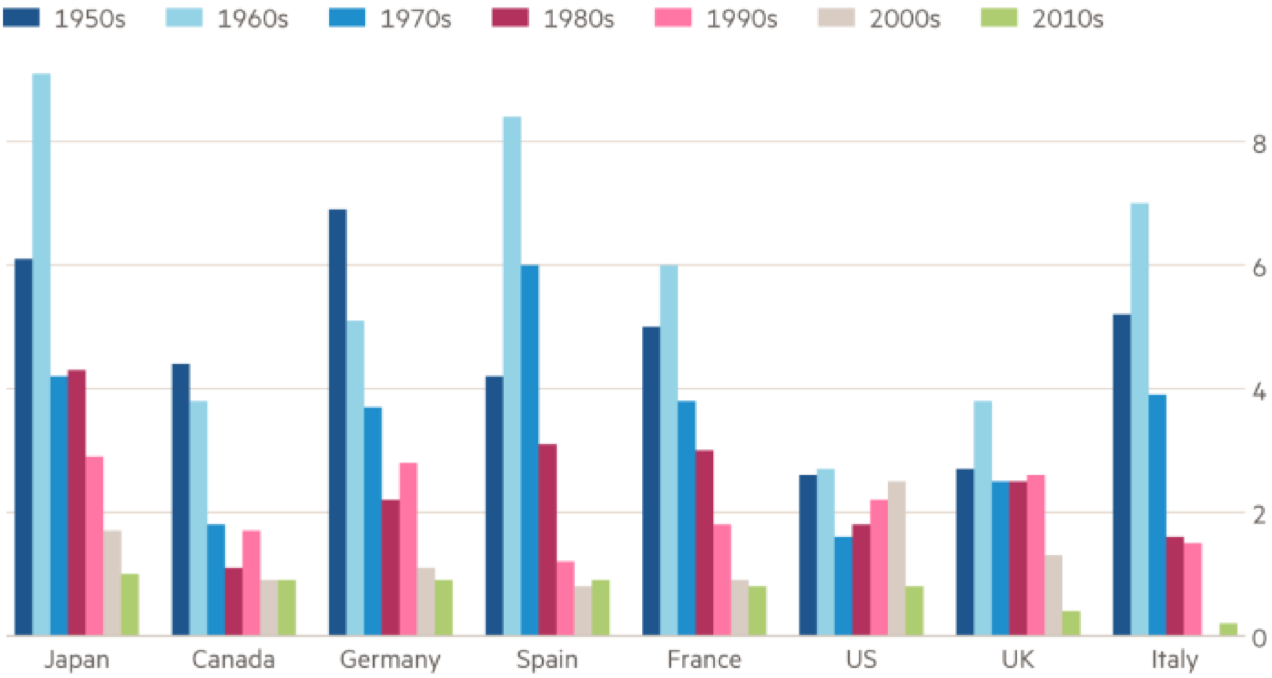
Harvard economist Elhanan Helpman ends his overview of a huge academic literature on the topic with the conclusion that “globalisation in the form of foreign trade and offshoring has not been a large contributor to rising inequality. Multiple studies of different events around the world point to this conclusion.”

The shift in the location of much manufacturing, principally to China, may have lowered investment in high-income economies a little. But this effect cannot have been powerful enough to reduce productivity growth significantly. To the contrary, the shift in the global division of labour induced high-income economies to specialise in skill-intensive sectors, where there was more potential for fast productivity growth.

Donald Trump, a naive mercantilist, focuses, instead, on bilateral trade imbalances as a cause of job losses. These deficits reflect bad trade deals, the American president insists. It is true that the US has overall trade deficits, while the EU has surpluses. But their trade policies are quite similar. Trade policies do not explain bilateral balances. Bilateral balances, in turn, do not explain overall balances. The latter are macroeconomic phenomena. Both theory and evidence concur on this.

Falling productivity in developed economies

Average growth (output per hour) in each decade (%, selected countries)



Countries ranked by 2010s' growth
Source: The Conference Board
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The economic impact of immigration has also been small, however big the political and cultural "shock of the foreigner" may be. Research strongly suggests that the effect of immigration on the real earnings of the native population and on receiving countries' fiscal position has been small and frequently positive.

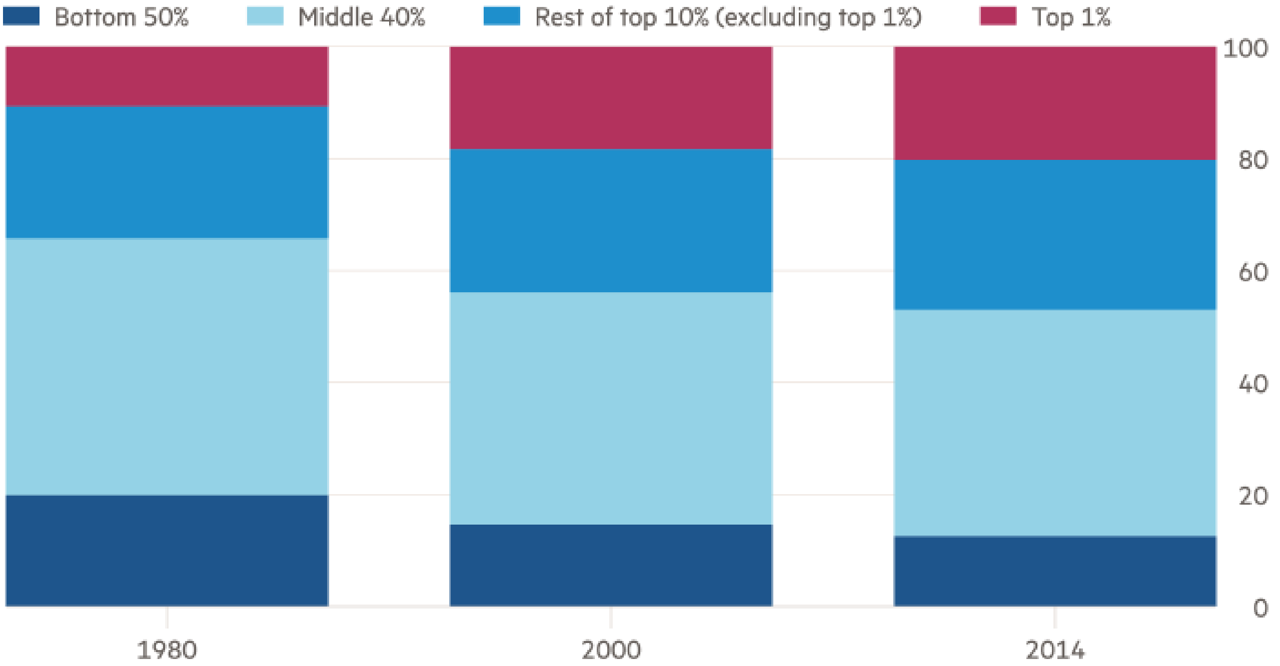
Far more productive than this politically rewarding, but mistaken, focus on the damage done by trade and migration is an examination of contemporary rentier capitalism itself.

Finance plays a key role, with several dimensions. Liberalised finance tends to metastasise, like a cancer. Thus, the financial sector's ability to create credit and money finances its own activities, incomes and (often illusory) profits.

A 2015 study by Stephen Cecchetti and Enisse Kharroubi for the Bank for International Settlements said "the level of financial development is good only up to a point, after which it becomes a drag on growth, and that a fast-growing financial sector is detrimental to aggregate productivity growth". When the financial sector grows quickly, they argue, it hires talented people. These then lend against property, because it generates collateral. This is a diversion of talented human resources in unproductive, useless directions.

Income flows to the top in the US

Shares in US pre-tax incomes, by segments of the income distribution (%)



Source: World Inequality Database
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Again, excessive growth of credit almost always leads to crises , as Carmen Reinhart and Kenneth Rogoff showed in *This Time is Different*. This is why no modern government dares let the supposedly market-driven financial sector operate unaided and unguided. But that in turn creates huge opportunities to gain from irresponsibility: heads, they win; tails, the rest of us lose. Further crises are guaranteed.

Finance also creates rising inequality. Thomas Philippon of the Stern School of Business and Ariell Reshef of the Paris School of Economics showed that the relative earnings of finance professionals exploded upwards in the 1980s with the deregulation of finance. They estimated that “rents” — earnings over and above those needed to attract people into the industry — accounted for 30-50 per cent of the pay differential between finance professionals and the rest of the private sector.

US president Donald Trump, a naive mercantilist, focuses on bilateral trade imbalances as a cause of job losses © Getty Images

This explosion of financial activity since 1980 has not raised the growth of productivity. If anything, it has lowered it, especially since the crisis. The same is true of the explosion in pay of corporate management, yet another form of rent extraction. As Deborah Hargreaves, founder of the High Pay Centre, notes, in the UK the ratio of average chief executive pay to that of average workers rose from 48 to one in 1998 to 129 to one in 2016. In the US, the same ratio rose from 42 to one in 1980 to 347 to one in 2017.

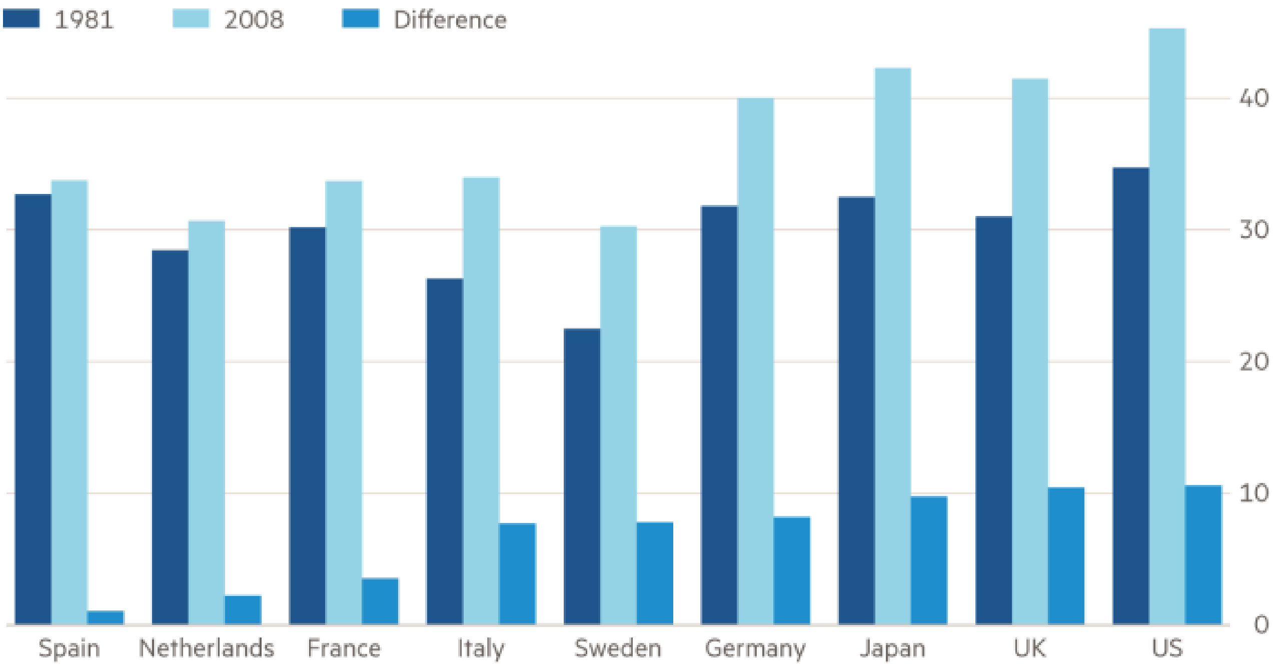
As the US essayist HL Mencken wrote: “For every complex problem, there is an answer that is clear, simple and wrong.” Pay linked to the share price gave management a huge incentive to raise that price, by manipulating earnings or borrowing money to buy the shares. Neither adds value to the company. But they can add a great deal of wealth to management. A related problem with governance is conflicts of interest, notably over independence of auditors.

In sum, personal financial considerations permeate corporate decision-making. As the independent economist Andrew Smithers argues in *Productivity and the Bonus Culture*, this comes at the expense of corporate investment and so of long-run productivity growth.

A possibly still more fundamental issue is the decline of competition. Mr Furman and Mr Orszag say there is evidence of increased market concentration in the US, a lower rate of entry of new firms and a lower share of young firms in the economy compared with three or four decades ago. Work by the OECD and Oxford Martin School also notes widening gaps in productivity and profit mark-ups between the leading businesses and the rest. This suggests weakening competition and rising monopoly rent. Moreover, a great deal of the increase in inequality arises from radically different rewards for workers with similar skills in different firms: this, too, is a form of rent extraction.

Levels of inequality vary

Shares of the top 10 per cent of income recipients in pre-tax national income (%)



Countries ranked by difference
Source: World Inequality Database
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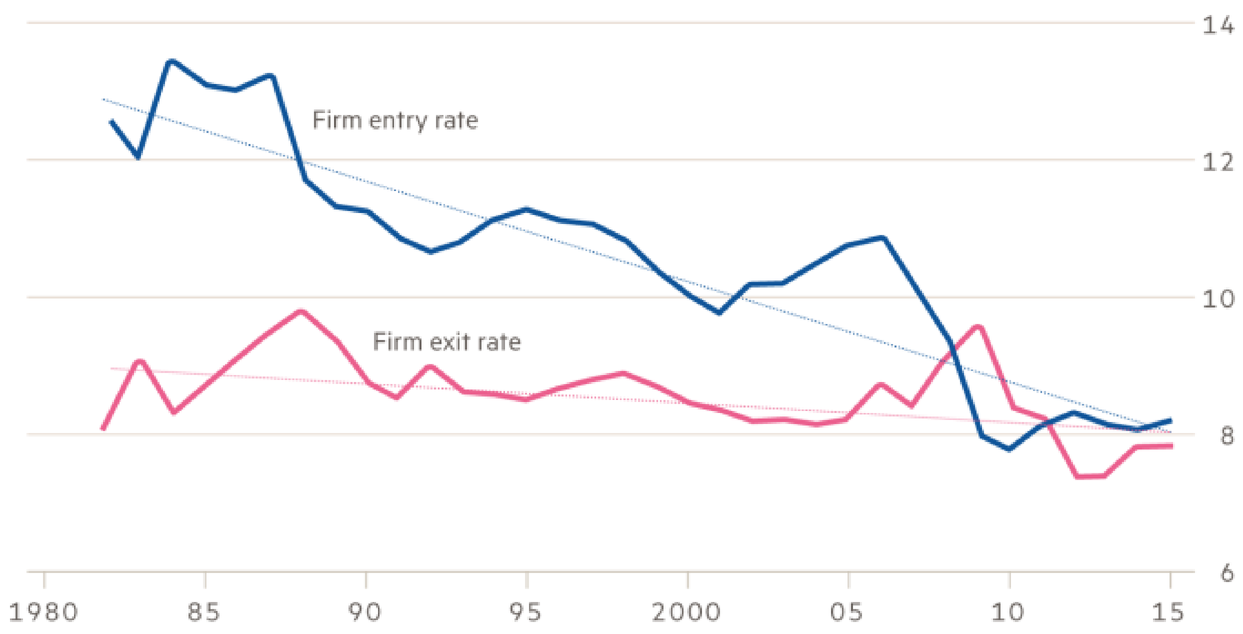
A part of the explanation for weaker competition is “winner-takes-almost-all” markets: superstar individuals and their companies earn monopoly rents, because they can now serve global markets so cheaply. The network externalities — benefits of using a network that others are using — and zero marginal costs of platform monopolies (Facebook, Google, Amazon, Alibaba and Tencent) are the dominant examples.

Another such natural force is the network externalities of agglomerations, stressed by Paul Collier in *The Future of Capitalism*. Successful metropolitan areas — London, New York, the Bay Area in California — generate powerful feedback loops, attracting and rewarding talented people. This disadvantages businesses and people trapped in left-behind towns. Agglomerations, too, create rents, not just in property prices, but also in earnings.

Yet monopoly rent is not just the product of such natural — albeit worrying — economic forces. It is also the result of policy. In the US, Yale University law professor Robert Bork argued in the 1970s that “consumer welfare” should be the sole objective of antitrust policy. As with shareholder value maximisation, this oversimplified highly complex issues. In this case, it led to complacency about monopoly power, provided prices stayed low. Yet tall trees deprive saplings of the light they need to grow. So, too, may giant companies.

The downturn in company creation

Entry and exit rates for US businesses (%)



Source: Furman & Orszag - 'Slower Productivity and Higher Inequality: Are They Related?' (Peterson Institute for International Economics, 2018)
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Some might argue, complacently, that the "monopoly rent" we now see in leading economies is largely a sign of the "creative destruction" lauded by the Austrian economist Joseph Schumpeter. In fact, we are not seeing enough creation, destruction or productivity growth to support that view convincingly.

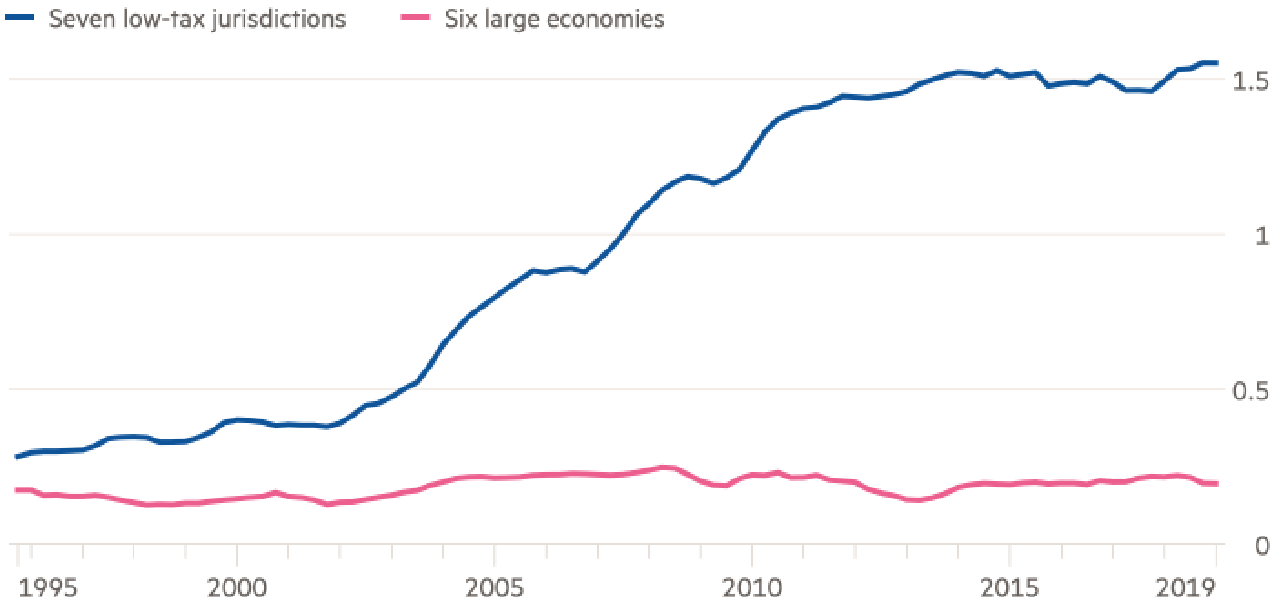
A disreputable aspect of rent-seeking is radical tax avoidance. Corporations (and so also shareholders) benefit from the public goods — security, legal systems, infrastructure, educated workforces and sociopolitical stability — provided by the world's most powerful liberal democracies. Yet they are also in a perfect position to exploit tax loopholes, especially those companies whose location of production or innovation is difficult to determine.

The biggest challenges within the corporate tax system are tax competition and base erosion and profit shifting. We see the former in falling tax rates. We see the latter in the location of intellectual property in tax havens, in charging tax-deductible debt against profits accruing in higher-tax jurisdictions and in rigging transfer prices within firms.

A 2015 study by the IMF calculated that base erosion and profit shifting reduced long-run annual revenue in OECD countries by about $450bn (1 per cent of gross domestic product) and in non-OECD countries by slightly over $200bn (1.3 per cent of GDP). These are significant figures in the context of a tax that raised an average of only 2.9 per cent of GDP in 2016 in OECD countries and just 2 per cent in the US.

The great profit manipulation

Offshore profits of US multinationals in select jurisdictions (% of US GDP)



Low-tax = Luxembourg, Ireland, Netherlands, Switzerland, Singapore, Bermuda, UK Caribbean territories. Large economies = Germany, France, Italy, India, China, Japan
Sources: Brad Setser/Council on Foreign Relations, BEA, Haver Analytics
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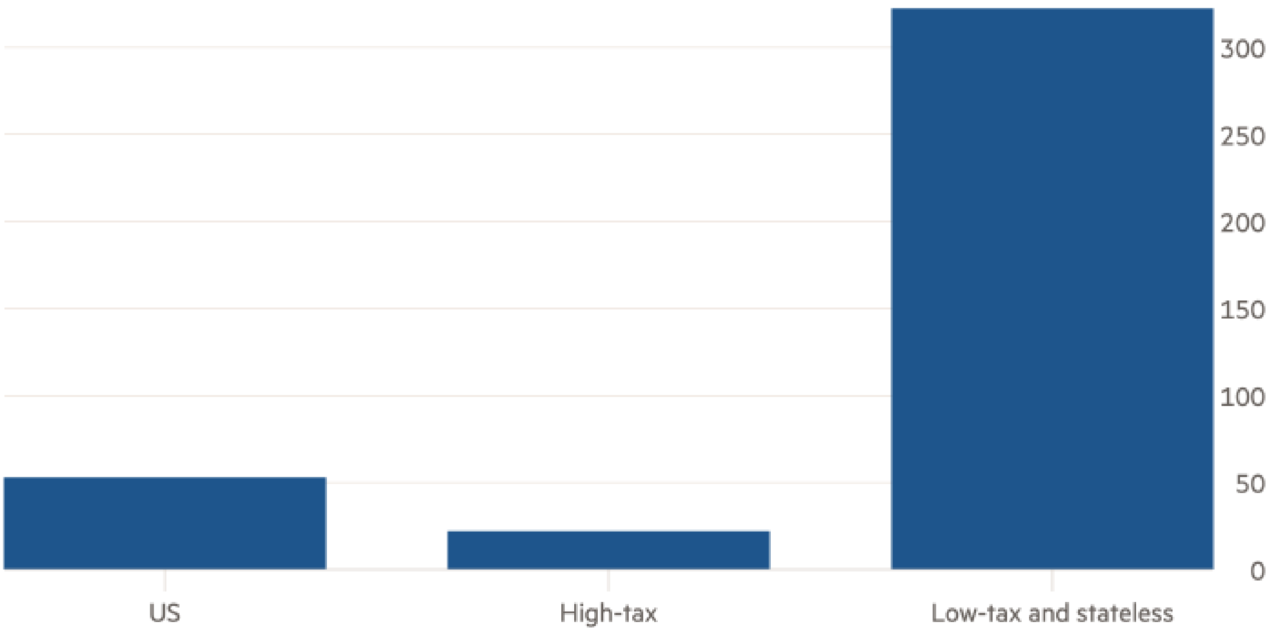
Brad Setser of the Council on Foreign Relations shows that US corporations report seven times as much profit in small tax havens (Bermuda, the British Caribbean, Ireland, Luxembourg, Netherlands, Singapore and Switzerland) as in six big economies (China, France, Germany, India, Italy and Japan). This is ludicrous. The tax reform under Mr Trump changed essentially nothing. Needless to say, not only US corporations benefit from such loopholes.

In such cases, rents are not merely being exploited. They are being created, through lobbying *for* distorting and unfair tax loopholes and *against* needed regulation of mergers, anti-competitive practices, financial misbehaviour, the environment and labour markets. Corporate lobbying overwhelms the interests of ordinary citizens. Indeed, some studies suggest that the wishes of ordinary people count for next to nothing in policymaking.

Not least, as some western economies have become more Latin American in their distribution of incomes, their politics have also become more Latin American. Some of the new populists are considering radical, but necessary, changes in competition, regulatory and tax policies. But others rely on xenophobic dog whistles while continuing to promote a capitalism rigged to favour a small elite. Such activities could well end up with the death of liberal democracy itself.

Tax havens' fictitious profits

Pre-tax profit per employee, by tax jurisdiction, 2016 ($'000s)



Sources: IRS, Bred Setser/Council on Foreign Relations
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Members of the Business Roundtable and their peers have tough questions to ask themselves. They are right: seeking to maximise shareholder value has proved a doubtful guide to managing corporations. But that realisation is the beginning, not the end. They need to ask themselves what this understanding means for how they set their own pay and how they exploit — indeed actively create — tax and regulatory loopholes.

Recommended

They must, not least, consider their activities in the public arena. What are they doing to ensure better laws governing the structure of the corporation, a fair and effective tax system, a safety net for those afflicted by economic forces beyond their control, a healthy local and global environment and a democracy responsive to the wishes of a broad majority?

We need a dynamic capitalist economy that gives everybody a justified belief that they can share in the benefits. What we increasingly seem to have instead is an unstable rentier capitalism, weakened competition, feeble productivity growth, high inequality and, not coincidentally, an increasingly degraded democracy. Fixing this is a challenge for us all, but especially for those who run the world's most important businesses. The way our economic and political systems work must change, or they will perish.