Elite Rent-Sharing and Income Inequality in the United States, Russia and China

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Motivating observation: income inequality is *high* and *similar* in Russia, China and the United States

WID: Pretax top 1% share is .2 in US, Russia; 13.9% in China;
Top decile share is 47% in the US, 46% in Russia, and 41% in China
All are outliers among peer countries
Higher than all but a few countries in world (eg Middle East oil kingdoms)
Wealth inequality still more extreme:
Bottom half share = -.13% in US; 3.5% in Russia; 6.4% in China
Sharp increase in inequality since late 1970s—trend common to most countries, but US, Russia and China have more *extreme growth* of inequality than most

A puzzle! Very different economic systems, starting points in recent development; similar U-shaped trend in inequality—but more extreme growth than nearly all other societies.

Why?

Basic argument: rents generated in course of early liberalization enable "early winners" to lock in gains through alliance with vulnerable, strategic politicians.
Coalition cuts taxes, weakens labor, tolerates rise of industry concentration.
Rents from reduced competition are shared between corporate and political elites
And feed inequality (hold down low-end wages, let high-level managers, owners capture larger share of profits)

Why care?

High and rising inequality harms social cohesion (Easterly 2001; Payne 2017; Marmot 2005; Wilkinson and Pickett 2009)

In democracy, fosters polarization and anti-democratic backlash movements (Edsall 1984; Stiglitz 2012, 2016, 2019; McCarty, Poole and Rosenthal 2016; Kuttner 2019;)

In non-democratic regimes, invites use of coercion to suppress opposition that poses a redistributive threat (Acemoglu and Robinson 2006; Boix 2003)

Over time, reduces social mobility and equality of opportunity (Chetty et al. 2014, 2017; Reardon 2011; Reardon and Bischoff 2011; Corak 2013)

Damages the prospects for sustained growth (Berg and Ostry 2011; OECD 2011; Alesina and Perotti 1996)

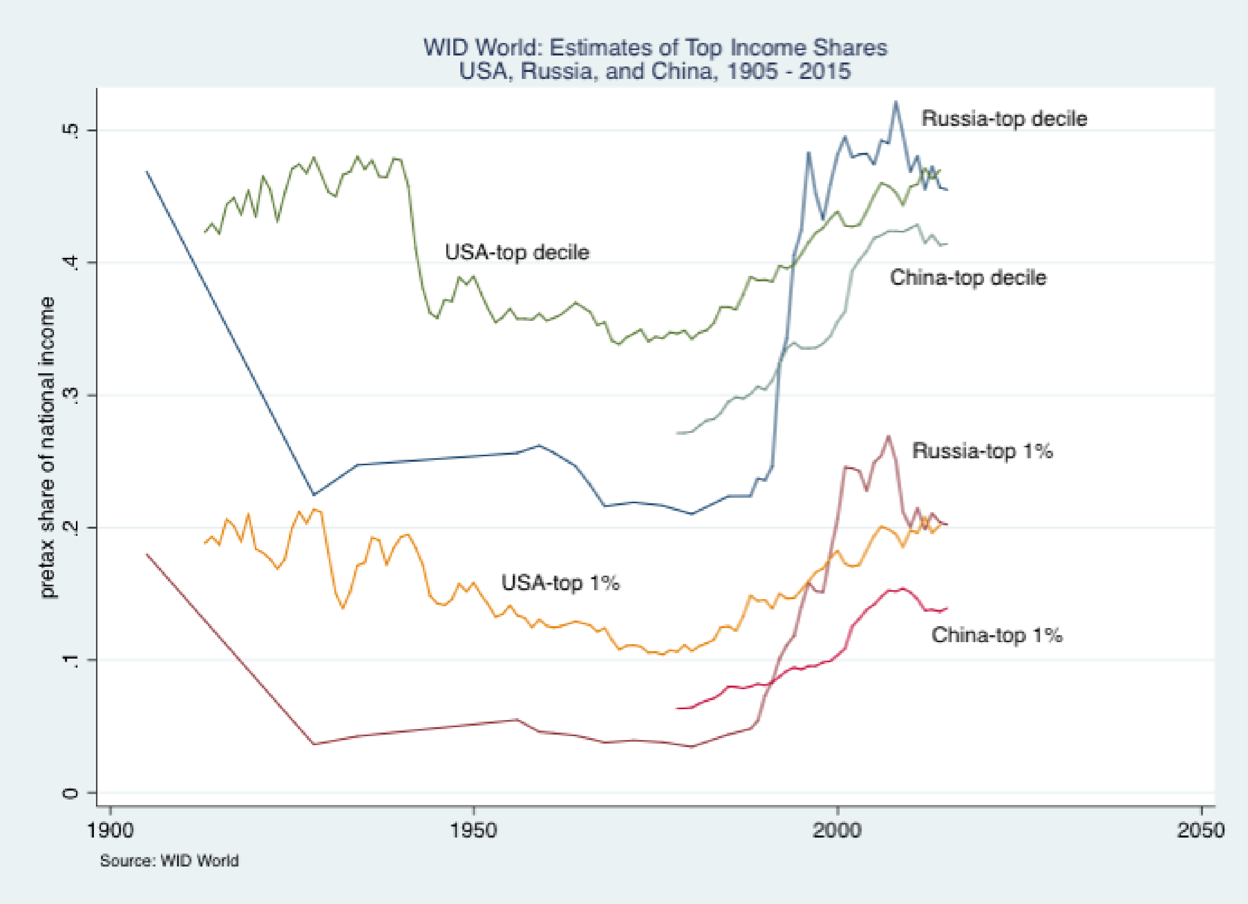
For American democracy, threatens promise of political equality (Jacobs and Skocpol 2005; Sitaraman 2018; Bartels 2016; Hacker 2005; Hacker and Pierson 2010; Schlozman, Brady and Verba 2018; Soss, Hacker and Mettler 2007; Dahl 1961, 1982, 2007)

WID World estimates of top income shares (pre-tax)

Modestly progressive tax system reduces share of post-tax income in US a little, not in Russia or China
Hidden incomes go primarily to top in all 3 countries

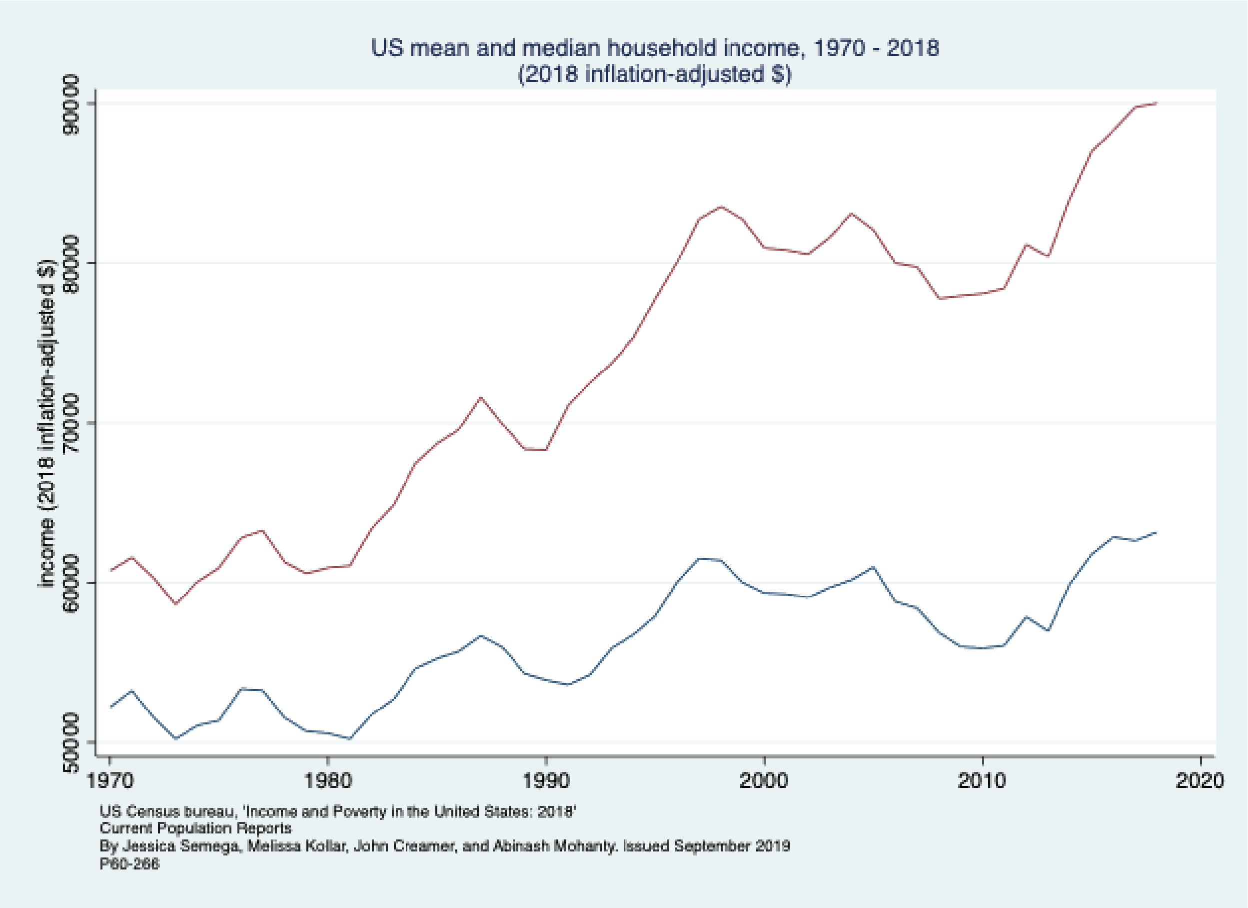
NB: Russia and China: perhaps 60% of hidden income goes to top decile)
(Braguinsky et al. 2014; Wang Xiaolu 2010).

Similar estimate for US though share of hidden income much lower (Slemrod and Johns 2010)



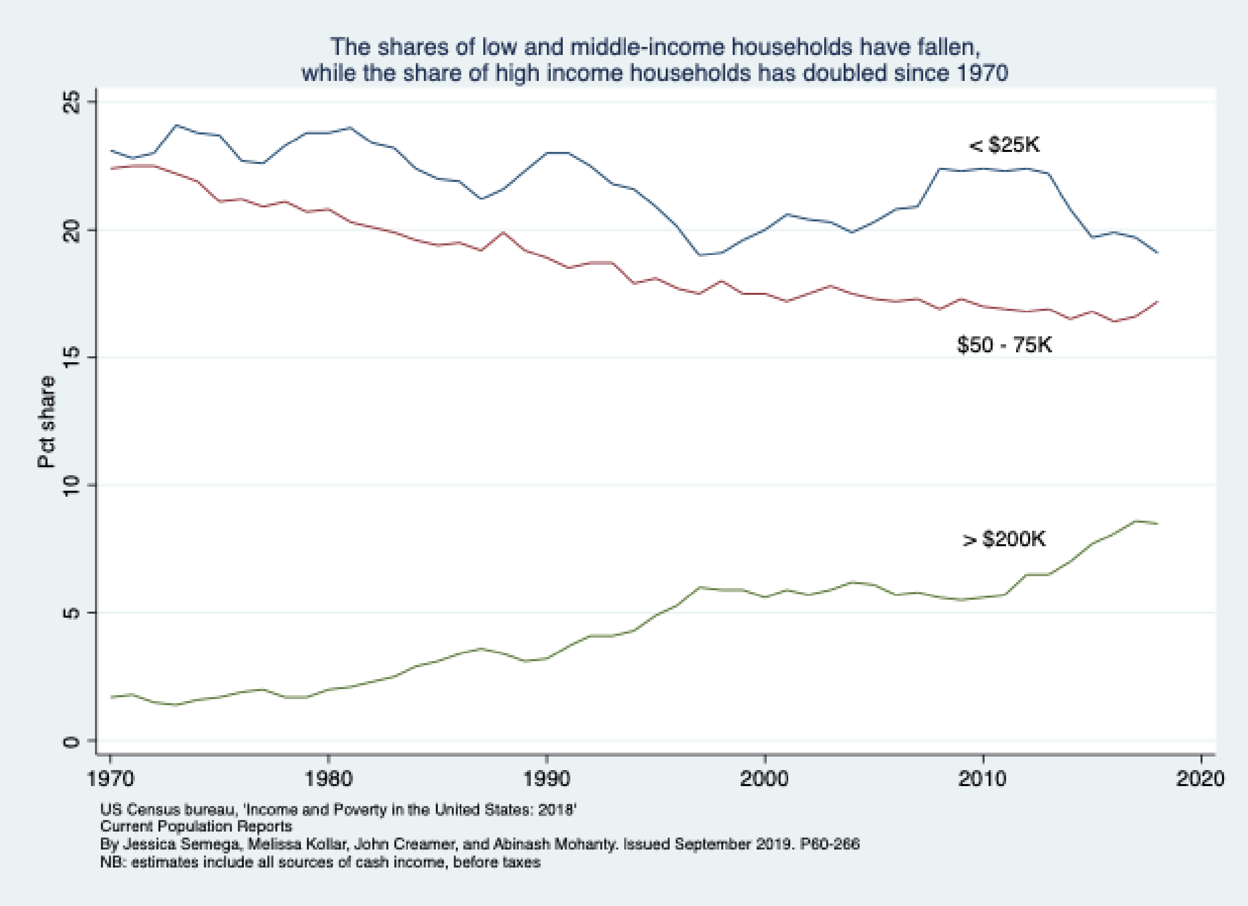
US: income gains go to top, driving up mean;

median income has risen much less (in constant $).

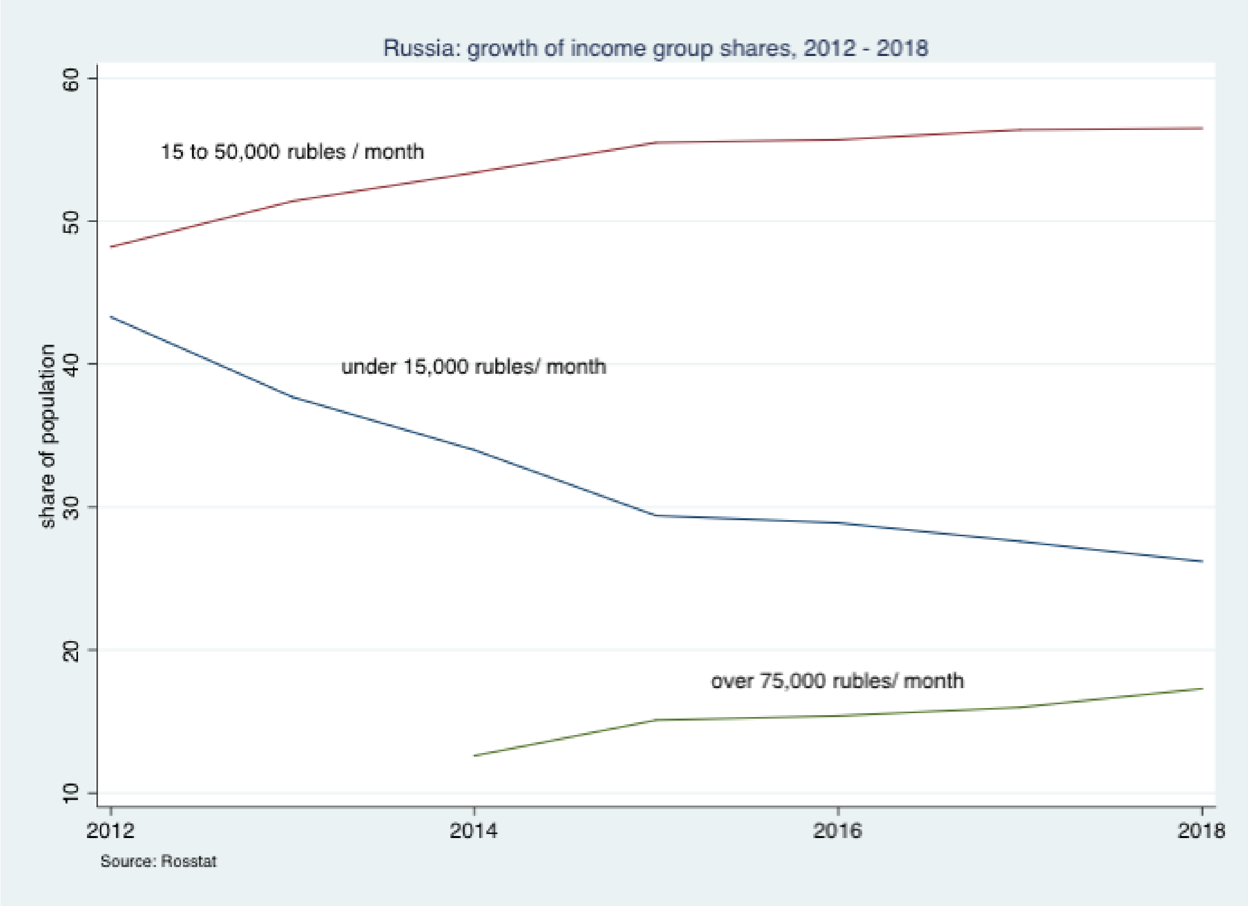


US: decline in shares of low and middle-income households;
big rise in share of high-income households

Ie shrinking middle class.



Russia: slight growth of share of households in middle income brackets; decline in share of households; more rapid increase in share of households in top third of distribution.



Explanation: Rent-seeking + rent-sharing between managers of market-dominating firms and their political allies.

Rent streams result from reforms enacted from the late 1970s in the US and China, late 1980s in Russia:

- Lax enforcement of competition regulation;
- Policies weakening labor's collective bargaining power,
- Tax cuts that favor the highest-income brackets.

Here I will concentrate on the first issue.

The market reform package:
- Lifting of price controls in many markets;
- Opening competition in product markets by eliminating restrictions on market entry and reducing regulation
- Reductions in state provision of social protection and public goods
- Privatization of many public services.
- In US: major tax cuts on personal and corporate incomes.
- In Russia and China large-scale privatization of state assets and the legalization of private enterprise.

Early fallacies of reformers.

“Getting property rights right” did not induce competition in Russia; absence of property rights in China did not Inhibit entrepreneurship; public and private oligopolies may have similar incentives to restrict competition.

Private owners do not necessarily have an incentive to maximize value of assets
—may prefer to seek protection from government;
Property rights regime is not endogenous to self-interest of private owners

Raghuram Rajan: “when we have to choose between competition and property rights, we should invariably choose competition.” (Rajan, *The Third Pillar*, 2019)

William Lewis: “the Washington Consensus about good economic policy profoundly underestimated the importance of a level playing field for competition.” (Lewis, *The Power of Productivity*, 2004)

Alternative perspective: “Ordo-liberalism” (Eucken; Böhm; Ludwig Erhard): strong government needed to enforce Market competition, market competition needed to drive growth; all strata of society should share in benefits of growth; Market economy serves social justice → “social market economy”

Proof of concept: development of FRG since 1945; post-unification development of Germany

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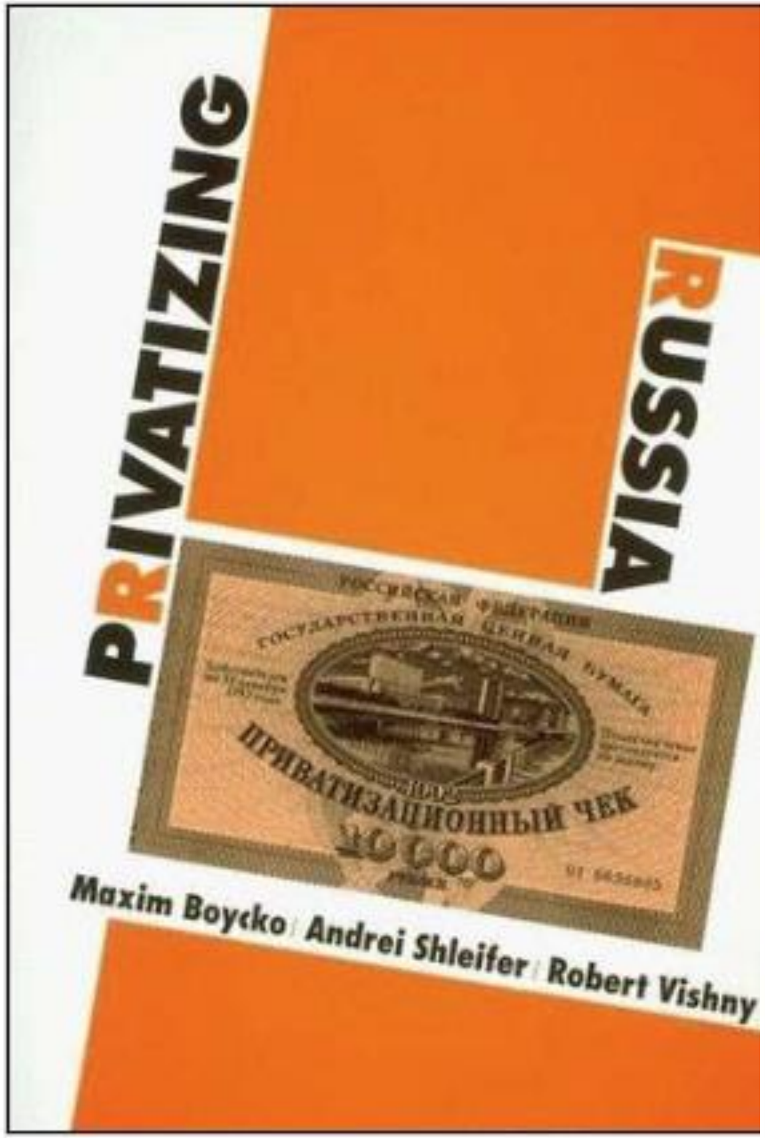
So why did no reformers or economists in the post-communist world refer to German experience??


PRIVATIZING RUSSIA
ПРИВАТИЗАЦИОННЫЙ ЧЕК
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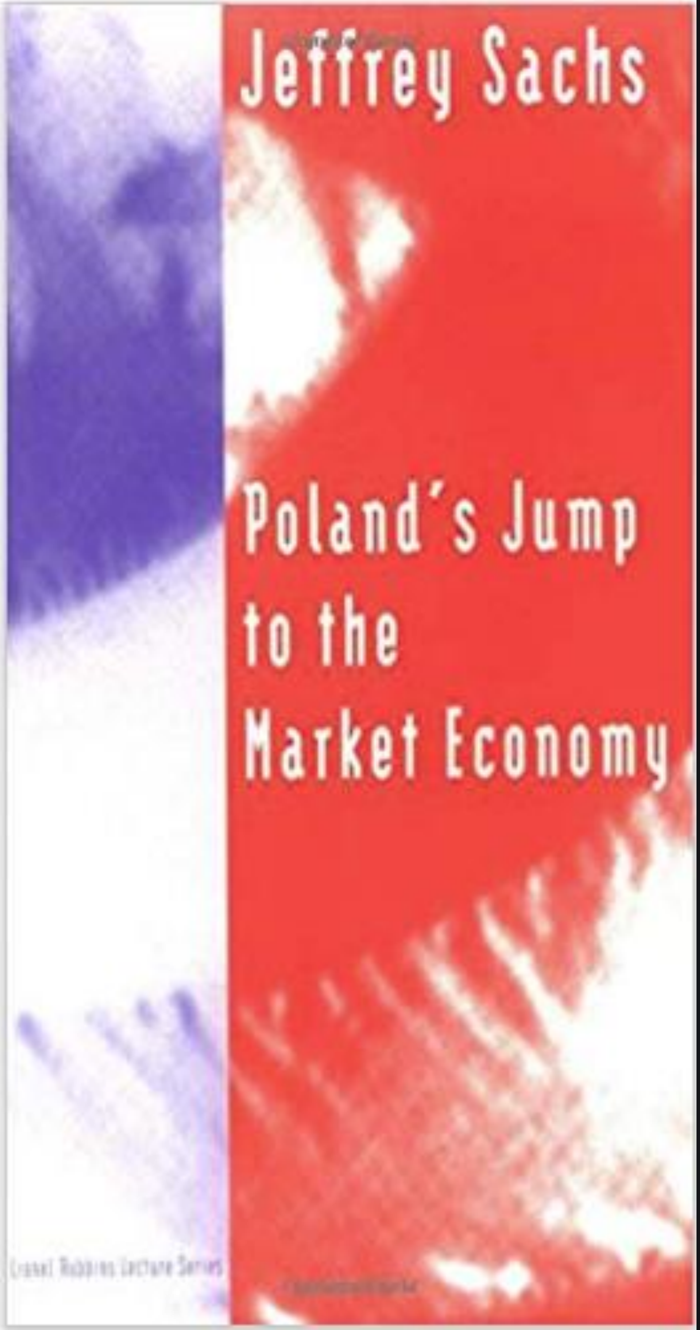
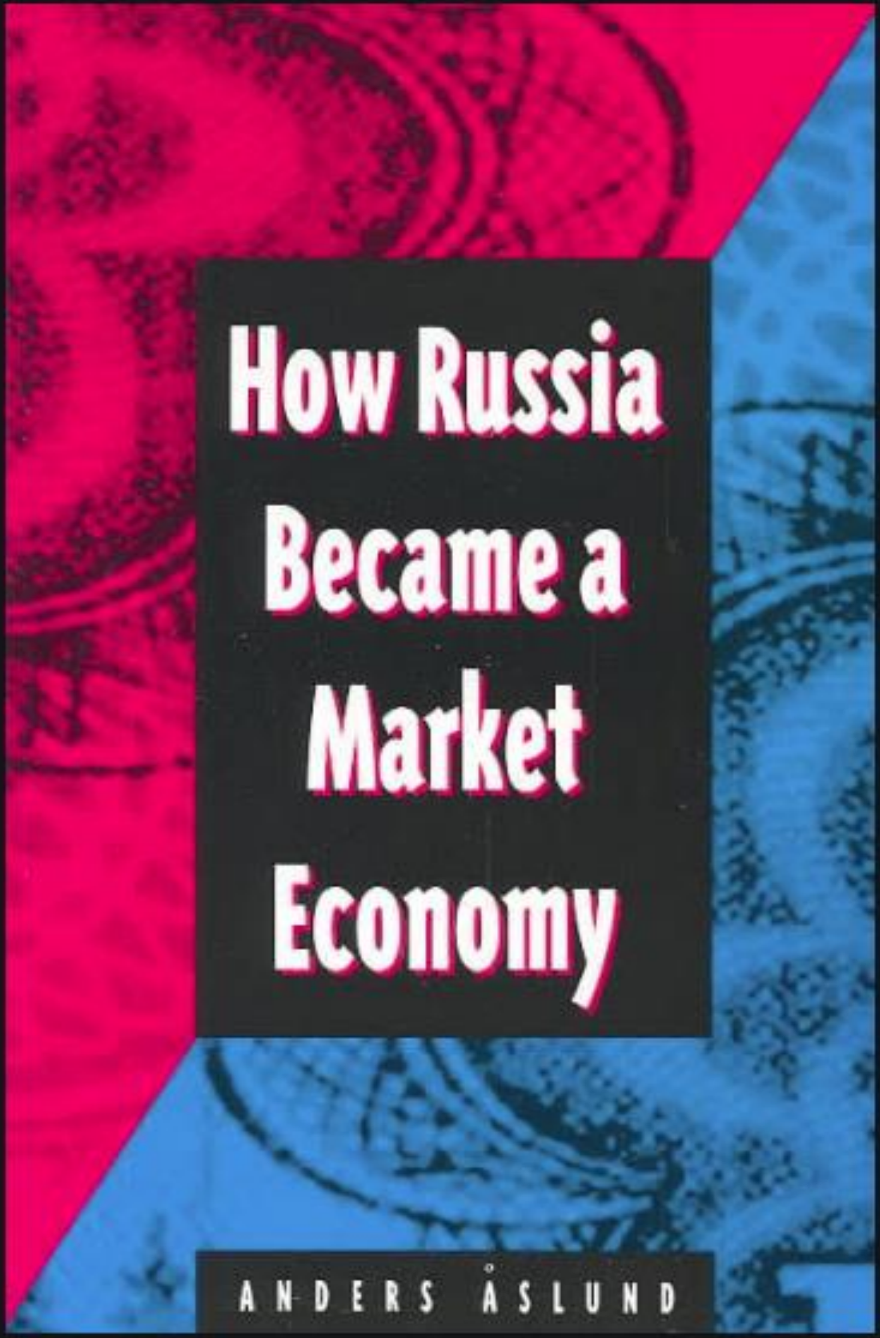
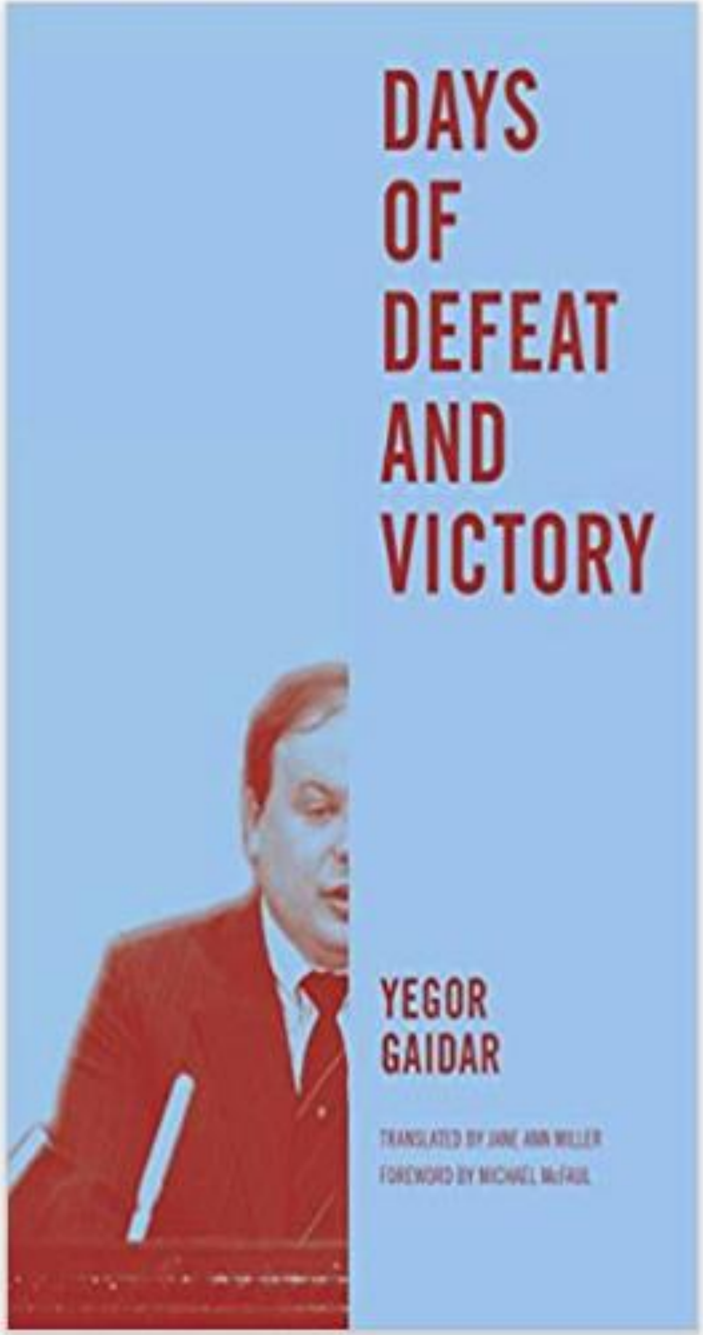

Jeffrey Sachs
Poland´s Jump to the Market Economy
Lionel Robbins Lecture Series


How Russia Became a Market Economy
ANDERS ÅSLUND


DAYS
OF
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GAIDAR
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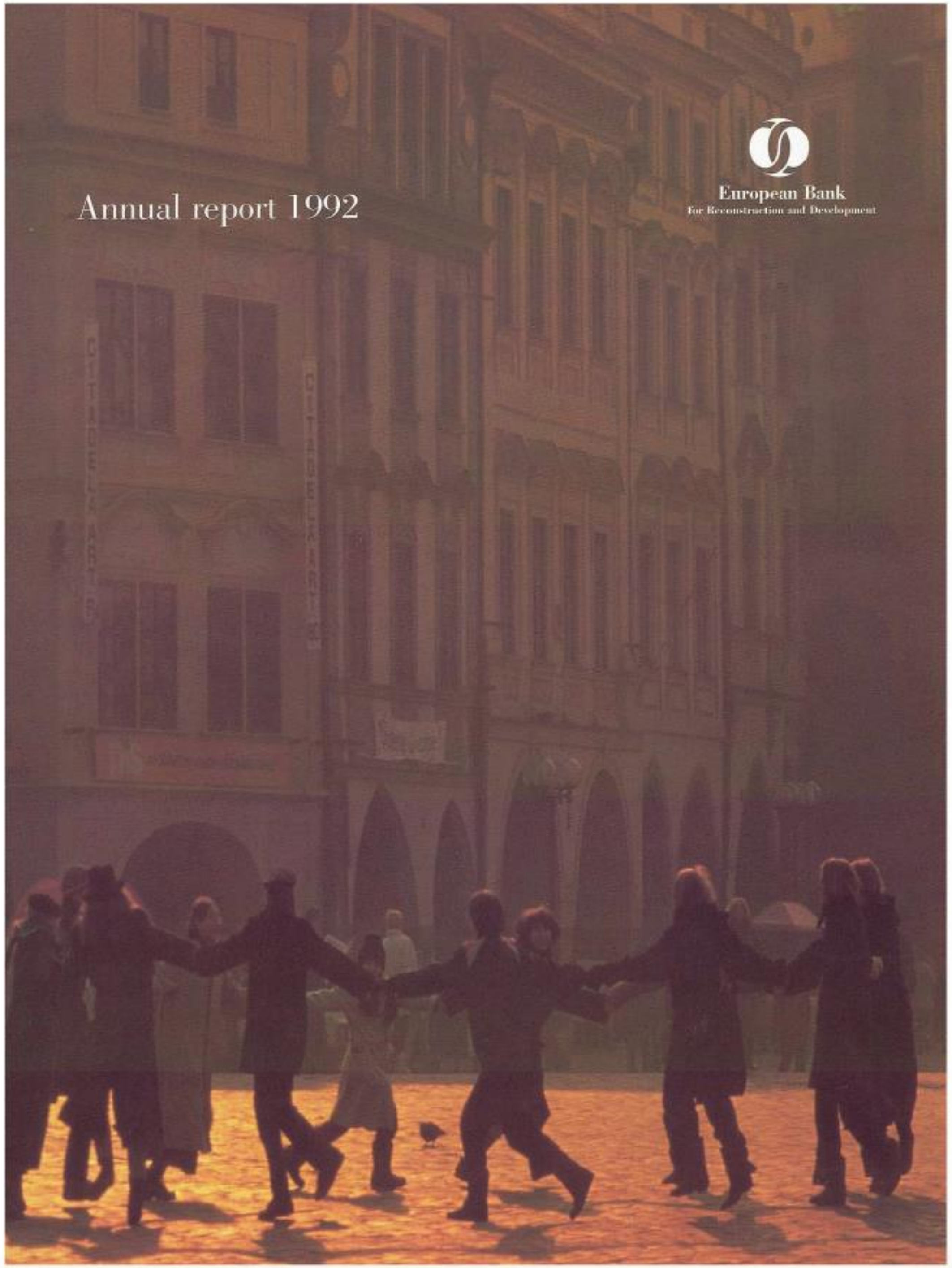
FOREWORD BY MICHAEL McFAUL


Annual report 1992
European Bank
for Reconstruction and Development


WITHOUT A MAP
Political Tactics and Economic Reform in Russia
Andrei Shleifer
Daniel Treisman

The argument builds on Hellman (1998): “Winners Take All”

Partial liberalization let a small group of powerful insiders cash in using market advantages;
Then used power to block further liberalization and competition;
Allied with political leaders to capture rents
Trapped liberalization in “partial reform equilibrium”

Frye: “elite exchange:” big business interests got influence over policy in return for providing benefits to policy-makers

Chinese variant: incremental reform let to powerful SOE monopolies with insider connections to party leaders;
provide revenues to government in return for protection from competition; yields high incomes, much of them hidden

Russian privatization

Privatization to precede deconcentration: tight money, price deregulation, property rights would induce competition. Leitzel (1994): “industrial concentration is not an important reform issue, irrespective of its detrimental impact on the Russian economy…with free enterprise, barriers to entry will largely disappear.” Market reform would do “much of this work automatically.” Big firms might seek protection from privatization, but more likely they were seeking “better terms for privatization.”

Joskow et al. (1994): “it has been important to get enough of the economy out of the hands of the state to create an effective constituency for further reform.” Further reform would induce a competitive dynamic, mitigate monopoly.

Once the oligarchs had established a sufficient degree of ownership and control over their assets, they would raise the productivity of their firms and even advocate for the rule of law (Boone and Rodionov, 2010).

In fact, market domination increased. High regional monopoly/ oligopoly.
1997: the average four-firm concentration ratio (CR4) at the oblast’ level was over 95% (Broadman 2000).

Owners did not generally raise productivity. Preferred concentration, asset stripping.
The more the more concentrated the ownership of a firm, the lower its productivity and performance (Filatochev et al., 2001). Inverse correlation between profitability and productivity (McKinsey 1999).

FAS: preferred approach to price inflation was price controls.

China: partial reform equilibrium

Rapid rise of TVE in 1980s, began to pose competitive threat to SOEs (Naughton 1995).

Market reformers forced to compromise with conservatives, preserve SOE enclave;
Result: bifurcated economy (state sector, private sector)
SOE's provide multiple political benefits to regime

Hon Chan: "the lack of competitiveness of Chinese public enterprises is the result of the implementation of the strategic choices and policies that maintain the preponderance of the key business sectors and core SOEs. The managerial performance of SOEs does not really reflect their market contestability….China's SOE managerial system unifies government and business and fuses economic power with administrative power" (2009).

Ren and Zhou (2009): 65% of total income gap across industrial branches due to monopoly and partial monopoly

SOEs protected from failure since ~2009 (Estrin & Prevezer 2010; Duan and Saich 2014; Sheng Hong 2013)

Anti-Monopoly law largely directed against foreign companies (Wang 2014)

Sectors where state enterprises dominate—oil & gas, rr's & telecom's—have high industrial concentration (Duan & Sach 2014)

The Reagan Revolution

Early round of deregulation starting in late 1970s; then stepped up under Reagan:
Lifted restrictions on prices, wages, and market entry in: trucking, electric power, telecommunications, banking, airlines.
Immediate impact: in the first five years after the 1978 Airline Deregulation Act, the number of certified airlines tripled.
Trucking: no. of certified carriers doubled in 10 years.
AT&T –the largest company in the world, > 1 million employees—broken up into 7 "Baby Bells."
Accompanied by broad doctrinal shift among policymakers, judges, and economists in favor of relaxing government regulatory restrictions on businesses more generally. (Hacker 2004; Hacker and Pierson 2010; Bartels 2008; Wood and Anderson 1993; Eisner and Meier 1990; Niskanen 1989; Card 1996; Teles 2008)

Competition quickly gave way to mergers, re-concentration
--Many firms filed for bankruptcy or were bought out;
Banking: after 1982 banking law, S & L's allowed to compete with commercial banks, using federally-guaranteed depositors' money; then > 700 failed, were bailed out by federal government ($130 billion from fed budget + $370 billion from private sources) (Stevenson 1996; Sherman 1999)

Similar pattern after 2008-2009 crisis. Federal government bailed out "systemically important" financial institutions
Example: AIG got $182 billion bailout, then paid top managers $165 million in "retention bonuses"

The winners collected the benefits of deregulation, while the costs were shifted to the general public!

The Demise of Antitrust

"Chicago School" theories embraced by conservatives, Republicans; eg Robert Bork, Th*e Antitrust Paradox* (1978);
very influential:
monopolies not dangerous because new entrants constantly threaten to dissipate monopoly rents thru competition;
therefore only "productive inefficiency" should be target of antitrust, not "allocative inefficiency"

Consumer welfare the only legitimate criterion for antitrust enforcement.

1982: new guidelines on control of mergers. Peltzman (2014): "the war against mergers was over, and Bork won"

As share of all proposed mergers, those subjected by DOJ review fell > 10X from 1985 to present (Xiao 2019)

Politicians' Strategies

Politicians more than *auctioneers*; are strategic agents, ie help solve corporations' collective action problems;
→ Exchange of benefits, rents for policy favors

Vulnerable politicians form coalitions with "early winners" of reform; coalition becomes self-reinforcing.

Rents: natural resources; technological; administrative. Dealing with administrative rents here.

Vulnerable politicians: in all 3 countries, liberalizers faced risk, opposition

In 1970s, US business felt besieged, threatened by business scandals, social protest. Sought political allies
Eg Lewis Powell memo (1971):

"The American economic system is under broad attack….Business must learn the lesson. . . that political power is necessary; that such power must be assiduously cultivated; and that when necessary, it must be used aggressively and with determination-without embarrassment and without the reluctance which has been so characteristic of American business….Strength lies in organization, in careful long-range planning and implementation, in consistency of action over an indefinite period of years, in the scale of financing available only through joint effort, and in the political power available only through united action and national organization." (from Hacker and Pierson 2010)

Reagan: average approval rating over 8 years = 53%; Republican Party id in 1979 = 21%; Reagan margin 1980 = 50.75%

Deng Xiaoping

Continuous intra-party factional conflict, dominated by reformers vs. conservatives

Deng & Zhao Ziyang (Deng's successor as leader) blocked from comprehensive price reform, would have required all SOEs and private enterprises to compete on level playing field, ie exogenous market-set prices (Shirk 1993; Naughton 1995)

Instead, accepted dual economy

Tiananmen protests, violent suppression → sidelining of reformers until Deng's "Southern tour" in January 1992

--compromise outcome: no more political reform; partial economic reform; SOEs won more subsidies, protection

SOEs very influential (eg major role in drafting anti-monopoly law)

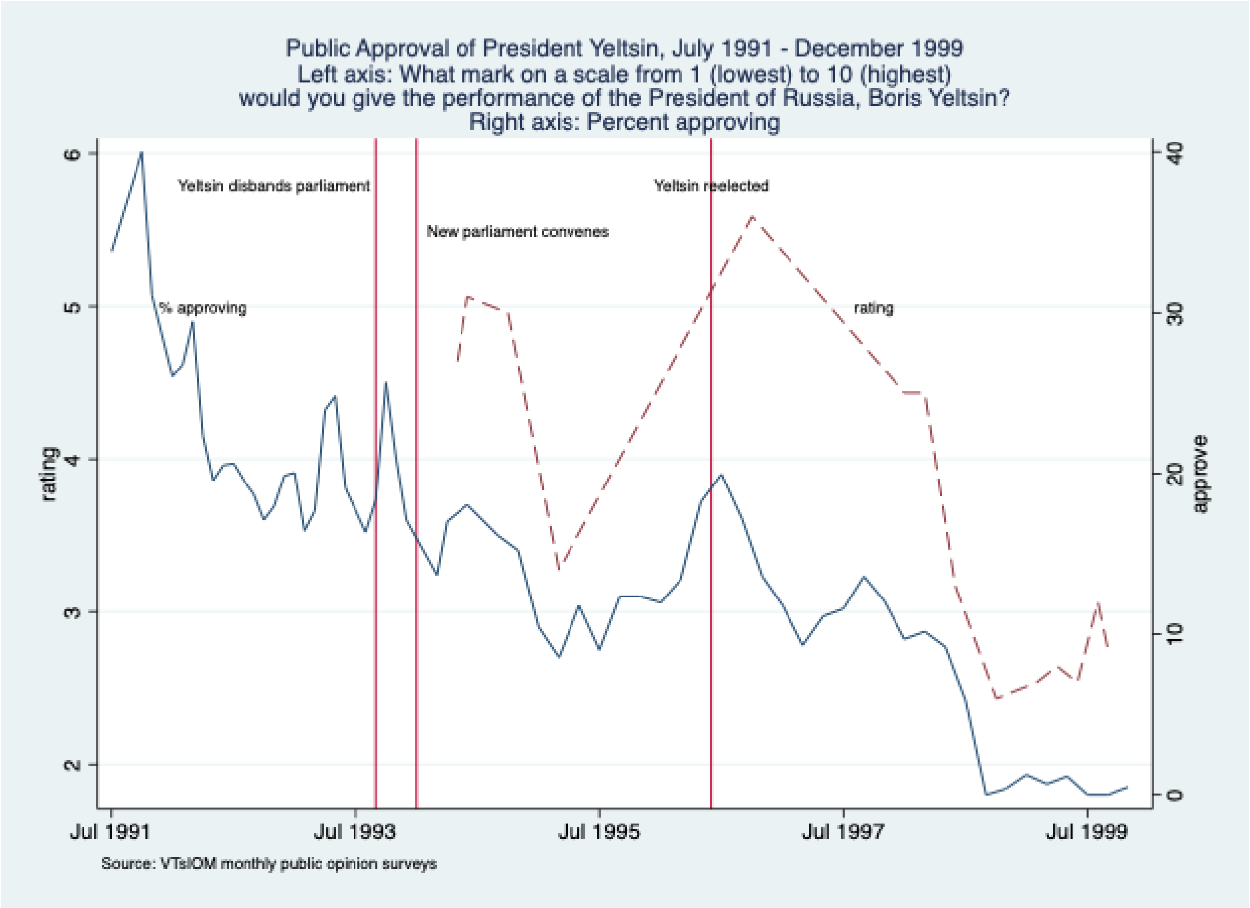
Yeltsin: Oligarchic pact
1995-96, loans for shares.
Early 1996: Chubais: “Boris Nikolaevich, your popularity is zero” → “semibankirschina”

Berezovsky 1996: “We, the seven richest businessmen, invested enormous money in Yeltsin’s election campaign, hired Chubais as its manager, and ensured the victory. Now we must harvest the fruits of our victory and occupy key posts in the government….”

“I think two types of power are possible. Either a power of ideology or a power of capital. Ideology is now dead, and today we have a period of transition from the power of ideology to the power of capital.”

Putin 2000: Kremlin meeting with corporate leaders: New rules for business-*vlast’* relations:
- property rights secure;
- no interference by oligarchs in high politics;
- invest profits in Russia.

Oligarchs to join RUIE for “civilized lobbying”



Concentration, Competition, and Rents: US vs. Europe

Market concentration in US economy rising; competition declining; market power raising income inequality (Baker 2017; Grullon et al., 2017; Raurich et al. 2012: DeLoecker and Eeckout 2017; Furman and Orszag 2015; Khan and Vaheesan 2017; Bivens et al. 2018; Autor et al. 2017; Wu 2018; Tepper and Hearn 2018; Baker and Salop 2015; Baker 2003; Peltzman 2014; Benmelech et al. 2018; Gans et al. 2018; Qiu and Sojourner 2019)

Contrast to EU competition policy: as antitrust enforcement in US weakened, EU competition policy grew more active (relieves national governments of some lobbying pressure) (Gutierrez and Philippon, 2018)

EU competition policy curbed industry concentration, profit levels, stimulated innovation, productivity growth (Gutierrez and Philippon 2018; Dierx et al. 2017)

OECD study: market power significantly associated with higher income inequality (Ennis et al., 2017)

Siegenthaler and Stucki 2015: Higher competition in industry associated with higher labor share:
"The size of the rent is determined by the firm's markup power, that is, its ability to charge a markup over prices."

Concentration, Competition, and Rents: China

Ren Zhong and Zhou Yunbo (2009): monopoly or partial monopoly status of state enterprises is associated with about 65% of the difference in average wages across industry branches.

Yue, Li, and Sicular (2011): over half the wage gap between monopoly and competitive industries is due to the administratively granted monopoly status of state enterprises rather than other individual worker and branch characteristics: “The source of high incomes in monopoly industries is imperfect competition.”

Zhang Yuanyuan and Lin Zhaonong (2014): “Monopoly is the fundamental factor that causes wage differentials in industry.”

Ximing Yue and Meng Cai (2016) ~two-thirds of the wages of highly paid managers and workers in state monopoly industries derives from monopoly rents.

Concentration, Competition, and Rents: Russia

Much of heavy industry has seen growth of concentration: C4 ratios:

Mineral extration: 40%
Pharmaceuticals: 60% of production of basic components
Natural gas: ~100% for Gazprom
Bauxite: ~100% for Rusal
Cement: 44%
Steel pipe: 95%
Iron ore: 70%
Paper & cardboard: ~100%

Igor’ Artem’ev (head of Russian FAS): “There has been no progress in developing competition in Russia; in some areas, things are getting worse...this due to the statification of the economy and the creation of state-monopoly capitalism, the interweaving [*srashchivanie*] of business and state.” (2018)

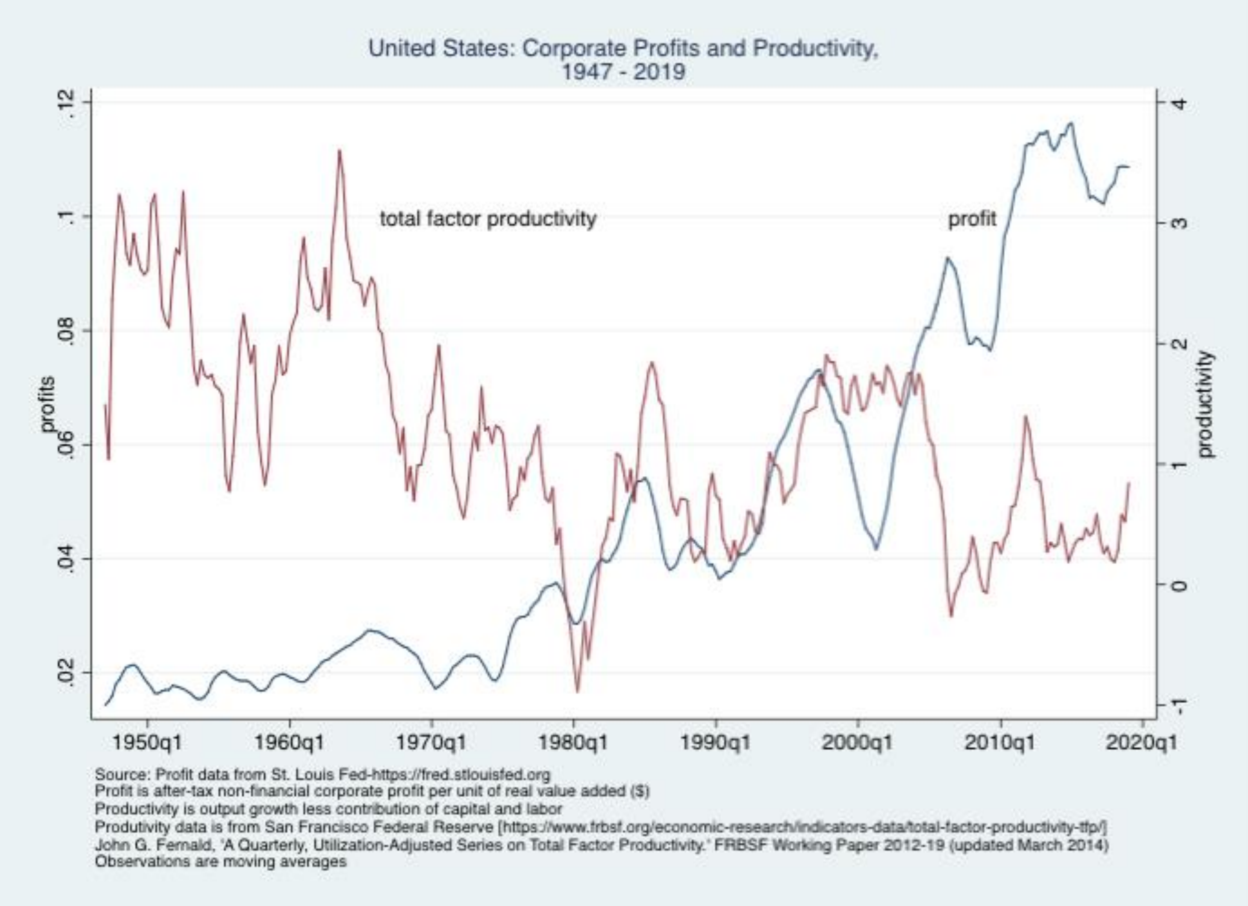
CEO pay: ratio of CEO of a top-50 private company to average wage in economy = ~500

Sechin on pay for Rosneft’ executives and board members: “the scale of income of our top-managers corresponds to the level of large Russian companies and must be comparable to the level of world companies, otherwise we will face an outflow of qualified cadres” (Podobedova and Telegina 2015)

All three countries: lower competition raises profits, markups, but reduces productivity.

US: total factor productivity (output growth less contribution of labor and capital) vs. profit (after-tax profit per unit of value-added, non-financial institutions)

(Highly aggregated figures—conceal wide variation across firms)



Rent-sharing

”Early winners” sought protection from risks of failure, benefits of domination

Grier, Munger, Roberts (1994): 1978 – 1986 period—corporate PAC spending almost tripled ($8.8 million to almost $25 million, 1988 $); oil industry especially active, ideologically motivated (Evans 1988)

Hill et al. (2013): firms that lobby realize higher 1.4% return, compared with equivalent portfolio of investments (exclusive of returns to campaign spending)

Center for Responsive Politics: 2017-18 political cycle: business contributed 2/3 of all campaign contributions; labor 4%; likewise lobbying: 2018 total spending $3.42 billion, 1.4% from labor

Quantifying direct effects of rents on inequality

1st: what is share of rents in GDP?

2nd: how are rent incomes distributed?

3rd: what is net effect of rent income distribution on aggregate inequality?

Quantifying direct effects of rents on inequality

1st: what is share of rents in GDP?

Khan and Vaheesan (2017): concentration of markets yields rents equivalent to 15-25% of revenues, net of efficiency loss to society

De Loecker and Eeckhout (2017): average firm's prices in 2014 were 67% higher than marginal cost; was 18% in 1980; increase driven by firms already possessing market power

Raurich, Sala and Sorolla (2012): average markup in US = 35%

Relationship between markups and share of rents in GDP =
$(Y - (wL + rK)) / Y = (m-1)/m$
Y = GDP; wL = cost of labor (wage unit per unit of output times employment (L)
rK = rate of rental on capital, ie interest rate
m = markup

If markup rate is .35: $(1.35 - 1) / 1.35 = .26$

(If markup rate is .67: $(1.67 - 1) / 1.67 = .4$)

Quantifying direct effects of rents on inequality

2^{nd}: how are rent incomes distributed?

Income distribution follows power law distribution
Pareto parameters (α and β)

(α and β) are mathematically equivalent. $\beta = \alpha / (\alpha - 1)$ and $\alpha = \beta / (\beta)$.
A higher β implies a longer tail of incomes at the top.
β represents the ratio of the average income of those above a certain income threshold to that threshold.
If β = 2, then the average income of those receiving \$1 million is \$2 million.

β has risen over time: from 1.69 in 1976 to 2.89 in 2007 as income shares have risen faster at each successively higher segment of distribution:

	1975	2017	Growth
top decile	32.62	47.88	0.47
top 1%	8.01	18.34	1.29
top .1%	2	7.9	2.95
top .01%	0.56	3.4	5.07

Quantifying direct effects of rents on inequality

3rd: what is net effect of rent income distribution on aggregate inequality?

Crude back-of-the-envelope calculation:
Suppose rents = 25% of the economy and 60% of rent income →top decile (ie equivalent to distribution of "hidden incomes" in US, China, and Russia)

That implies that .6 * .25 of the income of the top decile, or .15, is the share attributed to rents.
.4 * .25, or, .1, is the share of incomes of the bottom 90% attributed to rents.

Calculate contribution of rent income to Gini index using a Pyatt decomposition method.
Compare Gini in the 2016 US Micro-Census data (post-tax incomes) with a hypothetical distribution where we deduct 15% from the incomes of the top decile and 10% from the incomes of the rest by 10%,

Gini index falls from .442 to .433, or about 2%.

If the share of rent incomes at the bottom is lower, or even negative, rent incomes' contribution to overall inequality would be higher.

Alternative perspectives

Does inequality reflect differential returns to human capital?

Consider the composition of the top 1% in US:

Smith, Yagan, Zidar and Zwick (2018): 69% of top 1% of income earners own pass-through companies, eg S-corporations (pass-throughs treat profits as income; Smith et al. treat 75% of this as labor income).

S, Y, Z & Z say: 53% of this income reflects returns to human capital, defined as professional skills, personal networks, reputations, and “rent-extraction ability” (presumably including corrupt & cronyistic ties)

Highest profits in 2014 of pass-through companies were in: enterprise management; financial investment; automobile dealers; other professional and technical services; oil and gas extraction

Significance: automobile dealers heavily protected by state-level regulations protecting them from competition from direct sales by manufacturers to customers. Auto dealer associations highly influential at state level—much more so than auto manufacturers. Have pushed through prohibitions on direct manufacturer sales in every state.

Pure rent-seeking! Hard to call lobbying clout of dealers’ association “human capital”

Germany: the path not taken

Ordo-liberalism

Developed from Freiburg School in 1930s, reaction against Naziism, fascism, cartels, socialism, Austrian liberalism

Walter Eucken, Franz Böhm as major architects of the philosophy

Principles: economy always embedded in a social order framed by law and state power; law and state power must ensure competition in marketplace, prevent concentrations of economic and political power; laissez-faire ≠ competition; market competition should drive growth, productivity; benefits of growth should be shared by all strata; hence market system should serve social justice → "social market economy"

Ludwig Erhard applied Ordo-liberal principles to German postwar economic recovery
-- ran economic policy in Bavaria 1946; Bizonia 1947-48; FRG Economics Minister 1949-63; Chancellor 1963-66

"I regard the development of competition as the best guarantee both of a continuing increase in efficiency and of a just division of the national income."

"Competition is the most promising means to achieve and to secure prosperity. It alone enables people in their role of consumer to gain from economic progress. It ensures that all advantages which result from higher productivity would eventually be enjoyed." (Erhard, *Prosperity through Competition*, 2011)

Germany: natural experiment: unification after 1990

Why no oligarchs in East Germany?

Role of Treuanstalt—disposed of > 12K SOEs in DDR; > 8K were privatized, mostly by West German firms (Mittelbach 2005; Kettler 1997; von der Heyden 1995; Webber 1994)

Huge cost—net transfer of wealth from West to East, ~ 5% of West German GDP/ year in early 1990s;
Lingering difficulties, resentments

Huge volume of layoffs (manufacturing employment fell ~ ¾) (Webber 1994)
Productivity < 1/3 that of West German levels
Public expenditures = ~ 80% of East German income;
Welfare spending on unemployment insurance, labor market support ~20% of income

But inequality hardly budged:

Distribution of disposable household equivalent encome, West and East Germany, 1990-1993

	Gini	bottom quint	2nd quint	3rd quint	4th quint	top quint	poverty--50% line
West Germany							
1990	0.185	11.8	15.8	19.2	22.9	30.2	3.4
1991	0.198	11.3	16.1	18.9	22.3	31.2	4.4
1992	0.2	11.1	15.9	19.1	22.5	31.3	5.9
1993	0.216	10.6	15.5	18.8	22.7	32.4	7.3
East Germany							
1990	0.267	9.4	14	17.7	22.5	36.4	10.9
1991	0.263	9.5	14	17.8	22.8	35.9	10.7
1992	0.264	9.5	14.1	17.7	22.8	35.9	10.1
1993	0.274	9.2	13.8	17.7	22.8	36.5	11.5

Source: Richard Hauser, "Problems of the German Welfare State after Unification," *Oxford Review of Economic Policy* 11:3 (Autumn 1995), p. 52.
Household equivalent income is defined by the criteria used by the German social welfare system.
A head of household is equivalent to one; children to fractions of 1, according to age. The poverty line is defined as 50% of mean net personal income.

Industry concentration also did not increase following unification:

Source: Monopolkommission, Hauptgutachten XXII: Wettbewerb 2018. Kapitel II. "Stand und Entwicklung der Unternehmenskonzentration in Deutschland" (Germany: 2019), pp. 93-4 .
[http://www.monopolkommission.de/images/HG22/HGXXII_Kap2_Unternehmenskonzentration.pdf]

Conclusions

1. Neo-liberal theories thought post-communist reform in Russia and China would stimulate productive investment & competition once private property rights were secure; but failed to foresee that ”early winners” would use political means to preserve existing monopolies, share benefits of market power with political allies

2. Private property rights cannot be treated as both exogenous to market competition and endogenous to it
   --(ie don’t blame poorly aligned property rights for failure of reform if you also thought reform would induce incentives to get property rights right)

1. Anthony Atkinson: “the government’s actions cannot be treated as purely exogenous” (1997)

2. Dahl: dispersion of economic and political resources a necessary condition for democracy; given system of private property and market relations, social and economic inequalities are converted into political inequality

3. Possible solution: pluralism, ie a system of “dispersed inequalities” – competing organizations, associations, power centers prevent concentration of resources. But may not be sufficient answer to problem of cumulative inequality of resources. High concentration of income + wealth, low competition in economic & political arenas → oligarchy.

Schematic summary of argument:

1. Vulnerable politicians launch liberalizing reforms
2. Economic “early winners” concentrate gains from commercialization, privatization, deregulation
3. Vulnerable politicians form coalitions with early winners.

4. Policy outcomes: cut taxes, spending on public goods; reduce collective bargaining power of labor; lift barriers to market concentration

5. Economic outcomes: greater opportunity for rent-extraction; branches with highest rent extraction ability raise mean, top wages; managers convert market rents to higher wages at top, eg through enhanced bargaining power over own wages; managers keep low-end wages low

Coalition of managers and politicians: sustained by rent-sharing, eg recycling of rents to legal and illegal campaign contributions and other measures to support politicians; suppresses potential challenges from opposition forces; propounds ideologies of “free market economics,” “national greatness,” economic growth

Economic inequality: Concentration of income growth at top, Pareto distribution
Stagnation of labor incomes in middle, lower segments of distribution
Conversion of income differentials into wealth inequality

Thank you!

Questions?