Tackling Inequality and Creating a Strong Middle Class

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A rethinking of standard economic theory

- Advanced countries (including the US) have not been performing well
  - Growth has been anemic
  - The benefits of what growth occurs goes to the top
  - Trickle down economics hasn’t worked
- In the US, there has been near stagnation of the bottom 90% for a third of a century
  - With the median income of a full time male worker lower than four decades ago
  - With real wages at the bottom at the same level that they were sixty years ago
  - Life expectancies are in decline, deaths of despair on the increase
  - American style capitalism has not been working for large fractions of the American people
    - An economic model that does not deliver for the majority of the citizens is a failed economic model
US: bottom 90% have seen little increase in income over last third of a century

Source: World Wealth and Income Database
Share of total national income by the richest 1%

This share increased the most in South Korea compared to China, Japan and the US over this period.

**Growth in top 1% share, 1998 – most recent:**

<table>
<thead>
<tr>
<th>Country</th>
<th>Share (%)</th>
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<tbody>
<tr>
<td>South Korea</td>
<td>84.8%</td>
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<tr>
<td>China</td>
<td>41.8%</td>
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<tr>
<td>Japan</td>
<td>22.4%</td>
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<tr>
<td>USA</td>
<td>19.5%</td>
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</tbody>
</table>

Source: World Wealth and Income Database
US: Median income of a full time male worker is at the level that it was more than 4 decades ago

(constant 2016 $)

Note: Data is adjusted for the methodological change of 2013.
Source: U.S. Census Bureau.
US: Real wages at the bottom are at the level that they were roughly sixty years ago

US Minimum Wage

Source: Federal Reserve
Decline in life expectancies and an increase in deaths of despair

New research shows the increasing mortality rate among white Americans spans age groups and is most acute among the less-educated.
...in contrast to elsewhere...
Mortality rate for all causes, ages 45-54

...due in part to increases in 'deaths of despair'.
Mortality rate due to alcohol, drugs and suicide, ages 50-54
Life expectancies in Korea up, but suicide rates remain high—though still markedly lower than US

**Life expectancy at birth**

- USA
- Korea
- World

**Mortality and suicide rates**

- Deaths per 100,000 (LHS)
- Suicides per 100,000 (RHS)

Source: World Bank World Development Indicators
Many mysteries

- High profits and low investment

- Wealth income ratio is up but capital income ratio is down in US
  - Insufficient savings to sustain the capital output ratio
    - Result: declining share of capital income as well as labor income
  - But even in countries with higher savings (like France) huge gap between wealth and capital
    - Gap is rents
    - Causal link: savings goes into increases into “capitalized value of rents,” for instance, land and increased value of equity of rent-exploitation firms
Growing profits and low business investment

U.S. corporate profits as % of GDP

Source: Thomson Reuters Datastream

Recessions highlighted

Source: Federal Reserve Bank of St. Louis
Growing profits and low business investment

Source: Federal Reserve Bank of St. Louis
Simulated national wealth-income ratios in the absence of capital gains: U.S. 1970-2010

Authors' computations based on 1970 wealth-income ratios, 1970-2010 national saving flows (including other volume changes) and real income growth rates. Source: *Capital in the Twenty-First Century*, Thomas Piketty.
Simulated national wealth / national income ratios in the absence of capital gains: France, 1970-2010

Authors’ computations based on 1970 wealth-income ratios, 1970-2010 private saving flows (including other volume changes) and real income growth rates. Source: *Capital in the Twenty-First Century*, Thomas Piketty.
More mysteries

• Share of labor in decline—especially if one excludes top 1% of earners (bankers, CEO’s, etc.)

• Yawning gap between productivity and compensation
Share of income to labor has been declining

US labor compensation as share of GDP

Source: US Bureau of Economic Analysis
Decreased share of labor—especially if one focuses on bottom 99% of labor
US: Disconnect Between Productivity and a Typical Worker’s Compensation, 1948-2015

Note: Data are for average hourly compensation of production/nonsupervisory workers in the private sector and net productivity of the total economy. “Net productivity” is the growth of output of goods and services minus depreciation per hour worked.

Source: EPI analysis of data from the BEA and BLS (see technical appendix of Understanding the Historic Divergence Between Productivity and a Typical Worker’s Pay for more detailed information)

Economic Policy Institute
Europe: Disconnect in Productivity and Compensation

Source: Eurostat.
Not just the share of labor that is down

• Also the share of capital
  • What is up is the share of rents

• The gap between wealth and capital is the “capitalized value of rents”
  • Value of land
  • Value of intellectual property
  • Value of rents seized from the public (selling goods to government at above competitive price—like drugs—and getting assets from government at below market prices—like oil and mineral resources)
  • Most importantly: value of monopoly rents
• All of these have increased—but especially monopoly rents
The capital share of gross value added is declining

The figure shows the capital share of gross value added for the U.S. non-financial corporate sector over the period 1984–2014. Capital payments are the product of the required rate of return on capital and the value of the capital stock. The capital share is the ratio of capital payments to gross value added. The required rate of return on capital is calculated as \( R = (i - \bar{\pi} + \delta) \). Capital includes both physical capital and intangible capital. The cost of borrowing is set to Moody’s Aaa and expected inflation is calculated as a three-year moving average.

Source: Simcha Barkai, University of Chicago
In a supposedly innovation era, productivity growth is low.

Growth in GDP per capita

Source: OECD
Multiple explanations of anomalies

• But among key explanation is an increase in market power of corporations and a decrease of market power of workers, with market power being used to enrich the top—but not invest in the future of the country

• Evidenced by increased market concentrations
  • Consistent with high profit rates
  • Consistent with evidence on high mark-ups (price much greater than cost)
    • Estimates that almost 80% of equity value of publicly listed companies associated with rents, almost a quarter of value added
    • Much linked to the IT sector

• The standard competitive model—the benchmark model of economics since Adam Smith—is now being questioned
  • We live in a world of rent-seeking and exploitation
Explaining the increase in monopoly rents: Technology

- Network externalities have created new “natural monopolies”
  - But these twenty-first century natural monopolies are not regulated
- Hi-tech has learned how to exploit (and hoard) data
  - Engaging in discriminatory pricing
  - Transferring wealth from consumers to producers
  - Discriminatory pricing is inconsistent with the standard competitive model
Explaining the increase in monopoly rents:

Rules

- Changes in the rules of the game
- Failing to adapt the rules of the game to a changing world
- New interpretations of old rules
- Law enforcement
- All of these have resulted in greater ability of corporations to exploit workers and consumers, enhancing their market power at the expense of others
  - Resulting in a less efficient and dynamic economy
  - With firms focused more on increasing rents than on increasing societal well being
  - And using their “cleverness” to avoid paying taxes
    - Apple, the world’s largest corporation by capitalization paying less than 1% of its profits in taxes
    - Giving it an unfair advantage over small and medium sized firms that do pay taxes
    - Ironic: all the while it takes a posture of corporate responsibility
    - The first responsibility of a corporation is to pay its fair share of taxes
Not just anti-trust rules

• Though that is important

• But a host of regulations, including those related to corporate governance and labor
Emerging US response: A new post-Trump agenda

- At the center of the new agenda to revive the American economy and create shared prosperity is *rewriting the rules of the American economy*
  - Including new rules curbing corporate, CEO, and market power
- They were rewritten once before, under Reagan
  - Liberalization and low tax rates were supposed to unleash the power of the market
  - Everyone would benefit through trickle down economics
  - What happened was that growth slowed and inequality grew—the only winners were the wealthy
This is more than an economic agenda

• 125 years ago, the US faced a similar situation, with inequality sky-rocketing

• The country responded with the progressive era, including anti-trust law

• The concern then as today is that economic inequality leads to political inequality
  • Undermining democracy and the very nature of our society
II. Korea today

• In many dimensions Korea is performing far better than US
  • Growth
    • But GDP per capita remains markedly lower—showing that there is still much opportunity for growth (“catch-up”)
  • Unemployment
  • Inequality

• But market concentration remains a concern
  • Even though Korea is performing better than the US in creation of new firms
South Korea’s growth story

- South Korea’s annual growth rate has outstripped the US’ since the end of the Asian Financial Crisis.
- Growth in Korea’s GDP per capita is now nearly 2.4%, compared to less than 1% growth in the US.
- In 1990, South Korea’s GDP per capita was 1.5x the world average. Today, it is over 3.0x!
- Median income in Korea is US$ 17,200 vs. 30,000 in the US (OECD 2011).

Source: World Bank
Low unemployment

- South Korea has a very low unemployment rate, at 3.7%

Source: OECD, World Bank
Inequality comparison to the OECD

Source: OECD
Inequality comparison to the US

- South Korea has a Gini coefficient of 0.29, compared to the US’ Gini coefficient of 0.39
- In South Korea, a smaller proportion of total income goes to the top 10% than in the USA
- The labor share of income in Korea is 61%, compared to 58% in the US

Source: OECD, ILO
Market concentration: continuing source of concern

- High market concentration remains a source of inequality among corporations in Korea, despite improvements since the 1980s.
Growth in share of new firms in Korea outpaces the US

[source: OECD]
A new policy agenda

• For more than sixty years, conventional wisdom has been that the government should approach problems of unemployment, inequality, and low wages only indirectly, with mild instruments
  • Stimulate aggregate demand through fiscal and monetary measures
  • Improve skills
  • Grow the economy and everyone will benefit: trickle down economics
  • Small tweaks in the economy will achieve desired results

• Overwhelming evidence that this recipe has not worked and will not work
  • Weak job creation
  • Much of the job creation are temporary jobs, without economic security and paying low wages

• And voters have increasingly turned away the centrist parties that pretend that this is so
Approach based on ideology

• On a blind belief that governments are inefficient and markets are efficient
  • No government ever wasted money on the scale of America’s financial sector
  • Pervasive inefficiencies and corruption in many parts of the private sector
  • America’s private health care system spends 10% more per capita as France’s largely public system—with worse results
• Alternative view: we need to strive to increase efficiency of both the private and the public sector, to curb corruption in both, and to limit exploitation
A more direct attack on the problem

- In some cases it makes sense for government to be more actively engaged in both hiring and wage setting

- Key part of J-nomics

- Higher employment and increased wages in public sector will help drive up wages in the private sector, reducing inequality

- Rather than trickle down economics, trickle up
  - And building the economy up from the middle
  - The middle class is the basis of the success of every society, economy, and democracy
  - America’s failures today can be traced to the evisceration of the middle class
This is the right time for such a policy—and Korea is the right place

- All advanced economies are transitioning from manufacturing to service sector/knowledge economies
  - This is a major transition
  - Because of its highly educated labor force, Korea is in a good place to make such a transition
  - While the overall share of college-educated adults is similar in Korea and USA, Korea’s youth are much more likely to be educated: 69% of Korean adults 25-34 years of age have tertiary education, compared to 46% of young Americans
    - Korean students outperform American students on the math PISA tests, averaging 524 vs. 470 (#2 vs. #30 in the OECD)
  - South Korea R&D spending accounts for 4.2% of GDP, compared to 2.8% in the US

- Markets don’t make such transitions on their own well
  - Great Depression can be viewed as part of the failure of the transition from agriculture to manufacturing

- The newly expanding sectors—including health and education and caring for the aged—are sectors in which government naturally plays an important role
  - Wages in those sectors not really market determined
  - They reflect societal values: how much we value the education of our children, the care of our elderly

Source: OECD
Multi-prong approach to facilitating transition—ensuring inclusive growth

• Active labor market policies
• Social protection
• Industrial policies
  • Including credit, research, innovation, education, and public investment
  • Place-based policies
• Multiple aspects of transformation
  • From manufacturing to service sector
  • From export led growth to domestic demand
    • Especially important in new world of protectionism
  • Demographic transition to an aging economy
  • Knowledge economy different from traditional economy
    • “Creating a Learning Society”
    • Increase in knowledge basis of enormous increase in standards of living over past two centuries
Creating a new middle class society

• These policies offer the hope of an alternative to the current American model which has failed so miserably
  • Success is not automatic
  • Will require careful oversight—to make sure that money is spent well
  • A strengthened civil society can play an important role
Another prong of policy reform: curbing market power

• Concentration of market power has long been a problem in Korea
  • With those lucky enough jobs in the Chaebol receiving higher income than others

• Political consequences also long evident
  • But especially so more recently
  • Leading to a loss of trust in societal institutions over the past few years

• Some of Korea’s large firms have been very innovative
  • But there is an unlevel playing field, distorting the economy
  • Especially when the large enterprises receive special favors from government

• SMEs are almost always at a disadvantage
  • A result in part of imperfections in capital and knowledge markets
  • Good economic policy entails giving these firms some assistance.

Source: Gallup
Creating an innovation economy

• Need both large and small firms for an innovation economy
  • With an important role for government support for research
• Large firms can undertake research projects that are beyond the scope of small
  • But a large fraction of new ideas originate from new and small firms
• An unlevel playing field stifles these firms
  • And this is especially so when large firms take actions to protect and extend their market power
• Evident in the US, e.g. with Microsoft
  • Widespread concern that big firms today are again stifling innovation
    • Pace of creation of new firms down in US
  • Banks and investors won’t extend credit to new enterprises when they know that big-tech can crowd them out
The role of government

• A modern successful economy requires an important role for government
  • For instance, investment in technology, education, and infrastructure
  • Particularly important in transition—in structural transformation
  • Particularly important in ensuring a middle class society
    • Providing access to a middle class life for most citizens
• Part of the explanation of the weak performance of the US economy is insufficient public investment
  • Partly as a result of corporations not paying their taxes and lobbying to have their taxes reduced further
National innovation systems

Successful national innovation systems require a range of institutions

• Public investments in technology and basic research and education is crucial

• Intellectual property is important, but its importance has been exaggerated
  • When US Supreme Court curbed patents on genes, innovation increased, leading to lower prices of tests, higher quality—lives saved

• Often large disparity between private and social returns to innovation
  • Creating world’s most efficient advertising engine was not the world’s most important task
  • Saving the planet (climate change) and saving lives were more important
  • Much research is directed at enhancing market power and rent extraction, not maximizing societal welfare

• Small firms can play an important part in a dynamic innovative economy
  • Especially with appropriate support from government for capital
  • Provided in a variety of forms
New models of capitalism and the market economy

• Sad reality is that the American model has failed
  • Though it has some areas of impressive strength (e.g. higher education—where the private for-profit sector plays no important role: all of the major universities are either state or not-for-profit)
  • Evidence of a third of a century
  • Political consequences now evident
  • Should be an important warning for others

• There is a need for a new social contract

• Korea is charting an alternative path
  • Based on strengthening its highly educated middle class
  • Creating an innovative and dynamic economy
  • With every prospect of creating a new shared prosperity