INEQUALITY, STAGNATION, AND MARKET POWER

THE NEED FOR A NEW PROGRESSIVE ERA

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There is much to be concerned about in America today: a growing political and economic divide, slowing growth, decreasing life expectancy, an epidemic of diseases of despair. The unhappiness that is apparent has taken an ugly turn, with an increase in protectionism and nativism. Trump's diagnosis, which blames outsiders, is wrong, as are the prescriptions that follow.

But we have to ask: Is there an underlying problem that can and must be addressed?

There is a widespread sense of powerlessness, both in our economic and political life. We seem no longer to control our own destinies. If we don't like our internet company or our cable TV, we either have no place to turn, or the alternative is no better. Monopoly corporations are the primary reason that drug prices in the United States are higher than anywhere else in the world.[2] Whether we like it or not, a company like Equifax can gather data about us, and then blithely take insufficient cybersecurity measures, exposing half the country to the risk of identity fraud, and then charge us for but a partial restoration of the security that we had before a major breach.

Some century and a quarter ago, America was, in some ways, at a similar juncture: Political and economic power seemed concentrated in a few hands, in ways that were inconsonant with our democratic ideals. We passed the Sherman Anti-Trust Act in 1890, followed in the next quarter century by other

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[2] See Kesselheim *et. al* (2016).

legislation trying to ensure competition in the market place. Importantly, these laws were based on the belief that concentrations of economic power inevitably would lead to concentrations in political power. Anti-trust policy was not based on a finely honed economic analysis, resting on concurrent advances in economics. It was really about the nature of our society and democracy. But somehow, in the ensuing decades, anti-trust was taken over by an army of economists and lawyers. They redefined and narrowed the scope, to focus on consumer harm, with strong presumptions that the market was in fact naturally competitive, placing the burden of proof on those who contended otherwise. On this basis, it became almost impossible to successfully bring a predatory pricing case: Any attempt to raise prices above costs would instantaneously be met by an onslaught of new firm entry (so it was claimed).[3] Chicago economists would argue—with little backing in either theory or evidence—that one shouldn't even worry about monopoly: In an innovative economy, monopoly power would only be temporary, and the ensuing contest to become the monopolist maximized innovation and consumer welfare.[4]

Over the past four decades, economic theory and evidence has laid waste to such claims[5] and the belief that some variant of the competitive equilibrium model provides a good, or even adequate, description of our economy.

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[3] The Supreme Court seemed to buy this argument in Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

[4] Arnold Harberger of the University of Chicago (see Harberger, 1954) claimed that the loss in consumer welfare from monopoly power was of second order importance. Even if that conclusion was true then, the subsequent increase in market power (and the associated increase in mark-ups), imply that it is no longer true. See e.g. De Loecker and Eeckhout (2017).

[5] For instance, a third of a century ago, Dasgupta and Stiglitz (1980) showed that the Schumpeterian claim that monopolies were temporary was wrong: they had the power and incentives to persist. These conclusions have been reinforced by more recent results of Greenwald and Stiglitz (2014), especially chapters 5 and 6.

But if we begin with the obvious, opposite hypothesis—that what we see in our daily life is true, that our economy is marked in industry after industry by large concentrations of market power—then we can begin to simultaneously understand much of what is going on. There has been an increase in the market power and concentration of a few firms in industry after industry,[6] leading to an increase in prices relative to costs (in mark-ups). This lowers the standard of living every bit as much as it lowers workers' wages. When I wrote The Price of Inequality[7] five years ago, I attributed much of the increase in inequality to this redistribution from workers and ordinary savers to the owners of these oligopolies and monopolies. I explained the multiple sources of this increase in market power. Some of it might have been a natural result of the evolution of our economy, growth in industries with what economists call network externalities, which might lead to natural monopolies; some was the result of a shift in demand to local services, segments of the economy where local market power, based on differential information was more significant. But much of it was based on changing the implicit rules of the game—new anti-trust standards that made the creation, abuse, and leveraging of market power easier—and the failure of anti-trust standards to keep up with the changing evolution of the economy. That was why two years ago, the Roosevelt Institute called for Rewriting the Rules of the American Economy, and over the past two years has amplified this message, especially as it relates to market power.[8]

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[6] See Council of Economic Advisers (2016).
[7] See Stiglitz (2012).
[8] See Stiglitz *et. al* (2015).

The problem is greater than what I have just indicated, and its consequences are perhaps more wide ranging than has been widely understood. This increase in market power helps explain simultaneously the slowdown in productivity growth, the sluggishness of the economy, and the growth of inequality—in short, the poor performance of the American economy in so many dimensions. This in spite of the fact that we are supposed to be today the most innovative economy ever. Finally, I will say a few words about what is to be done.

The multi-faceted aspects of the increase in market power

Let's begin with a simple question: Is there any reason why US telecom prices should be so much higher than in many other countries and service so much poorer? Much of the innovation was done here in the United States. Our publicly supported research and education institutions provided the intellectual foundations. It is now a global technology, requiring little labor—so it cannot be high wages that provide the explanation. The answer is simple: market power.

We used to think that high profits were a sign of the successful working of the American economy, a better product, a better service. But now we know that higher profits can arise from a better way of exploiting consumers, a better way of price discrimination, extracting consumer surplus, the main effect of which is to redistribute income from consumers to our new super-wealthy. Standard economic theory was based on the absence of discriminatory pricing and information imperfection—and in particular, the absence of distortionary

asymmetries in information, whether those were natural or created by the market. The 21st century digital economy has created opportunities for endogenous information asymmetries beyond anything that anyone could have imagined not that long ago. And this has enhanced the ability of firms not only to engage in price discrimination, but, to use Akerlof and Shiller's colorful language, to phish for phools, to target those who they can take advantage of.[9]

Firms like Microsoft led in the innovation in creating new barriers to entry. How could one compete with a browser provided at a zero price? New forms of predation were created, and pre-emptive mergers—buying cheap potential competitors before they could be a competitive threat and before an acquisition would receive anti-trust scrutiny—became the norm. Even after Microsoft's anti-competitive practices were barred, their legacy of market concentration continued.

But our "innovative" firms did not rest there. In credit cards and airline reservation systems, they created new contractual forms that ensured that even a firm with a small market share could and would charge exorbitant prices, thus guaranteeing that market power, however created, would be perpetuated. Chicago economists created new specious defenses, for instance, entailing two-sided markets (a "meeting place"—today, typically an electronic platform—for two sets of agents to interact with each other), that succeeded in persuading some courts to allow these abuses of market power to continue.

[9] See Akerlof and Shiller (2015).

Perhaps long ago, the picture of innovative, if ruthless, competition and one monopolist succeeding another provided a good description of the American economy. But today we live in an economy where a few firms can get for themselves massive amounts of profits and persist in their dominant position for years and years.

Labor

The exploitation of firm market power is but half the story. We now face an increased problem of monopsony power, the ability of firms to use their market power over those from whom they buy goods and services, and in particular, over workers.[10] In Rewriting the Rules of the American Economy we detailed how changes in institutions (unionization), rules, norms, and practices had weakened workers' bargaining power, making it more difficult for unions to check pervasive abuses entailing corporate management taking advantage of deficiencies in corporate governance. Recent research, including that by Mark Stelzner of the University of Connecticut, in a paper aptly titled, "The new American way—how changes in labor law are increasing inequality,"[11] has provided further confirmation of our perspective. So too has Card and Krueger's work on the absence of negative employment effects from

[10] This issue received some attention from the Obama Administration. See CEA 2016b.
[11] See Stelzner (2017).

minimum wage increases.[12] The flip-side of the resulting decrease in workers' income and labor share is an increase in corporate rents.[13]

What Galbraith had described in the mid-century as an economy based on countervailing power[14] has become an economy based on the dominance of large corporations and financial institutions.

Globalization

Globalization was supposed to lead to a more competitive market place, but instead, it has provided space for the growth of global behemoths, who use their market power to extract rents from both sides of the market place, from small producers and consumers. Their competitive advantage is not based just on their greater efficiency; rather, it rests partly on their ability to exploit this market power and partly on their ability to use globalization to evade and avoid taxes. Just five American firms, Apple, Microsoft, Google, Cisco, and Oracle, collectively have more than a half trillion dollars stashed abroad as they achieve tax rates in some cases well under 1% of profits. We can debate what a "fair share" of taxes is, but what these companies pay is below any reasonable standard.

But the impact of globalization on workers has been perhaps its most devastating aspect, weakening their bargaining power, as firms threaten to

[12] See Card and Krueger (2000). If labor markets were competitive, an increase in minimum wages should have a large negative effect on employment. If labor markets are characterized by monopsony, there can be a positive effect. The fact that the observed effects seem small (though possibly negative) is consistent with the view that there are some areas where labor markets are competitive, but others where they may be far from so.
[13] Some of these corporate rents may, of course, be shared with top management. See Furman and Orszag, 2018. The extent to which this is so has, however, come under question. See Song *et al* 2017 and the references cited. The reason that firms might do so, and the consequences, are discussed in Stiglitz 2017a.
[14] See Galbraith (1968).

leave the country in search of lower labor costs. Labor has become commodified. Firms demanded that the US give up one of its main areas of competitive advantage, its protection of property rights and the rule of law, through investment agreements which gave corporations investing abroad even more rights than domestic firms. The adverse effects on workers may not have just been an unintended side effect of globalization; it may have been at the center of the thrust for globalization, as I argue in my forthcoming book, Globalization and Its Discontents Revisited: Anti-globalization in the Era of Trump. (Stiglitz, 2017b)

The overall picture

The national income pie, by definition, can be thought of as being divided into labor income, the return to capital, and rents. A stark aspect of growing inequality is the diminution in labor's share, especially if we exclude the income of the top 1% of earnings, which includes those of CEOs and bankers. But there is increasing attention to the diminution of the share of capital. While there is no clear data source to which we can easily turn, we can make inferences with considerable confidence. For instance, from national income data, we can trace the increase in the capital stock. If anything, the required real return to capital has decreased, as a result of improvements in the ability to manage risk. Thus, the ratio of income to capital, thus estimated, to national income has gone down. If the share of labor income and the share of

capital income have both gone down, it implies that the share of rents must have gone up—and significantly so.[15]

Precisely the same results can be seen by looking at "stock" measures rather than flows. A variety of studies have noted that wealth has increased far more than the increase in capital—so much so that for some countries, the wealth income ratio is increasing even as the capital income ratio is decreasing.[16] This disparity between wealth and the real value of the capital stock consists of a variety of forms of capitalized rents. These include land rents, returns on intangibles including intellectual property, rents firms achieve by exploiting the public purse, either through overpayment on sales to the government or underpayment in the acquisition of public assets, and, most importantly from the perspective of the topic of focus here, market power rents.

Multiple studies have confirmed these findings, some taking a close look at the corporate sector,[17] others focusing on manufacturing.[18] The latter shows a dramatic increase in mark-ups, as one would expect from an increase in market power. Mordecai Kurz of Stanford University has recently shown that almost 80% of the equity value of publicly listed firms is attributable to rents, representing almost a quarter of total value added, with much of this concentrated in the IT sector.[19] All of this is a marked change from 30 years ago.

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[15] Simcha Barchai (2017) has done an excellent job at parsing out the capital share and showing that the decrease in capital share cannot be accounted for by intangible capital.

[16] See Stiglitz (2015).

[17] See Barchai (2017).

[18] See Loecker and Eeckhout (2017).

[19] See Kurz (2017)

Why it matters

The adverse consequences of the resulting inequality are obvious. But there are numerous indirect consequences, which result in a more poorly performing economy. First, this wealth originating from the capitalization of rents, what I shall call rent-wealth, crowds out capital formation. The weak capital formation of recent years is part and parcel of the growth of rents and rent-wealth—leading to economic stagnation. Secondly, with monopolies, the marginal return to investment is lower than the average return—they know that their prices may decline if they produce more—explaining the anomalous result of huge corporate profits but low corporate investment rates, even as the cost of capital has plummeted. Third, the distortions in the allocation of resources associated with market power lead to a less efficient economy. Fourth, in particular, market power has been used to stifle innovation—just the opposite of the claim of the Chicago School. There is evidence of a decline in the pace of creation of new innovative firms, and especially of new firms headed by young entrepreneurs. Fifthly, the ability of these new behemoths to avoid taxation means that the public is being deprived of essential revenues to invest in infrastructure, people, and technology—contributing again to our economy's stagnation and distorting our economy by giving these firms an unfair competitive advantage. Sixthly, with money moving from the bottom of the pyramid to the top, which spends a smaller share of income, aggregate demand is weakened, unless offset by other macro-policies. In the decade since the beginning of the Great Recession, fiscal policy has been restrained and, given those constraints, monetary policy has been unable to fill the breach.

Political economy

I want to return now to where I started: We should be concerned about this agglomeration of market power not just because of its economic consequences, but also because of its political consequences. An increase in economic inequality leads to an increase in political inequality, which can and has been used to create rules of the game that perpetuate economic inequality. Saez and his colleagues have shown that lowering the corporate income tax rate increases incentives for rent-seeking.[20] Large monopoly rents provided greater incentives for lobbying for a low corporate income tax rate. A society—like America—could be trapped in a low corporate tax, high rent-seeking dysfunctional equilibrium.[21] Only political will—and rewriting the rules of the American economy and taking out the power of money from our politics—can move us to a better equilibrium.

The imminent danger to the American economy, with the Republican control of Congress and the Trump presidency, is that we are moving in the opposite direction. While a massive tax cut for corporations and the rich might provide a fiscal stimulus, the unbalanced way in which it would be done would starve the economy of the resources it needs for vital public investment, ensuring that the past lost decade becomes a lost quarter century.

Remedies

[20] See Piketty *et. al* (2014).
[21] See Stiglitz (2017a).

Making markets work—reforming our economy so that it looks more like the competitive market ideal of the college textbook—requires a comprehensive agenda. I have already described how the new high-tech firms have been innovative in avoiding taxes, extracting rents from all sides of the market, and entrenching their market power. We need, consequently, corresponding innovation on the public side.

A short list of reforms would include changes in both regulatory, labor and anti-trust laws and practices, including norms and burdens of proofs. I can't in this brief presentation review all the changes in each of these institutional arrangements that are needed. For a somewhat more extended discussion, see several of the Roosevelt Institute's recent papers on these subjects.[22]

I will focus here on just two issues, globalization and reforms in anti-trust—and even then I can just hint at some of the key issues.[23]

We noted how globalization, as it has been structured, has weakened workers' bargaining power, almost surely contributing to the adverse inequality trends that we have noted. There are two obvious reforms: Large multi-nationals have an unfair competitive advantage over smaller firms because of their greater ability to avoid taxes: this needs to be stopped. And investment agreements, which give foreign firms more secure property rights than domestic firms, and thus encourage the movement of jobs abroad, need to be rethought.[24]

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[22] See in particular, Stiglitz *et al* 2015 and Abernathy *et al* 2016. A particularly invidious aspects of the exercise of power is against minorities. For a discussion of what should be done, see Flynn *et al* 2016.

[23] For a somewhat more extensive discussion, including a discussion of the special issues relating to media and banking, see Stiglitz, 2017c.

[24] See Stiglitz 2017b. Ironically, this is one area where Trump, with his incoherent views on sovereignty, seems to be in agreement.

In the beginning of this talk I noted how anti-trust, which had originally focused on how the agglomeration of power, political as well as economic, undermines democratic societies. Over the last 50 years, anti-trust has been not only narrowed but also weakened. The Chicago School, with its presumption that the natural state of the economy is characterized by an efficient competitive market place has had a particularly invidious effect. Anti-trust has to be rewritten, now that we understand that the "natural" state of the economy is characterized by imperfect markets—imperfect information, incomplete markets, imperfect capital markets, and most importantly, imperfect competition. The "consumer welfare standard" has been shown to lead to a host of abuses. A monopsonist may use its market power to drive down wages and producer prices, passing along some of the benefits to consumers. But society as a whole and workers in particular can be worse off. It should be a violation of anti-trust laws to engage in the abuse of market power, no matter how acquired (as it is in many jurisdictions). The current presumption against predatory behavior needs to be reversed. Pre-emptive acquisitions—acquiring potential competitors before they become a threat—need to be questioned. Firms should be required to present more compelling cases for the efficiency gains from a proposed merger: If share prices go up by more than the claimed savings, there should be a presumption that the gain is from an increase in market power. Conflicts of interest too need to be looked with greater circumspection: Are there really economies of scale and scope, and do they really explain why firms are seeking to expand in the ways they propose? We might have a more dynamic and competitive economy if we proscribe these mergers that give rise to inherent conflicts of

interest; the claimed gains in static efficiency are dwarfed by the long run anti-competitive effects.

Moreover, even if there had been nothing wrong with anti-trust law as it evolved in the second half of the twentieth century (as it applied to the dominant industries then), it is clear that it has not been able to keep up with the challenges posed by the New Economy. Anti-competitive contract provisions that seemingly lead to more market power, such as those prevalent in credit card and airline distribution systems, should be seen for what they are: anti-competitive.

The digital economy presents an especial challenge, as control of information—big data—seemingly provides an opportunity to increase profits not based on standard arguments of greater efficiency, but of a tilted playing field, a greater ability to extract rents from others and leading to ever more concentration of market power. Each individual, in giving up control over his own data, pays little attention to the systemic consequences.

Concluding remarks

America faces a nexus of problems, manifesting itself as slow growth, with the benefits of what limited growth there is going to those at the very top. For a third of a century, the American economy has failed to enhance the well-being of a majority of its citizens. How could this happen to supposedly the most innovative economy in the world? There is no simple answer to problems as deep, longstanding, and pervasive as those I have discussed here. Still, there is a simple lens through which one can come to understand much of what has

happened. We have become a rent-seeking society, dominated by market power of large corporations, unchecked by countervailing powers. And the power of workers has been weakened, if not eviscerated. What is required is a panoply of reforms—rewriting the rules of the American economy to make it more competitive and dynamic, fairer and more equal.

We not only face the problems of understanding and vision, but also a problem of politics. Today, the powerful are more concentrated and have far greater influence over the rules. Organizing the many in a countervailing political force is necessary, but the dynamics are difficult, especially since our political system is now exceedingly weak. On the bright side: We now have more people than ever discussing concentrated market power as a central political and economic problem. As was true at the beginning of the Progressive era, so too today: Much is at stake—not just the efficiency of our market economy, but the very nature of our democratic society.

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