Draft

The Political Economy of an Anti-Rent-Seeking Equality Agenda

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The concept of economic rent has a long and interesting history. Without getting into the fine points of the definition or the history, the basic story is that rents occur where economic actors are being paid more than necessary to provide a particular service. To take a simple case to illustrate the point, suppose a hedge fund manager was earning $50 million a year. It is quite likely that the hedge fund manager would be willing to do the same work for $20 million, $10 million, and quite possibly even $1 million. It's not likely that she has other employment opportunities that would pay her anywhere near $50 million. If the rents earned by hedge fund managers could be reduced or eliminated, this could free up resources to be used elsewhere in the economy.

The argument put forward in this paper is that the income of the highest earners in the economy includes a large component of rent. This means that we can alter economic structures in ways that take away much of this rent and thereby allow a large share of GDP to be diverted to serving the broader economy rather than a narrow elite. The key point is that the focus is on adjusting economic structures to affect before-tax income rather than on tax and transfer policies that address after-tax inequality. The large increase in inequality in the last four decades was primarily in before-tax income, with policies that were designed to increase the rents earned by high income households. If the rise in inequality can be explained by rents going to high income households, it means that a different set of policies can lead to a more equal distribution of before-tax income while actually increasing overall income. In other words, the priority of an agenda aimed at reversing inequality should be on rewriting the rules that determine before-tax income distribution, not tax and transfer policy.

This paper has five parts. The first part argues that the rise in inequality is primarily a story of upward redistribution among wage earners, not redistribution from labor to capital. The second section points to CEO compensation as a major source of high-end rents. It argues that the soaring compensation of the last four decades has come to a large extent at the expense of shareholders. The third section outlines the evidence for rents in the financial sector. The fourth section examines patent and copyright monopolies as major sources of rent. The last section describes the licensing and immigration barriers in highly paid professions, such as doctors and dentists, which allow for substantial rents.

The logic to this approach is that in each case there are clearly identifiable parties that stand to gain from reducing or eliminating the rents going to the wealthy, including substantial interests. The right has effectively used a market-oriented approach to beat down the pay of workers at the middle and bottom of the income distribution, pointing to situations where they are real gains to substantial segments of society. For example, subjecting manufacturing workers to competition with low-paid workers in the developing does have the effect of lowering the price of manufactured goods. Proponents of this policy can accurately point to the reduced cost of a wide of range of product. This may not offset the loss of wages for large segments of the workforce, but it is nonetheless a real economic gain. It is possible to develop creative strategies that can be equally effective in using the market to beat down pay at the top, leaving more everyone else in society.

The Division of Income Between Labor and Capital

The upward redistribution of the last four decades has for the most part not been a redistribution from labor to capital. Rather it has been a redistribution from workers at the middle and bottom to high end workers. This point is important for two reasons. It is necessary to realize who are the big gainers from the pattern of redistribution if it is to be reversed. And the big gainers were mostly corporate CEOs, hedge fund and private equity managers, and others who were able to earn very high pay. They were not people who got rich from owning stock that paid out huge returns due to rising profits. The other reason this distinction is important is that it means that the conditions of competition that limit the profit share of income remain largely in place. This means that savings from beating down the pay of high end earners are likely to be large passed on to workers in the form of lower prices, which means higher real wages. Beating down the incomes of high earners is not just a gratuitous leveling exercise; it is a way to increase the real incomes of those at the middle and the bottom of the income distribution.

This second point is worth emphasizing since it is not immediately obvious and often missed in political debates. There is no comparable problem on the other side. An employer fully understands that her company's profits, and in all probability the top executives' incomes, will rise if they can find a way to reduce the pay and benefits of ordinary workers. There is no need to go through any economic analysis in this situation. The retail store that pays its workers' less will, at least initially, have higher profits (ignoring potential impacts on productivity and turnover). On the other hand, it is not immediately apparent that lowering the pay of doctors, dentists, and other high end professionals will translate into higher real wages for workers not in these professions. Only if we recognize that conditions of competition are likely to result in these reductions in costs ending up as lower prices and not higher profits does it follow that reducing the pay of high end workers means higher wages for those at the middle and bottom.

The pattern in profit shares over the last four decades largely supports this view. Figure 1 shows the before and after-tax share of profit in corporate income in the years from 1976 through the first three quarter of 2016.

Figure 1

As can be seen, there is no clear upward trend in the before tax profit share from 1976 to 2005.[1] The before-tax share peaked at 22.0 percent in 1977 and 1978. It did not exceed this share until 2006. The

[1] The before-tax share is defined as the net operating surplus divided net valued added, minus taxes on production and imports (NIPA Table 1.14, line 8 divided by (line 3 minus line 7). The after-tax share is defined as the net operating surplus minus corporate income taxes, divided net valued added, minus taxes on production and imports (NIPA Table 1.14, (line 8 minus line 12) divided by (line 3 minus line 7).

before-tax share fell in the downturn and then rose to more than 25 percent in 2012-2014. In the last two years the before-tax has fallen back somewhat, but it is still above 23.0 percent in the most recent data. The after-tax share follows a similar pattern, although its peak was in 1984 at just over 16 percent of corporate income. The after-tax share first rose past its 1970s peaks in 2004. After falling in the recession, it rose sharply in the recovery, peaking at just over 19.0 percent in 2012, almost five full percentage points above its 1970s peaks. Since 2014 it has fallen back by more than 2.5 percentage points, but it is still well above its 1970s peaks.

While profits shares have exceeded their 1970s levels in the last decade, it is worth noting that the vast majority of the upward redistribution of this period was accomplished by 2005. Figure 2 shows the share of the top percent in national income as calculated by Emmanual Saez (2016). The income share of the top one percent had gone from roughly 8.0 percent in the late 1970s to more than 17.0 percent in 2005. While the share does go 1.0-2.0 percentage points higher in the last decade, the overwhelming majority of the upward redistribution to the one percent occurred before there was any substantial shift from labor to capital.

Figure 2 here

The most obvious explanation for the shift from labor to capital in the last decade is the weakness of the labor market following the collapse of the housing bubble. In the deepest and most prolonged recession since the Great Depression, it was hardly surprising that workers had little bargaining power and ended up accepting a fall in real wages. Of course the shift from wages to profits did predate the recession by two years, so it possible that there is a different dynamic at work in recent years than had been present in prior decades. However, it is also worth noting that these years were the peak years of the housing bubble, which was leading to large economic distortions. In particular, many of the profits booked in these years were never realized, as the loans subsequently went bad and incurred large write-downs. This would imply that much of the profit that was booked in these pre-crash years was not real profit. [2]

The fact that profit shares seem to be falling as the labor market has tightened in the last three years suggests that if the labor market is allowed to tighten further, for example by allowing the employment to population ratio (EPOP) for prime age (ages 25-54) workers to return to at least the pre-recession

[2] In the national accounts, a loan that subsequently went bad would be booked at its full value at the time the loan was written. When payments were reduced or stopped on these loans in later years, it would appear as a loss in the national accounts. This means that profits that banks and other financial institutions were reporting on subprime mortgages issued in the bubble years would be adding to total profits, even though these loans ended up being sources of large losses over the longer term.

level, if not the 2000 level, profit shares may revert back to the levels of the period from the late 1970s up to 2005.[3] If that proves to be the case, then we can be comfortable that the conditions of competition have not qualitatively changed from the 1970s to the present. This means that redistribution is a question between wage earners, not between labor and capital.

However, it is possible that we will not see prime age EPOPs return to their 2000 level or even their 2007 level. This could be either because the Fed acts to slow the recovery, and prevent further rises in the EPOP, even without clear evidence of accelerating inflation, or it could be due to a situation where wage pressures are leading to a substantial increase in the rate of inflation. If the latter is the case, and inflation really does start to accelerate even with an EPOP substantially below the levels reached in the last two recoveries, it would imply that there actually had been some shift in the structure of the economy. In that case, the shift from wage to profits could not be undone by macroeconomic policy alone. It would mean that structural factors were responsible for at least part of the shift from wages to profits.

The alternative case, where the Fed acts to limit employment growth without compelling evidence of accelerating inflation, describes a prime policy opportunity for an anti-rent agenda. In this case, there are large potential gains to the economy, to workers, and especially workers at the lower end of the wage distribution, from a Fed policy targeting full employment. The losers from a full employment policy would be the portion of the financial sector that is holding large amounts of fixed interest long-term debt, as well as businesses that stand more to lose from paying workers higher wages than they can gain as a result of increased sales.

The potential gains from a full employment policy in that case would be enormous, since it would mean both a large increase in output and a substantial shift in distribution from capital to labor. If it is assumed that the productivity of the workers employed due to a full employment policy is half of average productivity, then an increase in the EPOP of 2.0 percentage points would raise GDP by 2.5 percent, while an increase in the EPOP of 4.0 percentage points would increase GDP by 5.0 percent.[4] In

[3] In November, 2016 the EPOP for prime age workers stood at 78.1 percent. It precession peak was 80.3 percent in January of 2007. The peak in 2000 was 81.9 percent, reached in April of that year. It is worth noting that the drop in prime age EPOPs has been for both men and women, so it cannot be explained problems affecting men alone, as some have argued. It is also worth noting that this drop in EPOPs has occurred at all levels of education (Bucknor and Baker, 2016). Furthermore, the declines in prime age EPOPs following the 2001 and 2008-09 recessions were not projected in any of the official forecasts, such as the ones by the Congressional Budget Office or the Office of Management and Budget. These points are consistent with the view that the main factor behind the drop in prime age employment rates is the weakness in the labor market, as opposed to a change in the skills of prime age workers or their willingness to work.

[4] The prime age EPOP was 78.1 percent in November, 2016, so an increase in employment of 2 percentage points is equal to a 2.5 percent increase, while an increase of 4 percentage points is a 5.0 percent increase. The calculation assumes a corresponding rise in employment in workers above and below prime age.

addition, the strengthening of the labor market could shift another 2.0-3.0 percentage points of GDP from labor to capital.

To sum up this discussion, at this point we can't know with any certainty whether the shift from labor capital that has taken place since 2005 will be reversed in the course of this recovery as the labor market tightens. However it is clear that the bulk of the upward redistribution that has taken place over the last four decades was a redistribution of labor income, with income going from workers at the middle and the bottom of the income distribution to those at the very top. An anti-rent agenda should be focused on altering the structures that have allowed these high end workers to gain such a large share of the economic pie.

Excessive CEO Pay as a Major Source of Rents in the Economy

The CEOs of major corporations rank among the highest paid workers in the country, with the pay of top executives often exceeding $10 million a year and frequently running into the tens of millions. While CEOs have always been well-paid, their pay has risen from a range of 20-30 times that of the median worker to close to 200 times the pay of a typical worker in the last two decades. The market rationale for this sort of run-up in CEO pay is that CEOs have become vastly more productive in recent years as result of the growth in firm size and increasingly complex economic environment.[5]

While there is considerable research suggesting that the rise in pay does not reflect the ability of CEOs to produce greater returns to shareholders, there are two important economic facts that suggest the opposite. The first is that the rise in CEO pay in the United States far exceeds the rise in other wealthy countries. While there has been an upward trajectory in the ratio of CEO pay to that of ordinary workers in Western Europe, Canada, and elsewhere. It has not reached the same extremes as in the United States. There are plenty of large, highly profitable companies in these countries that pay their CEOs half or a third as much as CEOs in the United States.

The other noteworthy item is that the rise in CEO pay does not appear to be associated with any gains for the overall economy. Specifically, if today's highly paid CEOs were better at adopting new technologies or adapting to a changing economic environment than the CEOs of the 1960s and 1970, we might expect to see it reflected in more rapid productivity growth. That does not appear to be the case. The initial run-up in CEO pay in the 1980s and early 1990s was in the middle of the long productivity slowdown from 1973-1995. While there was a pick-up in productivity growth over the years from 1995 to 2005, since 2005 the economy has settled into an even slower path of productivity growth. Clearly much more than CEO competence affects productivity growth, but we any economy-wide benefits from super-productive CEOs are not easy to find.

[5] Trends in CEO pay, along with the evidence on its justification, are discussed in chapter six of Baker (2016).

It is possible that CEOs may not make their companies more productive, but they may be effective at increasing returns to shareholders. By this argument, the highly paid CEOs of recent years are better at pressing down the pay of workers and supplier firms than their predecessors from forty years ago. This may not increase productivity, but it would mean higher returns to shareholders. While analyses relating individual CEO pay to shareholder returns often find weak relationships, the story in aggregate clearly does not fit. Figure 3 shows the real returns to shareholders of the S&P 500 averaged over 10-year intervals over the last sixty years.

Figure 3 here

While annual returns for the 10-year periods from 1985 to 1995 and 1995 and 2005 were both near 7.0 percent, following two decades in which average returns were negative, these returns do not come close to matching the 10 percent real return averaged in the decade from 1955 to 1965. Furthermore, returns averaged just 2.6 percent in the decade from 2005 to 2015.[6] It is always possible to look at this aggregate data and argue that shareholders would have fared even worse if their companies had been run by less talented and motivated individuals, but these data do not seem to support the case that highly paid CEOs are producing strong returns for shareholders.

The claim that CEO pay involves a large component of rent is based on the argument that the corporate directors, who most immediately determine CEO pay, largely owe their jobs to top management and therefore act in their interest rather the interest of shareholders. The directors have little incentive to ever challenge a CEO pay package since they risk angering the CEO and their fellow board members by pressing this issue. In contrast, virtually no director ever loses their job because they approved an excessive pay package for CEOs and top management. (More than 99 percent of directors that run for re-election win.)

Insofar as this story accurately describes the rise in CEO pay, the appropriate political strategy involves making it easier for shareholders to exercise control over the company they are supposed to own. An obvious route would be better rules for corporate governance that alter the structure of incentives for corporate directors. For example, the directors could lose their annual stipend if a CEO pay package is voted down in a Say-on-Pay vote by shareholders. The pay for directors can also be structured in ways that give them a direct incentive for holding down CEO pay. For example, the directors can be allowed to share half of the savings from cutting the pay of CEO and other top executives , as long as the company’s stock performance was not harmed.

[6] The data on returns are taken from Shiller (2016). The calculation of the real return takes the percentage rise in nominal S&P index, adjusted by the CPI-U-RS, and adds in the dividend paid out in a year as a percentage of the prior year’s index value. The numbers shown in Figure 3 are geometric means of the returns of the decade shown.

While changes in corporate governance rules could be implemented through Congress, this is not likely to happen any time soon. However it would be reasonable to push some changes as voluntary measures. For example, less than 3 percent of CEO pay packages are rejected by shareholders. This means that asking directors to voluntarily agree to an arrangement where they would surrender their pay in such cases is simply asking for a vote of confidence that they will not be in the bottom 3 percent of corporate boards. This is a rather low bar.

This also could be a situation where a few examples could prove very powerful. If the board of a major corporation agreed to accept a rule where it forfeited its pay in the event a Say-on-Pay initiative was defeated, it may shame other boards to follow its lead. After all, what can be the justification for large director salaries if they can't even hold CEO pay to reasonable levels?

The run-up in CEO pay has led to a parallel run-up in the pay of top executives in the non-profit sector. While the top executives are major universities and foundations are not getting paychecks in the tens of millions of dollars a year, it is not uncommon for their pay to cross $1 million, more than twenty five times the pay of the typical worker. This pay is largely subsidized by taxpayer dollars, since donations to these institutions are tax exempt. This means that roughly 40 percent of their donations came from taxpayers. In the case of a foundation or university president getting $1 million a year, effectively $400,000 is coming from taxpayers.

If taxpayers are paying the bill, it is reasonable to put limits on the top salaries that these institutions can pay. The president of the United States is paid $400,000 a year, which seems like a fair limit on the pay of people employed by tax-exempt institutions. Just to be clear, this is not limiting what non-profit institutions can pay their presidents or other top officials; it is just limiting what they can pay them and still get a subsidy from taxpayers. This is a measure that also can be put in place at the state level. While the most important tax subsidy is allowing contributors to write off the donation on their taxes, most states exempt non-profits from paying sales taxes and often property taxes. They could in principle make eligibility for this special tax treatment contingent on accepting limits on pay. As a practical matter, it is unlikely that states would have to worry too much about non-profits fleeing. Harvard is unlikely to leave the State of Massachusetts even if they were forced to reduce their president's pay to $400,000 a year as a condition of special tax treatment.

This is also an area where pressure on individual institutions could prove effective. Students, faculty, and alums could put pressure on schools to accept a salary limit. And, if some schools went this route it would put pressure on others to follow. And, the fruit of lower pay for those at the top is lower tuition costs and more money available for other employees.

In short, there should be many venues through which the excessive pay for those at the top in both the corporate and non-corporate sector can be attacked. And, this can be done in ways that are entirely consistent with the market. The rules of corporate governance are set by law; they are not generated as market outcomes. Rules that give more power to shareholders to limit the pay of top executives are every bit as consistent with market principles as the current rules. In the case of pay for top executives in the non-profit sector, this is currently subsidized by the government. It hardly violates any sort of market principle to put conditions on the receipt of a public subsidy. Universities and foundations would still have the option to pay their presidents and other top executives whatever they wanted, they would just have to get by without their government subsidies.

Curbing Excessive Pay in the Financial Sector

The financial sector is the basis of many of the country's most bloated incomes. Actors in this sector are able to get away with exorbitant pay at least in part because the public generally does not recognize that the seven, eight, and nine figure paychecks actually come at their expense. The very rich in the financial sector are often viewed positively, since they do create jobs with their spending and many are happy to give away a portion of their wealth to universities and charities.

Counterfeiting probably provides the best analogy to the riches pocketed by the top earners in the financial sector. The immediate effect of eliminating hundreds of billions of dollars of waste in the financial sector with a financial transactions tax and cracking down on abuses by the industry would be similar to the effect of shutting down a massive counterfeiting operation.[7] The counterfeiting operation directly employs people to print money and get it into circulation. It also indirectly employs people based on the spending of the counterfeiters. Exposing the bills as counterfeits will put all these people out of work. Nonetheless, shutting down counterfeiters is still considered to be good economic policy. The assumption is that the people now employed as a result of the fake bills will instead be reemployed in the real economy.

It would be a similar story with the financial sector. If we are eliminating waste that doesn't facilitate the working of the productive economy, then it has the same impact as shutting down counterfeiters. It should lead to a clear benefit to the economy as a whole, even if there may be some short-term costs as people need to adjust to an economy where they are not dependent on the spending of the counterfeiters or high flyers in the financial industry.

This can be true even in a financial center like New York City. In addition to the jobs lost by people employed in the industry, there would also be job loss among the hundreds of thousands of people employed serving their meals, cleaning their houses, caring for their kids, and providing a whole range of other services. But the flip side of this situation is that the demand for housing, and therefore the cost, would be dramatically reduced. Suppose that rents in the city fell by 30-40 percent, as the Wall Street crew was no longer able to pay outlandish prices for condominiums and apartments. This would allow many people to move to the city who might otherwise never have been able to afford it. That should provide a huge boost to other industries, since they will be able to attract more workers. Also, lower rents will free up tens of billions of dollars a year from the budgets of people who already live in the city.

[7] A financial transactions tax of 0.2 percent on equities and 0.01 percent on derivatives instruments could raise between $110 billion and $160 billion annually, based on 2015 trading volumes. It would also reduce the resources used each year in the financial sector by between $160 billion and $190 billion. (Baker 2016, chapter 3).

These people will have more money to spend on a whole range of goods and services, filling much of the gap created by the drop in spending from the Wall Street crew.

It is likely that even in the case of New York City, most people who do not work in the financial industry end up as winners by reducing the waste in the industry. It is unambiguously the case that the rest of the country comes out ahead by having less of its savings effectively taxed away by the financial industry.[8]

Of course the politics of a policy directly aimed at targeting waste in the financial industry will be very difficult. Just as autoworkers would resist a trade pact that is likely to lead to wide-scale job loss in the auto industry, the financial industry will strongly resist any proposal that will reduce the bloated incomes in the sector. The big difference is that the financial industry has its representatives in the seats of power. Top officials in administrations of both parties are drawn from the financial industry. While George W. Bush installed Henry Paulson, a former Goldman Sachs CEO, as Treasury Secretary, Bill Clinton installed Robert Rubin, also a former Goldman Sachs CEO as Treasury Secretary. And Barack Obama put in Jack Lew, formerly a top executive at Citigroup, as Treasury Secretary. The top ranks of all three administrations were chock full of representatives of the financial industry. These people can be expected to do everything in their power to block efforts to eliminate waste in the financial sector. After all, we're talking about their friends' income, not the paychecks of autoworkers.

The power of the financial industry certainly will make it difficult to enact measures at the national level to tax financial transactions or to break up too big to fail banks. But that hardly means that progressives should not continually point to the waste and high end rents in these areas. Also, it would be possible for states with major financial centers (e.g. New York and Illinois) to impose more modest financial transactions taxes on the trades that tax place in their financial centers. Since these trades can migrate fairly easily to other financial centers within the country, the taxes would have to be considerably lower than the levels that would be possible nationally.

It is possible to take more direct action at the state level to reduce some of the other sources of waste in the sector. For example, any state or set of states can establish a low-cost retirement system that is available for contributions from the state's workers. Illinois is implementing such a system in 2017 and California recently approved a similar system to go into operation in 2020.[9] It would be best if a national

[8] The prospects of London in the post-Brexit era may provide insights into the plight of a financial center after the industry has been downsized. It seems virtually certain that London will lose jobs in the financial industry if Brexit goes through, but it remains to be seen whether the net effect will be positive or negative for people not working in the industry. While the media are reporting declines in house prices as bad news, in fact the opposite is true for Londoners (or potential Londoners) who don't own a house or condo. The prospect of lower rent and the possibility of paying less for a house in the future is unambiguously good news for them.

[9] Illinois' law can be found here http://ilga.gov/legislation/billstatus.asp?DocNum=2758&GAID=12&GA=98&DocTypeID=SB&LegID=78572&SessionID=85

pension system was put in place, but it may be necessary for a number of states to take the lead before this can happen.

States may be able to set up low-cost services in other areas to compete with the financial industry. For example, there have been a number of proposals for a Postal Banking system that would provide basic banking services to low and moderate income households (Office of the Inspector General of the United States Postal Service, 2014).[10] It is possible that states may be able to follow this model, perhaps with the cooperation of the Postal Service. States may also be able to provide lower cost auto insurance. They can also reduce unnecessary costs associated with buying and selling homes.

In addition, state and local government can act to ensure that they are not wasting money in their pensions by paying high fees to hedge funds and private equity funds that don't end up producing returns that beat the market. An important step to ensure this outcome is increased transparency. All the contracts agreed to by these pensions should be publicly available, with everyone able to see what the pensions paid to hedge fund and private equity fund managers and what returns they got on their investments. Here also there can be real value in setting examples. If a relatively progressive state like Vermont or California required that all terms for their pension fund contracts be fully public, it may shame other states into following the example. The same could be the case if a city like San Francisco or New York went this route. And university endowments can also provide leadership in this area. There is no excuse for throwing away public money by paying high fees to the financial industry that are not justified by the returns they produce. The first step for avoiding this situation is public disclosure.

Finally, it is important to try to simplify the tax code in order to reduce the size of the tax avoidance industry. Allowing firms to issue non-voting shares of stock as an alternative to paying the corporate income tax is perhaps the best way to bring about simplification.[11] This is a policy that can be done at the state level in states that have corporate income taxes. The same principle would apply: the companies would be allowed to issue a number of shares that is roughly proportionate to the percentage of the corporate income that they expected to capture in taxes. If states followed this practice, they would likely both be reducing their own enforcement costs and setting a model that could be copied elsewhere.

If issuing shares were offered as an alternative to the corporate income tax at the national level it is difficult to believe there would not be some companies who now pay their taxes that would welcome the option of this simpler alternative. If any substantial number of companies went in their direction it could put pressure on the ones that didn't. Certainly it would be hard to explain why, if they actually are paying the taxes they owe, they would not prefer a simple mechanism that could save them a considerable amount of money in compliance costs. The first step is of course making the issuing of shares an option, which allows for the obvious question, what's wrong with giving people a choice?

[10] https://www.uspsoig.gov/sites/default/files/document-library-files/2015/rarc-wp-14-007_0.pdf

[11] These shares would provide a claim to the firm's profits, but no control over its actions.

As it stands there is little awareness, even among progressives, of the extent to which the tax avoidance industry is a major source of extremely high incomes. In fact, the private equity industry, which is responsible for many of the highest incomes in the country, is dependent to a large extent on being more effective in avoiding taxes than the companies which it buys (Appelbaum and Batt, 2014). A corporate tax reform that substantially reduced or eliminated opportunities for tax avoidance would lead to a substantial downsizing of the private equity industry.

The financial sector presents an enormous set of opportunities for making the rest of the country better off through the elimination of waste in the sector. The enormous political power of the sector does pose a substantial hurdle, but clearer thinking on the functioning of the sector is a necessary first step in overcoming it.

Alternatives to Patents and Copyrights

The pharmaceutical, entertainment and software industry can be expected to fight just as hard as the financial industry to keep in place the forms of protection that ensure their profitability. And, they are almost as powerful. In this case the market can be a great ally.

These industries, as currently structured, depend on an incredibly inefficient system of government imposed monopolies. These monopolies make items that would otherwise be cheap, like prescription drugs and medical equipment, incredibly expensive. They also make it expensive to get recorded music, movies, and software, all items which could otherwise be transferred at zero cost. The goal of a reform strategy is to expose the enormous waste associated with these monopolies and to find mechanisms to allow increased production and use of non-protected items. It is also important to block efforts by the government to extend the deeper reach of these monopolies to the rest of the world through trade agreements like the Trans-Pacific Partnership.

In the case of prescription drugs and medical equipment, there is little appreciation of the extent to which patent monopolies raise prices because people have become so used to paying outrageous prices. It is unlikely that many people are aware of the fact that high quality generic version of patent-protected drugs can sell in India for less than one percent of their price in the United States. These differences are incredible both at the level of the individual drug and also at the aggregate level. It is unlikely that even many economists are aware of the hundreds of billions of dollars of additional money spent on drugs, tests, and medical equipment each year as a result of their protected status. This sum is an order of magnitude larger than the amounts that are stake in the vast majority of policy disputes.

One way to publicize these differences is try to take advantage of them. Insofar as possible, people can attempt to buy generic versions of drugs in the countries where they are available. In the case of some new drugs, which are priced at more than $100,000 for a course of treatment, it would be easy to cover the cost of an extended stay in India or other countries, bringing along family members, and still have enormous savings. For example, the Hepatitis C drug Sovaldi has a list price of $84,000 in the United States. A high quality generic version is available in India for less than $200. While this is far from an ideal way to receive medical care, it is certainly better than going without care or mortgaging a house and draining savings to cover the cost of necessary medications. There is a basic principle that everyone should understand, drugs are cheap, patents and other forms of protection make them expensive.

The other route to pursue is to increase the room for non-patent supported research and development wherever possible. It is certainly not plausible that the country will flip over all at once from a system that relies on patent monopolies to one that relies on publicly funded research for prescription drugs and medical equipment. An intermediate step is having publicly funded clinical trials. In this case the government would contract with private companies, through a process of competitive bidding, to do clinical trials of chemicals that were either already in the public domain or to which they bought up rights. The results from the tests would be publicly posted for doctors and researchers to analyze. In addition, the drugs themselves would be available as generics once they had been brought through the FDA approval process so that anyone would be able to produce them.

A system of publicly funded clinical trials can be infinitely sliced and diced. There could public funding of trials in just some areas, for example cancer drugs, which would require a relatively small portion of the funding now going to the National Institutes of Health. The payoff would be both the availability of a large amount of data on the effectiveness of the trials – possibly shaming drug companies into more disclosure of test results – and the possibility that some number of important new cancer drugs would be available at generic prices. Instead of cost hundreds of thousands of dollars, generic versions of new cancer drugs might cost hundreds of dollars. The costs of clinical tests are low enough that a major foundation or a collaboration of smaller foundations could put up the necessary funding.[12] If this spending produced some number of effective drugs that were made available at generic prices, it could have a considerable impact.

There are many other ways that the process can be cut. For example, the government allows drug companies a six month patent extension when they test a drug for pediatric uses. The government could instead pay for the testing itself (making the results public) and compare the implicit cost of a six-month patent extension with the cost of direct payment.[13] The point here is to get a foot in the door to allow a

[12] Doctors Without Borders is already engaged in a process along these lines with its Drugs for Neglected Diseases Initiative http://www.dndi.org/ . While this project has a produced an enormous return on the money invested, it is explicitly targeted on diseases that primarily afflict poor people in the developing world. Therefore it does little to affect thinking on the process of drug development in wealthy countries.

[13] This idea was suggested to me by Jamie Love, the director of Knowledge Ecology International.

clear basis for comparing the efficiency of directly funded research with the current system of patent monopolies.[14]

It is likely that the patent monopoly system would flunk this test. It is also likely that the drug industry knows that the patent monopoly system would flunk this test, which is why they will do everything in their power to ensure that such tests don't take place. One advantage in this effort is that the generic drug industry stands to benefit from weakening or eliminating patent monopolies. Insurers in principle also stand to benefit from the availability of low cost drugs, as well as medical tests. And, even the large pharmaceutical companies could still profit through a system of publicly funded research, since they would presumably be the major recipients of contracts. However, as long as they can make large amounts of profits under the current system, they will not be interested in trying a new route, regardless of the costs they impose on the rest of the country and the world.

There is a similar story on the enforcement of copyright monopolies. This is an increasingly archaic way of supporting creative work as the Internet makes it ever more difficult to prevent the transfer of unauthorized copies. This is the motivation for more punitive laws on copyright enforcement and increasing efforts to make third parties share in the cost of enforcement.

The answers in this case are both to resist repressive efforts at enforcement and to increase the availability of work not supported through copyrights. In terms of repressive efforts, the defeat of the Stop Online Piracy Acts and the Prevent Online Piracy Acts, were notable achievements. These laws would have required web intermediaries to police their sites for copyright violations. This is a big step up from current law, which already requires that companies side with claims by copyright holders, against their customers, and immediately remove material that is alleged to be in breach. The Trans-Pacific Partnership and other trade deals under discussion also increase the strength of copyright protection, imposing larger burdens on intermediaries.

Baker (2016) outlines a tax credit system, modeled on the charitable giving tax deduction, as an alternative mechanism for supporting creative work. This can be implemented at the national level for an amount considerably smaller than the current cost of the charitable giving tax deduction. This would create a vast pool of funds to support creative work, which would almost certainly exceed the amount going to creative workers through the copyright system. The condition for being eligible for receiving funding through the tax credit system would be waving the right to get copyright protection for a limited period of time (e.g. 3-5 years). This has the great virtue of being self-enforcing, since someone

[14] Another possible route for demonstrating the inefficiency of the patent system would be to have a buyout of the rights to a major drug and then allow it to be sold as a generic. If a drug that had been selling for thousands or even tens of thousands of dollars for a year's treatment were suddenly available for just a couple of hundred dollars, it could drive home the point that patents make drugs expensive. In principle, a consortium of major insurers, possibly with a subsidy from a philanthropic organization, could be a position to carry through this sort of buyout.

attempting to cheat the system by getting a copyright during their period of ineligibility would find that their claim was not enforceable.

While such a system could produce a large amount of creative work if it were implemented nationally, it is possible that states or even local governments could experiment with a similar tool. Suppose a city of two hundred thousand people made a credit of $50 per adult available along similar lines as the national tax credit proposal. However, to be eligible for the credit a creative worker would not only have to forego copyright protection for a period of time, they would also have to physically live in the city for at least eight or nine months of the year. If three quarters of the population took advantage of the credit (presumably children would not be eligible) that would create a pool of $7.5 million to support creative workers.

Since these workers would be required to actually live in the city much of the year, they would have an incentive to perform their music or plays, conduct writing workshops, or do other work that would both help to support them and to increase their visibility to people deciding what to do with their tax credit. It is easy to envision a scenario in which this sort of influx of creative workers brings enough tourist revenue to more than cover the cost of the tax credit. Of course this would be an easier proposition if an innovative foundation was prepared to put up part of the cost of the system. Anyhow, there are many other mechanisms that can increase the supply of material supported outside of the copyrighted system. As more free material becomes available, it will be more difficult and irrelevant to maintain the copyright system.

Protectionism of Highly Paid Professionals

The last major form of rent is the pay of highly educated professionals, like doctors, dentists, and lawyers. These professionals are paid far more than their counterparts in other wealthy countries. If doctors in the United States were paid the same as their counterparts in other wealthy countries it would save roughly $100 billion a year in health care costs (Baker, 2016).

It's not an accident that the pay of these workers has not been put under pressure by globalization; it was the result of deliberate policy decisions to largely protect these highly educated workers from foreign and even domestic competition. In the case of doctors, foreign trained doctors are largely excluded from practicing medicine in the United States. There is a requirement that doctors pass a U.S. residency program – as though there were no other way for a person to become a competent physician. The number of residency slots in the United States is sharply restricted, as are the number of slots available to foreign medical school graduates. Similarly, dentists have to graduate from a U.S. dental school. (In 2010, the U.S. began allowing graduates of Canadian dental schools to practice here as well.)

These professions also protect themselves against domestic competition. For example, in many states nurse practitioners are prohibited from prescribing medicine, something that their training makes them entirely competent to do. Many states have regulations that sharply limit the extent to which dental hygienists can practice independently. Making them dependent on dentists lowers the pay of hygienists and raises the pay of dentists with no obvious payoff in better outcomes.

These issues of domestic forms of protection in the highly paid professions are likely to become more serious as technology makes it possible for many relatively complex tasks to be performed by professionals with lower levels of training. For example, advances in diagnostic technology may allow nurse practitioners to make diagnoses of most conditions with the same or better accuracy than the average doctor. However if doctors are allowed to determine standards of care, they are likely to leave in place regulations that effectively force people to see general practitioners or even highly paid specialists when a much lower paid professional perform the work equally well.

If our trade negotiators treated doctors and other highly paid professionals the same way they treated manufacturing workers then trade agreements would have been written to make it as easy as possible for smart ambitious kids in Mexico, India, and other developing countries to study to meet U.S. standards. They then would be able practice their profession in the United States in the same way as someone born and educated in the United States. The fact that manufacturing workers face competition from low paid workers in the developing world and doctors and other highly paid professionals do not has nothing to do with the inherent dynamics of globalization: it is about the differences in the power of these groups.

Ideally we would start to change trade deals so that we did see this sort of competition at the high end. It would lead to the same sorts of gains from trade that we get from buying cheaper clothes and car parts from abroad. However in this case the impact would be to reduce inequality rather than increase it.

It is not likely that our trade agenda will be taken over by genuine free traders any time soon, but there are other mechanisms that can help to bring about similar outcomes. One route is measures that make it easier for patients to take advantage of the lower prices for major medical procedures in other countries. There are many high quality facilities in countries like India that charge prices that are often less one-tenth the prices in the United States. Since the cost of some of these procedures runs into the hundreds of thousands of dollars in the United States, and they are usually not done on an emergency basis, patients could travel for their surgery, bring along family members, and still have large savings.

While this practice is not likely to be promoted at the national level due to the power of the doctors' lobby, there is no reason that a state couldn't take advantage of this opportunity for cost savings. States could offer their Medicaid patients the option to get major operations performed overseas, while splitting the savings, as an alternative to having procedures done in the United States. They could also write rules for insurers to facilitate such arrangements. In addition, a solid international licensing system for medical facilities would be helpful for ensuring quality standards, as would clear rules on malpractice. Allowing more people to take advantage of low cost health care in other countries will directly put downward pressure on prices in the United States by reducing demand. It can also have the beneficial political effect of allowing people to see first-hand that the quality of care in many other countries is comparable to that in the United States.

In principle, it would be possible to make similar arrangements with Medicare. The cost of providing health care to our retirees is more than twice as much person as in other wealthy countries. This creates the potential for large gains if Medicare beneficiaries are given the opportunity to use their Medicare to buy into the health care systems in other countries. The gap between the cost of providing care under the Medicare system and the cost of providing health care through another country's health care system could be shared between the beneficiary and the U.S. government. This would also reduce the demand for domestic medical services while educating people about the quality of health care in other countries.

Here also the doctors' lobbies will fight furiously the idea of globalizing Medicare. While it would be hard to overcome their resistance, it is a case where the doctors are clearly the enemies of globalization and relying on old-fashioned protectionism to maintain their bloated pay. If doctors were treated the same way in trade pacts as textile workers and autoworkers, they would face massive job loss and plunging paychecks.

There are similar, if less dramatic stories, with the other highly paid professions. There are enormous potential gains from opening these professions to international competition. It is only the political power of these relatively highly paid workers that prevents them from being subject to the same sort of international completion as their less highly paid counterparts.

Conclusion

Most of the changes outlined in the discussion above are not likely to happen any time soon. In fact, perhaps none of them are likely to happen any time soon. But the point of laying out these options is to show that the distribution of income can be hugely altered by restructuring the market to produce different outcomes. This doesn't dismiss the value of tax and transfer policies, but if the market is rigged to redistribute ever more income upward, it will be difficult to design tax and transfer policies to reverse this effect. And if the rigging efforts are never challenged, then they will impose an ever greater burden on those trying to reduce inequality through tax and transfer policy.

Table 1 shows the range of the gains from different structuring of the market from each of the sources describe above.

Table 1

The total comes to almost $2 trillion in additional income in 2016 in the low-end case, while it hits $3.7 trillion in the high end case. These are large numbers that are difficult to comprehend. A useful metric is annual spending on the food stamp program or SNAP, the federal government's largest means-tested transfer program. Spending on SNAP in 2016 came to a bit more than $70 billion. Expressed as units of SNAP spending, the low-end amount is equal to 26.4 units of annual SNAP spending, while the high-end is just under 50 units of SNAP spending. In short there is a lot of money at stake here.

There are several important qualifications to this calculation. First more than half of these potential gains are associated with full employment policy. The high end number is based on a projection of GDP that assumes the 2008 crash either never happened or that we responded to it quickly and aggressively enough to quickly restore GDP back to its potential. Of course this is not the case and we can't rewrite the past. The result of the crash and subsequent policy failures has been to permanently reduce potential GDP, both as a result of a lower capital stock and also due to some workers likely permanently leaving the labor force. The lower figure, which assumes that we can make up half of the gap between the pre-crash projection of potential GDP and actual output is probably an optimistic estimate of how much ground we can reasonably hope to make up at this point.

The second qualification is that not all of this money would be transferred from the rich to everyone else. For example, if we did increase GDP back to its potential, some of this would go the one percent. A disproportionate share of the additional output from getting back to full employment would go to people lower down on the income distribution, but the share going to the top one percent will not be zero (Baker and Bernstein, 2013). The same would hold true for all of the categories of potential gains from eliminating rents. Not all the benefits will go to those lower down in the income distribution, even if the bulk surely would.

Finally, there is likely to be a substantial interactive effect that would go in the right direction from the standpoint of reducing inequality. For example, there are more than 470,000 physicians who are specialists in the United States (Kaiser, 2016). The vast majority of these specialists earn over $250,000 a year, with many of them earning far above this amount. This means that this group accounts for roughly a quarter of these higher end earners in the United States (Social Security Administration, 2016). If the number of specialists was reduced to be more in line with ratios of specialists to primary care physicians in other countries, and their average pay was bought down to something closer to $200,000 (also more in line with other wealthy countries) then it would likely put downward pressure on the wages of high-end earners more generally. In the same vein, if a financial transactions tax could more than halve the number of people in the financial industry earning seven, eight, and nine figure salaries. A sharp reduction in the number of high-paying jobs would have a substantial impact on the high-end of the labor market just as the loss of a large number of manufacturing jobs will has an impact on the labor market for non-college educated workers more generally. For this reason, some of the figures noted above may actually understate the full impact of the ways in which eliminating rents may reduce income inequality.

For all the qualifications, there should be little doubt that there is potential to have a large impact on the distribution of income through economically plausible restructurings of the market. The gainers in the top one percent have structured the market over the last four decades in ways that increase their share of income. This restructuring can be reversed.

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Table 1

Gains from Restructuring Markets

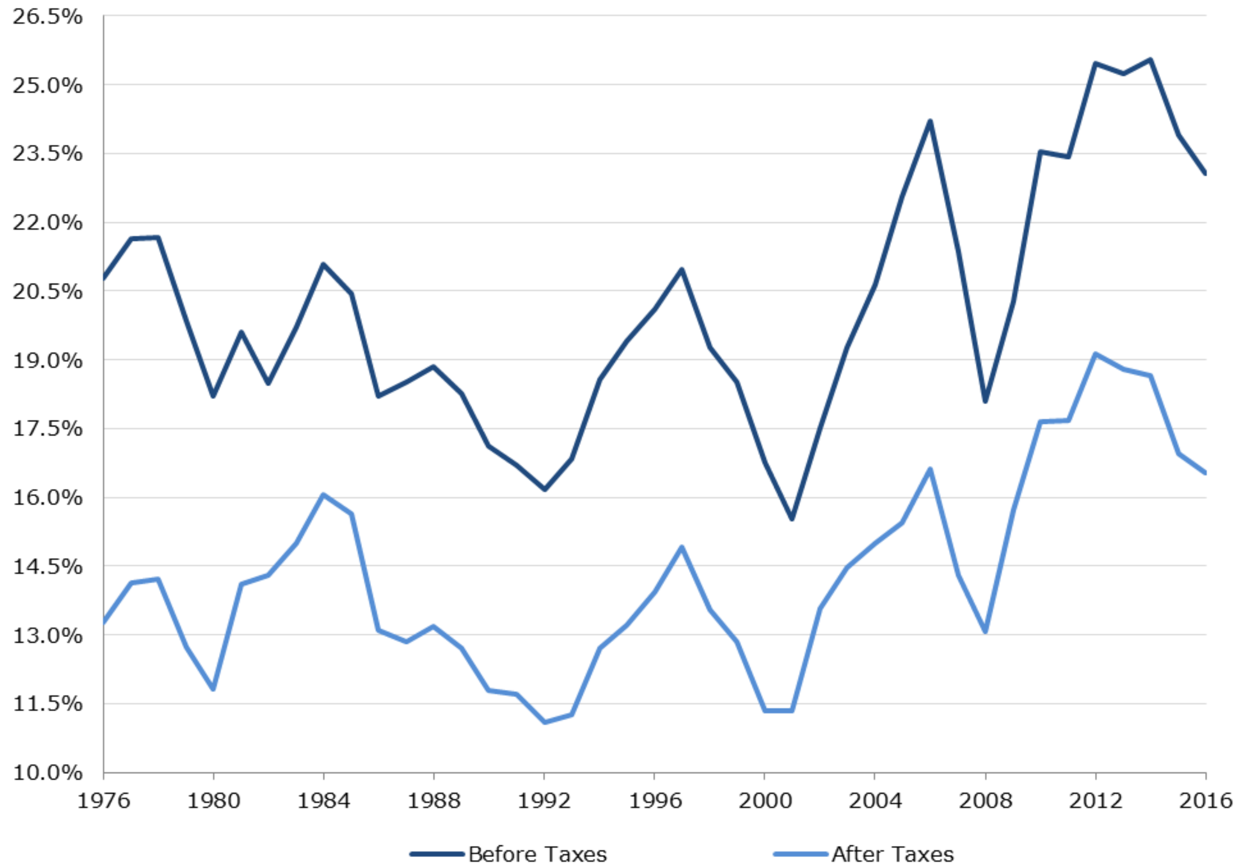
(billions of 2016 dollars)

	Low	**High**
Full Employment Policy	1,115	2,300
Eliminating Financial Sector Waste	460	636
Ending Patent/Copyright Monopolies	217	434
Reforming Corporate Governance	90	145
Ending Protection in Highly Paid Professions	100	200
Total	**1,982**	**3,715**

Source: Author's calculations, see text.

Figure 1

Capital share of corporate income

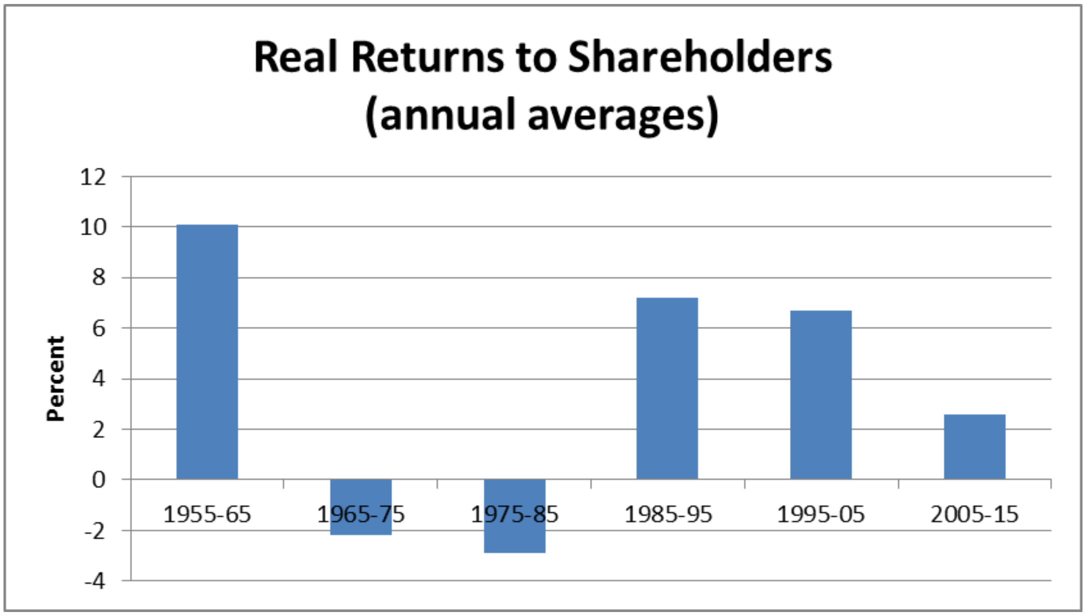


Source and notes: Bureau of Economic Analysis (2016).

Figure 2

Source and notes: Piketty and Saez (2016).

Figure 3



Source: Shiller (2016) and author's calculations.